SHAAE (2001) Master Limited Partnership
(the "Partnership")
Oversight Committee Meeting and Conference Call
Held on April 12, 2012
Summary dated May 2, 2012

On April 12, 2012, the first meeting of the Oversight Committee was conducted by David Davies of Thorsteinssons LLP, who is counsel to the Partnership's general partner (the "GP"). The meeting took place at Thorsteinssons' offices in Vancouver, BC. Robert Strother and Paul Darc, both principals of the GP, attended in person while Bradley Sherman and Kenneth Gordon, the other two principals of the GP, attended via conference call. One member of the Committee, namely Mr. Ryan, QC, was unable to attend. Each of Sam Sorbara and David Goldsmith (referred to as the "Committee Members" in this summary) attended via conference call. Also present were Susan Carmichael, the GP's VP, Finance, and Anneke Driessen, general counsel to Magnolia Capital Corp. (which is one of the entities Mr. Strother and Mr. Darc own/control).

Mr. Davies had conduct of the meeting and opened by inviting participants to ask questions or comment at any time, noting there would also be opportunity for inquiries as the last item on the agenda. The agenda, which had been circulated to the Committee Members in advance, was as follows:

1. Brief Summary of the Tax Dispute's History with the Canada Revenue Agency ("CRA") to date
2. Overview of the CRA's assessing position
3. Overview of Settlement Discussions and Present Status
4. Anticipated Next Steps/Timing
5. Questions to Counsel/General Partner

The meeting was informational only, and its primary purpose was to update the Committee Members. However, while all decisions in the tax dispute are being made by the GP (with the assistance of its counsel), the GP and its counsel were able to gauge the Committee Members' views on the further conduct of the tax dispute.

<u>Brief Summary of the Tax Dispute's History with CRA</u>

Mr. Davies provided a summary of the tax dispute's history, where it was noted that the tax dispute has already taken a significant amount of time. Based on past experience, further attempts at delays from the Crown's side may well be expected. However, Mr. Davies noted he will do his best to advance the litigation proceedings towards the earliest possible trial date.

- By 2005 it had become clear that CRA was intent on reassessing, even though an earlier reassessment of the 2000 Partnership had been resolved.

- Various filings, motions, and pleadings followed, including disagreement over whether or not (as the CRA argued) the rulings from CRA's Rulings Directorate issued in 1998 and 2001 should form part of the pleadings. (This particular challenge was ultimately resolved by consent, and their Reply was then filed in March of 2010.)

- There followed a lengthy period of negotiation in good faith on the part of the principals of Sentinel Hill. In an effort to resolve the matter without resort to the court system, they again contacted the CRA in the summer of 2009 and eventually a meeting was arranged for January 2010. The principals of Sentinel Hill discussed the concept of putting forward a numbers based settlement (a denial of a percentage of the losses of the 2001 Partnership) rather than a settlement based on an examination of the various issues raised in the Determination. The objective at that time was to reach a "percentage of losses" settlement comparable to the settlement reached for the 2000 Partnership in 2004.

- A settlement proposal was extended to CRA in February of 2010 that would have resulted in a denial of approximately 10% of the otherwise deductible expenses of each of the 1998 Partnership and 2001 Partnership. This would have been roughly equivalent to the settlement parameters for the 2000 Partnership.

- CRA's position continued to harden and centred on denying deductions as well as potentially pursuing additional income inclusions.

The Committee Members queried if the settlement offers made to CRA (in February and September of 2010, respectively) were still capable of being accepted, and Mr. Davies explained that they were, although they could be revoked. He also explained that generally, according to the Tax Court Rules, formal settlement offers can lead to higher cost awards to the party who had made the settlement offer if the outcome shows the offer ought to have been accepted. The Committee Members considered this principle and expressed their views on the matter of those offers, voicing their support for a revocation of those offers if the GP were inclined to do so. The GP and Mr. Davies considered the point and the GP decided to revoke the offers. Mr. Davies subsequently did so.

<u>Overview of the CRA's assessing position</u>

CRA's current argument involves an aggregate of about $180 million of denied deductions in the 2001 and 2002 taxation years, which amounts to about 46% of the total losses allocated from the Partnership to limited partners in those years.

Mr. Davies noted that while CRA has adopted separate positions and alternative arguments, one overarching theme appears to be the question of the "reasonableness" of deductions. If indeed the dispute is effectively about to what

extent, if any, deductions are reasonable, an outcome may lie anywhere in the spectrum of a full allowance of deduction to a complete denial of deductions up to the $180 million.

Mr. Davies noted also an alternative CRA position centred on their theory of an alleged "sham". Counsel and the GP obviously strongly disagree with such a characterization, and spent some time outlining their views in this regard.

Singling out CRA's argument that the deductions were effectively "rented" by the Partnerships (as alleged by the CRA) seems, in light of both the realities of the transaction and the support from CRA's Rulings Directorate for similar structures over the years, absurd. For instance, the "rented deductions" theory implies that the transaction did not involve any economic risk. There was lively discussion on this point, and it was noted that the schism between Rulings and Audit at CRA continues to be a major issue.

Mr. Davies explained in this context that an advance income tax ruling is not binding in the sense of a contract, though it is of course relevant to the background of the transaction, with which view the Tax Court agreed in 2007 in the context of the 1999 transaction when it rejected CRA's argument that the ruling should be excluded from the pleadings. (See also below for more information in this respect.)

Mr. Davies summarized the major headings of CRA's assessing position. As said previously, one overarching theme in CRA's position is the "reasonableness" of deductions claimed, which principally brings the dispute to a valuation level. The Committee Members asked what the impact would be on the individual taxpayers' situation depending on the outcome of the dispute. Mr. Davies noted that should the Partnership be entirely successful, there would be no impact on the limited partners (subject, of course, to a possible appeal). On the other hand, if the Partnership loses (either partially or entirely), the CRA would then pursue limited partners within the following year to issue reassessments against them. (Please refer to the letter dated April 26, 2005 on the Sentinel Hill website under the heading 'Investor Correspondence' where prepayment of taxes information was provided to the limited partners).

An example was noted to illustrate CRA's at times surprising attitude: In 2008, Sentinel Hill learned that even when Part XIII withholding tax is paid to CRA in error, they can stand on technicalities to keep those monies. CRA refused to refund the withholding tax to the PLPs. The non-resident studios did not claim the refund because they were not out-of-pocket (as the agreement between the parties contained a gross-up clause that kept them whole). However, the Court of Appeal found that *only* the non-resident studio had a cause of action against the CRA, despite the fact that (1) it was the PLPs that were out-of-pocket (not the studios) and (2) the CRA was effectively unjustly enriched if allowed to keep the funds paid in error. The Court of Appeal would not interfere with the statutory lay of the land.

Since leave to appeal to the Supreme Court of Canada was denied, the PLPs were out of luck and the CRA held on to the money. [1]

Overview of Settlement Discussions and Present Status

Mr. Davies related that he has been in discussions with CRA about a possible settlement. However, no formal settlement offer was made and in any event, based on what the CRA suggested might be entailed in a possible settlement proposal, counsel and the GP did not feel inclined to seriously consider a settlement on those terms. The Committee Members stated their agreement with that assessment.

Anticipated Next Steps/Timing

The anticipated next steps involve the imminent filing of the List of Documents by each side, followed by a request to the Case Management Judge for an order setting out deadlines for completion of undertakings and discoveries, followed by trial scheduling. Mr. Davies reiterated he would do his best to advance the litigation schedule to minimize, as best as possible, the time involved in bringing this tax dispute to a conclusion.

At the conclusion of the call, it was confirmed that a summary would be posted on the password-protected website for all limited partners. The next meeting was tentatively scheduled for end of June, 2012.

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Further Information

During the call, the matter of an earlier attempt by the Crown/CRA to have a ruling excluded in the context of the Sentinel Hill 1999 Master Limited Partnership was referenced. Here is an excerpt from a letter to the Partnership's limited partners dated October 8, 2009 (which can be viewed in its entirety on the website as item 7 under the heading "Investor Correspondence"):

> Rather than filing its Notice of Reply to the 1999 Partnership's Notice of Appeal so that a court date could be set down, the CRA's first step was to file a motion in Tax Court to deny the 1999 Partnership the ability to refer to the 1998 advance income tax rulings on the basis that the rulings were not relevant. We instructed Thorsteinssons to oppose this motion and we filed an affidavit in support of our position. The motion was heard by Chief Judge Bowman of the Tax Court on December 4, 2007.

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[1] For articles concerning CRA's apparent entitlement to keep withholding tax that was paid in error, see either one of these links: http://www.camagazine.com/archives/print-edition/2009/march/regulars/camagazine3735.aspx

http://www.casselsbrock.com/CBNewsletter/UPS_vs__Sentinel_Hill__New_Supreme_Court_Authority_for_Returning_Overpaid_Tax_to_the_Payor

Decision on the Motion

The decision of Chief Judge Bowman was delivered on December 19, 2007. The CRA's motion to deny the 1999 Partnership the right to refer to the 1998 advance rulings was dismissed with costs payable by the CRA. The CRA was ordered to file its Reply (i.e., commence the tax litigation in earnest) within 30 days.

The reasons of the Chief Judge were a powerful rejection of the CRA's position and are noteworthy in the following respects:

First, on the question of the relevance of the rulings, Bowman C.J. held that the matter was one which should be determined by a trial judge and not summarily dismissed in a chambers motion (in the following quotes, the "respondent" is the CRA and the "appellant" is Sentinel Hill):

"If the respondent wishes to challenge the facts alleged, a section 53 motion is not the place in which to do so. It is at trial where a judge hearing the evidence can determine the correctness, relevancy and weight to be assigned to the evidence adduced in support of the allegations". (Paragraph 6 of the Judgment)

"Whether I agree that the factual components of estoppel exist or whether the advance rulings constitute agreements is not germane to the disposition of these motions. The - 2 - appellants should be entitled to advance such arguments at trial on the basis of all the evidence." (Paragraph 11)

Second, as to the binding nature of an advance income tax ruling, quoting from a prior decision of the Chief Judge:

"I leave aside entirely the question of advance rulings which form so important and necessary a part of the administration of the Income Tax Act. These rulings are treated by the Department of National Revenue as binding. So far as I am aware no advance ruling that has been given to a taxpayer and acted upon has ever been repudiated as against the taxpayer to whom it was given. The system would fall apart if he ever did so." (Paragraph 8)

Third, as to the tactics of the CRA in using "procedural skirmishes" to delay the process of tax litigation and thereby raise the costs to taxpayers, including motions to strike tax payers' arguments and pleadings as "scandalous, frivolous or vexatious or an abuse of the process of the Court":

"However much jurisprudence may surround the words 'scandalous, frivolous or vexatious, or abuse of the process of the Court', they are nonetheless strong, emotionally charged and derogatory expressions denoting pleading that is patently and flagrantly without merit. Their application should be reserved for the plainest and most egregiously senseless assertion – as for example in William Shawn Davitt v. The Queen, 2001 DTC 702. Where senior and experienced counsel advances a proposition of fact or law in a pleading that merits serious consideration by a trial judge, it is at least presumptuous and at most insulting and offensive to force counsel

to face the argument that the position is so lacking in merit that it does not even deserve to be considered by a trial judge. It is a deplorable tactic for the Crown, as soon as it sees legal argument that it does not like, to move to strike. As I said in Sackman v. The Queen, 2007 TCC 455, it is this sort of skirmishing that is putting tax litigation out of the reach of ordinary people. I do not wish to see this court turned into a forum for procedural maneuvering. I repeat what was said in Satin Finish Hardwood Flooring (Ontario) Limited v. The Queen, 96 DTC 1402 at 1405:

> 'There was no justification for bringing this motion. It serves no purpose within the context of this litigation. The time that has been spent on this exercise in procedural one-upmanship would have been better spent, following the filing and serving of a reply, in conducting an examination for discovery in which the evidentiary basis of the appellant's challenge to the assessment could readily have been ascertained. The rules of this court, which are designed to facilitate, not impede, the expeditious determination of fiscal disputes, should not be used to carry out unproductive procedural maneuvering.'" (Paragraph 11)

Fourth, as to the notion that the CRA is entitled to repudiate advance rulings:

"The respondent's position is ambivalent. I asked counsel if he was saying that advance rulings were not binding or that the appellants had not conformed to them. His answer was "Both". If the argument is that they do not apply to the appellants or that their terms had not been complied with, this is a factual matter that contradicts the allegations in the - 3 - notices of appeal. It cannot be raised on these motions. It must be decided on evidence at trial. If the respondent is now seeking to establish that advance rulings can be repudiated by the Minister after decades of reliance by taxpayers upon them, this proposition, which would startle most practitioners, should be tested in a full trial and not a preliminary motion. This preliminary motion is certainly not the time or place to discuss the complex issues arising out of the Minister's remarkable position. The ruling process, which was created by Revenue Canada and has been enormously beneficial to taxpayers in creating certainty in predicting the tax consequences of commercial transactions, constitutes a fundamental cornerstone of Canadian tax administration. The idea that a motions judge could, on the basis of a one hour argument without evidence, demolish one of the essential underpinnings of our system is, quite frankly, appalling." (Paragraph 12)

"The magnitude of this question transcends the boundaries of a preliminary motion and is indeed of a greater importance in the field of taxation than any I have seen in many years." (Paragraph 13)

We were very frustrated with the treatment by the CRA of the 1999 Partnership and by the inactivity of the CRA regarding the Determination of the Partnership. We have previously communicated to you that we feel that the CRA has been and continues to be unfair in its dealings with Sentinel Hill. We don't appear to be alone in this view. In another recent Tax Court of Canada case (unrelated to Sentinel Hill) the judge was highly critical of the tactics of the federal government lawyer representing the CRA and decried the "win at all costs" approach of the CRA. The Tax Court noted that the

government lawyers (and by implication the CRA) are fulfilling a public duty; they should press their case firmly but fairly, and perform their duty with an ingrained sense of the dignity, the seriousness and the justness of judicial proceedings.

We take comfort in the Chief Judge of the Tax Court's characterization of the CRA's tactics as **"at least presumptuous and at most insulting and offensive", "deplorable" and "appalling."**