Federal Court of Appeal rules sham need not be specifically plead

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In a decision rendered verbally from the Bench by Justice Woods on September 16, 2021, the Federal Court of Appeal (FCA) dismissed the Taxpayers' appeal from the Tax Court of Canada's decision in *Paletta v The Queen*, 2019 TCC 205 (*Paletta*).

Background

The primary issue under appeal was whether breaches of procedural fairness tainted the Tax Court hearing. Critically, the Taxpayers submitted that they did not have a fair hearing before the Tax Court because the Crown's pleadings did not allow them to know the case they had to meet. Consequently, the Taxpayers argued they could not properly respond to the issue the case ultimately turned on; namely, sham.

In principle, appeals before the Tax Court of Canada ask the Court to determine whether the Minister was correct in fact and law in making the disputed assessment. Generally, a Taxpayer has the burden of demolishing, *i.e.* disproving, the assumptions of fact that the Minister relied on when rendering the disputed assessment. A Taxpayer will be successful if they prove that it is more likely than not that the assumptions made by the Minister in assessing the Taxpayer were incorrect.[1]

Paletta v The Queen

In *Paletta*, the primary issue before the Tax Court was whether the Taxpayers were right to deduct certain losses and expenses related to film distribution in their 2007 and 2008 taxation years. The deducted film distribution losses and expenses arose from transactions wherein 20th Century Fox (Fox) sold two of its newly produced films to partnerships, in which the Taxpayers were limited partners, subject to an option agreement to buy the films back. The majority of the deducted losses and expenses related to print and advertising expenses allegedly incurred by the partnerships soon after acquiring the films from Fox. After a short period, Fox exercised its options to reacquire all interests in the films, including those acquired by the partnerships, the arrangement was unwound and the right to the films returned to Fox.

The Minister reassessed the Taxpayers to disallow these losses and expenses on the basis that the transactions described above involved a tax loss scheme that used the appearance of incurring expenses in the distribution of a motion picture to generate a tax deferral and permanent tax savings.

The Tax Court upheld the reassessment of the losses and expenses on the basis that they were not incurred for the purpose of earning income and thus prohibited under paragraph 18(1)(a) of the *Income Tax Act*. The Tax Court concluded that the option agreements were "shams" designed to mask the parties' agreement that Fox would ultimately reacquire the films prior to their commercial release.

The FCA's decision

On Appeal to the FCA, the Taxpayers' argued that sham was not raised in the Minister's assumptions and, as such, it was not open to the Tax Court to find against them on that basis. The FCA dismissed this ground of appeal, holding that the assumptions pleaded by the Minister were sufficient to convey a similar meaning in that the Minister assumed:

1. There was never an intention by Fox to allow the partnerships to actually own, control, and exploit the films; and
2. The Taxpayers knew Fox would exercise its option and that any income from the films would not be realized while the partnerships had interest in the films. This, according to the FCA, was enough to alert the Taxpayers to the issues of sham and a pre-agreement.

As a further basis of appeal, the Taxpayers argued that it was significant that the Tax Court concluded the options were a sham as it was not part of the Crown's case. The Crown acknowledged that it was not part of the Minister's case but argued nothing turned on this point. The FCA agreed that the absence of the specific label of "sham" by the Crown did not mean the Taxpayers were denied notice of the case they had to meet. Instead, the FCA held that it was not required for the Minister to assume a sham or explicitly state there was a deception. Instead, the FCA held that it was sufficiently "obvious from the relevant assumptions that the Minister did assume that there was deception with respect to the options."

Conclusions

The FCA's conclusion is inconsistent with the general requirements on pleadings, as well as the edict that taxpayers are entitled to know the case against them and have an opportunity to meet it. The application of sham is not only a serious allegation but it also has the potential to cause negative reputational and financial consequences to the accused taxpayer, especially where the taxpayer is a public corporation. Aggressive pursuit of the sham argument has lead to large cost awards against the Crown.[2]

With the FCA's decision in *Paletta*, even though sham is a known and accepted legal concept, the Minister does not need to plead sham to benefit from it. In addition, it arguably provides the Minister with the flexibility to raise sham as late as argument at trial without prior notice to the Taxpayer. Such a result is grossly unfair to taxpayers and allows the Crown to potentially avoid the consequences of arguing sham while still

benefit from its application at trial. It is also contrary to the requirement to plead allegations of dishonesty, such as fraud and defamation with specificity.

As a result of the FCA's decision in *Paletta*, Taxpayers will be required to read between the lines when reviewing the Minister's assumptions in order to determine whether the facts pleaded implicitly raise sham, and expend cost and time, preparing to defeat an assessing position which is not specifically plead.

In our view, the FCA's decision in *Paletta* is a classic case of bad facts making bad law, and limits to its application should be urged upon the Tax Court and the FCA at the first opportunity.

[1] *Eisbrenner v. Canada*, 2020 FCA 93; leave to appeal to the Supreme Court denied at SCC No. 39303.

[2] *Cameco Corporation v. The Queen*, 2019 TCC 92.

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