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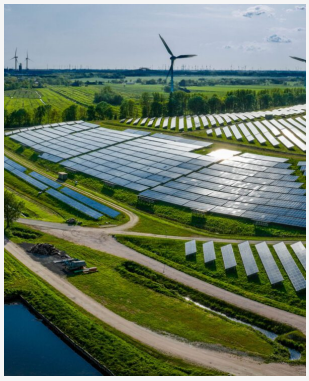
Canada introduces legislation to implement clean technology and carbon capture tax credits and provides update on remaining clean energy tax credits



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Osler's National Tax Group has prepared in-depth analysis of these developments. See our Updates on Bill C-59 and the revised EIFEL rules.

The *Fall Economic Statement Implementation Act, 2023* includes a variety of tax measures that were introduced in Parliament on November 30, 2023, as Bill C-59. The Canadian federal government also released Explanatory Notes [PDF] in respect of most of the measures in Bill C-59 on the same day.

Bill C-59 includes updated legislation to amend the *Income Tax Act* (Canada) (Tax Act) to implement the following clean energy related tax measures:

- The Carbon Capture, Utilization and Storage investment tax credit (CCUS ITC)
- The Clean Technology investment tax credit (Clean Tech ITC)
- The prevailing wages and apprenticeship hour requirements (Labour Requirements) applicable to the Clean Tech ITC, CCUS ITC and several other clean energy investment tax credits that the Government has announced

Draft legislation for the CCUS ITC, Clean Tech ITC and the Labour Requirements was released by the Government for comment in August 2023 (August Draft Legislation). Please see Osler's prior Update discussing the August Draft Legislation for the Clean Tech ITC and Labour Requirements.

Bill C-59 contains revisions to the August Draft Legislation and also delivers on commitments made by the Government in the 2023 Fall Economic Statement (2023 FES), released on November 21, 2023, to introduce legislation into Parliament to enact the CCUS ITC, Clean Tech ITC, and the Labour Requirements in the fall of 2023. This Update summarizes several of the more substantive and notable revisions made to these measures in Bill C-59.

The Government also set out in the 2023 FES its process and timeline for implementing the remaining clean energy measures, which include the Clean Hydrogen investment tax credit (Clean Hydrogen ITC), the Clean Electricity investment tax credit (Clean Electricity ITC), and the Clean Technology Manufacturing investment tax credit (Clean Tech Manufacturing ITC).

The 2023 FES provided further details on the Clean Hydrogen ITC, as well as a proposed expansion of the Clean Tech ITC and Clean Electricity ITC to apply to certain equipment that uses waste biomass as a fuel source. These announcements from the 2023 FES are summarized in the last part of this Update.

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CCUS Investment Tax Credit

The scope and design of the CCUS ITC have undergone significant modifications since the credit was first announced in Budget 2021, including as a result of feedback received through the numerous consultations conducted by the Government following the initial announcement and release of the first draft of the legislation in August 2022. Although the latest revisions made to the August Draft Legislation are relatively modest in comparison to the prior modifications made by the Government, there were nonetheless some fairly substantive changes that will be of interest to affected taxpayers.

The more substantive changes are summarized below.

Non-government assistance

The definition of "non-government assistance" is proposed to be amended to exclude amounts received directly from a government, municipality or other public authority. While this amendment is not specific to the CCUS ITC and applies for the Tax Act as a whole, including to the scientific research and experimental development (SRED) rules, it has significant importance for CCUS projects since the change appears to allow project owners to access other forms of governmental support without that support reducing the CCUS ITC. This is discussed in further detail below under "Non-Government Assistance and CAE Inc. Case".

Delaying recognition of expenditures

Since the announcement of the CCUS ITC, the Government has indicated that this credit will be available when the expenditures for qualified CCUS property are *incurred*. This is a departure from the general treatment of investment tax credits, which do not provide for expenditure recognition until the property is acquired and becomes available for use (for capital cost depreciation purposes). Making the credit available as the expenditures are incurred is important to attaining the Government's objectives of providing a credit that helps to offset the high capital requirements and risks associated with CCUS projects and promoting investment in these projects.

However, based on the legislation tabled in Parliament last week, this credit is not in fact available in all cases as the eligible expenditures are incurred. Specifically, there are two rules now included in the legislation that can delay the recognition of expenditures for the CCUS

ITC.

First, subsection 127.44(12) provides that if an expenditure (although incurred) is unpaid within 180 days after the end of the taxation year in which the expenditure was incurred, the expenditure is deemed to have been incurred at the time it is paid (the "180-day rule"). Where this rule applies, recognition of the expenditure would be delayed until the amount is paid.

Second, a new rule (paragraph 127.44(9)(e)) was introduced in Bill C-59 to address circumstances where expenditures for eligible CCUS properties are incurred in a different year than the acquisition of the property. In these circumstances, the new rule prescribes that the expenditure will not be considered to be incurred, and the property will not be considered to be acquired, for purposes of the credit until the year when the later of these two events occur. The Explanatory Notes also expressly state that paragraph 127.44(9)(e) does not override subsection 127.44(12). Therefore, if the 180-day rule applies to delay recognition of an expenditure until it is paid, the recognition of the expenditure could be further delayed if the related property has not been acquired.

For large infrastructure projects, the cost of equipment is often incurred (and paid) in instalments over the term of the procurement contract and in advance of the delivery of the property. It is also not unusual for the delivery of the equipment to be delayed. Due to the nature and uncertainty associated with the procurement and construction of large infrastructure projects, these timing rules will in some (and, perhaps, most) cases delay the recognition of the equipment costs for the CCUS ITC until the equipment is delivered, which may be several years after the related expenses are incurred and paid. These two provisions, especially the new rule in paragraph 127.44(9)(e), could have a significant impact on the overall effectiveness of the CCUS ITC.

Narrowing the Minister's powers to re-designate CCUS projects

The prior drafts of the CCUS ITC legislation provided the Minister with broad discretion (under subsection 127.44(7)) to, at any time, designate a CCUS project as a single project or as multiple projects. This broad discretion was concerning since the eligibility for (and quantum of) the CCUS ITC and the ongoing reporting and compliance obligations in Part XII.7 are both assessed against the assets or components comprising a "CCUS project". The concern is particularly acute where different components of a CCUS system are owned by different taxpayers. If these components were originally treated as separate CCUS projects for purposes of obtaining the initial project approval, and the Minister subsequently exercises the discretion to treat all the components as a single project, owners of those components would now be dependent on each other to qualify for their credits.

The legislation included in Bill C-59 introduces some restrictions and guardrails with respect to the Minister's discretion under subsection 127.44(7). Specifically, the Minister can only exercise the discretion to redesignate a CCUS project as a single project or multiple projects at the following times:

- Before the initial project evaluation is issued by the Minister for the project, or
- Where a revised project plan is submitted due to changes in anticipated performance of the CCUS project, before a revised project evaluation is issued by the Minister.

While the discretion to redesignate the project still remains, these amendments prevent the Minister from changing the makeup of the project assets on which the project evaluations are based and against which eligibility for the credit is measured. These amendments will help to preserve the value and certainty that the project plan review process is intended to provide to taxpayers.
Additionally, the latest draft of the legislation removes the discretion (set out in paragraph

127.44(8)(e) of the August Draft Legislation) for the Minister to treat a CCUS process that would otherwise be eligible for the credit as being ineligible. There were no limitations on this discretion other than the requirement that the determination must be on the recommendation of the Minister of Natural Resources. The Government stated that this provision would only be used in the unusual circumstances where a process satisfied the technical definition of "CCUS process" but was determined to be outside the intended scope of the CCUS ITC program. Given that there were effectively no guardrails in the legislation on when this discretion could be exercised and the resultant uncertainty created as to the true availability of the credit, the Government's decision to abandon this provision is a welcomed change.

Amended the 'first day of commercial operation' definition

The definition of "first day of commercial operation" is relevant for determining when project expenses cease to qualify for the CCUS development tax credit and become limited to the lower-rate CCUS refurbishment tax credit. It is also relevant for determining when the "total CCUS project review period" begins for purposes of the compliance and reporting obligations in Part XII.7 of the Tax Act.

In the August Draft Legislation, "first day of commercial operation" was defined as the day on which captured carbon is first delivered to a carbon transportation, carbon storage or carbon use system for the purpose of storage or use. This definition treated a project as reaching commercial operation prematurely since captured carbon would necessarily be delivered during the testing of the facility.

The definition has now been revised to "the day that is 120 days after the day on which captured carbon dioxide is first delivered to a carbon transportation, carbon storage or carbon use system for the purpose of storage or use *on an ongoing operational basis*". The Explanatory Notes state that the words "ongoing operational basis" were added and used to clarify that incidental delivery of captured carbon as part of start-up testing would not constitute commercial operations. It was further noted that a 120-day delay was introduced to provide some buffer in relation to expenditures that may straddle the start-up of operations.

Clean Technology Investment Tax Credit

The 30% refundable Clean Tech ITC was first announced in the 2022 Fall Economic Statement. The credit is available for "clean technology property" that is acquired and becomes available for use on or after March 28, 2023.

Bill C-59"s key revisions to the August Draft Legislation related to the Clean Tech ITC are outlined below.

Eligible property

The Clean Tech ITC applies in respect of the cost of certain eligible property, which for the purposes of the Clean Tech ITC is defined as "clean technology property". Bill C-59 contains two modifications to the definition of "clean technology property":

- First, the definition has been revised to expressly include property that is installed in the exclusive economic zone of Canada that uses wind or water to generate electricity (as described in subparagraph (d)(v) or (xiv) of Class 43.1 in Schedule II to the *Income Tax*

Regulations).

- Second, geothermal energy production equipment that is part of a system that extracts heat from a geothermal fluid for sale or use is no longer excluded from eligibility for this credit. As revised, geothermal energy production equipment that extracts fossil fuel for sale or use is still excluded.

Eligible claimants

The Clean Tech ITC can be claimed by a "qualifying taxpayer". This definition has been expanded to include a mutual fund trust that is a "real estate investment trust" (as defined in subsection 122.1(1) of the Tax Act) (REIT). With this change, the Clean Tech ITC can therefore be claimed by a taxable Canadian corporation or by a REIT that acquires eligible property, or by such an entity that is a member of a partnership that acquires eligible property.

Recapture of credit

Significant changes were made to the "recapture" provisions applicable to the Clean Tech ITC. These provisions effectively claw back the Clean Tech ITC if, within a certain period of the acquisition of the eligible property, the property: (i) ceases to qualify as "clean technology property" (i.e., converted to a non-eligible use), (ii) is disposed of (subject to a limited exception for transfers between related persons), or (iii) is exported from Canada (each a Recapture Event).

Shortened recapture period

Most notably, the recapture period has been reduced from 20 years to 10 years. In other words, the credit is subject to recapture if the eligible property ceases to be "clean technology property", is disposed of, or is exported within 10 years of being acquired.

Redesign of the application of recapture provisions to partnerships

Clean Tech ITCs earned on eligible property acquired and held through a partnership are subject to recapture. In the August Draft Legislation, this was achieved by adopting the existing recapture provisions in the Tax Act that applied to SRED and other existing ITCs earned through a partnership. Under those provisions, where a Recapture Event occurred:

- The recapture amount would have first been applied to reduce the partnership's Clean Tech ITC (before allocation to its partners), and
- Any excess recapture amount would have been allocated to the partners and included in each partner's Part I tax liability.

In the revised legislation, the Government has abandoned the approach of adopting the existing recapture provisions and has instead set out standalone rules within the Clean Tech ITC regime for partnerships. Under these rules:

- The computation of the recapture amount has not changed – it is still based on the percentage of the original cost of the property recovered under the Recapture Event and capped at the amount of the ITCs claimed on the property.
- The recapture amount is no longer applied to reduce ITCs that the partnership generated in the year the Recapture Event occurs.

- Instead, the entire recapture amount is included in the income of the partners of the partnership in proportion to their share. Unlike the CCUS ITC, there is no ability for a partner to elect to bear the entire cost of the recapture.
- The liability for recapture is borne by those taxpayers who are members of the partnership during the fiscal year when the Recapture Event occurs. Therefore, it still remains the case that the partners bearing the cost of the recapture may not be the partners that received the benefit of the ITCs.

Narrowing of the exception to the recapture rule

The other notable change is a further narrowing of the related party transfer exception to the recapture provisions. Where this exception applies, the potential recapture of the credit is, in effect, assumed by the related purchaser.

The exception, as set out in Bill C-59, now only applies to dispositions of property by a "taxable Canadian corporation" to a related "taxable Canadian corporation". Therefore, this exception does not apply to, and the Government has chosen to not provide a similar exception for, partnerships and REITs transferring eligible property within a related group.

Additionally, the Government chose to not adopt the arm's length transfer exception available to the CCUS credit. Under that exception, a corporation that disposes of all or substantially all of the property that is part of a qualified CCUS project to another taxable Canadian corporation could make an election to effectively have the purchaser step into the shoes of the vendor with respect to the recapture of the CCUS credit claimed on the acquired property.

The Explanatory Notes do not provide any explanation for the narrow exceptions provided for the recapture provisions, nor do they provide any explanation for the different approaches adopted for the CCUS and Clean Tech ITCs.

Notice requirement

The legislation now requires a taxpayer to report, in prescribed form, the occurrence of a Recapture Event and, where applicable, the reliance on the related person transfer exception. Failure to satisfy these notification requirements will result in the extension of the normal reassessment period for the CRA to reassess in respect of the application of the recapture rules to four years (in the case of a mutual fund trust or a corporation other than a CCPC) and three years (in any other case) from the date when the notification is filed.

Changes applicable to both CCUS and Clean Tech ITCs

"Non-government assistance" and CAE Inc. case

"Non-government assistance" is defined in subsection 127(9) of the Tax Act, and currently includes amounts received from "a government, municipality or other public authority" as assistance whether in the form of "a grant, subsidy, forgivable loan, deduction from tax, allowance or any other form of assistance". Therefore, notwithstanding the terminology, this definition would typically pick up assistance provided by a government.

Bill C-59 amends the definition of "non-government assistance" to exclude amounts "received directly from a government, municipality or other public authority".

This amendment will impact the CCUS ITC, which is only reduced by "non-government assistance" and not "government assistance". This amendment would appear to allow the CCUS ITC to be "stacked" with other credits and funding support provided by a government, municipality or other public authority – in other words, the receipt of funding support from a government, municipality or other public authority should not reduce the CCUS ITC. As both the federal and provincial governments have established other programs (and continue to announce new ones) to support the development of CCUS projects, this amendment will be well-received by stakeholders.

This amendment will not allow the Clean Tech ITC to be "stacked" with other forms of governmental support. This is because, unlike the CCUS ITC, the Clean Tech ITC is reduced by both "government assistance" and "non-government assistance". However, the amendment announced by the Government in the 2023 FES in response to the *CAE Inc.* decision may allow for some "stacking" between the Clean Tech ITC with government funding in the form of concessional loans.

Historically, non-forgivable loans from public authorities were generally not considered government assistance. This position extended to concessional loans (meaning loans that do not bear interest or that bear interest at below-market rates) from public authorities. However, in the *CAE Inc.* decision, the Tax Court of Canada determined that the full principal amount of a concessional loan was government assistance. This decision was affirmed by the Federal Court of Appeal in 2023.

In the 2023 FES, the Government announced that an amendment will be made to the Tax Act so that "bona fide concessional loans with reasonable repayment terms from public authorities" will generally not be treated as "government assistance". This amendment would come into force on the date the 2023 FES was released. Legislation to enact this amendment was not included in Bill C-59. The parameters of this carve-out from government assistance, and whether it fully addresses the concerns arising from the *CAE Inc.* decision, will need to be assessed when draft legislation is released.

ITCs earned through partnerships

Bill C-59 introduces a new section 127.47, which sets out a series of rules with respect to the application of the Clean Tech ITC and CCUS ITC to partnerships. The Explanatory Notes state that these rules will also apply to the Clean Hydrogen, Clean Technology Manufacturing and Clean Electricity ITCs when they are enacted.

Unreasonable allocation between partners

The August Draft Legislation proposed a new provision under section 103 that would allow the Minister to reallocate the CCUS ITC and Clean Tech ITC between partners if the allocation agreed to by the partners is unreasonable having regard to the capital each partner invested or work each partner performed for the partnership, or other such factors that may be relevant. Bill C-59 retains this provision, but it is now set out in new subsection 127.47(2), rather than as a subsection in section 103.

There is also a new "apportionment rule" in subsection 127.47(4), which states that the amount of any CCUS ITC or Clean Tech ITC earned by a partnership and included in a partner's computation of its CCUS ITC or Clean Tech ITC amount "is deemed to be the portion of the amount otherwise determined under [section 127.47] in respect of the [partner] that is reasonably attributable to each particular clean economy tax credit." The accompanying Explanatory Notes do not identify the specific concern or policy underlying the need for this rule. However, based on the example provided in the Explanatory Notes to illustrate the

application of this rule, the rule appears to require each type of ITC earned in a partnership to be allocated pro rata, in a reasonable manner, amongst all partners.

The example in the Explanatory Notes contemplates a scenario where a limited partnership generates a total of $7,500 of clean energy ITCs in a year, made up of a $6,000 CCUS ITC ($10,000 expenditure at 60%) and a $1,500 Clean Tech ITC ($5,000 expenditure at 30%). The limited partner of the partnership has $3,000 of at-risk amount. The Explanatory Notes suggest that the amount of *each particular* ITC that may be allocated to the limited partner (to a maximum total of its at-risk amount of $3,000) must be reasonable. The example sets out two reasonable allocation methods: the first apportions the ITCs based on their relative expenditure amounts; the second apportions the ITCs based on their relative credit amounts. The examples suggest that it would not be reasonable to allocate $3,000 of the CCUS ITC and $0 of the Clean Tech ITC to the limited partner in the scenario described.

Limited partners – at-risk amount restriction

The August Draft Legislation adopted the existing provisions of the Tax Act, subsections 127(8.1) to (8.5), which generally limit the amount of an ITC that may be allocated to a limited partner to *the lesser of* that partner's "at-risk amount" and "expenditure base" in respect of the partnership. Where ITCs cannot be allocated to limited partners due to these restrictions, the unallocated ITCs could be allocated to general partners.

In Bill C-59, the Government has abandoned this approach and instead introduced a new provision that only limits the allocation of the Clean Tech and CCUS ITCs to a limited partner by its "at-risk amount". This is a favourable amendment for taxpayers since the "expenditure base" restriction was generally expected to be more limiting than the "at-risk amount" restriction. However, by retaining the "at-risk amount" limitation, it remains the case that financing expenditures with partnership-level debt could operate to limit the amount of ITCs available to limited partners.

Under the revised regime, there is no longer an express provision that allows any ITCs that could not be allocated to the limited partners to be allocated to general partners. This raises a question as to whether it is permissible to allocate the unallocated amounts to the general partners.

Assistance received by partners will reduce partnership ITCs

Under new paragraph 127.47(5)(b), the amount of any government assistance or non-government assistance that a partner receives, is entitled to receive, or can reasonably be expected to receive that may reasonably be considered to be in respect of an eligible expenditure of the partnership, will be deemed to be received by the partnership. In effect, this provision operates to reduce a partnership's eligible expenditures by any assistance received by a partner if that assistance would have reduced the eligible expenditure had been received directly by the partnership.

The Explanatory Notes do not provide any guidance on what factors will be relevant in determining whether assistance will be "considered to be in respect of the expenditure" or the degree of connection that is required for this provision to apply. Additionally, where some (but not all) of the partners receive assistance that reduces the partnership's ITCs, there is no guidance on whether a reasonable allocation of the available ITCs should take into account the disproportionate impact of the partners' sources of financing on the ITCs earned on the project.

ITC claims reduce partnership CCA base

Bill C-59 introduces a new rule that treats ITCs allocated by a partnership to its partners and claimed by the partners as assistance received by the partnership. The result of this rule is a reduction of the partnership's undepreciated capital cost balance for the related eligible property by the amount of the ITCs claimed by the partners.

Tiered partnerships

A new rule confirms that clean energy ITCs, and the recapture of such credits, will flow up to the ultimate taxpayers when the eligible property is acquired and held through multiple levels of partnerships. Specifically, the rules treat a partner (Partner A) of a particular partnership (Partnership A) that is a partner of another partnership (Partnership B) to be a partner of Partnership B.

Labour Requirements

Bill C-59 includes legislative provisions to enact the Labour Requirements, which require projects to meet certain wage and apprenticeship standards to receive the full amount of the CCUS and Clean Technology ITCs. The Government has stated that the Labour Requirements will also apply to the Clean Hydrogen and Clean Electricity ITCs.

The legislative provisions are largely similar to the August Draft Legislation, which was discussed in a prior Osler Update. Below is a summary of the key changes made compared to the August Draft Legislation.

The coming into force date for the Labour Requirements has changed from October 1, 2023 to November 28, 2023.

Reasonable efforts

One of the main concerns with the August Draft Legislation was the interpretation of the "reasonable efforts" requirement that applies to the apprenticeship hours component of the Labour Requirements. Under that component, a claimant must make "reasonable efforts" (a) to ensure that registered apprentices work at least 10% of the total hours worked at a work site installing specified property, or (b) if a collective agreement restricts the amount of apprenticeship hours worked, to ensure that the highest possible percentage of labour hours worked is performed by registered apprentices when certain conditions are met.

Bill C-59 sets out a new provision that deems the "reasonable efforts" requirement to be satisfied where the following occurs:

- The claimant, at least every four months, does all of the following:
  - Posts a job advertisement seeking apprentices that (a) notes a commitment to facilitate participation in a Red Seal trade program, (b) includes a statement that the job is for existing employees and new hires, and (c) is readily accessible on three websites and is available for at least 30 days.
  - Communicates with a trade union and at least one secondary or post-secondary institution for the purposes of facilitating the hiring of apprentices.

    - Receives confirmation from the trade union that the union has provided as many apprentices as possible (or the claimant does not receive a response to a request for such confirmation within five business days)
- The claimant reviews and considers all applications received for apprenticeship opportunities in response to the advertisement, and takes reasonable steps to ensure all other applications are reviewed and considered.
- The claimant provides an attestation that it has complied with the above requirements.

The Explanatory Notes state that the above steps are meant to illustrate circumstances where the reasonable efforts tests in the apprenticeship requirements would be satisfied. It notes that variations on these actions to better reflect specific circumstances (such as shorter time periods for equipment installation) may also be considered reasonable efforts.

Reduced penalty for deficient apprentice hours

The penalty tax for failing to meet the hours prescribed under the apprenticeship requirement has been reduced from $100 per deficient hour (i.e., for each hour that was required to be worked but was not actually worked) to $50.

Sharing of penalty and costs accruing to a partnership

New subsection 127.46(17) sets out a series of rules to address the allocation of penalties and taxes incurred by a partnership that fails to satisfy the Labour Requirements amongst its partners and provides for the following:

- Partners of a partnership are jointly and severally liable for any unpaid tax or penalty of the partnership.
- A partner can elect to bear the full amount of a tax or penalty.
- Where no election is made, the partners will be responsible for their reasonable share of the tax or penalty.

Lithium from brines

Bill C-59 included legislation to implement the changes announced in the 2023 Federal Budget to allow for certain expenses related to mining lithium from brines to be eligible for flow-through treatment. The legislation has not changed from the August Draft Legislation, which was the subject of a prior Osler Update.

The coming into force of these provisions remains March 28, 2023, and any expenses incurred before that date are not eligible for flow-through treatment.

Other updates from the 2023 Fall Economic Statement

As noted earlier, the Government also provided an update on the process and timelines for implementing the Clean Hydrogen ITC, the Clean Electricity ITC, and the Clean Tech Manufacturing ITC. The 2023 FES provided further details for the Clean Hydrogen ITC and proposed an expansion to the Clean Tech ITC and Clean Electricity ITCs to apply to certain equipment that use waste biomass as a fuel source. These announcements are summarized below.

Timelines for implementing other clean energy tax incentives

With legislation now having been tabled to enact the CCUS ITC and Clean Tech ITC, the Government's focus should now turn to the implementing the remainder of the clean energy tax incentives. The Government provided an update in the 2023 FES on the process and timing for implementing the remaining measures.

Clean Hydrogen and Clean Tech Manufacturing ITCs

The Government indicated in the 2023 FES that draft legislation would be released for the Clean Hydrogen and Clean Tech Manufacturing ITCs in the fall of 2023 for comment from the public. As such, we should expect it to be released within the next few weeks.

The Government further signaled that legislation to enact these two credits would be introduced in Parliament by mid-2024.

The effective dates for these credits remain unchanged: the Clean Hydrogen ITC will be available for eligible property acquired on or after March 28, 2023 and the Clean Tech Manufacturing ITC will be available for eligible property acquired on or after January 1, 2024.

Clean Electricity ITC

The Government has announced that separate consultation processes will be conducted for publicly-owned utilities and non-publicly-owned utilities with respect to the Clean Electricity ITC:

- With respect to utilities that are not publicly-owned, the design and implementation details for the Clean Electricity ITC will be published in early 2024 and consultation on draft legislation will be launched in the summer of 2024.
- With respect to utilities that are publicly-owned, consultations with provinces and territories will take place in 2024.

Although it was not expressly explained in the 2023 FES, the likely reason for the separate consultation process for publicly-owned utilities is to address the requirement for provincial authorities to make commitments: (a) to use the credit to lower electricity bills, and (b) to achieve a net-zero electricity sector by 2035 as a condition for accessing the Clean Electricity ITC. The bifurcated process suggests that these requirements may only apply to claimants that are publicly-owned utilities. The separate process also suggests that the Government anticipates delays may arise from the provincial consultation process.

The Government is targeting to introduce legislation in Parliament to enact the credit for both public and non-public owners in fall 2024. The effective date of the credit remains unchanged and will be available from the day of Budget 2024 for projects that did not begin construction before March 28, 2023.

Clean Hydrogen Investment Tax Credit

The 2023 FES also set out further details on the Clean Hydrogen ITC.

Calculation of carbon intensity and recovery

The rate of the Clean Hydrogen ITC is based on the carbon intensity (CI) of the project. The calculation of CI will take into account life-cycle emissions of producing hydrogen — including upstream input emissions. In Budget 2023, the Government stated that power purchase agreements and other similar instruments to purchase clean electricity will be relevant in measuring the CI of a clean hydrogen project, but will be subject to conditions to be announced at a later date.

The 2023 FES provides further guidance on the calculation of the CI of a project where the project uses power purchase agreements (where clean electricity is purchased from the grid). The 2023 FES also proposes that the use of renewable natural gas as an input would also be eligible for purposes of calculating a project's CI.

Power purchase agreements will be considered in calculating the CI of a project where all of the following apply:

- The purchased electricity is sourced from hydro-, solar-, or wind-powered generation that first commenced production after March 28, 2023 and no more than one year before the initial project CI assessment is submitted.
- The purchased electricity is generated in the same province or territory as the clean hydrogen project and is connected to the grid.
- The owner demonstrates that the energy purchased under these agreements is for the operation of the clean hydrogen project.

The use of renewable natural gas as an input will be considered in calculating the CI of a project where all of the following applies:

- The renewable natural gas is produced by a supplier that is subject to the *Clean Fuel Regulations.*
- The renewable natural gas is from a facility that commenced production less than one year before the initial project CI assessment is submitted.
- The owner demonstrates that the renewable natural gas purchased is for the operation of the clean hydrogen project.

The CI of electricity purchased through an eligible power purchase agreement will correspond to the CI of the electricity in the Fuel Life Cycle Model. The CI of the renewable natural gas will correspond to the CI assessed under the *Clean Fuel Regulations*. In both cases, the calculation of CI will take into account the length of the contract in relation to the assumed 20-year life span of a clean hydrogen project.

Regarding the assessment of the initial CI of a project, the 2023 FES clarified that the assessment will need to be validated by a third-party engineering firm that meets certain requirements. Once the assessment has been validated by Natural Resources Canada, the ITC will be administered by the Canada Revenue Agency (CRA).

Finally, the 2023 FES contains further guidance on compliance and recovery of tax credits if the CI of the project falls short of what was initially assessed. The 2023 FES proposes a one-time verification, based on a five-year compliance period. Over the five-year period, the project will compute annually the CI of hydrogen that is produced (as verified by a third party). The results over the five-year period will be computed as a weighted average (based on hydrogen produced in each year) to determine the verified CI of a project.

If the verified CI of the project exceeds the originally estimated CI, there will be a mechanism for the CRA to recover the difference between the ITC received and the ITC that would have been available based on the verified CI of the project. However, Clean Hydrogen ITC claimed in respect of ammonia production equipment will be subject to full recovery if the hydrogen production project supplying the hydrogen used for ammonia production has a verified CI of 4 kg or more of CO_2e per kg of hydrogen. Of note, the 2023 FES proposes a safe harbour rule where projects with a verified CI of no more than 0.25kg of carbon dioxide equivalent per kg of hydrogen above the original assessed CI would not be subject to recovery of the Clean Hydrogen ITC.

The 2023 FES also notes that there will be no mechanism for the project owners to receive additional ITCs if the verified CI is lower than the initially assessed CI of a project.

Clean ammonia production equipment

Budget 2023 expanded the Clean Hydrogen ITC to cover property used for the sole purpose of converting clean hydrogen into ammonia at a lower 15% rate. The Government provided the following additional details on the eligibility criteria for this lower credit:

- The hydrogen used as feedstock for ammonia production must be the taxpayer's hydrogen and must come from clean hydrogen projects eligible for the Clean Hydrogen ITC.
- The clean hydrogen projects must have the production capacity to satisfy the needs of the taxpayer's ammonia production facility.
- If the hydrogen production and ammonia production are not occurring in the same location, the taxpayer must demonstrate the feasibility of transporting the hydrogen between the two sites.

If the hydrogen and ammonia are produced in an integrated facility, the cost of shared equipment will be allocated between hydrogen and ammonia equipment based on the equipment's relative use between hydrogen and ammonia production.

Expanded eligibility for the Clean Tech and Clean Electricity ITCs

As noted above, the 2023 FES also proposed to expand the Clean Tech and Clean Electricity ITCs to make them available to certain systems that generate heat, electricity, or both, from waste biomass (Biomass Expansion). The purpose of this new Biomass Expansion is to reduce biowaste and support new affordable electricity and heat generation in Canada.

The Biomass Expansion will capture systems that use "specified waste material" as defined in the *Income Tax Regulations* to generate electricity or heat. "*Specified waste material*" is defined to mean "wood waste, plant residue, municipal waste, sludge from an eligible sewage treatment facility, spent pulping liquor, food and animal waste, manure, pulp and paper by-product and separated organics."

Electricity generation and cogeneration from waste biomass

The expanded eligibility would apply to certain integrated waste biomass systems that use "specified waste material" solely to generate electricity or electricity and heat (i.e., cogeneration systems).

Eligible systems must be integrated. That is, eligible systems would be limited to those that

use feedstock, all or substantially all of the energy content of which is from "specified waste material", as determined on an annual basis. Systems that use a fuel that is not produced as an integrated part of the system, even if produced from specified waste materials, would not be eligible. In addition, eligible systems must not exceed a heat rate threshold of 11,000 British thermal units per kilowatt-hour.

The 2023 FES outlines that the following would be eligible property when they are part of an integrated electricity or cogeneration system:

- Electrical generating equipment (e.g., steam turbine generators)
- Heat generating equipment used primarily for to produce heat energy to operate electrical generating equipment (e.g., steam boilers producing steam to operate steam turbine generators)
- Equipment that generates both electrical and heat energy (e.g., gas turbine generators, reciprocating generator sets)
- Heat recovery equipment
- Equipment used to upgrade or enhance the combustibility of specified waste material (e.g., a gasifier)
- Ancillary equipment (e.g., control, feedwater, and condensate systems)

Heat generation from waste biomass

The expanded eligibility would also apply to certain integrated systems that use "specified waste material" (other than spent pulping liquor) solely to generate heat energy. Similar to the eligibility requirements for electricity and cogeneration systems, in order for heat generation systems to be eligible, they must be integrated.

Eligible property within an eligible integrated heat generation system would include:

- Heat generating equipment other than that used to operate electrical generating equipment
- Equipment used to upgrade or enhance combustibility of specified waste material (e.g. a gasifier)
- Ancillary equipment (e.g. control, feedwater, and condensate systems)

Compliance with environmental laws, by-laws, and regulations

The 2023 FES proposes to replace existing environmental compliance rules that must be satisfied for properties to fall within Class 43.1 and 43.2 with a similar rule that would bar eligibility only where there is significant environmental non-compliance. These rules would apply to Class 43.1 and 43.2 properties, as well as properties that are eligible for the Clean Tech and Clean Electricity ITCs.

Effective date

The Biomass Expansion would be available as follows:

- Clean Tech ITC: property that is acquired and becomes available for use *on or after* the date of the 2023 FES's release (being November 21, 2023), provided the property had not been

used for any purpose before it was acquired.

- Clean Electricity ITC: as of the date of Budget 2024 for projects that did not begin construction before March 28, 2023.

If you have any questions or require additional analysis on Bill C-59 and the clean energy related tax measures, please contact any member of our National Tax Department.