Most Negative Treatment: Distinguished
Most Recent Distinguished: General Electric Canada Co. v. R. | 2011 TCC 564, 2011 CarswellNat 5304, 2012 D.T.C. 1045 (Eng.), [2012] 2 C.T.C. 2134, 212 A.C.W.S. (3d) 576 | (T.C.C. [General Procedure], Dec 19, 2011)

2008 SCC 26
Supreme Court of Canada

McLarty v. R.

2008 CarswellNat 1380, 2008 CarswellNat 1381, 2008 SCC 26, [2008] 2 S.C.R. 79, [2008] 4 C.T.C. 221, [2008] S.C.J. No. 26, 166 A.C.W.S. (3d) 396, 2008 D.T.C. 6354 (Eng.), 2008 D.T.C. 6366 (Fr.), 293 D.L.R. (4th) 659, 374 N.R. 311, 46 B.L.R. (4th) 1, J.E. 2008-1055

Her Majesty the Queen (Appellant/Respondent on Cross-Appeal) v. Allan McLarty (Respondent/Appellant on Cross-Appeal)

McLachlin C.J.C., Bastarache, Binnie, LeBel, Deschamps, Fish, Abella, Charron, Rothstein JJ.

Heard: January 28, 2008
Judgment: May 22, 2008
Docket: 31516

Proceedings: reversing *McLarty v. R.* (2006), 2006 CAF 152, 2006 CarswellNat 2805, (sub nom. *McLarty v. Minister of National Revenue*) 348 N.R. 90, 2006 CarswellNat 1096, 2006 FCA 152, [2006] 4 C.T.C. 16, 2006 D.T.C. 6340 (F.C.A.); reversing *McLarty v. R.* (2005), 2005 CarswellNat 127, 2005 TCC 55, 2005 D.T.C. 217 (Eng.), [2005] 1 C.T.C. 2875 (T.C.C. [General Procedure])

Counsel: Wendy Burnham, Pierre Cossette, for Appellant / Respondent on Cross-Appeal
Jehad Haymour, Carman R. McNary, Peter D. Banks, for Respondent / Appellant on Cross-Appeal

Subject: Income Tax (Federal); Corporate and Commercial
Related Abridgment Classifications
Tax
II Income tax
II.6 Business and property income
II.6.p Resource taxation
II.6.p.v Canadian exploration expenses
Headnote
Tax --- Income tax — Business and property income — Resource taxation — Canadian exploration expenses
C Co. acquired proprietary seismic data for consideration totalling $21,000,000 — C Co. was owned 100 per cent by S, who was its sole officer and director — Taxpayer and other individuals entered into joint venture agreement with C Co. — Individual joint venturers, through their agent C Co., purchased 30.35 per cent undivided interest in proprietary interest in "Venture Data", being seismic data from C Co. — Taxpayer's share of purchase price of venture data was $100,000, which was satisfied by cash payment of $15,000 and limited recourse promissory note in amount of $85,000 — Taxpayer added amount of $100,000 to his Cumulative Canadian Exploration Expenses ("CCEE") and claimed CCEE deductions — Minister reassessed taxpayer, allowing CCEE in amount of $32,182 and disallowing remainder of purchase price of venture data — Taxpayer's appeal was allowed — Trial judge found taxpayer did purchase venture data for purpose of exploration for petroleum or natural gas as required in s. 66.1(6)(a) of Income Tax Act — Trial judge found promissory note provided by taxpayer did constitute expense as required by s. 66.1(6)(a) of Act and was not contingent liability — Trial judge found purchase by taxpayer of his interest in venture data was arm's length transaction — Minister's appeal

was allowed — Appellate court found trial judge erred in finding that taxpayer's purpose in acquiring data was sufficient as sole consideration for eligibility for CCEE — Transaction did not occur at arm's length, as C Co. acted both as agent and vendor on purchase — Minister appealed, taxpayer cross-appealed — Appeal dismissed; cross-appeal allowed — Liability was absolute rather than contingent — As liability was absolute, expense was legitimate — Although some terms of note were subject to conditions which may or may not occur, if at maturity any amount was owing, data was to be sold and amount received distributed in finite proportion — Data at issue had market value — Fact that insufficient funds might exist to repay debt did not make liability contingent — Appellate court erred in overruling factual finding that taxpayer acted at arm's length in acquiring liability — Seismic data was not acquired by C Co. at arm's length, as transaction was between C Co. as vendor and as purchaser — However, relevant transaction was between taxpayer and C Co., which occurred at arm's length — Trial judge gave proper weight to restrictions placed on C Co. in offering memorandum — Taxpayer did not suborn entire decision making power to C Co. as his agent.

Taxation --- Impôt sur le revenu — Revenu d'entreprise et de biens — Imposition des ressources — Dépenses liées à l'exploration au Canada

C Co. a fait l'acquisition de données sismiques exclusives moyennant contrepartie pour un total de 21 000 000 $ — C Co. appartenait à 100 pour 100 à S, son unique dirigeant et administrateur — Contribuable et d'autres individus ont conclu un contrat de coentreprise avec C Co. — Coentrepreneurs ont, par l'entremise de leur mandataire, C Co., acquis un intérêt indivis de 30,35 pour 100 dans les « données de l'entreprise », soit les données sismiques de C Co. — Portion du prix d'achat des données de l'entreprise revenant au contribuable s'élevait à 100 000 $, acquittée par le versement de 15 000 $ en argent comptant et un billet de 85 000 $ payable à une date ultérieure et assorti d'un recours limité — Contribuable a ajouté le montant de 100 000 $ à ses frais cumulatifs d'exploration au Canada (« FCEC ») et a demandé une déduction pour les FCEC — Ministre a établi de nouvelles cotisations à l'égard du contribuable, en accordant des FCEC à la hauteur de 32 182 $ et en refusant de reconnaître le solde du prix d'achat des données de l'entreprise — Appel interjeté par le contribuable a été accueilli — Juge du procès a conclu que le contribuable avait de fait acquis les données de l'entreprise en vue de l'exploration de gisements de pétrole ou de gaz naturel, comme l'exigeait l'art. 66.1(6)(a) de la Loi de l'impôt sur le revenu — Juge du procès a statué que le billet constituait une dépense telle que l'exigeait l'art. 66.1(6)(a) de la Loi et n'était pas une dette éventuelle — Juge du procès a conclu que l'acquisition d'un intérêt dans les données de l'entreprise par le contribuable constituait une opération sans lien de dépendance — Appel interjeté par le ministre a été accueilli — Cour d'appel a conclu que le juge du procès avait erré en concluant que le but poursuivi par le contribuable en faisant l'acquisition des données était suffisant à titre de contrepartie pour les fins de l'admissibilité aux FCEC — Opération ne s'était pas effectuée sans lien de dépendance puisque C Co. agissait à la fois comme mandataire et comme vendeur au moment de la vente — Ministre a formé un pourvoi et le contribuable a formé un pourvoi incident — Pourvoi rejeté, pourvoi incident accueilli — Dette était absolue et non éventuelle — Puisque la dette était absolue, la dépense était légitime — Bien que quelques-unes des conditions du billet dépendaient d'événements qui pouvaient ou pas se produire, si des montants étaient dûs à l'échéance, les données devaient être vendues et les montants distribués en proportions définies — Données en question avaient une valeur marchande — Qu'il existe des fonds insuffisants pour honorer la dette ne la transformait pas en dette éventuelle — Cour d'appel a erré en infirmant les conclusions de fait à l'effet que le contribuable avait agi sans lien de dépendance en faisant l'acquisition de la dette — Données sismiques n'ont pas été acquises par C Co. sans lien de dépendance puisque l'opération a été effectuée alors que C Co. agissait à la fois en tant que vendeur et acheteur — Toutefois, l'opération faisant l'objet de l'instance était celle qui avait été effectuée entre le contribuable et C Co., et celle-ci s'était effectuée sans lien de dépendance — Juge du procès a accordé une importance appropriée aux restrictions imposées à C Co. dans la notice d'offre proposée — Contribuable n'a pas totalement abandonné son pouvoir de prise de décision à C Co. à titre de mandataire.

C Co. acquired proprietary seismic data for consideration, totalling $21,000,000. C Co. was owned 100 per cent by S, who was its sole officer and director. The taxpayer and other individuals entered into a joint venture agreement with C Co.. The individual joint venturers, through their agent C Co., purchased a 30.35 per cent undivided interest in the proprietary interest in "Venture Data", being seismic data from C Co.. The taxpayer's share of the purchase price of the venture data was $100,000, which was satisfied by a cash payment of $15,000 and a limited recourse promissory note in the amount of $85,000. The taxpayer added the amount of $100,000 to his Cumulative Canadian Exploration Expenses ("CCEE") and claimed CCEE deductions. The minister reassessed the taxpayer, allowing CCEE in the amount

of $32,182 and disallowing the remainder of the purchase price of the venture data on the basis that the amount paid was in excess of the fair market value.

The taxpayer's appeal was allowed. The trial judge found the taxpayer did purchase the venture data for the purpose of exploration for petroleum or natural gas as required in s. 66.1(6)(a) of the Income Tax Act. The trial judge found the promissory note constituted an expense as required by s. 66.1(6)(a) of the Act and was not a contingent liability simply because at what time or for how much the note would be paid was unknown. The trial judge found the purchase by the taxpayer of his interest in the venture data was an arm's length transaction as no evidence existed to indicate that the taxpayer and C Co., through S, acted in concert without separate interests.

The minister's appeal was allowed and a new trial was ordered. The appellate court found the trial judge erred in finding that the taxpayer's purpose in acquiring the data was sufficient as the sole consideration for eligibility for CCEE. The transaction did not occur at arm's length, as C Co. acted both as agent and vendor on purchase.

The minister appealed, and the taxpayer cross-appealed.

Held: The appeal was dismissed and the cross-appeal was allowed.

Per Rothstein J. (McLachlin C.J.C., Binnie, Charron, Deschamps, Fish, LeBel JJ. concurring): The liability was absolute rather than contingent. As liability was absolute, the expense was legitimate. Although some terms of the promissory note were subject to conditions which may or may not occur, if at maturity any amount was owing, the data was to be sold and the amount received distributed in finite proportions. The data at issue had a market value and could be sold. The fact that insufficient funds might exist to repay the debt did not make the liability contingent. The appellate court erred in overruling the factual finding that the taxpayer acted at arm's length in acquiring liability for the debt. The seismic data was not acquired by C Co. at arm's length, as the transaction was between C Co. as vendor and as purchaser. However, the relevant transaction was between the taxpayer and C Co., which occurred at arm's length. The trial judge gave proper weight to restrictions placed on C Co. in the offering memorandum. The taxpayer did not suborn his entire decision making power to C Co. as his agent.

The liability was to be repaid, and whether the amount was to be repaid by revenue or from the sale of seismic data did not affect the attaching liability. The limit on liability to 60 per cent of proceeds received also did not make the liability contingent.

Per Bastarache, Abella JJ.: The appeal and cross-appeal should be allowed. The promissory note was a contingent liability and did not meet the requirements of s. 66.1(6) of the Act. The taxpayer's liability was contingent upon whether the venture proved to be sufficiently profitable. The note did not create personal liability on the part of the taxpayer, and only forced sale of seismic data and petroleum rights. Surrendering a portion of the proceeds of the sale of the data could not make the contingent liability into an absolute liability. The terms of the note specifically stated that the taxpayer was only obligated to repay 60 per cent of the sold data, and that any further balance owing would be forgiven. This provision was not the equivalent of debt forgiveness, as the term was set out in the agreement itself.

C Co. a fait l'acquisition de données sismiques exclusives moyennant contrepartie, pour un total de 21 000 000 $. C Co. appartenait à 100 pour 100 à S, son unique dirigeant et administrateur. Le contribuable et d'autres individus ont conclu un contrat de coentreprise avec C Co. Les coentrepreneurs ont, par l'entremise de leur mandataire, C Co., acquis un intérêt indivis de 30,35 pour 100 dans les « données de l'entreprise », soit les données sismiques de C Co. La portion du prix d'achat des données de l'entreprise revenant au contribuable s'élevait à 100 000 $, acquittée par le versement de 15 000 $ en argent comptant et un billet de 85 000 $ payable à une date ultérieure et assorti d'un recours limité. Le contribuable a ajouté le montant de 100 000 $ à ses frais cumulatifs d'exploration au Canada (« FCEC ») et a demandé une déduction pour les FCEC. Le ministre a établi de nouvelles cotisations à l'égard du contribuable, en accordant des FCEC à la hauteur de 32 182 $ et en refusant de reconnaître le solde du prix d'achat au motif que le prix payé excédait la juste valeur marchande des données de l'entreprise.

L'appel interjeté par le contribuable a été accueilli. Le juge du procès a conclu que le contribuable avait de fait acquis les données de l'entreprise en vue de l'exploration de gisements de pétrole ou de gaz naturel, comme l'exigeait l'art. 66.1(6) de la Loi de l'impôt sur le revenu. Le juge du procès a statué que le billet constituait une dépense telle que l'exigeait l'art. 66.1(6)(a) de la Loi et n'était pas une dette éventuelle simplement parce qu'on ignorait à quel moment et pour quel montant le billet serait honoré. Le juge du procès a conclu que l'acquisition d'un intérêt dans les données de l'entreprise

par le contribuable constituait une opération sans lien de dépendance puisque rien n'indiquait que le contribuable et C Co., par l'entremise de S, avaient agi de concert sans intérêts distincts.

L'appel interjeté par le ministre a été accueilli et un nouveau procès a été ordonné. La Cour d'appel a conclu que le juge du procès avait erré en concluant que le but poursuivi par le contribuable en faisant l'acquisition des données était suffisant à titre de contrepartie pour les fins de l'admissibilité aux FCEC. L'opération ne s'était pas effectuée sans lien de dépendance puisque C Co. agissait à la fois comme mandataire et comme vendeur au moment de la vente.

Le ministère a formé un pourvoi et le contribuable a formé un pourvoi incident.

Arrêt: Le pourvoi a été rejeté et le pourvoi incident a été accueilli.

Rothstein, J. (McLachlin, J.C.C., Binnie, Charron, Deschamps, Fish, LeBel, JJ., souscrivant à son opinion): La dette était absolue et non éventuelle. Puisque la dette était absolue, la dépense était légitime. Bien que quelques-unes des conditions du billet dépendaient d'événements qui pouvaient ou pas se produire, si des montants étaient dûs à l'échéance, les données devaient être vendues et les montants distribués en proportions définies. Les données en question avaient une valeur marchande et pouvaient être vendues. Qu'il existe des fonds insuffisants pour honorer la dette ne la transformait pas en dette éventuelle. La Cour d'appel a erré en infirmant les conclusions de fait à l'effet que le contribuable avait agi sans lien de dépendance en faisant l'acquisition de l'obligation relative à la dette. Les données sismiques n'ont pas été acquises par C Co. sans lien de dépendance puisque l'opération a été effectuée alors que C Co. agissait à la fois en tant que vendeur et acheteur. Toutefois, l'opération faisant l'objet de l'instance était celle qui avait été effectuée entre le contribuable et C Co., et celle-ci s'était effectuée sans lien de dépendance. Le juge du procès a accordé une importance appropriée aux restrictions imposées à C Co. dans la notice d'offre proposée. Le contribuable n'a pas totalement abandonné son pouvoir de prise de décision à C Co. à titre de mandataire.

La dette devait être remboursée et, qu'elle soit remboursée par la production de revenus ou par la vente des données sismiques, cela n'affectait en rien l'obligation s'y rattachant. La réduction de la dette à 60 pour 100 des produits reçus ne transformait pas non plus la dette en dette éventuelle.

Bastarache, Abella, JJ.: Le pourvoi et le pourvoi incident devraient être accueillis. Le billet était une dette éventuelle et ne satisfaisait pas aux exigences de l'art. 66.1(6) de la Loi. La dette du contribuable était de nature éventuelle parce que les obligations en découlant dépendaient de ce que l'entreprise s'avère suffisamment lucrative. Le billet n'a pas créé de responsabilité personnelle à l'endroit du contribuable mais prévoyait seulement une vente forcée des données sismiques et des droits relatifs aux hydrocarbures. Céder une partie des produits de la vente des données ne pouvait pas transformer une dette éventuelle en une dette absolue. Les conditions du billet spécifiaient que le contribuable n'était obligé de rembourser que 60 pour 100 des données vendues, et que tout solde impayé ferait l'objet d'une renonciation. Cette disposition n'équivalait pas à une renonciation à une créance, puisque la condition était énoncée dans l'entente elle-même.

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Hill v. R. (2002), 2002 D.T.C. 1749, [2003] 4 C.T.C. 2548, 2002 CarswellNat 946 (T.C.C. [General Procedure]) — referred to

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Mandel v. R. (1980), [1980] 1 S.C.R. 318, 1980 CarswellNat 231, [1980] C.T.C. 130, 80 D.T.C. 6148, 31 N.R. 97, 1980 CarswellNat 618 (S.C.C.) — referred to

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Winter v. Inland Revenue Commissioners (1961), [1963] A.C. 235, [1961] 3 All E.R. 855 (U.K. H.L.) — followed

Cases considered by *Bastarache J.* and *Abella J.*:

J.L. Guay Ltée v. Minister of National Revenue (1971), [1971] C.T.C. 686, 71 D.T.C. 5423, [1971] F.C. 237, 1971 CarswellNat 305, 6 N.R. 553, 1971 CarswellNat 362 (Fed. T.D.) — referred to

J.L. Guay Ltée v. Minister of National Revenue (1972), [1973] C.T.C. 506, 73 D.T.C. 5373, 6 N.R. 552, 1972 CarswellNat 410, [1972] F.C. 1441, 1972 CarswellNat 357 (Fed. C.A.) — referred to

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Mandel v. R. (1980), [1980] 1 S.C.R. 318, 1980 CarswellNat 231, [1980] C.T.C. 130, 80 D.T.C. 6148, 31 N.R. 97, 1980 CarswellNat 618 (S.C.C.) — considered

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Mandel v. R. (1978), [1979] 1 F.C. 560, 1978 CarswellNat 251, 1978 CarswellNat 534, [1978] C.T.C. 780, 24 N.R. 329, 78 D.T.C. 6518 (Fed. C.A.) — referred to

Wawang Forest Products Ltd. v. R. (2001), 2001 D.T.C. 5212, [2001] 2 C.T.C. 233, (sub nom. *Wawang Forest Products Ltd. v. Minister of National Revenue*) 271 N.R. 82, 2001 FCA 80, 2001 CarswellNat 528 (Fed. C.A.) — referred to

Winter v. Inland Revenue Commissioners (1961), [1963] A.C. 235, [1961] 3 All E.R. 855 (U.K. H.L.) — considered

Statutes considered by *Rothstein J.*:

Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.)

Generally — referred to

s. 66.1(6) "Canadian exploration expense" — considered

s. 66.1(6) "Canadian exploration expense" (a) — considered

s. 66.1(6) "frais d'exploration au Canada" (a) — considered

s. 69(1)(a) — considered

s. 251(1) — considered

Statutes considered by *Bastarache J.* and *Abella J.*:

Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.)

s. 66.1(6) "Canadian exploration expense" — considered

APPEAL by Minister of National Revenue and CROSS-APPEAL by taxpayer from judgment reported at *McLarty v. R.* (2006), 2006 CAF 152, 2006 CarswellNat 2805, (sub nom. *McLarty v. Minister of National Revenue*) 348 N.R. 90, 2006 CarswellNat 1096, 2006 FCA 152, [2006] 4 C.T.C. 16, 2006 D.T.C. 6340 (F.C.A.), reversing judgment reversing previous judgment regarding deductions for Cumulative Canadian Exploration Expenses.

POURVOI du ministre du Revenu national et POURVOI INCIDENT d'un contribuable à l'encontre d'un jugement publié à *McLarty v. R.* (2006), 2006 CAF 152, 2006 CarswellNat 2805, (sub nom. *McLarty v. Minister of National Revenue*) 348 N.R. 90, 2006 CarswellNat 1096, 2006 FCA 152, [2006] 4 C.T.C. 16, 2006 D.T.C. 6340 (F.C.A.), ayant infirmé un jugement infirmant une décision antérieure au sujet des déductions pour des frais cumulatifs d'exploration au Canada.

***Rothstein J.*:**

I. Introduction

1 The issue in this appeal is whether a liability is absolute or contingent. In the circumstances of this appeal, if it was absolute, it could be deducted as an expense for income tax purposes. If it was contingent, it could not.

2 The issue in the cross-appeal is whether, in acquiring an asset, the purchaser was dealing with the vendor at arm's length. If he was, the purchase price of the asset could be deducted as an expense for income tax purposes. If he was not, the Minister of National Revenue was entitled to reassess on the basis of the fair market value of the asset. In that case, it would only be the fair market value that could be deducted as an expense for income tax purposes.

3 In my opinion, the appeal should be dismissed and the cross-appeal allowed.

II. Facts

4 On December 31, 1992, the respondent, Allan McLarty, purchased from Compton Resource Corporation ("Compton" or "CRC") an interest in proprietary seismic data as a participant in an oil and gas joint venture, the CRC 1992/1993 Oil and Gas Investment Fund.

5 McLarty acquired a 1.57% interest in the data for the price of $100,000, satisfied by cash of $15,000 and a promissory note of $85,000 payable with interest to Compton on December 31, 1999.

6 On December 31, 2001, McLarty signed an acknowledgment whereby Compton agreed to extend the due date of the promissory note to December 31, 2002.

7 As of the end of 2001, the balance owing on the promissory note was $93,242.

8 On filing his income tax return for 1992, McLarty treated his purchase of seismic data as Canadian exploration expense ("CEE") and added $100,000 to his cumulative Canadian exploration expense pool. In calculating his income, he deducted $81,655 as CEE in 1992, and an additional $14,854 in 1994, reducing his pool accordingly. The Minister reassessed McLarty on the basis that the seismic data had a fair market value of $32,182, not $100,000.

9 The issues at trial were:

1. Whether McLarty's purchase of the seismic data was for the purpose of exploration for petroleum or natural gas as required by s. 66.1(6) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.).

2. Whether McLarty's liability under the promissory note was absolute or contingent.

3. Whether, in purchasing the seismic data, McLarty was dealing with the vendor, Compton, at arm's length.

4. If the dealing was not at arm's length, was the fair market value of the seismic data in excess of $32,182?

5. Whether a deduction in excess of $32,182 was reasonable.

The trial judge found in favour of McLarty on all issues entitling him to a deduction of $100,000 ([2005] 1 C.T.C. 2875, 2005 TCC 55 (T.C.C. [General Procedure])).

10 Except for the issue of whether a deduction in excess of $32,182 was reasonable, which was not appealed, the Federal Court of Appeal dealt with the remaining four issues ([2006] 4 C.T.C. 16, 2006 FCA 152 (F.C.A.)). It found in favour of McLarty on the issue of the business purpose of the purchase and on the issue of the nature of the liability. However,

it found that McLarty was not dealing with Compton at arm's length. It therefore allowed the appeal and remitted the matter to the Tax Court for a determination of whether the fair market value of the seismic data exceeded $32,182.

11 Before this Court, the only issues are whether McLarty's liability under the promissory note was absolute or contingent and whether McLarty was dealing with Compton at arm's length. I deal first with the absolute/contingent liability issue.

III. Provisions Under Which McLarty Claimed a Deduction

12 Section 66.1(6) of the *Income Tax Act* defines a Canadian exploration expense. The definition provides in relevant part:

> "Canadian exploration expense" of a taxpayer means any expense incurred ... that is
> (a) any expense including a geological, geophysical or geochemical expense incurred by the taxpayer . . . for the purpose of determining the existence, location, extent or quality of an accumulation of petroleum or natural gas . . . in Canada,
>
> « frais d'exploration au Canada » d'un contribuable, s'entend des dépenses suivantes, engagées . . .
> a) une dépense, y compris une dépense des fins géologiques, géophysiques ou géochimiques, engagée par le contribuable . . . en vue de déterminer l'existence, la localisation, l'étendue ou la qualité d'un gisement de pétrole ou de gaz naturel . . . au Canada;

13 An expense that qualifies as CEE is included in a taxpayer's "cumulative Canadian exploration expense" pool that can be deducted in full in the year the expense was incurred or carried forward for deduction when needed. Unlike many business expenses under the *Income Tax Act*, CEE is not tied to the source of the income in relation to which the expense is incurred, but may be deducted from any income of the taxpayer.

IV. Analysis

A. Was the Appellant's Liability Absolute or Contingent?

1. Definition of a Contingent Liability

14 As explained by Sharlow J.A. in *Wawang Forest Products Ltd. v. R.*, 2001 D.T.C. 5212, 2001 FCA 80 (Fed. C.A.), at para. 9, generally a taxpayer incurs an expense when he has a legal obligation to pay a sum of money. In the present case, in addition to his cash payment of $15,000, McLarty signed a promissory note for $85,000 on December 31, 1992 and deducted $81,655 in 1992 and a further $14,854 in 1994. He could only deduct amounts in excess of his cash payment if the note for $85,000 constituted an expense incurred under s. 66.1(6).

15 The Minister says the note for $85,000 was a contingent liability and was therefore not an expense incurred in 1992. McLarty says the obligation he incurred on signing the note was absolute and therefore was an expense incurred under s. 66.1(6) in 1992.

16 It is agreed that the expense will have been incurred if the liability is absolute and not if it is contingent.

17 The well-accepted test for a contingent liability was described by Lord Guest in *Winter v. Inland Revenue Commissioners* (1961), [1963] A.C. 235 (U.K. H.L.), at p. 262:

> I should define a contingency as an event which may or may not occur and a contingent liability as a liability which depends for its existence upon an event which may or may not happen.

The focus is therefore on two particular types of uncertainty: 1) whether an event may or may not occur; and 2) whether a liability depends for its existence upon whether that event may or may not happen.

18 What constitutes a contingent liability was further clarified by Sharlow J.A. in *Wawang*, at para. 15. By themselves, three uncertainties will not determine whether a liability is contingent. I paraphrase her reasons as follows:

> (a) Uncertainty as to whether the payment will be made. For example, a liability may be incurred when the taxpayer is in financial difficulty and there is a significant risk of non-payment. That does not mean the obligation was never incurred;
>
> (b) Uncertainty as to the amount payable. There is always uncertainty as to the amount that may be payable. There is never certainty that the borrower will be able to pay the amount owing when the note comes due. That type of uncertainty does not make a liability contingent;
>
> (c) Uncertainty as to the time by which payment shall be made. An obligation is not contingent because payment may be postponed if certain events occur.

The test is simply whether a legal obligation comes into existence at a point in time or whether it will not come into existence until the occurrence of an event which may never occur.

2. Is the Liability in this Case Absolute or Contingent?

19 To determine the answer to this question, it is necessary to have regard to the terms of the promissory note signed by McLarty on December 31, 1992.

20 The promissory note signed by McLarty was payable to Compton Resource Corporation. It reads as follows:

> The undersigned, FOR VALUE RECEIVED, hereby promises to pay to COMPTON RESOURCE CORPORATION (the "Noteholder") on the 31st day of December, 1999, the sum of Eighty-five Thousand ($85,000) in lawful money of Canada together with any accrued and unpaid interest on any unpaid portion of the said principal sum, which interest shall accrue from and after December 31, 1992, at the rate of eight percent (8%) per annum calculated annually and not in advance.
>
> The terms of repayment of this promissory note to the Noteholder shall be limited to those terms set out herein and no other action shall lie against the undersigned in respect of any covenant for payment.
>
> The indebtedness of the undersigned shall be reduced only in accordance with the provisions set forth in Schedule 1 attached hereto, which schedule is incorporated into and forms part of this promissory note.
>
> This promissory note shall be non-negotiable and non-assignable by the Noteholder without the prior written consent of the undersigned and the assignee first agreeing in writing with the undersigned to be bound by the terms hereof. The Noteholder shall have no right of recourse against any legal person other than the undersigned in respect of the covenants contained herein and shall further have no greater rights hereunder than as are conferred hereunder and in Schedule 1 attached hereto.
>
> DATED this 30th day of December, 1992.

21 The terms of repayment of principal and interest were set out in Schedule 1 to the promissory note, the relevant portions of which provide:

> 2. The undersigned hereby assigns to the Noteholder, in reduction of the undersigned's indebtedness under this promissory note, sixty (60%) percent of the cash proceeds received from any future sales or licensing net of commission of the Technical Assets (such 60% hereinafter referred to as the "Seismic Proceeds").
>
> 3. In addition to the provisions of Section 2, the undersigned hereby assigns to the Noteholder, in reduction of the undersigned's indebtedness under this promissory note, twenty (20%) percent of the Production Cash

Flow generated by the undersigned's Participating Interest in Petroleum Rights acquired by the Joint Venture pursuant to the Drilling Program (such 20% hereinafter referred to as the "Drilling Proceeds").

4. The Seismic Proceeds and the Drilling Proceeds assigned pursuant to the provisions of Sections 2 and 3 hereof shall be used by the Noteholder to pay down the interest accrued under this promissory note on a monthly basis and when such amounts assigned exceed such interest accrued thereof, the excess shall be applied to the principal amount outstanding under this promissory note. The provisions of Sections 2 and 3 and the rights of the Noteholder under such provisions shall, notwithstanding any other provisions of this agreement, wholly terminate on the earlier of the date upon which this promissory note is retired or the indebtedness hereunder is otherwise extinguished.

5. The undersigned hereby grants a security interest in the Technical Assets to secure the undersigned's liability to the Noteholder under this promissory note.

6. To the extent there is interest outstanding on this promissory note, the Noteholder's remuneration under the Joint Venture Agreement will be credited against this interest obligation on a monthly basis.

7. If the indebtedness created hereby either with respect to principal or interest remains in whole or in part unpaid as of December 31, 1999, the Noteholder will appoint an independent trustee to sell for cash only:

a. the Technical Assets; and

b. an undivided 20% of the undersigned's Participating Interest in Petroleum Rights acquired by the Joint Venture pursuant to the Drilling Program.

The proceeds of the sale will be allocated as follows:

a. Technical Assets:

i. 60% (net of commissions, if any) to the Noteholder as a reduction of amounts owing by the undersigned under this promissory note; and

ii. 40% (net of commission, if any) to the undersigned;

b. an undivided 20% of the undersigned's Participating Interest in Petroleum Rights acquired by the Joint Venture pursuant to the Drilling Program:

100% to the Noteholder as a reduction of amounts owing by the undersigned under this promissory note, allocated firstly as to interest and the remainder as to principal.

Any balance owing by the undersigned on this note after the allocation of the proceeds of the sale as described above will be forgiven by the Noteholder and the undersigned will have no further liability under this promissory note.

22 On its face, the note is for $85,000 plus interest at 8% per annum and it is due on December 31, 1999. Without more, the promissory note constitutes an absolute liability. However, the note is subject to other terms.

23 Section 2 of Schedule 1 to the note provides that 60% of the cash proceeds received from any future sales or licensing of technical assets is assigned to Compton. Section 3 provides that 20% of the production cash flow generated from petroleum rights from drilling programs is assigned to Compton.

24 There is no certainty that there will be future sales or licensing of technical assets, nor is there certainty that there will be drilling programs or that there will be production cash flow from petroleum rights from drilling programs. Were these the only conditions upon which the note would be repaid, the liability would be contingent, because repayment

was predicated on events which may or may not occur (see *Mandel v. R.* (1978), [1979] 1 F.C. 560 (Fed. C.A.), aff'd [1980] 1 S.C.R. 318 (S.C.C.)).

25 However, events are not uncertain at maturity. Section 7 provides that, should any principal or interest remain unpaid at the maturity of the note, a trustee is to be appointed to sell the seismic data with the proceeds of sale being allocated 60% in reduction of amounts owing under the note and 40% to McLarty.

26 The Minister relies on the decision of the Federal Court of Appeal in *Global Communications Ltd. v. R.* (1999), 99 D.T.C. 5377 (Fed. C.A.), that in circumstances similar to the ones in this case, the liability was found to be contingent. However, as the Court of Appeal in this case pointed out, it does not appear that in *Global* the court took account of the fact that on maturity of the note there was recourse to the asset pledged as security for repayment. With respect, the decision in *Global* does not take account of all the terms of the note in that case and is not authoritative in circumstances such as in the case now before this Court.

27 On December 31, 1992, McLarty agreed to pay $85,000 together with interest at 8%. The obligation to repay the principal and the interest under the note came into existence at that time. The note provided that, should any amount be outstanding at maturity, Compton would have recourse to the security, that is, the data acquired by McLarty. I agree with the Court of Appeal that the terms of the note demonstrate that McLarty's liability was absolute and not contingent.

28 In the Tax Court, Little J. found that there was an ongoing market for seismic data and that therefore the asset acquired by McLarty could be sold. While difficult to envision, perhaps if there was a serious question of whether the asset could be sold, it might be necessary to consider whether there was a market for such property. But I do not understand the Minister to argue that the asset might not be able to be sold. Indeed the Minister found there was a fair market value for the data and by necessary implication a market for its sale. Once the Minister conceded that the asset had a fair market value, it was unnecessary for Little J. to have considered whether there was a market for the seismic data.

3. Minister's Arguments

29 The present case involves limited recourse debt. In the context of debt, recourse means that the creditor has a right to repayment of a loan from the borrower, not just from the collateral that secured the loan. By contrast, non-recourse or limited recourse debt limits the creditor to recovery of specified security. The creditor is not entitled to seek repayment from the borrower should the proceeds from the disposition of the security be less than the total indebtedness.

30 The Minister and McLarty agree, as do I, that a creditor's limited recourse on default of a debt cannot make an otherwise absolute liability contingent, nor can it turn an otherwise contingent obligation into one that is absolute. In other words, the extent of recourse has no bearing on the question of whether a liability is absolute or contingent.

31 Nonetheless, the nature of the Minister's arguments are, in my respectful view, based on the promissory note in this case being non-recourse. For example, the Minister says that "[a]n expense requires that there be certainty of quantum" and that the amount payable must be certain (Minister's factum, at para. 24). In making this argument, the Minister is focussing on the fact that the proceeds of the sale of the asset may not be sufficient to repay the outstanding amount of principal and interest under the note at maturity. However, on December 31, 1992, an obligation to repay $85,000 plus interest was incurred. The fact that the amount that will be paid at the end of the day is uncertain does not make the liability contingent.

32 In oral argument, Minister's counsel agreed that if security in the form of a government bond worth $85,000 was pledged with no other recourse to the debtor, the obligation would be absolute. However, if stock worth $85,000 was pledged with no other recourse to the debtor and the price of the stock went down such that it was only worth $40,000 when the note matured, the obligation would be contingent.

33 The Minister seems to be saying that if there is risk to the value of the collateral security at maturity, liability is contingent because the creditor may not make full recovery of the total liability. If the Minister were correct, all liability

would be contingent. Although highly unlikely, even a government might default on a bond. And even in the case of a loan with full recourse to the debtor, there can never be absolute certainty that full repayment will always be made. The debtor may go bankrupt. But that does not make the liability contingent. It is inherent in a promissory note that there is a risk of non-payment. Indeed, interest rates are determined, in part, on the risk that repayment will not be made.

34 What is at the root of the Minister's difficulty in this case is that the Minister believes the price of the asset McLarty acquired was overvalued and that the data, as the only collateral security, was insufficient to cover repayment of the note. In fact, in January 2006, McLarty's 1.57% interest in the seismic data was sold through an independent receiver for approximately $17,600 of which 60% or only about $10,500 was used to repay the note. There are remedies for the Minister where assets are overvalued solely to obtain a tax advantage. Trying to characterize the loan portion of the purchase price as contingent in this case was not one of them.

35 The Minister says that the requirement to surrender assets does not make the liability to repay $85,000 absolute. Again this is an attack on non-recourse debt. Just as in the case of a mortgage foreclosure where there is a certainty of sale and proceeds from that sale and recourse is limited to those proceeds, here there is a certainty that the asset will be sold and a fixed percentage of the proceeds will be available to repay the loan (see *Hill v. R.*, 2002 D.T.C. 1749 (T.C.C. [General Procedure]), at para. 37). The only uncertainty, as in the case of a mortgage foreclosure, is as to the amount of the proceeds from the sale. However, that does not make the liability contingent.

36 The Minister argues that the mortgage foreclosure cases are distinguishable because the foreclosure only occurs once there is default under the mortgage whereas here, sale of the asset occurs as a term of the promise to repay. I must admit to not being able to appreciate the difference. Whether there is default because terms of repayment are breached or whether interim payments are not made because certain events do not occur, the result in each case is that the creditor looks to the collateral that secures the debt to satisfy the amount outstanding.

37 The Minister says that until the proceeds of the sale of the security are ascertained, McLarty has only a liability "to become subject to an obligation to pay" (Minister's factum, at para. 36). This again is an argument that the quantum of repayment must be certain in order for a liability not to be contingent. This is just another way of attacking non-recourse debt and looking at the value of security to test whether the liability was contingent or absolute. That is not the test for contingent liability. As already explained, there will always be uncertainty about the amount that will be repaid.

38 The note provides that if any balance is owing after allocation of the proceeds of the sale of the security, the balance "will be forgiven by the Noteholder and the undersigned will have no further liability under this promissory note". If the liability in this case was contingent upon the happening of a future event and the event did not occur, there would be no surviving liability and nothing to forgive. A forgiveness provision in a promissory note implies there is something to forgive, namely the absolute obligation that was initially incurred.

39 The arguments of the Minister do identify uncertainties. However, they are not uncertainties based on whether a future event will or will not occur. They do not meet the *Winter* test for contingent liability.

4. Reasons of Bastarache and Abella JJ.

40 I have had the opportunity to read the reasons of Bastarache and Abella JJ. They say that because the sale of the seismic data only occurs if there is insufficient revenue generated under ss. 2 and 3 of Schedule 1 to the note and because the generation of revenue is contingent, the sale of the seismic data under s. 7 of Schedule 1 is contingent and therefore the liability is contingent. I cannot agree with their approach. The *Winter* definition of contingent liability is "*a liability which depends for its existence* upon an event which may or may not happen" (p. 262 (emphasis added)). Whether liability under the note is to be satisfied from the generation of revenue or from the sale of the seismic data, when these events are viewed in the sequence they occur, it is clear the liability is to be repaid and thus its existence does not depend upon an event which may or may not happen. The terms of Schedule 1 to the note provide that the liability is to be satisfied one way or the other, either from the generation of revenue or the sale of the seismic data if the revenue generation is

insufficient. The uncertainty identified by my colleagues is uncertainty as to the source from which the liability is to be repaid. It does not affect the existence of the liability.

41 My colleagues also say that because McLarty is only obliged to repay 60% of the proceeds of the sale of the security that this cannot be equated to an absolute liability to pay $85,000. They say "[w]hat if the note had specified the default" as Mr. McLarty owing 30% of the sale of the proceeds, or even 2%? Would the note still be considered an absolute liability to repay $85,000? We think not" (para. 14). With respect, I think my colleagues, like the Minister, are conflating the issue of whether the security is sufficient to repay the full value of the note and implicitly, that the seismic data was overvalued, with the issue of whether the liability is absolute or contingent. In an appropriate case, overvaluation to obtain a tax advantage may be attacked by the Minister on at least the basis that the valuation is unreasonable or that a note constitutes a sham or that the parties are not dealing at arm's length. The Minister is not without remedies for overvaluation, but trying to characterize the liability as contingent in this case is not one of them.

42 I agree with the Federal Court of Appeal that the liability in this case is not contingent.

B. Were the Parties Dealing at Arms' Length?

1. Statutory Provisions

43 It has long been established that when parties are not dealing at arm's length, there is no assurance that the transaction "will reflect ordinary commercial dealing between parties acting in their separate interests" (*Swiss Bank Corp. v. Minister of National Revenue* (1972), [1974] S.C.R. 1144 (S.C.C.), at p. 1152). The provisions of the *Income Tax Act* pertaining to parties not dealing at arm's length are intended to preclude artificial transactions from conferring tax benefits on one or more of the parties. Where the parties are found not to be dealing at arm's length, the taxpayer who has made an acquisition is deemed to have made the acquisition at fair market value regardless of whether the amount paid was in excess of fair market value. Section 69(1)(*a*) provides:

> 69. (1) Except as expressly otherwise provided in this Act,
>
> > (a) Where a taxpayer has acquired anything from a person with whom the taxpayer was not dealing at arm's length at an amount in excess of the fair market value thereof at the time the taxpayer so acquired it, the taxpayer shall be deemed to have acquired it at that fair market value;

44 Arm's length is not defined in the *Income Tax Act*. However, s. 251(1) provides:

> (1) For the purposes of this Act,
>
> > (a) related persons shall be deemed not to deal with each other at arm's length;
> >
> > (b) it is a question of fact whether persons not related to each other were at a particular time dealing with each other at arm's length.

45 The parties in this case were not related. It is therefore a question of fact whether they were dealing at arm's length.

2. Facts Specific to the Arm's Length Issue

46 In the fall of 1992, McLarty received an Offering Memorandum which outlined the proposed CRC joint venture. The Offering Memorandum provided for the appointment of Compton as agent for the joint venture participants to acquire seismic data. The Offering Memorandum provided that the acquisition of the data was subject to the condition that the purchase price "will not be higher than the lowest appraised value received from three experienced, independent valuators". The three independent appraisals were for $39,787,800, $41,930,760 and $34,405,000.

47 On December 30, 1992, Compton acquired the seismic data, a portion of which was to be offered to the joint venture participants. On December 31, 1992, McLarty entered into a Subscription Agreement with Compton that incorporated three agreements, all dated December 31, 1992: the Subscription Agreement, the Joint Venture Agreement and the agreement to purchase the seismic data. These agreements implemented the transaction outlined in the Offering Memorandum and McLarty's subscription was subject to the terms of the Offering Memorandum.

48 The joint venture participants collectively acquired a 30.35% undivided interest in the data from Compton for a total consideration of $6,373,335. McLarty acquired a 1.57% undivided interest for $100,000.

3. Decision of the Trial Judge

49 The trial judge first noted that the Minister did not originally assess on the basis that McLarty and Compton were not dealing at arm's length. Therefore, the onus was on the Minister to prove the transactions were not at arm's length (trial judge's reasons, at para. 51).

50 The trial judge found:

a. The appropriate relationship to assess was that between Compton and McLarty.

b. It was McLarty's decision to invest.

c. There was no evidence that the principal of Compton, Ernie Sapieha, influenced the decision of McLarty to invest.

d. There was no evidence that McLarty and Compton acted in concert without separate interests.

e. There was no evidence that Compton or Sapieha imposed the purchase of the seismic data on McLarty or had the power to do so.

f. There was no collusion to inflate the price of the seismic data because McLarty had accepted the terms of the Offering Memorandum which limited the purchase price to not higher than the lowest of three independent appraisals.

51 The trial judge concluded that in acquiring his interest in the seismic data, McLarty was dealing with Compton at arm's length.

4. Decision of the Federal Court of Appeal

52 The Court of Appeal was of the opinion that there were three issues to consider in deciding the arm's length question.

a. Did the Trial Judge consider the correct transaction for purposes of s. 69(1)(*a*)?

b. Which entities needed to be at arm's length for purposes of s. 69(1)(*a*)?

c. Were the correct entities at arm's length?

53 In the view of the Court of Appeal, the trial judge failed to determine which transaction to analyse. Sexton J.A., writing for the court, said that the question of selecting the appropriate transaction was a question of law reviewable on a correctness standard. In his opinion, the key transaction was the purchase of the seismic data.

54 In deciding the question of which entities had to be dealing at arm's length, the Court of Appeal stated that it was not in dispute that McLarty and Compton were dealing at arm's length when McLarty decided to invest in the joint venture. However, with respect to the purchase of the seismic data, this transaction was between Compton as vendor

and Compton as purchasing agent for the joint venture participants. In the view of the Court of Appeal, when analysing whether parties are dealing at arm's length, it is necessary to look beyond the legal relationship of principal and agent to see what actually happened. Thus, it focussed on the relationship of Compton as vendor and Compton as agent for the participants in the joint venture.

55 Since Compton was both vendor and agent for the participants in the joint venture, as the same entity, it was not acting with separate interests. Further, Sapieha had *de facto* control over Compton both as vendor and as agent. The Court of Appeal found that the trial judge erred by not considering the relationship between Compton as vendor and Compton as agent, since Sapieha was the directing mind of both.

56 The Court of Appeal acknowledged that the Offering Memorandum provided that the purchase price of the seismic data was to be no higher than the lowest of three independent appraisals. However, that was the extent of McLarty's control over the terms. The trial judge did not indicate that McLarty was involved in choosing the appraisers or that he even reviewed these evaluations prior to purchase. The origin of the purchase price was unclear. It was not reflective of the price paid for the data by purchasers prior to it being purchased by Compton.

57 The Court of Appeal concluded that the parties to the transaction to acquire the data, Compton as vendor and Compton as purchasing agent for the joint venture participants, were not dealing at arm's length. Sexton J.A. therefore allowed this aspect of the Minister's appeal and remitted the matter to the Tax Court for determination of the fair market value of the data.

5. Was McLarty Dealing with the Vendor at Arm's Length?

58 Pursuant to s. 69(1)(*a*), the "dealing" must be between a taxpayer and the person from whom the taxpayer has made an acquisition. If the taxpayer and the vendor are not dealing at arm's length, the price at which the acquisition was made shall be deemed to be its fair market value irrespective of the actual price paid by the taxpayer.

59 In this case, the acquisition transaction was the purchase of the seismic data. This transaction was between Compton as vendor and Compton as agent for the participants in the joint venture. Obviously, Compton was not dealing with itself at arm's length. However, this does not end the analysis.

60 Compton is not the taxpayer referred to in s. 69(1)(*a*). The taxpayer is McLarty. Therefore, the question is whether McLarty, as an acquirer of an interest in the seismic data, was dealing at arm's length with Compton as vendor.

61 In this case, while the initial focus is on the transaction between the vendor and the agent of the acquiring taxpayer, all the relevant circumstances must be considered to determine if the acquiring taxpayer was dealing with the vendor at arm's length.

62 The Canada Revenue Agency Income Tax Interpretation Bulletin IT-419R2 "Meaning of Arm's Length" (June 8, 2004) sets out an approach to determine whether the parties are dealing at arm's length. Each case will depend on its own facts. However, there are some useful criteria that have been developed and accepted by the courts: see for example *Peter Cundill & Associates Ltd. v. R.*, [1991] 1 C.T.C. 197 (Fed. T.D.), aff'd [1991] 2 C.T.C. 221 (Fed. C.A.). The Bulletin provides:

> 22. . . . By providing general criteria to determine whether there is an arm's length relationship between unrelated persons for a given transaction, it must be recognized that all-encompassing guidelines to cover every situation cannot be supplied. Each particular transaction or series of transactions must be examined on its own merits. The following paragraphs set forth the CRA's general guidelines with some specific comments about certain relationships.
>
> 23. The following criteria have generally been used by the courts in determining whether parties to a transaction are not dealing at "arm's length":

• was there a common mind which directs the bargaining for both parties to a transaction;

• were the parties to a transaction acting in concert without separate interests; and

• was there "de facto" control.

63 The trial judge paraphrased the Canada Revenue Agency criteria at para. 56 of his reasons. He found that the appropriate relationship to assess was that between Compton and McLarty. Applying the indicia for identifying dealings not at arm's length, he found that Compton and Sapieha did not influence the decision of McLarty to invest, that there was no evidence that Compton and McLarty acted in concert without separate interests and that no party had the power to impose its will on the other.

64 It appears that the trial judge had regard to the relevant indicia for determining the arm's length question and applied these indicia to the evidence, or lack of evidence. It is important to remember that in this case, the onus was on the Minister to prove that McLarty was not dealing with Compton at arm's length. His conclusion indicates that, in his view, the Minister did not satisfy that onus.

65 The Minister states that "[i]t is the relationship between vendor and purchaser at the time of purchase that must be examined, and not the relationship at any other time or with respect to any other transaction" (Minister's factum on cross-appeal, at para. 26). I am unable to agree with such a restrictive approach. Of necessity, where the acquisition is made by an agent of the purchaser, the purchaser's connection to the acquisition transaction and to the question of whether the vendor and purchaser were dealing at arm's length will require that the agreement between the agent and the purchaser be considered. That agreement would normally precede the acquisition agreement (here all documents were signed on December 31, 1992). Indeed, even the Court of Appeal, which primarily focussed on the agreement between Compton as vendor and Compton as agent for the joint venture participants, also had regard for McLarty's involvement through the Subscription Agreement which incorporated the Offering Memorandum by reference. The Offering Memorandum contained restrictions on Compton as agent in respect of the price to be paid for the data. At paragraph 57, the Court of Appeal noted:

> The findings of the court below indicate that the respondent, and indeed, the Joint Venturers as a whole had minimal input into the terms of the Technical Data Base Purchase Agreement. To be sure, the Memorandum required the purchase price of the Data to be no higher than the lowest appraised value received from three experienced, independent valuators. However, that appears to be the extent of the respondent's control over the terms of the bargain. After all, Sapieha was responsible for obtaining the valuations. The findings of the court below do not indicate that the respondent was involved in choosing the appraisers or that he even reviewed their evaluations prior to purchase.

66 The Minister concedes that "[w]hile the surrounding circumstances form part of the factual underpinning, they may be relevant to a s. 69(1)(a) analysis, but only to the extent that they relate to the parties' dealings with respect to the purchase of the seismic data itself" (Minister's factum on cross-appeal, at para. 32). The Minister also concedes that the "restrictions on an agent's authority are relevant considerations in the arm's length analysis" (Minister's factum on cross-appeal, at para. 36). However, in this case, the Minister believes "the control retained by the joint venturers was insignificant" (Minister's factum on cross-appeal, at para. 36).

67 The Minister says that McLarty exercised minimal oversight in the purchase of the data and did not exhibit due diligence, that the independent appraisals were unrealistic, that McLarty did not even look at the purchase price and that the price he paid was 10 times the price that the entire data, consisting of even more data than that acquired by the joint venture participants had traded for earlier in 1992, and that McLarty was indifferent to the price.

68 As already noted, the trial judge placed significance on the limitations imposed on the purchase transaction by the Offering Memorandum. He stated at para. 60 of his reasons:

There was no collusion to inflate the price of the Venture Data because the Appellant had accepted the terms of the Memorandum which limited the purchase price to not higher than the lowest valuation.

69 The trial judge and the Federal Court of Appeal have both considered the limitation on the purchase price in the Offering Memorandum, but each has placed different significance on it. The trial judge considered it important; the Federal Court of Appeal did not.

70 The Court of Appeal made no finding of palpable and overriding error by the trial judge in his findings of fact. I am of the respectful view that the Federal Court of Appeal was in error in interfering with the factual findings and inferences drawn from the facts by the trial judge.

71 I cannot agree with the Federal Court of Appeal that the trial judge erred in law. It is true he placed more significance on the limitations on Compton imposed by the Offering Memorandum than did the Federal Court of Appeal. But barring palpable and overriding error, he was entitled to do so.

72 Had the trial judge found that McLarty had subordinated his entire decision making power to Compton as his agent, his dealings with Compton as vendor would not have been at arm's length. He would not have been making an independent decision about the purchase but would have left that completely to Compton. But those are not the facts found or inferences drawn by the trial judge.

73 It was appropriate for the trial judge to have considered the entirety of the transactions by which McLarty bound himself to purchase his interest in the seismic data and place limitations on Compton as his agent with respect to the purchase price of the data. It was for the trial judge to draw inferences from these facts. The Federal Court of Appeal was in error in interfering with the conclusion of the trial judge.

V. Conclusion

74 I am not unmindful that McLarty's involvement in the determination of the purchase price was minimal. The price paid was significantly in excess of the price paid for the data in transactions earlier in 1992. Another trial judge may well have concluded that McLarty was indifferent to the purchase price and that he had effectively subordinated his decision making to Compton with the conclusion that Compton as vendor and McLarty as purchaser were not dealing at arm's length. However, these were factual decisions for the trial judge and are not open to reinterpretation by an appellate court, barring a finding of palpable and overriding error which was not made in this case.

75 The Minister has numerous basis for challenging the deductions taken by a taxpayer. He may rely on sham or the *GAAR* to name just two. He did not do so in this case. In reassessment cases, the role of the court is solely to adjudicate disputes between the Minister and the taxpayer. It is not a protector of government revenue. The court must decide only whether the Minister, on the basis on which he chooses to assess, is right or wrong. In this Court, the Minister relied on contingent liability and non-arm's length dealing. The liability incurred by McLarty was not contingent and there was no basis to interfere with the findings of the trial judge that McLarty's dealings with Compton were at arm's length.

76 In the result, the appeal should be dismissed with costs throughout. The cross-appeal should be allowed with costs. The decision of the Federal Court of Appeal should be set aside and the decision of the trial judge restored.

The following are the reasons delivered by

***Bastarache, Abella JJ.*:**

77 Mr. McLarty attempted to take a deduction of $100,000 on his income tax return for a "Canadian exploration expense" under s. 66.1(6) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.). Section 66.1(6) allows tax deductions for expenses incurred "for the purpose of determining the existence, location, extent or quality of an accumulation of petroleum or natural gas (other than a mineral resource) in Canada". The $100,000 amount claimed by Mr. McLarty

consisted of two parts: $15,000 he paid up front in cash and $85,000 in the form of a promissory note. Both the cash and note were given to Compton Resource Corporation (CRC) as consideration for seismic data, which is geophysical information used to locate oil and gas reserves. CRC, in turn, purchased that data from a company called Seitel on the previous day, offering as consideration a cash payment and a promissory note; the latter had identical repayment terms to those in Mr. McLarty's note. The promissory notes, by their terms, were to be paid only out of revenues derived from the business venture. If revenues proved insufficient, the noteholders would be entitled to receive no more than 60% of the value from the resale of the seismic data when the note came due. As a result, there was no guarantee that Mr. McLarty would ever have to pay the full amount of the note.

78 The Minister of National Revenue offered two arguments for disallowing the $85,000 tax deduction based on the promissory note. First, the Minister argued that the promissory note was not an "expense incurred" but a "contingent liability", which is "a liability which depends for its existence upon an event which may or may not happen" (*Wawang Forest Products Ltd. v. R.*, 2001 D.T.C. 5212, 2001 FCA 80 (Fed. C.A.), at para. 11). Second, the Minister argued that the sale of seismic data to Mr. McLarty did not occur at arm's length because the vendor acted as Mr. McLarty's agent in the sale. Under tax law, if a transaction does not occur at arm's length, then the purchase price may be reassessed.

79 While we agree with the majority's holding that the transaction occurred at arm's length, we are of the view, with respect, that Mr. McLarty's promissory note is a contingent liability and therefore does not meet the requirements of s. 66.1(6).

80 Under s. 66.1(6) of the Act, Mr. McLarty may take a tax deduction where he has incurred an expense. The law is that "an expense is incurred for tax purposes when the taxpayer has a clear legal obligation to pay the amount in question" (Hogg, Magee & Li, *Principles of Canadian Income Tax Law* (6th ed. 2007), at p. 230). This Court propounded that principle in *J.L. Guay Ltée v. Minister of National Revenue*, [1975] C.T.C. 97 (S.C.C.), aff'g (1972), [1973] C.T.C. 506 (Fed. C.A.), aff'g [1971] C.T.C. 686 (Fed. T.D.).

81 Expenses (absolute liabilities) are distinguished from contingent liabilities (which are not tax deductible) with reference to the "*Winter* test". In *Winter v. Inland Revenue Commissioners* (1961), [1963] A.C. 235 (U.K. H.L.), Lords Reid and Guest discussed how to differentiate absolute from contingent liabilities. In *Winter*, Lord Guest explained:

> Contingent liabilities must . . . be something different from future liabilities which are binding on the company, but are not payable until a future date. I should define a contingency as an event which may or may not occur and a contingent liability as a liability which depends for its existence upon an event which may or may not happen. [p. 262]

82 This approach was adopted by this Court in *Mandel v. R.*, [1980] 1 S.C.R. 318 (S.C.C.), aff'g (1978), [1979] 1 F.C. 560 (Fed. C.A.), aff'g (1976), [1977] 1 F.C. 673 (Fed. T.D.).

83 In *Mandel*, this Court held that a liability is contingent when it exists only in the event that a business generates profits. Taxpayers acquired a movie for $577,892. They did not, however, pay the full purchase price. They made a down payment of $150,000 and agreed to pay the balance out of the profits to be generated once the movie was completed and distributed. The taxpayers assumed no liability for the balance of the purchase price in the event that the movie failed to generate sufficient profits. The Minister permitted a deduction, but only for the amount actually paid. The Federal Court, Trial Division, the Federal Court of Appeal and the Supreme Court agreed with that assessment. The taxpayers' liability to pay the balance of the purchase price was found to be a contingent liability since they were liable only if an uncertain event occurred, namely, that the movie generated sufficient profits.

84 The definition in *Winter* was also adopted by the Federal Court of Appeal, *per* Sharlow J.A., in *Wawang*, as follows: "I should define a contingency as an event which may or may not occur and a contingent liability as a liability which depends for its existence upon an event which may or may not happen" (para. 11).

85 Pursuant to *Winter*, we apply the following question to this note: Is the liability it creates to pay the full amount of $85,000 dependent for its existence on an event which may or may not happen? In our view, the liability in this case

is contingent because Mr. McLarty's obligations (including whether he must resell the data when the note comes due) depend on whether the venture proves to be sufficiently profitable.

86 Schedule 1 to the promissory note provided that it would be paid out by way of assignment to CRC (the vendor) of 60% of Mr. McLarty's share of any seismic licensing revenues and 20% of his share of the production cash flow from the drilling program. Any payments were to be credited against accrued interest first and then against principal. In the event that any portion of the principal or interest remained unpaid on December 31, 1999, the due date of the promissory note, then CRC would appoint an independent trustee to sell Mr. McLarty's 1.57% interest in the seismic data and 20% of his interest in the joint venture's petroleum rights, with any proceeds to be allocated against the outstanding debt as follows: (1) 60% of the sale proceeds from the disposition of Mr. McLarty's interest in the seismic data; and (2) all of Mr. McLarty's share of the sale proceeds from the disposition of 20% of his interest in the joint venture's petroleum rights. In sum, Mr. McLarty would never be personally liable for the $85,000. The noteholder would only receive the full amount in the event that the venture proved sufficiently profitable (or the data, on resale, sufficiently valuable) to cover the debt.

87 Mr. McLarty's promissory note read in part as follows:

> The undersigned, FOR VALUE RECEIVED, hereby promises to pay to COMPTON RESOURCE CORPORATION (the "Noteholder") on the 31st day of December, 1999, the sum of Eighty-five Thousand ($85,000) in lawful money of Canada together with any accrued and unpaid interest on any unpaid portion of the said principal sum, which interest shall accrue from and after December 31, 1992, at the rate of eight percent (8%) per annum calculated annually and not in advance.
>
> The terms of repayment of this promissory note to the Noteholder shall be limited to those terms set out herein and no other action shall lie against the undersigned in respect of any covenant for payment.
>
> The indebtedness of the undersigned shall be reduced only in accordance with the provisions set forth in Schedule 1 attached hereto, which schedule is incorporated into and forms part of this promissory note.
>
> This promissory note shall be non-negotiable and non-assignable by the Noteholder without the prior written consent of the undersigned and the assignee first agreeing in writing with the undersigned to be bound by the terms hereof.

88 The actual terms of the promissory note thus require payment of 60% of the profits from the sale of the data and 20% of the drilling rights. As a result, if no profits are made, the noteholder would be entitled to receive 60% of the proceeds of sale of the data. These terms are considered "default provisions" because they were only to be imposed in case of non-payment as of December 31, 1999. The data thus acted as security for CRC.

89 Both the Minister and Mr. McLarty agreed that a creditor's limited recourse on default of debt cannot make an otherwise absolute liability contingent nor can it turn an otherwise contingent obligation into an absolute one. As such, the fact that Mr. McLarty was to surrender 60% of the proceeds from the sale of the data does not render the note an absolute liability. On the contrary, Mr. McLarty's liability depends on whether the business venture generates revenues. Mr. McLarty only needs to sell the seismic data if the venture has not generated sufficient revenues to cover the $85,000 face value of the promissory note. Whether it will do so is uncertain. This in turn makes the liabilities that depend on revenue generation uncertain and, accordingly, contingent. This means that Mr. McLarty's obligation to resell the venture data is also contingent, because it too depends on whether sufficient revenues have been generated to cover the face value of the promissory note.

90 Moreover, the terms of the note specify that Mr. McLarty would only be obliged to repay 60% of the sold data and that any balance owing after the allocation of the proceeds will be forgiven. This cannot be equated to an absolute liability to pay $85,000. What if the note had specified the "default" as Mr. McLarty owing 30% of the sale of the proceeds, or even 2%? Would the note still be considered an absolute liability to repay $85,000? We think not. Mr. McLarty attempts to argue that this provision is the equivalent of debt forgiveness, which does not alter the status of a liability for tax

purposes. It is erroneous to equate the two situations because in the present case, the "debt forgiveness" was specified *within* the loan arrangement. The repayment of the $85,000 was thus contingent on whether the seismic data produced revenue or not. The "default" provisions cannot be considered to alter this contingency. The fact that Seitel characterized its note to CRC as contingent and that the repayment terms of this note are identical to those in the note between CRC and Mr. McLarty support this point.

91 Section 66.1(6) of the *Income Tax Act* offers deductions to taxpayers who have made themselves *absolutely* liable. Mr. McLarty is not in that category. In *Mandel*, this Court confirmed that where liabilities depend on whether a business venture generates revenues, they must be characterized, for tax purposes, as contingent. How much Mr. McLarty will pay CRC, and by what means, depend on the uncertain success of his business venture. Mr. McLarty may eventually claim a tax deduction, if he pays CRC some amount under the promissory note. In other words, he may take the deduction when he incurs the expense. Until then, it is difficult to see his liability as anything other than contingent.

92 We would therefore allow the appeal and cross-appeal, both with costs.

Appeal dismissed; cross-appeal allowed.

Pourvoi rejeté; pourvoi incident accueilli.