New Regulations Intended to Encourage Consolidation

June 13, 2016

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The Ministry of Finance ("MOF") published two regulations on April 25, 2016, implementing the changes described in the April 2015 Ontario Budget. The new regulations are intended to encourage the consolidation of the LDC sector by reducing, and in some cases eliminating significant tax barriers to consolidation.

Overview of New Regulations

The regulations are intended to provide three tax incentives related to the consolidation objective:

- The elimination of the capital gains tax that arises when a municipal electricity utility ("MEU") leaves the payments in lieu of taxes ("PILs") system.
- A reduction of transfer tax to 22%.
- The elimination of transfer tax on sales of electricity property made by a MEU which has less than 30,000 customers.

It is important to note that these tax incentives are time limited. They are applicable only to a sale agreement made during the three year period after December 31, 2015 and before January 1, 2019, provided such agreement is not materially changed after that date and an application for OEB approval is made before that date. If the sale agreement is made outside this three year window or fails those other conditions, the transfer tax reverts to the 33% rate.

The regulations also introduced a technical change related to the transfer of property to a partnership that had non-PILs members–the intention being to ensure that gains on such transfers of property would be taxed at full income rates at the time the transfer occurred. This change is not discussed in this bulletin.

Elimination of Capital Gains Tax

When a MEU leaves the PILs system there is an automatic deemed disposition of its property at a moment in time just prior to that departure point creating a tax liability, which is generally referred to as departure tax. The MEU is treated as having received proceeds of disposition equal to the fair market value ("FMV") of its property. Consequently, there is the potential for a significant tax liability payable by the MEU when its shares are acquired by a "**private purchaser** ". Technically, that tax liability will arise when a contingent right to purchase shares is created by a signed purchase and sale agreement.

The departure tax would normally require a MEU to include in its taxable income both the capital gains and recapture arising from the deemed disposition of its property. The new regulations provide that a capital gain that arises from a deemed disposition of property is effectively ignored for the period after December 31, 2015 and before January 1, 2019.

A share purchase made by a municipal buyer will not cause the MEU to lose its tax exempt status, and consequently the departure tax is not an issue for those transactions.

Transfer Tax Changes

The transfer tax rate for dispositions of electricity property during the period after December 31, 2015 and before January 1, 2019 is reduced to 22%. The seller can continue to use any PILs paid by a related MEU to reduce its transfer tax liability (a "PILs Credit"), provided those PILs Credits are positioned in the correct entity. If the seller is a municipal corporation, it can reduce its transfer tax costs by the amount of any PILs payable and paid by a related MEU. If the seller of electricity property is a MEU, it can reduce its transfer tax liability by any PILs that are payable and paid by such MEU.

The second major change is a complete transfer tax exemption related to the transfer by a municipal corporation or a MEU of shares of small and mid-sized MEUs. The exemption is applicable to sales of electricity property involving MEUs which have less than 30,000 customers. There are several supplementary rules in the regulations which appear to be directed to ensuring that no inappropriate use is made of the exemption. Query whether, if the objective was to create certainty and predictability, it would have been easier for the MOF to pass a new regulation which prescribes which MEUs meet the 30,000 customer test, based on the information publicly available? Instead, there are several deeming rules which potentially create some uncertainty.

First, the 30,000 customer test is based on a defined source – the Ontario Energy Board 2014 Yearbook. It is not clear whether that customer number is fixed so that if the actual number of customers attributed to a MEU increases past 30,000 between January 1, 2016 and before January 1, 2019, the exemption is still available. That is something a seller could presumably get clarification on when the need arises.

Second, the 30,000 customer test also seems to be impacted by circumstances in which a MEU or a municipal corporation has some form of contingent right to acquire an interest in electricity property or some other entity (like a partnership, corporation or trust) that distributes, generates, transmits or retails electricity. Without understanding the precise circumstances that this provision is directed at, the concern might be with a MEU which satisfies the 30,000 customer test but has some contingent right that would permit it to grow much larger. One would have thought that the exercise of this contingent right would have independently triggered a transfer tax liability that would have eliminated any misuse of the exemption. The other source of uncertainty is that the language of the regulation suggests that the holder of this contingent right could also be the vendor and not the MEU being sold. Again, if this rule is potentially relevant to your situation, you should seek clarification from the MOF.

Third, the 30,000 customer limit is subject to what we would characterize as associated enterprise rules. This means that the 30,000 customer limit includes customers of any corporation, trust, or partnership that is affiliated with the municipal corporation or MEU, or in which the municipal corporation or MEU has a direct or indirect interest. These associated enterprise rules incorporate by reference, sections 251 and 251.1 of the Income Tax Act (Canada) ("ITA") which set out a number of tests for determining when: (1) any two corporations are related or affiliated; (2) partnership and trusts are affiliated with other trusts or partnerships; or (3) a majority interest partner or a majority interest beneficiary is affiliated with a partnership or a trust. If the 30,000 customer MEU has an ownership interest in another corporation, trust or partnership, these provisions must be carefully considered. A similar analysis must be undertaken if another person has an ownership interest in the 30,000 customer MEU that is being sold. These provisions include some broadly worded anti-avoidance rules which deem persons to be related when one corporation has a contingent right to acquire shares of another corporation.

Looking back at the September 18, 2015 draft regulations, the intention seems to have been that a person counted towards that 30,000 customer limit if within 30 days prior to a purchase agreement involving the sale of a MEU, that person had purchased electricity as agent or principal from some other person that did not deal at arm's length with the MEU. The principal differences between the two versions of this associated enterprise rule is that the 30 day look back period is removed, and there is more technical drafting around what an associated enterprise is.

The other change from the September 18 draft regulation is the removal of the first agreement rule. This rule would have limited the availability of the exemption to only the first written agreement entered into after April 22, 2015 by a MEU. That limitation meant that if there was a purchase agreement in respect of a MEU, and the buyer did not close, the MEU would have lost the transfer tax exemption, permanently.

Interestingly, the MOF chooses to substitute the word “consumer” for the word "customer" in different parts of the regulation. The other interesting part of the regulations is the suggestion that a municipal corporation could have its own consumers or customers, for the purpose of applying the 30,000 customer test.

Planning Considerations

The capital gains exemption only applies to a capital gain created by the deeming rules in subsection 149(10) ITA. An asset sale will continue to be subject to both capital gains and recapture tax.

The federal tax regime changes for dispositions of eligible capital property ("ECP") in 2017. ECP effectively becomes depreciable capital property, giving rise to capital gains, rather than active business income to the extent that its' deemed proceeds exceed its original cost.

The elimination of the transfer tax payable by MEUs with less than 30,000 customers narrows the preference for selling shares to a municipal buyer. However, there is still a significant tax preference to sell shares of MEUs with 30,000 or more customers to a municipal buyer, because of the transfer tax exclusion available.

In either situation – a sale to a non-government entity or a municipal buyer, the seller will have a significant tax cost. The only exception is a merger with a municipal buyer, where the transaction is structured as a share for share exchange with no cash paid to the selling municipality.

For larger MEUs, the transfer tax rate has been reset to 22% during for transactions occurring during the three year window. Therefore it remains important to structure any sale to maximize the deduction of PILs Credits against that transfer tax cost.

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