



FEB 24 2005

SHAAE (2001) Master Limited Partnership
C/O Sentinel Hill Productions IV Corporation
920 – 1040 West Georgia Street
Vancouver, British Columbia
V6E 4H1

Your file Votre référence

Our file Notre référence

ATTENTION: Paul Darc / Robert Strother / Kenneth Gordon / Bradley Sherman

Dear Sirs:

Re: Audit of SHAAE (2001) Master Limited Partnership
("SHAAE (2001)") for 2001 and 2002 Fiscal Periods
Tax Shelter No. T064667 – Partnership ID No. HA6768618

We have substantially completed our review of the books and records of SHAAE (2001) for its 2001 and 2002 fiscal periods. As agreed between our respective legal counsels, we are attaching for discussion purposes the issues that we have identified for your review and input. The figures, per the attachment, have been determined by the auditor Robert Goodwin, Vancouver TSO. If you have any questions with respect to these figures, Mr. Goodwin will be pleased to review them with you. He can be reached at (604) 666-7937.

Due to time restraints, our audit did not focus on any Part XIII issues, if any, with respect to any payments to offshore entities. It is the responsibility of our International Division to examine the nature of the payments to determine if there are any Part XIII issues.

We are prepared to meet with you and/or your representatives at your earliest convenience to address the identified issues. In that regard, we request that you or your representative contact the undersigned at (613) 941-0129 to arrange a meeting accordingly.

Sincerely yours,

Sharon Gulliver
A/Director
Tax Avoidance and Special Audits Division
Compliance Programs Branch

Attachment

c.c.: David Davies
Thorsteinssons

**SHAAE (2001) Master Limited Partnership (“MLP”)
AUDIT ISSUES**

A. THE “AT-RISK” RULES

Paragraph 96(2.2)(d):

- Paragraph 96(2.2)(d) of the *Act* applies to reduce the at-risk amount of the investors on the basis that, in their positions as partners and via terms of the relevant Partnership Agreements, entered into by the Production Partnerships, the MLP and ultimately the investors are entitled, either immediately or in the future and either absolutely or contingently to receive or obtain amounts or benefits as a result of:
 - the Class B Unit Subscriptions totalling \$370,003,445 by “Cantrustee” (as directed by “THC”, a Cayman Island Co., the beneficiary of the trust) for consideration of secured promissory notes,

which issuances are granted for the purposes of reducing the impact, in whole or in part of any loss that the investors may sustain. (Class A unitholder has priority rights to the property of the PLP covering the Class A subscription amount and certain other costs),¹

It is recognized that this reduction to the “at-risk” amount of the investors will not impact any losses allocated to investors in the years 2001 and 2002. However, this reduction coupled with the 2003 distributions and other reductions to adjusted cost base for some investors who received rebates, the losses allocated in subsequent years may be affected accordingly.

B. EXPENSE ISSUES:

1. General Partner Management Fees

- Overstated General Partner Fees related to Investors’ Rebates

Included in General Partner Fees of the Production Partnerships are amounts totalling \$16,945,989 which have been traced as rebates given to a number of the investors including \$3,120,000 to 589918 BC Ltd. (Robert Strother), \$3,120,000 to Pacific Cascadia Capital Corporation (Paul Darc), \$1,578,421.94 to Kenneth Gordon and \$1,370,421.94 to Bradley Sherman.

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¹ Rulings’ letter opined a possible paragraph 96(2.2)(d) grind related to the Class B subscriptions.

It is our position that fees paid to a general partner to enable distributions to investors are not an expense of the partnership but a reduction to the cost of the recipient's adjusted cost base and "at-risk" amount. Therefore, the expense is disallowed pursuant to paragraphs 18(1)(a), (b) and the definition of "adjusted cost base" in Section 54 of the *Income Tax Act*. The investors' ACB of their partnership units will be reduced accordingly.

- **Unvouchered General Partner Expense**

General Partner Expense has also been overstated by an amount of \$4,045,107. This amount totalling \$4,045,107 cannot be reconciled to cash or cheque disbursements and is in excess of any contract amount. The expense is being disallowed pursuant to paragraph 18(1)(a) and Section 67 of the *Income Tax Act*.

2. **Unreasonable Expenses/Income (Paragraph 18(1)(a)/Section 67/paragraph 12(1)(x))**

It is our position the following expenses will be disallowed pursuant to paragraph 18(1)(a), paragraph 20(1)(c) and Section 67 based on amounts and circumstances. It is our view that these expenses are artificial, not incurred (if incurred at all) for the purpose of producing partnership income and in any event, unreasonable in the circumstances. These "expenses" represent amounts that are part of a pre-ordained arrangement where equivalent amounts can be traced back to the production partnerships as costs of the Class B units, which units have nominal value. Alternatively, equivalent amounts will be included into income pursuant to paragraph 12(1)(x) (expense reimbursement):

	<u>2001</u>	<u>2002</u>	<u>Total</u>
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 Fee	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 Fee	<u>15,655,648</u>	<u>1,973,834</u>	<u>17,629,482</u>
Totals	<u>\$74,262,302</u>	<u>\$27,637,228</u>	<u>\$101,899,712</u>

In addition, should any of the positions identified above be found not to be applicable, the commitment and set-up fees would alternatively be subject to the application of paragraph 20(1)(e) and the insurance fees be disallowed on the basis that they are an eligible capital expenditure (ECE) or a matchable expenditure pursuant to Section 18.1.

3. **Capital / Matchable Expenditures**

Disallowance of expenses claimed which we are of the view are eligible capital expenditures pursuant to Section 54 and Section 14 (amortization will be allowed pursuant to paragraph 20(1)(b) accordingly). Alternatively, it is CRA's position that the expenses are matchable expenditures pursuant to Section 18.1 that were not included in total NCLE expenses in calculating the 80.02% fee for purposes of the "safe harbour" rule.

	<u>Total</u>
Studio Access and Ancillary and Legal Fees (\$36,472,244 + \$5,507,279 + \$3,671,612)	\$45,651,136
Insurance Fees (\$1,1965,936 + \$15,663,546)	<u>17,629,482*</u>
Total	<u>\$63,280,618</u>

(*Note: The Insurance Fees are also subject to paragraph 18(1)(a) and section 67 and thus it is an alternative position that the Insurance Fees are capital or matchable expenditures.)

- **Misapplication of Section 18.1 in 2002**

Due to the gross receipts component of the fixed fee, not all of the 73 PLPs earned the full amounts of their Basic Fee Amounts during the 2002 fiscal period. SHAAE (2001) recognized this for 8 of the PLPs and applied Section 18.1 accordingly. It is CRA's position that the calculation is not correct based on subsection 143.2(10). CRA concludes that the production revenues reported by 5 PLPs are less than production expenditures incurred or deemed to be incurred in accordance with subsection 143.2(10) and thus they are not within the "safe harbour". We propose to disallow \$16,185,057, which will be amortized pursuant to Sections 18.1(3) and (4) accordingly.

4. **Miscellaneous Issue with Expenses**

- **Budgeted versus Actual NCLE Expensed**

PLP Production expenses were not to exceed the Closed Amounts and where the actual NCLE is less than the Closed Amounts then the actual amounts are to be used. Our audit has identified in one production that the closed amount of \$6,173,329 was used instead of actual amount of \$3,807,184 resulting in overstated production expenses for 2001 and 2002 of \$1,893,388 and \$472,756 respectively.