



*Paletta et al v. The Queen, Case Study*¹

In a recent case, the Tax Court of Canada was faced with deciding if the taxpayer's investment in a Hollywood film was "make believe" or real. In other words, did the complex series of transactions reflect the true intentions of the parties or were they a "sham".

Angelo Paletta and a family-owned corporation, Paletta International Corporation, (respectively, the individual and corporate "**Taxpayers**") claimed approximately CDN\$200 million in business losses from investing in two limited partnerships (the "**LPs**") established to acquire, exploit and monetize two feature films produced by Twentieth Century Fox Film Corporation ("**Fox**"). The LPs purchased the copyright in the two films through capital contributions by the Taxpayers of about CAD\$8 million with the balance funded by loans arranged through a complicated series of circular transactions. Fox agreed to distribute the films and the LPs agreed to incur the costs of over CAD\$200 million in respect of prints and advertising expenses ("**P&A Expenses**") for these films.

A critical part of the commercial arrangement involved the LPs granting Fox an option to reacquire the LPs that owned the films before, during or after commercial release of the films, for an aggregate amount of the cost of the films, plus the P&A Expenses, less 3% of the P&A Expenses.

The Canada Revenue Agency (the "**CRA**") disallowed the losses on several bases, the key one being an allegation that the transactions were a *sham*. The CRA alleged that the films were never transferred to the LPs, whose sole purpose was to enable the Taxpayers to benefit from tax savings and for Fox to benefit from the 3% discount which amounted to its fee for participation. The Taxpayers' tax savings would arise from the fact that the P&A Expenses would be fully deductible in computing income, while only one-half of the capital gain realized on the sale of the LPs to Fox would be included in income.

The Court began its analysis of *sham* by citing previous precedents to arrive at the guiding principles. The original statement of what constitutes *sham* is derived from the English case *Snook v. London & West Riding Investments Ltd.*², where the presiding judge held that *sham* means

"...acts done or documents executed by the parties to the "sham" which are intended by them to give 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.."

Canadian courts have adopted the *Snook* definition of *sham*. The Supreme Court of Canada in the leading case of *Stuart Investments Ltd. v. The Queen*³ 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 façade of reality quite different from the disguised reality..."

The Court in this case stated that in a tax context, a court will arrive at a finding of *sham* when the evidence shows that the parties misrepresented their arrangements to achieve a tax benefit that would be

¹ 2019 DTC 1143 (TCC).

² [1967] 1 All ER 518.

³ [1984] 1 S.C.R. 536.



denied if the nature of their arrangements had been properly disclosed. In tax matters, the party that is deceived by the *sham* is the CRA.

In considering *sham*, the court must examine 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.

Here the evidence consists primarily of the transaction documents themselves and testimony of the advisor/promoters and Mr. Paletta. The factors that inform the objective reality of the arrangements include the following:

- the circumstances surrounding the development of the transaction structure;
- the Taxpayers' due diligence, involvement and oversight, or lack thereof, in evaluating and participating in the transactions;
- the ordinary business and investment practices of the Taxpayers;
- the parties' stated goals and reasons for entering into the transactions; and
- the legal rights and obligations as defined in the transaction documents.

The Court noted that searching for the objective reality of a transaction does not conflate *sham* (i.e. a misrepresentation and deceit) with the notions of *economic substance* or *business purpose*. A transaction is not a *sham* because it is devoid of economic substance, lacks a business purpose or serves a tax avoidance purpose. *Sham* must also be distinguished from *abuse*. *Sham* is not an overall scheme that is abusive; it is a matter of the parties' misrepresenting the legal effect of a transaction.

Despite the Taxpayers' arguments that Fox never committed to exercise the options, the Court concluded that based on all the evidence, the parties understood that Fox would indeed exercise its options and reacquire the films. Accordingly, the options were a *sham* designed to mask the parties' true intention that Fox would reacquire the films prior to commercial release.

In arriving at this conclusion, the Court made the following findings of fact:

- The transactions were presented to the Taxpayers by two accountants with a history of participation in the film industry, one of whom was a partner in one of the big four accounting firms, whom the Taxpayers relied on for due diligence and negotiations with Fox;
- The history of the Taxpayers when making long-term investments in various fields had been to do their own due diligence and engage in direct negotiations, which was absent entirely here, despite the very large sums of money involved, and their lack of knowledge and experience in the film industry, which is more consistent with the goal of achieving tax savings from a short-term investment with little commercial risk, rather than a long-term, income-earning goal;
- The Court found the testimony of the promoters not to be credible in dealing with the likelihood of Fox exercising the options;
- From the point of view of Fox, the Court noted that evidence of eight previous deals resulted in Fox exercising its options and the similar circumstances of this deal made it virtually certain that it would do so here and earn the 3% discount as a fee for its participation.

Accordingly, the Court applied the doctrine of *sham* and upheld the disallowance. What is helpful from this decision is the Court's careful analysis and weighing of the circumstantial evidence, and



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clear expression of the underlying principles of *sham* as compared with, and contrasted from, other anti-avoidance tools, such as lack of economic substance, lack of business purpose and abuse.

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