Docket: 2015-2662(IT)G

BETWEEN:

THE ESTATE OF PASQUALE PALETTA,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Order concerning costs dealt with in writing without the appearance of the parties.

Before: The Honourable Justice David E. Spiro

Appearances:

Counsel for the Appellant:	Justin Kutyan and Kelly Ng
Counsel for the Respondent:	Suzanie Chua, Rana El-Khoury and Dina Elleithy

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ORDER

UPON reading the written submissions on costs filed by each party;

THIS COURT ORDERS that:

1. The award of costs to the Appellant made in paragraph 1 of the Judgment dated February 18, 2021 shall be satisfied by payment by the Respondent to the Appellant of an all-inclusive lump sum of $2,241,025; and

2. The award of costs to the Respondent made in paragraph 2 of the Judgment dated February 18, 2021 shall be satisfied by reducing the percentage of legal fees recoverable by the Appellant from 50% to 45% as reflected in the lump sum award of $2,241,025 in paragraph 1 above.

Signed at Toronto, Ontario, this 17th day of June 2021.

"David E. Spiro"

Spiro J.

Citation: 2021 TCC 41
Date: 20210617
Docket: 2015-2662(IT)G

BETWEEN:

THE ESTATE OF PASQUALE PALETTA,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR ORDER

Spiro J.

[1] Although it is abundantly clear that the Appellant was substantially successful in its appeals, the parties have been unable to agree on costs. After reviewing written submissions on costs from each party, I have awarded the Appellant costs in a lump sum of $2,241,025.

I. The Appellant's Position on Costs

[2] On the basis that it was almost entirely successful in these appeals, the Appellant sought a lump sum costs award of $3,500,000. That reflects total disbursements of $996,550 and almost 75% of total legal fees of $3,365,500.

II. The Crown's Position on Costs

[3] On the basis that "the parties enjoyed divided success", the Crown argued that each party should receive costs in accordance with Tariff B of Schedule II to the *Tax Court of Canada Rules (General Procedure)* (the "Rules") and that each party should bear their own disbursements.[1]

III. The Decision on the Merits[2]

[4] The appeals were in respect of eight taxation years, each of which had been reassessed by the Minister of National Revenue (the "Minister") beyond the normal reassessment period. In each of the first seven taxation years reassessed, Mr. Paletta claimed significant losses from a tax-driven method of structuring forward foreign exchange trading known as "straddle trading". In the eighth taxation year, Mr. Paletta chose to realize a modest gain.[3]

[5] The main issue was whether the entirety of the trading was a sham and, if not, whether the losses claimed by Mr. Paletta over the first seven taxation years were deductible (i.e., whether there was a "source of income"). I concluded that the trading was not a sham and that there was a source of income sufficient to permit the deduction of those losses.[4] That disposed of the main issue.

[6] The other issues were:

(a) whether Mr. Paletta made a misrepresentation attributable to neglect, carelessness or wilful default in filing his return for any taxation year at issue, thereby allowing the Minister to reassess outside the normal reassessment period in respect of his trading for that year; and

(b) whether Mr. Paletta knowingly, or under circumstances amounting to gross negligence, made a false statement or omission in his return for any of the first seven taxation years at issue, thereby allowing the Minister to assess a gross negligence penalty for any of those years under subsection 163(2) of the Act.

[7] I found that Mr. Paletta made a misrepresentation attributable to neglect or carelessness in his 2002 tax return by failing to report $8 million of gains from his trading for that year. The Minister was, therefore, permitted to reassess to include $8 million of trading gains in computing Mr. Paletta's income for the 2002 taxation year notwithstanding that the reassessment at issue for that year was issued outside the normal reassessment period.

[8] I also found that Mr. Paletta knowingly, or under circumstances amounting to gross negligence, made a false statement or omission in his 2002 tax return by failing to include $8 million in trading gains in computing his income for that year. The Minister was, therefore, permitted to assess a gross negligence penalty under

subsection 163(2) of the Act in respect of $8 million of unreported income for the 2002 taxation year.

[9] My decision in respect of the 2002 taxation year represented only a partial victory for the Crown for that year as I did not uphold the Minister's reassessment for that year in its entirety. The Minister's reassessment for that year disallowed 100% of the losses claimed by Mr. Paletta from his "purported" trades that year. In reassessing, the Minister assumed a number of facts suggesting that the trading was a sham. According to the Minister, no losses at all were realized during that year.

[10] I concluded that Mr. Paletta was entitled to use the tax avoidance scheme at issue for all taxation years before me. The only difference between the 2002 taxation year and the other loss years was that Mr. Paletta had not included in computing his income for that year the trading gains he had realized during that year. That misrepresentation resulted in a claim of $10 million of loss for the year instead of the $2 million of loss to which he was actually entitled. In effect, the judgment allowed $2 million of loss for a taxation year in which the Minister had allowed the deduction of no loss at all.

[11] Subsection 147(3) of the Rules sets out a number of factors to consider in awarding costs. Before considering each factor, I will deal briefly with disbursements claimed by the Appellant.

IV. Disbursements Claimed by the Appellant

[12] The Crown has raised questions about a relatively small number of disbursements claimed by the Appellant. I am satisfied, however, that the Appellant's total disbursements of $996,550 fall within a reasonable range.

[13] I reach this conclusion after comparing the Appellant's total disbursements to the Crown's total disbursements. The Appellant's disbursements were $996,550 while the Crown's disbursements were $710,000.[5] In light of the significant burden that rested on the Appellant to demolish the Minister's assumptions of fact in respect of sham, ineffective transactions, etc., I am satisfied that the Appellant's disbursements fall within a reasonable range.[6]

V. The Rule 147(3) Factors

[14] In arguing that it should be entitled to recover nearly 75% of its legal fees, the Appellant makes much of the Crown's failure to adduce any evidence of sham. In so doing, however, the Appellant has overlooked the fact that the Crown is entitled to rest her case on the Minister's assumptions of fact as disclosed in the Reply. To the extent that the Appellant has been put to the expense of fully preparing for trial, the factors listed in Rule 147(3) take that into account.[7] I will now consider each of those factors in turn.[8]

1. *The Result of the Proceeding – Rule 147(3)(a)*

[15] As I have already noted, the appeals involved one main issue and two other issues covering a total of eight taxation years. But for the relatively limited effect of Mr. Paletta's failure to include $8 million of trading gains in computing income for his 2002 taxation year, the Appellant would have been entirely successful in its appeals.

[16] In light of the fact that the Crown was only partially successful for one of the eight taxation years at issue, I cannot accept the Crown's submission that "the parties were equally successful."[9]

2. *The Amounts in Issue – Rule 147(3)(b)*

[17] The aggregate amount of losses at issue in these appeals was significant by any measure. As noted in the reasons for judgment:

> [13] Mr. Pat Paletta claimed some $55 million in losses for his 2000 to 2006 taxation years and reported just over $6 million in profit for his 2007 taxation year, for a total of almost $49 million in net losses from forward foreign exchange trading during the period at issue:

Taxation Year	Claimed Losses/Gains
2000	($6,184,460.89)
2001	($2,150,917.06)
2002	($10,007,726.00)
2003	($6,198,247.76)
2004	($4,294,300.06)
2005	($5,134,923.14)
2006	($21,236,115.40)
2007	$6,444,216.20
Total:	**($48,762,747.11)**

[18] Further, the Minister alleged that two corporations owned or controlled by Mr. Paletta participated in the same tax avoidance scheme with the same counterparties (UCAL, IFX and ODL). The Minister alleged that those corporations deducted over $150 million in losses during the period at issue.[10]

[19] In addition, the tax community is now aware that dozens to hundreds of this type of pre-2017 straddle trading case are currently on this Court's docket.[11] This comes as no surprise in light of the fact that the reassessments at issue were part of a much larger project. As my colleague Justice D'Arcy noted in deciding the Appellant's motion to compel answers at examination for discovery:

> [36] The CRA conducted audits of other taxpayers involved in transactions similar to the Trading Transactions, which also involved Tim and John Hodgins, UCAL, IFX and ODL. These audits were part of a project co-ordinated by officials located in CRA's Ottawa headquarters.[12]

[20] Finally, at paragraph 86 of his reasons, Justice D'Arcy referred to "the extremely large amounts at stake in this appeal and, I assume, other appeals involving ODL, UCAL and IFX."

3. *The Importance of the Issues – Rule 147(3)(c)*

[21] These appeals represented the first time that the Supreme Court of Canada's decision in *Friedberg* (involving the deductibility of losses on straddle trades using commodity futures contracts traded on a public exchange)[13] had been considered in the context of forward foreign exchange contracts entered into between counterparties dealing with one another over the counter (i.e., dealing privately rather than on the public market).

[22] These appeals also represented the first time that the Supreme Court of Canada's decisions in *Stewart* and *Walls* (involving the determination of the existence of a source of income)[14] have formed the foundation of the Crown's argument in the context of straddle trades modelled after those used in *Friedberg*.

[23] The highest levels of the Canada Revenue Agency ("CRA"), including the Commissioner's office, were extensively involved in the audit that resulted in the reassessments at issue.[15] The Commissioner's office does not generally become involved with matters that the CRA considers unimportant.

[24] Finally, the case was important enough for the Department of Finance to mention it in the 2021 Budget when discussing a proposal designed to ensure that the CRA would be able to reassess certain types of avoidance transactions within the normal reassessment period.[16]

4. *Any Offer of Settlement Made in Writing – Rule 147(3)(d)*

[25] No offer of settlement in writing was made by either party.

5. *The Volume of Work – Rule 147(3)(e)*

[26] The volume of work necessary to conduct a trial over a period of 15 days along with three days of argument is significant. That volume of work was necessary in these appeals in light of the following:

(a) the Crown pleaded a long list of arguments and alternative arguments in her Amended Reply. The Appellant had to be prepared to answer each of those arguments and alternative arguments at trial (emphasis added):[17]

> (a) all of the purported foreign currency option contracts and positions and all contracts and agreements entered into with Union CAL, IFX and ODL were shams;
>
> (b) if the trades occurred and were not shams, which is denied, the trades were not legally effective in that there were no legally effective contracts for the purchase or sale of any commodity;
>
> (c) the Appellant did not incur the Claimed Losses;
>
> (d) in the further alternative, the trades were not commercial transactions as the Appellant had no real liability at the end of the 2000 to 2007 taxation years and bore no risk;
>
> (e) in the further alternative, there was no business or potentially income producing property as, according to the understanding between the Appellant and the Hodgins, the group of trades engaged in by the Appellant could not produce any income to the Appellant. Therefore there could be no source of income with respect to the trades and the trades did not produce a loss under section 3 or 4 of the Act; and

> (f) in the further alternative, if there was a business activity, there were no realized losses as at the end of each of the Taxation Years as realization of losses and gains would have occurred simultaneously on the expiry or value dates.[105]
>
> [105] Amended Reply, paragraph 17 at page 41.

(b) the Crown's sham and ineffective transactions arguments impugned the legal effect of each trade, agreement, and arrangement entered into by Mr. Paletta over a period of eight years. The Appellant had to be prepared to prove the *bona fides* of each trade, agreement, and arrangement entered into by Mr. Paletta during each of those years;

(c) the Crown pleaded that the Minister had made no less than 259 assumptions of fact in reassessing Mr. Paletta. The Appellant had to be prepared to call evidence to demolish all assumptions of fact supporting the reassessments at issue;

(d) the Appellant had to call highly technical expert evidence to help the Court understand the nature and effect of the trading;

(e) the Appellant had to produce voluminous trading documents and records, along with a number of witnesses, in order to explain how the trading was structured and executed;

(f) many of the documents impugned by the Crown were created two decades before trial which significantly increased the volume of work necessary to locate, organize and explain them;

(g) most of the fact witnesses and expert witnesses necessary to explain the trading and the related documentation were located outside Canada; and

(h) by the time the trial opened, Mr. Paletta had died. This required the Appellant to adduce additional evidence addressing the purpose of the trading, etc.

6. *The Complexity of the Issues – Rule 147(3)(f)*

[27] My colleague Justice Owen heard a Rule 58 motion brought by the Appellant. In the course of dismissing the motion, he made the following observations regarding the complexity of the case, all of which proved to be entirely correct:[18]

> [3] The Notice of Appeal, the Amended Reply and the Answer filed by the parties . . . suggest a complex appeal in which a number of significant issues will have to be addressed by the trial judge. . . .
>
> . . .
>
> [40] In this case, the pleadings disclose complex facts and numerous contentious issues material to the appeal, including whether the trading transactions were a sham, whether the trading transactions were legally effective and whether the trading transactions were commercial transactions. . . .
>
> [41] To assess whether the Appellant acted as a wise and prudent person in the complex circumstances of this case, it is in my view necessary for the Court to understand all of the circumstances in which the relevant actions of the Appellant took place.

[28] The CRA itself recognized the complexity of the issues. As one of the CRA auditors on the file observed:

> The complex issues addressed in this audit were similar to those being simultaneously addressed in numerous other audits across the country,….[19]

[29] On the factual side alone, explaining how forward foreign exchange trading works in general, and the architecture of the straddle trades in particular, was a complex undertaking. Documentary evidence, oral evidence, and expert opinions were all required to allow the Court to understand and appreciate the nature and effect of the trading at issue.

7. *The Conduct of Any Party That Unnecessarily Affected the Duration of the Proceeding – Rule 147(3)(g)*

[30] I do not find that the conduct of either party crossed the line into conduct that was clearly unreasonable. The case was hard fought, well presented and well argued.

8. *The Denial or the Neglect or Refusal of Any Party to Admit Anything That Should Have Been Admitted – Rule 147(3)(h)*

[31] I am not aware of any refusal to answer requests to admit served by either party.

9. *Whether Any Stage in the Proceeding was Improper, Vexatious, or Unnecessary,or Taken Through Negligence, Mistake, or Excessive Caution – Rule 147(3)(i)*

[32] No stage in the proceeding was improper, vexatious or unnecessary and no stage in the proceeding was taken through negligence, mistake or excessive caution.

10. *Whether the Expense of Having an Expert Witness Was Justified – Rule 147(3)(i.1)*

[33] In retrospect, each party called one expert too many. The Crown called Mr. Poirier whose conclusion was unsustainable on the evidence.[20] The Appellant called Mr. Knight whose reports carried little weight.[21]

[34] Most of the disbursements attributable to Mr. Knight should be deducted from the disbursements allowed to the Appellant because the vast majority of Mr. Knight's opinion evidence was flawed by failing to assume the possibility that Mr. Paletta's trading was entirely tax-driven.

[35] In my view, only about 25% of Mr. Knight's opinion evidence was useful. The disbursements claimed by the Appellant in respect of Mr. Knight were approximately $360,000. Disallowing 75% of that amount would disallow $270,000 of the total disbursements claimed of $996,550 leaving an adjusted total amount of disbursements of $726,550.

[36] The Crown objects to the Appellant incurring the expense of retaining expert witnesses located outside Canada in respect of the forward foreign exchange

trading at issue. There is no basis for such an objection, particularly since the global centres of forward foreign exchange trading are all located outside Canada. There is no "buy Canadian" requirement when it comes to expert witnesses.

11. *Any Other Matter Relevant to Costs – Rule 147(3)(j)*

[37] Among other things, this factor offers an opportunity to consider the conduct of either party not falling within any of the earlier factors. Here, there were two such matters. The first had the effect of muddying the evidentiary waters. The second had the effect of prolonging the trial.

[38] First, the Appellant left the evidentiary record unclear by not admitting before the end of trial that Mr. Paletta had neglected to follow the architecture of the tax avoidance plan for his 2002 taxation year by failing to include trading gains of $8 million in computing his income for that year.[22] Considerable confusion and uncertainty in the evidence would have been avoided had that fact been conceded by the Appellant before the trial ended.[23] Such conduct does not fall within Rule 147(3)(h), but should nevertheless be taken into account with respect to costs.

[39] Second, the Appellant spent the better part of a morning at trial attempting to qualify an expert witness whose evidence was irrelevant and unnecessary.[24] The Appellant proposed to call an expert witness, Mr. Brown, to provide opinion evidence on English law, though English law was not a fact in issue in any of the appeals. Such conduct does not fall within Rule 147(3)(i), but should nevertheless be taken into account with respect to costs.

[40] In the absence of those two matters, I would have exercised my discretion to award the Appellant 55% of its legal fees.[25] In light of those two matters, the Appellant is entitled to 50% of its legal fees rather than 55%.

[41] Only one item remains for consideration – my award of costs to the Crown.

VI. Award of Costs to the Crown

[42] In my judgment dated February 18, 2021, I allowed the Appellant's appeal of the reassessment for the 2002 taxation year but awarded costs in respect of that year to the Crown.

[43] I did so because I had opened the statute-barred issue of Mr. Paletta's trading losses for that taxation year to allow the Minister to reassess to include $8 million of trading gains in computing income for that year. I also allowed the Minister to assess a gross negligence penalty on $8 million of understated income for that year.

[44] That award of costs to the Crown will be satisfied by further reducing the percentage of legal fees recoverable by the Appellant from 50% to 45%.

VII. Award of Costs to the Appellant

[45] Based on my assessment of all the relevant factors, and having considered the written submissions of the parties, I award the Appellant costs in a lump sum of $2,241,025 reflecting 45% of the Appellant's legal fees of $3,365,500 ($1,514,475) and its disbursements, as adjusted, of $726,550.[26]

Signed at Toronto, Ontario, this 17th day of June 2021.

"David E. Spiro"

Spiro J.

CITATION:	2021 TCC 41
COURT FILE NO.:	2015-2662(IT)G
STYLE OF CAUSE:	THE ESTATE OF PASQUALE PALETTA AND HER MAJESTY THE QUEEN
PLACE OF HEARING:	N/A
DATE OF HEARING:	N/A
REASONS FOR ORDER BY:	The Honourable Justice David E. Spiro
DATE OF ORDER:	June 17, 2021

APPEARANCES:

Counsel for the Appellants:	Justin Kutyan and Kelly Ng
Counsel for the Respondent:	Suzanie Chua, Rana El-Khoury and Dina Elleithy

COUNSEL OF RECORD:

For the Appellants:

Name:	Justin Kutyan and Kelly Ng
Firm:	KPMG Law LLP Toronto, Ontario

For the Respondent:	Nathalie G. Drouin Deputy Attorney General of Canada Ottawa, Canada

[1] Respondent's Written Submissions on Costs, paragraph 11 and Respondent's Response Submissions on Costs, paragraph 18.
[2] *Paletta Estate v The Queen*, 2021 TCC 11.
[3] See paragraph 17 below for a year-by-year breakdown.
[4] For the 2002 taxation year, only $2 million of the $10 million of losses claimed were deductible because Mr. Paletta failed to include $8 million in trading gains in computing his income for that year.
[5] Respondent's Written Submissions on Costs, paragraph 8.
[6] As noted in paragraphs 33 to 35, I have adjusted the Appellant's allowable disbursements by deducting 75% of the disbursements incurred in respect of Mr. Knight. The Appellant's adjusted disbursements are $726,550, an amount just slightly in excess of the Crown's disbursements.
[7] In particular, Rule 147(3)(e) dealing with the volume of work.
[8] For an excellent overview of the Rule 147(3) factors, see Derrick Hosanna and Erica Hennessey, "The Death of the Tariff: A Review of the Tax Court's Discretionary Approach to Costs Awards", *Canadian Tax Journal* (2020) 68:2, 409-38.
[9] Respondent's Written Submissions on Costs, paragraph 11(a).
[10] Paragraph 12 of the Reasons for Judgment.
[11] "Paletta: Straddles Can Work!", *Canadian Tax Focus*, Vol. 11, No. 2, May 2021, Canadian Tax Foundation. The "pre-2017" qualification is important because a specific anti-avoidance rule was enacted that year with a view to putting an end to the type of straddle-based tax avoidance scheme used by Mr. Paletta and others.
[12] *Paletta v The Queen*, 2017 TCC 233, paragraph 36, varied on consent by judgment dated February 2, 2018, Federal Court of Appeal File No. A-399-17 (unreported).
[13] *Friedberg v Canada*, [1993] 4 SCR 285.
[14] *Stewart v Canada*, 2002 SCC 46, [2002] SCR 645; *Walls v Canada*, [2002] 2 SCR 684.
[15] *Paletta, supra* note 12 at paragraph 61, varied on consent by judgment dated February 2, 2018, Federal Court of Appeal File No. A-399-17 (unreported).
[16] *Budget 2021*, April 19, 2021, Annex 6 Tax Measures: Supplementary Information, "Notifiable Transactions", at pages 633-634.
[17] Reasons for Judgment, paragraph 147.
[18] *Paletta v The Queen*, 2016 TCC 171, paragraphs 3, 40 and 41, aff'd at 2017 FCA 33.
[19] *Paletta, supra* note 18 at paragraph 40, aff'd at 2017 FCA 33.
[20] Reasons for Judgment, paragraph 135.
[21] Reasons for Judgment, paragraph 143.
[22] Reasons for Judgment, paragraphs 115 to 121. Mr. Paletta's failure to follow the architecture of the tax avoidance scheme by neglecting to include trading gains of $8 million in computing income for his 2002 taxation year went far beyond a "factual inaccuracy" or a "calculation error" as asserted at paragraph 35 of the Appellant's Written Submissions on Costs.
[23] Such an admission would not have precluded the Appellant from arguing the legal consequences of that fact, including its effect on the statute-barred issue and the gross negligence penalty issue. In the absence of such an admission, I was obliged to seek additional submissions from the parties after the conclusion of trial.
[24] Each of the four "*Mohan* factors" must be satisfied before expert evidence may be admitted: (a) logical relevance, (b) necessity in assisting the trier of fact, (c) the absence of any

exclusionary rule, and (d) a properly qualified expert. Mr. Brown's proposed expert evidence clearly failed the first two tests. See volume 8 of the transcript, pages 1154-1203 and pages 1209-1213. The Appellant, quite properly, has not claimed any disbursements in respect of Mr. Brown.

[25] The starting point of 55% is within the range suggested by Justice Campbell in her seminal decision in *Zeller Estate v The Queen*, 2009 TCC 135. Paragraphs 8 and 9 of that costs decision are instructive and have been followed in numerous decisions of this Court:

> [8] Party and party costs based on the Tariff Scale are intended to afford the party to whom they are awarded partial indemnity for the costs which must be paid to their own solicitor (Mark Orkin, *The Law of Costs*, 2nd ed., vol 1 (Aurora: Canada Law Book, 2008) at 1-9). However, in recent times, such costs have been used for more than indemnification:
>
> > Traditionally, the purpose of an award of costs within our "loser pay" system was to partially or, in some limited circumstances, wholly indemnify the winning party for the legal costs it incurred. However, costs have more recently come to be recognized as an important tool in the hands of the court to influence the way the parties conduct themselves and to prevent abuse of the court's process. Specifically, the three other recognized purposes of costs awards are to encourage settlement, to deter frivolous actions and defences, and to discourage unnecessary steps that unduly prolong the litigation (Mark Orkin, *The Law of Costs*, 2nd ed., vol 1 (Aurora: Canada Law Book, 2008) at 2-1)).
>
> [9] Traditionally, the degree of indemnification represented by partial indemnity costs has varied between 50% and 75% of solicitor-and-client or substantial indemnity costs (Mark Orkin, *The Law of Costs*, 2nd ed., vol 1 (Aurora: Canada Law Book, 2008) at 2-3).

[26] The adjustments to the Appellant's disbursements are set out in paragraphs 33 to 35.