Docket: 2013-225(IT)G
2013-2420(IT)G

BETWEEN:

ANGELO PALETTA,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

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Appeals heard on March 11-22, 2019 at Toronto, Ontario, May 28-31, 2019 at Vancouver, British Columbia, June 3, 2019 at San Jose, California, June 5-6, 2019 at Los Angeles, California, and June 10-12, 2019 at Vancouver, British Columbia.

Before: The Honourable Justice Robert J. Hogan

Appearances:

| | |
|---|---|
| Counsel for the Appellant: | David R. Davies<br>Alexander Demner<br>Vivian **Esper** |
| Counsel for the Respondent: | Charles M. Camirand<br>Nicole Levasseur |

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## **AMENDED** JUDGMENT

The Appellants' appeals are allowed in part only and the assessments are referred back to the Minister for reconsideration and reassessment in accordance with the attached Reasons for Judgment.

The parties will have until October 21, 2019 to arrive at an agreement for costs, failing which they must file written submissions on costs no later than October 21, 2019. Such submissions are not to exceed ten pages.

Signed at **Ottawa**, **Canada**, this **7th** day of October 2019.

"Robert Hogan"

Hogan J.

Docket: 2013-4837(IT)G

BETWEEN:

PALETTA INTERNATIONAL CORPORATION,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

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Hogan J.

Citation: 2019 TCC 205
Date: October **7**, 2019
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Docket: 2013-4837(IT)G

AND BETWEEN:

PALETTA INTERNATIONAL CORPORATION,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

## **AMENDED** REASONS FOR JUDGMENT

Hogan J.

## I. Overview

[1] These appeals concern a complex series of transactions purportedly designed to finance investments in Hollywood film productions. The Appellants characterize these transactions as bona fide investments made as part of an overall strategy to break into the film industry in a big way. The Respondent characterizes those same transactions as nothing more than shams and/or tax shelters.

[2] The transactions are explained in more depth below. The following provides an overview of the structure, using the 2006 investment as a guide.

[3] In 2006, Paletta International invested US$8,013,895 cash in the Six Iron Productions Limited Partnership ("Six Iron Partnership") to finance the alleged acquisition of a recently produced film entitled "Night at the Museum" ("Six Iron Film"). The film was produced for and on behalf of Twentieth Century Fox Film Corporation ("Fox"), which allegedly sold it to the Six Iron Partnership for US$128,310,000 through a complex series of transactions described below. As part of the transactions, the Six Iron Partnership signed a distribution agreement ("Distribution Agreement") with Fox and agreed to bear an amount of US$82,000,000 for the prints and advertising expenses ("P&A expenses") with respect to the film.

[4] Fox, or an affiliate, had the right to reacquire the film under a series of option agreements ("Option Agreements") prior to, or within five days following the commercial release of the film. The option price was essentially the cost of the film, plus the P&A expenses allegedly incurred by the Partnership, less 3% of the P&A expenses. The options were allegedly exercisable at the option holder's sole discretion. Fox, through its affiliate, exercised the options and reacquired the film prior to its commercial release. This series of transactions led to the dissolution of the Six Iron Partnership.

[5] The Six Iron Partnership reported a non-capital loss of US$82,763,192 for the P&A expenses, and Paletta International, as the sole limited partner, claimed the lion's share of that amount. In total, Paletta International reported a loss of US$96,109,415 from the Partnership.[1] Paletta International also reported a capital gain from the disposition of its partnership units and took advantage of the 5-year capital gains reserve. It further claimed other financing charges and expenses in connection with its investment in the Partnership.

[6] A few years later, Angelo Paletta, along with other members of his family, invested in the Swilcan Bridge Productions Limited Partnership ("Swilcan Partnership"). This Partnership allegedly acquired a second picture from Fox entitled "The Day the Earth Stood Still" ("Swilcan Film"). Like the Six Iron Partnership, the Swilcan Partnership also disposed of the film prior to its commercial release and realized a significant loss from the P&A expenses. Angelo

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1 Exhibit A1, volume 8, tab 160, page 11; see also Exhibit A1, volume 5, tab 75, page 105.

Paletta deducted his share of the loss, as well as other expenses that were allegedly incurred.

[7] The parties acknowledge that the Swilcan transactions are, in their entirety, virtually identical to the Six Iron transactions. I therefore refer almost exclusively to the Six Iron transactions in this judgment, and my reasons should be taken to extend to the Swilcan transactions as well. I will reference the Swilcan transactions to make necessary clarifications to point out any differences.

[8] The Minister of National Revenue ("Minister") disallowed all of the losses and other expenses claimed by the Appellants in respect of their investments in the partnerships on the grounds that:

i) some of the transactions entered into by the parties were a sham;

ii) the partnership interests acquired by the Appellants were unregistered "tax shelters";

iii) the partnerships were not validly created;

iv) the partnerships' acquisitions of the films were ineffective; and

v) the Appellants realized business income rather than capital gains from the disposition of their partnership interests.

[9] I will consider issues (iii) to (v) only if I dispose of the first two issues in favour of the Appellants.

[10] There are two subsidiary issues, one per appeal. In the Paletta International appeal - and this is an issue unrelated to the film transactions - the Appellant, Paletta International, disputes the characterization of real estate gains realized in its 2007 taxation year. When filing its return, the Appellant, Paletta International, reported the gains on income account. It now alleges that this was done in error and that the properties were capital in nature. In the case of Mr. Paletta's appeal, Mr. Paletta carried back part of his non-capital loss to his 2005 taxation year. The Minister's denial of that carry-back occurred outside the normal reassessment period and is therefore statute-barred unless the Court finds that Mr. Paletta made a misrepresentation attributable to carelessness, neglect or wilful default.

[11] For the most part, the appeals were heard on common evidence.

[12] For the reasons that follow, with respect to the main issue, the appeals are dismissed. The parties agreed from the start that Fox would reacquire the films before their commercial release by exercising its option to acquire all of the partnership interests. Consequently, the Appellants and the partners knew that they would never generate income from the films. I find that the Option Agreements in each appeal were a sham.

[13] Paletta International's appeal is allowed with respect to two of the nine real estate dispositions. I find that the Doble/Bluffs disposition and the "eco-gift" disposition were on account of capital. The disposition of the remaining properties were on income account. The appeals are dismissed in respect of these properties.

## II. **Facts**

[14] Paletta International was created by Pasquale "Pat" Paletta, who controlled it during the years under appeal. Pat Paletta, the recently deceased patriarch of the Paletta family was widely regarded as a very successful self-made business person. Paletta International carried on several businesses during the years under appeal. These businesses included real estate and farming, as well as film and foreign exchange dealings.

[15] Pat Paletta's son, Angelo Paletta ("Mr. Paletta"), began working in Paletta International's real estate and other businesses in the late 1980s. He eventually took over the day-to-day operations of the company in the early 2000s.

[16] Messrs. Warren Nimchuk and Warren Fergus presented Mr. Paletta with an opportunity to allegedly acquire ownership of a major motion picture. The details of these film transactions are set out below.

[17] On a matter unrelated to the film transactions, Paletta International claims that it realized its accountants had misreported gains from the disposition of long-term real estate holdings as business income instead of capital gains. The facts relating to this aspect of the appeal are discussed in the relevant analysis section below.

### A. Film Transactions

[18] The series of transactions for each film deal was complex and there were many individuals and entities involved. The following is a brief summary of the relevant individuals and entities in the Six Iron transactions:

i) Studio: Fox is a large international fully integrated film studio. It was involved in each of the film transactions. Fox purportedly had discussions with Mr. Nimchuk regarding its interest in selling its copyright to certain films after production and in the lead-up to theatrical release.

ii) Lending trust ("Fintrust"): Standard Finance Trust borrowed money from the Royal Bank of Canada ("RBC") and lent it to Paletta International.

iii) Corporate Trustee for Fintrust ("Fintrustee"): 0774339 B.C. Ltd. was Fintrust's trustee in the Six Iron transactions. The parties did not call Adrian Ward, an entertainment industry leader, who was the director of 0832307 B.C. Ltd. (the Fintrustee for the Swilcan transactions).

iv) Partners of the Partnerships:

i. General Partner: Six Iron Productions Inc. and Swilcan Bridge Productions Inc. were respectively the general partners in each of the transactions. Both of these corporations were controlled by Mr. Fergus.

ii. Limited Partners: Paletta International was the limited partner in the Six Iron transactions. Angelo Paletta, along with his parents Pasquale and Anita and his brothers Remigio, Paul and Michael were the Limited Partners in the Swilcan transactions.

v) Option-Holding Companies: In both transactions, Fox entered into secondary option agreements with related parties, through which Fox transferred the option granted by the partners on their partnership interest. In the Six Iron transactions, the second option agreement was with Wordsmith Inc. ("Wordsmith"),[2] which was a wholly owned subsidiary of Fox. Wordsmith then assigned its interest in the film by

[2] Wordsmith is also referred to as Optionco in the transaction documents.

transferring the option to its Canadian subsidiary, Faultline Productions Inc. ("Faultline").[3]

vi) Warren Nimchuk: Mr. Nimchuk was a chartered accountant. During the relevant years for the transactions under appeal, he was a senior manager and then a partner at PricewaterhouseCoopers ("PwC") in the field of entertainment tax. He stated in his testimony that he started working in the film industry in the mid-90s and had worked with all of the major studios on a variety of finance and tax credit facilitations in Canada and elsewhere. From his testimony, I found that Mr. Nimchuk had a great deal of knowledge about, and experience in, the film industry, particularly in the areas of film financing and film tax planning. He was involved with engineering the tax structure and setting up the partnerships. The Appellants admit that Mr. Nimchuk structured the film transactions in consultation with Mr. Fergus. Mr. Nimchuk also negotiated the contracts, including the copyright purchase price, the P&A expenses, the option price and the distribution fees, with Fox. Mr. Nimchuk himself testified that his role in these transactions was to assist the studio to sell the copyright in the films to a partnership.

vii) Warren Fergus: Mr. Fergus was a former chartered accountant. Mr. Fergus had a history in film financing. He was the director of the general partner in each of the film transactions. Mr. Fergus and Mr. Nimchuk together created and marketed to the Appellants the tax structure at issue.

viii) Isaac Tamssot: Mr. Tamssot was the director of the Fintrustee in the Six Iron transactions. During the time of these transactions, in 2006, Mr. Tamssot worked as an investment advisor at CIBC, a role that he had held since 1998. In this position, Mr. Tamssot was responsible for meeting with high-net-worth and sometimes ultra-high-net-worth individuals to provide financial planning and investment planning advice. Mr. Tamssot testified that he became involved in the Six Iron transactions through his connection with Mr. Fergus – Mr. Tamssot's brother had gone to school with Mr. Fergus and they had remained close friends.

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3 Fault line is also referred to as OptioncoCda in the transaction documents.

[19] Following the flow of funds in the transactions makes it clear that the cash flow was circular. The transactions are described in detail below. However, to summarize, the flow of funds occurred as follows:

i) Fintrust obtains a loan from RBC (“Daylight Loan”);

ii) Fintrust loans the Daylight Loan funds to the partners;

iii) The partners use the Daylight Loan funds, plus their own additional cash, to purchase the partnership units;

iv) The partnerships then direct the Daylight Loan funds to be paid to Fox as payment of both the purchase price of the copyright and the P&A expenses;

v) Fox receives part of the Appellant Paletta International’s proceeds as payments of the fee;

vi) Fox directs that the Daylight Loan funds be paid to Fintrust; and

vii) Fintrust directs that the Daylight Loan funds be repaid to RBC.

[20] Additionally, Fox allegedly paid the partnerships an advance in respect of Australian receipts; meanwhile, the Appellant Paletta International’s cash investment in the partnerships is used to pay Fox an amount equal to 3% of the P&A expenses and to pay fees to the promoters of the transactions.

[21] The essential transactions and documents for the Six Iron transactions are explained in detail below:

(1) Daylight Loan

[22] The Six Iron Fintrust borrowed US$212,000,000 from RBC under the Daylight Loan. This initial advance from RBC had a structuring fee of 0.1285%, which was payable at closing.[4]

[23] RBC complied with its own internal policies and guidelines in providing the Daylight Loan. However, in the internal RBC document, RBC’s employee made notations stating, “[a]lthough the transaction is not labelled by the tax lawyers as a

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4 Exhibit A1, volume 6, tab 84, page 47.

'tax shelter', it does present significant tax benefits to the investor",[5] as well as the "taxing authorities will likely view this as aggressive tax planning."[6]

[24] As security for the Daylight Loan, Fintrust provided to RBC a promissory note for the full amount of the loan. This note was later cancelled once the Daylight Loan was repaid.

[25] The Daylight Loan was repaid by Fintrust using funds it received as a loan from Fox.

(2) Loan from Fintrust to Paletta International

[26] Fintrust then loaned the US$212,000,000, which it had borrowed from RBC, to Paletta International ("Fintrust/Paletta International Loan"). On an outstanding principal amount of US$175,000,000 or more, Paletta International was required to pay 9.5% interest per annum. Once the principal dropped below US$175,000,000, the interest rate was lowered to 5% per annum.

[27] Under this loan, Paletta International was also required to pay a credit facility fee of US$2,500,000 and a foreign exchange fee of US$3,305,753, both of which were partially or fully capitalized and added to the principal borrowings and were interest-bearing. Additionally, if Paletta International wanted to have the ability to prepay the loan, it was subject to a one-time prepayment fee in the amount of US$2,650,000, which was payable within 180 days following the advance of the loan funds. This amount would also be capitalized and added to the principal of the loan and would bear interest.

[28] The interest on the loan would accrue for 10 years, at which point Paletta International was require to pay all of the accrued and unpaid interest in full.

[29] Paletta International was obligated to provide Fintrust with a "Collateral Security Agreement" along with the original unit certificates issued by the partnership as security.

5 Exhibit A1, volume 6, tab 84, page 40.
6 Exhibit A1, volume 6, tab 84, page 41.

(3) Partnerships

[30] The Six Iron Partnership was purportedly created to acquire, exploit and monetize the rights to the Six Iron Film. It was initially created on November 17, 2006, with Six Iron Productions Inc. as the general partner. The original limited partner was an entity the sole shareholder and director of which was Mr. Fergus. This entity was replaced by Paletta International when it invested in the Six Iron transactions. Thus, Paletta International became the sole limited partner.

[31] Pursuant to the Limited Partnership Agreement,[7] the business of the Six Iron Partnership was limited to purchasing the film, entering into a distribution agreement whereby Fox would exploit the film, promoting the film and paying the costs associated therewith, as well as lending excess funds of the Partnership to such parties as the general partner decided.

[32] To finance its investment, Paletta International used the US$212,000,000 that it had borrowed from Fintrust plus an additional US$6,121,475 of its own cash resources to subscribe for Class B units of the Six Iron Partnership. Thus, the aggregate subscription price for Paletta International's units of the Six Iron Partnership was US$218,121,475.

[33] Paletta International's total cash investment in the Six Iron deal was in the amount of US$8,013,895. It provided this amount to the Six Iron Partnership for the balance of the acquisition price of the partnership units and for financing fees payable by Paletta International to Fintrust.

[34] The Six Iron Partnership used the subscription proceeds to purchase the film and pay the P&A expenses. The Partnership had US$7,811,475 remaining plus the US$1,000,000 Australian advance (discussed below). The Partnership directed these funds to be used, in part, for paying Fintrust and paying Fox upon closing. The Six Iron Partnership retained the remainder of the funds to pay other partnership expenses.

[35] The Swilcan Partnership was purportedly created to acquire, exploit and monetize the rights to the Swilcan Film. Mr. Paletta was one of the limited partners and Swilcan Bridge Productions Inc. was the general partner. In similar fashion to

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7 Exhibit A1, volume 2, tab G01, Limited Partnership Agreement.

what was done in the Six Iron Partnership, the Swilcan partners used their own cash resources and a loan from Fintrust to subscribe for the partnership units.

[36] The film transactions were materially identical for both the Six Iron Partnership and the Swilcan Partnership (together the “Partnerships”). I will mostly refer to the film and parties involved in the Six Iron transactions. Unless otherwise stated, my findings in respect of the Six Iron Partnership will apply equally to the Swilcan Partnership.

[37] Pursuant to the Limited Partnership Agreement, the general partner is entitled to a reasonable fee as compensation for the services provided and is also responsible for paying all of the operating expenses of the partnership.

(4) Kagan Media Appraisals

[38] Kagan Media Appraisals (“Kagan”) is a company that specializes in film cash flow projections. Kagan was retained to prepare cash flow projections (“Kagan Report”) for the films. According to the Appellants, a satisfactory Kagan Report was a condition of closing.

[39] According to Mr. Derek Baine, a long-time employee of Kagan, Mr. Nimchuk commissioned the Kagan Reports for both transactions. The Appellants were never in contact with Kagan.

[40] Kagan has a proprietary database of motion picture information. This database includes items such as film budgets, genres and P&A expenses.

[41] Mr. Baine testified that, at the time of the Kagan Reports, his colleague Mr. Wade Holden was responsible for extrapolating the required numbers and information from Kagan’s database. Mr. Baine would order the numbers from Mr. Holden and then spend approximately one hour preparing the Kagan Report. Mr. Baine testified that, in preparing the Kagan Report, they primarily looked at budget, talent and genre with respect to the film. Kagan would not ask to view the film in order to prepare the report.

[42] From Mr. Baine’s testimony it became clear that the Kagan Report was merely a cash flow projection of how a film could do, based on the average success of films that had comparable budgets. This report was not at all a valuation of the film or an indication of its potential success. He stated that the report was not an indication of the investor’s rate of return.

[43] In preparing a valuation, he would ascertain the cost of capital, create discounted cash flows and discounted gross profits and losses and add the terminal value for the film. Mr. Baine stated, however, that a full valuation of a film would be more elaborate.

[44] Here, the cash flow projections were not discounted. However, Mr. Baine testified that, since all of the expenses for the film had been included in the calculations, even if the amounts in the cash flow projections had been discounted, the ventures would still be profitable for the Appellants.

[45] Additionally, Mr. Baine testified that he was not provided with the investment information package or the distribution agreement as part of his preparation materials. Essentially, it appeared that the only information that he was provided with was the budget, the P&A expenses and the genre. The cast was not considered when conducting the analysis here.

(5) Purchase and Sale of Copyright

[46] On November 21, 2006, Fox transferred the copyright and all rights in the Six Iron Film to its subsidiary, TX Productions Inc. ("TXP").[8]

[47] Also on November 21, 2006 ("Six Iron Closing Date"),[9] the Six Iron Partnership allegedly purchased the worldwide perpetual copyright from TXP.[10] The Six Iron Partnership paid US$128,310,000 for the film. It paid this amount using the subscription proceeds.

[48] Under the sale agreement, TXP provided representations and warranties that it validly owned the copyright to the film, free and clear of any encumbrances. Fox guaranteed TXP's representations and warranties.

(6) Distribution Agreement

[49] As part of the series of transactions, the Appellants and Fox entered into a Distribution & Other Rights Acquisition Agreement ("Distribution Agreement")

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8 Exhibit A1, volume 1, tab A01a, Assignment of Rights.
9 August 25, 2008 for the Swilcan transactions ("Swilcan Closing Date").
10 Exhibit A1, volume 1, tab A01, Purchase and Assignment of Rights Agreement.

on each closing date.[11] Pursuant to this agreement, the Partnerships grant Fox the rights to exploit the film on behalf of the Partnerships as the exclusive worldwide distributor for a term of 15 years. Fox is granted exclusive and unqualified discretion as to the time, manner and terms of distributing, exhibiting and exploiting the films.

[50] Fox is able to collect all royalties, fees and other revenues that the Partnerships would otherwise be entitled to collect. Pursuant to the Distribution Agreement, the Partnerships do not have the ability to make separate claims or to collect any of the copyright revenues.

[51] In the Six Iron transactions, following its acquisition of the film, Fox was obligated to spend a minimum of US$92,000,000 for "Distribution Expenses" in connection with the theatrical distribution of the film ("Fox's P&A Commitment"). Distribution Expenses are defined in the documents as the aggregate of the "Distribution Costs"[12], the distribution expenses for home video and on-demand reproduction materials, as well as the subdistributor distribution costs. The distribution and exploitation provision effectively transfers to the copyright owners (i.e., the Partnerships) liability for costs which are typically included in distribution expenses.

[52] Under its Distribution Agreement, the Six Iron Partnership agrees to incur US$82,000,000 in P&A expenses in the lead-up to the release of the film. The Six Iron Partnership paid this amount using the subscription proceeds. Each partnership claimed its P&A expenses in full and allocated that amount to its partners as a loss for its initial fiscal period.

[53] The Distribution Agreement also sets out the terms governing how payments from Fox are to be made to the Partnerships. Section 12 of the agreement states that Fox shall pay the Partnerships the amount of "Gross Receipts"[13] after

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[11] Exhibit A1, volume 1, tab A03, Distribution & Other Rights Acquisition Agreement.

[12] Defined as Fox's costs incurred in connection with the "Defined Gross Receipts," including the following: conversion/transmission of money; taxes; "checking costs" (checking attendance, box office reports and accounting statements); collection costs associated with the collection of money included in Defined Gross Receipts (including lawyer/auditor costs); trade association fees; guild payments (employer fringe benefits) and advertising costs.

[13] "Gross Receipts" is defined as all amounts (exclusive of sales, admissions and valued added taxes) that are actually received by Fox or its subsidiaries from distributing the film.

deducting the “Distribution Fees” and the “Release Costs”. The “Distribution Fees” are defined as being various rates that Fox shall be entitled to retain as its fee for distributing the film. The “Release Costs” are defined as meaning “Distribution Expenses”[14], except that the advertising administrative fee is to be based on 15% of costs instead of 10% of costs. Importantly, section 12 also provides that while Fox’s obligation to pay the Partnerships arises as and when any “Gross Receipts” are earned, Fox may defer the payment until May 31, 2007. Fox may also further defer payment if the Partnerships are in breach of any terms of the agreement or any other agreement entered into with Fox in respect of the film.

[54] Section 12A of the Distribution Agreement provides that the Partnerships are to earn US$1,000,000 as a non-recoupable advance for the Partnerships’ share of home video receipts from Australia. Mr. Nimchuk testified that he negotiated this fee with Fox to ensure that Australia would not be ignored with respect to distribution expenses. Mr. Fergus also testified that, since distributions occur over an extended period of time, this fee was intended to ensure that Fox would remain engaged in the worldwide distribution of the film.

(7) <u>Option Agreements</u>

[55] As a condition of the Six Iron transactions, Fox required the partners to grant it an option to acquire their units of the Six Iron Partnership (“Option 1”). According to Mr. Nimchuk, Fox was adamant about incorporating the option into the deal.

[56] Under the Option Agreement,[15] the price payable for the option, if the option was exercised, was US$218,093,121. Mr. Nimchuk testified that he negotiated this amount with Fox.

[57] Option 1 in the Six Iron transactions expired on the earlier of December 25, 2006 or five days after the theatrical release of the film.

[58] Under Option 1, the Partnerships were required to grant Fox a first-ranking mortgage and security interest in respect of their assets.

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[14] Exhibit A1, volume 1, tab A03, paragraph 12(b).
[15] Exhibit A1, volume 1, tab A05, Option Agreement.

[59] Fox then assigned its option to acquire the partnership units. In the case of the Six Iron transactions under the "Assignment and Option Agreement[16]" Fox assigned Option 1 to Wordsmith. In return, Wordsmith granted an irrevocable option back to Fox ("Option 2"), which allowed Fox to acquire the Six Iron Partnership's interest in the film upon Wordsmith exercising Option 1. In consideration of Option 2, Fox was required to pay US$214,521,000 to Wordsmith. The assignment agreement provided that if Fox exercised Option 2 Wordsmith would be required to exercise Option 1. Wordsmith agreed that upon Fox assigning Option 1 to it, Wordsmith would assume all of Fox's obligations under the Option Agreement. Wordsmith also agreed to deliver to the Partners a second-ranking security agreement containing a security interest with respect to all of its present and after-acquired property as security for its payment of the option price if it exercised Option 1. Additionally, as security for their obligations to Wordsmith (as the assignee of Fox), the partners were required to cause the Six Iron Partnership to grant to Wordsmith a second-ranking security (subject to the first-ranking security granted to Fox) providing a security interest in respect of all of the Six Iron Partnership's present and after-acquired personal property.

[60] Wordsmith later assigned Option 1 to Faultline, which also assumed the obligations of Wordsmith. Through the delivery of a promissory note, Faultline paid Wordsmith US$2,430,000 in order to acquire Wordsmith's rights and interests.

[61] The Appellant provided evidence and arguments in the hope of demonstrating that, at the time of closing, Fox had given no assurances or indications that it would exercise its option.

(8) Loan from Partnership to Fintrust

[62] The Partnerships and Fintrust entered into the Partnership/Fintrust Loan Agreement ("Partnership/Fintrust Loan").[17] From their remaining subscription proceeds, the Partnerships loaned US$6,000,000 to Fintrust. The agreement indicates that this loan was made to allow Fintrust to repay the Daylight Loan from RBC. Mr. Nimchuk tried to convince the Court that the structure was created with room for excess funds, such as this $6,000,000, in order to provide resources for

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[16] Exhibit A1, volume 1, tab A14, Assignment and Option Agreement.

[17] Exhibit A1, volume 2, tab D01, Partnership/Fintrust Loan Agreement.

marketing costs after the film had been released. He alleged in this regard that the Partnerships had always intended to retain ownership of the films.

[63] The loan was advanced on the closing date and was to be repaid either on the tenth closing date anniversary or at the Partnerships' demand. The interest rate on the loan was 9.5% per annum.

(9) Loan from Fox to Fintrust

[64] On the closing date, Fox and Fintrust entered into the Distributor/Fintrust Loan Agreement ("Fox/Fintrust Loan").[18] As regards the Six Iron transactions under this agreement Fox agreed to provide a credit facility to Fintrust in the amount of US$206,850,000. According to the agreement, this credit facility was made available partly to allow Fintrust to repay the Daylight Loan. The 5% per annum interest rate on the loan was to be paid on each closing date anniversary for 10 years, at which point all accrued and unpaid interest was to be paid in full.

[65] An important feature of this loan is that repayment in full of the loan was to be made at the earlier of the tenth closing date anniversary or at Fox's demand.

(10) Security Agreements

(a) *Partnership/Fox Security Agreement*[19]

[66] This Partnership/Distributor Security Agreement ("Partnership/Fox Security Agreement") is between Fox as the secured party and the Six Iron Partnership. Here, the Six Iron Partnership and its general partner agreed to grant Fox a security interest in certain collateral in consideration of Fox entering into the Distribution Agreement, the Option Agreement, the Assignment and Option Agreement, and the Fox/Fintrust Loan Agreement ("Transaction Documents").

[67] As collateral, the general partner and the Six Iron Partnership granted a fixed and floating charge to Fox over all of their present and after-acquired personal property. The collateral includes the Six Iron Partnership's property (including all rights to the film) and all accounts receivable (including all amounts that are due or

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[18] Exhibit A1, volume 1, tab C01, Distributor/Fintrust Loan Agreement.
[19] Exhibit A1, volume 1, tab A06, Partnership/Distributor Security Agreement.

owing to the partnership). The collateral also includes all proceeds from any of the other collateral property. The general partner also provided a security interest in its interest in the Six Iron Partnership.

[68] The security granted under this agreement had to be at all times a first-ranking priority charge.

[69] Under section 8 of the agreement, Fox could collect the accounts receivable "in such manner, upon such terms and conditions and at such time or times, whether before or after default, as may seem to it advisable and without notice to Partnership".[20] This provision also requires that all monies collected or received by the partnership from any accounts receivable be held in trust for Fox and immediately paid to Fox. Importantly, the provision also states that "all moneys collected or received by [Fox] in respect of the Accounts Receivable or other Collateral <u>may be applied</u> on account of such parts of the indebtedness and liability of Partnership to [Fox] as [Fox] deems best."[21]

[70] Section 11 of the agreement lists the events constituting default which include default by the Six Iron Partnership, any of the partners, Fintrust, Wordsmith or Faultline under any of the Transaction Documents. Pursuant to a "Pledge of Copyright Transfer Documents"[22] the general partner and the Six Iron Partnership are required to attach to the pledge document two undated assignment documents and to authorize Fox to complete the documents in the event of any default under section 11 of the Partnership/Distributor Security Agreement. However, Mr. Nimchuk stated that the pledge document was put in place to effect the transfer of the copyright if Fox chose to exercise the option.

(b) *Partners/Fox Security Agreement*[23]

[71] The Partners/Distributor Security Agreement ("Partners/Fox Security") is between the general and limited partners of the Six iron Partnership and Fox. Under the agreement, the partners grant Fox a security interest in each partner's

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[20] Exhibit A1, volume 1, tab A06, Partnership/Distributor Security Agreement, section 8 emphasis added.

[21] Exhibit A1, volume 1, tab A06, Partnership/Distributor Security Agreement, section 8 emphasis added.

[22] Exhibit A1, volume 1, tab A09, Pledge of Copyright Transfer Documents.

[23] Exhibit A1, volume 1, tab A10, Partners/Distributor Security Agreement.

rights to and interest in the Six Iron Partnership. The “security interest” includes any interest in the partnership units, the film, the Distribution Agreement, the Transaction Agreements[24] (or any agreements referred to therein), and the income and rights accruing to each partner as a holder of the partnership units.

[72] The security interest under this agreement is in addition to, and not in substitution for, any other security interests granted to Fox. Furthermore, except for the “Permitted Encumbrances” in Schedule B of the agreement, the security interest granted under the agreement must at all times be first in priority. Unless Fox provides written consent, no additional security interest can be granted which does or could rank *pari passu* with any security interest created by the agreement.

[73] Section 8 states that in the event of a default under the agreement or a breach under the Option Agreement or the Assignment and Option Agreement, all distributions on account of the partnership units owned by a partner will be applied to the obligations of that partner to Fox. Additionally, any proceeds received by the partner in respect of the partnership units will be added to and form part of the collateral.

[74] Section 9.1 of the agreement enables Fox to “receive any increase in profits on the Collateral” regardless of whether default has occurred.

[75] Finally, section 10 of the agreement states that all amounts collected or received by Fox will be applied on account of the partners’ indebtedness in the manner that Fox deems best or, at the option of Fox, such amounts may be held unappropriated in a collateral account or released to the Six Iron Partnership, all without prejudice to the liability of the partners or the rights of Fox under the agreement.

(c) *Other Security Agreements*

[76] These complex transactions contained numerous other security agreements, some of which I will mention here.

[77] The November 21, 2006 Partner/Fintrust Security Agreement (“Partner/Fintrust Security”)[25] was provided as security for the loan from Fintrust

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[24] Defined as being the Distribution Agreement, the Option Agreement and the Assignment and Option Agreement.

[25] Exhibit A1, volume 1, tab B02, Partner/Fintrust Security Agreement.

to Paletta International. Under this agreement, Paletta International granted a security interest in its units in the Six Iron Partnership. Section 9 of this agreement is identical to section 9 of the Partners/Fox Security Agreement, except that the party benefiting from the security is Fintrust.

[78] In accordance with the Partnership/Fintrust Loan, Fintrust granted a security interest in all of its present and after-acquired personal property to the Six Iron Partnership under the Fintrust/Partnership Security Agreement ("Fintrust/Partnership Security Agreement").[26]

(11) Escrow Agreements

[79] To accommodate the parties exercising their options sometime after the closing dates, the parties signed on the Six Iron Closing Date certain documents consequential upon the option exercises and placed those documents in escrow ("Escrowed Documents") with Davis & Company, the law firm acting as escrow agent. The escrow terms were set out in a written document. Pursuant to this document, the Escrowed Documents were to be executed and only released from escrow in accordance with the "Conditions of Post-Closing".[27]

(12) Exercise of Options

[80] In each of the transactions, Fox exercised its option near the release date of each film. The theatrical release date for the Six Iron Film was December 22, 2006. Prior to that, on December 18, 2006, Fox exercised Option 2 for the Six Iron transactions,[28] which forced Wordsmith to exercise Option 1.[29] On the same day, the Escrowed Documents were released from escrow. The aggregate price for Option 1 was US$218,093,121 and the price payable to Paletta International for its units under Option 1 was US$218,091,000.

[81] Wordsmith then assigned to Faultline all of its interest in the underlying copyright on the film, its interest in the related agreements, and its obligation to pay the option price to the former partners of the Six Iron Partnership.

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[26] Exhibit A1, volume 2, tab D02, Fintrust/Partnership Security Agreement.
[27] Exhibit A1, volume 1, tab 2, Escrow Undertaking.
[28] Exhibit A1, volume 2, tab Y01, Notice of Exercise of Option.
[29] Exhibit A1, volume 2, tab X01, Notice of Exercise of Option.

[82] According to the Appellants, once the options were exercised, the Partnerships ceased to exist as a matter of law. The Appellants claim that time that the Partnerships realized a loss for tax purposes because of the deductibility of the P&A expenses. These losses were denied by the Minister.

(13) Defeasance Transactions

[83] As explained above, under the Fox/Fintrust Loan, Fox agreed to provide a credit facility to Fintrust in the amount of US$206,850,000.

[84] Following the exercise of Option 1 and the assignment of the obligations thereunder to Faultline, Paletta International had an amount receivable from Faultline and an amount payable to Fintrust. Both were interest-bearing.

[85] Immediately after the closing, Fintrust owed US$206,850,000 to Fox.[30] After Fox exercised Option 2, Fox owed US$214,521,000 to Faultline.

[86] Pursuant to the Assumption of Obligations Agreement,[31] Fintrust paid the outstanding amount of the Fox/Fintrust Loan (i.e.,US$206,850,000) by assuming Fox's indebtedness to Faultline (i.e.,US$214,521,000). This is where the "defeasance" occurs. Following this defeasance, Fintrust had a greater liability than it started with.

[87] The difference between the principal amount of the Fox/Fintrust loan and the Fox/Faultline debt was US$7,671,000. The Appellants submit that this can be treated as a loss or deduction. The Appellants submit that this amount almost entirely offsets Fintrust's income – being the loan fees, the credit facility fee and the foreign exchange fee – which amounts to US$8,455,753.

[88] The Appellants also submit that the Fintrusts did not have tax liabilities because the income they earned, in the form of loan fees or interest income, was offset by the loss realized in connection with the defeasance transaction.

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[30] Exhibit A1, volume 1, tab C01, Distributor/Fintrust Loan Agreement.
[31] Exhibit A1, volume 2, tab Y05, Assumption of Obligations Agreement.

III. Preliminary Issue

[89] From the outset of the trial it became clear that **one of the important questions to be determined by me was whether** Fox had pre-agreed to exercise its option to acquire the partnership interests such that there would be a return of the films to Fox**. ~~would be a central issue~~**. In short, were the options shams designed to mask the parties' pre-agreement that the films would be reacquired by Fox prior to their commercial release?

[90] During argument, the Appellants' counsel raised an issue as to whether the Respondent failed to properly allege sham in relation to the Option Agreements. I invited both counsel to address this point as a matter of procedural fairness because I planned to address the issue in my reasons. After the hearing, both parties filed additional written submissions setting out their views on the matter.

[91] In her Replies, the Respondent does not explicitly state that the options were shams. In her statement of facts, the Respondent admits the Appellant's statement that Wordsmith exercised the option. Moreover, the Respondent assumes as a fact that Fox exercised its options. By contrast, the Respondent's assumptions of fact clearly identify the Daylight Loan, the "Partners Loan Agreement", the Purchase and Assignment of Rights Agreement and the Distribution Agreement as shams. The Respondent uses the words "purported" or "purportedly" in describing the transactions she alleges to be shams.

[92] The Respondent does, however, make several assumptions about the Option Agreements. She assumes that the Appellant knew that Fox would exercise the options and that no income would be realized while the Partnerships had an interest in the films that the options were preordained to be exercised and that the films were preordained to be transferred back to Fox. The Respondent also assumes that "[t]here was never any intention by Fox or any other party to allow the [partnership] to actually own, control and exploit the Picture."[32]

[93] The Appellant initially agreed that the absence of the identification of the options as shams in the Replies did not preclude the Court from deciding the issue and that the error raised only a question of onus:

> JUSTICE: Are you saying in your review of the pleadings that the Crown missed the option in alleging sham?

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32 2013-4837(IT)G Reply, at para. 16(ddd).

> MR. DAVIES: I am, Your Honour, yes.
>
> JUSTICE: And you're saying that some of the broader allegations that they make doesn't allow the Court to consider the impact of that option agreement and whether it was a facade or not?
>
> MR. DAVIES: Well, I wouldn't go that far, but certainly to the extent that the assumptions made by the Minister placed the onus of proof on the appellants, then we have to overcome it to the extent of those assumptions, but not beyond.
>
> JUSTICE: Right, but if the Court is preoccupied by the option and impact of the option and whether it was a true option or not, you're simply saying the onus goes to the Crown at that point.
>
> MR. DAVIES: Yes. And clearly that's part of the same transactions that are at issue in this case. And I think it becomes a question of onus.33

[94] At this point, the Appellants had submitted their initial written submissions. The submissions refer to the options throughout, and in doing so they deal as well with the allegation of sham. They allege that "Fox gave no assurances or indications that it would exercise its option at the time of closing."[34] In a section titled "The Facts Related to the Alleged Sham", the Appellants state that the "option exercise was not preordained nor was the fact of the exercise made known to any of the other participants in the transaction prior to its actual exercise."[35] The Appellants also argue the issue of the validity of the options in the "Effectiveness of Transfer" section by comparing the transaction structure to that of the Ingenious Film Partners transactions, which were a similar series of transactions that Fox entered into with another party:

> Further, the Ingenious transactions show that Fox is not hesitant to build in a compulsory reacquisition mechanism. They could have structured the transactions with Ingenious to incorporate a call option as well, but they did not. Its use in the Six Iron transactions is thus more noteworthy, and <u>should be respected as valid</u>.[36]

[Emphasis added.]

[95] The Appellants deal with the options in their tax shelter submissions arguing that the testimony of Messrs. Paletta, Nimchuk and Fergus indicates there was a

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33 Transcript, volume 6 June 11, 2019, at page 13, lines 6-25.
34 Appellants' Written Argument, page 9 at para. 35, page 11 at para. 54.
35 Appellants' Written Argument, page 33 at para. 51.
36 Appellants' Written Argument, page 42 at para. 26(i).

lack of certainty that the options would be exercised.[37] They also provide submissions regarding the options and the question of whether the partnership units were held on account of income or capital:

> Fox's requirement that the option be granted as part of the transactions sounded as "a negative" to Angelo, since he run [*sic*] the risk of having the film rights taken back from him (or his Company) after going through all the work and effort. However, this requirement did not seem unusual to Angelo, who was familiar with several real estate transactions where options were granted. In the Appellants' view, there was a 50/50 per cent chance of Fox exercising the option.
>
> . . .
>
> The option agreement was completely in the control of Fox. Angelo would not have the knowledge of which factors would lead Fox to exercise the option. The fact that the option had been exercised by Fox in other transactions had no bearing on the likelihood of Fox doing so in respect to the Palettas and Paletta International Corporation investments because, according to Angelo, every transaction is separate and different, the timing is different, conditions are different, people are different, the company purpose and direction is different, etc…[38]

[Footnotes omitted.]

[96] These submissions reflected the evidence adduced at trial and the framing of the case by the Appellants in their written Opening Statement. The Opening Statement contains numerous references to the Option Agreements. It repeats the statements from the Appellants' Written Argument that Fox gave no assurances or indications that it would exercise its option, and that any one of a number of factors could have prompted Fox to forego exercising the option.[39] The Opening Statement provides explanations and justifications for Fox's insistence on the option and the factors that would have influenced Fox in choosing to exercise the option.[40] The Opening Statement also describes the Minister's position as alleging "that the transactions as a whole were a sham"[41]

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37 Appellants' Written Argument, page 82 at para. 53(a).
38 Appellants' Written Argument, pages 99-100 at paras. 4 and 6.
39 Appellants' Opening Statement, at para. 36.
40 Appellants' Opening Statement, at paras. 55 and 56.
41 Appellants' Opening Statement, at para. 12(a).

[97] The Appellants led evidence at trial which demonstrates an understanding that the validity of the options was at issue. Counsel for the Appellants questioned several of its own witnesses in examination-in-chief on the likelihood of the options being exercised. Mr. Paletta testified at length as to his belief that there was a 50-50 chance of the options being exercised. Messrs. Nimchuk and Fergus also testified extensively as to their understanding of the likelihood of the options being exercised and concerning any information they received from Fox in that regard.

[98] Although the Appellants initially raised the issue regarding the Replies in the context of burden, the following day they argued that the Respondent had admitted the validity of the options and was therefore precluded from challenging their validity. This is when I asked for further written submissions on the issue.

[99] The Appellants frame the issue very narrowly in their submissions. According to them, the Respondent failed to plead that the options were shams or certain to be exercised and that the Respondent in fact admitted the validity of the options. The only solutions, in the Appellants' view, are to withdraw the admission and/or amend the Respondent's pleadings, neither of which is appropriate at this stage.

[100] I do not agree with the Appellants' view of this matter.

[101] The Respondent did not admit that the options were valid. Even if she did, in the circumstances such admission would not bind the Court. Furthermore, there is no unfairness to the Appellants in deciding these appeals on the basis that the options are shams.

A. There is no judicial admission that binds the Court

[102] A judicial admission (also known as a formal or express admission) is a concession by a party that a certain fact or issue is not in dispute.[42] In civil cases, a judicial admission is normally conclusive and binds the Court, even if contradicted by the evidence. However, it is not necessarily the same in tax cases.

[103] The Respondent's admission of the Appellants' statement that the option was exercised is not an admission that the option was valid. It is an admission that

[42] Sydney N. Lederman, Alan W. Bryant & Michelle K. Fuerst, Section, §19.1., *The Law of Evidence in Canada*, 5th ed. (Toronto: LexisNexis, 2018)

the documentary requirements with respect to the option occurred when and as described by the Appellants. The essence of sham is that the legal rights and relations set out in the documents are not the legal rights and relations the parties intended to and did create. On its face, the option was exercised. A sham would arise, however, if such exercise was preordained and the parties had pre-agreed from the very outset that Fox would reacquire the films prior to their commercial release.

[104] The Minister's assumptions clearly state that exercising the options was preordained. The Appellants argue that those assumptions are deficient because they inaccurately describe the parties to the option as the Six Iron Partnership and Fox, when the parties were in fact Paletta International and the general partner. The Appellant argues that this misdescription led to the erroneous assertion that the option was preordained. Firstly, the misdescription is not as clear as the Appellants assert. Secondly, I fail to see how it affects the assumption that the option exercise was preordained. To the extent that the Minister misstated the parties to the option, the Minister has the burden of proving who the parties were. Further, the Appellants fail to address the last sentence of the relevant paragraph of the Reply, in which it is stated that "the Picture itself was preordained to be transferred back to Fox."[43] The Reply also states that "the Appellant knew that Fox would exercise its option to reacquire the Picture".[44] Thus it is clear that the Respondent assumed that there was no doubt the options would be exercised.

[105] Even if I am wrong and the Respondent has admitted that the Option Agreements were valid and not shams, I do not think that the Court is bound by this admission in the circumstances. In *Hammill v. The Queen*[45] the Federal Court of Appeal held that the Tax Court is not bound by an admission which is shown to be contrary to the facts where the party benefitting from the admission has adduced

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[43] 2013-4837(IT)G Reply, at para 16(ttt).
[44] 2013-4837(IT)G Reply, at para 16(rrr).
[45] 2005 FCA 252 [*Hammill*].

evidence going beyond the admission.[46] This decision was followed in *Fiducie Alex Trust v. The Queen* [47] as well as in *Doiron v. The Queen*.[48]

[106] The Federal Court of Appeal held that due to the public nature of a tax appeal, the normal rule applicable to admissions in the civil context does not apply where a party itself places evidence in the record over and above what was agreed to:

> [29] Specifically, the appellant argues that the Tax Court Judge was bound by the facts as admitted, even if contrary evidence was adduced at trial. Sopinka, *The Law of Evidence in Canada*, 2nd ed, Butterworths, 2004 at page 1051; *Urquhart v. Butterfield* (1887), 37 Ch. D. 357, at 369 and 374; *Copp v. Clancy* (1957), 16 D.L.R. (2d) 415, at 425, are relied upon in this regard.
>
> [30] In my view, these authorities which derive from private party civil proceedings are of no assistance to the appellant in the context of this appeal. While the admission reflected in the Agreed Statement of Facts was favourable to the appellant, he was not satisfied to have his appeal disposed of on that basis. The appellant chose to place extensive evidence before the Court, over and beyond what had been agreed to, about the nature and extent of the scam.
>
> [31] In an appeal against an assessment under the Act, the outcome does not belong to the parties. Public funds are involved and the Tax Court is given, in the first instance, the statutory mandate to confirm or vary the assessment based on the facts, proven or admitted. In this respect, while the Court will not generally look behind a formal admission, the parties cannot by agreement dictate the outcome of a tax appeal. <u>The Tax Court is not bound by an admission which is shown, through properly tendered evidence, to be contrary to the facts.</u>
>
> [32] In this case, the relevant evidence was tendered by the appellant himself, and the Tax Court Judge concluded from this evidence that he had been the subject of a fraud from beginning to end, a conclusion which precludes the existence of a business. In my view, the Tax Court Judge could not pronounce on the validity of the reassessments while turning a blind eye on the evidence placed before him.

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46 In *Hammill*, the taxpayer sought to deduct expenses related to the sale of gemstones. In an Agreed Statement of Facts, the parties stated that the taxpayer was engaged in business by virtue of being engaged in an adventure in the nature of trade. The Tax Court judge found instead that the taxpayer had been a victim of a substantial fraud beginning the moment he was contacted about the gemstones and accordingly the expenses were not incurred for the purpose of earning income from a business.

47 2014 FCA 123.

48 2012 FCA 71.

> [33] Moreover, there is no basis for the appellant's contention (made during the hearing of the appeal) that this finding was not open to the Tax Court Judge because the statutory period for reassessing had expired when it was made (*Pedwell v. The Queen*, 2000 D.T.C. 6405 (F.C.A.)). The decision of the Tax Court Judge on this point confirms the reassessments on the primary basis on which they were issued (paragraph 18(1)(a)) and results in no taxes being payable beyond those originally assessed (compare *Anchor Pointe Energy Ltd. v. The Queen,* 2003 D.T.C. 5512 (F.C.A.) at paragraphs 39 and 40). [49]
>
> [Emphasis added.]

[107] As described above, the Appellants addressed the validity of the options as an issue from the start of the trial. They led extensive evidence on it. Even if I thought that the Respondent had admitted the validity of the options, this is a situation in which the Court would not be bound by the admission, given the evidence in the record.

B. There is no procedural unfairness to the Appellants

[108] Although I find that the Respondent did not admit that the options were valid, I acknowledge that it is clear from the Replies that the Respondent based her theory of the case on the idea that the means of transferring the films from Fox to the Partnerships were shams from the outset. According to that theory, it is not necessary to conclude that the options were shams inasmuch as the films had not in fact been transferred. Given this, I do not think there is any unfairness to the Appellants in deciding that the options were shams.

[109] There is a wealth of jurisprudence regarding the interplay between the Repondent’s Reply, new or alternative arguments and taxpayers’ rights. The Supreme Court of Canada in *Continental Bank* of *Canada v Canada* held that the Minister cannot raise a new argument that has the effect of creating a new basis of reassessment after the limitation period has expired.[50] The Court was concerned by the fact that the evidence necessary to support the new argument was not adduced at trial and that the new argument amounted to assessing beyond the limitation period.[51] The case prompted Parliament to enact subsection 152(9) of the *Income Tax Act* (the “Act”) which clearly allows the Minister to advance new arguments at

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49 *Hammill*, paras. 29-33.

50 [1998] 2 S.C.R. 358, [1998] 4 C.T.C. 77 [*Continental Bank* of *Canada*].

51 *Continental Bank of Canada*, at paras. 13 and 16

any stage of a proceeding, subject to a provision regarding evidentiary prejudice to the taxpayer.

[110] In these appeals, the Respondent assessed the Appellants *inter alia* under paragraph 18(1)(a) of the Act, denying the deduction of the partnership losses on the basis that the amounts were not incurred for the purpose of earning income from a business. As noted, the Respondent's theory of the case is that the transactions prior to the option were shams and/or not legally effective. The Respondent nevertheless assumed that the options were preordained and that it was known to the Appellants that they would be exercised. In light of the evidence adduced at trial, to decide that it is the option rather than the preceding transaction or transactions that is the sham does not change the basis of the reassessments. So deciding does not involve reliance on unpleaded assumptions. Nor does it result in more tax being payable by the Appellants. It is a determination that the amounts claimed by the Appellants are not deductible under paragraph 18(1)(a) as they are not expenses incurred for the purpose of earning income from a business. Accordingly, there is no new basis of assessment.

[111] I will now consider the question of prejudice to the Appellants. I do so not only in the event that I am wrong about whether deciding that the options were shams would amount to a new basis of assessment but also because litigation on subsection 152(9) can get bogged down in what Rothstein J.A., as he then was, termed "semantical argument".[52] I do not wish to dispose of the issue on technicalities: the heart of the matter is fairness to the Appellants.

[112] Fairness in this context means notice of the case to be met and the corresponding ability to adduce relevant evidence.[53]

[113] The Appellants argue that they presented their case on the basis that the options were not alleged to be shams and, as a result, the Court does not have before it a full factual record on which to decide the question. They allege that they

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52 *Anchor Pointe Energy Ltd. V. The Queen*, 2003 FCA 294 at para 38.

53 For example, in *The Queen v. Global Equity Fund Ltd.*, 2012 FCA 272, the FCA allowed the Crown to put forward new arguments that were neither relied on by the Minister in assessing nor raised by the Crown at trial. The FCA reversed the trial court's GAAR decision and decided in favour of the Crown. Relying on subsection 152(9), the FCA rejected two new arguments of mixed fact and law "for which an evidentiary basis was not established in the Tax Court of Canada" (at para. 37) but permitted other legal arguments made on the basis of the existing evidentiary record.

would have called additional witnesses, specifically from Fox, and the witnesses who actually were called would have been questioned differently or on additional matters. Therefore, the Appellants maintain, they have suffered prejudice.

[114] I do not agree that the Appellants suffered evidentiary prejudice.

[115] Recently, in *Bakorp Management Ltd. V. The Queen*, the Federal Court of Appeal dismissed the taxpayer's procedural fairness and natural justice argument in circumstances where the Respondent did not, in her Reply, indicate that she was relying on the provision that limits a taxpayer to claiming non-capital losses only once.[54] The taxpayer argued that the Tax Court could not rely on that provision to deny the taxpayer's claim for non-capital losses in one tax year on the basis that they had been claimed for another tax year. The Federal Court of Appeal noted that it was "obvious" from reading the taxpayer's notice of appeal that it understood the losses could only be claimed once. The taxpayer had also cited the relevant section, though not the specific paragraph. Furthermore, the Minister had relied on an assumption that the maximum amount of non-capital losses available was a particular dollar amount. The Federal Court of Appeal held that the reference to the paragraph by the Tax Court judge "did not introduce a new legal principle that was unknown to Bakorp" and that the "alleged breach of procedural fairness [was] without any merit."[55]

[116] In the current case, the Appellants cannot claim to be taken by surprise by the Respondent's theory. The validity of the options has been a focus of the trial from the outset. The Appellants led considerable evidence on the matter. When they raised this issue in argument, they initially took the position that any issues with respect to the options would not preclude the Court from ruling on the options, but would only be taken into account with respect to the question of burden.

[117] It was not until the following day that counsel took the position that the Respondent was precluded from arguing that the options were shams. This further indicates to the Court that the Appellants had not noticed the alleged deficiency in the Minister's pleading until recently.

[118] It follows that I cannot accept the Appellants' argument that they suffered evidentiary prejudice. The Appellants contend that they would have called

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54 2019 FCA 195 [*Bakorp*].

55 *Bakorp*, at para. 47.

additional or different witnesses if they had known that the options were in issue. However, I have found that the Appellants clearly viewed the options as an issue from the start and led evidence on that issue in their examinations-in-chief of multiple witnesses. The commission witnesses were finalized and subpoenaed *after* the first two weeks of trial had been completed, during which the options had been a focus of the Appellants' evidence and the Court's attention. When the Court suggested that a person from Fox's business affairs department would have been a good witness, counsel for the Appellants responded that such person was no longer with Fox:

> JUSTICE: But she had very little knowledge, if any, of the business deal.
>
> MR. DAVIES: Correct, she didn't have much knowledge of the business deal but –-
>
> JUSTICE: But Fox's purpose and objective was in terms of entering into the transaction, the business affairs person would have been a good witness in that regard.
>
> MR. DAVIES: Who is no longer with Fox.
>
> JUSTICE: I understand.[56]

[119] Respectfully, the Appellants' argument that they would have called different witnesses or questioned the ones they did call in a different manner reads as an attempt to have their cake and eat it too. The Appellants led evidence on the options through their own witnesses because they believed the evidence being led was favourable to them. They chose not to proceed with the riskier strategy of calling Fox business affairs witnesses, who would then be subject to cross-examination. They also chose not to pursue a risky line of questioning with the witnesses they did call who did not necessarily have an interest in portraying the transactions as the Appellants would have liked them to have been portrayed. This was a strategic decision and I do not draw a negative inference from it. I do not, however, think it fair to allow the Appellants to claim only the benefit of the upside of their strategy and disavow the downside.

[120] I conclude that there is nothing in the pleadings to preclude me from considering whether the options were shams designed to mask the parties'

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56 Transcript, volume 6, dated June 11, 2019, at page 35, lines 7-17.

agreement that the films would be reacquired by Fox prior to their commercial release.

## IV. Sham

### A. The Law

[121] There appears to be no dispute between the parties as to the meaning of sham. They both referred to the case of J. *Snook v. London & West Riding Investments, Ltd.*[57] In *Snook*, Diplock L.J. stated that "sham":

> . . . means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. One thing I think, however, is clear in legal principle, morality and the authorities . . . that for acts or documents to be a "sham", with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating. No unexpressed intentions of a "shammer" affect the rights of a party whom he deceived. . .[58]

[122] Canadian courts adopted the *Snook* definition of sham in 1972.[59] The Supreme Court of Canada reaffirmed and followed this definition of sham in *Stubart Investments Ltd. V. The Queen*.[60] In *Stubart*, Justice Estey defined sham as:

> . . . a transaction conducted with an element of deceit so as to create an illusion calculated to lead the tax collector away from the taxpayer or the true nature of the transaction; or, simple deception whereby the taxpayer creates a facade of reality quite different from the disguised reality. . .[61]

[123] Two more recent decisions of Justice Noël of the Federal Court of Appeal discuss sham. In *Antle v. The Queen*, he said, in obiter:

> . . . The required intent or state of mind is not equivalent to *mens rea* and need not go so far as to give rise to what is known at common law as the tort of deceit . . . .

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57 [1967] 1 All ER 518 [*Snook*].
58 *Snook*, at page 528.
59 *M.N.R. v. Cameron*, [1974] S.C.R. 1062.
60 [1984] 1 S.C.R. 536 [*Stubart*].
61 *Stubart*, at pages 545 and 546.

> It suffices that parties to a Transaction present it as being different from what they know it to be . . .[62]

[124] In 2529-1915 Québec Inc. v. The Queen, he said:

> [59] It follows from the above definitions that the existence of a sham under Canadian law requires an element of deceit which generally manifests itself by a misrepresentation by the parties of the actual transaction taking place between them. When confronted with this situation, courts will consider the real transaction and disregard the one that was represented as being the real one.[63]

[125] In a tax context, a Court will arrive at a finding of sham when the evidence shows that the parties misrepresented their arrangements in a bid to achieve a tax benefit that would be denied if the nature of their arrangements was properly disclosed. In tax matters, the party that is deceived by the sham is the Canada Revenue Agency ("CRA").

[126] In considering sham, the Court must examine the objective reality surrounding the arrangements to discern whether the transaction documents truly reflect the parties' intent. Direct evidence of sham is rare where a case proceeds to court; in the absence of an admission, the court is left to weigh circumstantial evidence.

[127] Here, the evidence consists primarily of the transaction documents themselves and testimony – particularly the testimony of Messrs. Fergus and Nimchuk (the "promoters") and Mr. Paletta. The factors that inform the objective reality of the arrangements include:

i) the circumstances surrounding the development of the transaction structure;

ii) the Appellants' due diligence, involvement and oversight, or lack thereof, in evaluating and participating in the transactions;

iii) the ordinary business and investment practices of the Appellants;

iv) the parties' stated goals and reasons for entering into the transactions; and

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62 2010 FCA 280 at para. 20.
63 2008 FCA 398 at para. 59.

v) the legal rights and obligations as defined in the transaction documents.

[128] This list is non-exhaustive. Taken together, these factors inform a court's analysis of whether the legal rights and obligations described in the transaction documents are consistent with the parties' avowed intent.

[129] I stress that searching for the objective reality of a transaction does not conflate sham (i.e.,misrepresentation and deceit) and the notions of "economic substance" or "business purpose". It is well established that a transaction is not a sham because it is devoid of economic substance, lacks a business purpose or serves a tax avoidance purpose. I shall look instead at whether the parties misrepresented the nature of their arrangements to the CRA.

[130] One final point is that sham must be distinguished from abuse. Sham is not an overall scheme that is abusive; it is a matter of the parties having misrepresented the legal effect of a transaction. Accordingly, I must point to certain transactions that are misrepresented. The structure in these appeals is complex and comprises many different transactions, and it is important not to combine all the transactions and steps into one, to paint every step as a sham – that would be to misconstrue what sham is. For example, the Respondent alleges that the Daylight Loan to Fintrust is a sham. I cannot agree. There is no evidence that the parties to the loan, who include RBC, intended anything other than what is indicated by the documents – a loan in the amount of US$212,000,000 (in the Six Iron appeal) to be repaid within 24 hours. The circularity of the cash flow does not equate to a sham in the case of this loan.

[131] However, once a transaction is identified as a sham, where that transaction forms part of a series of transactions it is not always easy to determine the effects of that sham transaction on transactions that follow (or perhaps precede). Here I identify the Option Agreements as shams – that is sufficient to dispose of these appeals. I also conclude that the Defeasance Transactions (defined below) that followed the option arrangements are shams.

B. <u>Positions of the Parties</u>

[132] The Appellants assert that the record shows that the parties intended to abide by the arrangements that they entered into. They describe a history of family and corporate dealings in the media and communications industry. Their position is that Mr. Paletta encouraged the family to invest, first through Paletta International in the Six Iron Partnership, then as individuals in the Swilcan Partnership, in order

to acquire and hold large newly produced films for long-term exploitation and profit. They deny that the options were preordained, and are adamant that the exercise of the options was in each instance a negative outcome for them.

[133] According to the Appellants, Fox was willing to enter into the arrangements to mitigate its risk during the films' post-production, pre-release period. For Fox, the option arrangements were crucial to achieving this risk mitigation purpose. If Fox thought that the films would be a commercial success, it would exercise prior to commercial release the options to reacquire them. Fox would then receive all of the revenue associated with the films. Fox would also retain cash equal to 3% of the P&A expenses incurred by the Partnerships. On the other hand, if Fox believed that the films would not be commercial successes, it could refrain from exercising the options. In that case, Fox would earn a return based on its entitlement under the Distribution Agreements.

[134] Unsurprisingly, the Respondent alleges the contrary. According to the Respondent, the films were never truly transferred to the Partnerships, whose sole purpose was to enable the Appellants to benefit from tax savings, and Fox to benefit from the 3% fee. The Appellants' tax savings would arise from the fact that the P&A expenses would be deductible while only one-half of the capital gains realized on the sale of the partnership units would be included in income.

[135] The Respondent says the conduct of the parties when structuring, reviewing and implementing the arrangements is not at all consistent with their stated intent of making a long-term investment in the films. According to the Respondent, the arrangements were structured to allow Fox to reacquire full ownership of the films prior to their commercial release and to receive a fee equal to 3% of the P&A expenses deducted by the Partnerships. The Appellants' intention in entering into the transactions was to benefit from the substantial tax savings associated with the deduction of these expenses.

[136] I will now examine the evidence to see which of these two contrary assessments of the evidence is accurate.

## C. Background of the Investment Structure

[137] The Appellants called the promoters who devised the structure, Messrs. Warren Nimchuk and Warren Fergus, as witnesses. Both are chartered accountants with years of experience at accounting firms. At the time of the transactions, Mr. Nimchuk was either a senior tax manager or a partner at PwC

with extensive experience in the Canadian film financing industry.[64] Mr. Fergus had left public practice some years before to market tax and insurance products with a former client, who introduced him to Mr. Nimchuk. Mr. Fergus left that business to join Grosvenor Park, a production services tax shelter company, and eventually became their national sales manager. When Parliament enacted the matchable expenditure rules (discussed below), Grosvenor Park folded. At that time, Mr. Fergus refocused his attention on the tax investment products he had been selling prior to joining Grosvenor Park. It was at this point that Messrs. Nimchuk and Fergus began the discussions that led to the creation of the structure that is before the Court today.

[138] It became clear at trial that Mr. Nimchuk was the technical expert while Mr. Fergus took the lead in marketing and client service. In examination-in-chief, Mr. Nimchuk acknowledged his extensive familiarity with the “matchable expenditure” rules found in section 18.1 of the Act and their impact on film production in Canada.

[139] Prior to the matchable expenditure rules, major US studios would receive tax-assisted financing by entering into production services arrangements with Canadian partnerships organized to finance production services in exchange for a future right to income. The partnership would realize a loss in the early years because it would deduct current expenses against a possible future right to income. The partners in these arrangements would claim losses in the early years and benefit from a significant tax deferral.

[140] Mr. Nimchuk acknowledged that the enactment of section 18.1 put an end to the above arrangements. The new regime offered refundable tax credits to foreign producers for eligible film production activities carried on in Canada. Mr. Nimchuk quickly became a recognized expert, who was frequently called upon to demystify the workings of this new regime. He testified that he had developed a broad range of contacts with the major film studios, including Fox.

[141] Following the enactment of the matchable expenditure rules, Mr. Nimchuk had a preliminary conversation with two of Fox’s business affairs executives, whom he knew through his prior dealings with Fox. He testified that he proposed a new arrangement whereby Fox would transfer a newly produced film to a Canadian partnership. The partnership would grant distribution rights to Fox and,

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64 At some point, Mr. Nimchuk became a partner at PwC but the timeline is unclear. He has since left that firm.

to maximize revenues for the partnership, would undertake to incur a significant part of the P&A expenses leading up to the film's commercial release. Mr. Nimchuk explained that Fox was interested in the proposal on the condition that it be granted an option that, if exercised, would allow it to reacquire the film.

[142] According to the promoters, this arrangement offered two significant potential benefits for investors. If Fox did not exercise its option, the investors stood to earn an attractive return from the commercial exhibition of the film. On the other hand, if Fox exercised its option and reacquired the film, the investors would benefit from significant tax savings. The tax savings arise from the fact that the P&A expenses would be fully deductible, whereas only one-half of the capital gains realized by the investors on the disposition of partnership units (which would occur automatically when Fox exercised the option) would be included in income.

[143] This new arrangement offered tax benefits similar to the "production services" arrangements described above, but was not affected by the matchable expenditure rules because the partnerships owned the films.

[144] According to Mr. Nimchuk, Fox enjoyed the best of both worlds under these arrangements. If Fox believed a film would be successful, it would exercise the option and retain 100% of the distribution revenue. If Fox believed the film would perform poorly, it would allow the option to lapse. In that case, Fox would earn the revenues provided for under the Distribution Agreements while the Appellants bore the risk of their share of the distribution revenues not being sufficient to enable them to recoup their investments in the film.

[145] Mr. Nimchuk had done most of the technical work in preparing the structure. Once the structure was in place, it came time to market it. This was Mr. Fergus' area of expertise, and he was successful. Various investors used this structure to generate tax losses in connection with eight Fox films. The Palettas, personally or through their corporate holdings, used it three times. Two of those investments are before the Court.

[146] The promoters testified that in their negotiations and discussions with Fox, Fox never gave any indication as to whether or not it would exercise the options. The promoters also acknowledged that Fox exercised the options every time. The Appellants and the promoters would have the Court believe that it was a mere coincidence that Fox caused the options to be exercised in all eight separate transactions implemented with the assistance of the promoters. For the reasons that follow, this is beyond reasonable belief.

D. Credibility of the Promoters

[147] I do not find either of the promoters to be a credible or trustworthy witness.

[148] Mr. Nimchuk was the first to testify. In the Appellants' Opening Statement, Mr. Nimchuk is described as a partner at PwC who assisted Mr. Fergus in negotiating with Fox, establishing the Partnerships and setting up the structure.[65] His examination-in-chief was conducted in a manner largely consistent with how he was presented at the start of the trial.

[149] The Respondent quickly established that this presentation was misleading. Early in cross-examination, the Respondent asked Mr. Nimchuk a series of questions designed to elicit whether he had a personal interest in the outcome of the structures. The record illustrates the extent to which Mr. Nimchuk tried to disguise the secret side deal that he struck with Mr. Fergus at the outset of their relationship:

> Q. In respect of this transaction you were involved as an employee of Price Waterhouse Cooper only? Or were you involved in any other capacity in these transactions?
>
> A. <u>No, just through Price Waterhouse.</u>
>
> Q. Okay. If we look at the documents that are part of the closing binders, there are numerous transactions. We have referred to them extensively. Are there side deals, to your knowledge, that are not in the closing binders?
>
> A. With the studio? Between the partnership?
>
> Q. In respect of this transaction?
>
> A. Not that I'm aware of.
>
> Q. Okay. Are there any secret deals?
>
> A. What's a secret deal?
>
> Q. A deal that was not supposed to be disclosed as part of the closing binders. That you know of?

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65 As noted, the question of when Mr. Nimchuk became a partner was not established clearly before the Court.

A. To the best of my knowledge there was no other agreements relating to the transaction between any of the parties.

Q. There were no written agreements that are not in the closing binders?

A. There were no agreements that I'm aware of, either written or otherwise.

Q. Otherwise being oral agreements or any sort of agreement that are not in the closing binders?

A. Yeah, no agreements.

Q. Can we say the same for the other Transaction, the Swilken [sic] Transaction? You were involved as an employee of Price Waterhouse Cooper?

A. Yes.

Q. Only in that capacity?

A. Yes.

Q. And there are no side deals in respect of the Swilken [*sic*] transaction either?

A. No.

Q. No oral arrangement?

A. No.

Q. No written arrangement?

A. No.[66]

[Emphasis added.]

[150] In fact, this was untrue. Counsel for the Respondent confronted Mr. Nimchuk with documentary evidence of his financial stake in the transactions beyond his involvement as an employee and/or partner of PwC. As the evidence mounted, Mr. Nimchuk attempted at every step to mislead the Court, admitting only what was immediately before him and denying the rest until eventually it all came out.

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[66] Transcript, volume 2, dated March 12, 2019, at page 229, line 18 to page 231, line 2.

[151] The promoters received their fees in two **stages**: firstly out of the cash put up by the Appellants and secondly from Fintrust at the defeasance stage. Both payments went to corporations controlled by Mr. Fergus or his wife ("Fergus Corporations"), including one called Puppy Productions Inc. and another called Savage Beagle Productions Inc. When directed to the evidence of the first payment stage, Mr. Nimchuk testified that he did not know why the money went to the Fergus Corporations and denied that it was his share of the profits:

> Q. --And the amount that was paid to that corporation was a division of this profit…of this amount, $2,243,457 between--it was split between Savage Beagle and Puppy Production. Do you know why is that?
>
> A. No.
>
> Q. It was split 50-50. There was $75,000 that was already in Warren Fergus's possession. And the balance is 50-50?
>
> A. Magnolia Lane?
>
> Q. Yes.
>
> A. Yes.
>
> Q. <u>So that was not your share of the profits?</u>
>
> A. <u>No.</u> [67]

[Emphasis added.]

[152] The second payment occurred at the defeasance stage of the structure. At that stage, Fintrust paid US$1,170,021.35 each to Puppy Productions and Savage Beagle Productions. When asked about these payments, Mr. Nimchuk was vague or could not recall the reason for them:

> Q. Correct. Before we move on from this document, I'd like you to address these two entries at page two. Equal amounts to Puppy Production and Savage Beagle. $1.17 million each.
>
> A. Yes.
>
> Q. Do you know why these payments were made?

---

[67] Transcript, volume 3, dated March 13, 2019, at page 306, lines 3-16.

> A. I believe they were either a fee or a loan that was made between those companies and Wordsmith.
>
> Q. You said there was no other arrangement--no other side deals yesterday?
>
> A. Yeah, I don't believe that was a side deal. It was after the transaction. Wordsmith had those fees that they earned on that transaction.
>
> Q. So you know that there's a deal in respect of Puppy Production and a deal in respect of Savage Beagle?
>
> A. I'm aware that they were paid money. I don't recall off-hand whether that was a loan or a fee.
>
> Q. And you don't know--you can't recall why this amount was paid?
>
> A. No.[68]
>
> [Emphasis added]

[153] The majority of the first payment, made out of the Appellants' cash investment, went to Puppy Productions. Puppy Productions then paid half of that amount[69] to Savage Beagle Productions. Again, Mr. Nimchuk obfuscated until confronted with documentary evidence:

> Q. This amount I would have--this amount paid to Puppy Production, there was a $1,084,229 that went to the bank account of Savage Beagle. Is it fair to say that?
>
> A. I don't recall.
>
> . . .
>
> Q. Okay, in that document, if you look at the first line on the column there's $1,084,229?
>
> A. Yes.
>
> Q. So this is a payment that's made? A debit memo. It says paid--you are writing paid to Savage Beagle on their direct from Hedgehog.
>
> A. Under direction from Hedgehog.

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68 Transcript, volume 3, dated March 13, 2019, at page 310, line 9 to page 311, line 1.

69 Minus $75,000, which was already in another one of the Fergus corporations.

Q. And so that's the amount that's paid to corporation of Warren Fergus?

A. Yes.

Q. Warren Fergus already had $75,000, right?

JUSTICE HOGAN: Sorry, Puppy Productions--do we know who owns--he had a statement that Puppy Productions belonged to Warren Fergus or his wife, was that correct?

THE WITNESS: Yes.

JUSTICE HOGAN: And do we know who Savage Beagle belongs to?

THE WITNESS: Either Warren Fergus or his wife.

BY MR. CAMIRAND:

Q. So if we add the $75,000, we get the 50 percent share that goes to--that remains with Puppy Production out of the $2,243,455 that is paid to Puppy Production?

A. Yes.

Q. Do you know why is that? Why the 50-50?

A. <u>I believe the amount was to be split between the two companies.</u>

Q. So it was 50-50 for the $1,170,000 that was paid to each of the corporations. And it was also true of that payment to Puppy Production? <u>It went back to the promoters?</u>

A. <u>Yes.</u>[70]

[Emphasis added.]

[154] Mr. Nimchuk admitted that he became the owner of Puppy Productions several years after the Six Iron transactions. Despite the evidence that had emerged, he continued to try to mislead the Court as to his reasons for becoming the owner and as to the remuneration he received for doing so. He attempted to paint his eventual ownership of Puppy Productions as a benevolent act to help out his friend, Mr. Fergus. He also attempted to deny the corporation's value:

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[70] Transcript, volume 3, dated March 13, 2019, at page 311, line 27 to page 314, line 21.

Q. Okay. But we do know that eventually you became the owner of that of Puppy Production, correct?

A. Yes.

JUSTICE HOGAN: Why would you buy a shell company essentially, if it had no assets?

THE WITNESS: I didn't. It was given to me.

JUSTICE HOGAN: The company was gifted to you?

THE WITNESS: Yes.

JUSTICE HOGAN: By?

THE WITNESS: It was either Warren Fergus or his spouse.

JUSTICE HOGAN: And did it have value at that time when it was gifted to you?

THE WITNESS: It didn't have any assets at that point.

JUSTICE HOGAN: Can I ask you the question, what would be your interest in acquiring the company, then, if it's just a shell?

THE WITNESS: It had I guess…it had continued filing obligations. It was considered part of the overall structure. By the time it was gifted to me, we were well aware that the transactions were being reviewed.

JUSTICE HOGAN: Why would you want to even touch it with a ten-foot pole?

THE WITNESS: I didn't think that it exposed me to any liability.

JUSTICE HOGAN: What's your upside in taking it?

THE WITNESS: I had a long standing relationship with Warren Fergus and just assisted in cleaning up those companies.[71]

[Emphasis added.]

[155] This was not, in fact, a benevolent act. Before Puppy Productions Inc. was gifted to Mr. Nimchuk, he and Mr. Fergus had directed that payments or loans be

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[71] Transcript, volume 3, dated March 13, 2019, at page 315, line 1 to page 316, line 3.

made to Mr. Nimchuk. Mr. Nimchuk was able to direct that payments be made to himself because he had signing authority on the account:

> Q. So they gifted it back to you after you withdrew from PWC, correct?
>
> A. Yes.
>
> Q. But in the meantime you had access to these funds?
>
> A. No, the funds belonged to the corporation.
>
> Q. Okay. You say the funds belonged to the corporation but the funds were taken out of the corporation before you got the corporation, right?
>
> A. Yes.
>
> Q. And they were taken out at your direction?
>
> A. In some cases, yes.
>
> Q. Okay. And those payments were gifts to you from Warren Fergus or his wife. Is it fair to say that?
>
> A. If they had payments that were made to me, then any payment that were made to me would have been a loan.
>
> JUSTICE HOGAN: But payments made at your direction sounds like you're directing who gets the benefit of the cash.
>
> THE WITNESS: Only because when this account was set up, they also had me as a signing officer on the account.[72]

[Emphasis added.]

[156] Mr. Nimchuk displayed an elastic understanding of the questions that the Respondent put to him regarding his compensation from the deal as well as of his ethical duties:

> Q. You said that your involvement was exclusively as an employee of PWC. Now we find that you were also involved as--or receiving money through Puppy Production. Is that fair to say that?

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[72] Transcript, volume 3, dated March 13, 2019, at page 316, line 28 to page 317, line 24.

A. No. You'd asked me if I'd received funds from the transaction. I did not. When Warren Fergus received funds from the transaction, then he made funds available to me. The funds that he did make available to me from Puppy Production were for the acquisition of a house and renovations. And so they were provided--

JUSTICE HOGAN: I have to say, I'm sitting here and I'm a little shocked. I'm shocked because normally--were you--you're supposed to be providing, I guess tax sheltering advice or advice to the partnership and indirectly to the partners, are you not?

THE WITNESS: I was providing advice to the partnership.

JUSTICE HOGAN: Doesn't this put you in a conflict situation vis a vis your duties to provide objective advice once you're economically--you have signing authority over an account and you are benefiting from funds?

THE WITNESS: I had no control over the receipt of the funds into Puppy Production. And once the funds were there--

JUSTICE HOGAN: It's starting to sound like you had a deal with Warren Fergus.

THE WITNESS: Only after the funds were in the accounts and when I had requirement for a use for a loan.

JUSTICE HOGAN: Did PWC--were they ever made aware of these arrangements?

THE WITNESS: No.

JUSTICE HOGAN: They are not aware of this?

THE WITNESS: No.

BY MR. CAMIRAND:

Q. Don't you have a concern duty of loyalty towards PWC?

A. I was always loyal towards PWC but I didn't have any obligation or legal requirement to disclose that I acquired a loan from a client.

Q. Yet you thought it was ideal to split 50-50 with Warren Fergus the profit from this arrangement?

A. As a loan from a corporation owned by a client.

Q. To pay out your personal home?

A. To acquire a house and to renovate it.[73]

[157] To close the circle, Mr. Nimchuk's misleading testimony regarding Puppy Productions' value when he received that company from Mr. Fergus disguised how Mr. Nimchuk had received his share. Mr. Nimchuk said Puppy Productions had no assets – in fact, the company did have an asset, which was the value of the loan to Mr. Nimchuk:

> JUSTICE HOGAN: We'll carry on. I mean, I'm not going to go much past 12:30. I just want to ask one last question. You said that the funds came out via loan. Was the loan ever repaid?
>
> THE WITNESS: It's still being repaid. I have a small balance owing still.
>
> JUSTICE HOGAN: But to a company that you own?
>
> THE WITNESS: Yes.
>
> JUSTICE HOGAN: <u>So in essence you did get the money from the transactio**n**… 50 percent of the fee because at the end of the piece you took the money out of the company via loan, created an asset in the company. So when the shares were gifted to you, they were worth presumably the value of the loan receivable.</u>
>
> THE WITNESS: <u>Yes.</u>[74]
>
> [Emphasis added.]

[158] This profit splitting happened in the same fashion in the Swilcan transactions, although the amounts were different. I also understand that Mr. Nimchuk benefited from similar arrangements with respect to the six other transactions implemented with Fox.

[159] Mr. Fergus testified some weeks after Mr. Nimchuk and put a different gloss on Mr. Nimchuk's testimony regarding the fees. He testified that the promoters never had "any specific conversations"[75] about compensation but that it was always his practice to work in an equal partnership. He testified that the nature of their relationship (i.e., as partners) would have been obvious to anyone who saw

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73 Transcript, volume 3, dated March 13, 2019, at pages 318, line 14 to page 320, line 2.
74 Transcript, volume 3, dated March 13, 2019, at page 320, line 23 to page 321, line 8.
75 Transcript, volume 1, dated May 28, 2019, at page 19, lines 20-24.

them working together and that they were very clearly a "twosome" and treated as interchangeable.[76]

[160] I cannot accept that two sophisticated accountants, with experience in tax investments and marketing, went into business together without ever discussing the terms of their business relationship and compensation. More to the point, the fees did not spontaneously appear in the transaction structure – the promoters built them in. The idea that the promoters built in a two-step fee structure, amounting to millions of dollars per transaction, but did not discuss if and how the money would be split stretches credulity to the breaking point.

[161] There is only one plausible explanation for the lack of transparency regarding the fees: Mr. Nimchuk and Mr. Fergus had a lot to gain from concealing their secret deal from PwC and perhaps from the other professionals called upon to provide advice in connection with the transactions.

[162] It is common knowledge that accounting firms adhere to strict conflict of interest guidelines. Undoubtedly, Mr. Nimchuk and Mr. Fergus feared that PwC would decline to get involved if their lucrative side deal was disclosed to PwC. They both had something to gain by cloaking their business dealings in secrecy.

[163] Mr. Fergus' wife acted as a nominee for Mr. Nimchuk. I surmise that Mr. Fergus played a role in convincing his wife to act in this capacity. It is certainly no coincidence that the nominee arrangement ended and Mr. Nimchuk became the shareholder of record of Puppy Productions only after he had retired from PwC.

[164] By hiding their relationship, Mr. Nimchuk did not have to choose between resigning from PwC or staying with PwC and abandoning his personal dealings with Mr. Fergus. By proceeding in this way, both individuals profited from PwC's reputation as a leading accounting and tax advisory firm experienced in the entertainment field. I have no doubt that Mr. Nimchuk led the parties to believe he was acting as an independent professional advisor when he negotiated the terms of the transactions with Fox.

[165] Given the above, it is not a stretch for me to believe that Mr. Nimchuk and Mr. Fergus may have encouraged the parties to enter into arrangements that were

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[76] Transcript, volume 1, dated May 28, 2019, at page 34, lines 19-22.

not fully reflective of these parties' true intent. Further, I cannot put any weight on their testimony and believe that they did not discuss the likelihood of the options being exercised with Fox business executives and that they did not know whether the options would be exercised.

E. Conduct of the Appellants

[166] Mr. Paletta testified on behalf of the Appellants. He was adamant that their intent in entering into these transactions was to acquire the films and exploit them for the long term under the Distribution Agreements. He was aware that the options could put a quick end to the Partnerships' ownership of the films, but he hoped they would not be exercised. Mr. Paletta claimed repeatedly that he believed there was a 50-50 chance that Fox would exercise the options. He acknowledged that he knew Fox had exercised the options in all prior transactions. He further testified that he was confident that Fox did not exercise the options, the Appellants could earn a substantial rate of return under the Distribution Agreements.

[167] Mr. Paletta contextualized the Appellants' choices within the framework of the family's history, its business and investment profile and his own interest in the media and entertainment industry.

[168] Paletta International is a family business. It was started by Pat Paletta, who built it up from a beef slaughterhouse to a multi-divisional company with interests in agriculture and cattle, as well as real estate and development. As Pat's son, Mr. Paletta joined the family business full-time at the age of 18. He became especially focused on the real estate side of things, earning a broker's licence and setting up his own real estate company to act for the Paletta companies in their real estate transactions.

[169] Mr. Paletta acknowledged that he and his family were very conservative investors. Pat's philosophy was to take on significant risk only early in one's life, when one had nothing to lose. The family followed this investment philosophy, investing in things they understood well and that presented average to below-average risk. A significant investment required that the whole family fully understand the pros and cons before the go-ahead was given.

[170] The Paletta family's real estate business illustrates this approach in action. To supplement the activities of their meat processing, feedlot and agricultural businesses and to gain the benefits of vertical integration, the Paletta family would acquire vacant land for the long term. They would use the land to fatten cattle or

grow crops for their feed lot or for human consumption. These activities helped defray the carrying costs of the vacant land. The Paletta family could thus afford to be patient, taking the time to have zoning restrictions removed so as to enhance the value of their substantial land bank holdings and then develop the land, or, as the evidence shows, sell it to developers for a sizeable profit.

[171] I will now contrast that approach with the conduct of the Appellants in the lead up to their investments in the Partnerships.

[172] These transactions, if implemented as the Appellants' say they intended, do not fit the Appellants' conservative investment strategy. The Appellants argue that Fox was willing to enter into the transactions in order to mitigate risk in the lead-up to the release of the films. The Appellants assumed that risk for the chance of being able to profit if the films were successful and not reacquired by Fox.

[173] Predicting the future gross receipts of a film is an inherently tricky business. There are numerous instances where big-budget films have simply bombed at the box office. Conversely, films produced independently on small budgets have gone on to great commercial success. Major studios like Fox can absorb the risks of a poorly performing high-budget film because they own a large library and/or control the distribution rights for many films. In short, their risk mitigation strategy is based on the age-old concept of diversification. Studios can also co-invest in projects alongside, for example, private equity funds which also diversify risk by investing in multiple projects. Studios also avail themselves of tax or film subsidies that are offered by most countries to attract film production activities.

[174] The Appellants have neither the experience in the industry nor the benefit of a film library and distribution rights to cushion them if a film flops. It is undisputed that the Appellants were novices in the film industry when they embarked on these investments. However, Mr. Paletta attempted to portray a family history of investing in media, communications and the film industry. Yet none of these ventures were similar to the transactions at hand, as they did not require an investment of hundreds of millions of dollars. I therefore find that these film transactions were the Palettas' first involvement in film deals of this magnitude. Furthermore, Mr. Paletta admitted that he had no training in forecasting film revenue or, for that matter, in evaluating forecasts commissioned from independent third parties. The amounts at stake are, as noted above, significant percentages of the family's net worth. The risk allegedly assumed in these transactions is wildly out of character for the Paletta family.

[175] The record shows that Mr. Paletta is a highly sophisticated business person who takes a hands-on approach to dealing with all facets of the family's traditional business operations. This side of Mr. Paletta was not in evidence when it came to investing in these structures.

[176] Mr. Paletta had no discussions or contact with Fox in either of these transactions. He testified that the family was content to allow the promoters to work out the details on their behalf, including the purchase price of US$128,310,000 in the Six Iron transactions and US$97,430,000 in the Swilcan transactions, plus, in each case, the P&A expenses of many tens of millions of dollars. The negotiations with Fox were carried out by Mr. Nimchuk, who Mr. Paletta met for the first time at the closing for the first transaction. Mr. Paletta agreed that the Six Iron investment represented approximately 10% of the Paletta family net worth. Mr. Paletta established that his family is both hands-on in the business and conservative in their investments. It is simply not credible that the Palettas would allow the negotiation of an asset acquisition worth a significant percentage of their wealth to be carried out, without any oversight or supervision, by someone they did not know.

[177] Mr. Paletta's non-involvement also undercuts his stated explanation for the size of the investment. He testified that the reason for risking such a large amount was to establish himself in the industry – to make "a splash". But surely, if that were so, he would have insisted on including himself in the negotiations with Fox so as to meet the players in order to establish relationships with them.

[178] Mr. Paletta asserted that he believed that Messrs. Fergus and Nimchuk were highly knowledgeable in the industry and that he could put stock in their evaluation of the long-term prospects of the proposals. He alleged that he believed he could rely upon Mr. Nimchuk to negotiate favourable terms with Fox for the benefit of the Appellants. Given the amount of faith Mr. Paletta placed in the promoters, I find it curious that he was so unconcerned about the possibility of the promoters having a conflict of interest as interested parties in the transactions. Mr. Paletta claimed that he did not believe the promoters had such a conflict from the standpoint of providing objective and independent advice he likened them to realtors, who only get paid if the deal closes. The crucial difference between a realtor and the promoters here is that the realtor's fee or commission is fully disclosed in the listing agreement, and often subject to negotiation. I suspect that Mr. Paletta, with his extensive experience in buying and selling real estate, has often negotiated and renegotiated a realtor's brokerage commission.

[179] Mr. Paletta's testimony that he was indifferent to the promoters' fees is not credible. He claimed not only that he was not concerned about whether the promoters had a financial interest in the arrangement, but that he did not enquire or even care about how much they stood to gain from the transactions:

> JUSTICE HOGAN: But you didn't -- you weren't -- you never asked Mr. Fergus how much money he was making off of this deal when he first came to meet you?
>
> THE WITNESS: I don't think he told me, number one, Your Honour, but in the -- the total $8-million and change I knew full well was going to corps and individuals. How it was split, no idea. And really, you know, at the end of the day it didn't matter to me, because the $8-million cash infusion, it's still $8-million, regardless how it's segregated and separated.[77]

[180] Mr. Paletta gave numerous examples of how his family sought to lower costs and maximize profit in the context of the family's real estate dealings. I believe it would be highly unusual for the Palettas to authorize an $8 million cash outlay without at the very least requiring a strict accounting.

[181] The Appellants point to the Kagan Report as evidence that they did their due diligence, that they sought an independent third party valuation opinion and that the projected revenues from the films justified the high investment. In my opinion, the Kagan Report is window dressing.

[182] Firstly, I note that the Appellants received the Kagan Report very shortly prior to closing and only after the Appellants had wired significant funds in trust to Davis & Company LLP (corporate counsel to the Partnerships). The Appellants also incurred well in advance of receiving the Kagan Report significant costs in the form of professional fees for reviewing the accounting and tax benefits of the transactions and preparing the legal documentation. If the Appellants were truly interested in the long-term viability of the transactions, I believe that they would have insisted on having the Kagan Report at a much earlier date.

[183] I also note that Mr. Paletta was uninvolved in the commissioning of the Kagan Report. In fact, he testified that he did not know who commissioned the report but assumed it was Mr. Fergus. But as noted above, it was Mr. Nimchuk who commissioned the Kagan Report. Mr. Paletta further acknowledged that he did not verify the credentials of the authors of the Kagan Report before it was commissioned. Aside from being additional evidence that demonstrates a

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[77] Transcript, volume 5, dated March 15, 2019, at page 672, lines 12-21.

surprising lack of interest in the details of the transactions, Mr. Paletta's blasé attitude towards the Kagan Report raises particular red flags.

[184] Mr. Paletta is well aware that valuation is more of an art than a science. He recognized that in the real estate field, a valuator's conclusion is often influenced by the client who hired him or her. In fact, Mr. Paletta cited the importance of understanding appraisals in real estate as one of the reasons he got his real estate broker's licence.[78] He introduced me to the concept of "AACI", or "appraisal according to client's instructions":

> MR. JUSTICE HOGAN: But often whoever hires the valuator is the person that kind of--I have seen numbers in this courtroom in many cases that two very competent valuators, transfer pricing cases, I mean, the gap is huge. Two very competent valuators. Often the Court has to balance between whether they are acting as an advocate for somebody or they have done something and the Court has to make a call on that based on the presentations. And it somehow seems that whoever hires the valuator has an influence on how things turn out at the end.
>
> THE WITNESS: <u>So I am very familiar, Your Honour, with AACI and of course the I guess the flippant way is, you know, appraisal according to client's instructions.</u> But to be honest, I mean, but they do have parameters that they should follow.[79]

[185] As an example, Mr. Paletta noted that an expropriated party's valuation report often justifies a much higher value than that defended by a valuator hired by the expropriating party. Given Mr. Paletta's extensive experience with the variability of appraisal values, his total lack of involvement in the Kagan Report process suggests strongly that he did not need an accurate or reliable appraisal of the films because he did not intend to retain ownership of them.

[186] This conclusion is strengthened by the testimony of Mr. Derek Baine, an executive of Kagan Media. Mr. Baine testified that the two reports were commissioned by Mr. Nimchuk and prepared solely according to his instructions. Kagan Media has a proprietary data bank that gathers detailed financial information on all of the films that have been theatrically released over the past few decades. To complete the reports, the Kagan appraisers simply had to select films that were comparable to the films at issue. The comparability of films was solely based on factors such as the budget and cost of the film, as well as whether

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78 Transcript, volume 4, dated March 14, 2019, at page 499, lines 9-13.
79 Transcript, volume 8, dated March 20, 2019, at page 1132, line 24 to page 1133, line 11.

the film had a wide release. The average revenue was then determined by dividing total revenue for the comparable films earned in each market by the total revenue earned for all films in the market. In the present case, it was a simple assignment because a full-blown appraisal of the films was not required; Kagan was merely tasked with providing a reasonable forecast of the revenue that the Appellants could expect to receive under the Distribution Agreements entered into with Fox. The assumption was then made that the films acquired by the Partnerships would achieve this average performance.

[187] Mr. Baine did not know why Mr. Nimchuk had commissioned the reports. He assumed it was in relation to government tax subsidies:

> THE WITNESS: He didn't tell me. I made the assumption that -- and I told you this on the phone. We call these reports reasonable expectation of profit reports. We've produce probably over a hundred of them in the 25 years that I've been here.
>
> The main purpose of those reports were [*sic*] that when a country has a tax subsidy, which it tends to flow from country to country to country as they compete to get filming done in their country. So we've done them in Australia, we've done them in New Zealand, we've done them in the UK and Canada.
>
> What the government typically requires when they are providing a tax subsidy on a film is they want a report saying that even if there was going to be no tax credit involved here, this film is predicted to be cash flow positive, just to make sure that they're not subsidizing a film that's going to lose money anyway.
>
> And that's what I thought this report was for. I've since found out that's not what it was for, but that's what I thought it was for at the time.[80]

[188] At the end of Mr. Baine’s cross-examination, I asked him how much an investor should rely on his report:

> JUSTICE HOGAN: Let me ask you a hard question. If you were putting up $200 million for a movie, how much stock would you put in your report if you were the investor? You're sophisticated, you know financial matters, you know the risk in the film industry and so forth, would this be the document that would cause you to invest or not invest?[81]

[189] He answered as follows:

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80 Transcript, volume 1, dated June 3, 2019, at page 31, line 19 to page 32, line 14.
81 Transcript, volume 1, dated June 3, 2019, at page107, lines 6-12.

> THE WITNESS: If I were investing $200 million in a movie, I would want to have a conversation with the person who wrote this report and ask them, you know, specifically how likely is this to play out. Because there are a lot of caveats in here that any movie can do anything, and I think anybody investing that kind of money would hopefully have good financial consultants, legal consultants, and want to talk to people putting up the reports and say how likely are we to hit these numbers.[82]

[Emphasis added.]

[190] In short, even the preparer of the Kagan Report believed it would be imprudent to treat the report as the key element in an investment decision.

[191] The only plausible explanation that I can find for ignoring the red flags detailed above is that the Appellants knew the films would be reacquired by Fox prior to their commercial release and that their entire return would be the tax savings described by the promoters. In other words, the Appellants' conduct was not consistent with that of an investor making a true long-term investment in these films. Instead, it was consistent with the conduct of a passive investor in an old-fashion d tax shelter investment.

F. Fox

[192] There is no direct evidence from Fox on why it entered into these transactions. As mentioned earlier, the business affairs executives who worked out the terms and conditions of the transactions were not called to testify. The Appellants explained that they were no longer employees of Fox and were hard to reach. Instead, two senior lawyers from Fox were called, but neither had knowledge of what Fox sought to gain from the transactions. That being said, circumstantial evidence in the record leads me to believe that Fox agreed to participate in a tax shelter in exchange for a fee equal to 3% of the P&A expenses deducted by the Partnerships.

[193] Fox received on the closing date of each transaction an amount of net cash equal, in each case, to 3% of the P&A expenses borne by the Partnerships. Juliet Smith, a Canadian corporate lawyer for Fox in these transactions, candidly referred to this amount as a "fee" in an email sent to Davis & Company containing Fox's wire instructions for payment. The email also indicated that the amount was 3% of US$85,000,000, which was the P&A expense in the Swilcan transactions. In court,

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82 Transcript, volume 1, dated June 3, 2019, at page 107, lines 13-22.

Ms. Smith attempted to clarify the meaning of her email by saying, that she had made a mistake in describing the amounts as a fee and in indicating that it was equal to 3% of the P&A expenses. I am unconvinced that her initial understanding as expressed in the email was incorrect.

[194] There is further evidence to suggest that Fox did not intend to give up ownership of the films.

[195] I note two facts that, on their own, are merely suggestive. First, in both appeals, Fox pre-signed the Option Agreements at closing and placed them in escrow. Second, Fox exercised the options in all eight of the structures it participated in with the promoters. I do not consider either of these facts to be determinative – they merely add to the weight of evidence indicating that the exercise of the option was baked into the structure.

[196] More concretely, Fox sold the films to the Partnerships at a price approximately equal to the production cost. The fact that Fox sold the films at cost is inconsistent with the Appellants’ theory that Fox entered into the transactions in order to mitigate risk during the lead-up to commercial release. If there was a real chance the films would remain the property of the Partnerships, I believe Fox would have taken steps to maximize the sale price of the films. Fox could have done so by sharing its information regarding the commercial prospects of the films with the Appellants – for example, test screenings and internal forecasts. This is what buyers and sellers do when selling high-value assets. However, no one involved with the Partnerships or with Kagan made any attempt to access or even inquire about this data.

[197] Finally, the distribution commission is another indication that Fox would retain ownership. Mr. Baine noted that the Distribution Agreements gave Fox a low distribution commission. Fox agreed to commissions in the range of 10-15%, whereas the general range of commission charged by major studios at the time was 25-35%.

[198] Why did Fox agree to a low commission structure? A low commission structure allows the Appellants to argue that they could reasonably expect to receive high revenues from the Distribution Agreements and therefore that it was not in the Appellants’ interest for Fox to exercise the options. It helps the Appellants challenge an assessment stating that they had invested in an unregistered tax shelter. If the parties agreed in advance that the options would be exercised, then it would not matter to Fox what the rate was, as Fox would never

receive it. This is the only explanation I can find for the low commission structure. I believe that this feature was added to the transactions because both parties had agreed that Fox would reacquire the films prior to their commercial release.

[199] As a related matter, there is the US$1,000,000 received by the Partnerships from Fox allegedly as an advance on the Australian home video receipts. This amount was represented to be the gross profit of the Partnerships and the Appellants, as limited partners, reported their pro rata share of that income in their tax returns. I find that this amount is window dressing. It existed to defend the legitimacy of the Partnerships, if challenged, by demonstrating that they had earned income. It also did not affect the overall cash flow and was taken into account in the calculation of Fox's 3% fee. As a result, that amount did not have to be included as income.

[200] Another important consideration in relation to Fox is its involvement in a similar type of transaction with a different investor. Prior to the transactions with Paletta International, Fox had also entered into a financing transaction for the Six Iron Film with Ingenious Film Partners 2 LLP ("Ingenious"), a UK Partnership. In this transaction, Ingenious was investing in the film production.

[201] At that time, Fox only owned the screenplay for the Six Iron Film, it did not own the copyright in the completed film as the film was not yet fully produced and completed.

[202] Part of investment by Ingenious was its own money and it obtained the remainder through a loan from Fox. The loan from Fox was repaid over time from Ingenious' share of the receipts. Fox granted Ingenious a one-picture licence in the screenplay to facilitate the production of the film. Ingenious was also granted a right to the "residuals" from the film.

[203] In 2006, after production of the film was complete, Ingenious assigned and transferred to Fox all rights, title and interest in the film.

[204] The Appellants submit that this transaction shows Fox's motivation to offload risk wherever it could.[83] They also submit that the fact that these transactions did not incorporate an option demonstrates that Fox is not hesitant to build in compulsory reacquisition mechanisms where it so desires.[84] However, in

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83 Appellants' Written Argument, page 42 at para. 26(h).

84 Appellants' Written Argument, page 42 at para. 26(i).

my opinion, the fact that the film was returned to Fox simply indicates that Fox always planned to earn all the distribution revenues from the film.

[205] In short, the Ingenious transaction had many features of Canadian production services transactions. Investors would benefit from deductions associated with production costs in consideration of a future right to income. Fox loaned the investors most of the cash through a circuitous route. The investors' cash then made its way to Fox, and presumably the promoters.

[206] The investors' right to income is set at a low amount to avoid the clawing back of the tax benefit. Any amounts received by the partnership are repaid to Fox. The record shows that after all these years of commercial distribution of the Six Iron Film, the Six Iron Partnership (or the investors) owes Fox money.

[207] In the instant case, the evidence that shows Fox wanted to share in the tax benefit that the Appellants received in order to lower the P&A expenses. They reacquired the film and received a fee equal to 3% percent of those P&A expenses. The appellants would have the Court believe that it was simply happenstance that Fox reacquired the films in the eight separate transactions arranged and promoted by Messrs. Nimchuk and Fergus. This is simply too good to be true.

[208] The transactions at issue demonstrate that Fox was seeking ways to lower its distribution costs. The transactions were tax shelter deals that Fox took part in. That being so, I am able to consider this as circumstantial evidence of Fox's willingness to enter into tax shelter deals and of its appetite for doing so.

G. Transaction Documents

[209] As I reviewed the transaction documents, I was struck by the fact that certain features of the transactions appear to have been designed solely with a view to the short term in that they facilitate the unwinding of the transactions and the return of the films to Fox. I shared my concerns in this regard in order to provide counsel with the opportunity to address them in argument. These features are, in my opinion, incompatible with the Appellants' alleged intent to hold the films for the long term.

[210] The transaction documents contained sloppy drafting and inconsistencies which would not generally be present in commercial transactions that were created for the long term.

[211] For example, section 4 of the Distribution Agreement allows Fox to terminate the agreement if the partnership does not comply with the specified material provisions; however, the agreement does not provide an equivalent provision allowing for the partnership to terminate the agreement in the same way that Fox could. In a transaction such as this, it is the copyright holder who has the greater bargaining power because the copyright holder may choose among countless distributors for distribution of the film. Accordingly, under reasonable commercial practice, the Distribution Agreement should allow the copyright holder to terminate it if the distributor is not performing its obligations in a satisfactory manner.

[212] Another example is inconsistencies in the security agreements, which are discussed in detail below.

[213] Factors such as these, though not determinative on their own, demonstrate a lack of long-term foresight in the drafting of the transaction documents.

H. Fintrust Financial Arrangements

[214] Fintrust's financial arrangements stand out in this respect. In the case of the Six Iron transactions, Fintrust borrowed US$206,850,000 from Fox. This loan was repayable on demand and had a 10-year sunset clause. This loan indirectly funded a loan of roughly similar size to Paletta International from Fintrust ("Paletta International Loan"). The Paletta International loan was a term loan: except in the case of default, Fintrust could not require Paletta International to repay the principal amount for 10 years. This is a classic mismatch, a demand loan versus a term loan. As a result, Fintrust is exposed to a higher risk of default because Fox could demand full repayment at any time. If Fox did so before Paletta International had repaid its obligation to Fintrust, Fintrust would be left in the difficult position of having to find a new source of financing.

[215] I seriously doubt Fintrust could have found a new lender to take on this risk. Fintrust was fully leveraged. It had no capital. Although the Appellants argue that Paletta International was extremely well capitalized, the Paletta International Loan was secured only by Paletta International's units in the partnership. It was otherwise unsecured with respect to Paletta International's other assets. It is general knowledge that lending institutions request negative covenants in order to preclude borrowers from restructuring their financial arrangements so as to grant new lenders better-ranking security on their other assets. Lenders do not like back-

to-back arrangements: they like to lend directly to the ultimate borrower in order to rank equally with other creditors in the event of bankruptcy.

[216] The sole director of Fintrust's corporate trustee, Mr. Tamssot, testified at the hearing. Mr. Tamssot has a long history in personal and commercial banking. He also has personal and professional connections with Mr. Fergus. He acted as trustee on five or six of Messrs. Nimchuk's and Fergus' deals, but he was not involved in the Swilcan transactions. When the dust settled, Mr. Tamssot's wife received a fee of US$20,000 for Mr. Tamssot's role in the Six Iron transactions.

[217] Mr. Tamssot is well aware that lending institutions, other than perhaps deposit-taking banks, strive to match the term of their loans with the term of their source of financing. He acknowledged that Fintrust would have had difficulty finding new financing in the circumstances described above.

[218] Mr. Tamssot also admitted that he would not have engaged in similar financial arrangements if he had had his own family trust for which he was acting as the trustee. This says a great deal about how Mr. Tamssot carried out his role as the sole director of the corporate trustee. He ignored the filing obligations of the trust. He was ignorant as to the trust's net income. When asked for specifics of Fintrust's financial arrangements, he turned repeatedly to the promoters for answers. I conclude that Mr. Tamssot simply followed the promoters' instructions with respect to the financing terms. He exercised no discretion in this regard.

[219] There is a situation in which Fintrust's financing terms would make sense. That situation is where the option is guaranteed to be exercised.

[220] As detailed above, the promoters prepared an analysis of the tax savings to the Appellants if Fox exercised the options. In each case, the Appellants' rate of return was enhanced through the use of the 5-year capital gains reserve in respect of the gains arising from the disposition of the partnership units.

[221] The Appellants' access to the capital gains reserve was baked into how the option arrangements would be carried out. The parties referred to the transactions under which the Appellants would access their capital gains reserve as the defeasance transactions ("Defeasance Transactions"). The salient aspects of the Defeasance Transactions as concerns Fintrust are as follows:

i. Fox caused Wordsmith to acquire all of the Six Iron Partnership units for US$218,091,000.

ii. Wordsmith assigned its interest in the copyright on the film to Faultline, which assumed the obligation to pay the amount owed to Paletta International.

iii. The amount owed to Paletta International was payable in five instalments. This provided Paletta International with the opportunity to claim the capital gains reserve.

iv. As a result of the above, Paletta International had an amount receivable from Faultline and an amount payable to Fintrust.

v. Faultline assigned the copyright to Fox; upon completion of this transaction, Fox owed Faultline US$214,521,000.

vi. Fintrust repaid the amount that it owed to Fox (US$206,850,000) by assuming Fox's obligation to Faultline (US$214,521,000).

[222] As a result of the above, Fintrust's liability went from US$206,850,000 to US$214,501,000. Why did Fintrust agree to take on a greater liability under the Defeasance Transactions? Mr. Tamssot offered the following explanation:

> Q. So why would Fintrust agree to this agreement?
>
> A. For the higher amount specifically?
>
> Q. Yes.
>
> A. It moves from a demand loan to a fixed term repaid loan. So from that specific part of it in terms of being called at any time on demand and not being able to meet obligations or potentially meet obligations, it removes that risk to a certain degree. It also reduces the length of time for repayment of the loan from ten years down to five years.[85]

[223] A lot was left unsaid by Mr. Tamssot. In particular, why did Fintrust agree to borrow US$206,850,000 payable on demand in the first place? The only reason I can find is that Fintrust agreed to a demand loan to justify its assuming a greater liability to Faultline under the Defeasance Transactions. In fact, Mr. Tamssot himself gave the following testimony:

> Q. So in consideration of being defeased of a debt of 206, Fintrust is agreeing to a debt of 214 and change?

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85 Transcript, volume 7, dated March 19, 2019, at page 987, lines 4-14.

A. Correct.

Q. And in your mind, again, the reason it would do that is because?

A. Significant reduction in potential risk on being called on demand and reduced level -- reduced length of time that the loan would be outstanding, from ten years down to five.[86]

[224] While it did not make sense from a commercial perspective for Fintrust to take on this risk initially, it offered Fintrust the opportunity to defend the Defeasance Transactions if the tax consequences, which were necessary to ensure that the Appellants had access to the capital gains reserve, were challenged by CRA. In other words, the Fintrust financial arrangements were in their entirety structured with the knowledge that it had been pre-agreed that the options would be exercised.

I. Paletta International Loan

[225] I have similar concerns about the Paletta International Loan. On paper, it is a 10-year-term loan, which differentiates it from the Fintrust loan. Paletta International appears to have financed a long-term asset – the limited partnership interest – through a long-term loan. Effectively, however, this was not the case. The partnership's security arrangements with Fox left Paletta International to bear a risk nearly equivalent to Fintrust's if Fox demanded early repayment of its loan (i.e.,Fox's loan to Fintrust).

[226] Under the security arrangements, the partnership pledged its interest in the film as security for the repayment of the Fox loan. If Fox demanded repayment and Fintrust could not find a substitute lender, Paletta International would have had to repay the loan or restructure its own loan, or else allow Fintrust to default on its loan from Fox. A Fintrust default would have resulted in Paletta International losing its indirect ownership interest in the film.

[227] As detailed above, Mr. Paletta impressed me with his business acumen. Assumption of risk of this kind strikes me as wildly out of his and his family's character. It tells me a great deal about what Mr. Paletta knew about the outcome of the transactions.

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86 Transcript, volume 7, dated March 19, 2019, at page 987, line 27 to page 988, line 8.

J. Security Arrangements

[228] Another surprising feature of the security arrangements further indicates to me that the Appellants knew that they would not hold the films for the long term.

[229] Mr. Paletta testified that he had relied on the financial projections prepared by the promoters in deciding whether to invest in the transactions. Those projections covered several scenarios in which Fox did not exercise its option, and one in which Fox did. For the scenarios in which the Partnerships kept the films, the projections analyzed the revenues necessary for the Appellants to break even on their investment or to earn a 15% rate of return. A third projection, based on the forecasted revenues in the Kagan Report, was implied but not in evidence. In the Six Iron transactions, the projection that assumed Fox would reacquire the film projected a 125% return on cash invested.

[230] The projections in which the Appellants retain the films all rely on a crucial assumption, namely that the Appellants would receive their share of the cash flow on an ongoing basis as the partnership earned income under the Distribution Agreements with Fox. For that reason, anything that affects the time at which the Appellants would be entitled to receive distributions from the Partnerships is materially relevant to the accuracy of the financial projections.

[231] I was therefore surprised to discover that, under section 9.1 of the Partners/Fox Security, Fox could, at its sole discretion, choose to add profits or distributions that were payable to the Appellants to Fox's collateral account instead of distributing them to the partners. Fox could then hold these amounts until the expiration of the Distribution Agreements.

[232] It is hard to imagine why an investor would agree to such a clause, and Mr. Paletta concurs; he is adamant that he would not have approved the transactions if my interpretation is correct, and further, that he would sue Fox if it attempted to hold on to the cash receivable by the Appellants.

[233] The relevant provisions of the Partners/Fox Security are as follows:

> **2. OBLIGATIONS SECURED**
>
> The Security Interest granted hereby is in addition to and not in substitution for any other security interest now or hereafter held by Distributor from any Partner or from any other person whomsoever and secures and is and will at all times be

general and continuing security for the payment, performance, and satisfaction of any and the performance of

(a) Partnership's obligations under the Distribution Agreement;

(b) each Partners' [*sic*] obligations under the Option Agreement and under this Security Agreement;

(c) Optionco's obligations and those of its successors and assigns under the Assignment and Option Agreement; and

(d) without limiting the generality of the foregoing, Partnership and each Partner's obligations under the Transaction Agreements and all other agreements referred to therein or contemplated thereby;

(all of which indebtedness, liability, and obligations are collectively called the "Indebtedness" or the "Obligations").

. . .

**8. INCOME FROM AND INTEREST ON COLLATERAL**

Following the occurrence of a default (as defined in Section 11.1) or a breach by a Partner under the Option Agreement or the Assignment and Option Agreement,

a) all distributions on account of the Units owned by a Partner will be applied to the obligations of that Partner to the Distributor and each Partner by this Agreement authorizes and directs the Managing General Partner, as the managing general partner of Partnership, in such event, to pay directly to the Distributor any such distributions and the Managing General Partner acknowledges such direction and agrees with the Distributor in such event to pay such distributions directly to the Distributor; and

b) any proceeds received by a Partner in respect of its Units will be added to and form part of the Collateral.

**9. INCREASES, PROFITS, PAYMENTS, OR DISTRIBUTIONS**

**9.1**Whether or not default has occurred, each Partner authorizes Distributor

a) to receive any increase in or profits on Collateral and to hold the same as part of Collateral, with money so received being treated as income for the purposes of section 8 and dealt with accordingly; and

b) to receive any payment or distribution upon redemption or retirement or upon dissolution and liquidation of the issuer of Collateral, to surrender

> such Collateral in exchange therefor, and to hold any such payment or distribution as part of Collateral.
>
> **9.2** If a Partner receives any such increase or profits or payments or distributions, the recipient will deliver the same promptly to Distributor to be held by Distributor as herein provided.
>
> **10. DISPOSITION OF MONIES**
>
> Subject to any applicable requirements of the PPSA, all monies collected or received by Distributor pursuant to or in exercise of any right it possesses with respect to Collateral will be applied on account of Indebtedness in such manner as Distributor deems best or, at the option of Distributor, may be held unappropriated in a collateral account or released to Partnership, all without prejudice to the liability of the Partners or the rights of Distributor hereunder, and any surplus will be accounted for as required by law.[87]

[234] The Appellants argue that my interpretation of paragraph 9.1(a) as allowing Fox to retain the revenue is incorrect because it does not take account of the context and surrounding provisions. They argue that full consideration must be given to paragraph 8(a), which provides that "all distributions on account of the Units owned by a Partner" may be seized upon an event of default under the Distribution Agreement. Paragraph 8(a) only applies after default occurs. Therefore, according to the Appellants, "[i]t would be non-sensical [*sic*] for section 9.1 to provide for the exact same result <u>prior</u> to any default."[88]

[235] I agree that a full contextual analysis is required. In my opinion, the Appellants' interpretation fails to take into account section 10.

[236] Section 10 provides that "all monies collected or received by Distributor . . . will be applied on account of Indebtedness . . . or, at the option of Distributor, may be held unappropriated in a collateral account or released to Partnership".[89] Under this provision, Fox could at any time opt to release any profits it had previously withheld. A default could occur after Fox opted to release the profits to the Partnerships. In that case, paragraph 8.1 would allow Fox to seize such profits.

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87 Partners/Distributor Security Agreement, Exhibit A1, volume 1, tab A10. It should be noted that "Transaction Agreements" is defined as meaning the Distribution Agreement, Option Agreement and the Assignment and Option Agreement.

88 Appellants' Written Argument, page 46 at para. 41(b). [emphasis in original].

89 Exhibit A1, volume 1, Tab A10, section 10 [emphasis added].

[237] Under this understanding, paragraphs 8(a) and 9.1(a) do not necessarily overlap.

[238] Mr. Fergus testified that he believed Fox was required to distribute the funds to the Partnerships:

> JUSTICE: Were you aware that Fox could put the cash into cash collateral account and hang onto it as security under the distribution agreement?
>
> A My understanding is the distribution agreement forces Fox to distribute to the partnership.[90]

[239] Mr. Fergus then suggested that there would be no reason for Fox to hold on to the cash, as it was necessary to distribute it to the partners in order to have Fox's own loan to Fintrust eventually paid off:

> JUSTICE: Do you know –- I know studios and presumably you do. If you can keep the cash yourself as opposed to give it to somebody else when somebody else still has to pay you, are you going to give it to them or are you going to keep it?
>
> A I don't disagree with the principle, the point I was making is that the cash that the studio pays to the partnership, the partnership is then compelled to distribute to the investors who are then compelled to pay to FinTrust who is then compelled to pay to the studio. So in my mind the studio would rather have cash in its own hands completely under its own control than dammed up at some point where the money was coming to them in any event. I'm struggling with the rationale.[91]

[240] Mr. Fergus seems to have forgotten that the Appellants are under no obligation to repay the loan to Fintrust prior to the expiration of its 10-year term. Meanwhile, it is undisputed that the value of a film decreases significantly during that time. If the Appellants diverted the income required to pay off their loan from Fintrust to another purpose, Fox could not intervene. During this time. Fox's income stream would disappear and the value of its collateral would decline. That provides a strong incentive to maintain broad discretion to hold on to a partner's share of the profits from the Partnerships.

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90 Transcript, volume 1, dated May 28, 2019, at page 39, lines 9-14.
91 Transcript, volume 1, dated May 28, 2019, at page 55, lines 12-26.

[241] As noted, Mr. Paletta testified that he did not believe Fox could withhold profits under the Distribution Agreements, and that he would not have entered into the transactions if that were the case. I think this is further evidence that he was not concerned about the terms of the security arrangements because he knew that the Appellants would, in all circumstances, not be subject to their application. The films would go back to Fox before any question of revenue under the Distribution Agreements arose. In this context, the most likely explanation for the inclusion of section 9.1 is that it was a boilerplate provision included in the security arrangement to no purpose. Likewise, there was no reason for the Appellants' counsel to object to the inclusion of the clause in the agreement if the Appellants knew that it would never apply.

[242] The Appellants also submit that the partners/Fox Security does not create a situation in which Fox could seize and retain any cash or collateral to which it is not entitled. The Appellant drew the Court's attention to the fact that section 12 of the Distribution Agreement states that "Fox shall pay . . . the amount of Gross Receipts [less its] Distribution Fees and Release Costs". However, the security agreements allow Fox to retain this amount as part of the collateral. At the very least, the contradictions in the agreements demonstrate a lack of attention in drafting the transaction documents. In a transaction dealing with hundreds of millions of dollars, commercial reasonability would warrant careful attention to detail in drafting those documents. The lack of attention to detail signals to me that the parties knew the options would be exercised.

K. Conclusion

[243] In light of all of the above, I find that the Appellants invested in the Six Iron and Swilcan Partnerships solely to avail themselves of the tax savings that the promoters led them to believe they could expect and that they felt secure in the knowledge that Fox had agreed to reacquire the films prior to their commercial release.

[244] Accordingly, I conclude that the options were shams designed to mask the parties' agreement that Fox would reacquire the films prior to their commercial release.

[245] Consequently, the P&A expenses allegedly borne by the partnerships were not incurred for the purpose of earning income. Likewise, the financing and other expenses incurred by the Appellants with respect to their partnership interests are not deductible.

[246] As a result of this finding, I conclude that the Appellants did not realize a gain of any kind in connection with the disposition of their partnership units because their proceeds of disposition were less than their adjusted cost base. I note that the Respondent conceded this point in the event that I should accept this theory of sham.

[247] I conclude that the Defeasance Transactions form part of the sham described earlier. Therefore, the Appellants have no interest revenue and interest expense to be taken into account.

L. <u>Statute-Barred Year</u>

[248] Mr. Paletta carried back part of a loss arising from his investment in the Swilcan Partnership to his 2005 taxation year. The reassessment disallowing the carry-back was issued beyond the normal assessment period.

[249] I conclude that Mr. Paletta made a misrepresentation attributable to carelessness, neglect or wilful default in respect of that loss; he claimed a loss that did not exist. I am satisfied that Mr. Paletta knew this to be wrong because he knew that it was agreed that Fox would reacquire the film prior to its commercial release. As a result, the 2005 reassessment is not statute-barred.

V. <u>Tax Shelter</u>

A. **Overview**

[250] Section 237.1 of the Act requires a "promoter" of a "tax shelter" to obtain an identification number from the CRA by registering the "tax shelter" in prescribed form. The purpose of the registration, as was admitted in the Appellants' Written Argument, is to bring to the CRA's attention certain types of investments that may benefit from substantial tax assistance in the circumstances described below. In this regard, the registration highlights the investment for early audit detection.

[251] An investor in an unregistered tax shelter is not entitled to deduct or claim any losses or expenses in relation to the tax shelter. In the instant case, the Appellants' investments in the Partnerships were not registered as tax shelters as both parties agree that no tax shelter identification number was obtained for either the Six Iron or Swilcan transactions. This has prompted the Respondent to raise this issue as an alternative argument. Therefore, in the event that my finding of

“sham” is incorrect, and in the interest of completeness, I will now analyze the parties’ alternative arguments on this point.

B. The Law

[252] During the taxation years at issue, the relevant parts of section 237.1 read as follows:

> **Definitions**
>
> **(1)** In this section,
>
> ***promoter*** in respect of a tax shelter means a person who in the course of a business
>
> **(a)** sells or issues, or promotes the sale, issuance or acquisition of, the tax shelter,
>
> **(b)** acts as an agent or adviser in respect of the sale or issuance, or the promotion of the sale, issuance or acquisition, of the tax shelter, or
>
> **(c)** accepts, whether as a principal or agent, consideration in respect of the tax shelter,
>
> and more than one person may be a tax shelter promoter in respect of the same tax shelter;
>
> ***tax shelter*** means
>
> . . .
>
> **(b)** . . . a property (including any right to income) . . . in respect of which it can reasonably be considered, having regard to statements or representations made or proposed to be made in connection with […] the property, that, if a person were to . . . acquire an interest in the property, at the end of a particular taxation year that ends within four years after the day on which the . . . interest is acquired,
>
> **(i)** the total of all amounts each of which is
>
> **(A)** an amount, or a loss in the case of a partnership interest, represented to be deductible in computing the person’s income for the particular year or any preceding taxation year in respect of

. . . the interest in the property (including, if the property is a right to income, an amount or loss in respect of that right that is stated or represented to be so deductible), or

**(B)** any other amount stated or represented to be deemed under this Act to be paid on account of the person's tax payable, or to be deductible in computing the person's income, taxable income or tax payable under this Act, for the particular year or any preceding taxation year in respect of . . . the interest in the property, other than an amount so stated or represented that is included in computing a loss described in clause (A),

would equal or exceed

**(ii)** in the amount, if any, by which

**(A)** the cost to the person of […] the interest in the property at the end of the particular year, determined without reference to section 143.2,

would exceed

**(B)** the total of all amounts each of which is the amount of any prescribed benefit that is expected to be received or enjoyed, directly or indirectly, in respect of […] the interest of the property, by the person or another person with whom the person does not deal at arm's length.

**Deductions and claims disallowed**

**(6)** No amount may be deducted or claimed by a person in respect of a tax shelter unless the person files with the Minister a prescribed form containing prescribed information, including the identification number for the tax shelter.[92]

[Emphasis added.]

[253] During the same period, subsection 231(6) of the Income Tax Regulations (the "Regulations") defined a "prescribed benefit" as follows:

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92 Act, section 237.1.

**(6)** For the purposes of paragraph (b) of the definition ***tax shelter*** in subsection 237.1(1) of the Act, ***prescribed benefit*** in respect of an interest in a property means any amount that may reasonably be expected, having regard to statements or representations made in respect of the interest, to be received or enjoyed by a person (in this subsection referred to as "the purchaser") who acquires the interest, or a person with whom the purchaser does not deal at arm's length, which receipt or enjoyment would have the effect of reducing the impact of any loss that the purchaser may sustain in respect of the interest, and includes such an amount

**(a)** that is, either immediately or in the future, owed to any other person by the purchaser or a person with whom the purchaser does not deal at arm's length, to the extent that

**(i)** liability to pay that amount is contingent,

**(ii)** payment of that amount is or will be guaranteed by, security is or will be provided by, or an agreement to indemnify the other person to whom the amount is owed is or will be entered into by

**(A)** a promoter in respect of the interest,

**(B)** a person with whom the promoter does not deal at arm's length, or

**(C)** a person who is to receive a payment (other than a payment made by the purchaser) in respect of the guarantee, security or agreement to indemnify,

**(iii)** the rights of that other person against the purchaser, or against a person with whom the purchaser does not deal at arm's length, in respect of the collection of all or part of the purchase price are limited to a maximum amount, are enforceable only against certain property, or are otherwise limited by agreement, or

**(iv)** payment of that amount is to be made in a foreign currency or is to be determined by reference to its value in a foreign currency and it may reasonably be considered, having regard to the history of the exchange rate between the foreign currency and Canadian currency, that the aggregate of all such payments, when converted to Canadian currency at the exchange rate expected to prevail at the date on which each such payment would be required to be made, will be substantially less than that aggregate would be if each such payment was converted to Canadian currency at the time that each such payment became owing,

**(b)** that the purchaser or a person with whom the purchaser does not deal at arm's length is entitled at any time to, directly or indirectly, receive or have available

**(i)** as a form of assistance from a government, municipality or other public authority, whether as a grant, subsidy, forgiveable loan, deduction from tax or investment allowance, or as any other form of assistance, or

**(ii)** by reason of a revenue guarantee or other agreement in respect of which revenue may be earned by the purchaser or a person with whom the purchaser does not deal at arm's length, to the extent that the revenue guarantee or other agreement may reasonably be considered to ensure that the purchaser or person will receive a return of all or a portion of the purchaser's outlays in respect of the interest,

**(c)** that is the proceeds of disposition to which the purchaser may be entitled by way of an agreement or other arrangement under which the purchaser has a right, either absolutely or contingently, to dispose of the interest (otherwise than as a consequence of the purchaser's death), including the fair market value of any property that the agreement or arrangement provides for the acquisition of in exchange for all or any part of the interest, and

**(d)** that is owed to a promoter, or a person with whom the promoter does not deal at arm's length, by the purchaser or a person with whom the purchaser does not deal at arm's length in respect of the interest,

but, except as otherwise provided in subparagraph (b)(ii), does not include profits earned in respect of the interest.

## C. Analysis

[254] On a textual, contextual and purposive interpretation of section 237.1 of the Act, the following conditions must be satisfied for a property to constitute a tax shelter:

i. there must be a property in respect of which statements and representations are made or proposed to be made;
ii. the statements and representations must be made by a "promoter";
iii. it must be reasonable to consider, having regard to the statements or representations, that there is an amount that is represented to be deductible in respect of the property; and

iv. the amount represented to be deductible must exceed or be equal to the investor's cost in the property less "prescribed benefits".

[255] The Appellants in their written submissions concede that conditions (i) through (iii) are satisfied. In this regard, they acknowledge that Messrs. Nimchuk and Fergus acted as promoters, and that statements and representations were made by Mr. Fergus to the Appellants to the effect that, *inter alia*, the P&A expenses incurred in the short period prior to the commercial exhibition of the pictures would be deductible by the Appellants. These are not big concessions. There is considerable evidence in the record that demonstrates that each of conditions (i) to (iii) is satisfied.

[256] The Appellants assert that only Mr. Fergus made statements and representations to the Paletta family. The Appellants point out that Mr. Paletta testified that he only met Mr. Nimchuk at the closing for one of the previous film deals and thus he would not have made any statements or representations to the Paletta family. I disagree. Mr. Fergus was not a credible and reliable witness. Mr. Fergus acknowledged that he and Mr. Nimchuk were partners in the venture and that they were interchangeable in their roles.

[257] The Appellants take issue with the Respondent regarding condition (iv) stated above. According to the Appellants, the amount represented to the Appellants as being deductible was considerably less than their cost of their investment. On this point, the Appellants assert that their cost is equal to the full subscription price paid for their partnership units. More specifically, the Appellants assert that the options would be exercised solely in circumstances that benefited Fox. In all cases, this would be done to the detriment of the Appellants. Therefore, the Appellants were not entitled to receive a "prescribed benefit" within the meaning of the preamble to subsection 231(6) of the Regulations.

[258] The Appellants submit that the only amounts represented as being deductible are the potential gross losses, which were included in the investment package provided to the Appellants and which do not bring the Appellants' cost of their partnership investments below the losses represented to be allocated to those investments.

[259] For the reasons that follow, I strongly disagree with the Appellants' assertion in this regard.

[260] As noted above, the preamble to subsection 231(6) of the Regulations states:

> For the purposes of paragraph (b) of the definition ***tax shelter*** . . . ***prescribed benefit*** in respect of an interest in a property means
>
> > any amount
> >
> > that [(i)] may reasonably be expected, having regard to statements or representations made in respect of the interest, to [(ii)] be received or enjoyed by a person . . .
> >
> > which receipt or enjoyment [(iii)] would have the effect of reducing the impact of any loss that the purchaser [who acquires the interest] [(iv)] may sustain in respect of the interest . . .

[Emphasis added.]

[261] For ease of reference, I have taken the liberty of highlighting and putting into list form the key conditions that give rise to the application of the preamble.

[262] The Appellants assert that the option price does not fall within the ambit of the preamble to subsection 231(6) of the Regulations because only Fox could decide whether to exercise the options. According to the Appellants, there is no evidence in the record to suggest that this was an outcome that was reasonably expectable.

[263] With respect, I disagree with the Appellants' assessment of the evidence in this regard. Accepting for now that my analysis of "sham" is wrong,[93] I believe at the very least that the evidence discussed earlier demonstrates that the Appellants expected the options to be exercised. The transactions were specifically structured to facilitate that very result.

[264] Therefore, in my opinion, conditions (i) and (ii) have been satisfied. This leaves conditions (iii) and (iv) to be analyzed.

[265] As noted earlier, the financial structure was very unstable. Assuming for the purpose of this analysis that Fox could have chosen not to exercise the option, Fox could still cause the early repayment of the Fintrust loan and, as an indirect result, the early repayment of the Paletta International Loan. Furthermore, Fox could

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[93] If my finding of "sham" is correct, it is indisputable that the option price falls within the meaning of subsection 231(6) of the Regulations because, in that case, the Appellants would have been entitled to receive that amount from the very outset of the transactions.

cause all of the distributions that were payable by the Partnerships to the Appellants to be held in a cash collateral account, maintained by Fox, until the expiration of the Distribution Agreements. If this happened, the Appellants would sustain a loss because they would bear the financing or opportunity costs of their investments without receiving revenue therefrom for a very long time.

[266] In that context, I believe there is ample evidence which demonstrates that the exercise of the options and the receipt by the Appellants of the option price would have the effect of reducing the impact of any loss that the Appellants may have sustained if the options remained unexercised. In my opinion, this is a significant "benefit" to the Appellants.

[267] The Appellants also asserted that the preamble to subsection 231(6) of the Regulations must be narrowly construed because of the word "would" used therein. In this regard, the Appellants' claim that the word "would" means "shall".

[268] In my opinion, the Appellants' interpretation of the word fails to take into account other important words used in the preamble, such as the phrases "reasonably be expected . . . to be received" and "reducing the impact of any loss that the purchaser may sustain". The Appellants assert that the word "would" signifies that "the option exercise price must have the effect of reducing the impact of any loss that the Appellant could sustain."[94] They state that there is no such effect here because the "remote possibility of any loss being reduced is insufficient."[95] However, I disagree. The mandatory characteristic derived from the word "would" has nothing to do with the likelihood of the benefit being received. That likelihood is rather determined by reference to the words "reasonably expected . . . to be received". The word "would" merely says that, if the benefit were to be received, it would reduce the impact of the loss. Therefore, the preamble to subsection 231(6) of the Regulations is of a wider import than that suggested by the Appellants.

[269] As a final observation, I believe my interpretation of subsection 231(6) conforms with the underlying rationale of the "tax shelter provisions". As noted earlier, the provisions are designed to flag a tax-assisted investment to the CRA so as to ensure that it is properly detected and audited. The investments made by the Appellants were represented by the promoters to be heavily tax-assisted.

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94 Appellants' Written Argument, page 82 at para. 53(a).

95 Appellants' Written Argument, page 82 at para. 53(a).

Mr. Paletta's rate of return, based on the amount of cash he invested, was calculated to be 257%.

[270] Likewise, Paletta International's return, based on the amount of cash it invested and as high as 289%, was estimated to be 125% if, as Paletta International ultimately did, it paid a capital dividend to its shareholders.

[271] Therefore, for all of the above reasons, by reason of the application of subsection 237.1(6) of the Act, I find that the Appellants are not entitled to deduct the losses or expenses claimed by them with respect to their investments in the Partnerships.

## VI. Real Estate

### A. Law

[272] The last issue in these appeals is the characterization of amounts received on the disposition of nine properties and whether those amounts were on income or capital account. Paletta International disposed of eight properties in its 2007 taxation year and one in 2006, for which a reserve was claimed in 2007. The Appellant, Paletta International, reported the gains or losses from those dispositions as income or losses from inventory on its 2007 return. Paletta International now disputes its filing, as is its right, saying that the dispositions were all on account of capital. Paletta International, alleges that error, inexperience on the part of Angelo Paletta and carelessness on the part of its controller and external accountant were the causes of the mistake.

### B. Capital Versus Income

[273] The law on this point is settled. The determination is a question of fact. The factors to consider were developed in, among other cases, *Friesen v. Canada*,[96] *Canada Safeway Ltd. V. The Queen*,[97] *Happy Valley Farms Ltd. v. The Queen*,[98] and *Hazeldean Farm Co. Ltd. v. M.N.R.*[99]

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96 [1995] 3 S.C.R. 103 [*Friesen*].

97 2008 FCA 24 [*Canada Safeway*].

98 86 DTC 6421, (1986), 7 F.T.R. 3 (F.C.T.D.).

99 [1967] 1 Ex. C.R. 245.

[274] There are multiple expressions of the factors to be considered. I reproduce the Supreme Court’s restatement in *Friesen* (at paragraph 17):

> (i) The taxpayer's intention with respect to the real estate at the time of purchase and the feasibility of that intention and the extent to which it was carried out. An intention to sell the property for a profit will make it more likely to be characterized as an adventure in the nature of trade.
>
> (ii) The nature of the business, profession, calling or trade of the taxpayer and associates. The more closely a taxpayer's business or occupation is related to real estate transactions, the more likely it is that the income will be considered business income rather than capital gain.
>
> (iii) The nature of the property and the use made of it by the taxpayer.
>
> (iv) The extent to which borrowed money was used to finance the transaction and the length of time that the real estate was held by the taxpayer. Transactions involving borrowed money and rapid resale are more likely to be adventures in the nature of trade.

[275] The most determinative is the taxpayer’s intention at the time of acquisition. A “scheme for profit-making”[100] indicates that the transaction is an adventure in the nature of trade, and not a capital transaction. A secondary profit-making intention at the time of acquisition is sufficient to characterize a transaction as being on income account. The whole conduct of the taxpayer must be assessed and inferences drawn.

[276] A number of principles emerge from the above-cited decisions, which I believe can be summarized as follows:

i) The boundary between income and capital gains cannot easily be drawn and, as a consequence, consideration of various factors, including the taxpayer's intent at the time of acquiring the property, becomes necessary for a proper determination to be made.
ii) For the transaction to constitute an adventure in the nature of trade, the possibility of resale as an operating motivation for the purchase must have been in the mind of the taxpayer. In order to make that determination, inferences will have to be drawn from all of the circumstances. In other words, the taxpayer's whole course of conduct has to be assessed.

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[100] *Friesen*, at para. 16 S.C.R.

iii) With respect to secondary intention, such intention must also have existed at the time of acquisition of the property and it must have been an operating motivation in the acquisition of the property.

iv) The fact that the taxpayer contemplated the possibility of resale of his or her property is not in itself a sufficient basis for concluding that there existed an adventure in the nature of trade. In *Principles of Canadian Income Tax Law*, in discussing the applicable test in relation to the existence of a secondary intention, the authors opine that "the secondary intention doctrine will not be satisfied unless the prospect of resale at a profit was an important factor in the decision to acquire the property."[101] I agree entirely with that proposition.

v) The *viva voce* evidence of the taxpayer with respect to his or her intention is not conclusive and has to be tested in light of all the surrounding circumstances.[102]

C. Eco Gift

[277] One of the dispositions in question was an "eco gift". A capital ecological gift entitles the taxpayer to a credit under paragraph 110.1(1)(d) of the Act and a deemed capital gain of zero under paragraph 38(a.2):

> **38.** For the purposes of this Act,
>
> . . .
>
> > **(a.2)** a taxpayer's taxable capital gain for a taxation year from the disposition of a property is equal to zero if
> >
> > > **(i)** the disposition is the making of a gift to a qualified donee (other than a private foundation) of a property described, in respect of the taxpayer, in paragraph 110.1(1)(d) or in the definition ***total ecological gifts*** in subsection 118.1(1), or
>
> **110.1 (1)** For the purpose of computing the taxable income of a corporation for a taxation year, there may be deducted such of the following amounts as the corporation claims

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101 Jinyan Li, Joanne Magee & J. Scott Wilkie, *Principles of Canadian Income Tax Law* (Toronto: Thomson Reuters, 2017) at 300.

102 Canada Safeway, at para. 61.

. . .

**Ecological gifts**

**(d)** the total of all amounts each of which is the eligible amount of a gift of land (including a covenant or an easement to which land is subject or, in the case of land in the Province of Quebec, a personal servitude (the rights to which the land is subject and which has a term of not less than 100 years) or a real servitude) if

**(i)** the fair market value of the gift is certified by the Minister of the Environment,

**(ii)** the land is certified by that Minister, or by a person designated by that Minister, to be ecologically sensitive land, the conservation and protection of which is, in the opinion of that Minister or the designated person, important to the preservation of Canada's environmental heritage, and

**(iii)** the gift was made by the corporation in the year or in any of the 10 preceding taxation years to a qualified donee that is

**(A)** Her Majesty in right of Canada or of a province,

**(B)** a municipality in Canada that is approved by that Minister or the designated person in respect of the gift,

**(C)** a municipal or public body performing a function of government in Canada that is approved by that Minister or the designated person in respect of the gift, or

**(D)** a registered charity (other than a private foundation) one of the main purposes of which is, in the opinion of that Minister, the conservation and protection of Canada's environmental heritage, and that is approved by that Minister or the designated person in respect of the gift.

[278] The deemed capital gain of zero is important because normally, the Act deems a donor to receive proceeds of disposition equal to the fair market value of the gift:

**Inadequate considerations**

**69. (1)** Except as expressly otherwise provided in this Act,

. . .

> **(b)** where a taxpayer has disposed of anything
>
> . . .
>
> **(ii)** to any person by way of gift *inter vivos*, or
>
> . . .
>
> the taxpayer shall be deemed to have received proceeds of disposition therefor equal to that fair market value; . . .

[279] If the eco gift is capital in nature, paragraph 38(a.2) overrides paragraph 69(1)(b) and the capital gain is equal to zero. This, in addition to the tax credit provided under subsection 118.1(3), provides an incentive to donate environmentally sensitive lands.

## D. Analysis

[280] The case law is clear that I must consider the taxpayer's whole course of conduct and draw inferences from the surrounding circumstances, so I note here some contextual factors that inform my analysis of each individual disposition.

[281] Real estate forms a significant part of the Paletta family's business. Pat Paletta began a number of years ago acquiring vacant land in the Burlington/Hamilton regions and the family has continued that activity – Paletta International's financial statements show a book value of approximately $112,000,000 for the company's total real estate holdings in the 2006 year, with the fair market value estimated at 10-20 times higher. Testimony established that the Palettas have a reputation as a large developer in the Golden Horseshoe area. Mr. Paletta has his real estate broker's licence and started a real-estate company solely to handle Paletta International's real estate transactions.

[282] The Appellant, Paletta International, claims that all of the properties were acquired either to farm or to develop for rental revenue. Mr. Paletta testified that the family philosophy when it came to real estate was to eventually turn all properties acquired into sources of rental revenue. He testified that the family does not do, and has no interest in, residential development but he acknowledges that residential development is often important on sites in order to support the retail market. I note in the Appellant, Paletta International's favour that there was minimal to no financing with respect to its acquisition of these lands.

[283] I struggle to accept the implication that the Palettas rarely had a secondary intention to profit from the sale of their lands if the retail or industrial opportunities did not pan out. This is not in keeping with the Palettas' shrewd financial instincts. Mr. Paletta testified as to his and his father's ability to find opportunities to squeeze extra profits out of their lands – such as through pylon sign rentals and crushing buildings to produce gravel for use on site. He also demonstrated that the family business has grown and evolved to include new areas of business, like media and film. Given the growth and diversity of the Palettas' business operations, the insistence that the business did not involve land speculation is difficult to accept. I note that all but two of the properties were sold as vacant land. The two properties with buildings were severed in order to allow the Palettas to retain the vacant land.

[284] Here, I must make a note about credibility, weight and burden. The Appellant, Paletta International, has the burden of demolishing the Minister's assumption that it had a secondary intention to resell the lands at a profit. The bulk of Paletta International's evidence regarding the real estate came from Mr. Paletta's testimony. I have already found that, with respect to the main issue in these appeals, he misrepresented the nature of his arrangements to the CRA. This naturally affects his credibility. I also found some of his testimony on the property issue not to be fully reliable, perhaps owing merely to faulty memory.[103] As an additional issue, the Appellants did not offer supporting evidence for many of Mr. Paletta's claims.[104] Collectively, these factors affect the weight I can give to Mr. Paletta's testimony.

[285] As a result, I place more emphasis on the circumstantial evidence marshalled by the Respondent with respect to the Appellants' patterns of land use.

[286] The Respondent demonstrated a pattern of real estate holdings in the Paletta companies whereby the Palettas accumulate properties outside urban boundaries and hold them for long periods of time. They undertake activities such as farming,

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103 See below, for example, with regard to Walmart's arrival in Ontario, changing the prospects for the property at 1963 Appleby Line; Mr. Paletta's testimony that there was farming on the lands at 1215 Appleby Line when he had commissioned documents indicating there was not; Mr. Paletta's answers on discovery in 2016, in respect of the 101 Masonry Court property, that the Palettas continued to own the balance of that land when it had in fact been sold.

104 For example, records of his negotiations with retailers or of other attempts to find tenants, evidence regarding the arrival of Walmart, and evidence concerning the change in water management rules.

parking rental and sign rental to defray the carrying costs of the land and then sell the lands at profit when the urban boundaries are expanded. The Respondent also demonstrated that the Appellants actively lobby for those boundaries to be expanded to include their lands. The Respondent's position is that this circumstantial evidence indicates that the Appellant, Paletta International, always has in mind the possibility of reselling such lands for profit.

[287] The Respondent also demonstrated that the financial statements show that the Appellants' revenue from farming was a marginal part of their business operations. It defrayed the carrying costs of the accumulated land. I also accept that, at one point, the agricultural component was of greater importance to the overall business.

[288] With these factors in mind, I turn now to the properties individually.

(1) 1963 Appleby Line

[289] A predecessor company of Paletta International purchased approximately 75 acres from Cadillac Fairview and Ivanhoe in 1986/1987. The property at issue is a parcel of approximately 1.4 acres zoned for midrise residential use. The Appellant, Paletta International, sold this property in 2006 for a gain of $980,615. Paletta International claimed a reserve of $783,211 in 2007 under paragraph 20(1)(n) of the Act but would now like to recharacterize that amount as a reserve under section 40 (i.e., as a capital reserve).

[290] Mr. Paletta testified that the land was vacant when purchased and immediately planted with crops for the feedlot operation. Eventually, approximately 25 acres was zoned for retail and office use because the ultimate intention was to generate rental income. The remaining roughly 50 acres was zoned for residential use. Mr. Paletta testified that the market could not support the entirety of the property being retail and that the residential portion would support the retail market as a source of employees and consumers.

[291] The Respondent demonstrated that the Appellants had a pattern of accumulating property around 1963 Appleby Line and parcelling it out and selling it off as vacant land.

[292] Mr. Paletta testified that his retail plans for the site were frustrated by the arrival of a Walmart at a site approximately one mile north of 1963 Appleby Line sometime in the 1990s. This shifted the retail market away from the Palettas' site

and the family found it could not develop retail on the site. The Palettas worked to rezone the lands as residential, went through the subdivision process, serviced the land and sold it off as residential lots.

[293] Mr. Paletta was unclear as to exactly when Walmart arrived – at various times, he testified that it was the early 1990s, the early-to-mid 1990s, the mid-to-late 1990s, and, in discovery, around 2000. No documents with respect to the exact date are in the record.

[294] Mr. Paletta acknowledged that only 25 acres of that would be used for retail and that the remaining 50 acres would be residential. Even if their intentions were frustrated by Walmart's arrival, the Appellants have not shown that the 1.4 acres in question was part of the area intended for retail use and not part of the majority that was intended to be residential. I further accept the Respondent's contention that sophisticated parties such as the Appellants would have contemplated the possibility of their plans being frustrated and would have given themselves the ability to resell the land at a profit.

[295] This disposition was on account of income.

(2) <u>1215 Appleby Line (two dispositions)</u>

[296] A predecessor company to the Appellant, Paletta International, bought this property approximately 8 acres of vacant land - in 1997 for $446,352. Paletta International severed the property into four vacant lots and sold them between 2004 and 2007. Two of those dispositions are at issue here, one for a gain of $1,936,631 and the other for a gain of $1,991,520. The first purchaser built a storage facility. The result of the second sale was not in evidence – it was described as a remnant parcel.

[297] Mr. Paletta testified that at the time of its acquisition by the company, the land was zoned for mixed use: retail and industrial, but more industrial than retail. He testified that he tried for many years to get more retail use on the property but was unsuccessful, and that this property was also affected by Walmart's shifting of the retail market north. Mr. Paletta did not refer to any documentary evidence of his attempts to rezone the land or find tenants. In the meantime, he used the land for renting pylon sign space to media companies. He also testified that from the time of acquisition, Paletta International farmed the site while attempting to develop the retail market.

[298] The Respondent directed Mr. Paletta to severance applications he commissioned in 2004, 2005 and 2006 that indicated that no agricultural operations existed on the land.

[299] The Appellant, Paletta International, has not convinced me that it lacked a secondary intention to sell this land for profit. The disposition is on account of income.

(3) <u>2330 Guyatt Road and 2141 Woodburn Road</u>

[300] These two 2007 dispositions are each of a single-family residence severed from a larger farm property in the Binbrook/Glanbrook area. Paletta International acquired the Guyatt property in 2005 and the Woodburn property in 2004. The amounts in issue are small, a loss of $1,132 for the Guyatt property and a gain of $42,463 on the Woodburn property. Mr. Paletta testified that the lands (approximately 200 acres for Guyatt and 90-100 acres for Woodburn) were acquired to be farmed for the company's agri services division. The Woodburn property also has an industrial building that generated rental revenue until the departure of the tenants. The houses were severed and sold because the Palettas do not wish to be rural landlords.

[301] The Respondent established a pattern of land acquisition by the Palettas in this area around the same period. These lands are all within the greenbelt area, also known as "protected countryside". The purpose of the greenbelt plan is the long-term protection of agricultural land and natural heritage. Urban areas are not permitted to expand into greenbelt lands. The Respondent established that the Palettas sought to remove the balance of the Guyatt and Woodburn properties (post-severance), as well as their other nearby properties, from the greenbelt scheme in 2015. The Respondent also established that the Palettas are part of a group of landowners challenging a provincial law that forbids municipalities, in this case Hamilton, from expanding their urban boundaries to include a particular area near the Binbrook/Glanbrook area.

[302] I am satisfied that the Appellant had a secondary, if not primary, intention to speculate on land values in respect of these properties. The dispositions are on account of income.

(4) 55 Queen Street/Market Street

[303] The Palettas purchased this downtown Hamilton lot with an existing office and industrial building for $1,175,000 in 1987. They sold it as vacant land in 2007 for $2.4 million. The total gain was $1,897,882.

[304] After acquisition, the Palettas rented the building and warehouse to various tenants until they eventually all vacated the property. Mr. Paletta testified that the building was old and unsuitable for most purposes so they demolished it and used the space for parking and pylon sign rentals. He testified that the ultimate plan was to build office and retail space to generate rental revenue. The documents establish that the parking lot was intended to be a temporary operation while the site was being marketed to an end-user.

[305] Paletta International applied for a demolition permit for the building in July 1991, just short of four years after purchase. At about the same time, Paletta International also applied to change the zoning from "Light and Limited Heavy Industry" to "High Density Multiple Dwellings" for a major portion of the site. The application was approved and a by-law passed permitting residential buildings of 3, 6 and 15 storeys in height. No construction plans were submitted to the City. Mr. Paletta testified that the residential development was necessary to support the retail. He also testified that his efforts to find a retail tenant did not extend beyond putting up a sign advertising retail and office space for lease.

[306] The Respondent has satisfied me that the Palettas took no concrete actions to develop the property for retail or commercial purposes and that the Appellant, Paletta International's, secondary purpose, if not its primary purpose, was to sell the land for profit at an appropriate time.

(5) 101 Masonry Court

[307] The Palettas purchased this approximately 40-acre property in 2002 for $1.6 million. At the time of purchase, the land had several buildings and an existing industrial tenant. The property was sold in parcels as vacant land between 2005 and 2013. The parcel at issue here was sold in 2007 to the Greater Toronto Transit Authority (now Metrolinx) for $6 million.

[308] Mr. Paletta testified that the land was zoned for industrial and retail use and that the Palettas' intention was to develop a retail shopping centre. He determined that the existing buildings were not suitable to be leased. They therefore

demolished them to create gravel to spread on the site for parking lots and, to be used as a foundation sub-base. The Palettas leased the site to an agent for Chrysler as a place to store and park cars. Mr. Paletta testified that the land had mixed-use zoning that did in fact permit some residential uses but that he did not put his mind to that at the time of purchase.

[309] In 2005, the Palettas sold approximately 15 acres of the site to the Greater Toronto Transit Authority (Metrolinx) in order to avoid an expropriation. He testified that this sale actually enhanced the value of the remaining retail component because it would create a captive clientele of commuters. Mr. Paletta sold a second portion of approximately 10 acres to Metrolinx in 2007, being the parcel at issue and retained approximately 14 acres.

[310] Mr. Paletta hired an architect to make preliminary concept plans in 2009 and put up a sign advertising retail space for lease on the site. He testified that he began discussions with the large supermarkets to find an anchor tenant for the site but nothing came of it. One of their issues was the lack of residential density to support the retail. Mr. Paletta testified that changes to the Conservation Authority's rules with respect to storm water management further affected the site, making it less marketable for retail. He sold the last parcel in 2014 for residential development.

[311] In his answers to undertakings in 2016, Mr. Paletta incorrectly stated that "the appellant continues to own the balance of this land and intends to develop a shopping centre on this site".

[312] The Respondent established that Paletta International has accumulated significant parcels of land near this property. For some, it has applied for a plan of subdivision to create commercial lots, and it continues to hold the others. The Respondent also established that Paletta International applied to have 75 hectares of nearby vacant farmland included in the urban boundary expansion.

[313] The Appellant has failed to convince me that he did not have a secondary intention to profit from the sale of this property. The Palettas' conduct with respect to this parcel in its entirety supports at least a secondary intention to speculate on land sales.

(6) <u>Doble/Bluffs and Eco Gift</u>

[314] This section deals with two dispositions in the 2007 year, both of which are parcels of an approximately 150-acre property purchased by Pat Paletta in 1979.

The land included several woodlots, which form the eco gift disposition at issue here. The Palettas made the eco gift to the Halton Region Conservation Authority at an appraised value of $3,952,500. The second disposition is an approximately 2-acre lot sold to the Doble couple for a total gain of $1,128,946.

[315] Mr. Paletta testified that the Palettas used the property to graze cattle and grow crops for the farming operations. They also harvested wood in the woodlots for lumber. When the City of Burlington began a process in 1987 to expand the urban boundary of the Mount Nemo hamlet, Mr. Paletta lobbied for these lands to be included. The City of Burlington declined and the Palettas successfully appealed to the Ontario Municipal Board. The lands were subdivided into 34 lots in two stages, the first in 2003 and the second in 2006. One of those lots is the Doble sale.

[316] I find that both dispositions were on account of capital. I accept the claim that Pat Paletta purchased these lands for use in the feedlot and agri-services business. The timing of the acquisition, in 1979, is consequential – I accept that at that point in time, farming was of greater significance to the family business than it is currently. I also accept that at that time real estate development was a more minor aspect of the Palettas' operations than it is currently. I therefore find that both dispositions are capital in nature, and the Appellant, Paletta International, is entitled to the benefit of paragraph 38(a.2) of the Act in respect of the eco gift.

Signed at **Ottawa**, **Canada**, this **7th** day of October 2019.

"Robert Hogan"

Hogan J.

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| CITATION: | 2019 TCC 205 |
| COURT FILE NO.: | 2013-225(IT)G, 2013-4837(IT)G, 2013-2420(IT)G |
| STYLE OF CAUSE: | ANGELO PALETTA and PALETTA INTERNATIONAL CORPORATION AND HER MAJESTY THE QUEEN |
| PLACE OF HEARING: | Toronto, Ontario, Vancouver, British Columbia, San Jose, California and Los Angeles, California |
| DATE OF HEARING: | March 11-22, 2019, May 28-31, 2019, June 3, 5-6, 2019 and June 10-12, 2019 |
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| DATE OF JUDGMENT: | October **7**, 2019 |
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