Harnessing The Power Of Clean Economy Investment Tax Credits

Over the past two and a half years, the Canadian government has proposed six different major investment tax credits (ITCs) that are aimed at incentivizing the decarbonization of the economy in Canada (the Clean Economy ITCs). Four of the Clean Economy ITCs are now enacted.

These ITCs are a powerful incentive for business, as among other things, the Clean Economy ITCs are generally 100 per cent refundable to project proponents. However, the legislation enacting them is complex and the certainty of ITC availability is critical for projects depending on ITCs. There are numerous steps which should be taken in order to optimize the ITC entitlement for a given project when it comes to:

- Determining the eligibility of a project for ITCs;
- Ensuring compliance of the project with labour requirements;
- Where applicable, ensuring that a project plan is filed;
- Reviewing the timing of the receipt of any ITCs; and
- Reviewing potential risk mitigation options available for the project.

The clean economy ITCs

The carbon capture, utilization, and storage ITC (the CCUS Tax Credit) is aimed at encouraging investment in carbon capture,

utilization, and storage (CCUS) infrastructure. Eligible expenditures include those that are solely aimed at CCUS as well as certain dual-use equipment. The specified percentage (i.e., the topline ITC rate) in respect of this ITC depends on the nature of the CCUS equipment, and is generally 50 per cent for carbon capture equipment (60 per cent for direct air capture equipment), and 37.5 per cent for transportation, storage, or use equipment. The CCUS Tax Credit is only available for CCUS projects which put the captured carbon to an "eligible use", which currently only includes dedicated geological storage or the use of captured carbon in producing concrete. The amount of CCUS Tax Credit that can be claimed is dependent on the percentage of carbon captured and put to an eligible use in a given project. An "eligible use" does not include enhanced recovery for oil and gas activities (this is expressly considered an "ineligible use" pursuant to the legislation).

The clean technology ITC (the Clean Tech ITC) is a 30 per cent ITC aimed at certain types of renewable energy generation (excluding large scale nuclear and hydro) and storage. It is available for renewable energy production equipment, low carbon heat and electricity equipment, electricity storage equipment, and industrial zero emission vehicles (ZEVs).

Another ITC which, covers similar equipment to the Clean Tech ITC is the clean electricity ITC (the Clean Electricity ITC). The Clean Electricity ITC has not yet been enacted; however, it will be a 15 per cent ITC, which will generally cover the same renewable energy production equipment and electricity storage equipment as the Clean Tech ITC, as well as large scale nuclear and hydro equipment, interprovincial electricity transmission equipment, and natural gas power generation equipment where abated with carbon capture. It will also apply to the refurbishment of existing equipment.

The clean technology manufacturing ITC (the CTM ITC) is a 30 per cent ITC, available for the capital cost of certain

equipment involved in either clean technology manufacturing (i.e., manufacturing batteries, ZEVs, etc.), or the extraction of certain critical minerals considered essential to the anticipated decarbonization of the economy. The CTM ITC is intended to operate in tandem with the zero-emission technology manufacturing tax deduction and the critical mineral exploration tax credit, the discussion of which is outside the scope of this article.

For certain electric vehicle (EV) supply chain businesses, they may receive a further 10 per cent ITC in the form of the recently announced electric vehicle ITC (the EV ITC). This ITC will be available for the cost of buildings where the project proponent has invested (and claimed the CTM ITC) in three different segments of the EV supply chain, including EV assembly, battery production, and cathode active material production (or has claimed the CTM ITC in two out of 3 of these segments, and holds a "qualifying minority interest" in a corporation that has claimed the CTM ITC in the third segment).

The Clean Hydrogen ITC (the Clean Hydrogen ITC) is an ITC available for certain clean hydrogen and ammonia production expenditures. The specified percentage of the ITC available is dependent on the lifecycle carbon intensity of the project, as calculated in kg CO2 emissions per kg H2 produced. The specified percentages based on carbon intensity are:

Who is eligible to claim ITC?

Generally, ITCs can only be claimed by taxable Canadian corporations. However, taxable Canadian corporations can also claim the ITCs through both partnerships and limited partnerships that hold and develop the project. Where a taxable Canadian corporation claims the ITC through a partnership, there are specific rules which provide that the ITC must be allocated to the partners of the partnership on a reasonable basis. Where claimed through a limited partnership,

these reasonable allocation rules also apply, however the allocation of the ITCs to limited partners is further restricted by the limited partner's "at-risk amount;" generally, their net equity participation in the limited partnership that is economically at risk.

As a practice point, project proponents should consult with their tax advisors in order to ensure that their particular proposed structure will not limit the ITCs that will be available for the project. This is particularly true where the project will receive project financing.

Labour requirements and other considerations

For all of the ITCs outside of the CTM ITC (and presumably the EV ITC), in order to qualify for the full ITC, the project proponent must meet certain labour requirements, including that they pay certain workers involved in building the project (Covered Workers) a "prevailing wage", and ensuring that at least 10 per cent of the tradespeople on the project site are registered apprentices.

Project proponents must attest that they have met both the prevailing wage and apprenticeship requirements for their projects. Among other requirements, this will involve attesting that they have made reasonable efforts to ensure that the requisite number of apprentices are employed on the project site, that they will pay a prevailing wage to their own employees and that they have taken reasonable steps to ensure that any workers employed by subcontractors are paid the prevailing wage.

Project proponents should carefully review these requirements, as not meeting them results in a 10 per cent reduction to the specified percentage of the ITC in question, in addition to potential penalties.

It is also noteworthy that labour costs incurred to install eligible equipment are included for the purposes of

determining the capital cost subject to the ITC. Consideration may need to be given in your project contracts with respect to the allocation of labour costs to the eligible equipment vs. ineligible equipment.

Filing of a project plan

The legislation for the CCUS Tax Credit and the Clean Hydrogen ITC require the project proponent file a project plan with Natural Resources Canada (NRCan), which NRCan will then review in order to verify that the project will meet the requirements of the relevant ITC, and additionally will review the expenditure characterization provided by the taxpayer in order to determine and verify what expenditures will qualify for the relevant ITC. Similar rules apply for the Clean Electricity ITC, in respect of natural gas power generation equipment where abated by carbon capture. NRCan will also provide a non-binding opinion as to whether certain equipment will qualify for the Clean Tech ITC or the Clean Electricity ITC. While non-binding, this opinion should significantly reduce the risks associated with future ITC disputes or eligibility.

For the Clean Tech ITC, the CTM ITC, and the Clean Electricity ITC the taxpayer must file a prescribed form with prescribed information with the return of income for the year in which the project becomes operational (as discussed below).

Further compliance requirements exist for many of these ITCs.

Timing for Receipt of ITC

For the ITCs outside of the CCUS Tax Credit, the ITC will be paid by the government following filing of the tax return of the taxpayer for the year in which the equipment becomes "available for use". Generally, this would be in Q3 of the year following when the project becomes operational. For the CCUS Tax Credit, the ITC is payable annually, based on the capital spend on qualified CCUS expenditures in the previous taxation year.

Risk mitigation strategies

Tax insurance is becoming available for many of the potential issues discussed above, in addition to many others that arise due to the complex legislation involved in these incentives. ITC specific insurance products are also entering the market to help insure receipt of ITCs, and we suspect insurance may play an important role for may ITC eligible projects, in particular where there is project financing. Further, the taxpayer may wish to request a binding ruling from the Canada Revenue Agency confirming their ITC entitlement

The Clean Economy ITCs are designed to reduce the carbon footprint of many industrial and power generation projects and have the potential to transform the Canadian economy over their lifetime. More specifically, ITCs are designed to assist emerging, or less economical technologies to compete with traditionally more carbon intensive projects. Due to their complexity, project proponents should discuss any potential projects with their commercial project and tax advisors early in the project development cycle to ensure that they properly understand the interaction of the rules for these ITCs with their particular circumstances.

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