

Federal Court of Appeal



Cour d'appel fédérale

Date: 20210916

**Dockets: A-417-19
A-418-19**

Citation: 2021 FCA 182

**CORAM: STRATAS J.A.
GLEASON J.A.
WOODS J.A.**

Docket: A-417-19

BETWEEN:

**PALETTA INTERNATIONAL
CORPORATION**

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Docket: A-418-19

AND BETWEEN:

ANGELO PALETTA

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Toronto, Ontario, on September 15 and 16, 2021.
Judgment delivered from the Bench at Toronto, Ontario, on September 16, 2021.

REASONS FOR JUDGMENT OF THE COURT BY:

WOODS J.A.

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REASONS FOR JUDGMENT OF THE COURT
(Delivered from the Bench at Toronto, Ontario, on September 16, 2021).

WOODS J.A.

[1] These are reasons delivered orally in the appeals of Paletta International Corporation and Angelo Paletta. The appeals are from judgments of the Tax Court which substantially upheld reassessments issued to the appellants under the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (2019 TCC 205, *per* Hogan J.).

[2] The appellants' primary argument in these appeals is that the judgments should be set aside and a new trial ordered because the Tax Court hearing was tainted by breaches of procedural fairness. The appellants submit that they did not have a fair hearing because they did not know the case they had to meet and did not have a proper opportunity to respond to an issue that was not raised by the parties. They cite various authorities, including *Mian v. The Queen*, 2014 SCC 54, [2014] 2 S.C.R. 689.

[3] The appeals centre on two tax issues. The main issue is whether expenses related to film distribution are deductible. The second issue is unrelated and is whether gains realized on the sale of four parcels of land are on income or capital account.

[4] With respect to the film distribution expenses, the appellants submit that the Tax Court decided this issue on a theory that was not raised by any of the parties and for which the appellants were not given adequate notice. They also submit that the procedural unfairness that

resulted from this tainted the Court's finding on the land sale issue. In particular, they submit that the Court made an unfair adverse credibility finding on the film distribution issue and that this finding unfairly influenced the Court's decision on the land sale issue.

[5] The relevant facts and background are described in detail in the reasons of the Tax Court. It is not necessary to repeat them here in depth.

[6] The procedural fairness issue with respect to the film distribution expenses will be considered first. In the 2007 and 2008 taxation years, the appellants deducted losses and expenses relating to the distribution of two films produced by 20th Century Fox (Fox). The arrangement involved a complex series of transactions in which Fox allegedly sold two of its newly-produced films to partnerships in which the appellants were limited partners. The majority of the losses and expenses that were deducted relate to expenses for print and advertising that were allegedly incurred by the partnerships soon after the films were acquired. After a short period of time, the arrangement was unwound. This involved the exercise of options by the Fox group of companies. The options permitted the Fox group to acquire all of the partnership interests, which for clarity included partnership interests that were not owned by the appellants. This resulted in the films being back in the hands of Fox.

[7] The Minister of National Revenue reassessed the appellants for the 2007 and 2008 taxation years to disallow the film distribution losses and expenses that were claimed. The Minister also reassessed to disallow the carryover of losses to other taxation years.

[8] The Crown provided an overview of the Minister's reassessing position in the replies filed in the Tax Court. The position is generally described in this excerpt from the overview: "The Appellant's claim involves a tax loss creation scheme that used the appearance of incurring expenses in the distribution of a motion picture to generate a tax deferral and permanent tax savings. The documents associated with this scheme involved a sham." (Appeal Book at p. 450). The replies set out numerous assumptions of fact made by the Minister and several legal arguments. Some of these are clearly alternative positions.

[9] The Tax Court upheld this part of the reassessments primarily on the basis that the expenses were not incurred for the purpose of earning income. The Court concluded that paragraph 18(1)(a) of the Act prohibited the deductions in these circumstances.

[10] It is useful to cite the Court's reason given for this conclusion. At paragraph 244 of the reasons, the Court states: "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."

[11] At the Tax Court hearing, Justice Hogan expressed the view that he was concerned whether this was new theory of the case which he should not consider on grounds of procedural fairness. He raised this after the evidence had closed and heard oral and written submissions on the point.

[12] The Court ultimately determined that it could consider the issue and provided extensive reasons for its conclusion at paragraphs 89 to 120.

[13] In this Court, the appellants submit that the Court wrongly concluded that this issue could be considered. In their view, the Court's reasoning was based on a new unpled theory which was raised too late. They suggest that they did not know the case they had to meet and did not have an appropriate opportunity to present evidence to address it.

[14] We do not agree with this submission and are in agreement with the reasons of the Tax Court on this issue. The appellants knew the case that they had to meet and had adequate opportunity to respond.

[15] The appellants' submissions focus on the assumptions made by the Minister as set out in the replies. They submit that these assumptions do not encompass the Court's findings. They focus on two particular findings of the Court, that the options were a sham and that the parties had a pre-agreement that the options would be exercised.

[16] In our view, these submissions have no merit. I will first address the finding of a pre-agreement. Although the replies do not use the term "agreement," the pleaded assumptions use other words to convey a similar meaning. In particular, the Minister assumed that: "There never was any intention by Fox or any other party to allow Six Iron LP to actually own, control and exploit the Picture." Further, the Minister assumed that: "The Appellant knew that Fox would exercise its option to reacquire the Picture and that any income from the exploitation of the Picture would not be realized while the Six Iron LP had any interest in the Picture." Finally, there is a parenthetical reference in the assumptions to the exercise of the option being preordained. (Appeal Book at pp. 464, 467).

[17] These assumptions were pleaded to put the appellants on notice that the Minister took the view that it was a certainty that the partnerships would not have any income from the exploitation of the films. This was the case that the appellants had to meet. And in fact the appellants tried to demolish these assumptions through evidence that there was a real possibility that the options may not be exercised. The evidence was not believed.

[18] The appellants also suggest that it is significant that the Tax Court concluded that the options were a sham. They say that this was not part of the Crown's case. As we understand it, the Crown agrees that it was not part of their case but it takes the view that nothing turns on it.

[19] We agree with the Crown on this issue. The label of "sham" that the Court attached to the arrangement does not mean that the appellants did not have notice of the case they had to meet. That case was clearly set out in the factual assumptions. There was no reason for the assumptions to explicitly use the term "sham" or to explicitly state that there was deception. But it is obvious from the relevant assumptions that the Minister did assume that there was deception with respect to the options. The case that the appellants had to meet was clear from the pleaded assumptions.

[20] At the hearing, the appellants also suggested that there was a world of difference between the pleaded assumptions and the Tax Court's finding that there was a pre-agreement. We do not agree. The purpose of pleading assumptions is to provide notice to the appellants of the case that they have to meet. The language used in the relevant assumptions does this. The Minister's pleaded assumption was that there was no intention that the partnership would exploit the film.

In this case, paragraph 18(1)(a) is properly applied to prohibit the deduction of the expenses at issue.

[21] We conclude that there has been no breach of procedural fairness. The theory that led to the application of paragraph 18(1)(a) was neither new nor unpled. Accordingly, regardless of the applicable standard of review, the underlying decision is not tainted as the appellants suggest.

[22] In light of this conclusion, it is not necessary that we consider the Crown's alternative argument which relates to the tax shelter rules.

[23] I turn now to the second issue, which is whether gains realized on the disposition of land are on income or capital account. The Tax Court considered nine parcels of land. Only four have been appealed.

[24] The issue is only relevant for the appeal of Paletta International Corporation. This appellant argued in the Tax Court that the four properties were held on capital account. The Tax Court disagreed.

[25] The appellant primarily submits that the Tax Court made two errors.

[26] First, the appellant submits that the Tax Court's breach of procedural fairness on the film issue taints the Court's analysis on the land issue. Since we have determined that there is no

breach of procedural fairness on the film issue, the Court's analysis on the land issue is not tainted on grounds of procedural fairness either.

[27] The appellant also submits that the Tax Court erred in law by misapplying the proper legal test for determining whether the appellant had a secondary intention to sell the properties at a profit. This is the well-known secondary intention doctrine.

[28] There are two parts to this argument. First, the appellant suggests that the Court did not correctly apply the test because it ignored the requirement that the possibility of reselling at a profit must have been an operating motivation for the acquisition of the properties. Second, the appellant submits that the Court erred by focussing on the use of the properties long after they were acquired.

[29] The four properties at issue are: (1) 101 Masonry Court, (2) 1963 Appleby Line, (3) 1215 Appleby Line, and (4) 55 Queen Street/Market Street.

[30] As a preliminary comment, I would mention that the Court's conclusion on three of the four properties at issue (at paras. 294, 299 and 313) was based primarily on a finding that the appellant had not satisfied the burden to demolish the Minister's assumption that it had a secondary intention to resell the lands at a profit. There is no error in this conclusion.

[31] With respect to the fourth property, 55 Queen Street/Market Street, the Court did not explicitly state that the appellant failed to satisfy the burden of proof. However, the Court

accepted the evidence led by the Crown that showed that the appellant's course of conduct with respect to this property during a lengthy period of ownership was inconsistent with Mr. Paletta's testimony that the intent was to build a rental property on the site. In particular, the Crown established that "no concrete actions" were taken to develop the property for this purpose despite a long hold period and inferred from this course of conduct that there was from the outset either a primary or secondary intention to sell. The Tax Court did not error in making such an inference.

[32] Finally, with respect to 1963 Appleby Line, the appellant suggests that the Court ignored the part of the legal test of secondary intention that the possibility of resale at a profit must be a motivating factor in the acquisition of the property. The Court's determination (at para. 294) does not support the appellant's submission. The Court made an inference from the evidence that 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". It is clear that the Court was making a finding that the secondary intention was a motivating factor in the acquisition. We find that there is no error on this issue.

[33] Accordingly, we are in agreement that the Tax Court made no reversible errors with result to the land sales that are at issue.

[34] The Crown seeks a higher level of costs for the appeals. We see no basis for this.

[35] Despite the able argument of counsel for the appellants, the appeals are dismissed with costs.

“Judith Woods”

J.A.

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKETS:	A-417-19 and A-418-19
DOCKET:	A-417-19
STYLE OF CAUSE:	PALETTA INTERNATIONAL CORPORATION v. HER MAJESTY THE QUEEN
AND DOCKET:	A-418-19
STYLE OF CAUSE:	ANGELO PALETTA v. HER MAJESTY THE QUEEN
PLACE OF HEARING:	TORONTO, ONTARIO
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REASONS FOR JUDGMENT OF THE COURT BY:	STRATAS J.A. GLEASON J.A. WOODS J.A.
DELIVERED FROM THE BENCH BY:	WOODS J.A.

APPEARANCES:

Al Meghji David Jacyk Theo Stathakos	FOR THE APPELLANTS (IN PERSON AND BY VIDEO CONFERENCE)
Charles Camirand Vincent Bourgeois	FOR THE RESPONDENT (IN PERSON AND BY VIDEO CONFERENCE)

SOLICITORS OF RECORD:

Osler, Hoskin & Harcourt LLP Barristers and Solicitors Vancouver, British Columbia	FOR THE APPELLANTS
A. François Daigle Deputy Attorney General of Canada	FOR THE RESPONDENT