



NOV 15 2010

SignalEnergy Inc.  
P.O. Box 1917 Station M  
Calgary AB T2P 2M2

NOV 18 2010

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Attention: Jamie Jeffs

Dear Sir:

**Re: Audit of SignalEnergy Inc.**

We have completed our restricted audit of the above corporation for the taxation years 2003 to 2006. As a result of this review the above taxation years will be reassessed as explained in our letter of January 15, 2010. The adjustments are as shown below:

Year	2004	2005	2006
Deduction Denied			
Non-Capital Loss Claimed	1,171,447	2,385,827	13,065,267

The 2006 return appears to have been assessed after the commencement of our review and the non-capital deducted was, therefore, not previously addressed in our proposal letter. The deduction is being disallowed for the same reason as in 2004 and 2005. The loss amount comes from the same pool of non-capital loss incurred before the change of de jure control. Our comments on the corporation's representation submitted through Brenton Perry of Felesky Flynn are included below.

## TAXPAYER REPRESENTATION

The taxpayer's representation disputing our reassessing position is set out in the letter of March 26 from Brenton Perry of Felesky Flynn. A summary of his arguments and the auditor's rebuttals are detailed below.

On the technical issues, the representative argued that there was no acquisition of control. Therefore all the restrictive provisions – subsection 111(5) in the case of non-capital losses, and subsection 37(6.1) in any eventual application of scientific research expenditures – had no application. He based his argument on the following grounds:

- (1) The purpose of the transactions was to recapitalize SignalEnergy and attract new management;
- (2) No person or group of persons acquired control of SignalEnergy; Network only acquired 45% of the common shares and these were distributed to a diverse group of investors. The preferred shares also acquired by Network did not have a conversion feature;
- (3) The concession in the Subscription Agreement granting Network the right to nominate a majority of Board of Directors, and the Share Options Plan which increased the optional shares issuable by the Board did not amount to paragraph 251(5)(b) rights; and
- (4) Subsection 256(8) did not apply since Network did not acquire paragraph 251(5)(b) rights.

### Rebuttal:

(1) Recapitalization: The representative is attempting to refute the alleged tax avoidance purpose of the transactions by claiming a bona fide purpose for Network's acquiring shares of SignalEnergy. However, the recapitalization was initiated by Network after SignalEnergy had already ceased business. In fact Network required SignalEnergy to liquidate its tangible assets and retrench its workforce as a condition for investing in the company. While the CRA takes no issue with recapitalizing a corporation no matter who initiates it, what the agency considers offensive is a takeover disguised as recapitalization. The purpose of the reorganization is evident in the assurance by Network 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.*" [Statement of Fact" of August 4, 2003]

An overt acquisition of control would render the tax pools of SignalEnergy useless since a change of business was intended. Therefore, to both recapitalize the company and safeguard the potential tax benefit, control by Network had to be subtle.

(2) No person or group of persons acquired control: There are two issues alluded to in this statement. The *first* is that Network acquired only 45% of the common shares. The representative also suggested that the preferred shares did not have a conversion feature and even if they were convertible, Network's holdings would not exceed 50%. His argument is that the provision in the Articles of Amalgamation that dealt with conversion did not specifically refer to preferred shares. Since only common and preferred shares were mentioned in the Articles, it is reasonable to assume that the conversion would be to common shares. In any case the Board had wide discretion with regard to the treatment of preferred shares.

Subsection 3.5 of the Articles deals with preferred shares and the representative admitted as much. Given that the preamble to paragraph 3.5.3 was about the treatment of preferred shares, there is little doubt that the phrase "exchange, convert, reclassify or cancel" refers to preferred shares and the vagueness the representative alleged is non-existent. In fact, the preferred shares were converted to non-voting common shares in a subsequent year which is proof of their conversion feature. Also since only Network owned preferred shares as a consequence of the Subscription Agreement, the requirement that approval be obtained from preferred share owners meant the Board only needed Network's own approval to convert to common shares.

The *second* issue he alluded to but did not expand on is the claim that as an investment firm, Network acquired the securities for its investors and managed such assets through its wholly-owned subsidiary Network Portfolio Management Inc. (NPMI). Two points must be noted in this regard. Firstly, Network pledged under the Subscription Agreement that it was subscribing for the shares for its own account (*Statement of Fact – Aug 22, 2003*). Secondly, these investors may be said to be acting in concert. As explained in paragraph 12 of Interpretation Bulletin IT-419,

*"The Courts have held that where one person (or a group of persons) is, in fact, the bargaining agent, or the mind directing the bargaining is directed, on behalf of both (or all) parties to a transaction, then the parties cannot be dealing at arms length. This principle has been expanded to include the concept of "acting in concert" with respect to an element of common interest."*

Therefore, the fact that the shares acquired by Network constituted the property of a diverse group of investors does not change the argument. Network could vote those shares as a block.

(3) Paragraph 251(5)(b) Rights: Paragraph 251(5) (b) 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 and their exercise could result in de jure control, the shareholder is deemed to have exercised them.

The representative does not believe that Network's rights under the Subscription Agreement amounted to paragraph 251(5)(b) rights. However, we are of the view that this is in fact the case. These rights included the right of Network to nominate four out of five members of the Board of Directors who had to be appointed as a condition of the agreement. A term of the agreement was that the proceeds of the share issue would be deposited with SignalEnergy only after all conditions in Sections 7 and 9 had been satisfied. One of the conditions in Section 7 was that the nominees of Network would be appointed as directors. In other words, if the nominees were not appointed the agreement would become void. According to jurisprudence the privilege of appointing a majority of the Board of Directors gives the shareholder effective control of the Board. The consequence of effective control of the Board is the same whether the privilege accrues from holding a majority of the voting shares or results from a legally enforceable agreement. Therefore it is not tenable to argue that this privilege ceded to Network under the Subscription Agreement did not constitute a right under paragraph 251(5)(b).

(4) *Subsection 256(8)*: Subsection 256(8) 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 time as it was acquired. In other words, legal control can no longer be deferred simply by acquiring a combination of minority shares and rights to more shares. The result is that provisions governing an acquisition of control are triggered immediately. 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.

The representative argued that subsection 256(8) did not apply because, in his opinion, Network had not acquired paragraph 251(5)(b) rights. However this argument has already been rebutted. The rebuttal removes one obstacle in the way of applying subsection 256(8). The representative also denied that a primary purpose of the transactions was to achieve a tax benefit. He argued that corporations are after all ordinarily permitted to deduct losses they have incurred in the past from current income.

The CRA's rebuttal is that the very initiation of the series of transactions (that made it possible for SignalEnergy to deduct non-capital losses after the reorganization) was predicated on the availability of the non-capital loss pool. As was stated in the proposal letter, Network and SignalEnergy were geographically far apart and SignalEnergy had no expertise in the Oil and Gas industry. Network could easily have incorporated an Oil and Gas Company in Alberta and raised additional funds by various practical means. Network was attracted to SignalEnergy in Montreal (thousands of kilometres away) because of the \$55 million in unused tax pools which represented significant tax savings. It is reasonable to argue that it was necessary for Network to acquire control of SignalEnergy (to safeguard its investment) but the tax benefit motive also meant it was necessary to avoid subsection 111(5) or any other restrictive provision. The CRA, therefore, concludes that one of the primary purposes for acquiring the paragraph 251(5)(b) type rights was to avoid a direct acquisition of control. Evidence of this purpose was indicated in the August 4, 2003 Statement of Fact. Hence subsection 256(8) applied.

## **THAT GAAR HAD NO APPLICATION**

In denying that GAAR applied to this case the representative presented the following arguments:

- (a) That SignalEnergy did not realize a tax benefit;
- (b) That there was no avoidance transaction;
- (c) That the tax avoidance, if any, was not abusive.

Although the CRA is not pursuing the GAAR position at this time, it is necessary to address the above arguments against the application of the GAAR.

### **Rebuttal:**

- (a) ) That SignalEnergy did not realize a tax benefit:

SignalEnergy claimed non-capital losses against income resulting in tax benefits in 2004 and 2005 and 2006. The term "Tax Benefit" is defined in subsection 245(1) as follows:

"tax benefit" means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance or deferral of tax or other amount that would be payable under this Act but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty;"

The deductions resulted in significant tax savings and fit the definition of a tax benefit. The representative argued that deducting non-capital losses from income is ordinarily permitted and would not constitute a tax benefit within the meaning of subsection 245(1). The CRA's position is that this interpretation does not agree with the above definition. Furthermore, if subsection 111(5) was applied properly it would restrict the application of the non-capital loss in this instance. Hence circumventing that provision resulted in a tax benefit.

- (b) That there was no avoidance transaction:

Subsection 245(3) defines "Avoidance Transaction" as follows:

"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 representative denied that there was a tax benefit as noted above and insisted that the transactions were undertaken primarily for bona fide purposes. It has already been established that the motive behind the transactions was access to the \$55 million in tax pools in SignalEnergy. In other words, the primary purpose was a tax benefit. This tax avoidance purpose has also been addressed in the context of the representative’s recapitalization argument.

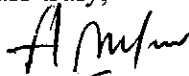
The representative further took issue with the inclusion of the amendment to the Stock Option Plan as one of the avoidance transactions. He argued that the shares available under the plan were increased by 10% which represents industry practice. However, he failed to note that the size of the Board of Directors had been reduced from seven members prior to the Subscription Agreement to five directors. He also failed to explain why additional optional shares were necessary even though the bulk of those previously approved under the original plan had yet to be issued. He glossed over the fact that entities such as Network were eligible to receive optional shares at the discretion of the Board. Our contention is that the number of optional shares issuable was bumped up as a precautionary measure. They could be issued to sustain control if the need arose. That purpose made the amendment to the plan part of the series of avoidance transactions.

(c) *That there was no abusive Tax Avoidance:*

The representative argued that even if a tax benefit or avoidance transaction was 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.*” In the view of the CRA this is a debatable proposition and the final arbiter is the Tax Court. However, the CRA considers the deliberate circumvention of subsection 111(5) when there had been a palpable acquisition of control to be in violation of the object, spirit and purpose of the loss provisions.

Although we do not plan a further review of your records at this time, the *Income Tax Act* requires that you do not destroy your books and records, including those in electronic format. We have enclosed Information Circular 78-10R4, Books and Records Retention/Destruction for your reference.

Yours truly,



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Ambrose Okoro  
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