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March 26, 2010

WITHOUT PREJUDICE

Canada Revenue Agency
Aggressive Tax Planning
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Calgary, AB T2G 0L1

DELIVERED

***Attention: Mr. Lawrence, Manager, Aggressive Tax Planning
Mr. Okoro, Aggressive Tax Planning***

Dear Sirs:

Re: Proposed Reassessment of Signal Energy Inc.'s 2004 and 2005 Taxation Years

We represent Fortress Energy Inc., the successor by amalgamation to Signal Energy Inc. (“**Signal**”) in connection with the review by the Canada Revenue Agency (“**CRA**”) of certain transactions involving Signal and its predecessor, SignalGene Inc.,¹ and the resulting proposed reassessments. We are writing in response to your letter to Signal dated January 20, 2010 (“**Proposal Letter**”).² Please find enclosed Form RC 59 authorizing our firm to deal with the CRA on behalf of Signal.

The Proposal Letter states that you would appreciate being informed of any errors or omissions in the “Statement of Fact” contained therein. To that end, we have summarized our

¹ Throughout this letter, Signal refers to SignalGene Inc., Signal Energy Inc. or Fortress Energy Inc. as the case may be.

² A copy of the Proposal Letter is included at Tab A of the binder of documents accompanying this submission (“**Exhibit Binder**”).

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understanding of the facts below. Our submissions herein are based on our understanding of the facts, the provisions of the *Income Tax Act* (Canada) (“**Act**”) and the regulations promulgated thereunder (“**Regulations**”) in effect at the relevant time, existing common law and our understanding of the current administrative practices of the CRA. All statutory references herein are to the Act unless otherwise specified.

I. FACTS

1. Network Capital Inc. (“**Network**”) was throughout the relevant time a “taxable Canadian corporation” and a “private corporation” within the meaning of subsection 89(1).
2. Network carried on the business of attracting investment capital from groups of investors and investing such capital on behalf of investors.
3. Network Portfolio Management Inc. (“**NPMI**”) was throughout the relevant time a wholly-owned subsidiary of Network and a “taxable Canadian corporation” and a “private corporation” within the meaning of subsection 89(1). NPMI was a registered portfolio manager within the meaning of the applicable securities legislation.
4. Signal was throughout the relevant time a “taxable Canadian corporation” and a “public corporation” within the meaning of subsection 89(1).
5. At all relevant times and pursuant to the Articles of Amalgamation³ of Signal dated January 1, 2000, Signal’s authorized share capital included one class of common shares (“**Common Shares**”), which class of shares entitled the holders thereof to one vote per share at, *inter alia*, meetings of the holders of shares of Signal (“**Signal Shareholders**”) including meetings held to elect the directors of Signal (“**Signal Directors**”). The holders of Common Shares also were entitled to dividends as and when declared by the Signal Directors and, subject to the rights of holders of Preferred Shares (defined below), to receive a *pro-rata* share of the assets of Signal upon the dissolution of that corporation. The Common Shares have been listed for trading on The Toronto Stock Exchange since May, 1996.
6. The authorized share capital of Signal also included one class of preferred shares (“**Preferred Shares**”), which class of shares provided that the Signal Directors could (i) cause Preferred Shares to be issued in one or more series and (ii) determine the rights, privileges, conditions and restrictions that attach to each series of Preferred Shares by adopting a by-law that specified such terms.

³ The Articles of Amalgamation are at Tab B of the Exhibit Binder.

7. The Articles of Amalgamation provided the Signal Directors with broad discretion over the rights that could be attached to any particular series of Preferred Shares. In the absence of an express exercise of such discretion to provide otherwise, the default position was that the Preferred Shares did not entitle the holder thereof to any votes at a meeting of the Signal Shareholders.⁴
8. The Preferred Shares ranked ahead of the Common Shares on the liquidation and dissolution of Signal and the holders thereof were entitled to receive amounts owing to them, including declared but unpaid dividends, before any amount was paid to holders of Common Shares.⁵
9. Once any series of Preferred Shares was authorized by the Signal Directors and while such Preferred Shares were outstanding, Signal was prohibited from unilaterally taking steps that could alter the economic rights applicable to such Preferred Shares. More specifically, and as outlined in paragraph 3.5 of the Articles of Amalgamation, the Signal Directors were generally prohibited from somehow changing the rights and conditions attaching to the Preferred Shares or somehow causing shares of another class to have rights or conditions equal to, or greater than, those of the Preferred Shares without the approval of the holders of the Preferred Shares. Notwithstanding the general theme of paragraph 3.5, the meaning of subparagraph 3.5.3. is unclear, and reads as follows:

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

...

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

In particular, it is unclear what the words “exchange, convert reclassify or cancel” refer to. Presumably these words refer to taking such action with other classes of shares, since such action can only be undertaken if all or a portion of the Preferred Shares are repurchased or redeemed by Signal.

10. On November 6, 2003, and at all relevant times prior to that date, there were 121,925,218 Common Shares outstanding, and such shares were owned by a diverse group of public shareholders (“**Existing Signal Shareholders**”). Two of the Existing Signal Shareholders held slightly more than 10% of the outstanding Common Shares and all other Existing Signal Shareholders owned less than 10%.

⁴ See paragraph 3.2 of the Articles of Amalgamation.

⁵ See paragraphs 3.3 and 3.4 of the Articles of Amalgamation.

11. At all relevant times the Common Shares were listed for trading on the Toronto Stock Exchange (“**TSX**”).
12. On August 22, 2003, after a series of negotiations over various details, including the price per share and the number of Common Shares and Preferred Shares to be acquired, Network entered into a subscription agreement (“**Subscription Agreement**”)⁶ with Signal whereby Network agreed to subscribe for 100,732,500 Common Shares and 21,192,500 Preferred Shares and to pay \$0.071 per share as consideration therefor. The agreed price per share took into account cash and temporary investments in the aggregate amount of approximately \$5.9 million and certain tax balances.
13. Network’s obligation to purchase shares from Signal under the Subscription Agreement was subject to a number of conditions precedent set out in Section 7 of the Subscription Agreement. These conditions precedent included:
 - (a) Signal creating a series of Preferred Shares that had specific terms and conditions and which expressly did not entitle the holder thereof to any vote at, *inter alia*, a meeting to elect the Signal Directors (“**Non-Voting Preferred Shares**”);
 - (b) the approval by the Existing Signal Shareholders of the subscription by Network under the Subscription Agreement;
 - (c) the resignation of three of the existing Signal Directors;
 - (d) the election, by the Existing Signal Shareholders, of four persons to be nominated by Network; and
 - (e) the appointment, by the Signal Directors, of Cameron Bailey as Chief Executive Officer of Signal.
14. One of the covenants provided by Network in the Subscription Agreement was that, after it subscribed for shares of Signal, it would use “all reasonable commercial efforts” to cause the Signal Directors to hire a management team with expertise in oil and gas exploration and development.⁷
15. On November 3, 2003, Network advised Signal that NPMI, rather than Network, would subscribe for the Common Shares and the Preferred Shares to be issued

⁶ A copy of the Subscription Agreement is included at Tab C of the Exhibit Binder.

⁷ See Section 3(v) of the Subscription Agreement.

under the Subscription Agreement and that such shares would be held on behalf of and allocated to the accounts of, specific investors.⁸

16. On November 6, 2003, Signal held a meeting of Existing Signal Shareholders. At this meeting, the Existing Signal Shareholders approved: (i) the issuance of Common Shares and Preferred Shares pursuant to the Subscription Agreement; (ii) the appointment of the persons nominated by Network to the board of directors of Signal; (iii) the change of the name of the corporation from SignalGene Inc. to Signal Energy Inc.; and (iv) an increase to the number of shares that could be issued under Signal's stock option plan ("**Signal Option Plan**"). Only the Existing Signal Shareholders were entitled to vote to approve the foregoing.
17. The stated purpose of the Signal Option Plan was, and continues to be, "to attract and retain skilled directors, senior officers, other officers, employees and consultants..."⁹ The number of shares that could be issued under the Stock Option Plan was increased to allow Signal to attract a new oil and gas management team and to keep the total number of shares that could be issued under the plan equal to approximately 10% of the total number of Common Shares that would be outstanding after the shares were issued under the Subscription Agreement, which is consistent with our understanding of the industry practice for publicly traded corporations. There were no other amendments made to the Signal Option Plan on November 6, 2003 (*i.e.*, contrary to the implication in the Proposed Letter, the Existing Signal Shareholders did not approve the addition of the ability to grant options to "entities"; such ability was contained in the Signal Option Plan prior to this date).¹⁰ Consistent with the stated purpose of the Signal Option Plan, since November 6, 2003, options under that plan have been granted only to directors, officers and other employees of Signal. Of particular note is that no options have been granted to Network or NPMI, nor is there any evidence or indication of there being any possibility or intention for such a grant to occur.
18. On November 20, 2003, the Signal Directors approved a resolution authorizing the adoption of a by-law which authorized the creation of the series of Preferred Shares that would constitute the Non-Voting Preferred Shares with the following stated rights, privileges, conditions and restrictions:

⁸ See the document titled "Undertaking" and Schedule "A" thereto, a copy of which is included at Tab D of the Exhibit Binder.

⁹ See page 8 of the Management Proxy Circular ("**Circular**") of Signal dated November 6, 2003, a copy of which is included at Tab E of the Exhibit Binder.

¹⁰ For the full text of the resolution the Existing Signal Shareholders approved on November 6, 2003 with respect to the Signal Option Plan, see Tab F of the Exhibit Binder. For the full text of the Signal Option Plan as it read immediately prior to being amended on November 6, 2003, see Tab G of the Exhibit Binder.

(a) Dividends: The holders of Preferred Shares, Series 1 shall only be entitled to receive on a share for share basis the same dividend declared on the Common Shares of the Company, if and when such dividend is declared. Such dividend, when declared, shall be paid in preference over the dividend declared on the Common Shares of the Company and over any dividends declared on shares ranking junior to the Preferred Shares, Series 1.

(b) Voting: Except as otherwise required by law, the holders of the Preferred Shares, Series 1 shall not be entitled as such to receive notice of or to attend any meeting of the shareholders of the Company or to vote at any such meeting.

(c) Dissolution: The Preferred Shares, Series 1 shall be entitled to preference for an amount equal to the price paid per share upon issuance of the Preferred Shares, Series 1 and, if any, the dividends declared and unpaid over the Common Shares of the Company and over any other shares ranking junior to the Preferred Shares, Series 1 with respect to payment of dividends and distribution of assets in the event of liquidation, dissolution or winding-up of the Company, whether voluntary or involuntary, or any other distribution of the assets of the Company among its shareholders for the purpose of winding-up its affairs.

19. On November 20, 2002, pursuant to the Subscription Agreement, NPMI subscribed for and was issued 100,732,500 Common Shares and paid the subscription price of \$0.71 per share, for an aggregate subscription price of \$7,152,007.50. After this subscription by NPMI, there were 222,657,718 Common Shares outstanding, of which NPMI owned 45.24%, all of which were allocated to the accounts of a specified group of investors.
20. On November 20, 2003, NPMI subscribed for and was issued 21,192,500 Non-Voting Preferred Shares and paid a subscription price of \$0.71 per share, for an aggregate subscription price of \$1,504,667.50. All Non-Voting Preferred Shares also were allocated to the accounts of specific investors.
21. On January 20, 2010, the CRA mailed the Proposal Letter to Signal. The Proposal Letter states that the CRA is proposing to reassess Signal to deny the deduction of \$1,171,447 and \$1,837,535 of non-capital losses claimed by Signal in computing its taxable income for purposes of the Act for its 2004 and 2005 taxation years, respectively. The Proposal Letter states that the CRA's view is that subsection 111(5) and subsection 37(6.1) apply to preclude the deduction by Signal of any non-capital loss balances or scientific research and experimental development ("SR&ED") expense balances that existed prior to the time NPMI acquired the Common Shares and the Preferred Shares under the Subscription Agreement. The Proposal Letter also states that, in the alternative, the CRA's view is that the general anti-avoidance rule in subsection 245(2) ("GAAR") should apply to preclude the deduction of any such amounts.
22. The Proposal Letter also indicates that the CRA will deny any deductions claimed by Signal in its 2006 and subsequent taxation years in respect of its non-

capital losses balance on November 7, 2003 or any SR&ED expenses incurred before such date.

II. SUMMARY OF SUBMISSIONS

The Act contains very specific rules that limit a corporation's ability to deduct certain tax balances, including non-capital losses and SR&ED expenses, after control of the corporation has been acquired by an unrelated person. Those rules are intended to prevent profitable corporations from simply "purchasing" tax losses to reduce their Canadian income tax liability. However, these carefully crafted rules do not preclude the deduction of such tax balances after *any* change in the shareholders of a corporation, but *only* when such change has resulted in a person or group of persons acquiring control of the corporation. This distinction is a critical element of the underlying tax policy, as this key distinction allows a corporation, and its shareholders, to take on the risk and challenges of a business venture with the knowledge that, if that initial business is not successful, provided control of the corporation is not acquired, additional capital can be raised and another business commenced without losing the ability to deduct the losses generated with the initial investment. This latter situation is precisely what happened here. Signal, and its investors, had invested material capital in an effort to develop new pharmaceutical technology. When it became apparent to Signal that such business was not going to be successful, Signal's management sought new investors to provide it with additional capital to allow it to change direction and invest in an oil and gas business. Network, through NPMI, agreed to assist in arranging such additional investment. Such additional investment came from a diverse group of new investors and the Existing Signal Shareholders remained as shareholders of Signal. The series of transactions at issue here amounted to a "recapitalization" of Signal rather than the purchase of the tax losses and, therefore, were exactly the type of transactions the detailed provisions in the Act are intended to facilitate.

Specifically, no person or group of persons acquired control of Signal and, therefore, subsections 111(5) and 37(6.1) do not apply to preclude the deduction of any amounts by Signal. For the purposes of these provisions, the case law is quite clear that control means ownership of that number of shares as carry with them the right to elect the board of directors. In the current circumstances, this would require ownership of greater than 50% of the Common Shares. Under the Subscription Agreement only 45.24% of the Common Shares were acquired and, moreover, such shares were allocated to the accounts of a diverse group of investors. The acquisition of the Common Shares and the Non-Voting Preferred Shares did not result in an acquisition of *de jure* control of Signal. It is important to note that the Existing Signal Shareholders did not sell their shares to Network, NPMI or to any other person but rather continued to own Common Shares of Signal. Moreover, neither Network nor NPMI acquired any rights described in paragraph 251(5)(b) and, therefore, subsection 256(8) does not apply to deem control of Signal to have been acquired.

Not only was there no deemed or actual acquisition of control of Signal, but the GAAR cannot apply to alter this result. That is, because there was no “tax benefit”, no “avoidance transaction” and no “misuse or abuse” of the provisions of the Act, the GAAR does not apply. In particular, we are unaware of any case law that states that the recapitalization of a corporation is grounds for the application of the GAAR.

III. DETAILED SUBMISSION

1. Subsections 111(5) and 37(6.1) Do Not Apply to Signal Because Network Did Not Acquire Control of Signal

(a) Overview

The Act contains very specific rules which are intended to restrict the utilization of tax losses or deductions in certain circumstances. In basic terms, the application of these specific rules turns on whether there has been an acquisition of control. These rules do not restrict the utilization of tax losses or deductions where the subject corporation attracts new investors, management, assets or capital. The sole focus of these specific rules is on whether there has been an acquisition of control. Parliament has carefully crafted a scheme of rules in the Act to allow two competing policy objectives to be achieved. In short, Parliament has introduced rules to limit the ability of a corporation to utilize its losses following an acquisition of control but, where no acquisition of control has occurred, Parliament has left intact the ability for a corporation to utilize its losses and other deductions from one business when it attracts new investment and commences a new business. If Parliament had intended a different policy result it would have been relatively easy for it to tailor the specific rules to achieve such a different result.

Subsections 111(5) and 37(6.1) are two of the provisions used to achieve the policy objective of restricting the use of tax losses and deductions after an acquisition of control. However, recognizing that if the application of these two provisions was overly broad the second policy objective of allowing corporations to recapitalize would be precluded, Parliament carefully limited the situations to which subsections 111(5) and 37(6.1) would apply.

Subsection 111(5) only applies to limit a corporation’s ability to deduct any amount in respect of, *inter alia*, non-capital business losses, where two distinct fundamental conditions are satisfied: (i) *de jure* control of a corporation must have been acquired by a person or group of persons, and (ii) the income earned by the corporation subsequent to the acquisition of control must not be earned from the same business that gave rise to the losses prior to the acquisition of control. Subsection 37(6.1) imposes similar restrictions in respect of a corporation’s ability to deduct amounts

in respect of its SR&ED expenditures. Where, as here, the specific requirements of these limiting provisions are not satisfied, there is no restriction on a corporation's ability to deduct amounts in respect of its non-capital losses or SR&ED expenditures. Moreover, and consistent with the second policy objective described above, no provision in the Act imposes any restriction on a corporation's ability to claim a deduction in respect of either non-capital losses or SR&ED expenditures simply because the corporation has completed an equity financing and issued more of its shares to new investors.

The relevant legal principles are reviewed below and then applied to the facts at hand to clearly demonstrate that there was no actual or deemed acquisition of control of Signal.

(b) Control Means *De Jure* Control

The relevant case law, including a decision by the Supreme Court of Canada, has established that a reference in the Act to "control" of a corporation means "*de jure* control."¹¹ Parliament has accepted that *de jure* control is the standard test for control under the Act. This acceptance was demonstrated by the enactment of subsection 256(5.1) in 1988, which subsection provided Parliament with the "tool" it needed to impose a lower threshold for "control" (*i.e.*, control in fact as compared to legal control) in those limited circumstances it considered such a lower standard was appropriate. By expressly requiring that the words "directly or indirectly in any manner whatever" be included in any provision where such lower standard was to apply Parliament provided a "bright line" test to distinguish circumstances where *de facto* control was sufficient from where, as under the two provisions at issue here, *de jure* control is required.

(c) *De jure* Control means the Power to Elect the Directors

De jure control refers to the "right of control that rests in ownership of such number of shares as carries with it the right to a majority of votes in the election of the board of directors" (see *Buckerfield's Ltd. v. M.N.R.*).¹² This test was affirmed in *Duha* where the Supreme Court of Canada held

¹¹ *Duha Printers (Western) Ltd. v. R.*, [1998] 3 C.T.C. 303 (S.C.C.) at para. 25, where the Court held that "[i]t has been well recognized that, under the *Income Tax Act*, 'control' of a corporation normally refers to *de jure* control and not *de facto* control." See also *Miller Estate v. R.*, [2002] 1 C.T.C. 2555 (T.C.C.), at para. 13 where the court held "[c]ontrol' without any modification such as 'directly or indirectly in any manner whatever' and without the expansion of that expression contained in subsection 256(5.1) of the I.T.A. means simply *de jure* control."

¹² *Buckerfields Ltd. et al v. M.N.R.*, 1964 C.T.C. 504 (Ex. Ct.).

that this inquiry is based on a determination of who is in “effective control” of a corporation:¹³

Thus, *de jure* control has emerged as the Canadian standard, with the test for such control generally accepted to be whether the controlling party enjoys, by virtue of its shareholdings, the ability to elect the majority of the board of directors. However, it must be recognized at the outset that this test 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. This was expressly recognized by Jackett P. when setting out the test in *Buckerfield's*...

[Emphasis added.]

It must be noted that the Supreme Court’s reference to “effective control” of the corporation in no way lowers the relevant standard of control to one of *de facto* control. To the contrary, in *Duha* the Supreme Court confirms that control rests with the majority shareholder as was “expressly recognized” by the Exchequer Court in *Buckerfield's*. What the Supreme Court instead states in *Duha* is that, in those very limited circumstances where a corporation’s constating documents or a unanimous shareholders agreement contain legally binding restrictions on either the ability of a majority shareholder to elect the board of directors or on the ability of the board of directors to manage the affairs of the corporation, determining who does have legal control of the corporation may require further investigation. In those limited situations where such a restriction exists, *de jure* control may be located elsewhere than in the hands of the owner of shares having the majority of votes to elect the board of directors. Such limitations do not exist in the case of Signal.

More specifically, *Duha* applied the following reasoning: *de jure* control will be located outside of a person that holds greater than 50% of the voting shares only in limited circumstances.¹⁴ Moreover, it is important to note that a court is limited to examining a very narrowly specified set of documents in determining *de jure* control, being a corporation’s

¹³ See *Duha, supra*, at para. 36.

¹⁴ See, for example, paragraphs 3(c) and 5 in the summary of principles on *de jure* control in *Duha*, set out below. However, we note that this item may only be relevant in situations where a majority shareholder exists, which is not the case here. In any event, a general review of case law indicates that only infrequently is the general rule in *Buckerfield's* not applied to determine *de jure* control.

governing statute, share register, and any unanimous shareholders' agreement. Other external documents may not be examined.¹⁵

To reiterate, the principles applicable in determining *de jure* control of a corporation, as articulated by the Supreme Court of Canada in *Duha* at paragraph 85, are as follows:

(1) Section 111(5) of the *Income Tax Act* contemplates *de jure*, not *de facto*, control.

(2) The general test for *de jure* control is that enunciated in Buckerfield's, *supra*: whether the majority shareholder enjoys "effective control" over the "affairs and fortunes" of the corporation, as manifested 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".

(3) To determine whether such "effective control" exists, one must consider:

(a) the corporation's governing statute;

(b) the share register of the corporation; and

(c) any specific or unique 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:

(i) the constating documents of the corporation; or

(ii) any unanimous shareholder agreement.

(4) Documents other than the share register, the constating documents, and any unanimous shareholder agreement are not generally to be considered for this purpose.

(5) If there exists any such limitation as contemplated by item 3(c), the majority shareholder may nonetheless possess *de jure* control, unless there remains no other way for that shareholder to exercise "effective control" over the affairs and fortunes of the corporation in a manner analogous or equivalent to the *Buckerfield's* test.

[Emphasis added.]

¹⁵ See *Duha* at paras. 55 and 71.

(d) **Subsection 256(8) Does Not Apply Unless a Paragraph 251(5)(b) Right Exists**

In a further effort to achieve the two policy objectives described above, Parliament enacted a specific anti-avoidance provision in subsection 256(8) which essentially provides that a person who has a right to acquire shares of a corporation will be treated, for purposes of determining whether control of the corporation was acquired, as if they had exercised that right and acquired the shares. This provision prevents a party from “technically” avoiding an acquisition of control by acquiring less than 50% of the voting of shares while simultaneously acquiring an option or right that, if exercised, would give such person ownership of greater than 50% of the voting shares. However, as with subsections 111(5) and 37(6.1), Parliament was required to balance competing policy objectives when enacting subsection 256(8) and, therefore, it is critical that the actual words of this provision be analyzed very closely to determine if it applies in any particular circumstance.

Subsection 256(8) reads 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),

...

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.]

To summarize, for these purposes, subsection 256(8) only will apply if (i) a taxpayer acquires a right in respect of a share referred to in paragraph 251(5)(b) (“**251(5)(b) Right**”), and (ii) it is reasonable to consider that one of the main purposes of acquiring the 251(5)(b) Right is to, *inter alia*,

avoid any limitation on the deductibility of any non-capital loss or SR&ED expense (*e.g.*, by virtue of the application of subsections 37(6.1) or 111(5) on an acquisition of control) (“**Main Purpose Requirement**”).

Only in those circumstances where both of the conditions for the application of subsection 256(8) are satisfied will the taxpayer be deemed to have immediately exercised the 251(5)(b) Right. Even then, it is only if the number of 251(5)(b) Rights that are deemed to be exercised by the taxpayer (or a group of persons that includes the taxpayer) cause the taxpayer to be deemed to own shares that carry greater than 50% of the voting rights to elect the corporation’s board of directors that the deeming rule in subsection 256(8) will cause the taxpayer to have acquired control of a corporation for purposes of subsections 111(5) and 37(6.1).

However, if, as here, no 251(5)(b) Right exists, subsection 256(8) cannot apply.

(e) Rights Referred to in Paragraph 251(5)(b)

Paragraph 251(5)(b) sets out the different types of 251(5)(b) Rights, and reads as follows:

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

...

(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, ...

(ii) to cause a corporation to redeem, acquire or cancel any shares of its capital stock owned by other shareholders of the corporation, ...

(iii) to, or to acquire or control, voting rights in respect of shares of the capital stock of a corporation, ... 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 preamble of paragraph 251(5)(b) refers to a “right” in very broad terms, referring to a right that a person has “under a contract, in equity or

otherwise, either immediately or in the future and either absolutely or contingently”. Notwithstanding this broad language, it is still necessary to identify a “right” of the person in question. That is, the person in question must have the ability to, assuming all contingencies are satisfied, go to a court of law and have the court order performance of some action or the payment of damages if such rights were breached. A “right” must be distinguished from a mere possibility. A person does not have a “right” to a share simply because he could decide to purchase such share on the open market or because he might be able to acquire a share from treasury if the corporation undertook to issue new equity. However, he may acquire a “right” to such share if he enters into a binding contract for its purchase or he acquires a property that confers on him the legal ability to unilaterally require the transfer or issuance to him of a share.

(f) There Was No Actual or Deemed Acquisition of Control of Signal

It is clear from the facts at hand that (1) neither Network nor NPMI acquired greater than 50% of the Common Shares of Signal, and (2) the Non-Voting Preferred Shares did not entitle NPMI to any votes at a meeting of Signal Shareholders to elect the Signal Directors. As a starting point, the Subscription Agreement resulted in Commons Shares being issued that, after issuance, represented significantly less than 50% of all Common Shares. Additionally, the Common Shares were acquired by NPMI as a portfolio manager and allocated to the accounts of a broad and diverse group of investors and not by NPMI for its own account.

Moreover, there is nothing in the constating documents of Signal that restricts the ability of the holders of Common Shares to elect the Signal Directors or the ability of the board of directors from managing the affairs of the corporation. Accordingly, as a matter of fact and law, NPMI did not acquire *de jure* control of Signal.

Moreover, neither Network nor NPMI acquired any right referred to in paragraph 251(5)(b) in respect of a share of Signal that, if such right were deemed to be exercised by NPMI, would cause it to acquire control of Signal. As described above, a 251(5)(b) Right can include any right to acquire shares of a corporation, even if such right is contingent. In the current circumstances, Network’s (and subsequently NPMI’s) rights to acquire Common Shares and Non-Voting Preferred Shares under the Subscription Agreement likely constituted 251(5)(b) Rights. However, since the actual exercise of the rights under the Subscription Agreement by NPMI on November 20, 2003 did not cause NPMI to acquire *de jure* control of Signal, it is impossible that the deemed exercise of the exact same rights could somehow cause Network or NPMI to acquire *de jure* control of Signal.

Other than the rights to acquire Common Shares and Non-Voting Preferred Shares contained in the Subscription Agreement, neither Network nor NPMI acquired any right referred to in paragraph 251(5)(b). More specifically, neither Network nor NPMI had any right to:

- (i) acquire any specific shares of Signal or control the voting rights in respect of any such shares;
- (ii) cause Signal to redeem, acquire or cancel any of its shares;
- (iii) acquire or control voting rights of any Common Shares; or
- (iv) to cause the reduction in the voting rights attached to any Common Shares.

To summarize, other than the rights in the Subscription Agreement (which rights did not cause an acquisition of control even when actually exercised), neither Network nor NPMI acquired any right referred to in paragraph 251(5)(b) in respect of a share of Signal and, therefore, subsection 256(8) has no application to the facts at hand.

(g) Specific Responses to the Proposal Letter

(i) Overview

While the Proposal Letter provides a useful summary of the relevant law which, generally, is consistent with the legal principles discussed and summarized above, it appears that there was some misunderstanding of the factual circumstances that caused the legal principles to be incorrectly applied. These errors led to the erroneous conclusion that Network acquired control of Signal. In an effort to correct the factual misunderstanding, each of these situations will be reviewed in turn.

(ii) Network Did Not Have the Right to Appoint Signal Directors

The Proposal Letter states, at page 12, that the Subscription Agreement provided Network with the right to appoint four directors of Signal. This is incorrect. As described above, it was a condition precedent to Network's obligation to complete the subscription for shares of Signal that the four people it nominated be elected to the board of directors of Signal. Election of these directors had to occur at a meeting of Signal's shareholders where only the Existing Signal Shareholders had a right to vote.

This situation is fundamentally different than providing Network with the right to simply appoint four members of the board of directors. Here, all Network had the right to do was identify four individuals that it was prepared to put forward to be Signal Directors. The Existing Signal Shareholders then had to vote to elect those four persons to the board of directors. As this election of these individuals was a condition precedent, this election happened prior to the time NPMI subscribed for shares under the Subscription Agreement and, therefore, NPMI did not even vote at this election of the directors. Had the Existing Signal Shareholders not elected the four directors nominated by Network, Network's recourse would have been to not complete its subscription for shares. Network could not have gone to court and demanded that its four nominees be appointed to the board. Accordingly, the ability to nominate four people for election to the board did not give Network either direct control over the constitution of Signal's board of director or any 251(5)(b) Right.

(iii) The Non-Voting Preferred Shares were not convertible into Common Shares

The Proposal Letter, at the bottom of page 12 and the top of page 13, appears to state that the Non-Voting Preferred Shares were convertible into Common Shares. Again, this is simply not the case. The provision in the Articles of Amalgamation referred to in the Proposal Letter, being paragraph 3.5.3, was described above and is at best unclear, and possibly void due to its uncertain meaning. While it does require that the holders of Preferred Shares must approve an exchange, conversion, reclassification or cancellation, it does not say of what. Arguably, this provision might refer to such actions taken in respect of any class of shares other than the Preferred Shares. If it is purported to refer to actions in respect of the Preferred Shares, it is unclear how the words "unless the Company purchases or redeems, in keeping with the Act or the provisions hereof, all or a portion of the preferred shares" have relevance or should be applied. In any event, this provision does not give the holders of the Preferred Shares any rights regarding conversion. To the contrary, it is an express prohibition on the ability of Signal to purport to make an exchange, conversion, reclassification or cancelation (of something) without the approval of the holders of the Preferred Shares. It is very difficult to see how a provision in the Articles of Amalgamation that expressly prohibits Signal from taking certain actions could somehow even be suggested to provide a shareholder with a 251(5)(b) Right.

Moreover, as the calculations in the Proposal Letter clearly demonstrate, even if the Non-Voting Preferred Shares were convertible for Common Shares (which, again, was not the case), NPMI would not have acquired sufficient Common Shares to exercise *de jure* control over Signal.

(iv) The Signal Option Plan did not constitute a 251(5)(b) Right to Network or NPMI

The Proposal Letter, at page 13, states that because the Signal Option Plan permitted the Signal Directors to issue stock options to persons or entities, Network could issue additional shares to itself. With respect, it is very difficult to comprehend how the mere existence of the Signal Option Plan provided Network or NPMI, or any other person for that matter, with any rights to acquire Signal shares. Had options to acquire Common Shares somehow actually been issued to Network or NPMI, there is little doubt that such options would have constituted 251(5)(b) Rights. However, until such options were granted, no person had any right to demand such options or to acquire any shares thereunder. In short, no person, including Network or NPMI, had any 251(5)(b) Rights in respect of any shares of Signal arising out of the mere existence of the Signal Option Plan.

2. The GAAR Does Not Apply

(a) Overview of the GAAR

The GAAR, found in section 245 of the Act, is an anti-avoidance rule that has no application to this situation.

Subsection 245(2) sets out the circumstances in which the GAAR will apply, and reads as follows:

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.

[Emphasis added.]

Only once (i) a transaction¹⁶ has been proven to be an avoidance transaction,¹⁷ and (ii) it has been established that such transaction results

¹⁶ As defined in subsection 245(1) and discussed below.

in, or is part of a series of transactions that results in, a tax benefit¹⁸ for a taxpayer, may a court rely on the GAAR to deny such tax benefit by determining the tax consequences¹⁹ that are reasonable in the circumstances. The GAAR does not apply in circumstances where as here, there was no avoidance transaction and no abusive tax avoidance.²⁰

The application of the GAAR was considered by the Supreme Court of Canada in the companion cases of *Canada Trustco v. R.*²¹ and *Mathew v. R.*²² At paragraph 66 of *Canada Trustco*, the Supreme Court of Canada summarized its views on the GAAR, writing:

The approach to s. 245 of the Income Tax Act may be summarized as follows.

1. Three requirements must be established to permit application of the GAAR:

(1) a tax benefit resulting from a transaction or part of a series of transactions (s. 245(1) and (2));

(2) that the transaction is an avoidance transaction in the sense that it cannot be said to have been reasonably undertaken or arranged primarily for a bona fide purpose other than to obtain a tax benefit; and

(3) that there was abusive tax avoidance in the sense that it cannot be reasonably concluded that a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer.

2. The burden is on the taxpayer to refute (1) and (2), and on the Minister to establish (3).

3. If the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer.

4. The courts proceed by conducting a unified textual, contextual and purposive analysis of the provisions giving rise to the tax benefit in order to determine why they were put in place and why the benefit was conferred. The goal is to arrive at a purposive interpretation that is

¹⁷ As defined in subsection 245(3) and discussed below.

¹⁸ As defined in subsection 245(1) and discussed below.

¹⁹ Pursuant to subsection 245(2) and subsection 245(5).

²⁰ As determined under the principles from *Canada Trustco, infra*, at note 21, and pursuant to subsection 245(4), discussed below.

²¹ [2005] 5 C.T.C. 215 (S.C.C.).

²² [2005] 5 C.T.C. 244 (S.C.C.).

of the GAAR requires the identification of a normative standard against which to compare what actually happened.

In reaching the conclusion that a tax benefit was realized here, the Proposal Letter appears to assume the correct normative standard of comparison is one in which Network acquired all of the shares of Signal and, consequently, subsections 111(5) and 37(6.1) applied. However, as pointed out above, that is not what happened, either in form or in substance. Rather, here, a group of new investors injected much needed capital into a corporation and received a percentage of the equity in the corporation. In our view, in this context, the correct normative standard for comparison is one where Signal did nothing. In such a case, it would have been entitled to claim its accumulated non-capital losses and SR&ED expenses. Alternatively, it could be asserted that the normative standard is one where Signal did not raise any new equity but just changed the course of its business, hired a new management team and utilized its remaining assets to acquire oil and gas properties. Similarly, in that scenario, there would be no doubt that Signal remained entitled to claim deductions for its non-capital losses and SR&ED expenses. It is asserted that Signal should not be viewed as realizing a tax benefit when all that it was claiming was recognition under the Act for expenditures that it had funded and which it otherwise would have been entitled to claim. When what did happen is compared to the correct normative standard, it becomes clear that no tax benefit resulted from the transactions at hand. Accordingly, the GAAR does not apply.

(c) There Was No Avoidance Transaction

Subsection 245(3) defines the expression “avoidance transaction” for purposes of the GAAR. To amount to an avoidance transaction, a transaction must, either by itself or as part of a series, result directly or indirectly in a tax benefit. Moreover, even if a transaction satisfies this first condition, it still only becomes an avoidance transaction if it is not reasonable to consider that it was undertaken primarily for *bona fide* purposes other than to achieve a tax benefit.

It is clear from the definition of “avoidance transaction” that where, as here, no tax benefit was realized, there simply cannot be any avoidance transaction. This should be the end of the matter and it should be easy to conclude the GAAR cannot apply to the current circumstances.

Nevertheless, and in an effort to be overly comprehensive, even if one were to assume a tax benefit was realized here (which we expressly do not admit and which was not the case), the second requirement for the finding of an avoidance transaction is not satisfied. That is, there was no

transaction undertaken that was not completed primarily for *bona fide* non-tax reasons.

The Proposal Letter, at page 17, identifies the Subscription Agreement, the amendment to the Signal Option Plan and the issuance of treasury shares as the relevant transactions. Each of these transactions had a very obvious, non-tax, commercial purpose.

(i) Subscription Agreement and Issuance of Shares

The Subscription Agreement and the resulting issuance of treasury shares were intended to, and did, result in additional money being invested into Signal to assist it in commencing its new oil and gas business.

(ii) Signal Option Plan

The amendments to the Signal Option Plan also served an important commercial purpose. The number of options the Signal Directors could issue was increased to an amount close to the industry standard 10% of outstanding shares. This put Signal in a position to effectively recruit experienced oil and gas professionals to ensure its new business was successful. It is very common practice for start-up oil and gas companies to entice key potential employees to become an employee (and possibly leave other employment) by granting them a large number of stock options to allow them to participate in the “upside” if the company is successful. Not only was this the stated purpose of the amendments to the Signal Option Plan at the time they were made, but it is the purpose and non-tax business objective that was achieved by the subsequent grant of options under the Signal Option Plan. No options ever were granted to Network or NPMI or other persons not involved in the ongoing management or operations of Signal and all options have been granted to employees and directors. This is entirely consistent with the standard practice in the oil and gas industry.

(iii) Commercial Purpose

The Proposal Letter, at page 18, states that the parties had the intention to maintain Signal’s ability to claim deductions for its non-capital losses and SR&ED expenses. The Proposal Letter states that this intention was evidenced, *inter alia*, by Network assuring Signal that the recapitalization would not result in an acquisition of control and that the value of the tax pools was one factor taken into account when determining the price Network

should pay for shares of Signal. Contrary to the assertions in the Proposal Letter, both of these factors fully support the position that the transactions were implemented to achieve Signal's commercial purpose of raising new capital. On the first point, had the purpose of these transactions been to simply "sell" the losses to Network or some other person, management and shareholders of Signal should not have cared whether there was an acquisition of control of Signal because, in such a case, they would not be shareholders after such a "sale" of the losses (*i.e.*, in a loss "trading" transaction, only the acquirer of the loss corporation should be concerned about an acquisition of control). On the second point, it is completely consistent with the commercial purpose of raising new equity that the existing shareholders want new shares to be sold to new investors at a price that fully reflects the value of the corporation as a going concern, which includes its tax attributes (that were acquired with money previously invested into the corporation).

(d) There Was No Abusive Tax Avoidance

(i) Overview

We expressly disagree that a court would find that any tax benefit or avoidance transaction existed in these circumstances. As a result, the GAAR cannot apply here. Further, even if a tax benefit and an avoidance transaction somehow could be proven, the CRA would not be able to satisfy its burden of proving that it cannot reasonably be concluded that the tax benefit was consistent with the object, spirit or purpose of the provisions relied on by Signal, as is expressly required under the Supreme Court of Canada's analytical framework.

Subsection 245(4) is a relieving provision to the application of subsection 245(2), and states as follows:

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,

... or

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

[Emphasis added.]

In *Canada Trustco*, the Supreme Court held that subsection 245(4) does not require a separate determination of “misuse” and “abuse”, but instead requires a single, unified approach to the textual, contextual and purposive interpretation of the specific provisions of the Act relied upon by a taxpayer to determine whether there was abusive tax avoidance. The Supreme Court held that there was only one (albeit multipart) test, being the “**Abuse**” test:

[t]he heart of the analysis under s. 245(4) lies in a contextual and purposive interpretation of the provisions of the Act that are relied on by the taxpayer, and the application of the properly interpreted provisions to the facts of a given case. The first task is to interpret the provisions giving rise to the tax benefit to determine their object, spirit and purpose. The next task is to determine whether the transaction falls within or frustrates that purpose. The overall inquiry thus involves a mixed question of fact and law. The textual, contextual and purposive interpretation of specific provisions of the Income Tax Act is essentially a question of law but the application of these provisions to the facts of a case is necessarily fact-intensive.²⁵

[Emphasis added.]

The Supreme Court reiterated this multipart test later in the judgment in *Canada Trustco*:

In summary, s. 245(4) imposes a two-part inquiry. The first step is to determine the object, spirit or purpose of the provisions of the *Income Tax Act* that are relied on for the tax benefit, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids. The second step is to examine the factual context of a case in order to determine whether the avoidance transaction defeated or frustrated the object, spirit or purpose of the provisions in issue.²⁶

²⁵ *Canada Trustco*, cited above, at par. 44.

²⁶ *Canada Trustco*, cited above, at par. 55.

The Supreme Court held that this analysis will lead to a finding of Abuse in three circumstances:²⁷

- (i) when a taxpayer relies on specific provisions of the Act in order to achieve an outcome that those provisions seek to prevent;
- (ii) when a transaction defeats the underlying rationale of the provisions that are relied upon; and
- (iii) when an arrangement circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the object, spirit or purpose of those provisions.

The Court also recognized the corollary: the Abuse test is not satisfied where it is reasonable to conclude that a transaction is within the object, spirit and purposes of the provisions that confer the tax benefit.

Each component in the multipart test is reviewed below.

(ii) Identification of the Relevant Provisions

Assuming that the tax benefit at issue is the deductions claimed by Signal under subsections 111(1) and 37(1), those two provisions are relevant to the Abuse analysis. In addition, where, as here, there are very specific anti-avoidance provisions such as subsections 37(6.1), 111(5) and 256(8) that potentially could, (but do not), apply, such provisions also need to be considered in the Abuse analysis. The specific distinction drawn in the Act between *de jure* control and *de facto* control also makes subsection 256(5.1) and the provisions that rely on its extended meaning of control relevant to the Abuse analysis.

(iii) Interpretation of Provisions

(A) Text

Pursuant to the text of subsections 111(1) and 37(1), Signal was entitled to the deductions it claimed in computing its income for purposes of the Act. That is, the general rule is, as the CRA recognizes, that business losses

²⁷ *Canada Trustco*, cited above, at par. 45.

can be deducted from all types of income.²⁸ Moreover, as reviewed in detail above, no person or group of persons acquired *de jure* control of Signal and, consequently, the specific anti-avoidance provisions in subsections 111(5) and 37(6.1) do not apply. Further, the anti-avoidance deeming rule in subsection 256(8) that is specifically designed to extend the application of the anti-avoidance rules in subsections 111(5) and 37(6.1) does not apply because no relevant 251(5)(b) Rights were acquired by Network or NPMI.

The text of subsection 256(5.1) also is pertinent to the Abuse analysis. As noted above, this provision extends the meaning of control for purposes of certain provisions of the Act from the stricter, narrower, *de jure* control test, to the broader, factual based *de facto* control standard. As discussed above, Parliament made a deliberate decision not to have this provision apply for purposes of subsections 37(6.1) or 111(5).

(B) Context

There is no reason why, if a tax benefit was achieved from the literal application (or non-application, as the case may be) of the relevant provisions (which we expressly deny), such tax benefit would be inconsistent with the legislative context of those provisions. We have considered whether there is any general scheme in the Act that prevents a corporation from claiming deductions to which it is entitled (and for which it paid with its own invested capital) simply because it raises additional financing by selling shares to a new investor. In searching for a general scheme in the Act, it is important to keep in mind Boyle J.'s comments in *Collins & Aikman Products Co. v. R.* that the search for a general scheme in the Act should begin with the provisions of the Act rather than some unstated premise that is not grounded in the provisions of the Act.²⁹

There is nothing in the context of the relevant provisions that would support a conclusion that the general scheme

²⁸ *Interpretation Bulletin* IT-232R3 – Losses – Their Deductibility in the Loss Year or in Other Years, dated July 4, 1997, at par. 1.

²⁹ 2009 T.C.C. 299, at para. 62.

described above exists. The relevant provisions form part of a detailed regime that limits a corporation's ability to deduct certain amounts only in certain circumstances where very specific requirements are satisfied. That is, each of the relevant provisions clearly articulate that unless *de jure* control of a corporation has been acquired, or could be acquired, by the exercise of a 251(5)(b) Right, there is no restriction on the corporation's ability to deduct its non-capital losses or SR&ED expenses.

These detailed rules, including the specific decision not to apply the *de facto* control standard, demonstrate that Parliament has turned its mind to when a corporation's ability to deduct such amounts should be limited and determined such limitations only should apply where *de jure* control of a corporation has been acquired or where a person acquired a right that, if exercised, would cause that person to acquire *de jure* control. As neither of these events occurred here, it is clear that this is not the context to which Parliament intended these provisions should apply.

(C) Purpose

The final stage of the method of analysis prescribed by the Supreme Court of Canada is to review the relevant provisions to determine the purpose of those provisions of the Act. When the purpose of each specific provision is considered, it becomes evident that none of these purposes were undermined here.

(1) Subsections 37(1) and 111(1)

The purpose of these provisions is to allow taxpayers who have invested money in a business where loss balances or undeducted pool balances remain at year end, to take such unutilized balances into account in computing income for purposes of the Act in subsequent years. These provisions demonstrate that Parliament understands that often a corporation will pursue certain ventures which are not profitable in the early stages and that such initial investments should be taken into account when determining the corporation's tax liability in its later profitable years. Parliament recently

reaffirmed the importance of the deduction available under subsection 111(1) by extending the carry-forward period to 20 years.³⁰

(2) Subsections 37(6.1) and 111(5)

The purpose of these provisions is to prevent a profitable corporation from acquiring a non-profitable corporation that does not carry on the same line of business and deducting the latter corporation's tax pools to reduce the profitable corporation's tax liability. These provisions generally restrict the trading of tax losses.

While the point has been made above, it is worth reiterating that the current circumstances did not constitute the trading of losses. The transactions completed by Signal are not analogous to those described in *Income Tax Technical News* No. 34 to which the CRA stated it would consider applying the GAAR.³¹ That is, Network did not acquire Signal and then deduct Signal's tax losses to reduce Network's income from other businesses. Rather, Network facilitated new investment in Signal and the change in Signal's business from a pharmaceutical business to an oil and gas business. Signal used its existing assets and the funds raised from the new investment and commenced a successful oil and gas business. Both the new investors and the Existing Signal Shareholders benefited from the success of this new business. We submit that this generation of new economic activity, with the potential for profit (and therefore taxable income), is exactly the type of contribution to the growth of the Canadian economy that Parliament intended to encourage and promote by means of its careful drafting of the tax attribute utilization restrictions.

In addition, it is important to consider the possible impact to the Existing Signal Shareholders of the

³⁰ See the amendments to subsection 111(1) in 2006, c.4, subsections 57(1) and (2).

³¹ *Income Tax Technical News* No. 34, dated April 27, 2006, under the heading "Sale of Tax Losses".

GAAR being applied in these circumstances. Those shareholders would be adversely affected notwithstanding that their shares continued to represent a significant portion of the ongoing equity in Signal. The application of the GAAR in circumstances such as this would mean existing shareholders have much more limited ability to recoup their initial investment than is permitted under the technical provisions of the Act. It is strongly asserted that a court would consider it inappropriate to adversely impact the original shareholder group by applying a discretionary and general provision such as the GAAR in these circumstances.

(3) Subsection 256(8)

The purpose of subsection 256(8) is to extend the circumstances where a person will be considered to have acquired *de jure* control of a corporation to situations where, technically, there was no such acquisition of control.³² Subsection 256(8) is a very specific anti-avoidance provision intended to apply to increase the circumstances to which other specific provisions, including subsections 37(6.1) and 111(5), can apply.

That is, in the context of provisions related to acquisitions of control, the purpose of subsection 256(8) is to be the relevant anti-avoidance provision, which renders the GAAR redundant in this context. As Bowman, C.J.T.C.C. held in *XCo Investments*:³³

Second, anti-avoidance sections such as 103 and 245 are not intended as a means of punishment for offending the Minister's olfactory sense. They do not give the Minister carte blanche to impose sanctions for transcending his notion of fiscal rectitude. Section 245 is there to counteract

³² See, *inter alia*, the December 1997 Technical Notes regarding subsection 256(8) issued by the Department of Finance.

³³ See paragraph 40 of *XCo Investments Ltd. v. R.* [2006] 1 C.T.C. 2220 (T.C.C.), affirmed by the Federal Court of Appeal at [2007] 2 C.T.C. 243.

serious forms of tax avoidance that would otherwise not be stopped by other specific anti-avoidance provisions. Where a specific anti-avoidance section covers a transaction but does not in the Minister's view provide a remedy that the Minister considers sufficient, section 245 is not there to permit the Minister to top up the remedy that the Minister believes to be inadequate.

[Emphasis added.]

Accordingly, where, as here, the very specific anti-avoidance provision crafted by Parliament has no application, it is not open to the CRA to resort to the GAAR in an effort to expand the scope or reach of the particular anti-avoidance rule beyond that which Parliament provided. Moreover, because no relevant 251(5)(b) Rights existed here, this was not a circumstances where the application of a specific anti-avoidance rule was circumvented.

(4) Subsection 256(5.1)

The purpose of subsection 256(5.1) is adequately summarized in the Technical Notes issued by the Department of Finance when this provision was introduced:

New subsection 256(5.1) provides that, for the purposes of the Act, a corporation shall be considered to be controlled, directly or indirectly in any manner whatever, by another corporation, a person or a group of persons (the "Controller") where the Controller has any direct or indirect influence that, if exercised, would result in control in fact of the corporation. An exception is provided where the corporation and the Controller are dealing at arm's length and the Controller's influence is derived from an agreement or arrangement – such as a franchise, licence, lease, distribution, supply or management agreement – the main purpose of which is to govern the relationship between the parties regarding the manner in which a business carried on by the corporation is to be conducted.

New subsection 256(5.1) expands the concept of control for certain provisions of the Act to include what is often referred to as *de facto* control. Under the existing rules, control of a corporation generally exists by reason of the ability to elect a majority of the directors of the corporation – *de jure* control. An example of *de facto* control might be a situation where a person held 49% of the voting control of a corporation and the balance was widely dispersed among many employees of the corporation or was held by persons who could reasonably be considered to act in respect of the corporation in accordance with his wishes. Whether a person can be said to be in actual control of a corporation, notwithstanding that he does not legally control more than 50% of its voting shares, will depend in each case on all of the circumstances.

[Emphasis added.]

As the Technical Notes indicate, subsection 256(5.1) was enacted to provide Parliament with a tool to use in those circumstances when it wanted to be able to look beyond strict legal control of a corporation. Parliament has been very selective in its utilization of this lower standard for control, and the fact that this standard does not apply for purposes of subsections 37(6.1) or 111(5) indicates very clearly that the Parliament did not intend the purpose of those provisions to be to apply where anything other than *de jure* control was acquired.

(e) In Summary, The GAAR Does Not Apply

There was no tax benefit realized, no avoidance transaction completed and no Abuse of any provision of the Act. As a result, the GAAR does not apply.

Once you have had an opportunity to review and consider our submissions we would like to meet with you to discuss this matter further. Please contact Brent Perry at (403) 260-3306 to arrange a time for this meeting. In the meantime, please do not hesitate to contact either of the undersigned if you need any additional information or clarification.

Yours very truly,

FELESKY FLYNN LLP

A handwritten signature in black ink that reads "Brent Perry". The signature is written in a cursive style with a large, looping initial "B".

PER: F. BRENTON PERRY, Q.C. / D. BRETT ANDERSON

DBA/ks/rc
Enclosure