Canadian Exploration Expense - Seismic Data

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McLarty v The Queen, 2014 TCC 30

At issue was whether the taxpayer, who purported to participate as part of a Joint Venture that included the purchase of seismic data, was entitled to claim deductions against income related to the purchase as Canadian Exploration Expense (as defined in ITA subsection 66.1(6)). The purchase amount was inflated through a series of purchases from about $800,000 to $6.5 Million, and was paid part in cash and part in the form of a limited recourse promissory note.

[The facts and assumptions made by the Minister are in the decision and will not be repeated here].

ANALYSIS

The first issue was whether the Appellant purchased the undivided interest in the technical data for the "purpose of exploration" as required by paragraph (a) of the definition of "Canadian Exploration Expense" in subsection 66.1(6). In looking at this purpose test, courts must look to what was actually done on the ground of or with the seismic data: *Global Communications Ltd. v. R.*, 99 DTC 5377; *Petro-Canada v. The Queen.*, 2004 FCA 158. What is required is some connection between the purchased seismic data and actual exploration work - either in the form of actual exploration or in the form of a credible plan for the use of the data in an exploration program within a reasonable time after its acquisition (para 53).

The second issue was determining the correct "cost amount" of the technical data purchased for purposes of the Canadian Exploration Expense. The Crown conceded that the promissory note was not a "contingent liability", leading the court to conclude that the amount of the promissory note is equal to an "incurred expense" (para 58). The Minister relied on section 67 of the ITA to stated that any expense in excess of the cash payment made and the future liability actually incurred (50% of net licencing revenues for 9 years) is unreasonable.

In determining whether an expense is unreasonable, is to ask whether a reasonable businessman would have contracted to pay such an amount having only the consideration of the appellant in mind: *Gabco Limited v. Minister of National Revenue*, [1968] 2 Ex.C.R. 511; *Petro-Canada v. The Queen.*, 2004 FCA 158. Reasonableness is a question of fact and paying fair market value for something (a matter not challenged by the Minister in this case) is *prima facie* reasonable. It is a question of fact whether paying more than FMV in the circumstances is reasonable or not.

Where an asset is difficult to value, and the sale is at arm's length, it is not appropriate to challenge the business judgment of the taxpayer: *McLarty v. The Queen*, 2005 TCC 55.

The court also allowed the interest deduction claimed by the Appellant as the liability to pay interest was a real one and interest was in fact paid.

In responding to the Minister's "sham argument" - that the transaction was conducted with an element of deceit so as to create an illusion meant to deceive the tax man by disguising reality: *Stubart Investments Ltd. v. The Queen*, [1984] 1 SCR 536 pages 545-46 - the court stated that what is required is:

- an intention of the parties to the transaction
- to give a false appearance
- that the legal rights and obligations have been created that are different from the actual legal rights and obligations of the parties

[for a summary of the Sham Doctrine see HERE]

Here, the required elements of a Sham were not present in the transactions carried on by the Appellant or the Joint Venture. Any claims of Sham relate to transactions by other entities. The court said:

> [78] In my opinion, the Crown cannot apply the doctrine of sham to only a part of a particular transaction while considering another part of the same transaction as being legally valid and effective. For example, I have difficulty with the Crown being permitted to apply the doctrine of sham to only that part of the acquisition by the appellant of an undivided interest in the Seismic Data that was paid for by the appellant's Promissory Note.
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> [...]
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> [88] Considering the evidence before me, I cannot accept the Crown's position that the creation of the Joint Venture and the transactions carried on by it and by Compton Petroleum Corporation on its behalf were mere window dressing intended to deceive the Minister. The legal rights and obligations created by the said transactions were not different from the actual legal rights and obligations of the parties. The way in which the financial statements of the Joint Venture were presented is not relevant in the circumstances because the issue does not involve determining whether or not the Joint Venture was an oil and gas entity for accounting purposes or whether or not the licensing revenues derived from the Seismic Data were incidental to the exploration activities of the Joint Venture or were related to a separate business. The financial statements of the Joint Venture were audited financial statements with no qualified opinion. As such, they were accurate and reliable.

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