Section 6 – Appendix H - Taxation of LDCs and Investment Interests – A Primer

Generally speaking, Ontario government entities, including municipal or municipally-owned corporations, are exempt from taxes under the *Income Tax Act (Canada)* ("ITA") and the *Ontario Corporations Tax Act* ("OCTA") (collectively, the "Tax Acts"). Consequently, as municipally-owned corporations (directly or indirectly), LDCs are generally tax exempt under the Tax Acts.

The Tax Acts impose an "Ownership Test" and "Income Test" on municipally-owned corporations and their subsidiaries for maintaining tax exempt status:

i. Corporations owned directly by municipalities:

   a. Ownership Test - not less than 90% of the shares or the capital must be owned by one or more municipalities; and
   b. Income Test - the income of the corporation from activities carried on outside the geographical boundaries of the municipalities must not exceed 10% of its income for the year.

ii. Subsidiaries of municipal corporations (i.e., indirectly owned by municipalities):

   a. Ownership Test – not less than 100% of the shares or the capital must be owned by tax exempt municipal corporations and/ or subsidiaries of municipal corporations; and
   b. Income Test - same as in i. b. above.

For purposes of the Income Test, and in general terms, income from the following activities is excluded from the municipal geographical boundary limitations:

i. Under an agreement in writing between the corporation and another tax exempt entity but within the geographical boundaries of such tax exempt entity (i.e., within the municipality of Burlington if the contract is with that municipality);
ii. In a province as a producer of electrical energy or natural gas or as a distributor of electrical energy, heat, natural gas, or water, where the activities of such are regulated under the laws of the province.

<u>Implications for LDCs</u>

Most of Ontario's LDCs are tax exempt under the Tax Acts (the Fortis-owned LDCs would not be Tax Exempt).

A private/ "non-tax exempt" investor could purchase or subscribe for up to 10% of the shares or capital of an LDC that is otherwise directly and wholly-owned by a municipality without causing a loss of tax exempt status of such LDC under the Tax Acts.

There is no opportunity for a private/ "non-tax exempt" investor to directly purchase or subscribe for any shares or capital of a tax exempt LDC that is otherwise indirectly owned by municipalities without offending the tax-exempt status. This notwithstanding, a corporate reorganization resulting in such LDC being owned directly by municipalities could overcome this barrier.

A private/ "non-tax exempt" investor could directly acquire property interests of a tax exempt LDC without offending the tax exempt status of the LDC. The LDC would be subject to Payments in lieu of corporate tax and Transfer Tax on the disposition, as described below.

The following represent implications for LDCs that cease to be tax exempt under the Tax Acts at any particular time:

1. A "deemed" year-end is triggered and a new taxation year commences such that the corporation is effectively deemed to be a new corporation subject to tax under the Tax Acts;
2. Certain tax reserve balances are adjusted to reflect an assumption that maximum related deductions were taken just prior to the deemed year end;
3. Just prior to the deemed year end, all property is deemed to have been disposed of and reacquired at Fair Market Value;

A loss of tax exempt status will also trigger a determination of PILs Departure Tax liability as described below.

LDC Taxable Status under *Electricity Act, 1998 (Ontario)* ("EA")

Municipal electricity utilities were reorganized into corporations to be incorporated under the *Business Corporations Act* ("BCA") pursuant to transitional provisions of the EA. It was the intention of the provincial government at that time that the resulting LDCs would effectively operate as private corporations and pay taxes.

Under the restructuring provisions of the EA, $19.4 billion of "Stranded Debt" of the former Ontario Hydro was reorganized into a new corporation: Ontario Electricity Financial Corporation ("OEFC"). It was the further intention of the provincial government that, while tax exempt under the Tax Acts, LDCs and other similarly exempt electricity corporations would remit income and certain other taxes to OEFC to service the Stranded Debt.

The EA effectively provides for two categories of taxation on LDCs:

1. Payments in lieu of corporate tax ("PILs")
2. Transfer Tax ("TT") on transfers of property used in connection with generating, transmitting, distributing, or retailing electricity

<u>PILs Departure Tax</u>

PILs are applicable while LDCs are tax exempt under the Tax Acts. These taxes are computed based on the provisions of the Tax Acts. Consequently, LDCs subject to PILs compute income, capital, capital gains, and related taxes similar to any tax paying corporation subject to the Tax Acts. However, as noted above, such PILs are remitted as liabilities to OEFC rather than Canada Revenue Agency and the Ministry of Revenue (Ontario).

LDCs became subject to PILs on October 1, 2001. It is noteworthy that this event effectively resulted in LDCs ceasing to be exempt from tax for purpose of PILs (although LDCs were not subject to any income or capital tax prior to that date). As such, the related provisions of the Tax Acts, as described above, were applicable in determining the opening PILs position for LDCs:

1. The first PILs year for LDCs commenced on October 1, 2001;
2. Certain deeming provisions applied with respect to the determination of opening tax reserve balances;
3. LDC property was deemed to be acquired at Fair Market Value ("FMV") and became the basis for related future tax deductions or tax values otherwise (e.g., adjusted cost base, undepreciated capital cost, eligible capital property, etc.,).

These concepts of "ceasing to be" or "becoming" tax exempt are very important as there are potentially material tax consequences of "ceasing to be" tax exempt under one tax regime (such as under the Tax Acts) and "becoming" tax exempt under another (such as PILs). The transition of an LDC from a PILs regime to the more traditional tax regime under the Tax Acts will trigger a determination of what is commonly referred to as "PILs Departure Tax".

When an LDC ceases to be exempt under the Tax Acts (i.e., and becomes subject to tax under the Tax Acts with a resulting deemed disposition of all LDC property at FMV), the following general rules apply:

a. The utility is deemed to remain exempt under the Tax Acts (for purposes of PILs only) until after a resulting deemed disposition of all LDC property;
b. The taxation year of the LDC is deemed to end immediately before the time it ceases to be exempt under the Tax Acts;
c. The LDC shall pay PILs Departure Tax imputed on the related taxable amounts arising from the deemed disposition of all of its property (i.e., in a.) at FMV (the scope of which would generally be capital gains tax, income tax arising from recapture of capital cost allowance, or eligible capital expenditures);
d. The LDC will, immediately after the deemed date in b., become subject to tax under the Tax Acts.

The PILs Departure Tax is obviously a potentially very material tax and LDCs will want to ensure such tax is contemplated in any investment, divestiture, or new business planning and, most importantly, is not triggered inadvertently.

It is equally important to recognize that, once a corporation ceases to be exempt under the Tax Acts, any downstream corporate investments also effectively cease to be exempt as well. As such, there are cascading implications with respect to potential PILs Departure Tax liabilities in downstream corporate investments. For example, if either Hamilton Utilities Corporation or St. Catharines Hydro Inc. ceases to be tax-exempt under the Tax Acts, all Horizon Holdings Group entities would cease to be so exempt as well.

<u>Transfer Tax</u>

As its name suggests, TT is a tax payable on the transfer value of an interest. Specifically, and subject to certain exclusions and credits, TT is payable at a prescribed rate of 33% on the FMV of property that has been used in connection with generating, transmitting, distributing, or retailing electricity (“Electricity Property”). Such property may include any interest (i.e., securities) in a corporation, partnership, or other entity that derives value from the same.

Consider that certain “non-regulated” properties of an LDC or affiliate may not be Electricity Property. For example, the assets of non-regulated businesses such as fibre-telecomm or water heater rentals would not generally be considered Electricity Property. Consequently, the transfer of such assets or interests therein would not generally be subject to TT. This notwithstanding, the same PILs and Tax Acts considerations described above would generally apply to non-regulated business activities of LDCs or their affiliates.

The gross amount of TT payable on a transfer of an interest in shares of an LDC is calculated by the formula:

A*(B/C)*D

Where:

A Is the FMV of Electricity Property in which the LDC has a direct or indirect interest (i.e., the Enterprise Value);
B Is the FMV if the interest in the shares of the LDC to be transferred;
C Is the FMV of all outstanding shares;
D Is 33%.

In addition to the assumptions in the example above, assume that the 2015 forecast borrowings of Horizon Utilities are $216MM. Following the above example, the value of shares forecast for 2015 would be in a range of $391MM - $438MM (approximately twice the book value of shareholder’s equity).

A disposition of a 10% shareholder interest would result in TT liability of $13MM to $14MM, before applicable credits. (Also consider that, as a subsidiary of a municipally-owned corporation, any level of transfer – even 1 share - would cause Horizon Utilities to cease to be exempt under the Tax Acts with potential related PILs Departure Tax consequences).

TT should not be confused with PILs Departure Tax, although the two may be related with respect to the nature of transactions that may result in liabilities for these taxes. There is also the potential for “double taxation” but it is expected that proper planning should result in an integration of these taxes to avoid this outcome (i.e., PILs Departure Tax should be creditable against the TT liability).

This notwithstanding, a very high level PILs Departure Tax could be triggered (as this is effectively an “all-or-nothing” tax) on a disposition of a relatively small portion of shareholder interests that further triggers a relatively small to nil amount of TT. In this case, proper planning might result in mitigating a TT liability by a the PILs Departure Tax credit.

Additionally, a disposition of LDC property other than share interests (i.e., assets) will not result in PILs Departure Tax; since there has been no transfer of LDC ownership. However, such transfer will be subject to TT.

As well, consider that it is possible for an LDC to be subject to tax under the Tax Acts (and not PILs) but remain liable for TT on a transfer of Electricity Property (i.e., where and to the extent that a municipal corporation or subsidiary retains an interest in the LDC).

The amount of TT liability may be reduced by:

1. Any past PILs amount “payable and paid” by the LDC up to and including the date of transfer (a tax planning point would be to consider factoring in and prepaying any PILs Departure Tax if the related transfer also were to trigger such in order to avoid the “double taxation” noted above);
2. Any amount “payable and paid” by the LDC under the OCTA in respect of any past taxation year or part up to and including the date of transfer (i.e., if the LDC were subject to taxes under the OCTA directly and not PILs);
3. Any tax liability under the ITA arising from capital gains or a gain on disposition of eligible capital property resulting from the transfer (i.e., if the LDC were subject to taxes under the ITA directly and not PILs).

Certain transfers of Electricity Property are specifically excluded from TT liability. Some of these include:

1. Subsequent transfers of property, under certain conditions, where transfer tax liabilities have previously been settled;
2. Transfers of Electricity Property that has become obsolete or has not been used in the past twelve months provided that: such transfers do not have an aggregate annual FMV greater than 5% of the total FMV of LDC Electricity Property; the transfers are in the ordinary course of business; and, the primary purpose of the transfers are to replace the transferred property;
3. Corporate reorganizations where transfers do not result in a change in the beneficial ownership of Electricity Property interests;
4. Transfers to secure a debt or loan;

5. Transfers to a municipal corporation, an LDC or affiliate, Hydro One Inc., or Ontario Power Generation (“OPG”) provided that the transferees are tax exempt under the Tax Acts.

Exclusion 5. effectively permits mergers, acquisitions, or divestitures of Electricity Property within municipal shareholders, LDCs, Hydro One, or OPG without any TT liability.

Additionally, subscriptions for LDC shares from treasury are not generally considered transfers of Electricity Property for purposes of the TT. However, the level of such subscription may result in an LDC ceasing to be exempt under the Tax Acts with related tax consequences.