Calgary 1969 / Mar. 6-7 / Ottawa / April 1

THE MINISTER OF NATIONAL REVENUE ..... APPELLANT;

AND

WARDEAN DRILLING LIMITED ..... RESPONDENT.

Income tax—Capital cost allowances—Contract to purchase equipment in 1963—Equipment not delivered until 1964—Test for determining year of acquisition—Income Tax Act, s. 20(5)(e)—"Acquired", meaning.

In December 1963 an oil drilling company made contracts in Alberta to purchase (1) a drilling rig and (2) a substructure for the rig. The rig, which was then in Texas and required substantial modifications, was by the terms of the contract to be paid for in 36 monthly instalments to be secured by a chattel mortgage, and title was to pass on shipment: it was shipped in February 1964. The substructure was not constructed nor delivered until 1964 In its accounts for 1963 respondent showed the rig and substructure as fixed assets and their prices as accounts payable.

Held (reversing the Tax Appeal Board), neither the rig nor the substructure was "acquired" in 1963 within the meaning of that word in s. 20(5)(*e*) of the *Income Tax Act*, and the purchaser was therefore not entitled to capital cost allowances therefor in 1963. The equipment was not "acquired" on the date of the contract to purchase, the test being when title passes or when the purchaser has all the incidents of title such as possession, use and risk though legal title may remain in the vendor as security. Here title to the rig did not pass until delivery (s. 20(1) of the Alberta *Sale of Goods Act*, R.S.A. 1955, c. 295); and title to the substructure did not pass until it was constructed (s. 21(1) Rule II of the Alberta statute *supra*).

INCOME tax appeal.

M. A. Mogan and *L. H. Pitfield* for appellant.

Marvin V. McDill for respondent.

CATTANACH J.:—In this appeal from a decision of the Tax Appeal Board dated February 22, 1966, whereby the respondent's appeal with respect to assessment for income tax for the respondent's 1963 taxation year was allowed and the assessment vacated, the sole issue is whether the respondent, in determining its taxable income for the 1963 taxation year, is entitled to deduct capital cost allowance on two items of equipment purchased by it being (1) one Ideco H-35 Drilling Rig (hereinafter referred to as the "rig") the purchase price of which was $94,847.40 and (2) one substructure for that rig (hereinafter referred to as the "substructure") the purchase price for which was $10,400.

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The contention of the Minister is that the rig and substructure were not acquired by the respondent in its 1963 taxation year from which it follows that the respondent is not entitled to deduct capital cost thereon in determining its taxable income for that year.

On the other hand, while admitting that the rig and substructure were not paid for or delivered until the year 1964, the respondent contends that both such items were acquired during the 1963 taxation year because prior to the end of that year there was in existence a binding contract of sale and purchase enforceable by the vendor against the respondent and conversely and that, therefore, the respondent is entitled to capital cost allowance on these two items of equipment in its 1963 taxation year even though they were not delivered until 1964.

The respondent is a joint stock company incorporated under the laws of the Province of Alberta and is engaged in the business of drilling oil wells in western Canada. The respondent possessed four drilling rigs in working order and incidental equipment therefor but because of drilling contracts available to it the respondent had need of an additional rig to undertake further drilling contracts.

Accordingly at a meeting of the board of directors of the respondent held on November 1, 1963 it was decided to acquire a new rig. The pertinent portion of the minutes, introduced in evidence as Exhibit R-1 reads as follows:

> (*a*) That it was desirable that the Company should acquire a new rig to be designated as Rig No. 6. A list of all the equipment required was presented by the President. This list was thoroughly discussed and on motion duly made and seconded it was unanimously resolved that the Company request Mr. Lyle Hawkes of Ideco Limited present the Company a list of specifications and prices.
>
> (*b*) That Wardean Drilling Ltd. place an order with Ideco Limited to commence construction of Rig No. 6 immediately after specifications and prices should be agreed on.
>
> (*c*) That Mr. W. E. Caskey and Mr. Dean Caskey be empowered to commence purchasing of auxiliary equipment immediately in order to take advantage of good used equipment available at competitive prices.

As intimated in paragraph (c) of the above minutes the respondent also purchased two other items of auxiliary equipment in addition to the rig and substructure, one such

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item being a used pump and the other a diesel engine which was selected from a catalogue of the vendor. Both these items were in a deliverable state in 1963 but they were not delivered until 1964. With respect to these two particular items the Minister conceded that the capital cost allowance thereon was deductible in the respondent's 1963 taxation year but did not make a similar concession with respect to the rig and substructure. Therefore the only issue before me is whether the respondent is entitled to a capital cost allowance on the rig and substructure in its 1963 taxation year and I mention these two additional items of equipment because during the course of his argument counsel for the respondent suggested that there was no basic difference between the purchase of the used pump and diesel engine, on the one hand and the rig and substructure on the other. He, therefore submitted that in assessing the respondent as he did the Minister was blowing hot and cold. Counsel for the Minister pointed out that the only question before me is that respecting the rig and substructure, in which he is right, but he added that there was a distinction between the purchases of these respective items of equipment and that the Minister was in fact consistent in his assessment. I shall mention this matter later.

Pursuant to the authorization in the minutes of its board of directors dated November 1, 1963 the respondent entered into negotiations and discussions with the representative of Ideco Canada Limited (hereinafter referred to as "Ideco") in Edmonton, Alberta, for the purchase of a drilling rig. Ideco had a rig in stock at the plant of its parent company in Beaumont, Texas. As it stood it could be utilized as a service rig but not as a drilling rig to which latter use the respondent intended to put it. To do so the standard rig in stock with Ideco required extensive modification and additional equipment to render it serviceable as a drilling rig and to withstand the more rigorous climate of western Canada as well as to drill to the depths dictated by western Canadian terrain and formations. In short the respondent's specifications required the rig to be much heavier and stronger. For example the rear end of the standard rig as it stood was rated at 3800 pounds, whereas the respondent required a 5400 pound rear end. All material to meet the specifications for modification and additional equipment

required by the respondent were on hand at the plant of Ideco's parent in Texas except spacer blocks for the installation of the heavier rear end. The delay encountered in obtaining this relatively minor but essential part resulted in a corresponding delay in adapting the standard service rig to a heavier drilling rig.

On December 2, 1963, the drilling superintendent of the respondent and the representative of Ideco flew to Texas to inspect the standard rig and to direct and agree upon the required changes. These matters were agreed upon at that time and delivery of the rig was to be taken by the respondent when the changes were made.

The purchase of the drilling rig was covered by a letter of agreement dated December 26, 1963 (introduced in evidence as Exhibit R-4) addressed to the respondent as purchaser from Ideco as vendor, the body of which reads as follows:

> To confirm your verbal order, we are enclosing the original and two copies of our Invoice No. 1-500-D covering the IDECO DIR-55 Drive-In Rambler Rig and components. Outlined below are the terms and conditions of sale as agreed
>
> 1. It is agreed that the total amount of this invoice excluding the sales tax will be financed over a three year period payable in thirty-six (36) equal monthly installments, plus seven percent (7%) interest on the declining balance. First payment due June 1, 1964, but interest to begin on date of shipment which is now scheduled for February 15, 1964.
> 2 We will accept your National T-20 Drawworks S/N *A 1542* in lieu of a down payment and will allow you $1,500 00 trade-in allowance as shown on our invoice. You are to give us possession of your T-20 Drawworks upon acceptance of this letter of agreement and the attached invoice.
> 3. The notes will be secured by a mortgage on the equipment covered by this sale
> 4 Wardean Drilling Company, Ltd. will maintain adequate insurance coverage of the equipment covered by any mortgage provided for herein at Wardean's expense against all risk of physical damage, including collapse and shall include a mortgage endorsement clause providing the coverage described in Exhibit A attached hereto and made a part of this letter agreement. A certificate of this insurance is to be furnished prior to delivery of the Ideco equipment.
> 5 All expense of loading, unloading, shipping, custom duties and taxes (sales, use, excise and other taxes) to be handled by and for the account of Wardean Drilling Company, Ltd.
>
> Ideco appreciates this opportunity to furnish your equipment needs. Please sign the original and one copy of this letter and return them to us promptly.

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In accordance with the request in the concluding paragraph the respondent endorsed its agreement thereto on December 31, 1963.

Accompanying that letter was an invoice dated December 26, 1963 referring to an order of December 2, 1963, for the drilling rig as modified in the amount of $94,847.40 U.S. currency being the basic price of the rig plus extras and additions which invoice was introduced in evidence as Exhibit R-5. On page five of this exhibit there is a note reading as follows:

> Title to pass and notes issued as of date shipment.

The drawworks referred to in paragraph numbered 2 in Exhibit R-5 above was delivered to Ideco well prior to December 31, 1963 for which a credit of $1500 was allowed to the respondent and treated by Ideco as a down payment on the purchase price of the rig.

On February 18, 1964 the drilling superintendent of the respondent went to Beaumont, Texas and there accepted delivery of the rig (see Exhibit A-1, being a warehouse delivery receipt) which he drove to Alberta, the rig being a self-propelled vehicle.

As indicated in paragraph numbered 1 in the letter of December 26, 1963 (Exhibit R-4) the purchase price was to be financed over a three year period payable in 36 equal monthly instalments to be secured by a chattel mortgage on the rig.

By a chattel mortgage dated February 19, 1964 (Exhibit R-8) the respondent assigned the drilling rig to Ideco by way of security for the payment of the purchase price thereof.

The substructure, to support the rig (being the other item of equipment with respect to which the Minister disallowed the respondent's claim for capital cost allowance in its 1963 taxation year) was ordered by the respondent's purchase order dated December 23, 1963 from Barber Machinery Ltd., 4608 McLeod Trail, Calgary, Alberta (Exhibit R-6) and described therein as "To fabricating substructure for Ideco H-35" at a contract price of $10,400 or less. The invoice of Barber Machinery Limited (Exhibit R-7) addressed to the respondent is dated December 31, 1963.

It is quite apparent to me from the evidence, nor do I think it was otherwise contended by the respondent, that the substructure and ramp were not in existence prior to December 31, 1963. They had to be constructed. The blueprint (Exhibit A-2) upon which the construction of the substructure would be based indicates that it was drawn and redrawn on January 3, 1964. It is admitted that the substructure was not delivered to the respondent nor paid for by the respondent until well into 1964.

The secretary and accountant of the respondent testified that in the double entry system of bookkeeping employed by her she recorded the rig and substructure (as well as the other items of equipment not here in issue) in the year 1963 as fixed assets with an off-setting entry in accounts payable to the amount of the respective purchase prices. With respect to this particular testimony I might mention here parenthetically that the authorities are clear that the bookkeeping entries of a taxpayer are not in themselves determinative of the true nature and substance of a transaction which give rise to such entries.

Section 11(1)(*a*) of the *Income Tax Act* (R.S.C. 1952, Chapter 148) provides as follows:

> 11. (1) Notwithstanding paragraphs (*a*), (*b*) and (*h*) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year·
>
> (*a*) such part of the capital cost to the taxpayer of property, or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation; .

The deductions so allowed in respect of capital cost are set forth in Regulation 1100 of the *Income Tax Regulations* reading as follows:

> 1100 (1) Under paragraph (*a*) of subsection (1) of section 11 of the Act, there is hereby allowed to a taxpayer, in computing his income from a business or property, as the case may be, deductions for each taxation year equal to
>
> (a) such amounts as he may claim in respect of property of each of the following classes in Schedule B not exceeding in respect of property
>
> (x) of class 10, 30%
>
> of the undepreciated capital cost to him as of the end of the taxation year (before making any deduction under this subsection for the taxation year) of property of the class.

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Regulation 1100(a) as reproduced above is as was applicable in 1963 and 1964. The concluding paragraph as reproduced above was amended effective March 30, 1966 by adding a reference to section 1107 in the last clause.

It was accepted by the parties that the rig and substructure here in question fall within class 10 of Schedule B.

Property is defined in section 139(1)(*ag*) of the Act as meaning

> property of any kind whatsoever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes a right of any kind whatsoever, a share or a chose in action.

In section 20(5)(*e*) of the Act "undepreciated capital cost" is defined as follows:

> (5) In this section and regulations made under paragraph (*a*) of subsection (1) of section 11,
>
> (*e*) "undepreciated capital cost" to a taxpayer of depreciable property of a prescribed class as of any time means the capital cost to the taxpayer of depreciable property of that class acquired before that time, minus ..

The decision in this appeal turns on the question as to when the rig and substructure were "acquired" by the respondent. The submission on behalf of the respondent was, as I understood it, that goods are acquired by a purchaser thereof when the vendor and the purchaser have entered into a binding and enforceable contract of sale and purchase. The test and concept of a contract was that adopted by the Tax Appeal Board in the decision now under appeal.

With all deference I cannot accede to that view.

In my opinion the proper test as to when property is acquired must relate to the title to the property in question or to the normal incidents of title, either actual or constructive, such as possession, use and risk.

On the facts in the present appeal there is no question whatsoever that the contracts for the purchase and sale of the rig and substructure were completed prior to December 31, 1963. Accordingly there is no question that as at the end of the respondent's 1963 taxation year it had rights under these contracts. Such rights are "property" within the meaning of section 139(1)(*ag*) of the *Income Tax Act* but Schedule B to the *Income Tax Regulations* does not include a class of property which is subject to capital

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cost allowance such as properties which are contractual rights under the contracts here in question. In order to fall within any of the specified classes in Schedule B there must be a right in the property itself rather than rights in a contract relating to the property which is the subject matter of the contract.

As I have indicated above, it is my opinion that a purchaser has acquired assets of a class in Schedule B when title has passed, assuming that the assets exist at that time, or when the purchaser has all the incidents of title, such as possession, use and risk, although legal title may remain in the vendor as security for the purchase price as is the commercial practice under conditional sales agreements. In my view the foregoing is the proper test to determine the acquisition of property described in Schedule B to the *Income Tax Regulations.*

This appeal was argued by both parties on the assumption that the contracts here in question are subject to the laws of the Province of Alberta. I think that assumption is correct. Both parties were resident in Alberta where the contracts were negotiated.

Section 20 and 21 of the *Alberta Sale Goods Act* (R.S.A. 1955 c. 285) outline the time of transfer of property in goods and rules for ascertaining the intention of the parties as to the time at which the property in the goods is to pass to the buyer.

Section 20 reads as follows:

> 20. (1) Where there is a contract for the sale of specific or ascertained goods, the property in them is transferred to the buyer at such time as the parties to the contract intend it to be transferred.
>
> (2) For the purpose of ascertaining the intention of the parties, regard shall be had to the terms of the contract, the conduct of the parties and the circumstances of the case.

Section 21(1) reads as follows:

> 21. (1) Unless a different intention appears the following are the rules for ascertaining the intention of the parties as to the time at which the property in the goods is to pass to the buyer:
>
> Rule I Where there is an unconditional contract for the sale of specific goods in a deliverable state, the property in the goods passes to the buyer when the contract is made and it is immaterial whether the time of payment or the time of delivery or both be postponed.
>
> Rule II. Where there is a contract for the sale of specific goods and the seller is bound to do something to the goods for the purpose of putting them into a deliverable state, the property does not pass until the thing is done and the buyer has notice thereof. ..

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I have not reproduced the remaining rules in section 21 because only Rules I and II are material to the circumstances of the present appeal.

With respect to the rig it was the submission on behalf of the Minister that it was not in a deliverable state and accordingly the contract with respect to the rig would fall within Rule II above, whereas it was submitted on behalf of the respondent that Rule I was applicable to the contract.

Because of the view I take of the matter, it is not necessary for me to resolve this subsidiary controversy.

The contract was for a specific rig which, as it stood, was a service rig. To meet the needs of the respondent for its use as a drilling rig, the service rig had to undergo substantial modification and have additional equipment fixed thereto.

At the time the contract was entered into by the parties thereto the service rig was readily identifiable.

Property in the rig could have passed forthwith had the parties so intended. But the parties did not so intend. It was agreed, as evidenced by the note on page 5 of the invoice (Exhibit R-5) that "Title to pass and notes issued as of date shipment". Delivery or shipment was not until February 18, 1964 and accordingly property in the rig did not pass to the respondent until that date.

It is my opinion that neither Rule I nor Rule II set forth in section 21 of the *Sale of Goods Act* is applicable to the circumstances of this particular contract but rather that the intention of the parties as to when property in the rig was to pass is determined by the terms of the contract in accordance with section 20 of the *Sale of Goods Act*.

With respect to the substructure, the contract for the fabrication thereof was completed in the 1963 taxation year but the manufacture thereof did not begin until 1964. Accordingly the substructure falls within Rule II of section 21 of the *Sale of Goods Act* above and property therein could not pass to the buyer until well into 1964. In the contract for the sale and purchase of the substructure the parties did not exhibit a contrary intention.

With respect to the used pump and diesel engine for which the Minister allowed the capital cost allowance

claimed by the respondent in its 1963 taxation year, the purchase of these two items of equipment fall precisely within Rule I above and accordingly the Minister acted properly and consistently in the allowing such claim and in disallowing the claim for the rig and substructure in the respondent's 1963 taxation year.

For the foregoing reasons it is my opinion that the Minister was right in disallowing the respondent's claim for capital cost allowance with respect to the rig and substructure in the respondent's 1963 taxation year.

It follows that the appeal is allowed and the assessment is referred back to the Minister for reassessment accordingly. The Minister is entitled to his costs to be taxed.