Department of Justice Canada

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March 31, 2010

BY COURIER

Warren J. A. Mitchell
Thorsteinssons
Barristers and Solicitors
P.O. Box 49123, 3 Bentall Centre
27th Floor - 595 Burrard Street
Vancouver, British Columbia
V7X 1J2

Dear Sir:

Re: Sentinel Hill Productions IV Corporation, member of SHAAE (2001) Master Limited Partnership v. Her Majesty The Queen
Court Number: 2009-2248(IT)G - Justice File: 3-707094

Enclosed please find a copy of the Crown's Reply to Notice of Appeal, which was filed with the Tax Court of Canada on March 31, 2010.

Please acknowledge service of the Reply by signing the duplicate copy of this letter and returning it to our office at your earliest convenience.

Yours truly,

Ryan R. Hall
Counsel

Encl.

cc. J. Shipley, R. Carvalho, I. Nwachukwu

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March 31, 2010

BY HAND

The Registrar
Tax Court of Canada
200 Kent Street
Ottawa, Ontario
K1A 0M1

ATTENTION: Linda Martel

Dear Madam:

Re: Sentinel Hill Productions IV Corporation, member of SHAAE (2001) Master Limited Partnership vs. Her Majesty The Queen
Court Number: 2009-2248(IT)G - Justice File: 3-707094

We enclose the original and five copies of the Reply to the Notice of Appeal. Please file the original and return three date-stamped copies to our office.

Yours truly,

Ryan R. Hall
Counsel

Encl.

c.c. Warren Mitchell, Counsel for the Appellant

2009-2248(IT)G

TAX COURT OF CANADA

BETWEEN:

SENTINEL HILL PRODUCTIONS IV CORPORATION,
in its capacity as designated member of SHAAE (2001) MASTER LIMITED PARTNERSHIP

Appellant

TAX COURT OF CANADA
RECEIVED
BY HAND
MAR 3 1 2010
COUR CANADIENNE DE L'IMPÔT
REÇU
PAR PORTEUR

- and -

HER MAJESTY THE QUEEN

Respondent

REPLY

In reply to the appellant's Amended Notice of Appeal filed March 2, 2010, with respect to the Minister's Notices of Determination issued on March 29, 2005 and March 30, 2005 for the appellant's fiscal periods ended December 31, 2001 and December 31, 2002, respectively, the Deputy Attorney General of Canada says:

Overview

U.S. Motion Picture Studios incurred production expenditures in carrying on the business of making movies. Canadian tax shelter promoters rented these expenditures. But, the rental of expenditures does not give rise to a cognizable deduction or loss in Canada.

The Studios and Canadian promoters or their respective designates purported to enter into a series of intricate, circular transactions designed to permit the promoters and their clients to

indirectly do what they could not do directly. However, the Studios and the promoters did not deal with the "transactions" as if they were genuine and simply ignored the supposed rights and obligations, when and as required to carry out their real intentions. The "transactions" were designed to create a facade of reality quite different from the disguised reality. The true nature of the relationship between the Studios and the promoters was simply this: the Studios rented to the promoters a portion of the Studios' expenditures.

Neither the SHAAE (2001) Master Limited Partnership (the "MLP") nor any of the 73 Production Limited Partnerships (the "PLPs") in which the MLP "invested" were partnerships in law. While fashioned to have the appearance of possessing the legal attributes of a partnership, the MLP and the PLPs lacked the essential ingredient of carrying on business in common with a view to profit. To the contrary, the *sole* purpose of the MLP and the PLPs was to create tax losses for use by the members.

If the transactions were genuine and the MLP and the PLPs were in fact partnerships at law, the Minister nevertheless correctly concluded that the MLP had failed to demonstrate the losses incurred, if any, exceeded amounts allowed by the determinations or were reasonable in the circumstances.

A. STATEMENT OF FACTS

1. The following definitions apply throughout this Reply to the Amended Notice of Appeal:

Definitions - Key Players

(a) **"Robert Strother (Strother)"** is a lawyer and businessperson practicing law in the City of Vancouver. At all relevant times, Strother was a promoter of the MLP and had an indirect ownership interest in Sentinel Hill Productions IV Corporation ("SHPC"), the General Partner of the MLP. SHPC is wholly owned by Sentinel Hill Venture Corporation ("SHVC"), a company in which Strother and/or his family have an indirect ownership interest through 589918 British Columbia Limited ("589918"). The relevant Offering Memoranda represents that Strother had practiced taxation and finance law in Canada for 24 years and was the head of the Tax Estate Planning Group of Davis & Company, a law firm operating in the City of Vancouver. Strother has been involved as senior tax counsel on numerous film and television offerings in Canada. At all relevant times, Strother was also a director and Chairman of SHPC and SHVC;

(b) **"Paul Darc (Darc)"** is a Vancouver Chartered Accountant and businessperson. At all relevant times, Darc was a promoter of the MLP and had an indirect ownership interest in SHPC, the General Partner of the MLP. Darc and/or his family have an indirect ownership interest in SHVC through Pacific Cascadia Capital Corporation ("Pacific"). The relevant Offering Memoranda represent that Darc had been for many years a senior officer of Monarch Entertainment Corporation, a Canadian promoter of film and television offerings, until he founded in 1998, the Sentinel Hill Entertainment Corporation. At all relevant times, Darc was

also a director, Chief Financial Officer and Treasurer of SHPC and SHVC;

(c) **"Bradley J. Sherman (Sherman)"** is a lawyer and businessperson. At all relevant times, Sherman was a promoter of the MLP and had an indirect ownership interest in SHPC, the General Partner of the MLP. Sherman and/or his family have an indirect ownership interest in SHVC through Sentinel Hill Sales Corporation ("S-H Sales"). The relevant Offering Memoranda represents that Sherman was a partner of Grosvenor Park, a Canadian promoter of film and television offerings, and had been involved in packaging in excess of $1.5 billion of film syndications in Canada and the United Kingdom over a 15 year period. In 1999, Sherman formed S-H Sales which, according to the Offering Memorandum, served as the exclusive marketing coordinator and an advisor to Sentinel Hill Entertainment Corporation. At all relevant times, Sherman was also the director, President and Chief Executive Officer of SHPC and SHVC;

(d) **"Kenneth Gordon (Gordon)"** is a lawyer and businessperson. At all relevant times, Gordon was a promoter of the MLP and had an indirect ownership interest in SHPC, the General Partner of the MLP. Sherman and/or his family also have an indirect ownership interest in SHVC through 1396444 Ontario Limited ("1396444"). The relevant Offering Memoranda represents that Gordon practiced with the firm of Heenen Blaikie where he specialized in corporate/commercial law, primarily focused on tax and entertainment syndications involving film and television productions. According to the Offering Memorandum, Gordon also co-founded Trilogy Capital Corporation and founded EquiGenesis Corporation, both private limited market dealer security firms and has participated in more than 35 film and television investment syndications having raised approximately $600 million. At all relevant times, Gordon

was also the director, Executive Vice-President and Secretary of SHPC and SHVC;

(e) **"Promoters"** means Strother, Darc, Sherman and Gordon. The relevant Offering Memoranda represents that Strother, Darc, Sherman and Gordon had extensive experience in creating, packaging, selling and managing film and television offerings in Canada; Darc, Strother, Sherman and Gordon or their respective designates were responsible for creating, packaging, selling and managing the MLP and PLPs;

(f) **"Sentinel Hill Alliance Atlantis Equicap Limited Partnership (SHAAE LP)"** is a limited partnership formed on February 25, 2000 pursuant to the laws of Ontario between SHVC, which according the relevant Offering Memorandum holds a 69.99% interest therein, and Alliance Atlantis Equicap Corporation, a subsidiary of Alliance Atlantis Communications Inc., which holds a 30% interest and Sentinel Hill GP Corporation ("SHAAE GP") which holds a 0.01% interest therein. The relevant Offering Memorandum represents SHAAE LP as the Promoter of the MLP;

(g) **"Sentinel Hill Ventures Corporation or SHVC"** a corporation incorporated under the *Canada Business Corporations Act* of Canada and which indirectly through SHAAE LP promoted the MLP. The relevant Offering Memorandum represents SHVC as part of the Sentinel Hill Group of companies, which is a private Canadian promoter of media-related structured finance products in Canada and is also actively involved in the design and marketing of non-media related specialty investment products for higher net worth individuals and corporations. At all material times, 589918, Pacific Pacific, S-H Sales and 1396444 each owned 25% of the shares of SHVC. Directly or indirectly, 589918, Pacific, S-H Sales and 139644, were each owned and controlled by or for

the benefit of Strother, Darc, Sherman and Gordon and or members of their respective families, respectively;

(h) **"Sentinel Hill Productions IV Corporation (SHPC)"** is a corporation incorporated under the laws of Ontario and at all material times was the the general partner of the MLP and each of the 73 PLPs. SHPC at all material times was a wholly owned subsidiary of SHVC;

(i) **"General Partner or GP" or the "appellant"** means SHPC, the general partner of the MLP and the 73 PLPs, and though it was at all material times called the general partner of the MLP and each of the PLPs, it did not carry on business in common with a view to profit;

(j) **"Sentinel Group"** means the Promoters, SHVC and the General Partner when referred to collectively;

(k) **"SHAAE (2001) Master Limited Partnership or MLP"** is a limited partnership registered under the laws of Ontario on October 27, 2000. Though at all material times it was called a partnership, it did not carry on business in common with a view to profit. Its purpose was to subscribe for Class A units of limited partnership units in a number of production limited partnerships, and as such in 2001 it acquired Class A units in the 73 PLPs. Its first fiscal year-end was December 31st;

(l) **"PLPs"** means the seventy-three production service limited partnerships, which are set out in Schedule "A" to this Reply, none of which carried on business in common with a view to profit. Each had a December 31st fiscal year-end;

(m) **"Investors"** means taxpayers resident in Canada who purchased units in the MLP;

(n) **"Studios"** are one or more affiliates of U.S. major motion picture as set out in Schedule "A" to this Reply;

(o) **"THCs"** collectively refers to companies incorporated under the laws of the Cayman Islands and not dealing at arms length with one of the Studios as set out in Schedule "A" to this Reply;

(p) **"Creditcos"** are either Canadian corporations incorporated and controlled by the Studios or other Canadian corporations which deal at arm's length with the Studios, which in either case were engaged by the Studios for the purpose of providing CLE production services and for certain financing purposes;

(q) **"Scotiabank"** means the Bank of Nova Scotia, a chartered Canadian bank which provided a "daylight overdraft" loan facility to the Veritus III Trust during 2001;

(r) **"Veritus III Trust"** is a trust that acted as a conduit for the circulation of amounts and did not operate at arm's length with the any of the Investors, Sentinel Group, the MLP or any of the PLPs;

(s) **"Emeritus Trusts"** collectively refer to the eight trusts resident in Alberta, which acted as conduits for the circularization of funds, and did not operate at arm's length with the any of the Investors, Sentinel Group, the MLP or any of the PLPs. Schedule "A" to this Reply lists the respective Emeritus Trusts;

(t) **"Acceptrusts"** are trusts which acted as conduits for the circularization of funds, and did not operate at arm's length with the any of the Investors, Sentinel Group, the MLP or any of the PLPs. Schedule "A" to this Reply lists the respective Acceptrusts;

Definitions - Key Terms

(u) **"PLP Production Services"** is defined in the PLP Production Services Agreements with the Studios to mean all production items and service required to be performed by the PLPs, the agreement dates of which, as well as the closing dates and parties thereto, are set out in Schedule "A" to this Reply;

(v) **"PLP Production Expenses"** is defined in the PLP Production Services Agreements with the Studios as all reasonable and necessary production costs, fees, and expenses (including the Canadian Labour Service Fee Reimbursement) incurred by the PLP or subcontractors in respect of the PLP production services including amounts payable to the Studio for overhead type services;

(w) **"Films"** means the theatrical motion pictures or one or more episodes of a television series listed in Schedule "A" to this Reply to the Amended Notice of Appeal;

(x) **"NCLE Production Services"** means that part of the PLP Production Expenses as provided in the PLP Production Services Agreements with the Studios that does not include the Canadian Labour Service Fee Reimbursement;

(y) **"Non-Canadian Labour Expenditures or NCLEs"** means the purported expenditures arising from the NCLE Production Services, which are set out in Schedule "A" to this Reply,;

(z) **"Canadian Labour Service Fee Reimbursement or "CLSFR"** is defined in the PLP Production Services Agreements with the Studios to mean the fee payable by the PLP to the Studio in respect of the CLE Production Services;

(aa) **"CLE Production Services"** is defined in the in the PLP Production Services Agreements with the Studios to means Canadian labour expenditures ("CLE") required to be performed by Creditcos;

(bb) **"MLP Closings"** means the various dates during 2001 in which the Investors acquired units in the MLP; and

(cc) **"PLP Closings"** means the closing dates in 2001 and 2002 described in the Class A Unit Subscription Agreements as the date on which the MLP was to acquire Class A units in the 73 PLPs.

Summary of Tax Loss Creation Scheme

2. The Studios incurred expenditures in the production of motion pictures. For a fee, the Studios agreed to rent a portion of their production expenses to Canadian promoters who marketed them in Canada as deductible expenses through tax shelters.

3. The promoters and the Studios purported to enter into a series of intricate, circular transactions (collectively referred to as the "tax loss creation scheme"). These transactions were designed to enable the promoters and their clients to do indirectly what they could not do directly: to deduct losses derived from a simple rental of expenditures. Some or all of the transactions comprising this tax loss creation scheme were sham transactions, incomplete, and/or legally ineffective. For example, by the time the production services contracts were executed, the Studios had already incurred part or all of the very expenditures and provided part or all of the very services that the PLPs contracted to provide. In some cases, the production services were already entirely completed.

4. To carry out the tax loss creation scheme, the promoters created the MLP, whose purpose was to acquire Class A units of the PLPs. The PLPs contracted to provide production services respecting motion pictures.

5. The Studios contracted with the PLPs to produce motion pictures. The PLPs contracted back with the Studios the same NCLE Production Services and the Studios provided the services at cost plus a mark-up. With respect to CLE Production Services, the Studios incurred these costs for which they were reimbursed by the PLPs.

6. To create the tax losses, each of the PLPs agreed to provide the PLP Production Services to the Studio for a fee fixed at only 80.02% of the cost of the services. The PLPs fixed that fee at 80.02% of cost without any negotiation, contrary to industry standards and without any business rationale. The PLPs selected 80.02% in an attempt to avoid the matchable expenditures rules in section 18.1 of the *Income Tax Act* (Canada) (the "*Act*") while maximizing the losses created.

7. The PLPs therefore committed to providing the PLP Production Services to the Studios at 80.02% of their cost while agreeing to pay the Studios that cost plus a mark-up to provide some of the same services. To overcome this guaranteed loss and create the appearance of a profit potential, the PLP production services contracts included a Net Profit Participation or NPP clause.

8. While creating an appearance of a profit potential, the Net Profit Participations were structured and intended to be, and were in fact, worthless. There was no prospect that the PLPs would receive any amount from the Net Profit Participation, much less produce a profit. The Net Profit Participations were at best mere window-dressing.

9. The clients of the Promoters, the Investors, acquired units in the MLP and the MLP allocated losses created in the PLPs to the Investors.

10. The Investors acquired units in the MLP through financing arrangements that were as circular as the production services contracts and which guaranteed that no funds beyond their actual cash were ever at risk.

11. The cash contributed by the Investors to acquire units of the MLPs was used to pay the fees of the promoters, the accommodating Studios and other "accommodators,"

not to pay for production services provided to the Studios. The MLP and PLPs created the appearance of working capital through a series of circular daylight "loans". In fact, there was no working capital.

12. The promoters ensured that any supposed liabilities of the Investors beyond the cash actually contributed was eliminated by inserting into the tax loss creation scheme mandatory acquisition of Class B units in the PLP by the Studios. The acquisition of the Class B units was designed to reduce the risk of loss to the Investors.

13. The units acquired by the Investors were not genuine partnership units in that they were designed and known by the Studios, the promoters and the Investors to be worthless. The scheme was designed to benefit the Investors who purchased tax losses, the promoters who received fees for arranging those purchases, and the Studios who received a premium for renting their expenditures. The tax loss creation scheme was not designed to produce a profit in either the MLP or the PLPs.

14. The transactions comprising the tax loss scheme were designed to create the appearance of persons carrying on business in common with a view to profit when the true relationship was decidedly different. The true relationship of the parties was simply the renting of expenses, which does not give rise to a deductible tax loss.

15. The sole intention and purpose of the MLP, the PLPs and members of the MLP and PLPs was to create losses through an intricate series of circular transactions, and not to carry on business in common with a view to profit.

Response to the Allegations of Fact in the Amended Notice of Appeal

16. He admits the allegations of fact stated in paragraphs 1, 6, 44 and 55 of the Amended Notice of Appeal.

17. Except insofar as the respondent denies that the MLP and the 73 PLPs carried on business in common with a view to profit, he admits paragraphs 7 and 8 the first

sentence of paragraph 14, 15, 16, 29, 37, 41, 45, 48, 52 and 56 of the Amended Notice of Appeal.

18. He has no knowledge of and therefore does not admit the allegations of fact stated in the second sentence of paragraph 14 of the Amended Notice of Appeal and puts the appellant to the strict proof thereof. He states further that neither the MLP nor any of the 73 PLPs carried on business in common with a view to profit.

19. He denies the allegations of fact stated in paragraphs 9, 10 and 30 of the Amended Notice of Appeal and puts the appellant to the strict proof thereof. He states that neither the MLP nor any of the PLPs carried on business in common with a view to profit. He states further that the MLP and PLPs were each exclusively formed for the purpose of entering into a series of circular transactions designed to create tax losses for the Investors and to siphon off the only cash into the hands of the Promoters and Studios. He states further that some or all of the "transactions" were designed to create a facade of reality quite different from the disguised reality.

20. With respect to paragraph 11 of the Amended Notice of Appeal, he admits only that the MLP purported to issue 52,233.6033 units to 2,200 Investors at a price of $16,200 per unit. He specifically denies the Investors carried on business in common with a view to profit. He states further that of the total subscription proceeds of $846,184,373, only $94,020,486 was in cash and that the balance of $752,163,887, representing 89% of the Investors cumulative contribution for units in the MLP, was financed. He states further that that the circular character of the underlying "transactions" insured the Investors would risk only their cash contributions. He states further the transactions were *designed* to eliminate any prospect of profit by the Investors except insofar as they might be able to acquire tax losses.

21. With respect to paragraph 18 of the Amended Notice of Appeal, he denies that the appellant and the Investors carried on business in common with a view to profit, and says that the document speaks for itself.

22. With respect to paragraphs 31 and 32 of the Amended Notice of Appeal, he admits only that the each of the named parties purportedly contracted as alleged but otherwise denies the said paragraphs. He states further that the alleged contracts were sham transactions, incomplete and/or legally ineffective. He specifically denies that the PLPs provided any services whatsoever under the "contracts".

23. He denies the allegations of fact made in paragraph 33 of the Amended Notice of Appeal. He states that the purported acquisition of Class B units in the PLPs was part of a series of circular transactions each of which was pre-ordained. Specifically, the following was pre-determined:

    (a) the PLPs would purportedly issue Class B units for an aggregate purchase price equal to the outstanding balance of the Investor Loans as of January 15, 2003;

    (b) the purchase price for the Class B units had to be "financed" by way of a promissory note bearing the same rate of interest and due dates for interest and principal payments as were the terms associated with the Investor Loans; and

    (c) the payments of interest and principal under the promissory note would be made to the PLPs and distributed to the MLP which in turn would fulfill the interest and principal obligations under the Investor Loans.

24. With respect to paragraphs 35, 36, 38, 39, 48, 49 and 50 of the Amended Notice of Appeal, he admits only that the PLPs and the MLP reported losses as alleged but denies they were correct in doing so. He further denies that the PLPs and the MLP incurred any business losses in 2001 and 2002. He repeats that neither the MLP nor any of the PLPs carried on business in common with a view to profit. He states further that the MLP and PLPs were each exclusively formed for the purpose of participating in a series of circular transactions designed to create tax losses for the Investors and to siphon off the only cash into the hands of the promoters, Studios and other accommodators. He states further that some or all of the "transactions" were

designed to create a façade, one that differed greatly from reality. He otherwise denies the allegations of fact set out in those paragraphs.

25. With respect to paragraphs 40 and 51 of the Amended Notice of Appeal, he admits only that the PLP and the MLP reported having received interest income, but otherwise denies the allegations of fact made in paragraphs 40 and 51.

26. Except insofar as the alleged manner in which the Minister issued the Determinations, he admits the allegations of fact stated in paragraphs 42, 43, 53 and 54. He further states that what is at issue in tax appeals in the correctness of the Minister's Determinations and not the conduct of officials of the Canada Revenue Agency (the "CRA").

Response to Rulings Allegations

27. He denies paragraphs 12, 13, 17, 23, 24, 25, 26, 27 and 28 of the Amended Notice of Appeal. He states further that an advance tax ruling respecting the specific transactions at issue in this appeal was neither sought by anyone nor given by CRA. He states further that the CRA had no correspondence or discussions in respect to the specific transactions at issue in this appeal upon which the appellant, the Sentinel Group, the Investors, the MLP or the PLPs might have relied.

28. With respect to paragraphs 2, 3, 4, 5, 19, 20, 21, 22 and 34 of the Amended Notice of Appeal, he admits only that the Rulings Division of the CRA issued an advance income tax ruling dated December 13, 2000 and that a fee was paid in respect of the ruling. He states further that the taxpayer seeking the December 13, 2000 ruling did not disclose all of the relevant facts. Had the taxpayer seeking the December 13, 2000 ruling fully and accurately disclosed the relevant facts, the Rulings Directorate may have either refused to rule on the transactions or may have provided an unfavourable ruling. He otherwise denies the allegations of fact set out in those paragraphs.

29. He states further that the Sentinel Group, the MLP, the PLPs and the Investors knew or ought to have known that the advance tax ruling only extended to transactions specifically described in the ruling. He further states that Sentinel Group, the MLP, the PLPs and the Investors knew or ought to have known the ruling was obtained without full disclosure of all of the relevant facts and that the specific transactions at issue in this appeal would, in any event, fail to satisfy the various caveats and limitations contained within the ruling.

30. He denies paragraphs 46, 47, 57 and 58 of the Amended Notice of Appeal. He states further that the ruling related to only those transactions specifically described therein and was obtained without full disclosure of all of the relevant facts and that the specific transactions at issue in this appeal would, in any event, fail to satisfy the various caveats and limitations contained within the ruling.

31. He states that the Determinations regarding the 2001 and 2002 fiscal periods of the MLP were not issued in contravention of any ruling. Advance income tax rulings apply only to the transactions specified in the ruling. No ruling was obtained in respect of the specific transactions at issue.

32. In any event, the Determinations are consistent with the Minister's interpretation of the law contained in the December 13, 2000 ruling.

33. He states the transactions by which several of the PLPs purported to contract to provide production services are purported to have been entered into prior to December 13, 2000, the date on which the ruling was issued.

34. The appellant and its agents abused the advanced income tax rulings process by obtaining the ruling through false representations of fact and material omissions of fact. The equitable doctrine of *estoppel* is, therefore, not available to the appellant.

Tax Reporting and Assessment

2001 Fiscal Period

35. During its fiscal period ended December 31, 2001, the MLP acquired 100% of the Class A units in the PLPs at a time when each of the PLPs was in a loss position and had no reasonable expectation of ever recovering the loss, let alone an expectation of profit.

36. For their fiscal periods ended December 31, 2001, the PLPs allotted cumulative "business losses" in the amount of $334,144,126 to the MLP.

37. For the fiscal period ended December 31, 2001, the MLP reported a net business loss of $335,506,103 and interest income of $3,528,976.

38. By the Determination dated March 29, 2005 regarding the MLP's 2001 fiscal year, the Minister determined the net business loss of the MLP to be no more than $199,404,223, interest income as reported of $3,528,976 and reduced the limited partner's at-risk amount to $439,900,353.

39. The appellant filed a Notice of Objection to the 2001 Determination on June 27, 2005.

40. The appellant filed this appeal prior to the Minister making a decision on the Notice of Objection in respect of the 2001 Determination.

2002 Fiscal Period

41. For their fiscal periods ended December 31, 2002, the PLPs allotted cumulative "business losses" in the amount of $73,585,345 to the MLP.

42. For the fiscal period ended December 31, 2002, the MLP reported a net business loss of $74,425,025 and interest income of $13,991,820.

43. By the Determination dated March 30, 2005 regarding the appellant's 2002 fiscal year, the Minister determined the net business loss of the MLP to be $30,640,652, interest income as reported of $13,991,820 and reduced the limited partner's at-risk amount to $250,954,148.

44. The appellant filed a Notice of Objection to the 2002 Determination on June 27, 2005.

45. The appellant filed this appeal prior to the Minister making a decision on the Notice of Objection in respect of the 2002 Determination.

46. In addition to the facts the Minister assumed in issuing the determinations for the 2001 and 2002 fiscal periods of the MLP, such facts being detailed in paragraph 47 below, the respondent also relies on the following facts:

The Real Arrangement

(a) the Sentinel Group sought to purchase the NCLEs of the Studios. The Studios agreed to receive a fee equal to a negotiated percentage of the Films' budget for renting its production expenses to the Investors indirectly through the PLPs and the MLP;

(b) the purchase and sale of PLP Production Expenses was the real arrangement between the Studios and the Sentinel Group;

(c) to carry out the tax loss creation scheme, the Sentinel Group, the Studios, the MLP, the PLPs and other accommodators entered into a series of "transactions" that did not reflect the true relationship of the parties;

Activities of the MLP

(d) the amended and restated partnership agreement between the MLP and the Investors dated October 27, 2000 defines its business activities as:

i. investing in Class A units of limited partnership interest in one or more PLPs,

ii. providing financing, through investments in such Class A units of each PLP, for expenditures incurred by each such PLP in performing or providing production services for or to the Studio under a PLP Production Service Agreement, and

iii. investing the funds of the Partnership in certificate of deposit and interest bearing accounts of Canadian chartered banks or such other investments as the General Partner determines;

(e) the business activities referred to in the above subparagraphs (ii) and (iii) were not in fact at any time materially carried on by the MLP. The financing for any of the purported expenditures of the PLPs was provided by either the Creditco or the Studios but not by the MLP. Further, the funds of the MLP were not invested in the manner so contemplated in paragraph (iii) above, so as to provide any material receipts to the MLP. Rather, the only activity undertaken by the MLP in relation to its stated business activities was its acquisition of its alleged partnership interests in the 73 PLPs;

(f) the MLP and the members of the MLP did not carry on business in common with a view to profit;

(g) the only "investment" of the MLP was in the PLPs;

(h) at the time of the MLP's investment in the PLPs, all of the PLPs showed significant losses and could only look to the Net Profit Participation to recover those losses;

(i) the Net Profit Participation of each PLP was worthless and not intended by the parties to generate any profits;

(j) the Net Profit Participation of each PLP was mere "window dressing" designed to give the MLP the appearance of investing in property of value when the property was in fact worthless;

(k) neither the management of the MLP nor the management of the PLPs made any independent analysis to determine whether it was reasonable to assume the films would generate revenue in addition to the fees already earned;

(l) neither the management of the MLP nor the management of the PLPs undertook any analysis to show that overall, the portfolio of films could reasonably be expected to break-even, much less generate a profit;

(m) the MLP never intended to profit from its "investment" in the PLPs but rather the MLP's sole intention was to acquire the losses resulting from the PLPs structure;

(n) the MLP did not have even an ancillary purpose of earning a profit from the "investment" in the PLPs;

(o) none of the PLPs had even an ancillary purpose of earning a profit from the provision of the PLP Production Services;

The Production Service Agreements were both circular and contrary to market

I. Circularity of PLP Production Service obligations

(p) the contractual obligation to provide the PLP Production Services was entirely circular;

(q) the Studios are in the business of producing and distributing movies. However, with respect to the 82 theatrical motion pictures or television projects (collectively referred to as the "Films," which are listed in Schedule "A" to this Reply) the Studios or their affiliates contracted with each of the 73 PLPs under the PLP Production Services Agreements to provide and pay for all the PLP Production Services in respect of the Picture. The PLPs in turn contracted back to the Studio the obligation to provide the very same PLP Production Services;

(r) in particular, between March 20, 2000 and December 1, 2001,

i. the Studios entered into Production Services Agreements with the PLPs ("PLP Production Services Agreements") to the PLP Production Services, including both the NCLE Productions Services and the CLE Production Services, in respect of the Films,

ii. each of the PLPs, in turn, entered into Services Agreements with the Studios ("Studio Services Agreements"), subcontracting back to the Studios the obligations to provide the NCLE Production Services in respect of the Films, and

iii. each of the PLPs and the Studios enter into CLE Production Services Agreements with a Creditco ("CLE Production Agreements"), pursuant to which a Creditco provides the CLE

Production Services to the Studios in respect of the Films, the cost of which to the Studio is reimbursed by the PLPs;

II. PLPs adopt cost *less* pricing strategy contrary to industry standards

(s) production service providers in the motion picture production business generally follow a cost *plus* pricing strategy, which is the industry standard;

(t) contrary to the industry standard, the PLPs, with the assistance of Darc, fashioned a unique cost *minus* pricing strategy which was coupled with a Net Profit Participation;

(u) in consideration for providing the PLP Production Services, the PLPs were paid certain fees as follows:

i. a fee equal to 80.02 % of the PLP Production Expenses ("the Basic Fee") composed of two amounts,

a. the Fixed Fee equal to 80.02% of the PLP Production Expenses, and

b. a Defined Gross Fee equal to 100% of the Defined Gross, a contingent compensation amount, payable if and when earned from the exploitation of the Film, and

ii. a Defined Proceed Fee, a contingent compensation amount, if and when earned from the exploitation of the Film, calculated by multiplying the 8 to 8.1% of the Defined Proceeds, by a fraction, the numerator of which was the NCLEs and the denominator was the aggregate production costs of the Film for which services had been provided (referred to as the "Net Profit Participation");

(v) the Fixed Fee was the "cost minus" component of the PLPs' pricing strategy respecting the provision of the PLP Production Services to the Studio. The Net Profit Participation is purportedly the plus part of the PLPs' pricing strategy;

(w) there were no negotiations with the Studios respecting the 80.02% Basic Fee. Rather, the fixed fee equal to 80.02% Basic Fee of the PLP Production Expenses was purely a mathematical exercise designed to avoid the application of the matching rules found in section 18.1 of the *Act*;

(x) there were no negotiations with the Studios respecting the percentage of net profits to be received by each of the PLPs. All Net Profit Participation were based on a proportion of identical 8 or 8.1 percentages;

(y) the actual percentage of profit participation by the PLPs is substantially less than 8% or 8.1%. In fact, the PLPs were only entitled to a tiny proportion of the 8% or 8.1% amount, as represented by the NCLEs incurred by the PLPs divided by the total production costs of producing the particular film or films;

(z) the Studios provided no information to the MLP or the PLPs in respect of what gross revenues they would expect a particular film would earn from its theatrical release, or other sources of revenue, such as video release;

(aa) Studios do their own estimates of what they expect a film to gross in a worst-case scenario and a best-case scenario, and generally the actual results fall somewhere in between those two scenarios. The Studios have policies of not providing estimates of gross receipts to participants, so as to avoid any litigation in the event that their projections are significantly different from the actual results. In accordance with their policies, the Studios did not provide their estimates to the MLP, the PLPs, the Promoters or any member of the MLP or PLPs;

III. Unlike the PLPs, Studios do not adopt cost *less* pricing strategy

(bb) each of the PLPs entered into a Studio Services Agreement with a Studio whereby the Studio agreed to provide to the PLPs the very same NCLE Production Services that the PLPs had contracted to provide to the Studios under PLP Production Services Agreements;

(cc) under the PLP Production Services Agreements, the PLPs each adopted a cost less pricing strategy for the PLP Production Expenses (which, again, includes both the NCLE and CLE Production Expenses), by which the PLPs recovered only 80.02% of the cost of the services and a worthless Net Profit Participation;

(dd) although the NCLE Production Services and the CLE Production Services provided under the Studio Services Agreements and CLE Production Services Agreements, respectively, were identical to the services obliged to be provided under the PLP Production Services Agreements, the Studios – unlike the PLPs – did not adopt a cost less pricing strategy. Rather, the Studios, under the Studio Services Agreements and the CLE Production Services Agreements, recovered all of their costs plus an administrative fee not exceeding 15% of the aggregate of all PLP Production Expenses;

(ee) under a Production Services Co-ordination Agreement, the Studio also received agency fees payable on closing of the various transactions;

(ff) the management of the MLP and the PLPs undertook no analysis of the expected gross receipts to be earned by the Studios in respect to any of the Films for which the PLPs contracted to provide the PLP Production Services, either before or after entering the PLP Production Services Agreements;

(gg) thus, neither the MLP nor the PLPs had any basis to conclude that the Net Profit Participation would have any value whatsoever or that the Net Profit Participation in the Films would provide the PLPs with sufficient revenues to provide them a reasonable expectation of earning an amount in excess of its deductible PLP Production Expenses in respect of the Films;

(hh) in the motion picture industry, profit participations are calculated in terms of "points" (percentages), usually described in terms of "net" and "gross." Net points are so notoriously worthless that they are commonly known as "monkey points" because only a monkey would accept them;

(ii) in short, there is a general awareness by participants in the movie and television industries that net profit participants rarely, if ever, earn any amounts from their net participations;

(jj) the Net Profit Participation clauses contained in the PLP Agreements were crafted to ensure that the Studios would not have to pay any amounts to the PLPs. Indeed, under the Net Profit Participation clauses, it was virtually impossible for the PLPs to achieve a net profit;

(kk) the Promoters, their companies, the management of the MLP and the PLP and their counsel, all of whom had significant exposure to the movie and television industry, clearly understood that the Net Profit Participation clauses were worthless and intended to be worthless;

(ll) prior to 2001, the Promoters collectively structured investments in 129 films, television movies or series through like limited partnership structures and using like net profit participation clauses, none of which clauses have generated any returns;

(mm) ***none*** of the Films for which the PLPs provided PLP Production Services had at the time of the issuance of the Determination even remotely come

close to breaking-even as computed under the definition of net profit found in the PLP Production Services Agreements, let alone made a net profit from which any distribution could be made to the PLPs;

(nn) by the time the MLP acquired its interests in the PLPs, they had completed their respective contractual obligations under the PLP Production Services Agreements, and they had earned the right to receive their 80.02% Fees. The relevant 80.02% Fees, PLP Production Expenses and closing dates for each of the PLPs is set out in Schedule "A" to this Reply;

(oo) generally speaking, the potential for financial success of a film project is based on strength of the script, the track records of the actors, directors, producers and studio involved in a project, and the studios' ability to bring these factors together in a successful film project;

(pp) the Investors were unable to carry out any personal investigation or obtain such information with respect to the Films or the provider of the production services, as their investment was a blind pool of film investments, and as such none of the requisite information was made available to the Investors;

(qq) pursuant to agreements with the Studios, the management of the MLP was not permitted to advise the Investors with respect to any of the following: what studios they were dealing with, what film projects they were investing in or what major actors, directors or producers were involved in the film projects;

(rr) the general information, which was made available by the MLP to each of the Investors with respect to their investment in the MLP to allow them to assess the MLP as an investment opportunity, was the limited information contained in the Offering Memorandum, Subscription Form, Promissory Note, Acknowledgment and Direction and the Financial Overview

prepared with respect to the relevant provincial laws. The Financial Overview provided to Investors was prepared on the basis that only the 80.02% Fees were earned by the PLPs. It only provided the losses, which would be apportioned to each Investor for the 2001 and 2002 taxation years as a subscriber for units in the MLP;

(ss) all that the MLP was marketing was a scheme to access the expenses of the Studios through the PLPs, and not a true investment in the movie or television industries. The receipt of only the 80.02% Fees by the PLPs would be what is commonly called in the investment industry a "worst case scenario";

(tt) no effort was made by the MLP or its management to provide the Investors with "median" or "best" case scenarios, if in fact the PLPs did earn some or sufficient Net Profit Participation amounts to allow the PLPs to earn a profit from their respective PLP Agreements;

(uu) the Investors acquired their respective partnership interests in the MLP on closing dates at various times throughout the 2001 calendar year, with no closings taking place after December 31, 2001. On each of the closing dates, the MLP acquired 100% of the Class A units of particular PLP until it had by year end acquired all Class A units in the 73 PLPs;

(vv) at the time the MLP acquired its interest in the PLPs, arrangements were put into place such that the account receivables in respect of the 80.02% Fees would be paid in full and the PLPs' liabilities to the Studios would be extinguished by no later than December 31, 2003, such that the sole remaining "asset" of each of the PLPs was the worthless Net Profit Participation respecting the each Film or group of Films;

(ww) after the MLP acquired its interests in all 73 PLPs, none of the PLPs carried on any further business of providing PLP Production Services in respect of any further motion pictures. Further, the PLPs did not carry on

any other activities, and did not incur any further liabilities with respect to any further activities. There were no management duties in respect of the Net Profit Participations of the PLPs;

(xx) neither the PLPs nor their agents expended anything other than nominal time, attention or labour on their Net Profit Participations, nor did they incur any liabilities in respect of the Net Profit Participations or any other business;

(yy) pursuant to the PLP Production Services Agreements, the PLPs would not have or claim to have any rights in the Films. The Studios would be the first and sole and exclusive owners in perpetuity of all right, title, and interest in and to the Films;

(zz) the Studios would have the right to use, exploit, advertise, exhibit, and otherwise turn to account the Films, or any portion thereof in any media, as the Studio, in its sole and absolute discretion, determined. In summary the PLPs have no rights with respect to whether or not any of the Films are released, or how they are marketed or otherwise exploited Rather, the Studios had the sole discretion as to whether or not a particular Film is released for theatrical or otherwise distributed or otherwise exploited;

(aaa) the pricing policy adopted by the management of the PLPs at the time that they entered into the PLP Production Services Agreements was not intended to provide the PLPs with a "profit" from the provision of the production services, but rather it was intended to generate an operating loss for the PLPs. This was because of the significant deficiency between the 80.02% Fee expected to be earned from the provision of the PLP Production Services, and the anticipated NCLEs and CLSFR the PLPs were obligated to pay. As such, it could not be reasonably be expected by the management of the PLPs that the Net Profit Participations would provide sufficient returns to allow the PLPs to earn a profit from the provision of PLP Production Services; and

(bbb) before December 31, 2001, when the MLP acquired its interests in each of the PLPs, each of the PLPs held two "assets": their account receivable in respect of the 80.02% Fee and their respective Net Profit Participations;

47. In issuing the determinations for the December 31, 2001 and December 31, 2002 fiscal periods of the MLP, the Minister made the following assumptions of fact:

Financing Structure

I. Investor Payment of Subscription Price

(a) the subscription price of each partnership unit in the MLP was $16,200. For every unit, each Investor contributed $1,800 in cash ($1,150 paid in 2001 and $650 paid on February 15, 2002). The $14,400 balance of the subscription price per unit was required to be financed by a loan arranged through the Promoters;

(b) the Promoters sold a total of 52,233.6033 limited partnership units in the MLP to 2,200 investors for total subscription proceeds of $846,184,373 of which only $94,020,486 ($60,068,644 in 2001 and $33,951,842 on February 15, 2002) was in cash. The balance of the subscription proceeds of $752,163,887 was financed, representing 90% of the Investors' cumulative contribution for units in the MLP (the "Investor Loans");

(c) for every unit, each Investor paid by way of cheques post-dated February 15, 2002 a further $1,000 in cash to the MLP to fund interest and financing costs, with the MLP further receiving in the aggregate, $52,233,603;

(d) on a unit basis, the only amount of the subscription price paid in cash for each limited partnership unit in the MLP was $1,800;

(e) the amount of $1,800 per Class A unit or $94,020,486 in the aggregate was the only amount ever put at risk by the Investors in acquiring the units;

II. Day-light Loan Financing of Investors and Production Services

(f) the financing of the Investors non-cash investment in the MLP and the financing of the PLP Production Services were both circular and accomplished by daylight loans. The series of daylight-loans did not add any additional cash beyond the Investor cash contribution of $1,800 per unit;

(g) while the circularization of funding was accomplished through the use of day-light loans, the extinguishment of the loans was achieved through a series of pre-ordained set-off transactions;

(h) in summary, the loans, in aggregate, occur as detailed in the following paragraphs;

III. Investor Loans—Stage One

(i) on the date of the various MLP Closings in 2001, Scotiabank, by daylight overdraft loan facility, loaned amounts cumulatively totaling $752,163,887 to the Veritus III Trust;

(j) on the date of the various MLP Closings in 2001, the Veritus III Trust loaned the Investors the total amount of $752,163,887 on a 10 year term, with interest payable annually at 11% from the MLP Closing date until January 15, 2003 and from January 16, 2003 until the loan was repaid in 2011, at an annual interest rate equal to the greater of

i. the prime rate as reported by the Royal Bank of Canada from time to time plus one and one-half percent, and

ii. the appropriate prescribed rate of interest for the purpose of section 143.2(7)(b) of the *Act* on the date the funds were advanced (the "Investor Loans");

(k) the Investors contribute the Investor Loans in the aggregate of $752,163,887 to the MLP to complete their subscription obligation;

(l) on December 31, 2001, the MLP subscribed for 806,633.089 Class A units at a price of $1,000 per unit in the 73 PLPs for a total cost of $806,633,089, funded from the combination of $752,163,887 from the Investor Loans and $54,469,200 from the cash portion of the Investor subscription proceeds for units in the MLP;

(m) on February 15, 2002, the Investors paid the remaining cash portion of the subscription price of $650 per unit or $33,951,842 in the aggregate to the MLP;

(n) on February 12, 2002, the MLP acquires additional Class A units in the PLPs for an aggregate subscription price of $33,951,842;

IV. Studio Loans to PLP—Stage One

(o) $875,990,284 was directly borrowed by the PLPs from the Studios at a specified rate of interest, of which $792,490,949 was borrowed in 2001 and $83,499,335 in 2002 ("Studio Loans");

(p) $65,670,595 was indirectly borrowed by the PLPs from the Studios as follows:

i. the Studios loaned to the Creditco the aggregate of $65,670,595 at no interest cost, of which $64,255,265 was loaned in 2001 and $1,415,330 in 2002, and

ii. the Creditcos in turn loaned the funds, in the same amounts and on the same dates, to the PLPs but did so at an interest rate of 12% ("Creditco Loans");

V. Studio Loans to PLP—Stage Two

(q) in 2001, the PLPs repaid $752,346,773 of the principal outstanding of $792,490,949 on the Studio Loans advanced in 2001;

(r) in 2001, the PLPs repaid $15,184,512 of the principal outstanding of $64,255,264 on the Creditco Loans advanced in 2001

(s) the Creditcos repaid $15,184,512 to the Studios in respect of the loans made to them by the Studios;

VI. Studio Loans to PLP—Stage Three

(t) in 2002, the PLPs repaid $123,728,368 to the Studios in satisfaction of the principal balance of the Studio Loans, together with interest of $33,545,182 and fees of $31,171,421;

(u) the PLPs repaid $50,486,084 to the Creditco in satisfaction of the remaining principal balance of the Creditco Loans, together with interest of $9,119,423 and fees of $2,671,080;

(v) the Creditcos repaid $50,486,084 to the Studios in satisfaction of the loans made to them by the Studios;

VII. Fixed Fee Payment –Stage One

(w) the Studios paid directly and indirectly to the PLPs its Fixed Fee for all production services under the Production Services Agreements in the aggregate amount of $745,205,823, of which

i. $11,682,306 in the aggregate is paid directly to the PLPs on the PLP Closings in 2001 in satisfaction of its Fixed Fee obligation for that year, and

ii. in 2001, $641,759,364 in the aggregate is paid by the Studio to the Acceptrusts in exchange for Acceptrusts agreeing to pay to the PLPs the balance of the Fixed Fee in the aggregate of $733,523,517 in two payments, first on December 15, 2002 then on January 15, 2003;

VIII. Acceptrusts Loans - Stage One

(x) in 2001, the Acceptrusts loan the aggregate amount of $641,759,364 to the Veritus III Trust with $259,598,919 repayable by December 15, 2002 and the remaining balance repayable by January 15, 2003 ("Acceptrusts Loans");

(y) the Acceptrusts Loans bore interest at a specified rate payable on or before February 28, 2002 and the remaining interest obligation payable by January 15, 2003, such that the sum of the principal and interest to be paid to the Acceptrusts by the Veritus III Trusts equaled $733,523,517 allowing the Acceptrusts to meet its Fixed Fee obligations with the PLPs;

IX. Class B Units – Stage One

(z) the Studios purchase from the THCs a 90% interest in every distribution on units of the Emeritus Trusts owned by the THCs for an aggregate purchase price of $370,003,442, with $110,404,523 payable on the PLP Closing in 2001 and $259,598,919 on December 15, 2002;

(aa) the 90% interest entitled the Studios through the THCs to indirectly share in the net profit payments (if any) made by Studios to the PLPs in respect of the Films;

(bb) the THCs, purchased for a cumulative amount of $370,003,442 capital units in the various Emeritus Trusts, with $110,404,523 payable on the PLP Closing in 2001 and $259,598,919 on December 15, 2002;

(cc) the various Emeritus Trusts, subscribed for Class B units in the PLP, at a price of $1,000 per unit or $370,003,442 in the aggregate $110,404,523 on the PLP Closings in 2001 and $259,598,919 on December 15, 2002), which entitled these trusts to share proportionately in the net profit payments (if any) made by Studios to the PLPs in respect of the Films;

(dd) the Emeritus Trusts issued promissory notes ("B Unit Notes") to the PLPs in the aggregate amount of $370,003,442 ($110,404,523 on the PLP Closings in 2001 and $259,598,919 on December 15, 2002), to secure payment for the Class B units on January 15, 2011 and bearing interest payable on or before February 28, 2002 and February 28, 2003 at a rate of 11% of the principal and thereafter on or before each February 28th until the full payment for the Class B units in 2011, at an annual interest rate equal to the greater of

i. the prime rate as reported by the Royal Bank of Canada from time to time plus one and one-half percent, and

ii. the appropriate prescribed rate of interest for the purpose of section 143.2(7)(b) of the *Act* on the date the funds were advanced;

(ee) the Emeritus Trusts loaned the aggregate of $370,003,442 ($110,404,523 on PLP Closing in 2001 and $259,598,919 on December 15, 2002) to the Veritus III Trust (the "Emeritus Trusts Loans"), on identical payment terms as the B Unit Notes, with the Emeritus Trusts Loans repayable on January 15, 2011 and bore interest payable on or before February 28, 2002 and on or before February 28, 2003 at a rate of 11% of the principal, and on or before each February 28th thereafter until the full payment of

the Emeritus Trusts Loans in 2011, at an annual interest rate equal to the greater of

i. the prime rate as reported by the Royal Bank of Canada from time to time plus one and one-half percent, and

ii. the appropriate prescribed rate of interest for the purpose of section 143.2(7)(b) of the *Act* on the date the funds were advanced;

(ff) the Veritus III Trust then repays the Scotiabank daylight overdraft loan facility in the amount of $752,163,887 from the combined proceeds of the Acceptrust Loans of $641,759,364 and a portion of the proceeds from the Emeritus Trust Loans of $110,404,523, completing the circular flow of the daylight loan and Scotiabank's role in the transactions ceases;

X. Acceptrusts Loans - Stage Two

(gg) the aggregate amount of $733,523,514 was paid or payable by the Veritus III Trust to the Acceptrusts in full satisfaction of the Acceptrusts Loans as follows:

i. in February 2002, the Veritus III Trust paid to the Acceptrusts $52,233,603, being

a. $21,285,510 in respect of its interest obligation under the Acceptrusts Loans, and

b. $30,948,093 as an advance,

the sum of which was designed to allow the Acceptrusts to meet its Fixed Fee obligations to the PLPs by February 15, 2002,

ii. on December 15, 2002, the Veritus III Trust repaid to the Acceptrusts $259,598,919, being a portion of the principal

amount in respect of the Acceptrust Loans designed to allow the Acceptrusts to meet its Fixed Fee obligations to the PLPs by December 15, 2002, and

iii. on January 15, 2003, the net aggregate amount of $421,690,992 was paid or payable by the Veritus III Trust to the Acceptrusts, being

a. $70,478,641 in respect of its interest obligation under the Acceptrusts Loans, and

b. $382,160,444 in respect of the remaining principal balance under the Acceptrusts Loans (of which only $375,278,169 may have been paid), less

c. $30,948,093, owed by Acceptrusts to the Veritus III Trust in respect of the advance to the Acceptrusts in February, 2002;

XI. Fixed Fee Payment –Stage Two

(hh) the aggregate amount of $733,523,514 was paid or payable by Acceptrusts to the PLPs in respect of the Fixed Fee obligations as follows:

i. on February 15, 2002, the Acceptrusts paid to the 73 PLPs the aggregate of $52,233,603,

ii. on December 15, 2002, the Acceptrusts paid to the 73 PLPs the aggregate of $259,598,919, and

iii. on January 15, 2003, the aggregate of $421,690,992 was payable by the Acceptrusts to the 73 PLPs (of which only $414,808,717 may have been paid) to fully satisfied its Fixed Fee obligations;

XII. Investor Loans - Stage Two

(ii) on January 15, 2003, the aggregate amount of $421,690,992 was to have been distributed by the PLPs to the MLP (of which only $414,808,717 may have been distributed), such payments having been made from the proceeds of the Fixed Fee payment made by the Acceptrusts;

(jj) from the aggregate amount of $421,690,992 that was to have been distributed by the PLPs to the MLP (of which again only $414,808,717 may have been distributed) the Investors in the MLP were entitled to a pro rata share, the General Partner was to have repaid to the Veritus III Trust $382,160,445 in respect principal on the Investor Loans (of which only $375,278,170 may have been so paid) and $39,530,547 to satisfy the accrued interest thereon, leaving a balance of $370,003,442 on the Investor Loans on January 15, 2003;

XIII. Investor Loans- Stage Three

(kk) the Veritus III Trust made annual interest payments to the Emeritus Trusts in respect of Emeritus Loans. This started a circular flow of funds which ensured that the annual interest obligation on the Investor Loans would be satisfied;

(ll) the Veritus III Trust made annual interest payments to the Emeritus Trusts totaling $186,677,351 as follows:

i. $3,526,657 was paid on or before February 28, 2002,

ii. $13,986,873 was paid on or before February 28, 2003,

iii. $147,312,053 in the aggregate or $21,044,579 annually was paid or payable on or before January 15th in each year from 2004 through to 2010, and

iv. $21,851,768 is payable on January 15, 2011;

(mm) the Emeritus Trusts made annual interest payments to the PLPs in respect of the B Unit Notes for the unpaid subscription price of Class B units of the PLPs totaling $186,677,351 as follows:

i. $3,526,657 was paid on or before February 28, 2002,

ii. $13,986,873 was paid on or before February 28, 2003,

iii. $147,312,053 in the aggregate or $21,044,579 annually was paid or payable on or before January 15th in each year from 2004 through to 2010, and

iv. $21,851,768 is payable on January 15, 2011;

(nn) the PLPs distributed to the MLP interest on the unpaid subscription price of Class B units of the PLPs made by the Emeritus Trusts totaling $186,677,351 as follows:

i. $3,526,657 was paid on or before February 28, 2002,

ii. $13,986,873 was paid on or before February 28, 2003,

iii. $147,312,053 in the aggregate or $21,044,579 annually was paid or payable on or before January 15th in each year from 2004 through to 2010, and

iv. $21,851,768 is payable on January 15, 2011;

(oo) the General Partner of the MLP paid to Veritus III Trust the annual interest obligation under the Investor Loans totaling $186,677,351, thus completing the circular flow of funds as follows:

i. $3,526,657 was paid on or before February 28, 2002,

ii. $13,986,873 was paid on or before February 28, 2003,

iii. $147,312,053 in the aggregate or $21,044,579 annually was paid or payable on or before January 15th in each year from 2004 through to 2010, and

iv. $21,851,768 is payable on January 15, 2011;

XIV. Investor Loans – Stage Four

(pp) in 2011, the Veritus III Trust is expected to make payments in the aggregate of $370,003,442 to the Emeritus Trusts in respect of Emeritus Loans, that will set off a circular flow of funds that will allow the remaining balance of Investor Loans to be satisfied as follows:

i. the Veritus III Trust will pay $370,003,442 to the Emeritus Trusts in full satisfaction of the Emeritus Loans,

ii. the Emeritus Trusts will pay to the PLP the aggregate of $370,003,442 in full satisfaction of the subscription price for the Class B units in the PLPs,

iii. the PLPs plan a mandatory distribution of $370,003,442 to the MLP upon receipt of the payment of Class B units by the Emeritus Trusts, and

iv. the General Partner of the MLP will pay $370,003,442 to the Veritus III Trust in full satisfaction of the remaining balance under the Investor Loans, thus completing the circular flow of funds in respect to the Investor Loans;

The Investors received a benefit of $370,003,442 to reduce the risk of loss

(qq) the Emeritus Trusts were required to pay for the initial Class B units subscribed for in 2001, and did so pay, by the issuance of B Unit Notes to the PLPs;

(rr) the Emeritus Trusts had the option to pay for the additional Class B units subscribed for in 2002, by cash or cheque or by way of promissory and in each case opted to pay by way of the B Unit Notes;

(ss) at the time when the Class B units for each of the PLPs were issued to the respective Emeritus Trusts in 2001 and 2002, they were not admitted as a limited partner in any of the PLPs;

(tt) the Emeritus Trusts only became limited partners in respect of the Class B units of the PLPs when the aggregate amount of $370,003,442 in respect of the B Unit Notes was satisfied in 2011 by way of the circular flow of funds;

(uu) at the time the Emeritus Trusts subscribed for Class B units in the PLPs the units had no value;

(vv) after January 15, 2003, the remaining balance of the Investor Loans of $370,003,442 owed by the Investors to the Veritus III Trust and the amounts owed by the Emeritus Trust to the PLPs in respect of the B Unit Notes were identical and called for identical interest payments;

(ww) the subscription price for the Class B units was contrived so that the aggregate subscription cost to the Emeritus Trust for the Class B units would equate to the outstanding balance of the Investors Loans and as such, after interest and principal payments are made by the Emeritus Trusts to the PLPs, the resulting mandatory distributions to the MLPs

were in the exact amount to satisfy the interest and principal obligations under the Investor Loans with the Veritus III Trusts;

(xx) acquiring the Class B units in 2001 and 2002 at the value utilized unrepresentative of FMV, did not benefit the Emeritus Trust. By acquiring the Class B units by way of the B Unit Notes, the Emeritus Trusts locked themselves into annual interest payments until January 15, 2011 when the B Unit Notes become due, without any access to revenues from the PLPs over the intervening years because they are not entitled to receive any income from the PLPs until the obligation under B Unit notes is full satisfied;

(yy) rather, the acquisition of the Class B units where the purchase price had to be paid initially by way of the B Unit Notes was engineered to benefited the Investors in that the identical annual interest rate paid by the Emeritus Trust on the B Units Notes allowed for the payment of the annual interest expense and the repayment of remaining principal balance of the Investor Loans;

(zz) the subscription of Class B units by the Emeritus Trusts was designed solely to set-off the annual interest obligations and principal repayment obligations on the Investor Loans against the annual interest obligation and principal repayment obligations of the Emeritus Trusts;

(aaa) the Investors received a benefit designed to reduce the risk of loss in respect of their investment in the MLP, the aggregate value of which is $370,003,442, as detailed more specifically with respect to each of the PLPs in Schedule "B" to this Reply;

Overstated General Partner Management Fees of the PLPs

(bbb) the MLP, the General Partner and each of the PLPs entered into Management Service Agreements, whereby the PLPs agreed to pay collectively $48,838,419 in management fees to the MLP;

(ccc) the PLPs claimed a total of $20,321,383 in management fees to the MLP in excess of the aggregate sum they were obligated to pay, $18,220,443 and $2,100,940 in respect of the 2001 and 2002 fiscal periods, respectively; Schedule "C" to this Reply lists the amounts overstated by the respective PLPs;

(ddd) the overstated fees were not paid to produce income in the hands of the PLP but rather they were paid to the MLP to enable it to rebate certain Investors, including the Promoters, directly or indirectly through their holding companies;

(eee) none of the Investors' adjusted cost bases of their units in the MLP were reduced as a result of the rebates;

(fff) none of these overstated expenses are reasonable in the circumstances;

Unreasonable Expenses of the PLPs

(ggg) the mind and management that managed the affairs of the General Partner, which therefore guided the business affairs of the MLP and each of the PLPs, was the same mind and management that had prior to 2001 guided the affairs of like structured investments in 129 films, television movies or series through limited partnerships other than the MLP and PLPs using like net profit participation clauses, none of which clauses had generated any returns;

(hhh) these like structured investments adopted, contrary to industry standard, a cost minus plus a net participation pricing strategy, the 80.02% Fee is the

cost minus, and the Net Profit Participation is the plus part of their strategy. This pricing strategy relies on the Net Profit Participation to generate sufficient revenues to cover the 19.98% deficiency in the PLP Production Expenses and all other additional expenditures incurred by the respective PLPs;

(iii) each of the PLPs were single purpose limited partnerships purportedly formed for the sole purpose of undertaking to provide specific PLP Production Services in respect of a specific film or group of films;

(jjj) at the date of each PLP Production Services Agreement, the exact amount of the PLP Production Expenses that they were obligated to incur in providing the PLP Production Services was known, since the amount of the expenditures that each PLP was obligated to pay was fixed by the PLP Production Services Agreements. Thus the amounts claimed by each of the PLPs as PLP Production Expenses for their fiscal periods ending December 31, 2001 and 2002 were determined on or before the date that the PLPs entered into their specific PLP Productions Services Agreements;

(kkk) at the date of each PLP Production Services Agreement, the PLPs knew that they would only be able to by way of the Basic Fees up to 80.02% of the amounts they were obligated to incur under the PLP Production Services Agreements, this being the maximum Basic Fee amount fixed by the PLP Production Services Agreement;

(lll) at the date of each PLP Production Services Agreement, the PLPs knew that the maximum Basic Fees amount was less than the amount of the PLP Production Expenses that they contracted to provide under the PLP Production Services Agreements, creating a revenue deficiency of 19.98% *vis-à-vis* expenditures since the Basic Fee was calculated as 80.02% of the PLP Production Expenses;

(mmm) at the date of each PLP Production Services Agreement, each PLP also entered into Co-ordination Agreements and/or Access Agreements, pursuant to which they were obligated to pay certain predetermined fixed fees to the Studios and Creditco, such fees being referred to as either the Studio Fee or Agency Fee. The PLPs claimed these amounts as "Access and Ancillary Fees" expenses for their 2001 and 2002 fiscal periods;

(nnn) at the date of each PLP Production Services Agreement, each PLP also entered into Management Agreements, pursuant to which they were obligated to pay certain predetermined fixed fees to the MLP for providing the PLPs consultation and management services. The PLP claimed these amounts as general partner expenses for their 2001 and 2002 fiscal periods;

(ooo) the amounts claimed by the PLPs as interest and financing costs for their 2001 and 2002 fiscal periods are composed of the general ledger amounts for the Studio Loan Fees, the Withholding Tax for the Studio Loan Fees, Commitment Fees to the Creditcos, and interest payable on loans from the Studios and Creditcos;

(ppp) the obligation to pay these amounts was known at the date of each PLP Production Services Agreement, at which time the PLPs also entered into the Studio/PLP Loan Agreements and the Creditco/PLP Loan Agreements pursuant to which the amounts were fixed and payable;

(qqq) the PLPs also claimed cumulatively $15,655,648 and $1,973,834 in 2001 and 2002, respectively, as Insurance Fees paid to the respective Studio pursuant to their respective PLP Production Services Agreements;

(rrr) at the date of each PLP Production Services Agreement, the PLPs would have known that its expenditures in respect of PLP Production Expenses, Insurance fees, General Partner's fees, Access and Ancillary Fees, and

interest and financing charges were significantly greater than the expected production revenue;

(sss) having regard to the failure of the investments in the 129 films, television movies or series previously invested in by the Promoters to generate any revenue from like structured net participations, it would not be reasonable for the mind and management of the PLPs to expect that the Net Profit Participations of the PLPs would provide sufficient revenues to cover the known revenue deficiencies;

(ttt) having regard to the fact that that the total amounts claimed by each of the PLPs in their 2001 and 2002 fiscal periods for Production costs, Insurance Fees, General Partner's fees costs, Access and Ancillary Fees costs, and interest and financing charges costs with respect to production services rendered by the PLPs in respect to the Films, are significantly in excess of any Basic Fees to be earned from the provision of said services, these amounts, as detailed below (referred to hereinafter as the "Unreasonable Expenses"), were not incurred for the purpose of producing income or for borrowings used for that purpose, nor in any event were they reasonable in the circumstances:

	2001	2002	*Totals*
Creditco Commitment & Set-Up Fees	$2,671,080	nil	$2,671,080
Creditco Loan Interest	2,772,959	6,346,464	9,119,605
Studio Loan Commitment & Set-up Fees	31,410,240	nil	31,410,240
Studio Loan Interest	15,593,829	17,951,353	33,545,182
Fees and interest re: Part XIII tax (as expensed)	6,158,546	1,365,577	7,524,123
Insurance Fees	15,655,648	1,973,834	17,629,482
Totals	$74,262,302	$27,637,228	$101,899,712

(uuu) the amounts of the Unreasonable Expenses correspond to the amounts that were pre-ordained to be paid to the PLPs for the Class B units in the PLPs, which units had no value. These payments were either reimbursements for the Unreasonable Expenses or payment for services under the PLP Production Services Agreements;

Matchable Expenditures

(vvv) the MLP and each of the PLPs are tax shelters within the meaning assigned by subsection 237.1(1) of the *Act*. The General Partner and each of the PLPs applied for and were assigned tax shelter identification numbers;

(www) the MLP and each of the PLPs are also tax shelter investments within the meaning assigned by subsection 143.2(1) of the *Act*;

Right to Receive Production

(xxx) the PLPs entered into PLP Production Services Agreements with the Studios to provide PLP Production Services and thereby each received a right to receive production, namely a right to receive an amount comprised of:

i. the 80.02% Fee, and
ii. a Net Profit Participation of an indefinite duration regarding certain films

(collectively, the "Right to Production");

(yyy) the PLPs included the aggregate amount of $599,158,798 in computing income for the 2001 fiscal period from the Right to Production;

Production Expenses

(zzz) the PLPs reported in the partnership information returns for the 2001 fiscal period production expenditures in the aggregate of $748,761,307, that if incurred were incurred to acquire the Right to Production;

I. Access and Ancillary and Insurance Fees

(aaaa) for the 2001 fiscal period, the PLPs claimed to have incurred Access & Ancillary Fees and Insurance Fees in the aggregate amounts of $45,651,136 and $15,655,648, respectively and Insurance Fees for the 2002 fiscal period in the amount of $1,973,834;

(bbbb) the obligations to pay the Access and Ancillary Fees and the Insurance Fees relate to the Right to Production;

(cccc) the PLP Production Expenses claimed by each of the PLPs in calculating their income for their 2001 fiscal periods and the Access and Ancillary Fees and the Insurance Fees (collectively the "Matchable Expenditures") are detailed below:

PLP Production Expenses	$748,761,307
Access & Ancillary Fees	45,651,136
Insurance Fees	15,655,648
Matchable Expenditures	$810,068,090

Application of Matchable Expenditure Rules

(dddd) the PLP Production Expenses and the Access and Ancillary Fees and the Insurance Fees can reasonably be considered to relate to a tax shelter or tax shelter investment, the purpose of which being to obtain a tax benefit;

(eeee) by December 31, 2001, the total of all income inclusions in respect of the Right to Production did not exceed 80% of the Matchable Expenditures as detailed below and further in Schedule "D" to this Reply:

Matchable Expenditures	$810,068,090
80.02% Fees Revenue	599,158,798
Net Profit Participation	nil
Revenue as a Percentage	**73.96%**

(ffff) by application of the matchable expenditure rules, the income of the PLPs for the 2001 fiscal period would be as follows:

Business Loss Reported	($330,650,886)
Add: Matchable Expenses	810,068,090
Less: 18.1 Deduction	(35,158,618)
PLPs' Revised Net Income	$444,258,586
MLP's 99.99% Share of Net Income	$440,687,855

II. PLPs 207, 226, 227, 235 and 239

(gggg) PLPs 207, 226, 227, 235 and 239 did not receive the full amount of their respective Basic Fees for the 2002 fiscal period;

(hhhh) by December 31, 2002, the total of all income inclusions in respect of the Right to Production did not exceed 80% of the Matchable Expenditures of PLPs 207, 226, 227, 235 and 239, as detailed below:

	PLP 207	PLP 226	PLP 227	PLP 235	PLP 239
PLP Production Expenses	$3,701,705	$937,662	$5,358,465	$11,028,061	$730,939
Revenue/Productions Fees	1,349,600	469,301	4,022,872	7,560,000	420,000
Production Revenue as a percentage of PLP Production Expenses	36.46%	50.05%	75.08%	68.55%	57.46%

Overstated Production Expenditures of PLP 198

(iiii) the PLPs agreed by way of the PLP Production Services Agreements and other agreements they entered into with the Studios that the PLP Production Expenses were not to exceed the Closed Amounts and where the PLP Production Expenses are less than the Closed Amounts then the actual amounts are to be used;

(jjjj) the Closed Amount for PLP 198 was $6,173,329, and this amount – not the actual amount of the PLP Production Expenses of $3,8047,184 – was claimed in respect of PLP 198;

(kkkk) in so claiming, PLP 198 overstated its production expenses by $1,893,388 and $472,756 for the 2001 and 2002 fiscal periods, respectively;

(llll) PLP 198 also overstated its production fees revenue by $1,515,089 and $378,299 for the 2001 and 2002 fiscal periods, respectively; and

(mmmm) the net amounts by which PLP 198 overstated its production expenses are $378,299 and $94,457 for its 2001 and 2002 fiscal periods, respectively.

B. ISSUES TO BE DECIDED

48. The issues to be decided in this appeal for both the 2001 and 2002 Determinations are:

(a) Whether the tax loss creation scheme was supported by a variety of transactions which were sham transactions? If so, what were the real transactions and what is the legal effect of those transactions?

(b) Whether the various transactions creating the tax loss creation scheme were legally effective? If not, what is the impact, if any, on the correctness of the Determinations?

(c) Whether the net profit participation was mere "window dressing" designed to create the illusion of commerciality when there in fact was none? Whether the PLPs and the MLP carried on business with a view to profit?

(d) Whether the Minister correctly applied paragraph 96(2.2)(d) of the *Act* to reduce the at-risk amount of the Investors in respect of losses of the MLP?

(e) Whether the Minister correctly concluded that the General Partner's Fees of the PLPs had been overstated?

(f) With respect to the Unreasonable Expenses, whether the Minister correctly concluded

i. that they had not been incurred for the purpose of producing income?

ii. that in the alternative, they were not reasonable in the circumstances?

iii. that in the further alternative, they were reimbursements or payments for services and as such income under paragraph 12(1)(x) or section 68 of the *Act*, respectively?

iv. that in the still further alternative with respect to the Insurance Fees, these particular fees are eligible capital property or matchable expenditures for the purposes of sections 14 and 18.1 of the *Act*, respectively?

(g) Whether the Minister correctly concluded that the Access and Ancillary Fees are eligible capital property or, in the alternative, matchable expenditures for the purposes of sections 14 and 18.1 of the *Act*, respectively?

(h) Whether in the alternative, section 18.1 of the *Act* should apply to limit the tax losses claimed by the MLP in respect of PLPs 207, 226, 227, 235 and 239 for their 2002 fiscal periods to the amounts as determined by the Minister?

(i) Whether the Minister correctly concluded that the production expenses of PLP-198 had been overstated?

C. STATUTORY PROVISIONS RELIED ON

49. He relies on sections 3, 9, 12, 18.1, 20, 54, 67, 68, 96, 102, 143.2, 152, 248 and 251 of the *Act*.

D. GROUNDS RELIED ON AND RELIEF SOUGHT

50. He submits that the "losses" of the MLP for its 2001 and 2002 fiscal periods did not exceed the losses determined by the Minister.

51. He submits that the Minister correctly reduced the at-risk amounts of the Investors in the MLP per paragraph 96(2.2)(d) of the *Act*.

52. He further submits that the series of transactions created by the Promoters and purportedly entered into by the Studios, the MLP, the PLPs and others did not reflect the true nature of the transactions. Rather, the "transactions" were mere shams designed to create a facade of reality quite different from the disguised reality. The true relationship between the Studios and the Promoters was a simple contract for the rental of expenditures. In consequence, neither the MLP nor any of the PLPs suffered any business losses recognizable by the *Act*.

53. He submits that some or all of the various transactions creating the tax loss creation scheme were not legally effective.

54. He submits that neither the MLP nor any of the PLPs carried on business in common with a view to profit. They were not therefore partnerships in law.

55. He submits that the Minister correctly concluded that General Partner's Fees of the PLPs had been overstated.

56. He submits that the Minister correctly concluded that Unreasonable Expenses were not incurred for the purpose of producing income or, in the alternative, that they were not reasonable.

57. In the alternative, he submits that the Minister correctly concluded that the Unreasonable Expenses were expense reimbursements and/or payments for services.

58. In the further alternative with respect to the Insurance Fees, he submits that the Minister correctly concluded that these particular fees are eligible capital property or, in the alternative, they are matchable expenditures.

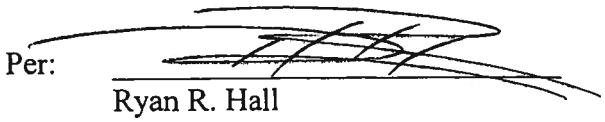
59. He submits that the Minister correctly concluded that the Access and Ancillary Fees are also eligible capital property or, in the alternative, they are matchable expenditures.

60. He submits in the alternative, that section 18.1 of the *Act* should be applied in respect of PLPs 207, 226, 227, 235 and 239 for their 2002 fiscal periods to reduce the losses claimed.

He requests that the appeal be dismissed with costs.

DATED at the City of Ottawa, Ontario, this 31st day of March, 2010.

John H. Sims, Q.C.
Deputy Attorney General of Canada
Solicitor for the Respondent

Per: 

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