


Is a Green New (Tax) Deal Coming To Canada?

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In this article, the authors compare tax incentives for green energy in Canada and the United States.

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As the world continues to battle the immediate challenges of the COVID-19 pandemic, on September 23, 2020, the Canadian government made commitments to “build back better to create a stronger, more resilient Canada” and address climate change. The particulars of how the government intends to usher in that green recovery are unknown. However, one thing is certain: Fiscal policy will be a key driver.

North America is at the cusp of a “Green New Deal.” This article reviews Canadian tax incentives for green energy and juxtaposes them with those offered by the United States.

Background

By signing the 2015 Paris Climate Agreement, Canada became part of a growing group of nations committed to net-zero carbon emissions by 2050: The European Green Deal (COM(2019) 640 final), presented December 11, 2019, is intended to “make Europe the first climate-neutral continent by 2050,” and U.S. President-elect Joe Biden has released a sustainable infrastructure and clean energy plan that reflects campaign proposals to achieve net-zero emissions by that time. The net-zero goal was precipitated by a 2018 U.N. report warning that CO₂ emissions had to be reduced to zero by 2050 to avoid irremediable consequences to the environment.

With massive amounts of public funds being invested in battling the ongoing pandemic and its economic consequences, there has been increasing focus on and demands for building back better for a sustainable, resilient recovery. The OECD has said:

Many governments have included “green” recovery measures in their crisis recovery packages [preliminary OECD estimates suggest those amounts to be about \$312 billion] — for example through grants, loans and tax reliefs directed towards green transport, circular economy and clean energy research, development and deployment.¹

¹ OECD, “Focus on Green Recovery.”

According to the OECD, measures also include new funding and programs to create jobs and stimulate economic activity through ecosystem restoration, control of invasive alien species, and forest conservation.

While there are myriad ways to address climate change, renewable energy generation, including wind, solar, hydro, tidal, geothermal, and biomass energy generation systems,² is central to efforts to shift to a net-zero economy. In the September 23 speech, the Canadian government promised to “support investments in renewable energy and next-generation clean energy and technology solutions.” This article focuses on tax incentives to develop, build, and operate that kind of equipment.³

Canadian Tax Incentives for Green Energy

The Income Tax Act (Canada) includes four tax incentives to promote investment in green energy generation projects:

- an accelerated capital cost allowance (CCA) rate for specified clean energy generation and energy efficiency equipment;
- an immediate deduction for some expenses incurred in the development of clean or green energy generation projects;
- a flowthrough share mechanism by which principal business corporations may renounce some expenditures to their shareholders, allowing those shareholders to shelter other sources of income and thereby encouraging them to invest; and
- the 10 percent Atlantic investment tax credit, which applies to the capital cost of specific prescribed energy generation and conservation properties.⁴

Accelerated CCA

CCA is the means by which depreciation expense may be claimed in calculating income under the ITA. CCA rates are generally based on

²For a list of renewable energy sources, see EDF Group, “Types of Renewable Energy.”

³Tax incentives of broader application that may be relevant to renewable energy generation are beyond the scope of this article.

⁴See generally Canada Revenue Agency, “Tax Incentives for Clean Energy Equipment,” Income Tax Folio S3-F8-C2 (last modified Aug. 2, 2019).

the useful life of an asset and can be taken on a declining basis.⁵

Since 1996, Canada’s tax regime has encouraged businesses to invest in specified clean energy generation and energy efficiency equipment by providing accelerated CCA. The relevant rules have been updated several times in recent years, including in the 2018 Federal Budget.

Classes 43.1 and 43.2 of Schedule II of the ITA regulations list the properties eligible for accelerated depreciation and include various stationary equipment that generates or conserves energy by:

- using a renewable energy source (for example, wind, solar, or small-scale hydro);
- using fuel from waste (for example, landfill gas, wood waste, or manure); or
- making efficient use of fossil fuels (for example, high-efficiency cogeneration systems).

The original class 43.1 provided an accelerated CCA rate of 30 percent a year on a declining balance basis for that kind of equipment. As a further incentive, class 43.2 provided an accelerated CCA rate of 50 percent a year on a declining balance basis for those same types of equipment acquired after February 22, 2005, and before 2025.⁶

Importantly, availability of the accelerated CCA for class 43.1 and 43.2 properties is limited by the specified energy property rules in reg. 1100(24)ff. In a nutshell, those rules limit the CCA deduction to the income from the specified energy property or from a business of selling the product of that property. Hence, the deduction cannot be used to shelter other unrelated income.

Canadian Renewable and Conservation Expenses

Because the upfront costs incurred to develop green energy projects can be substantial, the 1996 budget enacted an immediate tax deduction for so-called Canadian renewable and conservation expenses (CRCE) as an extension of the Canadian

⁵For instance, most buildings can be depreciated at a rate of 4 percent annually.

⁶For more information on classes 43.1 and 43.2, see CanmetENERGY, “Technical Guide to Class 43.1 and 43.2” (2013).

exploration expense system for oil and gas projects.

Before the enactment of CRCE, development expenses could have been added to the capital cost of property for CCA purposes or covered by the now-repealed eligible capital property tax depreciation regime for unlimited-life intangibles. Thus, there was a relative disincentive to undertaking speculative work in the renewable energy sector. Now most renewable-energy-related development work is included in the definition of CRCE and is fully deductible when incurred and can be carried forward indefinitely or renounced under a flowthrough share agreement. There is a corresponding carveout from the CCA regime for property, whose cost is included in CRCE.⁷

Broadly, CRCE covers specific expenses incurred by a principal business corporation payable to an arm's-length party in connection with the development of an energy project for which it is reasonable to expect that at least 50 percent of the capital cost of the depreciable property will constitute class 43.1 or 43.2 property.

For clean energy generation and energy conservation industries, a principal business corporation can be understood as including a corporation whose principal business is any of, or a combination of, the generation or distribution of energy or the production of fuel using property described in class 43.1 or 43.2, and the development of projects for which it is reasonable to expect that at least 50 percent of the capital cost of the depreciable property to be used in each project would qualify for inclusion in class 43.1 or 43.2. A principal business corporation also includes a corporation all or substantially all of whose assets are shares or debt of another principal business corporation that is related to the corporation.

CRCE is defined in ITA section 66.1(6) by reference to reg. 1219. Qualifying expenses include:

- the cost of some prefeasibility and feasibility studies;
- environmental assessment expenditures;
- the cost of socioeconomic studies;

- expenditures for negotiating power purchase agreements;
- site approval and preparation costs;
- start-up and commissioning costs; and
- the cost of building service connections for the transmission of electricity or power.

Expenses that do not qualify include project management fees, legal fees, insurance costs, interest and financing fees, and other expenses incurred in the management or administration of the business. Those nonqualifying expenses may be deducted under other ITA provisions or added to the adjusted cost base of the equipment or property.

Flowthrough Shares

To further assist principal business corporations in financing their development activities in clean energy generation and energy conservation, ITA section 66(15) contains rules whereby, in some circumstances, those kinds of corporations may renounce CRCE to its shareholder investors that subscribe for flowthrough shares. That is particularly advantageous when a corporation is not currently taxable and thus cannot use CRCE. In turn, shareholders can use renounced CRCE to offset other sources of income.

To take advantage of that mechanism, the corporation must enter into a flowthrough share subscription agreement whereby the investor agrees to purchase the flowthrough shares and the corporation agrees to incur an amount equal to the subscription price on CRCE within a specific period not exceeding 24 months after the subscription is made and renounce that amount of CRCE to the shareholders. The renounced amount cannot exceed the initial subscription price.

If, however, the risk of loss to the investor is limited, or if it is reasonable to consider that there is an obligation to repay or return all or part of the original investment, the shares or rights will constitute prescribed shares or rights and will be ineligible for flowthrough treatment.

The flowthrough shares rules also contain a lookback provision whereby CRCE incurred in the year after the flowthrough share subscription agreement is entered into may be renounced to

⁷ Reg. 1102(1)(a.1).

the shareholders effective in the first year, so that the shareholders can deduct in the first year all the CRCE incurred in both the first and second years.

Atlantic ITC

The Atlantic ITC of 10 percent applies to the capital cost of qualified property acquired primarily for use in the Atlantic region of Canada.⁸ For the credit, qualified property means a category of new assets acquired primarily for use in the Atlantic region that are mainly used for farming or fishing, logging, manufacturing and processing, storing grain, or harvesting peat. Importantly, the refundable credit applies to all new energy generation and conservation property described in classes 43.1 and 43.2 acquired by a taxpayer in the Atlantic region after March 28, 2012.⁹

Structuring Considerations

When structuring renewable energy generation projects in Canada, typical vehicles are either limited partnerships or corporations.¹⁰ The traditional vehicle of choice has been a limited partnership in which the promoter is or sets up the general partner and is the initial limited partner while investors subscribe for further limited partnership units.

The promoter arranges for the design, financing, construction, and installation of the renewable energy equipment by the limited partnership. The various expenses incurred should either give rise to class 43.1 or 43.2 property eligible for the accelerated CCA or be immediately deductible as CRCE. Significantly, for a partnership, if any partner is not a principal business corporation, then none of the partners will have access to losses that could have been generated by accelerated depreciation.¹¹

Otherwise, limited partners may deduct losses up to their at-risk amount.¹²

Alternatively, a renewable energy project may be carried on by a corporation. As noted, if the corporation qualifies as a principal business corporation, it may issue flowthrough shares that allow CRCE to be renounced to the shareholders and be available to offset their income from other sources.

U.S. Tax Incentives for Green Energy

U.S. renewable energy projects, such as wind and solar projects, have historically been structured to qualify for one of two primary types of tax subsidies: the production tax credit (PTC) or the ITC.

PTCs for Wind Facilities

IRC section 45 allows a PTC for each tax year during the 10-year period beginning on the date a qualified facility is originally placed in service¹³ equal to 1.5 cents¹⁴ times the kilowatt hours of electricity a taxpayer produces from qualified energy resources at the facility and sold to an unrelated person. The term “qualified energy resources” includes wind energy. For the production of wind energy, the IRC defines a qualified facility as any facility owned by the taxpayer that is originally placed in service after December 31, 1993, and whose construction began before January 1, 2021.

Historically, developers have had to face uncertainty resulting from short-term extensions of the PTC along with hopes for legislative relief before its expiration. Most recently, the PTC was scheduled to be phased out completely by the end of 2019 but was extended through the end of 2020 as part of a year-end tax package allowing wind developers an additional year to commence construction on wind projects. As part of the one-year extension, the amount of PTCs available for

⁸ Defined as the Gaspé Peninsula of Québec and the provinces of Newfoundland and Labrador, Prince Edward Island, Nova Scotia, and New Brunswick, as well as their respective offshore regions. There are historical reasons for the incentive's targeted nature.

⁹ See reg. 4600.

¹⁰ See, e.g., Jack Bernstein and Barbara Worndl, “Structuring Solar Projects,” CCH Tax Topics No. 2061 (Sept. 8, 2011).

¹¹ Reg. 1100(26)(b).

¹² Para. 96(2.1)ff. The at-risk amount is generally invested capital plus income allocated less income and capital distributions and any guaranteed amounts.

¹³ The amount of credits available to a taxpayer in a given year can be limited under other IRC sections. In some circumstances, disallowed credits may be carried back one year and carried forward for up to 20 years.

¹⁴ Adjusted for inflation.

wind facilities, as determined under IRC section 45(a), phase out as follows:

- a 20 percent reduction for any facility whose construction began after December 31, 2016, and before January 1, 2018;
- a 40 percent reduction for any facility whose construction began after December 31, 2017, and before January 1, 2019;
- a 60 percent reduction for any facility whose construction began after December 31, 2018, and before January 1, 2020; and
- a 40 percent reduction for any facility whose construction began after December 31, 2019, and before January 1, 2021.

Developers have also been able to qualify repowered wind projects containing used property as originally placed in service for PTC qualification. That can allow for a new 10-year PTC period for those repowered projects at reduced capital costs, as long as the fair market value of the used property for each wind turbine is not more than 20 percent of the repowered turbine's total value.¹⁵

The IRS has issued various notices providing guidance for determining when the construction of a wind facility has begun.¹⁶ Notice 2013-29 provides two methods a taxpayer may use to establish that construction of a wind facility has begun: starting "physical work of a significant nature," or satisfying a 5 percent safe harbor test.¹⁷ Under the physical work test, construction of a wind facility will be considered as having begun if physical work of a significant nature has commenced and the taxpayer maintains a continuous program of construction. Under the safe harbor, construction of a wind facility will be considered as having begun if a taxpayer pays or incurs at least 5 percent of the total cost of the facility and thereafter makes continuous efforts to advance toward the facility's completion. The taxpayer will be deemed to have made continuous efforts toward completion if the

¹⁵ Notice 2016-31, 2016-23 IRB 1025, section 6.01; and Notice 2017-4, 2017-3 IRB 1, section 5. See also Notice 2018-59, 2018-28 IRB 196, section 7.05.

¹⁶ Notice 2013-29, 2013-20 IRB 1085; Notice 2013-60, 2013-44 IRB 431; Notice 2014-46, 2014-35 IRB 520; Notice 2015-25, 2015-13 IRB 814; Notice 2016-31; and Notice 2017-4.

¹⁷ Notice 2013-29, clarified by Notice 2013-60.

facility is placed in service no later than four calendar years after the calendar year when construction began.¹⁸

Based on the PTC landscape, although wind developers may be getting projects ready to be placed in service in accordance with the above rules, in the absence of new legislation, projects for which construction has not yet commenced will be ineligible for the full PTC.

ITCs for Solar Facilities

IRC section 46 allows taxpayers to claim an energy ITC under section 48(a). A taxpayer is allowed that credit for the portion of expenditures made in placing energy property in service. The credit equals the energy percentage (generally 30 percent for solar energy property) multiplied by the eligible tax basis of energy property placed in service during the year.

For property to qualify as energy property, tests must be satisfied. First, the property must be of a type eligible for the credit, including solar energy property, solar illumination property, and qualified investment credit facilities. Second, the taxpayer must complete the construction, reconstruction, or erection of the property, or if the taxpayer acquires the property, the property's original use must commence with the taxpayer. Third, the property must be of a type for which depreciation or amortization is allowable. It must also not be property that is part of a facility whose production is allowed a PTC.¹⁹ Despite that requirement, qualified wind facilities generally have been able to claim the ITC in lieu of the PTC. Solar projects, however, are ineligible for the PTC, so solar developers typically rely on the ITC to fund facility development.

As noted, equipment that uses solar energy to generate electricity, heat or cool a structure, or provide solar process heat other than for heating swimming pools generally is eligible for the 30 percent ITC if its construction began before January 1, 2020.²⁰

As with developers of wind projects seeking to qualify for the PTC, solar developers are subject

¹⁸ Notice 2016-31.

¹⁹ IRC section 48(a)(3)(B).

²⁰ IRC section 48(a)(2)(A)(i)(II).

to a phaseout of the ITC. Specifically, the amount of ITCs available for solar property as determined under IRC section 48(a) phases out as follows:

- for any property whose construction began after December 31, 2019, and before January 1, 2021, the energy percentage is reduced to 26 percent;
- for any property whose construction began after December 31, 2020, and before January 1, 2022, the energy percentage is reduced to 22 percent; and
- after 2021, the energy percentage is reduced to 10 percent.

Similar wind project rules for determining whether construction has begun and whether the project is eligible for the applicable tax credit apply for determining whether construction has begun on a solar project and whether it is eligible for the ITC. Based on the above, in the absence of extensions of the ITC program, new projects for which construction has not yet begun will be ineligible for the full 30 percent ITC and instead be eligible only for a reduced credit.

Structuring Considerations

Renewable energy projects in the United States often face difficulties in obtaining affordable financing. As a result, developers historically have sought to obtain equity financing from investors whose equity participation relied on the availability of such tax subsidies as PTCs and ITCs.

Traditionally, the participation of so-called tax equity investors has been achieved through limited liability companies that are treated as partnerships for U.S. income tax purposes. For wind power projects, the developer and the tax equity investor have used a flip partnership structure that in effect permits substantially all the PTCs (as well as depreciation deductions) from a project to be allocated to the investor until the investor has achieved some agreed-on after-tax internal rate of return on its investment. Although similar flip partnership structures can also be used for solar projects, solar developers have used other structures to permit tax equity investors to benefit from ITCs and depreciation deductions, while cash distributions from operating income and control of the project stays with the project

developer (for example, sale-leaseback structures and inverted lease structures).

One limiting factor in the use of LLCs is that the potential income tax benefits are valuable only to potential tax equity investors with substantial taxable income (and tax liability) from other sources. Investors that do not have a substantial tax appetite (such as non-U.S. persons without a large U.S. tax liability) are not viable sources of tax equity investment. Moreover, some categories of potential investors, such as individuals or closely held corporations, generally cannot currently use tax credits or losses unless they satisfy tax rules regarding passive investments.

Is the Green New Tax Deal Coming?

As Canada attempts to achieve a goal of net-zero carbon emissions by 2050 — the most ambitious climate target ever set by a Canadian government — and with 2030 emissions goals looming, it is unclear how it will deliver on those promises and what the transition will look like.²¹ This section examines considerations that are expected to shape Canadian income tax policy for the climate target.

Playing Catch-Up With Oil and Gas Incentives

So far, the increase in federal income tax incentives for green energy in the 1990s that were most recently upgraded by the 2018 Canadian Federal Budget have not dwarfed existing Canadian oil and gas incentives, which include various deductions similar to the CRCE that allow immediate full or partial deduction of exploration and development expenses that might otherwise be tax depreciable over time:

- Canadian exploration expenses allow the immediate deduction of up to 100 percent of some expenses incurred during the exploration stage of oil and gas activities and can be carried forward indefinitely.
- Canadian development expenses typically group expenses that do not qualify as

²¹ On November 19, 2020, Parliament tabled Bill C-12, the Canadian Net-Zero Emissions Accountability Act. Enactment requires that national targets for the reduction of greenhouse gas emissions in Canada be set, with the objective of attaining net-zero emissions by 2050. The targets are to be set by the Minister of the Environment for 2030, 2035, 2040, and 2045.

exploration expenses. A taxpayer can deduct up to 30 percent of the balance of cumulative expenses in a tax year, and any unused balance can be carried forward indefinitely and claimed in future years.

- Canadian oil and gas property expenses include the acquisition cost of oil and gas resource properties. A taxpayer may deduct up to 10 percent of the balance of cumulative expenses, and any unused balance can be carried forward indefinitely and claimed in future years.
- Foreign resource expenses are for drilling, exploration, prospecting, surveying, and acquisition costs for a foreign resource property. Cumulative expenses are pooled on a per-country basis, and a taxpayer can deduct up to 30 percent of the cumulative expenses for a particular country in a tax year. Any unused balance can be carried forward indefinitely and claimed in future years.

Other oil and gas incentives include favorable successor corporation rules in ITA section 66.7, which, departing from the ITA's general rules, allow a taxpayer's unclaimed exploration and development expense balances to be inherited by a successor corporation in specified circumstances; a flowthrough share mechanism for qualifying exploration and development expenses, similar to the mechanism for CRCE; and CCA rates of 25 percent for most oil and gas equipment, 30 percent for manufacturing and processing property, and 4 to 20 percent for different types of pipelines.

If the government's goals are to be realized, the tax incentives for renewable energy will have to catch up to and surpass those for the oil and gas sector. As a manifestation of that transition, oil and gas project eligibility for the Atlantic ITC has been phased out.

And the U.S. Green New Deal?

Canada's tax policies for renewable energy incentives will likely be informed, and presumably spurred, by U.S. developments expected to unfold under the incoming Biden administration.

Despite the phasing out of the PTC and ITC for wind and solar facilities, the political

uncertainty regarding the future of renewable energy credits, and the limits on the types of investors that can benefit from investments in traditional renewable energy LLC structures, the United States, much like Canada, is expected to take major steps to address the existential threat of climate change.

It is hoped that as president, Biden will be able to reshape the U.S. energy sector to move away from fossil fuels and toward green energy policies. His campaign set goals and priorities, including generating clean, U.S.-made electricity to achieve a carbon-pollution-free power sector by 2035; putting the United States on a path to achieve net-zero emissions by 2050; pushing for a \$2 trillion accelerated investment to be deployed over his first term in areas such as infrastructure, energy-efficient affordable housing, innovation, and sustainable agriculture; and immediately rejoining the Paris Agreement.

As with other energy sources, such as fossil fuels, tax policy can benefit the U.S. economy, create jobs, and be an important driver of private investment. Tax policy has played, and will continue to play, an important role as Biden tries to shift the United States away from fossil fuels and toward renewable energy sources. For example, PTCs and ITCs have helped wind and solar developers access capital from tax equity investors that has proven important for financing the development of new renewable energy projects.

Some aspects of Biden's plan can move forward via executive order. Those include rejoining the Paris Agreement, as well as rolling back some of Trump's executive orders on energy and climate and replacing them with orders to reduce greenhouse gas emissions. Recent administrations have increasingly and more aggressively used executive orders, so it would be unsurprising to see Biden further push the boundaries, especially if he is unable to pass climate-related reform through more traditional legislative means.

Other aspects of Biden's plan — particularly some of the more ambitious components — will require legislative action and the enactment of green energy tax policies. When Biden is inaugurated on January 20, 2021, he will face

strong headwinds that will make some of his grander climate policies challenging to achieve.

First and foremost, when Biden enters office, the United States and the rest of the world will still be in the midst of the COVID-19 pandemic. Addressing that will be a top priority as Biden seeks to mitigate the health and economic harms experienced by many Americans. However, presidents are expected to be able to manage multiple crises at once, and although pandemic response may be Biden's top priority, he is still expected to move forward with legislative goals and executive orders to start addressing some of his climate initiatives.

Second, during the 2020 election, the Democratic party lost some House seats, and as of the time of publication, it is unclear whether the Democrats or Republicans will control the Senate. Biden's ability to proceed with his climate-related agenda will partly turn on the outcome of Georgia's special Senate election on January 5. If both Democratic candidates win, Democrats will control both chambers of Congress. Otherwise, Biden will need the cooperation of a Republican Senate to enact any legislation.

Although Biden will certainly face challenges on that front, some aspects of renewable energy tax policy might receive bipartisan support. Renewable federal tax credits such as PTCs and ITCs have been a major component of the financial viability of wind and solar projects to date. Moreover, the resulting economic activity attributable to those projects can benefit the states where they are developed, regardless of whether those states are viewed as "blue" or "red." In fact, the PTC was originally authored in 1992 by Sen. Chuck Grassley, R-Iowa, and former Rep. Phil Sharp as part of bipartisan energy legislation.

There is optimism in both the wind and solar industries that a Biden stimulus bill could include tax provisions to extend existing and expired renewable energy tax incentives and that those extenders would generate enough bipartisan support to pass through Congress.

Conclusion

The teaser provided by the September 23 speech provides some limited indication of what

Canada's green recovery might look like.²² The details, however, will be revealed in an upcoming federal budget, which is not expected before 2021. Until then, all we can do is speculate. Accordingly, we offer our thoughts on how tax incentives for renewable energy can be upgraded in pursuance of Canada's ambitious climate objectives.

First, the class 43.1 and 43.2 CCA deductions are useful only to renewable energy businesses that are already profitable. Moreover, their availability is limited to the income from renewable energy properties or from a business of selling the product of those properties. That incentive could be expanded by making it generally deductible against other sources of income, including through a partnership, which would be consistent with the U.S. tax policy of allowing flip partnership structures. Promisingly, on December 16, 2020, Natural Resources Canada published its "Hydrogen Strategy for Canada," which includes discussion of de-risking and attracting investments to cleantech by providing 100 percent accelerated CCA.

Second, the CRCE deduction, which is effectively an extension of the exploration expense system for oil and gas, should be expanded in line with deductions available to the oil and gas sector. That should also increase the potential for flowthrough share financing deals of renewable energy companies.

Third, the 10 percent Atlantic ITC for renewable energy could be extended to the rest of the country or, better, be transferred into a new category of ITC for renewable energy. ITCs — especially the 35 percent refundable credits available to Canadian-controlled private corporations — are a key incentive for scientific research and experimental development. Considering the importance of renewable energy investments, it is arguably desirable that a generous ITC for renewable energy equipment be available throughout Canada.

Time will tell how ambitious and extensive the measures expected from the Canadian Department of Finance will be. ■

²² So far, the Canadian government has indicated that it plans to halve the corporate tax rate for clean technology companies.