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Attention: Jamie Jeffs

January 20, 2010



Dear Sir:

**Re: SignalEnergy Inc; Network Capital Corporation**

Our review of the series of transactions pertaining to the "conversion" of SignalEnergy Inc, (SignalEnergy), formerly known as SignalGene Inc, into an oil and gas enterprise is completed. The primary issue under review was the availability of SignalEnergy's tax pools (non-capital losses, SR&ED, Tax Credits) subsequent to the company's 2003 "conversion".

As a result of this review, the CRA proposes to deny the use of these tax pools on the grounds that Network Capital Corporation ("Network") acquired control of SignalEnergy but the criteria set out in subsections 111(5) and 37(6.1) of the Income Tax Act ("the Act") were not met. The post acquisition income of SignalEnergy was not earned from the same or similar business as the pre-acquisition business. As an alternative position, it is our contention that subsection 245(2) of the Income Tax Act applies to deny the use of the tax pools. The amounts of non-capital losses we propose to deny are as follows:

2004	...	\$1,171,447
2005	...	\$1,837,535

We further propose to deny future application of these pre-acquisition pools unless SignalEnergy complies with the provisions of subsections 37(6.1) and 111(5) of the Act.

A statement of facts on which our positions are based follows below. We would appreciate being informed if there are any errors or omissions in these facts that we should consider.

## STATEMENTS OF FACT

**January, 2000** – SignalEnergy Inc (Signal) adopted its Articles of Amalgamation, which, among other provisions, conferred on the Board of Directors the power to

- (a) issue common shares
- (b) exchange, convert or cancel preferred shares as stipulated in Article 3.5:

Article 3.5:

*When preferred shares are outstanding, the Company may not, without obtaining the approval of those holding preferred shares in the manner provided below:*

*3.5.3.1. exchange, convert, reclassify or cancel, unless the Company purchases or redeems, in keeping with the Act or provisions hereof, all or a portion of the preferred shares.*

**March 12, 2003** – In a press release on this date, George Masters, Chairman and Interim President and Chief Executive Officer of SignalEnergy announced that the company would cease business and sell off its assets:

*“Having examined all available options to maximize shareholder value, including merger and acquisition opportunities, the Board of Directors has decided that shareholders will be best served through the sale of SignalGene’s assets.”*

**April 30, 2003** – In its 2002 Annual Report the Chairman of the Board confirmed the above press release:

*“Subsequent to year-end, after evaluating a number of alternatives to maximize shareholder value, we made the difficult decision to cease operations and sell the remaining assets of the Company.[...] SignalGene’s aim is to conclude the sales within the first half of the year.”*

**May 27, 2003** – Network made an initial proposal to SignalEnergy on the recapitalization of SignalEnergy, stressing the credentials of its [Network’s] management team and its past history of accomplishments in recapitalizing distressed companies. Its submission included the fact

- (i) that the partners of Network had over 75 years combined experience in the Calgary business community.
- (ii) that some members of its management team had previous experience in energy investment, public accounting practice and institutional trading.

- (iii) that some members of its management had participated in the formation of numerous oil and gas companies.
- (iv) that Network had over \$45 million under its management.

Network stated that it based its proposal on the assumption

- (i) that all material assets of SignalEnergy had been sold;
- (ii) that SignalEnergy had approximately \$55 million of unused tax pools, which could be used to shelter Federal Income Tax Payable;
- (iii) that SignalEnergy had terminated its employees other than those required to manage the day-to-day operations and administration; and
- (iv) that SignalEnergy had approximately 121,925,218 common shares outstanding.

Based on these assumptions Network offered to buy 121,925,000 common shares at \$0.04 per share. The proposed agreement would entitle Network to appoint four directors (out of the present 7) and require that four existing directors resign.

**June 12, 2003** – SignalEnergy announced in a news release that “the Board of Directors has concluded that, in light of recent events, a smaller Board would be equally effective in meeting the Company’s strategic and corporate governance requirements. Accordingly, the Board would be reduced from seven to four directors subsequent to the annual meeting of shareholders scheduled for June 26, 2003 in Montreal.”

**June 13, 2003** – Network informed (by facsimile) SignalEnergy that it would be represented at the annual shareholder meeting and wished to take that opportunity to make a presentation to SignalEnergy’s Board of Directors regarding Network’s recapitalization proposal. The presentation would highlight the value of the tax pools and provide more information on a previous recapitalization arranged by Network for Synsorb Biotech Inc.

**June 27, 2003** – SignalEnergy announced a new Board consisting of four directors.

**August 4, 2003** – Network Capital Inc sent a revised proposal to SignalEnergy for the recapitalization of the corporation. Under this proposal

- (a) Network would transfer the sum of \$8,084,400 to SignalEnergy in exchange for a treasury issue of 113,425,000 common shares and 8,500,000 non-voting preferred shares
- (b) Network would offer 5.2 cents to the dollar for SignalEnergy’s tax pools. This value would be factored into the price of shares to be acquired by Network, the common and preferred shares being equally priced.

- (c) Network would provide management expertise and engineer acquisitions of oil and gas properties and mergers with existing companies. Network gave the assurance that *“such transactions will include arrangements whereby a new management team, and other investors, acquire shares of the Company from treasury and Signal may subsequently enter into a business combination or merger, in each case on a basis that an acquisition of control of Signal within the meaning of the Income Tax Act (Canada) does not occur.”*
- (d) Network assured SignalEnergy it had significant experience in recapitalizing technology companies and had recently completed the reorganization of another biotech company, Synsorb Biotech Inc.

**August 22, 2003** – Pursuant to a Subscription Agreement finally reached by Network and SignalEnergy, SignalEnergy issued 100,732,500 common shares and 21,192,500 non-voting preferred shares to Network Capital Inc for \$8,677,750 consideration. Both voting and non-voting shares were equally priced. The essential terms of the agreement included the following:

- (a) Three current directors of SignalEnergy were to tender their resignations or be terminated;
- (b) Four nominees of the Subscriber (Network) were to be appointed as directors of SignalEnergy;
- (c) Cameron J. Bailey, Managing Director of Network, was to be appointed Chief Executive Officer of SignalEnergy;
- (d) All previous pledges by SignalEnergy such as the promise to dispose of assets were to be implemented;
- (e) Network pledged it was subscribing for its own account; and
- (f) Network pledged that *“it shall use all reasonable commercial efforts to ensure that the directors of the Corporation [SignalEnergy] hire a management team with oil and gas expertise and instruct such management team to prepare and implement a business plan for the Corporation.”*

**Nov 6, 2003** – A press release on this date announced that 93% of SignalEnergy’s shareholders approved four resolutions, which were to transform the company to an oil and gas enterprise, including the issue of common and preferred shares to Network. According to the report, SignalEnergy’s shareholders approved the following resolutions:

*“To appoint J. Cameron Bailey, David Richards, George Watson, Barry Giovanetto and Bernard Coupal as Directors of the Company, such appointment*

*to be effective only upon closing of the private placement. The resignation of George Masters, Andre Tremblay and Doris Belzile as Directors of the Company will be effective at the same time.*

*To amend the Articles of Incorporation of the Company to change its name to SignalEnergy Inc.*

*To amend the Company's stock option plan to reserve for issuance up to an additional 12,192,500 Common Shares.”*

**Nov 6, 2003** – The Stock Option Plan that was amended on this date contained the following provisions, among others:

*“The Plan is established in order to allow certain officers, directors of the Company, and persons and/or entities designated by the Company, to acquire shares directly from the Company.*

*The Plan is managed by the Board which has full power to interpret its provisions as it may deem necessary or desirable to manage the Plan. In this respect, the Board may take decisions on matters which may arise in connection with the Plan and these decisions shall be final and bind all interested parties.*

*The Board may determine eligibility criteria which may, among others, be based on the position of the eligible persons, their seniority, their current and future contribution to the success of the Company, as well as any other factor judged relevant for the granting of these options. Furthermore, the Board may determine the number of shares concerning which options shall be granted to each eligible person.*

*The aggregate number of 26,460,543 common shares is issuable pursuant to the terms of the Plan. The total number of shares which may be issued pursuant to the Plan to any one person is limited to 5% of the aggregate issued common shares of the Company. No holder of options shall hold options for more than five percent (5%) of the issued and outstanding shares of the Company.*

*Furthermore, the Plan, together with all the Company's other previously established or proposed share compensation arrangements, may not result, at any time, in:*

- 1. the number of shares reserved for issuance pursuant to options granted to insiders exceeding ten percent (10%) of the outstanding issue of the Company.*

2. *the issuance to outsiders, within a year period, of number of shares exceeding ten percent (10%) of the outstanding issue of the Company; or*
3. *the issuance to any one insider and such insiders' associates, within a one year period, of a number of shares exceeding five percent (5%) of the outstanding issue of the company.*

*For purposes of paragraphs 1, 2, and 3 above, shares issued pursuant to an entitlement granted prior to the grantee becoming an insider may be excluded in determining the number shares issuable to insiders.” (Emphasis Added)*

**Nov 21, 2003** – SignalEnergy transferred funds from its account in Montreal to Calgary in two installments of \$14,200,000 and \$80,000, respectively, through the National Bank of Canada. The reason for the transfer as stated on the bank form was “Change of Control of the Company following a Private Placement.” (Emphasis added) ↗

**December 9, 2003** – In a letter to the Toronto Stock Exchange, the law firm of Fasken Martineau which acted as SignalEnergy’s counsel in Quebec stated as follows:

*“The amendment [to the Stock Option Plan] consists in the reservation for issuance of an additional 12,192,500 common shares, for a total of 26,460,543 common shares issuable pursuant to the Plan.”*

**March 8, 2007** – The assessment of the 2004 T2 return showed that SignalEnergy deducted \$1,171,447 in non-capital loss incurred prior to reorganization.

**December 18, 2007** – The assessment of the 2005 T2 return indicates that SignalEnergy deducted \$1,837,535 in non-capital loss incurred prior to reorganization.

Explanations of CRA’s assessing positions are set out below.

### (I) ACQUISITION OF CONTROL

The facts confirm that Network acquired de jure control of SignalEnergy by the operation of paragraph 251(5) (b) and subsection 256(8). Subsection 251(5) - Control by related groups, options, etc, - states as follows:

**“For the purposes of subsection (2) and the definition “Canadian-controlled private corporation” in subsection 125(7),**

**(a) where a related group is in a position to control a corporation, it shall be deemed to be a related group that controls the corporation whether or not it is part of a larger group by which the corporation is in fact controlled;**

**(b) where at any time a person has a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently,**

**(i) to, or to acquire, shares of the capital stock of a corporation or to control the voting rights of such shares, the person shall, except where the right is not exercisable at that time because the exercise thereof is contingent on the death, bankruptcy or permanent disability of an individual, be deemed to have the same position in relation to the control of the corporation as if the person owned the shares at that time,**

**(ii) to cause a corporation to redeem, acquire or cancel any shares of its capital stock owned by other shareholders of the corporation, the person shall, except where the right is not exercisable at that time because the exercise thereof is contingent on the death, bankruptcy or permanent disability of an individual, be deemed to have the same position in relation to the control of the corporation as if the shares were so redeemed, acquired or cancelled by the corporation at that time;**

**(iii) to, or to acquire or control, voting rights in respect of shares of the capital stock of a corporation, the person is, except where the right is not exercisable at that time because its exercise is contingent on the death, bankruptcy or permanent disability of an individual, deemed to have the same position in relation to the control of the corporation as if the person could exercise the voting rights at that time, or**

**(iv) to cause the reduction of voting rights in respect of shares, owned by other shareholders, of the capital stock of a corporation, the person is, except where the right is not exercisable at that time because its exercise is contingent on the death, bankruptcy or permanent disability of an individual, deemed to have the same position in relation to the control of the corporation as if the voting rights were so reduced at that time;**

Paragraph 251(5)(b) thus applies where a shareholder otherwise in a minority position is invested with rights which if exercised give the shareholder majority control. Such rights include the right of the shareholder to acquire shares directly, to control the voting rights or cause the corporation to acquire or redeem shares owned by other shareholders. The intent of paragraph 251(5)(b) is to ensure that where such rights exist under an arrangement or contract that could result in potential de jure control, the shareholder is deemed to have exercised them. This reasoning is congruent with the Supreme Court's expanded concept of de jure control, which holds that effective control may depend on a combination of factors other than sheer majority share ownership (*Duha Printers*).

The following explanatory note on Bill C-28; S.C. 1998, c. 19, s. 242(2) and (3), throws more light on this issue:

*"..... Paragraph 251(5) (b) of the Act describes how a person who has any of certain rights is to be treated in determining who controls a corporation.*

*These rights — which may be held under a contract, in equity or otherwise, and may be immediate or future, absolute or contingent — are described in subparagraphs 251(5)(b)(i) and (ii) of the Act. Those subparagraphs also describe the consequences of holding the rights.”(emphasis added)*

The explanatory note implies that the right referred to in subparagraph 251(5) (b) is not restricted to equity but “*may be held under a contract, in equity or otherwise.*” Rights arising under a contract need not, therefore, include options to acquire shares. They are pertinent if they place a shareholder in a position to wield the same influence accruing from ownership of the majority of voting shares. *In Rostal Sales Agency Ltd v. Her Majesty The Queen* 83 DTC 5036, the Minister argued that a right under the terms of a trust deed, to dismiss the trustee at any time meant the settlor could appoint himself trustee and inherit control of the voting rights of the shares held by the trust. In accordance with paragraph 251(5) (b), the argument continued, the settlor would be deemed to be in the same position as if he owned the shares. The same argument would apply to a situation where the control of the Board of Directors gives a shareholder access to powers vested in the Board, to grant optional shares, for example. Although the Federal court rejected the crown’s argument in *Rostal Sales Agency* because the trust deed was not considered a contract in law, such rebuttal would not be tenable where such powers stem from a legally enforceable contract such as the Subscription Agreement.

Subsection 256(8) - Deemed exercise of right – ties these potential rights of control to the acquisition of control provisions. It states as follows:

**“Where at any time a taxpayer acquires a right referred to in paragraph 251(5) (b) in respect of a share and it can reasonably be concluded that one of the main purposes of the acquisition is**  
**(a) to avoid any limitation on the deductibility of any non-capital loss, net capital loss, farm loss or any expense or other amount referred to in subsection 66(11), 66.5(3) or 66.7(10) or (11),**  
**(b) to avoid the application of subsection 10(10) or 13(24), paragraph 37(1)(h) or subsection 55(2) or 66(11.4) or (11.5), paragraph 88(1)(c.3) or subsection 111(4), (5.1), (5.2) or (5.3), 181.1(7) or 190.1(6),**

.....

**the taxpayer is deemed to be in the same position in relation to the control of the corporation as if the right were immediate and absolute and as if the taxpayer had exercised the right at that time for the purpose of determining whether control of a corporation has been acquired for the purposes of subsections 10(10) and 13(24), section 37, subsections 55(2), 66(11), (11.4) and (11.5), 66.5(3), 66.7(10) and (11), section 80, paragraph 80.04(4)(h), subparagraph 88(1)(c)(vi), paragraph 88(1)(c.3), sections 111 and 127 and subsections 181.1(7),**

**190.1(6) and 249(4), and in determining for the purpose of section 251.1 whether a corporation is controlled by any person or group of persons”**  
*(emphasis added)*

Commentaries from several sources including explanatory notes, Canadian Tax Reporter and academic literature provide greater clarity on the operation of subsection 256(8). The explanatory notes on Bill C-28 explain the provision as follows:

*“Subsection 256(8) of the Act extends the circumstances in which an acquisition of control is considered to have occurred for the purposes of a number of provisions of the Act. If a taxpayer acquires a right referred to in paragraph 251(5)(b) of the Act with respect to shares, and it can reasonably be concluded that one of the main purposes of acquiring the right is to avoid the application of certain tax provisions that are triggered by an acquisition of control, subsection 256(8) will apply. In its current form, the subsection treats the taxpayer, for the purposes of determining whether control of the corporation has been acquired, as having acquired the shares.”*

The editorial commentary from Canadian Tax Reporter expatiates further on how the rights referred to in paragraph 251(5)(b) could be used to frustrate the application of the restrictive provisions that are triggered by an acquisition of control but for the operation of subsection 256(8):

*“Paragraph 251(5)(b) generally refers to rights to acquire shares, or to acquire or control the voting rights over shares, and to rights to cause the corporation to redeem or cancel any other shareholder's shares. It is applicable for the purposes of determining whether persons are related for the purposes of the Act and determining Canadian-controlled private corporation status. But for subsection 256(8), the rights referred to in paragraph 251(5)(b) could be used as part of a scheme to avoid the provisions which deny certain deductions when changes of control take place. It is generally accepted that an acquisition of control occurs when shares carrying the majority of the votes for the board of directors are acquired. Prior to the introduction of subsection 256(8), a potential purchaser of the shares of a corporation which had loss carry-forwards or available resource deductions or investment tax credits from prior years could acquire effective, but not legal, control over the corporation by acquiring, for example, a right (e.g., an option) to purchase all of its issued shares. A new profitable business would be transferred into the corporation and the losses, deductions or credits would be deducted for tax purposes from the profits of the new business. The right to acquire the shares would be exercised only when the available losses or resource deductions had been used. This procedure is no longer available since subsection 256(8) deems the right to have been exercised at the time it was acquired if one of the main purposes of acquiring the right was to avoid the change of control rules (specifically, to avoid the limitation or application of the provisions set out in paragraphs 256(8)(a) through 256(8)(d)). It will be a question of fact whether one*

*of the main purposes of acquiring such a right was to avoid the application of these provisions. However, for example, if events occurring around and after the acquisition of the right are such that losses, deductions or credits are used which could not have been used if the shares themselves had been acquired at the time the right with respect to those shares was acquired, there may be a strong inference as to one of the main purposes of the acquisition of the right."*

All the commentaries on the relation of paragraph 251(5)(b) and subsection 256(8) may be summarized as follows:

- (a) Paragraph 251(5)(b) makes it possible to acquire control without immediately acquiring a majority of the voting shares. It is sufficient to acquire a right to a majority of the shares or such rights as permit effective control even without a majority of the voting shares. Paragraph 251(5)(b) deems such rights to have been exercised immediately.
- (b) Since 251(5)(b) applies to CCPCs and for purposes of determining related persons, it would not ordinarily apply to public corporations. Subsection 256(8) permits 251(5)(b) to be applied to effective control of a public corporation.
- (c) The avoidance of de jure control by simply avoiding ownership of a majority of voting shares would circumvent the restrictive provisions such as subsections 111(5) and 37(6.1) usually triggered on acquisition of control. This state of affairs would allow the corporation to deduct non-capital losses or research expenditures and other tax pools from the profits of the corporation which may be derived from an entirely new business distinct from the business that gave rise to the tax pools. Subsection 256(8) thus, works as an anti-avoidance provision by requiring that any right acquired by the taxpayer pursuant to paragraph 251(5)(b) be deemed to have been exercised at the same time as it was acquired.
- (d) Subsection 256(8) can only be applied where one of the main purposes for acquiring the rights under paragraph 251(5)(b) is to avoid the application of the acquisition of control provisions.

Main Purpose: The determination of a main purpose in anti-avoidance provisions of the Income Tax Act is based on the facts of each case. The courts have, however, offered some guidance in this regard. Referring to the expression "*it may reasonably be considered that one of the main purposes thereof was to avoid the tax*" contained in subsection 181(5) for example, in the case of *Brennan Educational Supply Ltd v The Queen*, 90 DTC 55, the court offered the following hint:

*"The focus of subsection 181(5) is one of anti-avoidance; it applies where it could reasonably be considered that one of the main purposes of the one or more*

*transactions was to avoid the Part II corporate distributions tax. In my view, the crucial time to be examined is the time when the dividends were declared and paid, and that all aspects of the decision making process, prospectively and retroactively, must be examined. This includes matters of omission as well as commission, and that a reasonable subjective and objective standard is to be applied."*

Hence, all actions taken preparatory to the suspected avoidance transactions and subsequent actions are pertinent in determining whether a tax benefit is a main purpose. In *The Queen v. Placer Dome Inc.* 96 DTC 6562, the Federal Court of Appeal commented as follows:

*"Practically speaking, it is evident that once it is established that a transaction has the effect of reducing significantly a capital gain, it is proper for the Minister to infer that the taxpayer has such a purpose. To rebut this inference, the taxpayer (or his advisors) must offer an explanation which reveals the purposes underlying the transaction. That explanation must be neither improbable nor unreasonable."*

It is, therefore, reasonable to assume that one of the main purposes of a transaction is to avoid tax where significant tax reduction results from the transaction. The onus is on the taxpayer to refute this assumption by offering a plausible explanation of purpose. The following facts provide compelling evidence that one of the main purposes of Network's acquisition of rights under the Subscription Agreement was to avoid the application of subsections 37(6.1) and 111(5) of the Act:

- (i) Network had prior knowledge of the unused tax pools left over in SignalEnergy. Prior to the agreement the amount and value of these pools, consisting of non-capital losses and research expenditure pools were discussed. A power-point presentation on these tax pools was prepared for the benefit of SignalEnergy's Board of Directors. The value of the tax pools was also negotiated and featured in the determination of the price of the shares issued to Network;
- (ii) Network implied in its exchanges with SignalEnergy that it had in the past successfully arranged a similar reorganization without jeopardizing the deductibility of tax pools by avoiding an acquisition of control;
- (iii) Network assured SignalEnergy that the transition in its business from Pharmaceuticals to Oil and Gas would be effected by business combinations conducted in such a fashion as to avoid the acquisition of control rules. Network was thus aware that SignalEnergy could not deduct the non-capital losses and research expenditure pool from income from its oil and gas business if it (Network) acquired de jure control;
- (iv) In negotiating for rights under the Subscription Agreement, it is assumed that from past experience Network had prior knowledge of the ramifications of the power to

control of the Board of Directors, and the powers vested in the Board in such public documents as the Articles of Amalgamation and the Stock Options Plan. Network, therefore, knew that these rights would permit it to exercise effective control from a minority share position; and

- (v) It is not unusual that Network should seek control of SignalEnergy considering it had considerable expertise in the oil and gas business and also needed to safeguard its investment. Network's initial investment of approximately \$8.7 million exceeded the \$5 million cash reserve remaining in SignalEnergy prior to recapitalization. Although additional value was ascribed to SignalEnergy's non-capital loss and research expenditure balances such value depended to a considerable degree on the avoidance of an acquisition of control.

Hence one of the main purposes of acquiring rights under the Subscription Agreement was to acquire control while avoiding the operation of the acquisition of control provisions. Therefore, subsection 256(8) is applicable.

Paragraph 251(5)(b) Rights Acquired:

As the facts below demonstrate, the combination of the rights under the Subscription Agreement and the shares acquired directly by Network provided the potential majority of voting shares sufficient for an acquisition of control.

- (i) Control of the Board: After the Subscription Agreement was signed and the appropriate shareholder motions passed, the Board of Directors of SignalEnergy was reduced to 5 directors. Under the agreement Network exercised the right to appoint 4 of them. Therefore, Network had immediate control of the Board of Directors. To underscore its new influence, Network pledged to "ensure that the directors of the Corporation hire a management team with oil and gas expertise and instruct such management team to prepare and implement a business plan for the Corporation."
- (ii) Ownership of Voting Shares: Network had immediate ownership of the following stocks:

Common Shares	---	100,732,500
<u>Preferred Shares</u>	---	<u>21,192,500</u>
Total Shares owned	---	121,925,000
Shares Owned by Other Parties		121,925,218

Number of Shares Required for Majority Ownership = 219

It follows that a conversion of the preferred shares held by Network, as provided for in the Articles of Amalgamation, would only leave Network 219 shares short of

majority (discounting the influence of shares held personally by SignalEnergy's directors who were also directors of Network).

- (iii) Articles of Amalgamation: The January 2000 Articles of Amalgamation, which was still in effect at the time of the Subscription Agreement, among other provisions, conferred on the Board of Directors the power to
- (a) issue common shares.
  - (b) exchange, convert or cancel preferred shares as stipulated in Article 3.5:

Article 3.5 had the following provision:

*“When preferred shares are outstanding, the Company may not, without obtaining the approval of those holding preferred shares in the manner provided below:*

*3.5.3.1 exchange, convert, reclassify or cancel, unless the Company purchases or redeems, in keeping with the Act or provisions hereof, all or a portion of the preferred shares.”*

- (iv) Stock Option Plan: As noted in the **Statement of Facts**, SignalEnergy had a Stock Option Plan, which permitted the Board to issue optional common shares to “*persons and entities*” according to its discretion. The Plan was amended simultaneously with the approval of the Subscription Agreement to provide for additional 12,192,500 common shares, bringing the total issuable shares to 26,460,543. The timing of the increase in optional shares provided Network with the opportunity to issue additional shares to itself, should the necessity arise, in order to maintain de jure control of SignalEnergy.

It is evident from the foregoing that the Subscription Agreement gave Network all the rights it needed to assume legal control of SignalEnergy in accordance with the provisions of paragraph 251(5)(b) and subsection 256(8).

#### TAX EFFECTS OF ACQUISITION OF CONTROL

##### (A). SUBSECTION 111(5) APPLIES

This subsection states in part:

**“Where, at any time, control of a corporation has been acquired by a person or group of persons, no amount in respect of its non-capital loss or farm loss for a taxation year ending before that time is deductible by**

**the corporation for a taxation year ending after that time and no amount in respect of its non-capital loss or farm loss for a taxation year ending after that time is deductible by the corporation for a taxation year ending before that time except that**

**(a) such portion of the corporation's non-capital loss or farm loss, as the case may be, for a taxation year ending before that time as may reasonably be regarded as its loss from carrying on a business and, where a business was carried on the corporation in that year, such portion of the non-capital loss as may reasonably be regarded as being in respect of an amount deductible under paragraph 110(1)(k) in computing its taxable income for the year is deductible by the corporation for a particular taxation year ending after that time**

**(i) only if that business was carried on by the corporation for profit or with a reasonable expectation of profit throughout the particular year, and**

**(ii) only to the extent of the total of the corporation's income for the particular year from that business and, where properties were sold, leased or rented or developed or services rendered in the course of carrying on that business before that time, from any other business substantially all the income of which was derived from the sale, leasing, rental or development, as the case may be, of similar properties or the rendering of similar services;....."**

In computing taxable income paragraph 111(1)(a) allows a taxpayer to deduct non-capital loss, defined in subsection 111(8) to include loss from business or property. These provisions allow a taxpayer to accumulate a pool of non-capital losses from various businesses which the taxpayer may use to reduce taxable income from other sources. However, there are restrictions on deductibility where an acquisition of control has occurred. Where a change of control has occurred subsection 111(5) imposes the following conditions:

- (a) Firstly, the corporation must engage in the same or similar business after a change of control as the pre-acquisition business that incurred the losses.
- (b) Secondly, the deduction is limited to the extent of the income accruing from this same or similar business.

(B) SUBSECTION 37(6.1) APPLIES

SR&ED POOLS: Paragraph 37(1)(h) and subsection 37(6.1), which govern the deductibility of scientific research and experimental development expense pools when an acquisition of control has occurred are parallel provisions to paragraph 111(1)(a) and subsection 111(5). Paragraph 37(1)(h) states:

**Where a taxpayer carried on a business in Canada in a taxation year, there may be deducted in computing the taxpayer's income from the business for the year such amount as the taxpayer claims not exceeding the amount, if any, by which the total of.....**

- (h) where the taxpayer is a corporation control of which has been acquired by a person or group of persons before the end of the year, the amount determined for the year under subsection (6.1) with respect to the corporation.**

Subsection 37 (6.1) provides as follows:

**“Where a taxpayer is a corporation control of which was last acquired by a person or group of persons at any time (in this subsection referred to as “that time”) before the end of a taxation year of the corporation, the amount determined for the purposes of paragraph (1)(h) for the year with respect to the corporation in respect of a business is the amount, if any, by which**

**(a) the amount, if any, by which**

**(i) the total of all amounts each of which is**

**(A) an expenditure described in paragraph (1)(a) or (c) that was made by the corporation before that time,**

**(B) the lesser of the amounts determined in respect of the corporation under subparagraphs (1)(b)(i) and (ii) immediately before that time, or**

**(C) an amount determined in respect of the corporation under paragraph (1)(c.1) for its taxation year ending immediately before that time**

**exceeds the total of all amounts each of which is**

**(ii) the total of all amounts determined in respect of the corporation under paragraphs (1)(d) to (g) for its taxation year ending immediately before that time, or**

**(iii) the amount deducted by virtue of subsection (1) in computing the corporation's income for its taxation year ending immediately before that time**

**exceeds**

**(b) the total of**

- (i) where the business to which the amounts described in clause (a)(i)(A), (B) or (C) may reasonably be considered to have been related was carried on by the corporation for profit or with a reasonable expectation of profit throughout the year, the total of
  - (A) the corporation's income for the year from the business before making any deduction under subsection (1), and
  - (B) where properties were sold, leased, rented or developed, or services were rendered, in the course of carrying on the business before that time, the corporation's income for the year, before making any deduction under subsection (1), from any other business substantially all the income of which was derived from the sale, leasing, rental or development, as the case may be, of similar properties or the rendering of similar services, and
- (ii) the total of all amounts each of which is an amount determined in respect of a preceding taxation year of the corporation that ended after that time equal to the lesser of
  - (A) the amount determined under subparagraph (i) with respect to the corporation in respect of the business for that preceding year, and
  - (B) the amount in respect of the business deducted by virtue of subsection (1) in computing the corporation's income for that preceding year.”

The explanatory notes on Bill C-139; S.C. 1988, clarify this provision:

*“Paragraph 37(1)(h) and subsection 37(6.1), taken together, restrict a corporation's ability to carry forward its pool of unused R&D deductions where there has been a change of control. In general terms, the undeducted portion of R&D expenditures made before control of a corporation is acquired may be carried forward to be deducted in computing its income for a subsequent taxation year only where the business to which the expenditures related is carried on by the corporation for profit or with a reasonable expectation of profit, and only to the extent of its income for the year (before making any deduction under subsection 37(1)) from that or a similar business.” [emphasis added]*

Hence similar to subsection 111(5), subsection 37(6.1) also demands that pre-change-of-control SR&ED expenses be applied only to income from the same or similar business.

## **(II) GENERAL ANTI-AVOIDANCE RULE**

In the event that it is determined that subsections 251(5), 256(8), 111(5), and/or 37(6.1) do not apply and all the tax pools are available to SignalEnergy, we are of the view that section 245 is applicable as an alternative position. The CRA considers the

transactions designed to retain access to the tax pools of SignalEnergy as avoidance transactions. An avoidance transaction is defined in subsection 245(3) of the Act:

- “An avoidance transaction means any transaction**
- (a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit; or**
- (b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.”**

The series of transactions consisted of the following:

- (a) The Subscription Agreement;
- (b) The Stock Option Plan Amendment;
- (e) Issue of treasury shares (common and preferred) to Network for cash consideration in the amount of \$8,677,750.

TAX BENEFIT:

The tax benefit lay in the current and future application of SignalEnergy’s tax pools which consisted of the following:

Non-capital Losses	\$18,472,000
Scientific Research Expenditures	33,733,000
Investment Tax Credit	<u>2,935,000</u>
Total Pool	\$55,140,000

The deductions taken to date are as follows:

<u>Year</u>	<u>Amount Deducted from Income</u>
2004	\$1,171,447
2005	\$1,837,535

### PRIMARY PURPOSE:

The parties had as their intention to retain access to the tax pools of SignalEnergy. The evidence exists in the proposal letter of August 4, 2003, where Network assured SignalEnergy that the recapitalization would be effected without an acquisition of control. For reasons outlined below there do not appear to be other compelling purposes for these transactions:

- (i) SignalEnergy had no residual tangible assets or infrastructure that could be of benefit to an Oil and Gas company. Prior to the avoidance transactions SignalEnergy was already in the process of liquidating its assets. Furthermore, a complete liquidation of existing assets was a condition of the Subscription Agreement;
- (ii) SignalEnergy's former management possessed no expertise in Oil and Gas. They had no experience to pass on to the new venture;
- (iii) The advantage of being already listed on the TSX was offset by SignalEnergy's history of poor stock performance. Even then SignalEnergy was required to meet the listing requirements for an Oil and Gas company.
- (iv) The purchase price for the common and preferred shares took into consideration the negotiated value of the loss pools available in SignalEnergy. This is in recognition of the expected benefits inherent in the existing tax pools.

The absence of other compelling reasons for the recapitalization suggests that the primary purpose of the reorganization was to take advantage of the existing tax pools of SignalEnergy.

### MISUSE and ABUSE:

The general policy governing corporate control is central to understanding whether there has been a misuse and abuse of relevant provisions of the Act in this case. Abuse is alleged because the control exercised by Network even if technically de facto, has the nature of de jure control in effect. Hence the CRA concludes that the circumvention of the restrictive provisions of subsections 37(6.1) and 111(5) is contrary to the object and spirit of the acquisition of control provisions.

Acquisition of Control: An often cited case which provides a test of de jure control is *Buckerfield's Ltd v. Minister of National Revenue, 64 DTC 5301*, where the court defined de jure control as

*“the right of control that rests in ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors.”*

This test has since been expanded by the Supreme Court of Canada in *Duha Printers (Western) Ltd v. Canada* [1968] 1 SCR 795, with emphasis on effective control:

*“However, it must be recognized at the outset that this test [of de jure control] is really an attempt to ascertain who is in effective control of the affairs and fortunes of the corporation. That is, although the directors generally have, by operation of the corporate law statute governing the corporation, the formal right to direct the management of the corporation, the majority shareholder enjoys the indirect exercise of this control through his or her ability to elect the board of directors. Thus, it is in reality the majority shareholder, not the directors per se, who is in effective control of the corporation.”*

The Supreme Court appears to have added to the test of de jure control, the criterion of effective control of a corporation. Simple majority ownership would no longer suffice since effective control could be undermined by “*a specific limitation on either the majority shareholder’s power to control the election of the board or the board’s power to manage the business and affairs of the company (as manifested in either the constating documents of the corporation, or in any “unanimous shareholder agreement” as defined in the relevant governing corporate legislation)*” – (*Duha Printers*).

There is no definition of “*constating documents*” in the Income Tax Act but Black’s Law Dictionary defines “*Constating Instruments of a Corporation*” as its charter, organic law, or grant of powers to it. Hence, constating documents may be interpreted to include documents incident to the incorporation of a company – the certificate of incorporation; articles of incorporation or amalgamation. Other documents, such as a unanimous shareholder agreement and legally binding contracts signed by the corporation are also relevant in determining de jure control. This expanded concept of control is an endorsement, by the Supreme Court, of an earlier Federal Court of Appeal conclusion in the same case:

*“that it is important to look at the legal position of the parties as displayed in the wider circumstances of the parties’ affairs ... True de jure control is just what it is stated to be, control at law. Any binding instrument, therefore, must be reckoned in the analysis if it affects voting rights.”*

Hence, it is important to consider all agreements entered into by the parties which are legally enforceable and affect effective control of the corporation.

In the case of SignalEnergy we made the following observations:

(i) Control of the Board: Immediately after the Subscription Agreement Network had control of the Board of Directors having exercised the right under the agreement to appoint four of the five directors.

(ii) Ownership of Voting Shares: As previously noted, Network acquired 121,925,000 out of 243,850,218 shares (common and preferred) representing 49.99 percent. The inclusion of preferred shares in the total is important since they could be converted into voting shares.

(iii) Stock Option Plan: This was amended to increase the optional shares by 12,192,500 to be granted to “persons and entities” at the discretion of the Board of Directors.

(iv) Shareholder Approval: The appointment of the directors was approved by 93% of the shareholders of SignalEnergy. The Management Proxy Circular for the Special General Meeting of shareholders held on November 6, 2003 contained the following statement:

*“According to applicable law and the Articles of the Company, such change in the composition of the Board members of the Company could be effected without shareholder approval. However, in accordance with SignalGene’s good corporate governance practices, and in view of the contemplated transformation of SignalGene into an oil and gas company and the extensive Management Change, it is proposed by the management of the Company that the vote of the Shareholders be sought regarding the election of the following five nominees as directors of the Company.”*

The above announcement implied that there was no requirement for a unanimous shareholder resolution on changes to the membership of the Board. The essence of the shareholder approval was to ensure that no obstacle would be expected from the shareholders to the enforcement of the Subscription Agreement. In other words, there would be no unanimous shareholder agreement limiting the exercise of effective control by Network.

Applying the Supreme Court’s expanded test of de jure control to SignalEnergy we reach the following conclusions:

- (a) Although Network owned a minority of the common (voting) shares (about 45%) it had the power to increase its equity to majority status by virtue of the conversion feature of the preferred shares and by exercising its effective control of the Board to issue optional shares to itself;
- (b) Network’s potential to own a majority of the voting shares was rooted in a legally binding agreement that gave it control of the Board of Directors; and

- (c) This legally binding agreement was endorsed by 93% of the shareholders, forestalling a unanimous shareholder agreement.
- (d) Therefore, Network had long-term control of SignalEnergy as a result of the Subscription Agreement.

Therefore, although the parties deliberately sought to technically avoid de jure control, they nevertheless fashioned a situation comparable to de jure control in object and spirit. On funds transfer forms for the transfer of money from Montreal to Calgary (following the continuance of SignalEnergy in Alberta) the reason for the transfer was stated as “*Change of Control following a Private Placement.*”

The *Westminster Principle* holds that a taxpayer is entitled to take advantage of the provisions of the Act to minimize tax payable. However subsection 245(4) imposes a limit on this entitlement:

**“Subsection (2) applies to a transaction only if it may reasonably be considered that the transaction**

**(a) would, if this Act were read without reference to this section, result directly or indirectly in a misuse of the provisions of any one or more of**

**(i) this Act,**

**(ii) the Income Tax Regulations,**

**(iii) the Income Tax Application Rules,**

**(iv) a tax treaty, or**

**(v) any other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under this Act or in determining any amount that is relevant for the purposes of that computation; or**

**(b) would result directly or indirectly in an abuse having regard to those provisions, other than this section, read as a whole.”**

This provision suggests that it is necessary to identify the provisions of the Act that have been misused or those that have been abused in the context of the Act read as a whole. In *OSFC Holdings Ltd. V. Her Majesty The Queen 2001 DTC 5471*, the court stated at para 59:

*“The first question is whether it may reasonably be considered that any of the avoidance transactions would result in a misuse of a specific provision of provisions of the Income Tax Act. If so, the tax benefit resulting from the series will be denied. If not, it is then necessary to determine whether it may reasonably be considered that any of the avoidance transactions would result in an abuse, having regard to the provisions of the Act other than section 245,*

*read as a whole. Upon a finding of abuse, the tax benefit resulting from the series will be denied.”*

It is not necessary, therefore, for specific provisions to be misused in order for an abuse of provisions of the Act to occur. In other words, the two-step approach suggested above is not inevitable. In *Her Majesty The Queen v. Canada Trustco Mortgage Company 2005 DTC 5523*, the court stated at paragraph 39:

*“Parliament could not have intended this two-step approach, which on its face raises the impossible question of how one can abuse the Act as a whole without misusing any of its provisions.”*

Hence, while a provision of the Act may not have been misused because its application was technically avoided, an abuse may still result from the avoidance. The transaction (or series of transactions) must be examined to determine if it agrees with or violates the underlying policy behind specific provisions (the object and spirit). This analysis must, however, centre on specific provisions and not be based, in the words of the court, on *“an overriding policy of the Income Tax Act that is not anchored in a textual, contextual and purposive interpretation of the specific provisions that are relied upon for the tax benefit.”* (*Canada Trusco*, para 42).

Commenting further on the standard proof required, the court stated that *“a finding of abuse is only warranted where the opposite conclusion – that the avoidance transaction was consistent with the object, spirit or purpose of the provisions of the Act that are relied on by the taxpayer – cannot be reasonably entertained. In other words, the abusive nature of the transaction must be clear.”* (*Canada Trustco*, para 62).

Parliament’s purpose in introducing the restrictions on the trading of losses is clearly stated in the Department of Finance Press Release of January 15, 1987, which announced the intention of the then Finance Minister, The Honourable Michael Wilson to limit the transfers of losses and other deductions between unrelated corporations. The statements are reproduced as follows:

*“The Minister said he has become aware of a variety of loss-trading or loss-offset transactions that are motivated largely or exclusively to avoid tax. For example, a vendor of property may use a loss corporation as an intermediary in a sale of business assets to a third party, avoiding the tax that would have been payable on a direct sale by offsetting his profit on the sale with the intermediary’s losses. As another example, a loss corporation with unutilized capital cost allowances or other deductions may acquire a shell corporation with a tax liability and transfer its assets to that corporation, thereby eliminating that corporation’s tax liability and, in certain circumstances, recovering its taxes paid in previous years.*

*The details of the changes are set out in the draft legislation and technical notes attached. The principal changes are described below:*

- (1) *New rules will require a corporation to end its taxation year immediately before the time of a change in control occurring after January 15, 1987, and will restrict the use of losses realized or accrued up to the end of that year.*
- (2) *New rules will treat depreciable and resource properties acquired by a corporation within the 12 months preceding a change in its control as having been acquired after control changes.*
- (3) *An anti-avoidance rule will prevent the transfer of accrued gains to loss corporations and other arm's length taxpayers with available deductions and tax credits. Similarly, a new anti-avoidance rule will prevent the transfer of accrued losses to arm's length parties. These rules apply to transfers after January 15, 1987.*
- (4) *New rules will limit the utilization of a corporation's unused research and development expenses following a change of control after January 15, 1987.*
- (5) *New rules will limit so called "seeding" and other tax avoidance transactions designed to circumvent the successor corporation rules for resource companies. These rules will be effective for acquisitions of property and changes of control after January 15, 1987.*

*Mr. Wilson noted: "As a matter of tax fairness, it is necessary to introduce legislation to make it clear that such transactions will not be accepted as a means of avoiding payment of taxes that are properly owing." In announcing the proposed changes the Minister confirmed his commitment to prevent the inappropriate transfer of unusable tax deductions and credits to unrelated taxpayers. The Minister also noted that as part of the consultation process respecting the draft legislation, the government will determine whether the provisions announced today should be extended to similar arrangements involving the use of partnerships and trusts established to circumvent the new rules."*

The above policy intention regarding the trading of losses has since come to fruition in various anti-avoidance provisions dealing with the application of losses after a change of control. The acquisition of control rules, in keeping with the intent of Parliament, aim to ensure that the benefits of non-capital losses and unused expenditure pools are not transferred to arms length parties except under prescribed conditions. Hence, when any change in circumstances result in long-term control an acquisition of control has occurred and the rules should apply. Long-term control without the application of the rules limiting the use of pre-acquisition tax pools would constitute an abuse. The provisions in play in this case are as follows:

- (1) Paragraph 251(5) (b) -- which deems control to have been transferred where certain rights are vested in an otherwise minority shareholder;
- (2) Subsection 256(8) -- which deems paragraph 251(5) (b) to apply (to other than a CCPC) where the purpose for of avoiding de jure control includes the circumvention of subsections 111(5) and 37(6.1);

- (3) *Subsection 111(5)* -- which restricts the application of pre-acquisition non-capital loss in circumstances where there has been an acquisition of control;
- (4) *Subsection 37(6.1)* -- which limits the application of pre-acquisition resource expenditures in circumstances where there has been an acquisition of control;
- (5) *Paragraph 111(1) (a)* -- which ordinarily permits the deduction of non-capital loss; and
- (6) *Paragraph 37(1) (h)* -- which ordinarily permits the deduction of resource expenditures.

Since we can show that effective control shifted to Network through direct acquisition of shares coupled with control of the Board, it is apparent that paragraph 111(1)(a) was misused since SignalEnergy invoked this provision to apply pre-acquisition-of-control non-capital loss. This is contrary to the object and spirit of the provision requiring

- (a) that the company continue in the same or similar business, and
- (b) that the non-capital loss be applied to income from the same or similar business.

The Department of Finance Technical Notes (June 30, 1988) stresses:

*“a transaction structured to take advantage of technical provisions of the Act but which would be inconsistent with the overall purpose of these provisions would be seen as a misuse of these provisions.”*

It is established both from jurisprudence and other external sources that the general policy underlying the loss provisions is that loss-trading between unrelated parties is not permitted. Professor Krishna explains at page 513 of The Fundamentals of Canadian Income Tax :

*“In the absence of consolidated corporate reporting for tax purposes, the Act applies stringent restrictions on the use of accumulated losses following a change of corporate control. The general thrust of these rules is to limit transfers of losses between unrelated corporate taxpayers and to discourage business arrangements that are nothing more than ‘loss-trading’ or ‘loss-offset’ transactions.”* (emphasis added)

Thus, except in the case of related corporations, loss transfer between corporations is prohibited, and the general policy sees a corporation under the control of different persons in the same light as unrelated corporations. This principle is further explained in *Silicon Graphics Limited v. Her Majesty the Queen*, 2002 DTC 7112, at paragraph 24:

*“Subsection 111(5) of the Income Tax Act restricted the claiming of losses by a corporation in circumstances where “control of the corporation has been acquired by a person or group of persons” that did not control the corporation when the losses were incurred.”*

In OSFC Holdings Ltd. 2001 DTC 5471 (FCA), the court also explicitly affirmed the general policy of prohibition of loss-trading when it stated at paragraph 92 of this same case:

*“The obviously limited nature of the exception allowing the transfer of losses appears to underscore the general policy that loss trading for tax purposes is not permitted.”*

In this context it is pertinent to draw your attention to excerpts from CRA *Income Tax Technical News no. 34* [April 27, 2006] which discusses CRA policy on the matter of loss trading with particular reference to “tech wrecks”:

#### **Sale of Tax Losses**

.....We understand that, in recent years, several public transactions, [sometimes euphemistically referred to as corporate “reinventions”, “restart” transactions, or “tech-wreck restructurings”] have been designed to exploit this deficiency. For example, assume that Lossco is a widely held, publicly traded corporation. Lossco is insolvent and has ceased to carry on its business. Lossco has substantial unused non-capital losses. Profitco is an unrelated corporation that carries on a profitable business that is fundamentally different from the former Lossco business. Profitco would like to avail itself of the benefit of Lossco's tax losses.....

#### **CRA comments on acquisition of control as follows:**

.....if Profitco together with persons that *act in concert* or have some *common connection* [bold emphasis added] with Profitco hold a majority of the voting shares of Lossco, Profitco and those persons *could be considered to be a group of persons that has acquired de jure control of Lossco* [bold emphasis added].

**Further, in ITTN No. 34 CRA responds that The GAAR may apply to such “Tech Wreck” arrangements:**

.....The Federal Court of Appeal in *OSFC Holdings Ltd. v. R.*<sup>7</sup> concluded that the general policy of the Act is against the trading of non-capital losses by corporations, subject to specific limited circumstances. We are of the view that transactions that are designed to allow a person to acquire a very substantial economic interest in a corporation (for example, perhaps by having both *de facto* control and a substantial equity interest in the corporation) and to benefit from the corporation's tax losses, without being subjected to the “same or similar” business restrictions in subsection 111(5), could reasonably be considered to result in an abuse having regard to the general policy of the Act against the trading of non-capital losses by unrelated corporations.

Hence, even if a technical acquisition of control was avoided by the parties, the fact remains, as has been demonstrated, that effective or long-term control of SignalEnergy shifted to Network which was a party to the incurrence of the losses. Loss-trading was also evident because a value of 5.2 cents to the dollar, was assigned to the tax pool after some negotiation. Even the self-evident presumption that business loss has value was recognized by the court in OSFC Holdings Ltd. At paragraph 86 of the court decision it stated:

*“Where a business incurs a loss, that loss may have value for income tax purposes. Paragraph 111(1)(a) of the Income Tax Act permits the carry-back and carry-forward of losses for a specified number of years whereby the losses may be offset against the profits in those years..... . Therefore, to a taxpayer that has been or will be profitable, it is liability for income tax that gives a business loss its value.”*

The 5.2 cents to the dollar offered by Network to SignalEnergy while significant in and off itself, pales in comparison with the potential tax savings from application of the tax pools. That means a substantial benefit of applying the tax pools would be enjoyed by a new group of controlling shareholders who did not participate in their incurrence. Thus by technically circumventing subsection 111(5) and 37(6.1) the result of the avoidance transactions was offensive to the object and spirit of the loss provisions.

**Summary of GAAR Argument:**

Paragraph 251(5)(b) seeks to broaden the concept of a control. It considers control not merely from shareholdings but by ascertaining who has effective control of a corporation by virtue of rights conferred by a contract or other documents. The object and spirit of this provision demands that where effective control occurs, whether by virtue of majority ownership or by unexercised rights available to a shareholder, the corporation is bound by the same restrictions with regard to pre-change-of-control tax balances. As previously noted, the general policy regarding losses is that loss-trading is prohibited. Furthermore, although paragraph 251(5)(b) applies to Canadian Controlled Private Corporations, subsection 256(8) extends its [251(5)(b)] application to public corporations where one of the main purposes of acquiring paragraph 251(5)(b) rights is to circumvent subsections 111(5) and 37(6.1) and other restrictive provisions. The avoidance transactions conferred rights on Network similar to those referred to in paragraph 251(5)(b) by virtue of the Subscription Agreement, Stock Option Plan and Shareholder approvals. By permitting SignalEnergy to retain access to tax pools generated before Network assumed control, the avoidance transactions circumvented the restrictions of subsections 111(5) and 37(6.1) as well as subsection 256(8) and paragraph 251(5)(b), thus violating the object and spirit of the control provisions.

## GAAR REMEDY

The series of transactions including the Subscription Agreement and Stock Options Plan constitute avoidance transactions the primary purpose of which was to retain access to tax pools accumulated by SignalEnergy from its previous business in pharmaceutical research. In structuring the transactions to technically avoid an acquisition of control by Network, the parties circumvented the restrictions imposed by of subsections 111(5) and 37(6.1). These transactions were abusive because they produced results contrary to the object and spirit of the loss provisions. Subsection 245(2) provides that

**“Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.”**

In accordance with this subsection, SignalEnergy should be denied the tax benefits resulting from the avoidance transactions.

## CONCLUSION:

Pursuant to both the technical arguments and GAAR CRA proposes as follows:

- (1) To deny the deduction of \$1,171,447 in non-capital loss of prior years in 2004;
- (2) To deny the deduction of \$1,837,535 in non-capital loss of prior years in 2005;
- (3) To deny future deductions from the non-capital loss and SR&ED pools except in accordance with the requirements of subsections 111(5) and 37(6.1), i.e.
  - (a) the corporation reverts to the pharmaceutical or similar business; and
  - (b) deductions from the tax pools are applicable only to income from this same or similar business

We will delay the processing of this proposal for thirty (30) days from the date of this letter to allow you the opportunity to make any written representations that you feel are necessary. If the CRA does not receive a response from you within the thirty-day period, the Agency will reassess your Income Tax return as stated above. If you have any questions please contact Ambrose Okoro at (403) 508-5732.

Yours truly,



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