

2007-329(IT)G

TAX COURT OF CANADA

BETWEEN:

ROBERT STROTHER

Appellant

- and -

HER MAJESTY THE QUEEN

Respondent

**FURTHER FURTHER AMENDED NOTICE OF APPEAL**

(Filed January 19, 2007; amended November 5, 2007; further amended November 9, 2007, December 18, 2008 and February 11, 2010)

**OVERVIEW**

1. This is an appeal under paragraph 169(1)(a) of the *Income Tax Act* (Canada) (the "Act") from Notices of Reassessment issued by the Minister of National Revenue (the "Minister") on May 30, 2003 for the Appellant's 1998 and 1999 taxation years.
2. The transactions described in this Notice of Appeal were implemented in furtherance of a policy of the Government of Canada intended to encourage the development of the film industry in Canada.
3. In general terms, arrangements implementing this policy provided that Canadian investors would obtain a deduction for the cost of the investment in a partnership in year one (1998) and bring a like amount into the income computation in year 10(2008). Thus, the policy recognized a ten-year deferral for tax purposes.



4. The details of the transaction in this case (the "Plan") and the documents evidencing and implementing the Plan were submitted to the Rulings Division of the Canada Revenue Agency (the "CRA"). The Plan and implementing documents were carefully reviewed by the CRA and an advance income tax ruling was issued on October 6, 1998 (the "Ruling"), and applied to the Sentinel Hill 1998 Master Limited Partnership (the "Master LP" , the Appellant, certain Production Limited Partnership (the "PLPs"), and the general partners thereof, of of whom were described in the Plan, the implementing documents and the Ruling. A copy of the Ruling is Appendix A to this Notice of Appeal.
5. Subsequent to the granting of the Ruling, and after extensive debate between members of the CRA Rulings Division, Audit Division and members of the Department of Justice, and between those officials and taxpayers' representatives, the CRA decided that it would not honour the advance tax rulings.

### FACTS

6. The Appellant is an individual resident in the Province of British Columbia.
7. This appeal relates to the amount and deductibility of the Appellant's share of losses from the Master LP.

#### *The Master LP*

8. The Master LP was formed as a limited partnership in accordance with the British Columbia *Partnership Act*, R.S.B.C. 1996, c. 348, pursuant to a certificate filed with the British Columbia Registrar of Companies on August 19, 1998.
9. The MLP is governed by a Partnership Agreement dated August 19, 1998.
10. The Master LP was a formed for the purpose of earning income from:
  - a. investing in Class A units of a number of PLPs;

- b. providing financing, through investments in Class A units of the PLPs, for expenditures incurred by the PLPs in performing or providing Canadian-based production services in respect of a full-length motion picture film, a television movie of the week, or one or more episodes of a television series; and
  - c. investing funds of the Partnership on an interim basis in certificates of deposit and interest-bearing accounts of Canadian chartered banks.
11. The fiscal period of the Master LP and each PLP ends on December 31<sup>st</sup> of each year.
  12. At all material times, Sentinel Hill Productions Corporation ("SHPC") was the only general partner of the Master LP.
  13. The Master LP applied for and obtained a tax shelter identification number in 1998 under section 237.1 of the Act.
  14. The Appellant subscribed and paid for 300 units in the Master LP at \$1,000.00 per unit. The Appellant's subscription for units was accepted by SHPC as general partner of the Master LP on December 31, 1998.
  15. In addition to the subscription price, the Appellant paid the Lender a financing fee of \$16.58 for each unit that the Appellant acquired in the Master LP.
  16. The Master LP was structured as a ten-year tax deferral in reliance on the Ruling.
  17. As a tax shelter, Master LP units were suitable for investment by high-income, high-net worth investors.
  18. By the end of 1998 the Master LP had 108 limited partners, including the Appellant, owning 33,837 units in total.
  19. Pursuant to the Partnership Agreement, the Appellant was entitled to his aliquot percentage, based on his number of units, of the net income and loss and taxable income and loss of the Master LP.

*The Sentinel Hill Group*

20. Sentinel Hill Productions Corporation ("SHPC") was incorporated under the British Columbia *Company Act*, R.S.B.C. 1996, c. 62, on January 7, 1998 under the name "557072 B.C. Ltd.". It changed its name to "Sentinel Hill Services Corporation" on May 5, 1998 and then to "Sentinel Hill Productions Corporation" on July 20, 1998.
21. At all material times, SHPC was a wholly-owned subsidiary of Sentinel Hill Entertainment Corporation ("SHEC").
22. At all material times Sentinel Hill Management Corporation ("SHMC") was a wholly-owned subsidiary of SHEC. SHMC provided management and other services to entities within the Sentinel Hill group.
23. Until August 20, 1999, SHEC was a wholly-owned subsidiary of Pacific Cascadia Capital Corporation.
24. At all material times Mr. Paul Darc owned all the shares of Pacific Cascadia Capital Corporation.
25. On August 20, 1999, 589918 British Columbia Ltd. subscribed for an additional 100 common shares in the capital of SHEC, resulting in 589918 British Columbia Ltd. owning 50% of SHEC's issued and outstanding shares. Pacific Cascadia Capital Corporation continued to own the other 50% of SHEC's issued and outstanding shares.
26. At all material times the shares of 589918 British Columbia Ltd. were owned by Mr. Robert Strother.
27. SHEC also owned all the shares of Sentinel Hill Productions II Corporation at all material times. Sentinel Hill Productions II Corporation was at all material times the sole general partner of the Sentinel Hill 1998-2 Master Limited Partnership.

*The Lender*

28. The Lender is a trust, the sole trustee of which was at all material times Veritus Capital Corp.
29. Veritus Capital Corp. was incorporated under the laws of the Province of Alberta, the shares of which were, at all material times, controlled and owned by Mr. Terry Clark.
30. Mr. Clark is unrelated to the controlling shareholders of SHPC, SHEC, SHMC, Pacific Cascadia Capital Corporation and 589918 British Columbia Ltd.
31. There were no agreements or other arrangements under which Mr. Clark could control, direct or influence the actions of Mr. Darc, Mr. Strother, SHPC, SHEC, SHMC, the Master LP or any other entity owned or controlled by any of those persons.
32. There were no agreements or other arrangements under which Mr. Darc, Mr. Strother or any entity controlled by either or both of them could control, direct or influence the actions of Mr. Clark, the Lender or Veritus Capital Corp.
33. Mr. Clark, the Lender and Veritus Capital Corp. retained their own legal counsel and accountants in connection with the loans the Lender made to subscribers in the Master LP and the other transactions to which it was a party.
34. Mr. Darc, Mr. Strother, SHPC, SHEC, SHMC and the Master LP retained different legal counsel and accountants from those employed by Mr. Clark, the Lender and Veritus Capital Corp.
35. The Trustee as trustee of the Veritus Trust earned fees for the services it provided. The Trustee at all times acted in the best interests of the beneficiaries of the Veritus Trust.

*The Loan*

36. The Lender lent the Appellant for each unit acquired, \$711.64 of the \$1,000 subscription price (the "Loan") on a full-recourse basis at a commercial interest rate in excess of the interest rate prescribed for the purposes of s.143.2 of the Act.
37. The Loan required interest to be paid annually. The Loan was due in full on December 31, 2008.
38. The Loan was evidenced by a promissory note in favour of the Lender and was secured by a pledge of the Appellant's units in the Partnership and an assignment of any distributions from the Partnership.
39. In addition to using the advance on the Loan of \$711.64 per unit, the Appellant paid the remaining \$288.34 per unit subscription price from his own funds (the "Cash Contribution").
40. The Appellant also paid the Lender a further \$16.58 per unit as a financing fee.
41. The Lender and the Partnership each had their own separate legal counsel advising them on all legal aspects of the transactions.
42. The Appellant has, since closing, paid the accrued interest on the Loan annually within 60 days from the end of each taxation year and repaid the entire outstanding balance of the Loan on December 31, 2008.

*The Production Limited Partnerships*

43. SHPC as the general partner and the Master LP as the Class A limited partner were partners in three production limited partnerships – Sentinel Hill Productions No. 4 Limited Partnership ("PLP 4"), Sentinel Hill Productions No. 16 Limited Partnership ("PLP 16"), and Sentinel Hill Productions No. 17 Limited Partnership ("PLP 17") (collectively referred to as the "PLPs").

44. Each PLP was formed for the purpose of earning a profit from carrying on the business of providing production services in respect of one or more film productions.
45. The Master LP subscribed and paid for Class A units of PLP 4 having a cost of \$7,370,493.
46. The Master LP subscribed and paid for Class A units of PLP 16 having a cost of \$4,423,515.
47. The Master LP subscribed and paid for Class A units of PLP 17 having a cost of \$13,553,647.
48. Each PLP applied for and obtained a tax shelter identification number in 1998 under section 237.1 of the Act.
49. SHMC on behalf of the Master LP contracted with film studio companies (the "Studios") within the Universal City Studios, Inc. group (Gilmore Films, Inc. and NF Films, Inc.) and the New Line Cinemas, Inc. group (Avery Pix, Inc. and Alex Entertainment, Inc.) whereby the Studios agreed to contract with the PLPs for the provision of certain production services.
50. The total amount incurred by SHMC on behalf of the Master LP to the Studios in 1998 in order to induce the Studios to enter into production services arrangements with the PLPs was \$2,935,698 (the "Studio Fees").
51. The Studios initially contracted with one of two Cayman Islands corporations, UK3 Limited or UK4 Limited, to provide the production services. UK3 Limited and UK4 Limited then subcontracted with the PLPs.
52. UK3 Limited contracted with PLP 4 to provide production services in respect of the film production titled "Dudley Do-Right". In return, UK3 Limited agreed to pay PLP 4 a fixed fee equal to 80.1% of all qualifying expenses incurred by PLP 4 plus a percentage of receipts from the commercial exploitation of the film.

53. UK4 Limited contracted with PLP 16 to provide production services in respect of two films titled "Detroit Rock City" and "Corruptor". In return, UK4 Limited agreed to pay PLP 16 a fixed fee equal to 80.1% of all qualifying expenses incurred by PLP 4 plus a percentage of receipts from the commercial exploitation of the films.
54. UK3 Limited contracted with PLP 17 to provide production services in respect of four films titled "Snow Falling on Cedars", "Isn't She Great", "Pittsburgh", and "New Jersey Turnpikes". In return, UK3 Limited agreed to pay PLP 17 a fixed fee equal to 80.1% of all qualifying expenses incurred by PLP 17 plus a percentage of receipts from the commercial exploitation of the films.
55. Each PLP also granted an option to either UK3 Limited or UK4 Limited (the "Optionee") (depending on which corporation the PLP had initially contracted with) to acquire a number of Class B units in the PLP equal to the number of Class A units in the PLP issued to the Master LP.
56. The option price for the Class B units was set at the parties' estimate of the fair market value of the Class B units at the time the PLP issued Class A units to the Master LP.
57. Under the Option Agreements the Optionee was under no legal obligation to exercise the options. However, the Appellant had a practical expectation that the Optionee would exercise the options in the manner described in paragraph 60 hereof, and that interest would be paid to the PLPs as described in paragraph 61 hereof.
58. On December 31, 1998 UK3 Limited and UK4 Limited both assigned their interests in the Class B unit option agreements with the PLPs to Emeritus Capital Corp. in its capacity as trustee of the Emeritus Trust.
59. Emeritus Capital Corp. is a corporation controlled and owned by Mr. Terry Clark.
60. In 1999, the Emeritus Trust exercised its options to subscribe for Class B units in the PLPs and issued interest-bearing promissory notes to each of PLP 4, PLP 16 and PLP 17



in the amounts of \$7,001,825.96, \$4,202,234.20 and \$12,875,702.52 respectively (the “Class B Promissory Notes”).

61. The three PLPs in aggregate received interest income paid on the Class B Promissory Notes in the following amounts:

	<u>Allocated to MLP</u>	<u>Allocated to GP</u>	<u>Total Interest Income Earned by PLPs</u>
2000	\$1,203,868	\$120	\$1,203,988
2001	\$1,203,868	\$120	\$1,203,988
2002	\$1,203,868	\$120	\$1,203,988
2004	\$1,203,868	\$120	\$1,203,988
2005	\$1,203,868	\$120	\$1,203,988
2006	\$1,203,868	\$120	\$1,203,988
2007	\$1,203,868	\$120	\$1,203,988

62. In computing income or losses for each relevant taxation year, the PLPs included such interest income received on the Class B Promissory Notes.
63. The PLPs’ losses and profits so determined were then allocated, *inter alia*, to the Master LP, which in turn made like allocations to the Appellant and other Limited Partners.
64. In 1999, the Appellant received a rebate in respect of the purchase price of the Appellant’s units of the Master LP (the “Rebate”).

***The Ruling***

65. The Plan and documents implementing the Plan were submitted to the CRA together with a fee paid as consideration for an advance income tax ruling.

66. Officials of the Rulings Division of the CRA carefully reviewed the Plan and the documents and on October 6, 1998 issued the Ruling. The Ruling has not been withdrawn and has continued to remain in effect.
67. Among other things, the Ruling addressed the existence of the Partnership, the computation of at-risk amounts and the non-application of the matchable expenditure rules.
68. The Ruling contemplated its application to SHEC, SHPC, the Master LP and the limited partners thereof including the Appellant.
69. The Minister based his assumption in reassessing the Appellant on a comparison of the facts set forth in the Ruling with the facts as he found them in the transactions here in issue.

#### *Income Tax Filings*

70. The fiscal period of the Master LP, PLP 4, PLP 16 and PLP 17 ends on December 31 each year.
71. For its fiscal period ending December 31, 1998, PLP 4 reported production services revenues of \$29,666,946 less production services expenses of \$37,037,439 and \$9 of other expenses, for a net business loss of \$7,370,502. PLP 4 allocated 99.99% of its business losses for the year, or \$7,369,765, to the Master LP, and 0.01% to SHPC, its general partner.
72. For its fiscal period ending December 31, 1998, PLP 16 reported production services revenues of \$17,804,992 less production services expenses of \$22,228,487 and \$19 of other expenses, for a net business loss of \$4,423,514. PLP 16 allocated 99.99% of its business losses for the year, or \$4,423,072, to the Master LP, and 0.01% to SHPC, its general partner.
73. For its fiscal period ending December 31, 1998, PLP 17 reported production services revenues of \$54,554,737 less production services expenses of \$68,108,384 and \$37 of

other expenses, for a net business loss of \$13,553,684. PLP 17 allocated 99.99% of its business losses for the year, or \$13,552,329, to the Master LP, and 0.01% to SHPC, its general partner.

74. The Master LP reported a business loss for 1998 in the amount of \$28,991,890. This was comprised of the following elements:
  - a. The Master LP's 99.99% share of the PLPs' business losses totalling \$25,345,165;
  - b. Studio Fees deducted by the Master LP in the amount of \$2,935,698;
  - c. management fees deducted by the Master LP in the amount of \$500,995; and
  - d. financing fees deducted by the Master LP under paragraph 20(1)(e) of the Act in the amount of \$210,032.
75. On May 30, 2003, the Minister reassessed the Appellant's 1998 taxation year (the "1998 Reassessment") to reduce the Appellant's reported losses from the Master LP from \$856.81 per unit down to approximately \$58.48 per unit.
76. In so reassessing, the Minister asserted that the Appellant was entitled to receive an amount or benefit for the purpose of reducing the Appellant's loss from owning or holding units in the Master LP, which thereby reduced the Appellant's at-risk amount in respect of the Master LP for the purposes of paragraph 96(2.2)(d) of the *Income Tax Act* to \$58.48 per unit.
77. The Minister characterized the Appellant's 1998 denied losses from the Master LP as "limited partnership losses" under paragraph 111(1)(e) of the Act.
78. On May 30, 2003, the Minister reassessed the Appellant's 1999 taxation year (the "1999 Reassessment") to include the Rebate in the Appellant's income, and to allow a small amount of the Appellant's "limited partnership loss" as a deduction in 1999.

79. The Appellant filed Notices of Objection to the 1998 Reassessment and the 1999 Reassessment within the time limited by section 165 of the Act.
80. On October 24, 2006, the Minister issued a Notification of Confirmation under subsection 165(3) of the Act confirming the 1998 Reassessment and the 1999 Reassessment on numerous and varied grounds, stating the following in the Notification of Confirmation:
  - a. the Master LP did not carry on business in common with a view to profit;
  - b. in the alternative, the Appellant's contribution to the Master LP did not exceed the amount of cash contributed and the Appellant's loss is therefore restricted to the Appellant's cash contribution pursuant to paragraph 96(2.2)(a) of the Act;
  - c. in the further alternative, the Appellant's losses were reduced by the "at-risk adjustments" in paragraphs 96(2.2)(c) and (d) of the Act;
  - d. in the further alternative, the Master LP's loss for 1998 was nil pursuant to section 18.1 of the Act;
  - e. in the further alternative, the Master LP's loss for 1998 was overstated because:
    - i. The Studio Fee of \$2,935,698 was not laid out by the Master LP for the purpose of earning income pursuant to paragraph 18(1)(a) or is unreasonable in the circumstances pursuant to section 67 of the Act, and
    - ii. The losses of the PLPs were overstated by \$8,082,271; and
  - f. the amounts paid or credited to the Appellant by the Master LP on account of the Rebate were income of the Appellant.

81. The Appellant's reassessments were issued notwithstanding that the transactions accorded with the advance income tax rulings, practice, correspondence and discussions described in paragraphs 2 to 4 and 65 to 69 hereof.
82. This appeal is brought pursuant to paragraph 169(1)(a) of the Act.

### **ISSUES TO BE DECIDED**

83. The issues to be decided in this appeal in respect of the 1998 Reassessment are:
  - a. whether the members of the Master LP carried on business in common with a view to profit;
  - b. whether the Appellant paid \$1,000.00 per unit for the Appellant's units of the Master LP;
  - c. whether the Lender dealt at arm's length with the Master LP for the purposes of paragraph 96(2.2)(c) of the Act;
  - d. whether the Appellant's at-risk amount in respect of the Master LP was reduced by any entitlement to an amount or benefit granted for the purpose of reducing the Appellant's loss, under paragraph 96(2.2)(d) of the Act;
  - e. whether section 18.1 of the Act applies to the Master LP or the PLPs to reduce their 1998 business losses otherwise determined;
  - f. whether the Studio Fees were incurred by the Master LP for the purpose of gaining or producing income;
  - g. whether the Studio Fees were reasonable in the circumstances; and
  - h. whether the business losses incurred by the PLPs were as reported, or whether they were overstated as alleged by the Minister by an amount up to \$8,082,271.

84. The issue to be decided in this appeal in respect of the 1999 Reassessment is whether the Rebate was an income receipt or a capital receipt to the Appellant.

**STATUTORY PROVISIONS ON WHICH THE APPELLANT RELIES**

85. The Appellant relies on Part I of the Act and the Regulations thereto including, *inter alia*, sections 3, 9, 12, 18, 18.1, 20, 53, 67, 96, 111, 143.2, 152, 248 and 251 of the Act.

**REASONS ON WHICH THE APPELLANT RELIES**

86. The members of the Master LP carried on business in common with a view to profit.
87. The Lender was unrelated to and dealt factually at arm's length with the Master LP and the PLPs at all relevant times.
88. The Class B unit options were not granted for the purpose of reducing, in whole or in part, the impact of any loss the Master LP or the PLPs might sustain in respect of the PLP granting the option and thus no reduction to the Appellant's at-risk amount is required or justified under paragraph 96(2.2)(d) of the Act.
89. In the alternative, the PLPs were not entitled to any amount or benefit under the Class B Options because they could not force the exercise of the option.
90. In the further alternative, the option price for the PLP Class B units under the option agreements was equal to the fair market value of the units.
91. The Studio Fees were properly incurred by the Master LP; they were reasonable in amount; they were not "matchable expenditures"; and, in the alternative, the exception to the matchable expenditure rules in subparagraph 18.1(15)(a)(ii) applies to exclude the application of section 18.1 to the Studio Fees.
92. The Appellant says that the business losses of the PLPs were properly calculated and were equal to the amounts initially reported by the PLPs.

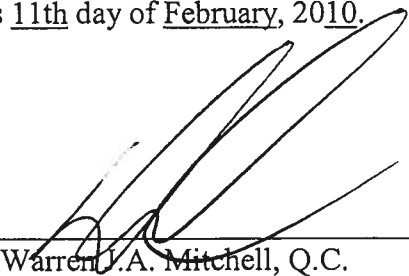
93. The Rebate was a capital receipt and not income to the Appellant.

RELIEF SOUGHT

94. The Appellant asks this Honourable Court to allow this appeal and:

- a. vacate the 1998 Reassessment;
- b. vary the 1999 Reassessment to exclude the Rebate from the Appellant's 1999 income; and
- c. that costs of this appeal be awarded to the Appellant.

DATED at Vancouver, British Columbia this 11th day of February, 2010.



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Warren J.A. Mitchell, Q.C.  
David R. Davies  
Counsel for the Appellant

TO: Her Majesty in Right of Canada  
Attention: Deputy Attorney General of Canada  
c/o John Shipley  
Department of Justice  
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This Further Amended Notice of Appeal is filed on behalf of the Appellant by Warren J.A. Mitchell, Q.C. and David R. Davies, whose address for service, telephone number and facsimile number are:

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APPENDIX A

Davis & Company  
Barristers & Solicitors  
2800 Park Place  
666 Burrard Street  
Vancouver, British Columbia  
V6C 2Z7

Attention: Robert Strother

October 6, 1998

Dear Sirs:

Re: Sentinel Hill Production Services Transaction  
Advance Income Tax Ruling

This is in reply to your letter dated March 3, 1998, as amended and restated July 23, 1998; and our numerous telephone conversations, wherein you requested an advance income tax ruling on behalf of the proposed Sentinel Hill Production Services transactions described herein. Unless otherwise stated, all dollar amounts quoted in this letter are in U.S. dollars.

**FACTS**

1. Sentinel Hill Entertainment Corporation ("Sentinel") is a corporation incorporated under the *British Columbia Company Act*, R.S.B.C. 1996, c.62, as amended. Its principal office and its tax services office is in Vancouver, British Columbia and its taxation centre is Surrey, British Columbia. It will be applying for a tax account number. Sentinel's shares are owned by Pacific Cascadia Capital Corporation. Paul Darc, a Vancouver businessperson, owns all the shares of Pacific Cascadia Capital Corporation. Sentinel has agreed to provide production services for certain feature film and television productions in Canada, one of which is the subject of this letter.

Our file / Votre référence

Our file / Votre référence

980551

Allan Nelson

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.../cont'd

2. 567789 British Columbia Ltd. ("Creditco") is incorporated under the laws of British Columbia, as a wholly-owned subsidiary of Sentinel. Creditco's principal office is in Vancouver, British Columbia. Its principal business is the provision of production services which qualify as "Canadian labour expenditures" for the purposes of the film or video production services tax credit under section 125.5 of the *Income Tax Act* (Canada) (the "Act"), and any equivalent provincial tax credit programs. Creditco's tax services office is Vancouver, its taxation centre is Surrey, British Columbia, and it will be applying for a tax account number.
3. "Sentinel Hill Productions Corporation", (formerly "Sentinel Hill Services Corporation", herein "Productions") is a corporation incorporated under the *British Columbia Company Act*. Its principal office and its tax services office is in Vancouver, British Columbia and its taxation centre is Surrey, British Columbia. It will be applying for a tax account number. Productions is a wholly-owned subsidiary of Sentinel.
4. To the best of your knowledge and that of the taxpayers involved, none of the issues involved in this ruling
  - (i) is in an earlier return of the taxpayers or a related person,
  - (ii) is being considered by a tax services office or taxation centre in connection with a previously filed tax return of the taxpayers or a related person,
  - (iii) is under objection by the taxpayers or a related person,
  - (iv) is before the courts or, if a judgment has been issued, the time limit for appeal to a higher court has not expired,
  - (v) ... is the subject of a ruling previously issued by the Directorate.

**PROPOSED TRANSACTIONS**

5. THC is a corporation to be formed under the laws of Cayman Islands to make motion picture films and television productions in Canada and other jurisdictions outside the United States. All of the shares in THC will be owned by Universal Studios ("Studio"), a U.S. company.

6. Sentinel Hill Productions No. 1 Limited Partnership (the "Production Partnership") is a limited partnership to be formed in British Columbia pursuant to the *Partnership Act*, R.S.B.C., c.348, as amended. Its fiscal year-end will be December 31. Its general partner will be Productions and its initial limited partner will be 557634 British Columbia Limited ("557634"). 557634 is owned by Robert C. Strother, a Vancouver lawyer and businessperson. 557634's interest in the Production Partnership will be redeemed when Class A units of the Production Partnership are issued to the Master Limited Partnership (see paragraph 17, below). The redemption proceeds in respect of 557634's initial limited partnership unit in the Production Partnership will be the amount of the original investment, being the nominal sum of \$10.
7. Sentinel Hill 1998 Master Limited Partnership (the "MLP") is a limited partnership to be formed in British Columbia pursuant to the *Partnership Act*, R.S.B.C., c.348, as amended. Its fiscal year-end will be December 31. Its purpose will be to subscribe for Class A units of limited partnership interest in a number of production limited partnerships, one of which will be the Production Partnership. Productions will be the general partner of the MLP, and its initial limited partner will be 557634. As was the case for the Production Partnership, 557634's interest in the MLP will be redeemed when Class A units of the Production Partnership are issued to the Master Limited Partnership (see paragraph 17, below). The redemption proceeds in respect of 557634's initial limited partnership unit in the MLP will be the amount of the original investment, being the nominal sum of \$10.
8. Studio is a member of the Seagram Group of corporations which are controlled by the Bronfman family. Studio is a United States corporation headquartered in Los Angeles, California. Studio will hire THC to produce and deliver the completed negative for a feature motion picture currently titled "The Bone Collector" (the "Film"). THC will obtain from Studio a limited-use licence to the copyright in the script for the Film to enable THC to produce the Film. THC will own the copyright in the Film during production. The production budget for the Film will approximate \$40 million. Under the agreement between Studio and THC, Studio will lend THC an amount equal to the amount of the production budget (i.e. approximately \$40 million) to make the Film. In turn, THC will loan these funds to Creditco and to the Production Partnership (see below to paragraphs 10 and 13).

9. Pursuant to a production services agreement, THC will engage Creditco to perform \$20 million of production services in connection with the production of the Film. These services will require Creditco to perform production accounting services and audit and oversight services, in addition to paying salary and wages to Canadian residents in respect of the performance of production services in Canada. These salary and wage expenses will qualify Creditco to be entitled to the film or video production services tax credit in respect of "Canadian labour expenditures" in accordance with section 125.5 of the Act. The amount of this federal tax credit, plus the corresponding Quebec provincial tax credit (together referred to herein as the "Tax Credits"), is estimated to be \$4,000,000 in aggregate. Creditco's consideration for the providing of its services will be the \$4,000,000 of Tax Credits, plus a fee of \$16,004,000 from THC.
10. THC will lend \$20 million to Creditco, without charging interest, to fund its production services on an interim basis. Creditco will repay this loan from THC as follows:
- (a) \$16,004,000 upon receipt of the proceeds of the fee that is referred to above in paragraph 9; and
  - (b) the balance, using a portion of the Tax Credits received by Creditco.
11. THC will then repay approximately \$4 million of its loan from Studio with the amount of the loan repayments received from Creditco, as described above in paragraph 10.
12. Pursuant to a production services agreement, THC will engage the Production Partnership to provide to THC \$20 million of production services in connection with the Film. These services will not qualify as Canadian labour expenditures under section 125.5 of the Act. The consideration payable by THC to the Production Partnership in respect of the production services will be a fixed amount (the "80.1% Fee") equal to 80.1% of the amount of the production expenses of the Production Partnership payable upon satisfactory completion of the production services (generally upon completion and delivery of the Film). There are no guarantees or other unconditional commitments with respect to the

entitlement of the Production Partnership to the 80.1% Fee, if it fails to provide the production services, and no such guarantee agreements will be entered into. In addition, the Production Partnership will be entitled to 8.5% of the net profits from the Film, calculated in accordance with an industry standard definition. Further, the Production Partnership may earn bonuses if the Film is nominated for, or receives, certain industry-recognized awards for excellence, such as Golden Globes or Academy Awards. The net profits percentages and bonus amounts that the Production Partnership could earn will be open-ended, both as to amount and duration. It is expected that the quantum of these amounts, together with the 80.1% Fee, will be at least sufficient to give the Production Partnership a reasonable expectation of earning an amount in excess of its deductible production expenses, and in the case of a successful film, the potential to realize a significant amount.

13. THC will lend \$20 million to the Production Partnership, without charging interest, to fund the production services expenses noted above in paragraph 12, on an interim basis. The Production Partnership will repay this loan from THC as follows:

- (a) 80.1% of the indebtedness when the 80.1% Fee is received; and
- (b) the balance, using a portion of the capital raised by the sale of Class A units of the Production Partnership to the MLP (refer below to paragraph 17).

14. THC will then repay approximately another \$4 million of its loan from Studio with the amount of the loan repayments received from the Production Partnership, as described above in paragraph 13. The balance of the loan from Studio to THC will be repaid from the sales proceeds THC receives from Studio when, upon completion of the Film, THC assigns to Studio any intellectual property and other rights that it acquires in the Film, including the underlying copyright in the Film and sells to Studio, for fair market value, all exploitation rights in the Film in all media throughout the universe in perpetuity.

15. Units of limited partnership interest in the MLP will be offered to Canadian investors ("Investors") pursuant to prospectus exemptions available in the Provinces of Canada where the units are offered for sale. The sale will occur without issuing an offering memorandum, if it is determined that the Investors do not require one. If an offering memorandum is required by the Investors, it will be substantially in the form provided to us with your letter to us dated July 23, 1998, as amended September 29, 1998. In any event, the offering documents or executive summary will contain the following mention:

**"THE RULING OBTAINED FROM REVENUE CANADA, CUSTOMS, EXCISE AND TAXATION CONTAINS CAVEATS. THE RULING MAY BE VIEWED ON REQUEST, SUBJECT TO THE SIGNING OF A CONFIDENTIALITY AGREEMENT."**

The total subscription amount from selling limited partnership interests in the MLP will be approximately \$20 million. The subscription price will be \$1,300 per unit, payable as to \$950 from a full-recourse loan from a Canadian financial institution (the "Financial Institution") and as to \$350 from each Investors' own sources, none of which will be obtained from the proceeds of any limited-recourse financing. The loans from the Financial Institution to the Investors (the "Investment Loans") will have a 10-year term and will bear interest at a rate equal to the greater of 10% per annum and the prescribed rate (for purposes of section 143.2 of the Act) prevailing at the time the Investor Loans arise. Interest for the 10-year term of the Investment Loans will be due and payable annually. Interest will be paid by the Investors, in respect of each year, no later than 60 days after the end of the particular taxation year. At the time of closing of subscription for their units in the MLP, each Investor will pay an amount equal to the first year's interest on their Investment Loan. Financing charges (e.g. loan commitment fees and legal fees) in respect of the Investment Loans will be paid by the Investors to the Financial Institution at the time of subscription.

16. It is anticipated that the Investors will invest in units in the MLP at various times throughout the year. Subscription proceeds will be held by the MLP and applied to acquire Class A units in the various production partnerships at various times during the year, but in each case before any fee similar to the 80.1% Fee is earned by a particular production partnership.

17. \$1,000 per unit of the proceeds of subscription for units in the MLP will be used by the MLP to subscribe for Class A units of the Production Partnership (the "Class A Units"). \$300 per unit of the subscription proceeds received by the MLP will be used to pay the fees, costs, expenses and commissions related to the MLP's offering. The Class A Units will each have a cost of \$1,000 and it is estimated that a maximum amount of \$4 million will be raised from their sale. As noted above in paragraph 16, the MLP will use the estimated \$16 million balance of the subscription proceeds from the sale of units in the MLP to acquire Class A units in various other production partnerships.
18. a) THC will, on closing, have the option, but will not be required, to subscribe for 4,000 Class B units of the Production Partnership (the "Class B Units") at a purchase price of \$875 per unit, for an aggregate subscription amount (the "Subscription Amount") of \$3.5 million. THC may exercise this option at any time, up to and including the beginning of the tenth year following the closing of subscriptions for Class A Units (see paragraph 17, above). Upon such a subscription, THC can choose to immediately pay the full amount of the Subscription Amount in cash, or it can choose to defer its obligation to pay the Subscription Amount to the tenth year following the closing of subscriptions for Class A Units. THC may pay for its investment in the Class B Units at any time, thereby entitling it to a share of any income or losses of the Production Partnership, as outlined below in paragraph 19. THC will not become a partner in the Production Partnership until the full amount of the Subscription Amount is paid in cash. The Subscription Amount will represent an amount equal to the fair market value of the Class B Units at the time of closing of subscription for the Class A Units (see paragraph 17, above).
- b) At the time of payment of the Subscription Amount, the Production Partnership will decide whether the Subscription Amount will be included in the amount of cash on hand to be distributed to its partners, as noted below in paragraph 19, or whether it will be used by the Production Partnership to make additional investments in, for example, another film.
19. Under the partnership agreement for the Production Partnership:
- a) the Class A Units, in the aggregate, will represent a 99.99% interest and entitlement to the income and losses of the Production Partnership, unless and until the Class B Units have been subscribed for and paid in full (see paragraph 18, above). The general partner of the Production Partnership will own a 0.01% interest;

- b) once the subscription price for Class B Units has been paid in cash, subject to the exemption described below in paragraph c), 99.99% of the profits and losses of the Production Partnership will be allocated ratably between the holders of the Class A Units and the Class B Units, based upon the amount of their partnership capital at the end of the relevant fiscal period (i.e. approximately 53.3% of the 99.99% share of the Production Partnership's profits and losses for the MLP, and approximately 46.7% of the 99.99% share for THC). In computing partnership capital for these purposes, adjustments will be made for each partner's share of the net income and losses of the Production Partnership, the amount of any distributions made to each partner, and contributions to the Production Partnership's capital. These capital contributions will only include amounts paid in cash and not amounts owing to the Production Partnership;
- c) if the Class B Units are not subscribed for in cash by the end of a particular fiscal period of the Production Partnership and, in the result, losses are allocated solely to the holder of the Class A Units (i.e. the MLP), profits of the Production Partnership for subsequent fiscal periods will be allocated solely to the holder of the Class A Units in an amount equal to the losses previously allocated to the holder of the Class A Units, and, other than a liquidating distribution on the termination of the Production Partnership, no cash distributions will be made to the holder of the Class A Units that would reduce its capital account to an amount less than its original capital account (see paragraph 17);
- d) once the Production Partnership has repaid in full its interim production loan to THC (see paragraph 13, above), any additional cash on hand, after paying its operating expenses, will be distributed by the Production Partnership to the holders of Class A Units and Class B Units in accordance with their respective participating interests, as described above in c) and below in e);
- e) subject to c) above, the Class A Units will be entitled to a priority distribution of cash on hand, to a maximum amount equal to their investment in respect of the Class A Units (refer to paragraph 17, above). The Class B Units will be entitled to cash on hand which is distributed after the priority distribution to the holder of the Class A Units, to a maximum of the Class B Unit holders' investment in respect of the Class B Units (refer to



paragraph 18, above). However, no cash distributions will be made to either partner, except on dissolution of the Production Partnership, if such distributions would reduce either of their capital accounts below the amount of their initial capital investments in the Production Partnership (i.e. approximately \$4 million and \$3.5 million for the MLP and THC, respectively). In addition, any such cash distributions must be made in a manner that the relative capital accounts of the partners are maintained (i.e. approximately 53.3% for the MLP and 46.7% for THC); and

f) each Class A Unit and Class B Unit will have equal voting rights. Other than the revenue sharing entitlements described in this paragraph, owners of the Class A Units will have the same rights and obligations as the owners of the Class B Units.

20. If and when any 80.1% Fees, percentage of net profits payments or bonuses (all as described above in paragraph 12, and together referred to hereafter as the "Revenues") are earned by the Production Partnership, they will be paid by THC to the Production Partnership. These payments will be made, regardless of whether the Investors are able to repay their Investment Loans to the Financial Institution.

21. Under the partnership agreement for the MLP,

- a) the limited partners of the MLP will be entitled to 99.99% of the profits and losses allocated to the MLP by the Production Partnership, and
- b) the general partner of the MLP will be entitled to 0.01% of the profits and losses allocated to the MLP by the Production Partnership.

22. MLP will pay out to its partners all revenues it receives from the Production Partnership. In the event that cash distributions from the MLP are insufficient to enable Investors to repay their Investment Loans, the Investors will be responsible for the shortfall on the basis that the Investment Loans represent unconditional, full-recourse obligations of each Investor. There will be no set-off, or other mechanisms, that will protect the Investors from an insolvency at either the Production Partnership or the MLP level. For greater certainty, there are no assurances of the amount of any cash distributions from the Production Partnership to the MLP or from the MLP to the Investors.

23. The MLP and the Production Partnership will be tax shelters within the meaning assigned by subsection 237.1(1) of the Act. The general partner of the MLP and the general partner of the Production Partnership will apply for tax shelter identification numbers for the MLP and the Production Partnership, respectively, and upon receipt of the number will file annual tax shelter information returns, pursuant to and in accordance with subsections 237.1(2) and (7) of the Act.
24. Neither Creditco nor the Production Partnership will be in an agency relationship with THC or Studio in respect of the production of the Film.
25. In your letter of July 23, 1998, as amended in your letter of September 29, 1998, you provided us with copies of the following draft documents in support of your ruling request:
- Production, Finance, Distribution Agreement;
  - CLE Production Services Agreement;
  - NCLE Production Services Agreement;
  - Co-Production and Services Allocation Agreement;
  - Guaranty Agreement;
  - Master Loan Agreement;
  - Master Security Agreement;
  - Unit Loan Agreement;
  - Collateral Security Agreement;
  - PLP Partnership Agreement;
  - MLP Partnership Agreement;
  - Offering Memorandum;
  - Waiver and Indemnity Agreement;
  - Option Agreement; and the
  - B Unit Subscription Agreement.

**PURPOSE OF THE PROPOSED TRANSACTION**

26. The purpose of the proposed transactions is as follows:

- a) to afford private Canadian investors the opportunity to invest in the motion picture and television industry, through the provision of production services in Canada, thereby providing investors with the opportunity to participate financially in the receipts generated from the worldwide exploitation of the films; and

- b) in tandem with the federal and provincial tax credit system for film and television production services, to encourage and facilitate the production of film in Canada by non-resident producers, thereby creating employment in Canada and utilizing and enhancing the expertise of Canadian production personnel.

## RULINGS

27. Provided that the statement of facts, the proposed transactions and the purposes thereof, all as described above, are accurate and constitute complete disclosure of all of the representations, relevant facts, proposed transactions and the purposes thereof, and provided further that all of the proposed transactions are carried out as described above, and that the offering documents or executive summary contain a reference, such as described on page 6 of this letter, in respect of the existence of caveats in the rulings given, and provided the final documents listed above in paragraph 25 are as submitted in draft, and provided that the Production Partnership and the MLP are partnerships at law, we confirm the following:

- A. The production services expenses incurred by the Production Partnership after the date of this letter and forming part of the production services rendered by it pursuant to the agreement referred to above in paragraph 12, will, subject to the provisions of section 18.1 of the Act, be deductible in the computation of the Production Partnership's income or loss for the relevant taxation year in which the expenses are incurred, pursuant to section 9 of the Act, to the extent that:
- i) such reporting conforms with generally accepted accounting principles;
  - ii) the outlays and expenses are reasonable in amount and are not on account of capital; and
  - iii) the outlays and expenses are made or incurred for the purpose of gaining or producing income from a business with a reasonable expectation of profit.
- B. Section 18.1 of the Act will not apply to restrict the deductibility of the production expenses incurred by the Production Partnership pursuant to the proposed transactions (referred to above in paragraph 12), so long as before the end of the taxation year in which the production expenditures are made, Revenues included in computing the Production Partnership's income for that year (other than any portion of such an amount that is

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the subject of a reserve claimed by the Production Partnership for the year under the Act) in respect of the Film, exceed 80% of such production expenses.

- C. Losses for a taxation year of the Production Partnership which are allocated by the Production Partnership, in accordance with the terms of the partnership agreement referred to above in paragraph 19, to the holders of Class A Units and Class B Units will be deductible in computing the income or loss of such holders of Class A Units and Class B Units at the end of the taxation year of such holders in which such fiscal year-end of the Production Partnership ends, to the extent of the at-risk amount (as defined in subsection 96(2.2) of the Act) of the holder in respect of the Production Partnership at the end of that taxation year.
- D. THC will be considered to be carrying on business in Canada when it is a partner of the Production Partnership.
- E. Losses for a taxation year of the MLP which are allocated by the MLP to an Investor, in accordance with the terms of the partnership agreement referred to above in paragraph 21, will be deductible in computing the income or loss of the Investor at the end of the taxation year of that Investor in which such fiscal year-end of the MLP ends, to the extent of the at-risk amount (as defined in subsection 96(2.2) of the Act) of the Investor in respect of the MLP at the end of that taxation year.
- F. Subject to the application of paragraphs (b), (b.1) and (c) of subsection 96(2.2) of the Act, the at-risk amount, within the meaning of subsection 96(2.2) of the Act, of the MLP in the Production Partnership, at the end of the 1998 fiscal year of the Production Partnership, will be equal to the amount of the MLP's investment in the Class A Units, as described above in paragraph 17, to the extent that the MLP, or a person with whom the MLP does not deal at arm's length, does not receive or obtain any amount or benefit referred to in paragraph 96(2.2)(d) of the Act, other than an amount or benefit excluded by one of subparagraphs (i), (iii), (vi) or (vii) of that paragraph.
- G. Subject to the application of paragraphs (b), (b.1) and (c) of subsection 96(2.2) of the Act, the at-risk amount, within the meaning of subsection 96(2.2) of the Act, of an Investor in the MLP, at the end of the 1998 fiscal year of the MLP, will be equal to the amount of the Investors investment in units of the MLP, as described in 15 and 16 above, to the extent that the Investor, or a person with whom the Investor does not deal at arm's length, does not receive or obtain any amount or benefit

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referred to in paragraph 96(2.2)(d) of the Act, other than an amount or benefit excluded by one of subparagraphs (i), (iii), (vi) or (vii) of that paragraph.

For greater certainty, in calculating the at-risk amount of an investor in the MLP or in calculating the at-risk amount of the MLP in the Production Partnership, the Production Partnership's entitlement to the 80.1% Fees, referred to above in paragraph 12, will not constitute an amount or benefit for the purposes of paragraph 96(2.2)(d) of the Act.

- H. Subject to the application of subsections 18(9) and (9.2) to (9.8) of the Act, interest paid in a taxation year or payable in respect of a taxation year by an investor (depending upon the method regularly followed by the investor in computing income) in connection with their investment loan will be deductible in computing income in that taxation year in accordance with paragraph 20(1)(c) of the Act, to the extent that the amount thereof is reasonable and paid pursuant to a legal obligation to pay interest on borrowed money used for the purpose of earning income from a business or property with a reasonable expectation of profit.
- I. Any amount of unpaid principal which the Production Partnership owes to THC (refer above to paragraph 13) will be a limited-recourse amount of the Production Partnership, and the provisions of subsection 143.2(6) of the Act will apply, *inter alia*. To the extent the amount owing to THC is repaid by the Production Partnership, the provisions of subsection 143.2(10) of the Act will apply.
- J. If any investor funds any portion of the balance of their \$350 investment in a unit in the MLP (as described above in paragraph 15) with limited-recourse financing, the provisions of subsection 143.2(6) of the Act will apply.
- K. Subsection 143.2(6) of the Act will not apply to reduce the amount of an investor's expenditure to acquire units of the MLP:
- i) by reason of the distribution of capital by the Production Partnership to the MLP as described above in paragraph 19(e); or
  - by reason of the Production Partnership's entitlement to the Revenues as described above in paragraphs 12 and 20.

These rulings are given subject to the general limitations and qualifications set forth in Information Circular 70-6R3 issued by Revenue Canada December 30, 1996, and are binding provided the proposed transactions are entered into on or before December 31, 1998. These rulings are based on the draft documents referred to above in paragraph 25, and are based on the Act in its present form and do not take into account the effect of any proposed amendments. Except as expressly stated, our rulings do not imply acceptance, approval or confirmation of any income tax implications of the facts or proposed transactions. In particular, nothing in this letter should be interpreted as confirming, either expressly or implicitly:

- a) the reasonableness or fair market value of any expenditures referred to in this letter;
- b) the proper generally accepted accounting principle applicable in the determination of the timing of the deduction of the cost of any of the production expenses incurred by the Production Partnership;
- c) the existence of reasonable expectation of profit of Creditco, the Production Partnership, the MLP or any of the Investors;
- d) whether Creditco will be an eligible production corporation in respect of the Film, for the purposes of section 125.5 of the Act;
- e) whether the Production Partnership or Creditco will be acting as legal agents for THC or Studio in respect of the making of the Film;
- f) the applicability or non-applicability of subsection 245(2) of the Act;
- g) the GST implications of any of the proposed transactions;
- h) the applicability or non-applicability of paragraph 96(2.2)(d) of the Act. In this regard, it is our opinion that if any amount of gross revenue related to the Film is ascertainable, whether contingent or otherwise, at the time that an Investor acquires an interest in the MLP, or at the time the MLP acquires a unit of the Production Partnership, this would affect the at-risk amount of the Investor and the MLP; and
- i) any other tax consequences of the proposed transactions or of related transactions or events that are not described herein.

As stated in paragraph 7 of Information Circular 70-673, rulings are not provided for transactions that are not seriously contemplated and are hypothetical in nature. Therefore, notwithstanding that the MLP will be subscribing for Class A units of limited partnership interest in a number of production limited partnerships (refer to paragraphs 7, 16 and 17, above), we are not ruling on the MLP's investment in any limited partnerships other than their investment in the Production Partnership, as described herein. In addition, notwithstanding that the Production Partnership may invest in other films (refer to paragraph 180), above), we are also not ruling on the Production Partnership's investment in any films other than the Film.

Yours truly,



for Director  
Resources, Partnerships and Trusts Division  
Income Tax Rulings and Interpretations Directorate  
Policy and Legislation Branch

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