Opportunities for Municipally Owned Corporations in Ontario's Electricity Market

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INTRODUCTION

The principal purpose of this paper is to describe some of the new business opportunities available to municipally owned corporations in Ontario's new electricity market. We will describe the development of this market and provide a brief summary of the regulatory environment in which municipally owned electricity distribution companies and other electricity-related businesses will operate. We will outline the tax regime established under part VI of the Electricity Act, 1998,[1] examine the interaction of this special tax regime with the federal and provincial corporate tax rules, and provide some suggestions and guidelines on how to structure the business operations of municipally owned electricity-related projects.

RESTRUCTURING OF ONTARIO'S ELECTRICITY INDUSTRY

The Ontario government opened the province's electricity market to competition on May 1, 2002. Owners of electricity transmission and distribution systems are now required to provide electricity generators, retailers, and consumers with non-discriminatory access to their systems. Electricity consumers may choose to contract for supply from electricity retailers or generators or accept default supply at spot prices established through a market overseen by the Independent Electricity Market Operator (IMO). Ontario's arrival at a competitive electricity market arises from a fundamental restructuring of the electricity industry implemented over a remarkably short period of time.

The former Ontario Hydro dominated all aspects of electricity generation, transmission, distribution, and sales by virtue of its authority under the former

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Power Corporation Act (Ontario).[2] Ontario Hydro held a monopoly in electricity generation; approximately 86 percent[3] was directly generated by Ontario Hydro, 7 percent[4] was purchased exclusively for resale from non-utility generators under long-term contracts with Ontario Hydro, and the balance was purchased for resale from neighbouring jurisdictions. Ontario Hydro also owned the electricity transmission grid. The Power Corporation Act provided Ontario Hydro with monopoly authority to set wholesale and retail electricity rates charged both by itself and by municipal electricity utilities to retail customers and industrial users. This arrangement came under close scrutiny as Ontario Hydro experienced a series of financial reversals, including mounting debt, mismanagement of its nuclear assets, and a provincially mandated rate freeze commencing in 1993. These financial reversals led to a restructuring process, commencing with the formation of the Macdonald commission in 1996[5] and then the release, in 1997, of the government's white paper[6] setting out a restructuring plan. The white paper was adopted as a guide to the fundamental restructuring of the electricity industry in Ontario.

Legislative Restructuring

The legislative authority for restructuring the electricity industry and governing its ongoing operation is the Energy Competition Act, 1998.[7] The ECA was the vehicle for implementing the Electricity Act, the Ontario Energy Board Act, 1998,[8] and numerous amendments to existing Ontario statutes. The Electricity Act oversees the restructuring of provincial and municipal electricity assets and ongoing market regulation. The OEB Act oversees ongoing regulation of electricity (and gas) market participants.

The ECA provided for the repeal of the Power Corporation Act. The Electricity Act oversaw the breakup and transfer of the assets and liabilities of Ontario Hydro into five new corporations: Ontario Power Generation Inc. (OPGI), Hydro One Inc. ("Hydro One"), the IMO, the Electrical Safety Authority, and the Ontario Electricity Financial Corporation (OEFC). Of these successor corporations, OPGI and Hydro One are subject to a special tax regime with similarities to the special tax regime applicable to municipally owned electricity businesses. The tax regime applicable to OPGI and Hydro One is not addressed in this paper. OEFC took on the residual obligations and liabilities of Ontario Hydro and is also the recipient of the payment of the special taxes established under the Electricity Act.

Municipal Restructuring

While Ontario Hydro distributed electricity to rural and remote communities and some urban areas, the majority of consumers' distribution needs were served by geographically oriented local public utilities commissions or hydroelectric commissions, which are commonly referred to as municipal electricity utilities (MEUs). The province took the policy position that local municipal governments ("municipalities") owned the MEUs. To give this policy a definitive legal underpinning and to take the first step in establishing the MEUs on a commercial basis, the Electricity Act required municipalities to transfer the assets and liabilities of MEUs within their geographical jurisdiction to companies incorporated under the Business Corporations Act (Ontario),[9] by November 7, 2000 pursuant to a transfer bylaw.[10] Section 142 of the Electricity Act established that municipalities owned the shares of these OBCA companies. After November 7, 2000, most municipalities adopted a corporate structure in which the municipality is typically the owner of the shares of a holding company, which in turn owns the shares of a distribution company, in some cases a generation company, and in some cases a retail company, services company, or fibre/telecommunications company.

Market Restructuring

The fundamental market change arising from the ECA is the requirement to separate the natural monopoly[11] electricity transmission and distribution business from the potentially multiparticipant electricity generation and retail business. The OEB Act facilitates the introduction of competition into the generation of power and the retailing of electricity by prohibiting electricity transmitters and distributors from carrying on any other business activity, except through an affiliate.[12] With the repeal of the Power Corporation Act, investors will be able to establish independent electricity generating and retailing companies and purchase/sell electricity from/to the electricity marketplace. The price of electricity will no longer be regulated. Some aspects of all of these activities, however, will fall under the regulatory authority of the Ontario Energy Board (OEB) and the rule-making powers of the IMO.

The OEB Act provides guidelines for the regulation of the natural monopoly activities of electricity transmission and distribution. The Electricity Act facilitates competition and an open electricity market by providing generators, retailers, and consumers with non-discriminatory access to the transmission or distribution systems owned by Hydro One (and its subsidiaries) and the MEUs.

In the context of municipalities, the Electricity Act requirement to transfer MEU assets and liabilities to OBCA corporations also required municipalities to separate any electricity retail and generation assets they owned or acquired from electricity distribution assets and further required the MEU to establish separate OBCA corporations to carry on non-distribution activities. Where electricity retail or generation businesses did not initially exist, municipalities now have the statutory ability to establish such companies. Alternatively, the municipally owned corporation or a subsidiary of such a corporation could establish such companies. Each municipally owned company can engage in a greater range of business activities and relationships than did the former MEUs. At the same time, these companies will bear greater risks and be subject to additional compliance requirements in the new electricity marketplace. Municipally owned companies will be able to experience the range of mergers, acquisitions, and joint venture opportunities that other corporations enjoy (although subject to OEB review in certain circumstances). Financing opportunities will arise as these companies will have the opportunity to recapitalize through issuing debt, shares, and other securities to investors.

Regulatory Restructuring

The ECA imposes an entirely new regulatory structure on the electricity industry. The OEB Act expands the OEB's regulatory oversight of the natural gas industry to include the electricity industry. The Electricity Act establishes the IMO as a non-profit and independent central market operator. The IMO's responsibilities include overseeing the safety and reliability of the electricity transmission system; establishing and administering the spot market for electricity and the rules under which parties will act in that market; establishing Ontario demand forecasts and planning; and developing future market features such as a forward market for electricity prices.

The repeal of the Power Corporation Act represented a shift in electricity market regulation from the integrated Ontario Hydro, with regulatory oversight of the MEUs, to the independent and arm's-length OEB. Under the OEB Act, the OEB licenses electricity generators, transmitters, distributors, and retailers; regulates the rates charged by electricity transmission and distribution companies; establishes rules, guidelines, and codes of conduct to govern licensees; and approves the sale of transmission and distribution companies or assets.

Instead of taking direction from Ontario Hydro as to rates, accounting policies, and capital structure, the new electricity distribution companies take direction from the OEB. Electricity distribution and transmission companies submit rate applications to and have their rates approved by the OEB, have an OEB-mandated commercial capital structure, and earn an OEB-approved commercial rate of return on their assets. The charges of non-regulated companies, such as electricity retailers and generators, are not subject to OEB oversight.

The OEB-issued licence governing each electricity generator, transmitter, distributor, and retailer has its own terms and conditions for maintenance of the licence. Each licence stipulates additional OEB codes of conduct to be observed by the licensee. In general terms, the Electricity Act, the OEB Act, licence conditions, and codes strive for the broad goals of consumer protection; the separation of electricity retail, generation, and other competitive activities from electricity distribution and transmission activities; and the prevention of cross-subsidization of competitive business by the rate-regulated electricity distribution or transmission businesses.

The OEB has established various codes of conduct that are relevant to the new companies and to their affiliates, suppliers, and customers.[13] Several of these codes are described briefly below.

Affiliate Relationship Code

As described earlier, a typical corporate structure arising from the breakup of MEU business functions under the Electricity Act is a municipally owned holding company, which in turn owns the regulated local electricity distribution company and, in some cases, one or more of an unregulated retail company, competitive services company, and fibre/telecommunications company. The affiliate relationship code applies to the electricity distribution company and governs certain interactions with its affiliates.

The purpose of the code is to prevent the electricity distribution company from using its natural monopoly to cross-subsidize the businesses of its competitive affiliates by, for example, providing preferential access to the distribution system, recommending the products and services of the affiliate, or providing goods and services to the affiliate that are not priced at fair market value.

Distribution System Code

The distribution system code provides the framework for the electricity distribution company's interaction with its customers. The code governs the distribution company's reporting requirements to its customers, the terms and conditions of offers to connect a customer to the local distribution system, and the method of calculating whether or not a customer is required to make a capital contribution toward new facilities required to connect it to the local distribution system.

Standard Supply Service Code

Under the ECA, consumers who do not elect to contract directly for supply of the electricity commodity with an electricity retailer or generator will receive a default supply through their distribution company. The standard supply service code governs the distribution company in its provision of such default electricity supply. Generally, consumers will receive the electricity supply at spot market prices (as determined by the IMO-administered market) or smoothed spot market prices, with an annual true-up to reflect actual spot market prices.

Retail Settlement Code

The retail settlement code governs the relationship between distribution companies and electricity retailers. The code provides for customer billing options; the procedure for submitting service transaction requests to move customers off standard supply service to receive the commodity from the electricity retailer; switching between retailers and switching from a retailer back to standard service supply; and the terms and conditions of service level agreements between distribution companies and retailers.

Retail Metering Code

The obligations of each electricity distribution company to provide metering services between the transmission system, itself, and customers are to be governed by the retail metering code.

The Local Distribution Company Revenue Model

The electricity retailer, generator, services company, or fibre/telecommunications company will act in a competitive, non-regulated business environment; will set its own capital structure; and will experience fluctuation in its revenue stream according to its business plan and the economy. In contrast, the distribution company will operate as a local natural monopoly in its licensed distribution area. The OEB will regulate the rates the local distribution company charges to its customers and will regulate its capital structure.

The OEB is to issue rate orders each year to distribution companies establishing revenues required to recover certain approved costs plus a specified rate of return. Section 78(2) of the OEB Act states, "No distributor shall distribute electricity or meet its obligations under section 29 of the Electricity Act except in accordance with an order of the Board." In issuing such an order, the OEB also has the power, under section 78(3) of the OEB Act, to set rates: "The Board may make orders approving or fixing just and reasonable rates for the transmitting or distributing of electricity and for the retailing of electricity in order to meet a distributor's obligations under section 29 of the Electricity Act." Two documents set out the process by which a local distribution company is expected to structure its accounts, set its capital structure, and ultimately calculate its rates to be approved by the OEB. The first document is the OEB's *Electricity Distribution Rate Handbook* ("the rate handbook").[14] The second is the OEB's *Accounting Procedures Handbook* (APH) and *Uniform System of Accounts* (USA).[15] The APH and the USA provide the local distribution company with a standard system of accounts on which to base its accounting records for regulatory purposes.

Rate Handbook—PBR

The rate handbook adopts performance-based regulation (PBR) as the principal rate and incentive mechanism. Where the former Ontario Hydro regime saw local utilities operate on a "cost-of-service" model under which rates were matched with expenditures, the PBR regime separates rates charged by the local distribution company from the cost of providing the service. Once the local distribution company's rates are set, they may increase annually according to the OEB's determination of the applicable year's increase to the distribution industry's input prices, less a productivity factor of 1.5 percent, plus an adjustment for potential extraordinary events, if any, that are specific to the company. Where the local distribution company can reduce its costs by more than the offsetting 1.5 percent productivity factor, it may keep the revenues since the rates it charges to its customers do not change as a result of the company's ability to reduce costs during the effective period of the company's current rate approval.

The PBR mechanism described above is a transitional measure arising out of industry restructuring. Accordingly, the OEB refers to it as "first generation PBR." The OEB undertook an initial review of first generation PBR in 2001 with a view to developing second generation PBR, which will replace the transitional mechanism in 2003.

Another fundamental transitional measure addressed by the rate handbook is the "unbundling" of rates charged to customers into separate commodity, transmission, distribution, retail, IMO, and tax components. The OEB required unbundling of rates to be completed by market opening (May 1, 2002). Consequently, the rates of a local distribution company will be established on an unbundled basis. The principal financial focus for the local distribution company is now its capital structure and regulated rate of return calculations.

The rate handbook deems a local distribution company to adopt a commercial capital structure. The debt-equity ratio of a local distribution company is based on the size of the company's defined rate base, as shown in table 1.

The rate handbook permits the distribution company to earn a market-based rate of return (MBRR) on its rate base. A distribution company may choose to base its rates at any level up to the MBRR. (That is, in theory, the company could be managed and operated on a not-for-profit basis.) The MBRR consists of a target return on equity of 9.88 percent and a deemed debt rate (varied according to the size of the distribution company's rate base, as described in table 1) applied to the utility's deemed debt-equity ratio. Both the target return on equity and the deemed debt rate will be reviewed by the OEB for second generation PBR.

As a result of a directive issued by the minister of energy to the OEB on June 7, 2000, the OEB issued a decision regarding revisions to the rate handbook.[16] The OEB decision requires distribution companies to phase in their maximum MBRR equally over the three-year period of first generation PBR. After lengthy discussion, the OEB has issued a guideline generally addressing the recovery of payments in lieu of taxes (described in greater detail below) by local distribution companies in connection with the rate-setting process.[17] The OEB has stated that it considers payments in lieu of taxes paid on distribution revenue to be an additional expense that should be recovered through an increase in distribution rates. The OEB proposed that such recovery by distribution companies of payments in lieu of taxes be implemented through adjustments to each company's rate application to the OEB. The OEB has stated that it intends to hold further consultation on this matter.

Tax Restructuring

The province's restructuring of the electricity industry brought about two significant changes to the financial environment in which electricity distribution companies and their affiliates operate. The first involved the need to address the outstanding debt and other liabilities of Ontario Hydro. The second involved the need to create a level playing field for the taxation of companies involved in the deregulated Ontario electricity industry.

Similar to the experience of other jurisdictions, the restructuring of Ontario Hydro and the movement to a competitive marketplace made the liabilities of the old system uneconomic, resulting in what some economists and the Electricity Act refer to as stranded debt. Upon the breakup of Ontario Hydro, its outstanding bonds, unfunded nuclear liabilities, and other liabilities were left with one of the five successor corporations—OEFC. The Ontario government estimated that those liabilities represented an amount of approximately $38 billion. In contrast, the creation of the Ontario Hydro successor entities OPGI and Hydro One represented approximately $17.1 billion in offsetting assets from the province's perspective.

TABLE 1 Deemed Common Equity and Debt Ratios and Debt Cost Rates

Size of utility rate base	CER[a]	(1-CER)[b]	DR[c]
Greater than $1 billion	35	65	6.80
Between $250 million and $1 billion	40	60	6.90
Between $100 million and $250 million	45	55	7.00
Under $100 million	50	50	7.25

[a] Deemed common equity ratio.
[b] Debt-to-capital ratio.
[c] Debt rate.

Accordingly, the Ontario government estimated the resulting stranded debt to be $20 billion.

The Electricity Act requires OPGI, Hydro One, and the local municipally owned electricity distribution companies and their affiliates to make payments in lieu of taxes to OEFC in order to pay down the stranded debt while these entities are provincially or municipally owned. Any amount not paid down through this method and through other receivables from OPGI and Hydro One is termed "residual stranded debt" under the Electricity Act. The Ontario government has estimated the residual stranded debt to be $7.8 billion. The residual stranded debt is to be paid to OEFC over time through a debt retirement charge under the Electricity Act, which will be paid by most consumers of electricity at a rate of 0.7 cents per kWh.

Before the introduction of the Electricity Act, the former Ontario Hydro and the former municipally owned distribution companies were exempt from federal and Ontario tax. In order to create a so-called level playing field with taxable corporations that the province hoped would enter the market, it was proposed that the successor companies to these entities, which would otherwise be exempt from tax (as discussed below), be required to make payments in lieu of taxes (which would also be used to help pay down the stranded debt). Accordingly, the Electricity Act obligates the municipally owned distribution companies and their affiliates to pay an equivalent amount in lieu of taxes, and also to pay an additional "transfer tax" should they cease to be municipally owned. The remainder of this paper will describe the application of this new tax regime and the opportunities available to municipally owned distribution companies and their affiliates in the new electricity marketplace.

TAXATION UNDER PART VI OF THE ELECTRICITY ACT

Part VI of the Electricity Act imposes a number of special taxation provisions applicable to distribution companies and their affiliates. As indicated above, the principal taxing provisions that this paper will address are the payments in lieu of taxes and the transfer tax.[18]

First, it is important to explain the nomenclature used in the legislation. As discussed above, the Electricity Act required the former public utilities commissions, hydroelectric commissions, and MEUs to transfer their electricity assets and liabilities to OBCA corporations. Further, the Electricity Act and related legislation, such as the OEB Act, oversaw the breakup of these assets into separate corporations differentiated by their activities. Accordingly, in the new marketplace, there are distribution companies, generation companies, retail companies, services companies, and fibre/telecommunications companies. Part VI of the Electricity Act, however, uses the legacy term "municipal electricity utility" to identify *any* company that (1) is exempt from taxation under subsection 149(1) of the Income Tax Act (Canada)[19] and (2) generates, transmits, distributes, or retails electricity. Indeed, only part VI of the Electricity Act and section 1.1 of O. Reg. 161/99 under the OEB Act use this term.[20] The remainder of the Electricity Act and the OEB Act use the terms "generator," "transmitter," "distributor," and "retailer." This paper will use the abbreviation MEU in describing the taxation of these companies (where they fit within the following definition in the Electricity Act).

Section 88(1) of the Electricity Act defines a "municipal electricity utility" as

> (a) a municipal corporation that generates, transmits, distributes or retails electricity directly;
> (b) a commission established under the *Public Utilities Act* or any other general or special Act through which a municipal corporation generates, transmits, distributes or retails electricity;
> (c) any other body, however established, through which a municipal corporation generates, transmits, distributes or retails electricity;
> (d) a corporation established pursuant to section 142 or a subsidiary of such a corporation, if a municipal corporation holds an interest, directly or indirectly, in one or more shares of such a corporation or subsidiary;
> (e) a police village that generates, transmits, distributes or retails electricity directly or indirectly, or a corporation or other entity owned by the members of a police village for the purpose of generating, transmitting, distributing or retailing electricity; or
> (f) a person or entity prescribed by the regulations.

The general catchall part of this definition, which has far-reaching consequences for the MEU group, is paragraph (d). This provision stipulates that a "subsidiary" of a MEU is itself a MEU if a municipal corporation directly or indirectly holds shares of the subsidiary.

Payments in Lieu of Corporate Income Tax

Section 93 of the Electricity Act requires each MEU that is exempt from taxation under subsection 149(1) of the ITA to make special payments in lieu of taxes (PILs) computed as if the MEU were subject to tax under the federal and provincial corporate tax regimes. Section 91 of the Electricity Act imposes a similar tax on OPGI and Hydro One. As explained earlier, in all cases, these payments are to be made to OEFC and are intended to retire Ontario Hydro's stranded debt. The charging provisions in sections 93(1) and (2) are set out below.

> 93(1) If a municipal electricity utility is exempt under subsection 149(1) of the *Income Tax Act* (Canada) from the payment of tax under that Act, it shall pay to the Financial Corporation in respect of each taxation year an amount equal to the amount of the tax that it would be liable to pay under that Act if it were not exempt.
>
> 93(2) If a municipal electricity utility is exempt under subsection 57(1), section 57.11 or subsection 71(1) of the *Corporations Tax Act* from the payment of a tax under that Act, it shall pay to the Financial Corporation in respect of each taxation year an amount equal to the amount of the tax that it would be liable to pay under that Act if it were not exempt.

The PILs regime applies only to a MEU that is exempt from taxation under the specified provisions of the ITA and the Corporations Tax Act (Ontario).[21] If a MEU is subject to the PILs, it must calculate the PILs amount in accordance with the rules found in the ITA and the CTA, as supplemented by regulations released under the Electricity Act from time to time.[22] The Ministry of Finance (MOF) released the PILs regulation on May 11, 2001, prescribing special rules for the calculation and administration of PILs to be paid by MEUs.

This paper will not examine the PILs calculation in detail. We note, however, that the PILs liability will extend to all federal and provincial corporate taxes, including capital taxes and corporate minimum tax, and municipal and school taxes pursuant to the Assessment Act.[23]

Administrative Provisions

The PILs regulation provides administrative rules dealing with the filing of tax returns and the payment of PILs liability by instalment.[24] The MOF has supplemented the PILs regulation by releasing a tax advisory bulletin that sets out the filing requirements for MEUs.[25] The PILs regulation requires a MEU to pay its PILs in monthly instalments over the course of the taxation year starting October 1, 2001, with the first instalment due on or before October 31, 2001. A MEU will have to file Ontario CT23 corporations tax and annual returns, federal T2 corporate tax returns, financial statements, and any applicable tax elections, within six months of the taxation year-end. Such returns and accompanying documents must be delivered to the MOF in a yellow envelope provided by the MOF (to distinguish the returns from those of non-MEUs). This arrangement will facilitate the payment of PILs to OEFC, rather than to the general revenue account.

Instalments are required for each taxation year where the PILs liability equals or exceeds $2,000. For the first taxation year, each instalment is equal to one-twelfth of the PILs liability estimated for the taxation year. In the second taxation year, the instalments can be calculated in one of two ways:

1. each instalment is equal to one-twelfth of the PILs liability for the current taxation year, or
2. each instalment is equal to one-twelfth of the PILs liability for the previous taxation year.

Further modifications are made to the instalment system for the third taxation year. The MEU must pay any balance owing for a taxation year on or before the end of the third month from the end of that taxation year.[26]

The First Taxation Year

In order to calculate the amount of PILs that will have to be paid, a MEU must determine its taxable income for the taxation year and must fix the date on which its taxation year ends. The PILs regulation provides that the first taxation year of the MEU will end on the same day as its first fiscal period ending after October 1, 2001. For example, for a MEU whose fiscal period begins January 1, 2001, the first taxation year begins on October 1, 2001 and ends on December 31, 2001. Once the MEU has fixed its taxation year-end, it cannot change that date without the approval of the Ontario minister of finance.[27]

Pre-October 1, 2001 Losses and Expenses

Section 8 of the PILs regulation precludes a MEU from deducting any expenses or losses incurred before October 1, 2001.

> 8(1) The following rule applies in determining a municipal electricity utility's income for its first taxation year ending after October 1, 2001:
>
> 1. The amount of any deduction claimed under section 20 of the Federal Act is determined as if the utility has always been a corporation subject to tax under that Act and had deducted in its prior taxation year the maximum amounts it would have been entitled to deduct under that section for that prior taxation year.
>
> 8(2) The following rules apply in determining a municipal electricity utility's income, taxable income and amount payable under section 93 of the Act for a taxation year ending after October 1, 2001:
>
> 1. The utility is not entitled to deduct an amount in respect of any expense or loss incurred before October 1, 2001.
> 2. The amount of any deduction from the amount that would otherwise be payable under section 93 of the Act is determined as if the utility were a corporation incorporated on October 1, 2001.
>
> 8(3) Subsections (1) and (2) do not apply to a municipal electricity utility that is subject to tax under the Federal Act or the *Corporations Tax Act* immediately before its first taxation year under section 93 of the Act ending after October 1, 2001.

A MEU is entitled to claim any deductions available to it for items such as financing expenses, reserves, doubtful or bad debts, interest and financing expenses, contributions to registered pension plans, and other amounts for which a discretionary deduction is contemplated by section 20 of the ITA. Presumably, the restriction in section 8(2) would prevent a MEU from capitalizing the interest on any outstanding debt incurred to acquire depreciable property in accordance with the provisions of subsection 21(1) of the ITA and accrued between the period of incorporation and October 1, 2001.

The limitation on the deduction of pre-October 1, 2001 expenses and losses appears unfair given that such expenses and losses are likely attributable to the delay in market opening from November 2001 to May 2002. This provision may also provide an unfair advantage to taxable corporations competing with a MEU in the retail or distribution sectors, since such corporations that have incurred similar startup losses can carry the losses forward and deduct them against taxable income.

Intercompany Charges

One of the key issues in planning the original capital structure of a MEU group of companies was the deductibility of financing costs and other service fees charged between related parties. Some concern was expressed by professional advisers that the PILs regulation, when effective, might mandate a capital structure for a MEU identical to the capital structure applied to distribution companies for rate-setting purposes by the OEB. Other concerns were expressed about a possible prohibition on the deductibility of any non-arm's-length charges in computing PILs. The PILs regulation does not address either of these concerns.

Deemed Partnership

One of the interesting anomalies that has cropped up in the interaction of the PILs regime and the definition of a municipal corporation in paragraphs 149(1)(d.5) and (d.6) of the ITA (discussed below) is the possibility that a corporation formed to carry out a joint venture on behalf of several different MEUs could itself be tax-exempt but not subject to the PILs regime. Section 10 of the PILs regulation appears to address this issue by deeming such a joint venture corporation to be a partnership and including in the income of each of the MEUs its proportionate share of the income of this deemed partnership.

Application of Fresh Start Rules

Section 7 of the PILs regulation provides that a MEU will be deemed to have acquired, at fair market value, any property acquired under a transfer bylaw[28] or any other property subsequently acquired by the MEU following the effective date of the transfer bylaw. Such property will be revalued to its fair market value on October 1, 2001 for the purpose of determining its cost amount for tax purposes.

> 7(1) The following property shall be deemed to be acquired by a municipal electricity utility on October 1, 2001 at a cost equal to the fair market value of the property on that date:
>
> 1. Property that is transferred to the utility under a transfer by-law.
> 2. Property that is acquired by the utility before October 1, 2001 but after any property is transferred to the utility under a transfer by-law.
>
> 7(2) In determining the fair market value of property referred to in subsection (1), a municipal electricity utility shall use a valuation method,

(a) that is generally accepted as a reasonable method for determining the fair market value of the particular type of property; and

(b) that is acceptable to the Minister of Finance.

Section 7(2) of the PILs regulation provides that the MEU will be required to use a valuation method that is generally accepted as a "reasonable method" for determining the fair market value of the particular type of property and is "acceptable" to the minister of finance. The MOF was unable to describe what these reasonable methods of valuation might be but indicated that a formal valuation may be necessary for "larger" MEUs. The fair market value will serve as the capital cost of depreciable capital property, the adjusted cost base of non-depreciable capital property, and the cost of inventory held by the MEU. One of the significant challenges in this area will be achieving consistency between MEUs in adopting valuation methodology. The professionals in this area are fond of pointing out that "valuation is an art, not a science."

PILs Anomalies

A number of anomalies arise from the potential application of the general corporate tax rules to a MEU.

As described above, section 7 of the PILs regulation provides that the capital cost of property received by a MEU pursuant to the transfer bylaw and any property subsequently acquired will be equal to the fair market value of the property at October 1, 2001. The depreciable capital property transferred pursuant to the transfer bylaw must be separated into the appropriate capital cost allowance (CCA) classes by the MEU. Generally, this will not be an issue; however, it is not clear how property that is generating or distributing equipment acquired by the former public utilities commission before 1988 will be treated on the transfer to a MEU. The acquisition date of such property is relevant because such property is depreciable at 6 percent if it was acquired before 1988 but at 4 percent if acquired after that time. Normally, when depreciable capital property is transferred in a non-arm's-length transaction, the recipient is deemed to include it in the same class as the previous owner; accordingly, the MEU would include the property in class 2 at the higher depreciation rate.[29] In the case of a former public utilities commission, however, the property would not have been included in a CCA class owing to the commission's tax-exempt status. Accordingly, it is not clear whether a rollover of the CCA class would apply in this situation.

Section 16.1 of the ITA is a special provision relating to lease transactions. This section permits a lessor and a lessee to jointly elect to have a lease of property recast from the lessee's perspective as a borrowing and purchase of property. Such an election allows the lessee to deduct CCA and notional interest on the fair market value of the leased property rather than its rental payments. This election is not available where the lessor (that is, the MEU) is tax-exempt under the ITA; therefore, it is not available for the operating leases contemplated under the transfer tax regulation (discussed below).[30]

Subsection 112(1) of the ITA allows a corporation that has received a taxable dividend in the year from a Canadian resident corporation to deduct the amount of the dividend from its income for the purposes of calculating its taxable income. This deduction is not permitted if the dividend is paid by a corporation that is tax-exempt under the ITA. Accordingly, a corporation that receives taxable dividends from a tax-exempt MEU will not be entitled to the dividend deduction.[31]

The Tax-Exempt Corporation

PILs are payable by a MEU only for so long as it remains tax-exempt. A MEU may determine that there is some advantage to its remaining within the PILs system. Although the tax payable under both systems should be the same, the PILs system provides a MEU with a significantly larger credit against transfer tax that may be payable in the future (discussed below).

The proliferation of municipally owned and controlled corporations arising out of section 142 of the Electricity Act raises some interesting technical and policy issues regarding the scope of the tax exemption provisions in the ITA and the limitations on business activities imposed by municipal law considerations. The first part of this section of the paper will provide an overview of the rules in subsection 149(1) that define tax-exempt municipal corporations and will note some of the interesting anomalies that have arisen. The second part of this section will examine the special tax that applies on transfer of MEU property. A later section of the paper will apply these rules to some of the joint venture arrangements that are surfacing in the Ontario electricity sector.

The Ownership and Source-of-Income Tests

In order to be exempt from corporate income tax under the ITA, a corporation must satisfy both an ownership test and a source-of-income test. Three provisions are potentially applicable to municipalities, their subsidiary corporations, and indirect subsidiary corporations: paragraphs 149(1)(d.5) and (d.6), and subsection 149(1.2).

The Ownership Test

Paragraph 149(1)(c) of the ITA exempts from part I tax a municipality in Canada or a municipal or public body performing functions of government in Canada. Paragraphs 149(1)(d.5) and (d.6) contain exempting provisions applicable to a corporate subsidiary of a municipality ("a d.5 corporation") and an indirect subsidiary ("a d.6 corporation"), as follows:

> (d.5) subject to subsections (1.2) and (1.3), a corporation, commission or association not less than 90% of the capital of which was owned by one or more municipalities in Canada, if the income for the period of the corporation, commission or association from activities carried on outside the geographical boundaries of the municipalities does not exceed 10% of its income for the period;
>
> (d.6) subject to subsections (1.2) and (1.3), a particular corporation all of the shares (except directors' qualifying shares) or of the capital of which was owned by

> one or more persons each of which is a corporation, commission or association to which paragraph (d.5) or this paragraph applies for the period if the income for the period of the particular corporation from activities carried on outside
>
> (i) if paragraph (d.5) applies to the other corporation, commission or association, the geographical boundaries of the municipalities referred to in that paragraph in its application to that other corporation, commission or association, or
>
> (ii) if this paragraph applies to the other corporation, commission or association, the geographical boundaries of the municipalities referred to in subparagraph (i) in its application to that other corporation, commission or association,
>
> does not exceed 10% of its income for the period.

A corporation will be a d.5 corporation if not less than 90 percent of its capital is owned by one or more municipalities in Canada. Subsection 149(1.3) of the ITA provides that 90 percent of the capital of a corporation that has issued share capital is considered to be owned by one or more municipalities only if the municipalities are entitled to at least 90 percent of the votes associated with the shares of the corporation. A d.6 corporation, however, must be a wholly owned subsidiary of one or more d.5 or d.6 corporations.

One important issue to consider is that a corporation can lose its tax-exempt status as a d.5 or d.6 corporation if certain persons have a right to acquire shares of the corporation.[32] The ITA effectively deems a person who has a right to acquire shares of a tax-exempt corporation to actually own those shares for the purpose of determining whether both the ownership test and the source-of-income test are met.[33]

Source-of-Income Test

Municipal corporations and their subsidiaries must both satisfy the same source-of-income test. The income of a corporation for the period from activities carried on outside the geographical boundaries of the ultimate municipal shareholder cannot exceed 10 percent of the corporation's income for the period. Generally, when the ITA refers to income, it is contemplating a net income calculation rather than gross revenues. This approach is consistent with one ruling made by the Canada Customs and Revenue Agency ("the CCRA") in connection with revenues and income earned on reserve by a corporate subsidiary of a First Nations bank, on the basis that the CCRA considers a reserve to be a municipality.[34]

Whether income is earned from activities carried on outside the geographical boundaries of the municipality is a question of fact. One must have regard to the location of the offices of the municipal corporation, where its property is situated, where its employees provide their services, where its products or services are created, and where its customers reside.

Subsection 149(1.2) of the ITA excludes certain income from the determination of whether more than 10 percent of the income of a corporation is derived from activities carried on outside the geographical boundaries of the municipality or municipalities that own the corporation. Specifically, income derived from activities carried on pursuant to an agreement in writing with the federal Crown, a province, or a municipality within the geographical boundaries of that contracting party is not included in the determination. A further modification to the source-of-income test is contemplated by a recent amendment to the ITA,[35] which provides that the test *does not* include

> income from activities carried on . . .
> (b) in a province as
> (i) a producer of electrical energy or natural gas, or
> (ii) a distributor of electrical energy, heat, natural gas or water,
> where the activities are regulated under the laws of the province.

One question is whether a "distributor of electrical energy" would include a person who sells electricity in the retail market. This interpretation is consistent with the ordinary dictionary meaning of "distribution." The CCRA, however, has indicated that it would likely interpret the phrase on the basis of its industry meaning and thereby exclude electricity retailers from reliance on these relieving provisions.[36]

The other part of the test that requires clarification is whether an activity is considered to be regulated when the selling price of the activity is subject to review by a provincial agency, as is the case with electricity distribution and transmission rates,[37] or whether the provision is intended to address all activities that are subject to any licensing requirements. For example, a generator of electricity must be licensed, but the selling price of that electricity is not regulated.[38]

Situations are likely to arise in the new electricity market where tax-exempt municipal corporations form a joint venture company to carry on electricity-related activities. The tax status of each shareholder will be dependent on whether the joint venture company meets the source-of-income test. If dividends received from the joint venture company are considered to be income from outside a shareholder's geographical boundaries, that shareholder might exceed the 10 percent threshold and become taxable under the ITA. The question whether dividends are income from activities carried on outside a municipal shareholder's geographical boundaries has not been considered by the courts. The CCRA has issued a technical interpretation in which it takes the position that where a municipally owned corporation acquires shares of a taxable Canadian corporation for investment purposes and holds the shares in a passive manner, any capital gains or dividends from the investment will be considered to have been earned within the municipality's geographical boundaries.[39] One question is whether the CCRA will be of the same opinion with respect to the ownership of a joint venture company's shares. We have had informal discussions with the CCRA on a no-names basis on this issue, but the agency is not yet prepared to express a firm opinion.

Transition to Taxable Entity

A municipal corporation that is the shareholder of a MEU may wish to sell some or all of its shares of the MEU to a third party. If, as a result of the sale, the municipal corporation owns less than 90 percent of the MEU, the MEU will become a taxable corporation and will have to pay tax under the ITA and the CTA.[40] Accordingly, the MEU will no longer have to remit PILs to OEFC.

The fresh start rules in subsection 149(10) of the ITA provide for a deemed year-end and a disposition of property immediately before that year-end as a consequence of an entity's losing its tax-exempt status. The ITA includes a number of provisions that give a former tax-exempt corporation a fresh start as a taxable entity. The MEU will be deemed to have disposed of all of its property for its fair market value at that time and to have reacquired it for the same amount. This deemed disposition and reacquisition may create recapture, a terminal loss, a capital gain, or a capital loss, which will be included in the calculation of the PILs for the transition year. The effect of these rules is to treat the MEU as if it were beginning its operations at the time it became taxable. As a result, the MEU will not be able to make use of any losses that were incurred while it was tax-exempt to reduce its taxable income after ceasing to be tax-exempt, and it will have to claim the maximum reserves available to it, immediately prior to that time.[41]

Section 12 of the PILs regulation provides that where a MEU ceases to be tax-exempt and a deemed disposition occurs by reason of the fresh start rules under the ITA, the MEU is deemed to continue to be exempt until after the deemed disposition. As a result, the taxable gain, if any, arising from the deemed disposition will be included in the computation of PILs.

Section 11 of the PILs regulation provides that where the fresh start rules become applicable to a subsidiary when a MEU disposes of shares of the subsidiary, the amount of PILs otherwise payable by the MEU (from the gains on the shares of the subsidiary) will be reduced by the amount of PILs payable by the subsidiary attributable to income arising from the deemed disposition of its assets.

This transitional provision was amended by a subsequent regulation promulgated in March 2002 in response to the planned initial public offering (IPO) of Hydro One's shares.[42] The amendment also provides that if a MEU ceases to be exempt from normal corporate income taxes arising from an IPO, the MEU and the Ontario minister of finance may agree to an amount that reasonably approximates the PILs, if any, that will arise owing to the deemed disposition of all of the MEU's property on the switch between the tax systems. Normally, a MEU would determine and report its PILs liability, and the minister of finance would reassess the MEU if the minister disagreed with the MEU's reported PILs calculation. Now, in the case of an IPO, a MEU and the minister of finance will agree to the MEU's PILs liability ahead of time, and that amount may not be subsequently contested by an objection or appeal, unless the minister is of the opinion that there was a misrepresentation that is attributable to neglect, carelessness, or wilful default or the commission of a fraud in giving information to the minister.

The transfer tax that is discussed in the next section continues to apply even after the MEU has become a taxable entity.[43]

Tax on the Transfer of Electricity Property

Section 94(1) of the Electricity Act provides that a municipal corporation or MEU shall not transfer any interest in real or personal property that has been used in connection with generating, transmitting, distributing, or retailing electricity (referred to for purposes of this paper as "electricity property") unless it has paid a transfer tax equal to 33 percent of the fair market value of that electricity property. Section 94(2) provides as follows:

> For the purpose of subsection (1), an interest in real or personal property that has been used in connection with generating, transmitting, distributing or retailing electricity shall be deemed to include *any interest in a corporation, partnership or other entity* that derives its value in whole or in part from real or personal property that has been used in connection with generating, transmitting, distributing or retailing electricity [emphasis added].

Section 94(2) extends the definition of electricity property to include any interest in a corporation, partnership, or other entity that derives its value in whole or in part from electricity property. Therefore, the transfer tax applies to a transfer of either a direct or an indirect interest in electricity property. In either case, transfer tax will be imposed on the fair market value of the interest in electricity property being transferred.

Extensive regulations were introduced by O. Reg. 124/99 under the Electricity Act,[44] and subsequently amended on several occasions, to provide an administrative framework for the collection of the transfer tax and to describe in greater detail the types of transfers that would or would not attract the application of the tax. These rules are discussed below.

Notice of a proposed transfer of electricity property must be given to the MOF and the transfer tax must be paid by the transferor of electricity property before the transfer, or security must be provided. A transfer that does not comply with this requirement is void.[45] Payment of the transfer tax is to be made to OEFC; however, should OEFC be dissolved before the proposed transfer, the payment is to be made to the MOF.[46] The MOF will provide a certificate specifying the details of the proposed transfer and confirming that the transfer tax was paid or adequate security provided.

The requirement to pay transfer tax is subject to a number of rules that deem certain transactions to constitute a transfer subject to the charging provision in section 94(1) of the Electricity Act. Such deemed transfers include a loosely described avoidance transaction, the transfer of property to a partnership, and the exchange of property that occurs on an amalgamation.[47] The transfer tax regulation also prescribes certain transactions that are not a transfer to which section 94(1) applies, referred to in this paper as "excluded transfers."[48] The principal excluded transfers are transfers of electricity property made by a MEU to certain affiliates, the transfer of an interest in electricity property made by way of an operating lease, and the transfer of surplus electricity property. Deemed transfers and excluded transfers are described in more detail below.

Computation of Transfer Tax

Section 3.1 of the transfer tax regulation was introduced to remedy an unintended result where an interest in electricity property is transferred by indirect means.

Before the introduction of this provision, the transfer of the shares of the MEU would have attracted transfer tax calculated on the fair market value of those shares irrespective of the amount of debt being assumed on the transfer. Now, section 3.1 provides that the tax is calculated on the value of the underlying property, proportionate to the fair market value of the *interest in shares* of the corporation that the municipality proposes to transfer. It is interesting to note that the amended transfer tax regulation only modified the calculation of transfer tax to make the level of debt of the MEU irrelevant. No amendments have been made or proposed which would modify the calculation of transfer tax where debt, rather than shares, is created or transferred by the operating entity.

Deemed Transfers of Electricity Property

As noted above, the transfer tax regulation contains several provisions that deem particular transactions to be a transfer of electricity property that attracts transfer tax. These deeming rules include a broadly worded anti-avoidance rule,[49] which deems a transaction or series of transactions to be subject to transfer tax where

- as a result of the transaction or series of transactions, a municipal corporation or MEU ceases to own electricity property; and
- it is reasonable to conclude that one of the primary purposes of the transaction or series of transactions is to avoid the application of the transfer tax.

As no technical notes accompany these provisions, it is difficult to discern the type of situation that would lead to the application of this anti-avoidance rule, given the broad language used in section 94 to describe a transfer of an interest in electricity property.

A deemed transfer of electricity property also occurs when a corporation ceases to be a subsidiary of a MEU, presumably as a result of the transfer of a majority of the issued shares of the subsidiary.[50] Section 2(3) of the transfer tax regulation provides:

> When a corporation ceases to be a subsidiary of a municipal electricity utility, the corporation's interest in property described in subsection (1) shall be deemed to have been transferred from the corporation to another person immediately before the corporation ceases to be such a subsidiary. The deemed transfer of the interest in property from the corporation shall be deemed to constitute a transfer described in subsection (1).

Where a MEU transfers electricity property to a partnership, a portion of the property transferred is deemed to constitute a transfer as contemplated by section 94(1) of the Electricity Act, in accordance with the following formula:

> A × (B/C)
>
> where,
>
> "A" is the fair market value of the interest in property described in subsection (1) that the municipal corporation or municipal electricity utility transfers to the partnership;

"B" is the fair market value of that portion of interests in the partnership that are owned by persons other than the municipal corporation or the municipal electricity utility; and
"C" is the fair market value of all ownership interests in the partnership.[51]

No guidance is provided on how one ascertains the value of an ownership interest in a partnership, which could vary from year to year. Presumably, the MOF would take into consideration the valuation methodology used by MEUs in computing the fair market value as at October 1, 2001, in compliance with the PILs regulation.

The transfer tax regulation establishes certain rules with respect to the imposition of transfer tax on the amalgamation or merger of two or more corporations.

2(5) If a corporation (the "successor corporation") is formed as a result of the amalgamation or merger of two or more corporations (the "predecessor corporations"), an interest in property described in subsection (1) that is held by a predecessor corporation immediately before the amalgamation or merger shall be deemed to have been transferred to the successor corporation upon the amalgamation or merger. That transfer shall be deemed to constitute a transfer described in subsection (1).

(6) Subsection (5) does not apply with respect to an amalgamation of two or more municipal corporations or municipal electricity utilities, if the amalgamation is required by an Act or is otherwise required by law.

When a corporation ("the successor corporation") is formed as a result of the amalgamation or merger of two or more corporations ("the predecessor corporations"), any electricity property that is held by a predecessor corporation immediately before the amalgamation or merger is deemed to be a transfer of electricity property to the successor corporation that is subject to the transfer tax rules.[52] A relieving provision applies to an amalgamation of two or more MEUs, or municipal corporations, where the amalgamation is required by law.[53] If this relieving provision is not available, transfer tax will be payable unless the successor corporation can rely on either the "subsidiary exclusion" or the "affiliate exclusion" (discussed below) to shield it from the application of transfer tax.

Finally, the transfer tax regulation contains rules that may result in a deemed transfer of electricity property where there is a capital reorganization of a corporation.

(7) If a shareholder of a corporation ceases to own a share of the capital stock of the corporation because the corporation redeems, acquires or cancels the share, the shareholder shall be deemed to have transferred to a person other than a municipal electricity utility an interest in the corporation having a fair market value equal to the fair market value of the share. That transfer shall be deemed to constitute a transfer described in subsection (1).

(8) If a shareholder of a corporation receives an amount on the reduction of capital in respect of a share of the corporation otherwise than by way of a redemption, acquisition or cancellation of the share, the shareholder shall be deemed to have transferred to a person other than a municipal electricity utility an interest in the corporation having a fair market value equal to the amount received on the reduction

of capital. That transfer shall be deemed to constitute a transfer described in subsection (1).

(9) Subsections (7) and (8) do not apply if the Minister of Finance is satisfied that the redemption, acquisition or cancellation of the share is not part of a transaction or series of transactions that results in a change in the direct or indirect ownership of the corporation.

If a shareholder of a MEU ceases to own a share because the corporation redeems, acquires, or cancels the share, the shareholder is deemed to have transferred an interest in the corporation to a person other than a MEU.[54] This transfer is deemed to be a transfer of electricity property, subject to the application of section 94(1) of the Electricity Act. The MEU is taxed on the value of the share redeemed, acquired, or cancelled, whether or not any property has been distributed to the shareholder. A similar deeming rule applies where the change in ownership is effected by a reduction of capital.[55] In that case, the MEU is taxed on the amount received on the reduction of capital. No transfer tax is payable, however, if the minister of finance is satisfied that this capital reorganization does not result in a change in the direct or indirect ownership of the corporation.[56] We have adopted the practice of requesting a comfort letter from the MOF for any situation where the MEU expects to rely on the latter provision, rather than waiting to deal with the issue on audit.

Excluded Transfers

Section 3 of the transfer tax regulation excludes certain transfers of electricity property made by a municipal corporation or a MEU, from the application of transfer tax. These exclusions may be applicable in the context of future reorganizations involving municipalities and the corporations established pursuant to section 142 of the Electricity Act. The exclusions are available only where the transferee is a MEU. A transfer of electricity property from a MEU to a municipal corporation is not an excluded transaction.

Subsidiary Exclusion

The subsidiary exclusion applies where the transferee is a MEU that is a direct or indirect subsidiary of the transferor. Sections 3(8) and (9) of the transfer tax regulation exclude the following transfers of electricity property from the application of the transfer tax:

1. a municipal corporation or MEU ("the transferor") transfers an interest in electricity property to a corporation that is a MEU ("the transferee"); and
2. the transferor owns, directly or indirectly, at least 95 percent of the total issued and outstanding share capital, excluding the directors' qualifying shares,
   a. of the transferee, or
   b. of a corporation that owns, directly or indirectly, at least 95 percent of the total issued and outstanding share capital of the transferee, excluding the directors' qualifying shares.

Note that this exclusion applies only to transfers from the parent to the subsidiary and not from the subsidiary to the parent. Also, the exclusion seems to apply only to transfers from the parent to its direct subsidiary or to a corporation that is at least 95 percent owned by that subsidiary.

Affiliate Exclusion

The affiliate exclusion applies where the transferee and the transferor are affiliates and both are MEUs. Sections 3(10) and (11) of the transfer tax regulation exclude the following transfers of electricity property from the application of the transfer tax:

1. a MEU ("the transferor") transfers an interest in electricity property to a corporation that is a MEU ("the transferee"); and
2. a corporation owns, directly or indirectly, at least 95 percent of the total issued and outstanding share capital, excluding the directors' qualifying shares,
   a. of the transferor and of the transferee, or
   b. of another corporation that owns, directly or indirectly, at least 95 percent of the total issued and outstanding share capital, excluding the directors' qualifying shares, of the transferor and of the transferee.

The affiliate exclusion seems to apply only to transfers to affiliates that have a common parent company (based on 95 percent ownership). Accordingly, this concept of "affiliate" does not seem as broad as the definition in the OBCA.[57]

Surplus Assets

Sections 3(12) and (13) of the transfer tax regulation provide a limited exclusion for obsolete or surplus electricity property that satisfies a two-part test. First, the fair market value of the surplus property cannot exceed 5 percent of the fair market value of all interests in electricity property that are owned by the transferor at the end of the preceding taxation year. Accordingly, each company in the MEU group must be considered separately in applying this limitation. Second, the surplus property must be either obsolete or not being used, or alternatively, the transfer of property is made in the ordinary course of the transferor's business and the primary purpose of the transfer is to replace the property. As in the case of the other exclusions described in this part of the paper, it would be prudent to file a notice with the MOF describing the transfer and the exclusion relied upon.[58]

Operating Leases

Section 3(14) of the transfer tax regulation provides that transfer tax does not apply to the transfer of a leasehold interest in electricity property, provided that the lease arrangements satisfy four tests set out in the regulation. The application of the operating lease exclusion is discussed in more detail below, in our review of financing options available to municipalities.

No Change in Beneficial Ownership

Section 3(15)(a) of the transfer tax regulation provides that transfer tax does not apply if the transfer does not result in a change in the beneficial ownership of the interest in the electricity property.

Transfer Tax and Corporate Reorganizations

In many MEU arrangements, a holding company ("Holdco") is used to hold the shares of the regulated local distribution company and the shares of one or more affiliates, which are engaged in unregulated activities. The shares of Holdco are owned by the municipal corporation, which is the ultimate shareholder in the structure. It is important to remember, in undertaking any future reorganization, that the interaction of the deeming rules related to transfer tax in the context of amalgamations can lead to some anomalous results.

For example, if Holdco is involved in an amalgamation with one or more of its wholly owned subsidiaries, it is possible that the exclusion for the transfer of electricity property to an affiliate may not be available. The amalgamation is treated as a transfer of electricity property by each of the predecessor corporations (Holdco and the affiliate) to the successor corporation. The broadest transfer tax exclusion available is the "affiliate exclusion," which would be available if each of the predecessor corporations and the successor corporation had a common parent corporation. However, the shares of the successor corporation will be owned by a municipal corporation, which may not be considered to be a corporation for the purposes of the affiliate exclusion if it includes only normal business corporations.[59] If a municipal corporation is not a corporation as contemplated by the transfer tax regulation, this exemption from transfer tax will not be available unless one can rely on the subsidiary exclusion.

Another type of transaction that will have to be considered carefully is the issuance of treasury shares in a MEU to the existing shareholder or an affiliate. One view is that the issuance of treasury shares to either the existing shareholder or an affiliate is not a transfer of electricity property because section 94(2) of the Electricity Act is a secondary charging provision, which is directed toward a third party indirectly acquiring an ownership interest in assets that are used in the generation, transmission, distribution, or retailing of electricity. This is a reasonable interpretation given that the regulations exclude transfers that do not result in a change of beneficial ownership. This interpretation, however, requires us to read additional words into section 94(1) of the Electricity Act, such as "a municipal corporation or municipal electricity utility shall not transfer an interest in electricity property to any person *other than itself or an affiliate*." Until this uncertainty is resolved by legislative amendment, the better approach is to rely on section 3(15) of the transfer tax regulation and issue treasury shares only to the sole shareholder of the MEU.[60]

Credit Against Transfer Tax

Some of the planning involved in potential acquisition and financing structures makes use of the credit against transfer tax for PILs paid by the MEU that has incurred the transfer tax liability, or by a municipal corporation in respect of the PILs paid by MEUs that are related to it. Specifically, section 94(3) of the Electricity Act allows a municipal corporation to reduce its transfer tax liability by any amount payable and paid by the MEU under section 93 of the Electricity Act (that is, its PILs payable and paid) or under the CTA in respect of a previous taxation year or a part of the current taxation year in which the transfer tax liability has arisen. A MEU can also offset any federal tax related to the capital gain realized on the transfer of electricity property. These provisions are set out below:

> (3) Subject to subsection (5), the amount payable under subsection (1) in a taxation year by a *municipal electricity utility* may be reduced by the following amounts:
>
> 1. Any amount payable and paid by the municipal electricity utility under section 93 in respect of the part of the taxation year before the date of the transfer or in respect of a previous taxation year.
>
> 2. Any amount payable and paid by the municipal electricity utility under Part II, II.1 or III of the *Corporations Tax Act* in respect of the part of the taxation year before the date of the transfer or in respect of a previous taxation year.
>
> 3. Any amount that the municipal electricity utility would be liable to pay as tax under Part I of the *Income Tax Act* (Canada) in respect of the taxation year if that tax were computed on the basis that the municipal electricity utility had no income during the taxation year other than the capital gain realized on the transfer of its interest in the property [emphasis added].

The transfer tax credit available to a municipal corporation is potentially broader since it incorporates the PILs and corporation taxes paid by related MEUs. Section 94(4) of the Electricity Act provides:

> (4) Subject to subsections (5) and (6.1), the amount payable under subsection (1) in a taxation year by a *municipal corporation* may be reduced by the following amounts:
>
> 1. Any amount payable and paid by a municipal electricity utility under section 93 in respect of the part of the taxation year before the date of the transfer or in respect of a previous taxation year, but only if the municipal electricity utility is related to the municipal corporation immediately before the transfer.
>
> 2. Any amount payable and paid by a municipal electricity utility under Part II, II.1 or III of the *Corporations Tax Act* in respect of the part of the taxation year before the date of the transfer or in respect of a previous taxation year, but only if the municipal electricity utility is related to the municipal corporation immediately before the transfer [emphasis added].

Note that the transfer tax credit available to a municipal corporation that transfers an interest in electricity property is available only if the MEU that has paid the PILs and thereby generates the credit is related to the municipal corporation immediately before the transfer. Section 94(6) of the Electricity Act provides that a MEU is deemed to be related to a municipal corporation if they are "related persons" within the meaning of section 251 of the ITA.

A number of MEUs have multiple municipal shareholders, and in some circumstances, there is no controlling shareholder. Section 94(6.1) of the Electricity Act was introduced to address the problem this ownership arrangement creates. The MOF takes the view that this provision now allows municipal corporations owning a minority interest in a MEU to benefit from the transfer tax credit based on their proportionate interest in unrelated MEUs.[61] Section 94(6.1) sets out a formula by which any transfer tax credits are allocated among shareholders on the basis of ownership percentages. The MOF has also expressed the view that section 94(6.1) supersedes section 94(6) and therefore the related-party test referred to above is not relevant.

NEW FINANCING AND BUSINESS OPPORTUNITIES

To this point, we have reviewed the restructuring of Ontario's electricity industry, the industry revenue model, and the taxation of municipally owned companies and their affiliates. Against that background, in this section of the paper, we will consider the following financing and business opportunities available to municipalities and municipally owned corporations operating in the new electricity marketplace:

- A municipality can distribute the business profits of MEU operations through the payment of interest and/or dividends on the debt and equity investments made in MEUs.
- A municipality can sell the shares or assets of the MEU business.
- A municipality can secure a steady stream of cash flow by entering into a long-term lease arrangement with any number of international energy companies interested in exploring the Ontario market.
- A municipality can seek to expand its income-earning potential by investing in new energy projects alone or with joint venture partners.
- A municipality can monetize its debt or equity investment in its MEU or refinance the capital structure of the MEU with commercial lenders.

Distribution of Business Profits

With the restructuring of the industry and the creation of a "for profit" business model, it is anticipated that a number of MEUs will have surplus cash on hand, or will generate surplus cash, from their electricity distribution business. Also, surplus cash may be generated from the sale or long-term lease of electricity distribution assets or from the electricity-related assets of affiliates. Some consideration must be given to ways of distributing that surplus cash to the municipal shareholder without attracting transfer tax (discussed above). The distribution of surplus cash is an issue because section 94(1.1) was added to the Electricity Act to potentially include, as property subject to transfer tax, cash and certain intangible properties such as goodwill and customer lists, to the extent that such property was used in connection with the generation, distribution, transmission, or retailing of electricity. Section 94 (1.1) provides:

> For the purposes of subsection (1), real or personal property that has been used in connection with generating, transmitting, distributing or retailing electricity includes cash, amounts receivable, investments, customer lists, licences, goodwill and other intangible property used in connection with those activities.

One alternative is to use the surplus cash to repay all or a portion of the principal amount of any debt held by the municipality. If the debt was issued by the regulated electricity distributor MEU, such repayment could adversely affect the rate of return that could be earned by that distributor in the future. This is an issue that needs to be explored further both in the context of OEB rules and in regard to the issuance of future debt to the municipality. This approach would also have a negative tax impact, in that it would reduce the future amount of interest that could be paid to the municipality, thereby increasing the PILs liability.

Other alternatives are to distribute the surplus cash by making a return of capital, redeeming shares, or paying a cash dividend. As described previously, a redemption, acquisition, or cancellation of a share by a MEU or a reduction of capital in respect of the shares of a MEU is not considered to be a transfer subject to transfer tax described in section 94(1) of the Electricity Act if the minister of finance is satisfied that the transaction or series of transactions does not result in a change in the direct or indirect ownership of the MEU.[62] Also, a transfer of an interest in property described in section 94(1) or (2) of the Electricity Act which does not result in a change in the beneficial ownership of that property is not subject to the transfer tax imposed by section 94(1).[63] A reduction of capital, however, results in a corresponding reduction in the adjusted cost base of the shares of the MEU. If the shares of the MEU were held by the municipality, this would not have any PILs implications, on the basis of the tax-exempt status of the municipality. However, if the shares of the MEU were held by another MEU, the reduction of the adjusted cost base could have negative tax implications on a future sale of those shares to a third party.

The better alternative is to pay a cash dividend to the municipal shareholder, provided that the MEU can confirm that the cash has not been used in connection with the distribution, generation, transmission, or retailing of electricity and is therefore not electricity property as contemplated by the transfer tax provisions of section 94(1.1) of the Electricity Act.

Currently, there is no jurisprudence or commentary that can provide us with specific guidance on the question whether cash has been used in connection with the generation, transmission, distribution, or retailing of electricity. The MOF has declined to provide any specific guidelines on the issue other than to state that cash dividends issued in the normal course of business and generated from operating revenues are generally not subject to transfer tax.[64]

A line of jurisprudence in the federal income tax sphere, however, considers when cash is used in the course of an active business and therefore may be of some assistance in interpreting when cash has been used in connection with the distribution, generation, transmission, or retailing of electricity. In *Ensite*,[65] the Supreme

Court of Canada established a test for determining whether money was used or held by a corporation in the course of carrying on a business. The court held that the test is whether the money was used to fulfill a requirement that had to be met in order to do business, since the property would then truly be employed and risked in the business. The threshold of the test is met when the withdrawal of the funds would have a decidedly destabilizing effect on corporate operations. This test has been applied in a number of income tax cases, such as *Munich Insurance Co.*[66] and *Skidmore*.[67]

The CCRA has published a useful summary of its views on the circumstances in which cash held by a corporation will be considered to be used in the course of an active business.[68] This summary is consistent with the legal principles set out in *Ensite* and subsequent cases and is reproduced below:

> 1. The question of whether a particular asset is an "asset used principally in an active business" is one of fact which must be determined based on all the relevant facts and circumstances of each case. The relevant circumstances include the actual use to which the cash or near cash properties are put in the course of the business, the nature of the business and the practice in the particular business.
>
> 2. Cash or near cash property is considered to be used principally in the business if its withdrawal would destabilize the business.
>
> 3. Cash which is temporarily surplus to the needs of the business and is invested in short-term income producing investments could be considered to be used in the business.
>
> 4. Cash balances which accumulate and are then depleted in accordance with the annual seasonal fluctuations of an ongoing business will generally be considered to be used in the business but a permanent balance in excess of the company's reasonable working capital needs will generally not be considered to be so used.
>
> 5. The accumulation of funds in anticipation of the replacement or purchase of capital assets or the repayment of a long-term debt will not generally in itself qualify the funds as being used in the business.
>
> 6. Cash or near cash property is considered to be used principally in the business if its retention fulfils a requirement which had to be met in order to do business, such as certificates of deposits required to be maintained by a supplier.
>
> 7. The Department recognizes that prudent financial management requires businesses to maintain current assets (including inventories and accounts receivables, as well as cash and near cash properties) in excess of current liabilities and will consider this requirement in assessing whether cash or near cash assets are used principally in a business. In the Department's view, cash and near cash assets held to offset the non-current portion of long term liabilities will not generally be considered to be used in the business.

Although not strictly related to the transfer tax, another important consideration before surplus cash is distributed to the municipality is the restriction that the Municipal Act (Ontario)[69] places on the powers of a municipality to provide financial assistance to corporations. Section 111 of the Municipal Act provides that a municipality may not assist any manufacturing business or other industrial or commercial enterprise through the granting of bonuses in aid thereof, including the giving or lending of property, including money, and the guaranteeing of loans.

Sale of MEU Business

Before November 7, 2000, there were approximately 265 electricity distributors operating in Ontario. That number has been reduced to approximately 105 OEB-licensed electricity distributors through mergers and acquisitions.

The reduced number of electricity distributors in Ontario is the result of sales to Hydro One Networks Inc. (approximately 88 were purchased by this entity) or mergers that have taken place between such distributors. In each case, the transfer of electricity property that accompanied the merger or acquisition was sheltered from transfer tax by section 94(7) of the Electricity Act. That provision excluded from the transfer tax any transfer of electricity property to a MEU, OPGI, or Hydro One, provided that each of them was exempt from tax under subsection 149(1) of the ITA.[70]

Grandfathering rules[71] were put in place to extend the sunset date of November 7, 2000 in situations where written agreements for the transfer of electricity property by merger or acquisition were in place, an application for approval of the transfer was made to the OEB before November 7, 2000, and the written agreements regarding the transfer of electricity property were not materially changed after that date. These requirements were the subject of a number of advance tax rulings sought from and issued by the MOF, which are of historical interest only at this point.

Prospectively, an alternative method of effecting a sale of electricity property on a deferred basis would involve making use of the PILs credit described in sections 94(3) and (4) of the Electricity Act. In this type of planning, a municipal corporation completes the sale of electricity property on or about the time at which the PILs paid and payable by MEUs that are related to the municipal corporation equal the transfer tax otherwise payable on a sale of shares of the MEU (that is, the electricity property). Normally, a third-party purchaser would make an initial investment in the MEU owned by the municipal corporation by acquiring up to 10 percent of its shares from treasury and acquiring an option to purchase the remaining shares of the MEU, or its assets, after an operating period of five to seven years, during which the MEU will pay PILs.[72]

In structuring this type of transaction, the municipality should note that the amount of transfer tax payable is based on the value of the electricity property at the time the option is exercised and not at the time the investor acquires an interest in the MEU. This means that the transfer tax will include the value of any additions made to the electricity distribution system during the operating period and will reflect any decline in value of the existing assets. The calculation of the PILs credit would have to exclude the portion of the PILs attributable to the ownership interest of the third-party purchaser.

Leasing Transactions

Another alternative for providing cash to the municipality that is considered frequently, but has seldom been used to date, is a lease of MEU assets to an arm's-length third party. The principal advantages of this arrangement are that the municipality can earn a steady stream of income from the lease payments while utilizing a transfer tax exemption and relieve itself of the obligation to retool its management and accounting systems to adjust to an open electricity market, while preserving some control over the use of the assets. A leasing transaction can also be structured to provide a substantial prepayment of a long-term lease obligation.[73]

Negotiation of Principal Agreements

The principal challenge with the lease alternative is that it is time consuming and costly to negotiate an operating lease and deal with all the ancillary property rights and business issues. An electricity distribution system requires a significant level of ongoing replacements and expansions to accommodate the customer base. One of the key issues that must be negotiated in the lease agreement is how the municipality regains possession of the entire distribution system at the conclusion of the lease, given that the lessee will own a significant number of capital improvements.

In addition to negotiating an operating lease agreement for the distribution assets, the parties to a lease arrangement will have to negotiate one or more agreements to deal with issues such as the transfer of employees from the MEU to the lessee and any related collective bargaining agreements; various access agreements allowing the lessee to access municipal land to maintain the utility wires, fibre-optic cables, ducts, manholes, and other structures and equipment; the transfer of intellectual property rights; and arrangements to obtain the necessary third-party approvals or provide required notice of the transactions to third parties. The latter would include notices to the MOF[74] and the OEB.[75]

Operating Leases Excluded from Transfer Tax

The principal tax issue arising from a leasing transaction is whether the transfer of electricity property contemplated by the lease agreement is an excluded transfer under the transfer tax regulation such that the payments required to be made under the lease agreement and any ancillary agreements are not subject to the 33 percent transfer tax. As indicated earlier, section 3(14) of the transfer tax regulation exempts certain transfers of an interest in electricity property (including a transfer of a leasehold interest) from the transfer tax provided that four conditions are met.

The first condition is that the lease cannot provide for the automatic vesting of the ownership of the leased property at less than the fair market value of the property before or upon termination of the lease. Part of that test requires the opinion of an economist or other valuation expert as to the expected fair market value of the leased property at the end of the lease term. This condition also requires a careful analysis of the lease agreement and any related agreements, to ensure that there are no terms that effectively compel the lessee to complete the purchase of the leased property at the end of the lease agreement.

The second condition is that the lessee cannot have a conditional or unconditional right to acquire title to the leased property at less than its fair market value before or upon termination of the lease. A lease agreement will normally have option rights, which will require the economic analysis referred to above to be undertaken with respect to each prospective option date.

The third condition is that the term of the lease, including any renewal or extension provided, cannot exceed 75 percent of the anticipated economic life of the leased property.

The fourth condition is that the net present value of any payments required to be made under the lease cannot exceed 90 percent of the fair market value of the leased property at the beginning of the lease term. The regulation requires the taxpayer to take into consideration any payments connected with a guarantee of any residual value or penalties payable for failing to renew the lease. The third and fourth conditions under the regulation are normally satisfied in a leasing transaction by obtaining one or more opinions from a qualified economist as to the anticipated economic life of the assets and their current value. Some regard should also be given to the accounting standards established for assets owned by MEUs pursuant to the OEB's published guidelines referred to earlier.[76]

Although the leasing option has been considered frequently by potential third-party investors, we are aware of only one transaction filed with the OEB that involves the operation of an electricity distribution system by a lessee. Part of the challenge may be that the various business elements that make up an electricity distribution system are not typical of leasing transactions. For example, a number of ancillary agreements would be needed to deal with various easements and access rights, and to address regulatory and working capital issues.

Other Commodity Taxes

The lease agreement should apportion the lease payments between personalty and realty. The allocation is important in the context of applicable sales taxes. Ontario retail sales tax (RST) is exigible on the portion of the lease payment allocable to personalty only; it is not exigible on the portion allocable to realty, which would include items such as the substations and perhaps the transformer station. Federal goods and services tax (GST), on the other hand, is exigible on the entire amount of the lease payment.

The lessor is required to collect and remit RST that is exigible. If the allocation is incorrect, the amount collected and remitted will be incorrect, and the lessor may be liable for any additional RST that should have been collected, as well as certain penalties and interest.[77] Therefore, the lease agreement should ensure that there is a reasonable allocation of the lease payments between personalty and realty. It should also provide that if the allocation is incorrect, the lessor will be indemnified for any additional RST for which it may be liable, as well as any penalties and/or interest stemming therefrom.

The lessor is required to register for GST and RST, and file the appropriate returns. Although the lease agreement can direct the lessee to remit these amounts directly to the revenue authorities, this provision will not relieve the lessor of the obligation to prepare and file GST and RST returns.

Provided that the lease term does not exceed 50 years, including renewal terms or extensions, Ontario land transfer tax will not apply to lease payments attributable to realty.[78]

Structuring Joint Ventures Involving MEUs

Municipally owned MEUs and their affiliates are expected to play an important role in the development of new electricity generation projects because of their proximity to consumers. Electricity distributors, through their affiliates, also expect that their involvement in these projects will create a significant new source of revenue. A secondary advantage of the participation of distributors, through their affiliates, in generation projects is the ability to obtain favourable financing terms for the project by leveraging off the strong credit ratings of the distributors.

In structuring the joint venture, MEUs and their joint venture partners will have to consider the usual corporate and tax issues arising from the MEUs' obligation to pay PILs. However, the overriding concern in structuring any joint venture involving the equity participation of a MEU distributor or affiliate must be the transfer tax. As described above, the transfer tax is levied at the rate of 33 percent on the current value of any property used in connection with the distribution, transmission, retailing, or generation of electricity. The transfer tax is payable when the electricity property is transferred by an entity that meets the definition of a MEU under the Electricity Act, which would include any electricity distributor, retailer, generator, or services company created under a transfer bylaw and any subsidiary. In recognition of the punitive cost of this tax and its broad application, it is submitted that any structuring of joint ventures involving MEUs must make the avoidance or minimization of transfer tax its principal objective.

Contribution of Property to Joint Venture

The transfer tax could apply at a number of levels in both the formation and the winding up of the joint venture project. The initial contribution of capital or property by the MEU to capitalize the joint venture could itself be considered a transfer of electricity property, which would be subject to transfer tax. As discussed above, section 94(1.1) of the Electricity Act expands the definition of electricity property to which the transfer tax may apply as follows:

> For the purposes of subsection (1), real or personal property that has been used in connection with generating, transmitting, distributing or retailing electricity includes cash, amounts receivable, investments, customer lists, licences, goodwill and other intangible property used in connection with those activities.

The provision thus contemplates exactly the type of property that would be contributed to a joint venture if that property has been used in an electricity-related business.

Careful attention will have to be paid to the drafting of the joint venture contracts to ensure that some of the items, such as goodwill and customer lists, are not referred to in the documents or are implicitly made part of the joint venture transaction. The most problematic item in the list of includible property is cash.

Not all cash that is held by a MEU is subject to transfer tax. Since section 94(1.1) refers to property that "has been used" in connection with electricity-related activities, in our view cash that has not been so used would not be included. We suggest that the "working capital" test discussed above in connection with the distribution of surplus profits as a dividend should function as a guide in determining whether cash is part of the MEU's electricity distribution business or is instead surplus working capital, which can be contributed to a joint venture without incurring transfer tax.

If no surplus working capital is available, or if there is some uncertainty regarding this issue, the joint venture or special purpose corporation formed to invest in the joint venture could borrow the necessary working capital with a guarantee from the electricity distributor MEU. A guarantee is not listed in the expanded definition of electricity property in section 94(1.1), nor would it likely be considered an asset that has somehow been used in connection with the electricity business and therefore falls into the more general definition in section 94(1). In this instance, however, consideration would need to be given to the potential impact of other rules such as the OEB's affiliate relationships code and section 71 of the OEB Act.[79]

The Joint Venture Entity

Once the form of the capital contribution to the joint venture has been identified, the next step is to select an operating structure for the joint venture that will minimize transfer tax. This is an important consideration for the joint venture participants that are not MEUs, because if the joint venture entity is considered to be a MEU, *all of its electricity property will be subject to transfer tax*, and not just the portion of the electricity property attributable to the ownership position of the MEU or its affiliates.

It will be recalled that a "municipal electricity utility," as defined in section 88(1) of the Electricity Act, includes

- a corporation established pursuant to section 142 of the Electricity Act;
- a subsidiary of such a corporation; and
- any other body, however established, through which a *municipal corporation* generates, transmits, distributes, or retails electricity.

Thus, care must be taken to ensure that the joint venture entity does not fall into any of these categories. In particular, participants may have to rethink the normal bias in the energy area toward owning an energy project inside a special purpose corporation.

A corporation is a subsidiary corporation of a MEU under the Electricity Act if it meets the definition of "subsidiary" in the OBCA. That definition focuses on the ownership of securities sufficient to give the owner or shareholder the right to elect a majority of the board of directors of the corporation. A recent decision of the Supreme Court of Canada that considered the meaning of the word "control" suggests that one could structure the ownership of a corporation to create a degree of separation between voting control and economic participation by issuing securities that have limited voting rights but are entitled to substantially all of the value of the corporation on a winding up.[80] A corporation could also be used to own the energy project in circumstances where the economic participation is to be split on a 50:50 basis. In either of these circumstances, however, a shareholders' agreement would normally be used with terms that provide for various obligations between the parties to either purchase shares, arrange for the sale of shares to a third party, or grant first refusal rights. The ability to execute these obligations in a commercial fashion could be restricted by the lingering presence of the transfer tax if the upshot of the execution would be to convert the corporation, even for a moment of time, into a company that is controlled by the MEU or its affiliates.

Subject to any overriding corporate, liability, or labour law concerns, it would normally be prudent to structure a joint venture involving a MEU or its affiliates as either a partnership or a co-ownership arrangement. In a partnership structure, the partnership units owned by the MEU would be electricity property by virtue of section 94(2) of the Electricity Act, and the disposition of those units would be subject to transfer tax. The sale of property by the partnership itself, however, should not trigger transfer tax on the basis of the view that the partnership is not a MEU. In that case, any profit or loss on the sale of electricity property by the partnership would be allocated to the partners in normal course. To the extent that there was profit, the MEU and the other partners would pay the normal PILs liability on the allocation of profit.

A co-ownership structure is probably less satisfactory from the perspective of a MEU. In a co-ownership structure, each participant directly owns its percentage interest of property used in the joint venture. A participant computes its discretionary deductions and its own profit and loss separately. Accordingly, when property is disposed of by the co-owner, that co-owner is responsible for any taxes payable on the profit attributed to that disposition. In the case of a co-owner that is a MEU or its affiliate, those taxes would also include transfer tax at the rate of 33 percent on the current value of the property disposed of.

Some advisers and MEUs have expressed the view that the transfer tax is intended to apply only to assets and property transferred to the MEU under the initial transfer bylaw. In our view, this interpretation is not supported by the language of the charging provision in section 94(1) of the Electricity Act. Section 94(1) is drafted in prospective language, and its application is not limited to the property initially transferred under section 142 of the Electricity Act. If this had been the legislative intention, it would have been relatively easy to have identified the property transferred under the transfer bylaw and to have explicitly restricted the application of section 94(1) to that property.

The other type of structure that is sometimes used in commercial transactions is a commercial trust. This type of vehicle is more commonly used to hold pooled fund investments or to isolate cash flows as part of a financing transaction. Although a commercial trust is not the type of structure that would normally be used to own and operate an energy project, it could be used as part of the financing arrangements in connection with the development of the energy project, particularly where a pension fund or other non-taxable entity is involved.

Refinancing the MEU Capital Structure

Municipal owners may be able to monetize their equity investment in a MEU by refinancing the capital structure. Again, however, care must be taken to avoid exposure to transfer tax. A risk exists that either the issuance of public debt by a MEU or the refinancing of its existing capital structure could create a liability for transfer tax.

The concern arises because transfer tax is potentially applicable to a recapitalization scenario if a literal interpretation is given to the words "any interest in a corporation" and "transfer" used in section 94 of the Electricity Act. This language can be broadly interpreted to attach a transfer tax liability to the creation of any claim on a MEU's asset base. A literal reading of sections 94(1) and (2) of the Electricity Act could lead to the conclusion that any issuance of debt could be a transfer of an interest in an entity identified in section 94(2). The word "interest" is a broad term that could denote any right, claim, title, or share in any of the assets of the corporation.[81] Indebtedness issued by a corporation could give the creditor both the right to receive payments of interest and principal from the MEU and contingent rights against the MEU's property if the debt is not repaid. These would constitute property rights in the MEU itself, although not equity interests. Accordingly, if a municipality held a promissory note of a MEU and sold that promissory note to a private purchaser, the municipality could be liable for transfer tax equal to the fair market value of the promissory note. An interest in a corporation that owns electricity property is itself deemed by section 94(2) of the Electricity Act to be electricity property.

In our view, however, the more logical approach is to focus on the concept of a transfer of property and determine whether the corporation itself has transferred any of its property that *has been used in connection with* the generation, transmission, distribution, or retailing of electricity. A line of case law considers the meaning of the word "transfer" in the context of section 160 of the ITA, which imposes tax liability in respect of non-arm's-length transfers of property by tax debtors. Certain parts of the case law consider what is a "transfer of property" in the context of a corporate debtor. In *Algoa Trust*, Judge Rip comments:

> The payment of a stock dividend is not a transfer of property. The shares authorized in a corporation's articles of incorporation are not assets of the corporation. When a person subscribes for the shares and pays the corporation for the shares, the shares are issued to that person and recorded in the share registry of the corporation. The payment is consideration for the shares. The issue of shares is not a transfer since the

> corporation has not divested itself of its property: the shares were never owned by the corporation. Assets are transferred for purposes of section 160 only at the time one person is divested of ownership of property and another person is vested in that property. Prior to issue and during issue the shares of a corporation are not property of that corporation.
>
> When a corporation pays a stock dividend to its shareholders it issues shares to those shareholders. A corporation's paid-up capital is increased when it issues shares. The corporation is usually enriched, not impoverished, when shares are issued for consideration; when a corporation issues a stock dividend it is neither enriched nor impoverished. The value of the assets of the corporation are [sic] not reduced on the payment of a stock dividend. As a result of the stock dividend there are changes in the corporation's balance sheet; for example, accounts comprising shareholders equity are adjusted to reflect the increase in paid-up capital. These accounts, however, are not assets of the corporation.[82]

Although this case law does not consider whether the issuance of debt by a corporation is a transfer of property, the reasoning applicable to similar transactions is helpful. Generally, the case law concludes that neither a stock dividend nor an issuance of treasury shares would be considered to be a transfer of property by the corporation where

- the corporation has not divested itself of any of its property by the issuance of further share capital; and
- the shares are not property "owned" by the corporation.

A similar argument could be made in respect of the issuance of debt by a corporation. This approach is consistent with a conclusion that section 94(1) of the Electricity Act is the only charging provision in respect of a transfer tax liability and should be given a purposive interpretation. This purposive approach is consistent with the view that section 94(1) is the principal charging provision and that section 94(2) creates supplementary rules for enlarging the tax base but is not a charging provision itself. The purpose of section 94(2) is to ensure that the transfer tax payable is not improperly reduced or deferred because there is an indirect transfer of an interest in an entity that owns electricity property.

The introduction of section 3.1 of the transfer tax regulation seems to support the view that the intent of the legislation is to tax municipal corporations and MEUs when they dispose of electricity property, not when they receive financing to carry on their electricity businesses.

Administrative Position of the MOF

The published comments of the MOF on the transfer tax[83] suggest two important general conclusions:

1. the ministry intended that the transfer tax would apply only once with respect to a particular interest in electricity property; and

2. the ministry intended the transfer tax to apply only to the sale of assets or shares.

The MOF has been aggressively lobbied to issue some clarification on the application of transfer tax to capital financing transactions. After a lengthy period of deliberation, the MOF issued an interpretation letter[84] on the application of the transfer tax to either

1. the issuance of a debt obligation (such as a bond or debenture) to the public by a MEU, or
2. the sale by a municipality to the public of a debt obligation that was previously issued to the municipality by a MEU.

The MOF's views in responding to these issues can be summarized as follows:

1. The repayment (or replacement) of debt by a MEU in the conduct of its normal business activities will generally not attract transfer tax provided that there is no transfer of an ownership interest in the MEU. Such transactions, however, must be considered on a case-by-case basis.
2. The sale or issuance of a non-convertible debt obligation will not be subject to transfer tax. The sale or issuance of a debt obligation that includes conversion privileges or an equity interest, however, may be subject to transfer tax depending on the facts.
3. The transfer tax is designed to capture the transfer of all value from a MEU to other persons where such transfer results in either a disposition of assets or a change in the actual or beneficial ownership interest in the MEU.
4. The policy objective of the transfer tax is to ensure that any transaction involving the transfer of an "equity" or "ownership" interest in a MEU is subject to transfer tax.
5. The issuance of new share capital by a MEU in return for a fresh infusion of capital will not result in transfer tax liability provided that the additional capital corresponds to the increase in equity ownership.
6. The transfer tax rules do not discriminate between the use of proceeds raised from an issuance of debt for general corporate purposes and their use in the retirement of debt held by a shareholder, subject to any future changes to the legislation.

What is particularly interesting is the following comment from the MOF's letter regarding the interpretation of these provisions:

> We agree with your comment that the meaning of the term "transfer" is extremely broad and could potentially lend itself to the issuance of debt. However, the Ministry recognizes that a common sense approach is required in interpreting the Act and its regulations so as not to tax normal business transactions that do not result in a change or transfer of an ownership interest in a MEU.[85]

The MOF's response should provide some comfort to MEUs (and their municipal shareholders) that are contemplating refinancing their existing debt or raising fresh equity capital. These comments help to alleviate some of the uncertainty that has surrounded the application of the transfer tax since it was introduced in 1998. One must note, however, that the letter we have cited is not an advance tax ruling and therefore is not binding on the MOF with respect to any particular transaction.

Current Examples of Municipal Debt Refinancing

A number of recapitalization transactions are in various stages of development. Both Hydro One and Enersource Corporation have completed public debt offerings.[86] Hydro One has issued three tranches of senior unsecured debt directly to the capital markets, and Enersource has issued its debt through a special purpose trust, the Borealis Infrastructure Trust, which is a qualified issuer under the prompt offering prospectus (POP) system. The business activities of Borealis Infrastructure Trust are limited to the financing, acquisition, and administration of interests in infrastructure projects and related programs through the issuance of asset booked securities. These securities have an approved rating and are serviced by cash flows from a discrete pool of receivables.[87]

Interestingly, in assessing the credit of the corporate debt issued by Enersource, the Dominion Bond Rating Service noted that the most significant credit risk affecting the municipal sector was the political risk. This risk is based on previous political forays, such as the introduction of Bill 100 regarding electricity distribution rates and the issuance of directives on rates by the government to the OEB.

CONCLUSION

Ontario's transition to a restructured electricity industry, based on a competitive business model with regulatory oversight, has important implications for Ontario's municipalities. Although municipal involvement in activities related to the supply of electricity has a long history, municipal ownership of competitive businesses is new in Ontario. These businesses must learn to adapt to an unfamiliar competitive and regulatory landscape. While the same challenges arise for all electricity market participants, municipally owned corporations face the added complication of operating within a unique and complex tax regime.

At the same time, municipal ownership of electricity-related businesses creates a different risk/reward model for municipalities. Municipalities now have the opportunity to realize enhanced revenue streams from their electricity businesses in the form of interest, dividends, lease payments, or proceeds of refinancings or dispositions. As in any competitive business, there is also an element of risk to shareholder value, and municipalities will need to consider growth and value strategies such as joint ventures in future energy projects, operating leases, or further mergers or acquisitions.

Sustaining these new business ventures will require a high level of skill, since the supply of electricity is a basic commodity in our economy and one that is susceptible to a degree of political involvement. As the restructured electricity industry matures, and as growing revenues from this source are found to alleviate pressures on the municipal tax base, the experience of opening Ontario's electricity market to competition can serve as a guide to similar initiatives in the provision of other essential municipal services (such as water and sewer services).

NOTES

1 SO 1998, c. 15, as amended, schedule A (herein referred to as "the Electricity Act").

2 RSO 1990, c. P.18, as amended.

3 Borealis Infrastructure Trust prospectus, April 25, 2001, 12.

4 Ibid.

5 The Advisory Committee on Competition in Ontario's Electricity System, chaired by the Honourable Donald S. Macdonald, reported to the Ontario government in 1996: *A Framework for Competition: The Report of the Advisory Committee on Competition in Ontario's Electricity System* (Toronto: Queen's Printer for Ontario, 1996).

6 Ontario, *Direction for Change: Charting a Course for Competitive Electricity and Jobs in Ontario* (Toronto: Queen's Printer for Ontario, November 1997).

7 SO 1998, c. 15, as amended (herein referred to as "the ECA").

8 SO 1998, c. 15, as amended, schedule B (herein referred to as "the OEB Act").

9 RSO 1990, c. B.16, as amended (herein referred to as "the OBCA").

10 Sections 142, 144, and 145 of the Electricity Act.

11 As the transmission and distribution of electricity can be characterized as involving "one wire" when interfacing with the customer, this business is sometimes referred to as a natural monopoly over the provision of such services to the customer. In exchange for this right, owners of transmission and distribution systems are subject to rate regulation under the OEB Act.

12 Section 71 of the OEB Act.

13 These codes are available at the OEB Web site at http://www.oeb.gov.on.ca

14 Ontario Energy Board, *Electricity Distribution Rate Handbook* (Toronto: Ontario Energy Board), online publication available at the OEB Web site, ibid.

15 Ontario Energy Board, *Accounting Procedures Handbook* (Toronto: Ontario Energy Board) and *Uniform System of Accounts* (Toronto: Ontario Energy Board), online publications available at the OEB Web site, ibid.

16 Ontario Energy Board Decision with Reasons (RP-2000-0069) on the Generic Hearing on the Minister's Directive, September 29, 2000.

17 See the following OEB letters addressed to all electricity distribution companies: "Re: Impact of Proposed Proxy Taxes on Rates," August 24, 2001; "Re: Supplemented Instructions Regarding Filing Guidelines for March 1, 2002 Distribution Rate Adjustment," January 18, 2002; and "Re: Reporting Requirements—PILS, Trial Balance, Financial Statements," June 3, 2002 (all available on the Ontario Energy Board Web site at http://www.oeb.gov.on.ca).

18 This paper does not address payments in lieu of property tax levied under section 92 of the Electricity Act.

19 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the ITA").

20 Part XI of the Electricity Act uses the phrase "municipal electricity utilities" as a heading but does not repeat or use the term in any section.

21 RSO 1990, c. C.40, as amended (herein referred to as "the CTA").

22 Electricity Act, 1998, O. Reg. 162/01, as amended (herein referred to as "the PILs regulation").

23 RSO 1990, c. A.31, as amended, section 27(3.1).

24 Sections 13 and 14 of the PILs regulation provide that a MEU must file the normal federal and Ontario income tax returns used by taxable corporations. These returns must be delivered to the Ontario minister of finance no later than six months after the end of the taxation year. Similarly, any elections or designations that would normally be filed with the federal minister of national revenue must be filed with the Ontario minister of finance.

25 Ontario, Ministry of Finance, *Filing Requirements for Municipal Electricity Utilities* (Toronto: Ministry of Finance, June 2001).

26 Ibid.

27 Section 6 of the PILs regulation.

28 That is, a transfer bylaw under section 145 of the Electricity Act.

29 Regulation 1102(14) of the Income Tax Regulations (Canada).

30 Section 5 of the PILs regulation deems a MEU to be a private corporation but only for the purposes of the PILs calculation.

31 Section 5 of the PILs regulation does not seem to address this issue, since it deems a MEU to be a "private corporation," which is defined in subsection 89(1) of the ITA, but does not provide that a MEU is also deemed to be a "taxable Canadian corporation."

32 Subsection 149(1.1) of the ITA.

33 *Interpretation Bulletin* IT-347R2, "Income Tax Act—Crown Corporations," July 15, 1994, paragraph 3. The Canada Customs and Revenue Agency takes the view that a right to acquire shares includes a lien on the shares.

34 CCRA document no. 2000-0020555, May 11, 2000.

35 Subsection 149(1.2) of the ITA, applicable to taxation years and fiscal periods that begin after 1998.

36 Comments provided in discussions with the CCRA's Rulings Directorate in 2001.

37 Sections 56 and 57 of the OEB Act require both a distributor and a retailer of electricity to be licensed. However, only a distributor has its rates fixed by the OEB.

38 Section 57(1)(e) of the OEB Act.

39 CCRA document no. 1999-0006955, February 21, 2000.

40 Paragraphs 149(1)(d.5) and (d.6) of the ITA and section 57(1)(a) of the CTA.

41 Subsection 149(10) of the ITA.

42 Electricity Act, 1998, O. Reg. 123/02, March 22, 2002.

43 Section 94(3) of the Electricity Act.

44 Electricity Act, 1998, O. Reg. 124/99, as amended (herein referred to as "the transfer tax regulation").

45 Section 94(9) of the Electricity Act.

46 Section 94(10) of the Electricity Act.

47 Section 2 of the transfer tax regulation.

48 Section 3 of the transfer tax regulation.

49 Section 2(2) of the transfer tax regulation.

50 Section 2(3) of the transfer tax regulation.

51 Section 2(4) of the transfer tax regulation.

52 Section 2(5) of the transfer tax regulation. It should be noted that an amalgamation under the OBCA does not create a new corporation. Rather, the amalgamating corporations are continued as one corporation (see *The Queen v. Black & Decker Manu. Co.*, [1975] 1 SCR 411). Accordingly, there may be a legal argument that section 2(5) of the transfer tax regulation is ineffective in creating a transfer tax liability on an amalgamation. As a comparison, the ITA contains a specific provision, paragraph 87(2)(a), that deems the amalgamated entity to be a new corporation.

53 Section 2(6) of the transfer tax regulation.

54 Section 2(7) of the transfer tax regulation.

55 Section 2(8) of the transfer tax regulation.

56 Section 2(9) of the transfer tax regulation.

57 For example, section 1(4) of the OBCA would extend the affiliate group to corporations controlled by the same person through one or more subsidiaries.

58 The principal reason for taking this approach is that, as noted earlier, transfers of property without proper notice, when required, are void. The principal drawback is that the filing of the notice may cause the MOF to raise issues about the transfer of property. For example, in circumstances where various MEUs have merged and one or more office buildings have become redundant, are those surplus buildings obsolete? Alternatively, could one assert that such buildings have not been used in connection with the distribution of electricity?

59 A municipal corporation is not a "corporation" within the commonly understood meaning of the word. It is not created pursuant to a normal companies statute such as the OBCA but rather by its own special legislation.

60 Section 3(15) does not refer to direct or indirect beneficial ownership. Therefore, the prudent view is that it protects the issuance of treasury shares only to a single shareholder and not to a parent company or affiliate.

61 Letter from the MOF to Borden Ladner Gervais LLP, November 13, 2001.

62 Section 2(9) of the transfer tax regulation.

63 Section 3(15) of the transfer tax regulation.

64 Letter from the MOF to Borden Ladner Gervais LLP, December 12, 2001.

65 In *Ensite Limited v. The Queen*, 86 DTC 6521 (SCC), the taxpayer was denied a dividend refund in respect of interest received from foreign deposits on the basis that it was not foreign investment income. Rather, the deposit interest was considered business income because it was derived from property used or held by the taxpayer in the course of carrying on a business.

66 *Munich Insurance Company (Canada Branch) v. The Queen*, 2000 DTC 2009 (TCC).

67 In *Skidmore et al. v. The Queen*, 98 DTC 1135 (TCC), aff'd. 2000 DTC 6186 (FCA), the Federal Court of Appeal upheld the decision of the lower court denying the taxpayer the exemption on the basis that the corporation in which he owned shares was not a "small business corporation" because of the excessive amount of term deposits held in the company. The taxpayer argued that these cash reserves were a necessary asset in its tree-growing business, since they would be required in the event that the company experienced certain misfortunes in its business operations, such as a crop failure. The court determined that the cash reserves were not an integral aspect of the business operations, nor was there a relationship of significant financial dependence between the business and the amounts in question. The holding of cash reserves for a rainy day was simply not a strong enough argument.

68 CCRA document no. 9605165, June 13, 1996. See also *Interpretation Bulletin* IT-73R6, "The Small Business Deduction," March 25, 2002, paragraph 6.

69 RSO 1990, c. M.45, as amended. Effective January 1, 2003, this Act will be repealed by the Municipal Act, 2001, SO 2001, c. 25.

70 This exemption was repealed on November 7, 2000, subject to certain grandfathering rules described in the transfer tax regulation (amended to O. Reg. 524/00) filed on September 22, 2000.

71 The transfer tax regulation applied to transfers of property to another MEU, Hydro One, or Ontario Power Generation, or any subsidiary thereof. The regulation contains the caveat that no material changes can be made to the agreement making the transfer of electricity property.

72 The 10 percent cap is necessary to ensure that the MEU qualifies as a "municipal corporation" under the definition in paragraph 149(1)(d.5) of the ITA, and therefore remains a tax-exempt corporation. Should the MEU lose this tax-exempt status, only the provincial component of its tax payments would generate a PILs credit. Therefore, for this structure to be effective, any investment in a MEU group of companies requires a purchase of treasury shares to be made at the holding company level.

73 The MOF acknowledged in a private advance tax ruling, dated July 24, 2001, that a substantial prepayment of rent would not affect the availability of the operating lease exclusion from transfer tax.

74 As discussed earlier, section 4(1) of the transfer tax regulation requires prior notice of any transfer of electricity property. A lease is considered to be a transfer of property, but an operating lease that meets certain conditions is considered to be an excluded transaction.

75 Section 86(1) of the OEB Act requires the filing of the transaction documents for OEB approval. The lessee must also file a separate application under section 60 of the OEB Act for a distribution licence.

76 Supra note 15.

77 Retail Sales Tax Act, RSO 1990, c. R.31, as amended, section 20(3).

78 Land Transfer Tax Act, RSO 1990, c. L.6, as amended, section 1(6).

79 See supra notes 12 and 13 and the accompanying text.

80 *Duha Printers (Western) Ltd. v. The Queen*, 98 DTC 6334 (SCC).

81 The phrase "any interest in a corporation" is not necessarily limited to an equity interest. *Black's Law Dictionary*, 7th ed., defines an interest as the most general term that can be employed to denote a right, claim, title, or legal share in something. More particularly, it means a right to have the advantage accruing from anything; any right in the nature of property, but less than title. Obviously, the term can be applied to a wide range of property rights, including the right to payment arising under a debenture or a promissory note.

82 *Algoa Trust et al. v. The Queen*, 93 DTC 405, at 412 (TCC).

83 In Ontario, Ministry of Finance, "Electricity Competition: A Financial Update," *News Release*, July 8, 1998, the MOF explained that the purpose behind the transfer tax, as well as the other new taxes created by the Act, was to establish a source of revenue to service Ontario Hydro's stranded debt. The MOF stated, "Revenue to recover stranded debt would also come from a transfer tax on *the sale of the assets or shares of a MEU* to private interests. Bill 35 provides for a two-year window for public sector organizations to consolidate to encourage efficiencies. After this period, the transfer tax will apply on sales to other MEUs or to Servco, as well as on sales to private interests [emphasis added]." In Ontario, Ministry of Finance, "Electricity Act, 1998: Update for Municipal Electricity Utilities," *News Release*, March 22, 1999, which accompanied the introduction of the transfer tax regulation, the MOF stated, "Certain transfers are *excluded* from the transfer tax to ensure that the tax applies as a *one-time charge only to the disposition of municipal assets* and to ensure that it does not interfere with the ordinary business operations of utilities [emphasis added]."

84 Letter from the MOF to Borden Ladner Gervais LLP, July 17, 2001.

85 Ibid.

86 Hydro One Inc. prospectus, May 24, 2000.

87 Borealis Infrastructure Trust, supra note 3.