**Date: 20090210**

**Docket: A-69-08**
**A-70-08**

**Citation: 2009 FCA 33**

**CORAM:** **NADON J.A.**
**SHARLOW J.A.**
**PELLETIER J.A.**

**BETWEEN:**

**A-69-08**

**SYLVANO TESAINER**

**Appellant**

**and**

**HER MAJESTY THE QUEEN**

**Respondent**

**A-70-08**

**MARY LYNNE TESAINER**

**Appellant**

**and**

**HER MAJESTY THE QUEEN**

**Respondent**

Heard at Toronto, Ontario, on January 14, 2009.

Judgment delivered at Ottawa, Ontario, on February 10, 2009.

REASONS FOR JUDGMENT BY: SHARLOW J.A.

CONCURRED IN BY: NADON J.A.
PELLETIER J.A.

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## REASONS FOR JUDGMENT

**SHARLOW J.A.**

[1] This is an appeal of a judgment of Justice McArthur of the Tax Court of Canada dismissing the appeals of Silvano Tesainer and Mary Lynne Tesainer from assessments made under the *Income Tax Act*, R.S.C. 1985, c. 1 (5th supp.), for 1992, 1993 and 1995. The issue in the income tax appeals

was whether an amount received by Mr. Tesainer and Ms. Tesainer in settlement of a legal action resulted in a taxable capital gain. Justice McArthur concluded that it did. The issue in this appeal is whether that conclusion is correct in law.

[2] Fenix Development Limited Partnership ("Fenix") was a limited partnership. The general partner was Fenix Developments G.P. Inc. There were 93 limited partners. In 1988, Mr. Tesainer and Ms. Tesainer purchased limited partnership units of Fenix in a private placement described in an offering memorandum dated August 16, 1988. Mr. Tesainer and Ms. Tesainer together incurred a cost of $100,000 for their limited partnership units.

[3] It is undisputed that the limited partnership units acquired by Mr. Tesainer and Ms. Tesainer comprised an "interest in a partnership" as that term is used in section 53 of the *Income Tax Act*. It is also undisputed that for the purposes of this case, nothing turns on the fact that Fenix was a limited partnership rather than a general partnership.

[4] The intended business of Fenix was the development and operation of commercial real estate. When the offering memorandum for limited partnership units was issued in 1989, Fenix had commenced the process of acquiring property on which it intended to build a project called Meadowpines. Meadowpines was never completed because in 1989, the promoters of Fenix ran into difficulties with the Ontario Securities Commission which led to the loss of the Meadowpines property and the failure of the business. After 1991, Fenix ceased to be active in the business for

which it was formed. In 1995, a special resolution was made to dissolve Fenix. The parties agree that for income tax purposes, Fenix was regarded as having ceased to exist in 1995.

[5] It was asserted by Mr. Tesainer and Ms. Tesainer, and not questioned by the Crown, that all of the capital of Fenix was lost when its business failed, leaving substantial unsatisfied creditor claims. The record contains little financial information about Fenix, but for the purposes of this appeal I have assumed that all of the partnership capital was lost before 1992.

[6] In 1992, an action was commenced against the lawyers who had been retained to advise Fenix on matters of securities law in relation to the private placement and the offering memorandum. There were 75 named plaintiffs. One was Fenix (named as "Fenix Developments G.P. Inc., on behalf of Fenix Development Limited Partnership"). The other 74 were individuals, including Mr. Tesainer and Ms. Tesainer. All of the plaintiffs were represented by the same counsel.

[7] The individual plaintiffs, including Mr. Tesainer and Ms. Tesainer, were holders of limited units of Fenix. As indicated above, only 74 of the 83 limited partners were individual plaintiffs but all of the partners of Fenix were represented in the lawsuit through Fenix, which was also a plaintiff.

[8] The claims against the lawyers are summarized in paragraph 1 of the statement of claim, which reads as follows:

> 1. The plaintiffs claim as follows:

(i) the individual plaintiffs claim the amount of their investment, being the total of $3,261,000, in accordance with Schedule "A" attached hereto [Schedule "A" lists the individual plaintiffs and the amount invested by each of them to acquire limited partnership units; Mr. Tesainer and Ms. Tesainer are shown as having invested $100,000];

(ii) the plaintiff Fenix Developments G.P. Inc., on behalf of Fenix Developments Limited Partnerships, claims:

(a) in the alternative to the claim in sub-paragraph (i), damages in the amount of $3,261,000; and

(b) in any event, damages in the amount of $3,500,000 in respect of liabilities incurred in connection with the Meadowpines Project as more particularly described below; and

(i) all of the plaintiffs claim:

(a) lost profits in the amount of $4,135,000;

(b) punitive damages in the amount of $5,000,000;

(c) pre and post-judgment interest in accordance with the Courts of Justice Act; and

(d) their costs on a solicitor and client basis.

[9] It is alleged in the statement of claim that the lawyers were negligent and in breach of their legal obligations to Fenix and to prospective and actual investors (i.e., the individual plaintiffs) when they gave erroneous legal advice, when they failed to advise Fenix and the individual plaintiffs on a timely basis when they knew or ought to have known that the legal advice they gave was wrong, and when they dealt with the Ontario Securities Commission in a manner that put their own interests in conflict with their duty to Fenix and the individual plaintiffs.

[10] It is also alleged in the statement of claim that, but for the negligence and other wrongful conduct of the lawyers, the private placement would not have closed when it did, there would have been no breach of the securities laws and no trouble with the Ontario Securities Commission, the business of Fenix would not have failed but would have succeeded and resulted in profits that would have been shared by the individual plaintiffs, Fenix would not have lost its capital, and the individual plaintiffs would not have lost the value of their investments in Fenix.

[11] The Crown did not dispute that the allegations in the statement of claim, if true, would have established for the individual plaintiffs a cause of action against the lawyers that was independent of the cause of action of Fenix against the lawyers. Therefore, for the purposes of this appeal I will assume that independent causes of action could have been made out on the same factual foundation.

[12] The action was settled in 1995. The terms of the settlement agreement are confidential. It is sufficient for the purposes of this appeal to say that all of the claims were settled by the payment of a sum of money in trust for the individual plaintiffs. That amount, net of a deduction for legal fees, was divided among the individual plaintiffs in proportion to the amount they had paid to acquire their limited partnership units. Mr. Tesainer and Ms. Tesainer received a total of $98,300 of the settlement payment.

[13] Mr. Tesainer and Ms. Tesainer took the position, when filing their income tax returns, that the settlement payment was not taxable as income or as a capital gain. However, they were reassessed on the basis that the settlement payment should be treated for income tax purposes as

though it were a distribution of capital by Fenix. On that basis, by the combined operation of subparagraph 53(2)(*c*)(v) and paragraph 98(1)(*c*) of the *Income Tax Act*, the payment gave rise to a taxable capital gain taxable in the hands of Mr. Tesainer and Ms. Tesainer.

[14] Pursuant to subparagraph 53(2)(*c*)(v) of the *Income Tax Act*, a distribution of partnership capital is treated for income tax purposes as a reduction in the adjusted cost base of the partnership interest in relation to which it is made. If the resulting adjusted cost base of the partnership interest is a positive amount, the only tax consequence of the distribution is to increase the capital gain (or reduce the capital loss) that may arise in future if, for example, there is a sale or other disposition of the partnership interest. However if, as in this case, the capital distribution reduces the adjusted cost base of the partnership interest to a negative amount, paragraph 98(1)(*c*) of the *Income Tax Act* requires the negative amount to be treated for income tax purposes as a gain on the disposition of the partnership interest.

[15] The payment in issue in this case was not a distribution of partnership capital. There was no change in the corpus of the partnership capital of Fenix, or the relative interests of the limited partners of Fenix (see *Stursberg v. M.N.R.* (1993), 155 N.R. 366, [1993] 2 C.T.C. 76, 93 D.T.C. 5271 (F.C.A.). It was a payment made by the lawyers to the individual plaintiffs, and not to Fenix. Although it was paid in settlement of all of the claims of Fenix and the individual plaintiffs against the lawyers, there is no suggestion and no evidence that any part of the settlement was paid to or for the benefit of Fenix. There is no basis for concluding that an amount was owed to Fenix and paid to the individual plaintiffs at the direction or with the concurrence of Fenix.

[16] Although the payment was not actually a distribution of partnership capital, the Crown argues that it should be treated as such for income tax purposes because it is intended to replace a distribution of partnership capital. This is a reference to the *surrogatum* principle discussed in *Tsiaprailis v. Canada*, [2005] 1 S.C.R. 113. Justice McArthur accepted that argument because, as he explained at paragraph 17 of his reasons:

> […] (i) it replaced the Appellants' capital investment […]; (ii) the Appellants' lawsuit was for the amount of their investment; (iii) they claimed the return of their $100,000 and received $98,300; (iv) the documentary evidence clearly points to it being a return of capital; and (v) the partnership agreement was in reality at an end in 1991.

[17] In my view, the Crown's argument is based on a misunderstanding of the *surrogatum* principle, and Justice McArthur erred in law in accepting it. The settlement payment in this case cannot be said to have replaced a distribution of partnership capital because, as a matter of law, it did not and could not have discharged any claim of the individual plaintiffs against Fenix, much less a claim for a distribution of partnership capital.

[18] The claim of the individual plaintiffs against the lawyers, as described in paragraph 1(i) of the statement of claim, is quantified by reference to the amounts they invested in Fenix. However, it does not follow that the settlement payments must be characterized as a return of the invested amount, or an amount paid in substitution for that amount. The transaction that occurred in this case did not and could not serve the legal or practical function of a distribution of partnership capital.

[19] The validity of that conclusion is demonstrated by considering what would have happened if the action against the lawyers had been settled by the payment of an amount to Fenix. In that event, Fenix might have determined that it should make a capital distribution to the limited partners, but no such distribution could have been made without first settling any outstanding claims of the creditors of Fenix, and then the distribution of any remaining amount would necessarily have been shared among all of the limited partners in accordance with the distribution rights (except to the extent those rights were waived). That is not what happened in this case. What happened was that each individual plaintiff received an amount in settlement of his or her personal claim for damages.

[20] For these reasons, I would allow this appeal with costs in this Court and in the Tax Court of Canada. I would set aside the judgment of the Tax Court and allow the income tax appeals of Mr. Tesainer and Ms. Tesainer, and refer this matter back to the Minister for reassessment on the basis that subparagraph 53(2)(*c*)(v) does not apply to the settlement payments.

"K. Sharlow"
J.A.

"I agree.
M. Nadon J.A."

"I agree.
J.D. Denis Pelletier J.A."

**FEDERAL COURT OF APPEAL**

**NAMES OF COUNSEL AND SOLICITORS OF RECORD**

| | |
|---|---|
| **DOCKET:** | A-69-08 |
| **APPEAL FROM A JUDGMENT JUSTICE McARTHUR OF THE TAX COURT OF CANADA DATED JANUARY 23, 2008, NO. 2006-2260 (IT) G** | |
| **STYLE OF CAUSE:** | Silvano Tesainer v. Her Majesty the Queen |
| **PLACE OF HEARING:** | Toronto, Ontario |
| **DATE OF HEARING:** | January 14, 2009 |
| **REASONS FOR JUDGMENT BY:** | SHARLOW J.A. |
| **CONCURRED IN BY:** | NADON J.A.<br>PELLETIER J.A. |
| **DATED:** | February 10, 2009 |

**APPEARANCES:**

| | |
|---|---|
| Richard van Banning | FOR THE APPELLANT |
| Margaret J. Nott | FOR THE RESPONDENT |

**SOLICITORS OF RECORD:**

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| Toronto, Ontario | |
| John H. Sims, Q.C.<br>Deputy Attorney General of Canada | FOR THE RESPONDENT |

**FEDERAL COURT OF APPEAL**

**NAMES OF COUNSEL AND SOLICITORS OF RECORD**

| | |
|---|---|
| **DOCKET:** | A-70-08 |
| **APPEAL FROM A JUDGMENT OF JUSTICE McARTHUR OF THE TAX COURT OF CANADA DATED JANUARY 23, 2008, NO. 2006-2259 (IT) G** | |
| **STYLE OF CAUSE:** | Mary Lynne Tesainer<br>v. Her Majesty the Queen |
| **PLACE OF HEARING:** | Toronto, Ontario |
| **DATE OF HEARING:** | January 14, 2009 |
| **REASONS FOR JUDGMENT BY:** | SHARLOW J.A. |
| **CONCURRED IN BY:** | NADON J.A.<br>PELLETIER J.A. |
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