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May 25, 2011

Canada Revenue Agency
Appeals Division
Room 828
220 - 4th Avenue S.E.
Calgary, AB T2G 0L1

Without Prejudice

Attention: Mrs. Lise Nixon

Dear Madam:

Re: *Income Tax Notices of Objection for Signal Energy Inc.'s 2003-2006 Taxation Years*
GB 1109 6171 6314
GB 1110 1112 7428
GB 1110 1113 1201
GB 1110 1110 8439

Thank you for your letter of May 10, 2011 and for providing copies of the audit report (“**Audit Report**”) and position paper (“**Position Paper**”) prepared by the Aggressive Tax Planning group of the Canada Revenue Agency (“**CRA**”) regarding the question of whether there was an “acquisition of control” of Signal for purposes of the *Income Tax Act* (Canada) (“**Act**”) in 2003.¹

As you may know, the Audit Report and the Position Paper are nearly identical to the documents the CRA previously provided to Fortress Energy Inc. That is, the Audit Report is substantially the same as the letter the CRA mailed to Signal in November of 2010. Moreover, the Position Paper is merely a very slightly modified version of the letter sent by the CRA to Signal in January, 2010. The latter document is particularly troubling as it provides clear indication that the CRA did not even consider or respond to any of the detailed legal and factual considerations set forth in the written submissions made in our written correspondence to the CRA Aggressive Tax Planning group in response to the January, 2010 letter. This lack of consideration of our

¹ All statutory reference herein are to the Act unless otherwise noted.

written submission is consistent with the fact that the CRA Aggressive Tax Planning Group did not acknowledge our request for a meeting to discuss this matter, but rather simply proceeded to reassess without providing opportunity to discuss this matter.

As the Audit Report and Position Paper do not raise any new facts or reasons to support the Reassessments,² the detailed written submission (“**Submission**”) on this matter which was provided to the Appeals Division of the CRA on March 28, 2011 continues to reflect our views on this matter and our response to these documents. We reiterate our request that you carefully consider the Submission before reaching any conclusions in this matter, particularly since the fundamental factual and legal errors contained in the Audit Report and the Position Paper are dealt with at length therein. To further assist you in your review of this matter, we have taken this opportunity to summarize certain of the key points of the Submission and to highlight fundamental factual and legal errors contained in the Audit Report and the Position Paper. All capitalized terms used but not defined herein have the meaning ascribed to them in the Submission.

Summary of Submission

We submit that the Audit Report and the Position Paper demonstrate an incorrect understanding of the relevant facts and the legal relationships created by the legal documentation. Moreover, the application of the relevant legal principles in the Audit Report and Position Paper is confused and incorrect. We submit that the facts of this file and the relevant legal principles are relatively clear and lead to the unavoidable conclusion that *de jure* control of Signal was not acquired by any person or group of persons.

The most important facts can be summarized as follows:

- (a) Network had a right to nominate (not “appoint” or “elect”) four individuals for possible elections to Signal’s Board by the Existing Signal Shareholders (being the shareholders of Signal immediately prior to Network acquiring 45% (voting) and 49% (equity) percentage interests in Signal noted below). Network had no legal ability to ensure those individuals became directors of Signal. There was no legal impediment for other persons to nominate other directors to Signal’s Board. The Existing Signal Shareholders never relinquished their right to vote on/elect the members of Signal’s Board and did in fact, exercise that right at the shareholder meeting of November 6, 2003.
- (b) Only after the Existing Signal Shareholders voted at the shareholder meeting on November 6, 2003 did Network acquire 45% of the voting shares of Signal and 49% of the equity. At no time did Network ever acquire more than the foregoing percentage interests in Signal’s share equity.
- (c) Network had no right to acquire any additional shares of Signal. That is, the mere possibility that Signal theoretically could issue shares to a broad number of persons and, while there was no specific impediment to issuing shares to Network in the future (which,

² As defined in the Notices of Objections (“**Objections**”) filed with the CRA on March 29, 2011

in fact, never happened), such lack of a strict legal impediment nevertheless did not give Network a “right” to such shares.

The very clear legal principles are as follows:

- (a) The Act distinguishes between *de jure* control and *de facto* control, as recognized by the Supreme Court of Canada in *Duha Printers (Western) Ltd. v. R.*³.
- (b) Only *de jure* control is relevant for purposes of subsections 111(5) and 37(6.1).
- (c) *De jure* control rests with the shareholders who control that number of voting shares as are required to elect the board of directors. Typically, such control rests with (and did in Signal’s case) the shareholders who control greater than 50% of the voting shares. At all relevant times, the Existing Signal Shareholder’s held greater than 50% of Signal’s voting shares. Moreover, the Existing Signal Shareholders did, in fact, exercise their right to vote on and elect the members of the Signal Board at the November 6, 2003 shareholder meeting and, at that time, the Existing Signal Shareholders held 100% of the voting shares of Signal.
- (d) The Supreme Court of Canada stated in *Duha* that in very limited situations where a corporation’s constating documents or a unanimous shareholders agreement limit (i) the ability of the persons holding greater than 50% of the voting shares to elect the board of directors or (ii) limit the ability of the board of directors to control the corporation, that it may be necessary to look beyond who owns the majority of the voting shares. Neither of these circumstances existed in Signal’s case.
 - Nothing in the constating documents or a unanimous shareholders agreement limited the ability of the Existing Signal Shareholders (who owned 100% of the voting shares at the time of the November 6, 2003 shareholder meeting) from voting such shares to elect whomever they wanted to the board of directors.
 - The Supreme Court of Canada has determined that because a basic agreement such as the Subscription Agreement does not, and cannot, constitute either a constating document or a unanimous shareholders agreement, as a matter of law (and, as discussed below, contrary to the conclusion in the Position Paper) the Subscription Agreement is not relevant to the *de jure* control analysis.
 - Even if the Subscription Agreement had any relevance at law for purposes of determining whether there was an acquisition of control of Signal for purposes of the Act, (which the Supreme Court of Canada has clearly opined is not the case), the ability to nominate directors falls far short of an ability to “appoint” or “elect” directors.

³ [1998] 3 C.T.C. 303 (S.C.C.), at paragraph 52. For your convenience, a complete copy of the Supreme Court of Canada’s reasons in this case, the leading Canadian case on *de jure* control, is attached hereto for your convenience.

Fundamental Factual and Legal Errors

To assist your review of this matter, we reiterate the key point made in the Submission: the Reassessments are based on serious and fundamental errors of both fact and law.

While by no means an exhaustive list, the most significant errors of fact include the following.

- (a) The “fact” that Network entered into a business combination with Signal. This demonstrates a fundamental misunderstanding of the facts as the business of Network was never combined with that of Signal. Rather, Network assisted with the investment of new capital into Signal.
- (b) The “fact” that the Subscription Agreement provided Network with “effective” control of the Board. As discussed below, the Supreme Court of Canada has very clearly held that external agreements such as the Subscription Agreement are not relevant to the determination of who has *de jure* control of a corporation. Moreover, we submit that the foregoing “fact” cannot possibly be supported by the legal documents. Both the Audit Report and the Position Paper repeatedly state that after the Subscription Agreement Network controlled the board because it appointed four directors. This is absolutely and indisputably incorrect. Under the Subscription Agreement, Network did have the right to nominate four people for election to the Board but the Existing Signal Shareholders had the right to elect, or not to elect, those individuals. If the Existing Signal Shareholders chose not to elect Network’s nominees, Network’s only recourse would have been to not subscribe for shares of Signal. At the November 6, 2003 shareholder meeting, Network did not have any legal right to elect its nominees to the Board or otherwise force such persons to be appointed to the Board, nor did Network even have the right to participate as a 45% voting shareholder, since it had not yet acquired such shares. Moreover, the fact that Network made their investment in Signal conditional on the Existing Signal Shareholders electing its nominees to the Board prior to the time it invested in Signal demonstrates that Network understood that, after the subscription, it would not have enough votes to determine who would be the directors of Signal.
- (c) The “fact” that the Non-Voting Preferred Shares were convertible to Common Shares. Again, as discussed at length in the Submission, this statement is not supported by the legal documents. Moreover, because Network would not have acquired more than 50% of the voting shares even if all the Non-Voting Preferred Shares were converted to Common Shares, even if it were accurate, this “fact” would be irrelevant.

Again, while not an exhaustive list, the most fundamental legal errors made by the CRA include the following:

- (a) That the Subscription Agreement is in any way relevant to the determination of *de jure* control. The Audit Report, at page 16, correctly quotes the Supreme Court of Canada as stating that only those limits on a shareholder’s right to elect the directors that are “manifested in either the constating documents or in any “unanimous shareholder

agreement” as defined in the relevant governing corporate legislation” are relevant to this determination. However, the CRA then makes a fundamental error when it includes any “legally binding contract signed by the corporation” in its summary of the documents that can effect legal control. More specifically, the CRA wrote:

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 a (sic) 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.”

[Underlining added; italics in original.]

With all due respect, even a cursory reading of the Supreme Court of Canada’s decision in Duha reveals that this is an absolutely incorrect statement of the law. The Supreme Court of Canada of Canada considered this statement by Linden J.A. of the Federal Court of Appeal in great detail and wrote:

In the view of Linden J.A. (at p. 118) “it is important to look to the legal position of the parties as displayed in the wider circumstances of the parties’ affairs.” But while this might seem a sensible approach at first glance, I can find no general support in the extensive authorities cited for Linden J.A.’s application of it.

40 The general approach to the determination of control, as I have already noted, as been to examine the share register of the corporation to ascertain which shareholder, if any, possesses the ability to elect a majority of the board of directors and, therefore, has the type of power contemplated by the *Buckerfield’s* test, *supra*. The case law seems to point only to limited circumstances in which other documents may be examined, and then only to a narrow range of documents which may be considered. In my view, this is readily apparent even in the case law cited by Linden J.A. in support of the opposite position, which I shall now briefly discuss.

...

42 In his reasons, Linden J.A. appears to have taken this statement to support the proposition that the court is entitled to consider ordinary contracts between shareholders to assess control. However, the flaw in this interpretation is immediately obvious: in Dworkin, Hall J. was dealing not with an “ordinary” contractual arrangement but with a provision of the company’s articles of

association, one of its constating documents. It is entirely proper to look beyond the share register when the constating documents provide for something unusual which alters the control of the company. To consider every legally binding arrangement between shareholders as such, however, is another matter entirely. As I will explain in more detail below, the distinction between contractually binding agreements outside the constating documents on the one hand, and legally binding provisions within the constating documents on the other, is crucial. With respect, Linden J.A.'s interpretation of *Dworkin Furs* cannot be sustained. In fact, Gibson J. in *International Iron & Metal Co v. Minister of National Revenue*, [1969] C.T.C. 688 (Can. Ex. Ct), expressly distinguished the shareholders' agreement there at issue for the "contract" considered in *Dworkin Furs*, which was "part of the constitution of the Company" (p. 674).\

...

50 In any event, I certainly do not think it can be said that *Consolidated Holding* supports the very broad proposition gleaned from it by Linden J.A. (at p. 118), that "[a]ny binding instrument ... must be reckoned in the analysis if it affects voting rights". For precisely the reasons expressed by Wilson J. in the above-quoted passage of her dissent in *Imperial General Properties*, and in keeping with the approach taken by courts since *Buckerfield's*, it is clear that the general test for *de jure* control remains majority voting control over the corporation, as manifested by the ability to elect the directors of the corporation. While this Court has occasionally been willing to examine factors other than the share register of the company, its assessment has been restricted only to the constating documents, not external agreements. The only exception to this rule has been in cases like *Consolidated Holdings*, where the shareholders' very capacity to act has been limited by external documents, but this has to date been manifested only in cases where the shares are held by trustees.

51 Thus, I would conclude that, as a general rule, external agreements are not to be taken into account as determinants of *de jure* control.

...

For Linden J.A. to rest his disposition of the instant case on the basis that, in determining issues of corporate control, "the Court will look to the time in question, to legal documents pertaining to the issue, and to any actual or contingent legal obligations affecting the voting rights of shares" (p. 121) was, with respect, inconsistent with the Canadian jurisprudence in this area.

...

55 Therefore, as I have indicated, I conclude that Linden J.A. erred in considering the Agreement for the purposes of ascertaining *de jure* control, even assuming, for the sake of argument only, that he was correct in treating it as an ordinary shareholders' agreement.

...

59 As I have already indicated, agreements among shareholders, voting agreements, and the like are, as a general matter, arrangements that are not examined by courts to ascertain control. In my view, this is because they give rise to obligations that are contractual and not legal or constitutional in nature.

...

71 Therefore, I would conclude that, while “ordinary” shareholder agreements and other external documents generally should not be considered in assessing *de jure* control, in keeping with the long line of jurisprudence to this effect, the USA is a constating document and as such must be considered for the purposes of this analysis.

[Emphasis added.]

It is difficult to image the Supreme Court of Canada could have been more clear in rejecting the exact statement of Linden J.A. of the Federal Court of Appeal that the CRA states was endorsed by the Supreme Court of Canada. This fundamental legal error permeates the analysis in both the Audit Report and the Position Paper as the CRA’s entire position seems to be based on the supposed “rights” under the Subscription Agreement. In fact, the Audit Report, under the heading “Extent of the Audit” states:

The audit was restricted to a review of a subscription agreement for shares between Signal Energy Inc. and Network Capital Inc.

As this statement clearly demonstrates, the audit was limited to reviewing a document which the Supreme Court of Canada has, in the most clear terms, held not to be relevant to determining which shareholders, if any, exercise *de jure* control of a corporation.

- (b) That the right to nominate directors somehow provided Network with a right as described in paragraph 251(5)(b) of the Act. There is simply no possible way that the ability to nominate people for possible election to a board of directors (*i.e.*, not a right to appoint or elect), which generally is an ability enjoyed by every shareholder of any corporation, provided Network with a “right” to (i) acquire shares of Signal; (ii) to control the voting rights of other shareholders; or (iii) to cause the corporation to acquire or redeem shares owned by other shareholders. The CRA’s assertions to the contrary are hard to follow, illogical and ignore both the statutory language and the Supreme Court of Canada’s very clear statements that external agreements are not relevant to determining *de jure* control.
- (c) The mere possibility of acquiring an option to acquire shares amounted to a paragraph 251(5)(b) right. As noted in the Submission, while an option to acquire shares amounts to a 251(5)(b) right, the mere possibility that an option may be issued to a person cannot possibly be viewed as giving such person a “right” to a share. Any person with money has the same possibility of acquiring a share because a corporation can always choose to issue additional shares and any person to whom a corporation may grant an option (whether for cash or in recognition of services rendered) also has the same possibility. There is no case law or statutory authority that would suggest such a possibility amounts to a “right” as contemplated under paragraph 251(5)(b) (and indeed, elevating a “possibility” to a “right” would lead to many absurdities and defeat the purpose of paragraph 251(5)(b)).

We ask that the forgoing summary, the Submission and the relevant legal documents be carefully reviewed and considered. We strongly submit that such careful consideration leads to the

unavoidable conclusion that Network did not acquire *de jure* control of Signal for purposes of the Act in 2003. If you have any questions or comments regarding your ability to reach the same conclusion after reviewing the written material, we request an opportunity to meet with you to discuss any remaining concerns. Please contact Brent Perry (403-260-3306) or Brett Anderson (403-260-5637) to arrange such a meeting.

Yours very truly,

FELESKY FLYNN LLP

PER: F. Brent Perry, QC / Brett Anderson

FBP:d:gk