Date: 20070919

Dockets: A-295-06
A-296-06
A-297-06
A-298-06

Citation: 2007 FCA 294

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

BETWEEN:

A-295-06

SERAFINO SPEZZANO

Appellant

and

HER MAJESTY THE QUEEN

Respondent

BETWEEN:

A-296-06

ANTONIO SPEZZANO

Appellant

and

HER MAJESTY THE QUEEN

Respondent

BETWEEN:

A-297-06

FRANCESCO BUETI

Appellant

and

HER MAJESTY THE QUEEN

Respondent

BETWEEN:

A-298-06

VINCENZO BUETI

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Winnipeg, Manitoba, on September 12, 2007.

Judgment delivered at Ottawa, Ontario, on September 19, 2007.

REASONS FOR JUDGMENT BY: NOËL J.A.

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

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REASONS FOR JUDGMENT

NOËL J.A.

[1] These are four appeals from a decision of Miller J. of the Tax Court of Canada ("the Tax Court Judge"), who confirmed the Minister of National Revenue's ("the Minister) reassessments issued with respect to the appellants' 1995 taxation year, on the basis that, a lease termination payment which they received during that year was to be treated on an income account.

[2] The appellants maintain that the amount in question ought to have been characterized as a capital receipt and that the Tax Court Judge committed a variety of errors in holding otherwise.

[3] The four appeals were consolidated by order of this Court dated September 22, 2006 and file A-295-06 was designated as the lead file. Pursuant to this order, these reasons will be filed in Court file A-295-06 and copy thereof will be filed as reasons for judgment in the three other appeals.

RELEVANT FACTS

[4] On March 23, 1994, the four appellants acquired beneficial ownership in a property, located at 1376 Grant avenue in Winnipeg ("the property"), at a cost of $1,050,000 and assumed a mortgage with Co-Operators Life Insurance Company ("Co-Operators life"), valued at $941, 047. The property had been built to specification for a particular tenant, who was to occupy the premises under a 10 year lease.

[5] According to the appellants, the property was acquired as a long-term, bond like investment with one sole triple-A tenant, Co-Operators General Insurance Company ("Co-Operators General" or "the tenant"). Co-Operators General paid $15.00 per square foot rent under a 10 year lease of which two years had passed. The tenant was also responsible for paying all the costs of operating and maintaining the premise.

[6] By letter dated July 8, 1994, the appellants were advised that Co-Operators General had entered into a conditional sublease agreement with an entity called Ranger Unicity. The

letter sought the approval of the landlords. This was the first indication that the appellants had that their tenant wished to leave.

[7] By letter dated July 14, 1994, before the appellants could respond to the request for the sublease, Co-Operators General presented an offer to terminate the lease.

[8] On July 21, 1994, Francesco Bueti acting for himself and the other appellants refused both offers. The appellants did not consent to the sublease because they did not view Ranger Unicity as a quality tenant, the rental value was lower than the existing rent, they were concerned about lowering the value of the building and the fact that considerable renovations would be necessary to accommodate the new tenant, although Co-Operators General would have been responsible for the necessary changes.

[9] With respect to the offer to terminate the lease, the appellants responded with a counter-offer, according to which they would surrender the head lease on payment of $1,015,941. Mr. Bueti's letter characterized the payment as the "net tenant commitment" outstanding under the lease. The amount was calculated based on the amount of minimum rent, additional rent, property tax and utilities owing under the lease, less an amount allowed for sub-tenant recoveries. This counter-offer was not accepted.

[10] On September 16, 1994 the tenant attempted once again, unsuccessfully, to obtain the appellants' consent to the sublease.

[11] On October 5, 1994, the appellants and tenant entered into a settlement agreement, which required Co-Operators General to pay rent and perform all other obligations under the lease until December 31, 1994 and to pay $500,000 to the landlord on or before December 31, 1994.

[12] However, the October 5, 1994 settlement did not proceed as the mortgagee (the tenant's sister company, Co-Operators Life Insurance) requested that the termination payment be paid to it rather than to the appellants. The mortgagee made this request relying on an assignment of rents agreement which gave it a security interest in all rents and other monies (collectively referred to as "Rental Income") due under the lease.

[13] Around this time, the appellants looked into the possibility of selling the building. They received a purchase offer of $825, 000 but an environmental report derailed the offer and so, a second offer was made for $750,000. This offer was accepted by the appellants subject to the condition that they obtain an acceptable lease termination payment from Co-operators General.

[14] This occurred on August 31, 1995, at which time the appellants agreed with Co-Operators General and the mortgagee, Co-operators Life, to a termination of the lease, effective September 30, 1995 as follows:

> 2. In consideration of termination of the Lease effective September 30, 1995, the Tenant covenants and agrees:
>
> > (a) to pay the sum of Seven Hundred and Sixty-Two Thousand Five Hundred Dollars ($762,500.00) Dollars (plus applicable GST) to the landlord on the 30th September 1995 and

> (b) subject to paragraph 3 thereof, to pay minimum rental pursuant to Article 3.00 of the Lease and Operating Costs pursuant to Article 4.00 of the Lease during the period August 31, 1995 to September 30, 1995 as if the Lease was in full force and effect
>
> And in accordance with the Mortgage and the Assignment, the Landlord hereby irrevocably authorizes and directs the Tenant to make payment of $762,500.00 directly to the mortgagee and all such payments shall for all purposes hereof constitute payment to the landlord

[15] Mr. Dabolins, who acted as leasing agent for Co-Operators General, testified that from the perspective of his client, the purpose of the payment was to reduce the tenant's obligation in terms of rent and operating costs and property costs.

[16] The sale of the property took place for the agreed amount of $750,000. Thereby triggering a $300,000 loss on the property which the appellants had purchased a year earlier for $1,050,000.

[17] In filing their tax return for their 1995 taxation year, the appellants reported their share of the capital loss and took the position that their respective portion of the lease termination payment was a capital receipt. The Minister subsequently issued reassessments whereby the appellants' share of the termination payment was added to their income.

[18] Upon the appellants challenging these reassessments before the Tax Court of Canada, the Minister's reassessments were confirmed.

TAX COURT OF CANADA DECISION

[19] The Tax Court Judge identified the issue at hand as being the correct characterization of the lease cancellation payment made in September 1995 (Reasons, para. 10). Applying the *surrogatum* principle (*Tsiaprailis v. Canada*, [2005] 1 S.C.R. 113, para. 7), he concluded that the tenant's purpose in making the payment was to relieve itself of its obligation to pay the outstanding rent through the life of the lease (Reasons, para. 18). Similarly, he found that the appellants' purpose in accepting this payment was to recover the rent they were having to forgo (Reasons, para. 27).

[20] The Tax Court Judge accepted that the termination of the lease had a negative impact on the value of the property. However, he rejected the appellant's contention that the purpose of the payment was to compensate for this decrease in value. There was no evidence to suggest that the compensation was based on the reduced value of a building. Further, there was no link between the payment and the reduced value (Reasons, para. 18).

[21] At the end of his reasons, the Tax Court Judge asked whether the effect of the payment (as opposed to its purpose) might not have been, in part, compensation for the reduced value of the property. He said (Reasons, para. 19):

> I floated one possible scenario to both counsel, and that was that, in accordance with the idea of two effects to the payment, would either side consider the possibility that $300,000 of the payment is attributable to capital, as it restored the value of the property to its fair market value as a single-tenant occupied building, with the balance to income as compensation for forgone rent. Neither side bit on what I thought was a logical supportable resolution and I will, therefore, not pursue this further, but will decide on the all-or-nothing approach demanded by both sides.

[22] The Tax Court Judge went on to reject the four appeals with one set of costs.

ALLEGED ERRORS IN DECISION UNDER APPEAL

[23] The appellants submit that the long term lease was a capital asset. It follows in their view that the payment which they received to terminate the lease is to be treated on account of capital. They maintain that the Tax Court Judge failed to take into account the importance of the lease and its impact on the value of the property.

[24] The appellants further submit that even if a lease is not a capital asset, the decrease in the value of the building was so severe so as to significantly affect their "business structure". They rely by analogy on *Westfair Foods Ltd. v. Her Majesty the Queen* (1990) 40 F.T.R. 207 ("*Westfair Foods*"), *T. Eaton Co. Limited v. Her Majesty the Queen* [1999] 3 C.F. 123 ("*T. Eaton*"), numerous cases cited within this decision (*Commissioner of Inland Revenue v. Fleming & Co. (Machinery) Ltd.* (1951), 33 T.C. 56 ("*Fleming*"); *Pe Ben Industries Co. v. the Queen*, *London and Thames Haven Oil Wharves, Ltd. v. Attwooll*, [1967] 2 All. E.R. 124(C.A.); *Joffe v. Minister of National Revenue*, [1972] C.T.C. 2543) as well as *R. Reusse Constrution Co. Ltd. v. Her Majesty the Queen* (1999), 99 D.T.C. 823 (T.C.C) ("*R.* Reusse") and *Farb Investments Limited v. M.N.R.* [1985] 58 D.T.C. 91.

[25] In the alternative, the appellants ask that this Court give effect to the Tax Court Judge's suggestion at the conclusion of his reasons (para. 19) that part of the payment (i.e., $300,000) could be treated on capital account.

ANALYSIS AND DECISION

[26] The appeal cannot succeed. While there are a variety of circumstances where a long term lease will be viewed as a capital asset in the hands of lessee, I am aware of no case where a lease was given this characterization from the perspective of the landlord.

[27] The capital asset which the appellants purchased back in 1994 is the income producing property. It is true that the lease in place at that time provided for an income stream throughout the life of the lease. However, income producing asset was the property and not the lease.

[28] I can see no error in the Tax Court Judge's conclusion that the sole capital asset acquired by the appellants was the building and that the long term lease was but a means of exploiting that asset (Reasons, para. 11).

[29] Nor can I detect any error in the Tax Court Judge's conclusion that the payment in issue was intended to replace rents otherwise payable under the long term lease. As was stated by the Supreme Court in *Tsiaprailis v. Canada* [2005] 1 S.C.R. 113, para. 7:

> [i]n assessing whether the monies will be taxable, we must look to the nature and purpose of the payment to determine what it is intended to replace. The inquiry is a factual one. The tax consequences of the damage and settlement payment is then determined according to this characterization. In other words, the tax treatment of the item will depend on what the amount is intended to replace. The approach is known as the *surrogatum* principle.

[30] Tax Court Judge correctly identified and applied this principle (Reasons, paras. 15 and 18). His conclusion, "that the lease cancellation payment was a payment replacing the rent commitment

under the lease", is a finding of fact, which cannot be overturned absent a palpable or overriding error (*Housen v. Nikolaisen* [2002] 2 S.C.R. 235).

[31] In coming to this conclusion, the Tax Court Judge considered four factors to be particularly persuasive:

> 1) The Appellants' response of July 21, 1994 to the tenant's counsel, calculating the tenant commitments, being primarily rent, less subtenant recoveries and seeking such amount as compensation for the surrender of the lease;
>
> 2) Mr. Dabilons' testimony that Co-Operators General was not concerned with the value of the building, but simply to get out from under the lease paying as little as possible;
>
> 3) The lease termination agreement itself which makes no mention of any money being paid on account of capital; and
>
> 4) The Assignment of Rents agreement with Co-Operators Life entitling Co-Operators Life to receive money that is on account of rent under the lease. Pursuant to such agreement, Co-Operators Life received the full amount of the payment
>
> (Reasons, para. 15)

[32] In my view, the Tax Court Judge was on solid grounds in identifying the purpose of the payment as he did. The lease reflects no particular provision making the tenant responsible for a loss in value of the rented property or providing for compensation in the event of such a loss. The tenant's fundamental obligation under the lease was to pay the rent throughout the life of the lease. On the other hand, it could terminate the lease by paying the rents which would have accrued over the life of the lease, less a proper adjustment, to account for the early payment. This is what it did in this instance.

[33] The extensive case law relied upon by the appellants in support of their view that the payment was intended to compensate for the crippling effect of the early termination on their property is of no assistance because even if I was to assume the appellants' property was permanently damaged, the Tax Court Judge found as a fact that the purpose of the payment was intended to compensate something else, i.e., the outstanding rents.

[34] Finally, the appellants ask that this Court consider attributing part of the termination payment to capital as suggested by the Tax Court Judge at the end of his reasons. In making this suggestion, the Tax Court Judge focussed on the effect of the payment, as opposed to its purpose, and reasoned that part thereof ($300,000) although intended to replace the rent commitment may be looked upon as having "… restored the value of the property to its fair market value …" (Reasons, para. 19).

[35] As noted earlier, the *surrogatum* principle places the focus on "the nature and purpose of the payment to determine what it is intended to replace" (*Tsiaprailis, supra*, para. 7). It does not hinge on the effect of the payment. In this case, the Tax Court Judge found that the purpose of the payment was to compensate for the loss rents from the perspective of both the appellants and the tenant. In my view, there is no basis in law for apportioning to payment on some other basis.

[36] I would dismiss the four appeals with one set of costs in file A-295-06.

"Marc Noël"

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

DOCKETS:	A-295-06, A-296-06, A-297-06, A-298-06

(APPEAL FROM AN ORDER OF TAX COURT OF CANADA DATED JUNE 5, 2006, DOCKET NO. 2004-3487 (IT)G)

STYLE OF CAUSE:

SERAFINO SPEZZANO v. HER MAJESTY THE QUEEN (A-295-06)
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PLACE OF HEARING:	Winnipeg, Manitoba
DATE OF HEARING:	September 12, 2007
REASONS FOR JUDGMENT BY:	NOËL J.A.
CONCURRED IN BY:	NADON J.A. PELLETIER J.A.
DATED:	September 19, 2007

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