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Canada releases long-awaited draft legislation for tax credits supporting the clean energy sector

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Osler's National Tax Group has been following these developments closely. See our Updates on the draft tax legislation package, the global minimum tax and revised EIFEL rules.

On August 4, 2023, the Canadian federal government released a significant package of draft legislation to implement various tax measures, update certain previously released draft legislation and make certain technical changes. Included in this package is draft legislation for the Clean Technology Investment Tax Credit (Clean Technology ITC) first announced in the 2022 Fall Economic Statement, the labour requirements applicable to various clean energy investment tax credits, legislative amendments to the Carbon Capture, Utilization and Storage Investment Tax Credit (CCUS ITC) announced in the 2023 Federal Budget and various other tax supports for the clean energy sector announced in the 2023 Federal Budget or earlier (Proposals).

The news release that accompanied the Proposals invites interested parties to make submissions with respect to the Proposals by September 8, 2023.

Notably, the legislative package does not include draft legislation for the Clean Hydrogen, the Clean Electricity or the Clean Technology Manufacturing ITCs. The news release indicated that draft legislation for the Clean Hydrogen ITC would be released soon, and noted that the cleanest forms of blue hydrogen (hydrogen produced from natural gas where emissions are abated using CCUS) would be eligible for the investment tax credit, which would include hydrogen produced using clean-powered autothermal reforming with a high rate of carbon capture. The government did not provide any timing commitment on the other ITCs.

Table of contents

- Clean Technology Investment Tax Credit
- Labour requirements
- Carbon Capture, Utilization and Storage Investment Tax Credit
- Flow-through shares and Critical Mineral Exploration Tax Credit for lithium from brines

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- Temporary rate reduction for zero-emission technology manufacturers

Clean Technology Investment Tax Credit

The Clean Technology ITC is aimed at supporting investment in low-emitting energy generation and storage equipment. This 30% refundable ITC was first announced in the 2022 Fall Economic Statement, with an update in the 2023 Federal Budget that the ITC would also be available for geothermal energy equipment.

The draft legislation released last week largely aligns with the prior announcements on the Clean Technology ITC. The proposed mechanics for the credit also largely follow the existing ITC framework in the *Income Tax Act* (Canada) (Tax Act) and adopts certain elements of that framework, in particular those for the Scientific Research and Experimental Development (SRED) investment tax credit. The remainder of this section summarizes the key elements of the Clean Technology ITC draft legislation.

Eligible property

The Clean Technology ITC is only available in respect of the cost of eligible property. The types of eligible property include the following:

- zero-emission electricity generation technologies, like solar, wind, small hydro, concentrated solar energy and small modular nuclear reactors;
- electricity storage systems that do not use fossil fuels in their operations, like batteries, flywheels, compressed air energy storage, pumped hydroelectric energy storage, gravity energy storage and thermal energy storage;
- certain active solar heating equipment, air-source heat pumps and ground-source heat pumps;
- equipment used exclusively for generating electrical energy or heat (or a combination) solely from geothermal energy, but excluding any equipment that is part of a system that extracts both heat from geothermal fluid and fossil fuel for sale or use; and
- non-road zero-emission vehicles that are fully electric or powered by hydrogen, and charging or refueling equipment primarily used to support such vehicles.

There are a few aspects concerning the scope and definition of eligible property that project proponents should note.

First, the eligible property must be new equipment, situated in Canada and intended for use exclusively in Canada.

Second, the draft legislation clearly states that electricity storage equipment is eligible if the equipment does not use fossil fuels in its system. However, the explanatory notes refer to storage equipment “for zero-emission energy,” which could be interpretated to restrict eligible storage equipment to those that only store electricity produced from zero-emission sources. Grid-connected electricity storage projects in Canada in the foreseeable future will not be in a position to control the percentage of non-emitting electricity that they are charged with. The disconnect between the legislative text and the explanatory notes appears

to be inadvertent as the latter does not align with the legislation, nor prior statements from the government.

Lastly, there are specific provisions defining eligible "concentrated solar energy equipment" and "small modular nuclear reactors" (SMNRs), with specific components of these systems being excluded from the credit:

- In the case of concentrated solar energy equipment, auxiliary heating and electrical generating equipment that use any fossil fuels and distribution equipment are excluded.
- In the case of SMNRs, eligibility is limited to a reactor that (a) is part of a system that has gross rated generating capacity not exceeding 300 megawatts electric, or an energy balance equivalent gross rated generating capacity of electricity or heat equivalent of 1,000 megawatts thermal and (b) is part of a system all or substantially all of which is comprised of modules that are factory-assembled and transported pre-built to the installation site. Eligible SMNR equipment expressly excludes nuclear waste disposal equipment, transmission equipment and distribution equipment.

Credit available for 10 years

The credit is available for eligible property acquired on or after March 28, 2023 (Budget Day).

Generally, a taxpayer is not considered to have "acquired" the eligible property until such time as the property becomes "available for use" (AFU), as determined for purposes of the capital cost allowance rules in subsection 13 of the Tax Act (without reference to the rules that accelerate AFU status on disposition of the property or, in the case of a building, on completion of construction). However, property acquired prior to Budget Day is not eligible for the credit regardless of whether such property becomes AFU before or after Budget Day.

The credit will be phased out after 2034, with the credit rate reduced to 15% for 2034 and nil thereafter.

Eligible claimants – taxable Canadian corporations and partnerships

The Clean Technology ITC may be claimed by taxable Canadian corporations which acquire eligible property or by taxable Canadian corporations which are partners in partnerships that acquire eligible property. Individuals (including trusts) and tax-exempt entities are not eligible.

The ITC is also not available where the eligible property, or an interest in a person or partnership that has an interest in that property, is a tax shelter investment.

In the case of eligible properties acquired by a partnership, the Clean Technology ITC is computed as if the partnership were a taxable Canadian corporation and then is allocated to the partners. The allocation of the ITC amongst the partners must be reasonable (and section 103 is modified to apply to the allocation of this credit).

In the case of limited partnerships, the draft legislation adopts the existing provisions in subsections 127(8.1) and (8.2) that impose further limitations on the amount of ITC that may be allocated to limited partners. Under these restrictions, the amount of the partnership's ITC for a fiscal year that can be allocated to a limited partner is limited to the lesser of the limited

partner’s “at risk amount” and “expenditure base” (as determined at the end of that fiscal period):

- The at-risk amount is computed under subsection 96(2.2) and is, very generally, equal to the tax cost of the partner’s partnership interest plus (or minus) the partner’s share of the partnership’s income (or losses) for the fiscal period.
- The expenditure base is defined in subsection 127(8.2) and, very generally, limits the amount of ITCs allocated to a limited partner to an amount that is attributable to eligible expenditures funded by contributions from that partner.

The computation of a limited partner’s “at-risk amount” and “expenditure base” are both highly technical. Any amounts that cannot be allocated to the limited partners by virtue of these limitations can be allocated to non-limited partners.

Labour requirement

The credit is subject to the Labour Requirements, which are discussed in more detail below.

Claiming the Clean Technology ITC

The Clean Technology ITC is claimed by filing a prescribed form with the claimant’s income tax return for the year in which the eligible property is acquired. Upon claiming the Clean Technology ITC, the taxpayer is deemed to have made a payment against its tax liability for that year equal to the amount of the ITC. The draft legislation does not give the taxpayer discretion, as with other ITCs, to roll forward and defer claiming the ITC.

A late filing is permitted up to one year from the claimant’s filing due date for the year. The Minister does not have discretion to accept a late filing beyond that date.

Reduction to eligible expenditures

The cost of eligible property, and therefore the expenditure base used to compute the ITC, is adjusted in certain circumstances, including:

- *Assistance*: The cost of eligible property is reduced by any governmental or non-governmental assistance that can reasonably be considered to be in respect of the property that, at the time of filing the tax return for the year in which the property is acquired, the taxpayer has received, is entitled to receive or can reasonably be expected to receive. Given this broad language, assistance can reduce the ITC expenditure base even before it is actually received. There is a mechanism for restoring the ITC expenditure base in the event the taxpayer repays the assistance or is no longer entitled to the assistance.
- *Acquisition from non-arm’s length persons*: Where the eligible property is acquired from a non-arm’s length person, the cost of the property is limited to the lesser of the cost to the purchaser and the cost to the vendor. In essence, the purchaser’s ITC will not capture any increase in the value of the eligible property between the time the vendor acquired the property and the time it was sold to the non-arm’s length purchaser.

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- *Unpaid amounts*: If the cost for eligible property is unpaid 180 days after the end of the taxation year in which the ITC would otherwise be available, that cost is excluded from the expenditure base until it is paid.

Recapture

Similar to the existing SRED ITC regime, the Clean Technology ITC is subject to recapture if, within 20 calendar years of the acquisition of the eligible property, the property is converted to a non-clean technology use, exported from Canada or otherwise disposed of by the taxpayer.

The recapture amount is equal to the ITCs claimed multiplied by a fraction with the numerator equal to the fair market value proceeds and the denominator equal to the taxpayer's cost in the property. On a sale of the property to an arm's length person, the numerator, and therefore the recapture amount, will be based on the taxpayer's proceeds of disposition. On a disposition of the property to a non-arm's length person, or the conversion or export of the property, the numerator will be based on the fair market value of the property at the time of the disposition, conversion or export. The recapture amount is capped at the amount of the ITC claimed in respect of the property.

In the case of a taxable Canadian corporation, the recapture amount is added to the corporation's tax liability for the year in which the disposition, conversion or export occurs.

In the case of a partnership, the recapture amount is first applied to reduce the partnership's Clean Technology ITC (before allocation to its partners) and any excess is allocated to its partners and included in the partners' Part I tax liability. In the circumstances where the membership of the partnership changes between the time the ITC is claimed and the recapture event occurs, it is possible that partners receiving the benefit of the ITC and the party bearing the cost of the recapture could be different. This latent recapture liability will need to be considered in negotiating the commercial terms for partner withdrawals and partner admissions.

The recapture rules do not apply where the disposition is between *related persons* and the property would be eligible property to the acquirer (without regard to the new property requirement). The scope of this limited exception is unclear:

- The parallel exception in the SRED ITC recapture rules excludes transfers between *non-arm's length persons*, which includes related persons and factually non-arm's length persons. In contrast, the Clean Technology ITC adopts the more restrictive "related persons" concept.
- Subsection 251(2), which defines persons who are considered related for purposes of the Tax Act, does not address partnerships. As a result, how this exception in the Clean Technology ITC would apply to transfers involving a partnership is uncertain.

The recapture rules will be particularly important (and may be problematic as currently drafted) in the context of commercial real estate sales, where rooftop solar generating facilities may be integrated into a building that is sold as an asset transfer to the purchaser. As currently drafted, neither the existing building owner that accesses the ITC to build the solar project, nor the purchaser of the building with the solar project included, would appear to realize the full benefit of the ITC.

Other consequential amendments

The draft legislation also sets out a list of consequential amendments to other provisions of the Tax Act to reflect the introduction of the Clean Technology ITC. These include an amendment to provide for a reduction in the capital cost of eligible property (for capital cost allowance purposes) in respect of the ITC claim and adjustments to a taxpayer's cost in a partnership interest to reflect the allocation and recapture of ITCs from the partnership.

Still outstanding

The announcement and draft legislation do not provide insight into how the Clean Technology ITC will interact with the overlapping Clean Electricity ITC. Further clarity on this interaction is particularly important where a partnership acquires property that is eligible for both the Clean Technology and Clean Electricity ITCs and has both taxable corporations and tax-exempt entities as partners.

Labour Requirements

The 2023 Federal Budget set out the basic parameters of the prevailing wage and apprenticeship conditions comprising the Labour Requirements, as well as the government's intention to apply those requirements to the proposed Clean Technology, Clean Hydrogen, Clean Electricity and CCUS ITCs.

Overview of the requirements

While draft legislation setting out the Labour Requirements largely aligns with what was announced in the 2023 Federal Budget, it clarifies the prior announcements and introduces certain additional requirements:

- Under the prevailing wage component, covered workers must be paid in accordance with an "eligible collective agreement" or in an amount at least equal to the amount of wages and benefits in the "eligible collective agreement" most closely aligned with the covered worker's experience level, tasks and location. In provinces other than Québec, the "eligible collective agreement" is generally a collective agreement for the relevant industry and type of work performed which aligns with the worker's duties and location. In Québec, the eligible collective agreements are those negotiated under relevant provincial law.
- With respect to the apprenticeship component, registered apprentices must work at least 10% of the total labour hours that would be performed by a worker in a Red Seal trade.
- Responsibility for satisfying the Labour Requirement falls on the "incentive claimant", which is defined to be the person claiming the credit or a partnership where at least one partner is claiming the credit.
- The incentive claimant elects into the Labour Requirements, and therefore elects into claiming the higher ITC rate. If this election is not made, the available ITC is reduced by 10 percentage points.

- The Labour Requirements only apply to "covered workers" at a "designated work site" of the incentive claimant.
  - "Covered workers" is defined to mean workers who are engaged in the preparation or installation of property that is eligible for a specified tax credit and whose work is primarily manual or physical in nature. Covered workers include employees of the incentive claimant or those of any other person or partnership (contractors or subcontractors) who are engaged in the preparation or installation of eligible property.
  - A "designated work site" means a work site where eligible property of the incentive claimant is located during the year. This definition does not require that the work site belong to the incentive claimant or be under its control.
- The Labour Requirements must be complied with during each taxation year where preparation or installation work is completed with respect to an eligible property. Since the requirement only refers to preparation and installation, the manufacturing of the eligible property appears to be excluded from the Labour Requirements. However, addition clarity may be required as to the exact meaning of "preparation" in this context to ensure that "designated work site" does not apply to each portion of the supply chain for eligible property.
- Even though, as currently drafted, the Labour Requirements only apply in respect of a "specified tax credit" (which is defined to mean the CCUS tax credit and the Clean Technology ITC), the Explanatory Notes confirm that the intention is still for the Labour Requirements to apply in respect of the Clean Hydrogen and Clean Electricity ITCs. The Labour Requirements do not apply to the 15% CCUS Refurbishment ITC or the Clean Technology ITC claimed for the acquisition of off-road zero-emission vehicles or for the acquisition or installation of low-carbon heat equipment.

Attestation and other compliance obligations

With respect to the prevailing wage requirements, the incentive claimant is required to attest that its own employees who are covered workers for purposes of the Labour Requirements are being compensated in accordance with the requirements. The claimant will also need to attest that it has taken reasonable steps to ensure that any covered workers who are employed by any other persons or partnerships (contractors or subcontractors) are being compensated in accordance with the requirements. Furthermore, the incentive claimant must communicate in a manner readily visible and accessible by covered workers, either at the work site or by electronic means, that the work site is subject to prevailing wage requirements, including a plain language explanation of what that means and information regarding how to report non-compliance.

With respect to the apprenticeship requirements, the draft legislation specifies that where the 10% apprenticeship labour hours requirement cannot be met because of restrictions under applicable labour laws or a collective agreement, the incentive claimant must make reasonable efforts to ensure that the highest possible percentage of the total labour hours performed during the year by Red Seal workers on the preparation and installation of eligible property is performed by apprentices registered in a Red Seal trade while respecting the applicable labour laws or collective agreement. The incentive claimant must then attest that

the apprenticeship requirements have been met in respect of covered workers at a work site.

The draft legislation does not provide any guidance on what would constitute "reasonable steps" or "reasonable efforts", as required in the drafting legislation, to ensure compliance with the Labour Requirements.

Consequences of non-compliance

The draft legislation also sets out the penalties for not complying with the labour requirements where the incentive claimant has elected into those requirements and claimed the regular (higher) credit rate:

- *Per diem penalty for prevailing wages*: If a covered worker was not compensated in accordance with the specified wage requirements for one or more days in a taxation year in respect of which a specified tax credit is being claimed at the regular rate, the incentive claimant is liable to pay an additional tax of $20 per day for each day in that taxation year that the covered worker was not paid the prevailing wage.
- *Top-up for prevailing wages*: An incentive claimant may, within one year after receipt of notification from the Minister (or such longer period as is acceptable to the Minister) of its non-compliance with the prevailing wage requirement, cause each covered worker to be paid a top-up amount to resolve the non-compliance.
  - The top-up amount is generally equal to the difference between the prevailing wages that were required to have been paid and the amount the covered worker was actually paid.
  - The top-up amount will be deemed to be salary and wages to the worker in the year received and will be deductible by the incentive claimant in computing income for the year in which it is paid. However, it will not constitute an expenditure that qualifies for any specified tax credit.
  - If the top-up amount is not paid, the incentive claimant will be liable to pay a penalty equal to 120% of the top-up amount in respect of each worker that was not paid the top-up amount. Paying the top-up does not appear to eliminate the $20 *per diem* penalty.
- *Penalty for apprenticeship*: If the apprenticeship hours requirement is not met at a particular work site during a taxation year in respect of which a specified tax credit is being claimed at the regular rate, the incentive claimant is liable to pay an additional tax equal to $100 multiplied by the difference between the number of hours that were required to have been performed by apprentices and the number of hours of labour that were actually performed by apprentices.
- *Misconduct or gross negligence*: If an incentive claimant's failure to meet any of the labour requirements was done knowingly or in circumstances amounting to gross negligence, the incentive claimant is (a) disentitled to the regular tax credit rate and is entitled only to the

reduced tax credit rate; and (b) liable to pay a penalty equal to 50% of the difference between the amount of the specified tax credit claimed and the amount that the incentive claimant would have been entitled to under the reduced rate. In such cases, the *per diem* prevailing wage and apprenticeship penalties (described above) are not applicable and the claimant is not entitled to make a top-up payment in respect of the prevailing wage requirement. It is not clear whether the claimant would otherwise be subject to the 120% penalty on the top-up amount.

Effective date

Consistent with the 2023 Federal Budget announcement, the Labour Requirements are proposed to be effective in respect of specified property prepared or installed after September 30, 2023.

Notably, the application of the Labour Requirements to a particular property is not based on when the property is acquired (as it the case for determining *when* the associated ITC may be claimed). As the application of the Labour Requirements is based on the date when property is prepared or installed, property that is prepared and installed on or after October 1, 2023, would appear to be subject to the Labour Requirements even if the property was acquired before that effective date.

Carbon Capture, Utilization and Storage Investment Tax Credit

The CCUS ITC was first announced in the 2022 Federal Budget, with draft legislation released in mid-2022. The 2023 Federal Budget proposed additional design changes to the CCUS Credit. The draft legislation released on August 4, 2023 largely reflects the 2023 Federal Budget announcement. The draft legislation for the CCUS ITC will be addressed in a separate Update.

If enacted, the CCUS ITC will be deemed to have come into force on January 1, 2022, and apply to eligible expenses incurred from that day to December 31, 2040.

Flow-through shares and Critical Mineral Exploration Tax Credit for lithium from brines

The draft legislation implements changes announced in the 2023 Federal Budget to allow for certain expenses relating to mining lithium from brines to be treated as Canadian exploration expenses (CEE) and Canadian development expenses (CDE) eligible for flow-through treatment and to expand eligibility for the Critical Mineral Exploration Tax Credit.

The proposed draft legislation makes several amendments to the CEE and CDE regime to implement the announced changes, including:

- The definition of “principal business corporation” in subsection 66(15) is amended to include corporations whose principal business includes the production or marketing of lithium and the manufacturing of products, where the manufacturing involves processing of lithium. Only “principal business corporations” can issue flow-through shares to renounce CEE and CDE to subscribers.

- Paragraphs (c.2) and (d) of the definition of CDE in subsection 66.2(5) are amended to include expenses related to the drilling of a well for the extraction of lithium from brines.
- The definition of “mineral resource” in subsection 248(1) is amended to include lithium as a mineral resource. The “mineral resource” definition is relevant to determining a taxpayer’s eligibility to claim CEE and CDE.
- A new provision is added (subsection 66(21)) to ensure that projects for the exploration and development of lithium from brines are treated similarly to traditional mineral resource mines. Specifically:
  - a well for the extraction of material from lithium brine deposits is deemed to be a mine for the purposes of the definitions of CEE and CDE;
  - all wells of a taxpayer are deemed to be from the same mine, if the materials extracted are sent to the same plant for processing; and
  - wells can be deemed to be one mine if the Minister, in consultation with the Minister of Natural Resources, determines the wells to constitute one project.
- As a consequence of the above changes, an individual (other than a trust) who invests in flow-through shares may also be eligible to claim the Critical Mineral Exploration Tax Credit or the Mineral Exploration Tax Credit under subsection 127(5) in respect of certain CEE related to mining lithium from brines.

The above amendments are deemed to come into force on March 28, 2023, but do not apply in respect of expenses incurred before March 28, 2023.

Temporary Rate Reduction for Zero-emission technology manufacturers

The 2023 Federal Budget announced two changes to the temporary 50% rate reduction for zero-emission technology manufacturers that was first introduced in the 2021 Federal Budget. First, the rate reduction will be expanded, for taxation years beginning after 2023, to include manufacturers of nuclear energy equipment, processing or recycling of nuclear fuels and heavy water, and manufacturing of nuclear fuel rods. Second, the rate reduction, originally planned to be fully phased out in 2032, will now be fully phased out three years later in 2035. The newly released draft legislation implements these two changes.

If you have any questions or require additional analysis on the clean energy Proposals, please contact Edward Rowe, Colena Der or Jake Sadikman.