CANADIAN RENEWABLE & CONSERVATION EXPENSE ("CRCE") "GREEN" ENERGY TAX INCENTIVES

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This article is an overview of the Canadian income tax considerations relevant to Canadian renewable and conservation expense ("CRCE") which were introduced in the March 6, 1996 Federal Budget as a new category of deductible expenses.

CRCE was invoked to place the renewable energy sector on equal footing with the non-renewable resource sector namely, oil and gas and mining, by treating CRCE as a deductible pool of expenses with tax treatment similar to that of Canadian exploration expense ("CEE") under Section 66 of the *Income Tax Act* (Canada) (the "Act"). As the upfront soft costs incurred in developing and exploring for oil and gas and minerals can be very expensive, the Act contains provisions that in many cases permit immediate deductions for such expenditures called CEE. Similar issues exist for developers/operators of environmentally friendly or otherwise known as "green" energy projects.

Before the creation of CRCE, development expenses could have been characterized as eligible capital expenditures or added to the cost of the equipment or property. In either case, there was a significant disincentive to undertaking speculative work in the “green” energy or renewable energy sector. Now certain renewable energy-related development work, subject to certain specific exceptions as described in the regulations to the Act, is included in the definition of CRCE and is fully deductible when incurred and can be carried forward indefinitely.

CRCE represents the intangible expenses incurred by a "principal-business corporation" and payable to an arm's length party in connection with the development of an energy project wherein at least 50% of the capital cost of the depreciable property in the renewal energy project will be property described in Class 43.1 (a “Class 43.1 Asset”) or Class 43.2 (a “Class 43.2 Asset”), under the Canadian system for capital cost allowance ("CCA").

Class 43.1 Assets

Separate CCA classes are prescribed in the regulations to the Act for various types of tangible fixed assets used in a business and the cost of the assets in each class can be depreciated at prescribed rates. The Class 43.1 Technical Guide prepared by Canada Revenue Agency ("CRA") provides an extensive list of the expenses that qualify for CRCE. Class 43.1 Assets include new assets used in systems to conserve energy or that use renewable forms of energy such as water, heat, wind, certain waste fuels or heat exchange/recovery systems that recirculate heat from thermal waste. Simply put, some of the types of systems that qualify under Class 43.1 are cogeneration systems that generate electricity and reusable heat that do not exceed an efficiency rating of 6,000 BTU per kilowatt-hour; electrical generating equipment, heat production and recovery equipment, fossil fuel equipment, feed water and condensate equipment; energy systems that produce power from sunlight; wind energy systems (i.e., wind-driven turbines, electrical generating equipment, supports, battery storage equipment and

transmission equipment); heat recovery systems that reuse heat from thermal waste, heat exchangers, compressors and boilers; and small hydro electric projects that have an annual rate capacity not to exceed 50 megawatts. These types of Class 43.1 Assets qualify for a 30% CCA deduction on a declining basis subject to the half-year rule.

Class 43.2 Assets

Class 43.2 Assets are certain assets that are also included as Class 43.1 Assets but are new and acquired after February 22, 2005 and before 2012. Class 43.2 Assets are certain highly fossil-fuel efficient and renewable energy generation equipment. If the asset qualifies as a Class 43.2 Asset, the CCA deduction is increased to 50%.

Qualifying expenses under CRCE include:

1. The cost of temporary roads to the site;

2. Pre-feasibility studies;

3. Negotiation costs that are not property or finance related;

4. Site approval costs;

5. Evaluations and feasibility studies;

6. Environmental or other site specific feasibility studies;

7. Site preparation costs;

8. Start-up and/or commissioning;

9. Training of operators and maintenance personnel;

10. The cost of building service connections for the transmission of electricity or power; and

11. The cost of acquiring and installing test wind-driven turbines (provided however that a favourable opinion regarding the testing of a specific wind turbine is obtained from Natural Resources Canada).

Non-qualifying CRCE expenses include certain soft costs such as:

1. Project management fees;

2. Legal fees;

3. Insurance;

4. Interest and financing fees; and

5. Accounts payable to non-residents and partnerships that are not Canadian partnerships.

The non-qualifying expenses may be deducted under other provisions of the Act or allocated to the actual cost base of the equipment or property.

"Flow-Through" Share Financings

A new opportunity for equity financing has blossomed as a result of the ability of a "principal-business corporation" to renounce CRCE to its shareholders. A “principal-business corporation” includes, but is not limited to, a corporation of which the principal business is any of, or a combination of, the production, refining or marketing of petroleum, petroleum products or natural gas; exploring or drilling for petroleum or natural gases; mining or exploring for minerals; the generation of energy using Class 43.1 Assets and the development of projects for which it is reasonable to expect that at least 50% of the capital cost of the depreciable property to be used in each project would be the capital cost of Class 43.1 Assets. This source of capital may be an integral part of a principal-business corporation's financing requirements. The introduction of the "flow-through" share rules to the renewable energy sector has provided access to financing for small to medium size energy companies that are customarily not in a position to use the expenses incurred in the development of renewal energy projects. "Flow-through" shares are true equity shares and are generally garden-variety common shares. A "flow-through" share subscription agreement is the mechanism entered into under which the subscribers agree to purchase the "flow-through" shares and the issuer agrees to incur an amount equal to the subscription price on CRCE and to renounce that amount of CRCE to the shareholders. 100% of CRCE renounced to a shareholder can be deductible by the shareholder from ordinary income in calculating the shareholder’s liability for income tax.

The "flow-through" share provisions contain a "look-back" rule that provides an additional tax advantage. Under the "look-back" rule, CRCE incurred in the year after the "flow-through" share subscription agreement is concluded may be renounced to the shareholders effective in the first year so that all the CRCE incurred in both first and second years can be deducted in the first year. Another significant benefit of "flow-through" shares is that CRCE may be renounced to a shareholder by a "principal-business corporation" that may not currently need the tax deductions. The amount of CRCE renounced to the shareholder cannot exceed the initial subscription price for the "flow-through" shares. The CRCE must be renounced to the shareholder during a period that begins on the day the agreement is made and ends 24 months after the end of the month in which the subscription agreement is made. The issuer must file a Form T100 with CRA along with a copy of the "flow-through" share subscription agreement or an offering document within the time prescribed by Subsection 66(12.68) of the Act. The Form T100 provides information as to the number of shares issued and an estimate of the type and amount of expenses to be incurred by the "principal-business corporation". Subsequent reporting on a Form T101 is required at the end of each month in which a renunciation of CRCE is made to an investor.

Conclusion

In summary, the three main federal income tax incentives offered to "green” energy projects are as follows:

1. The immediate deduction available for certain expenses incurred in the development of CRCE-related projects;

2. The accelerated CCA permitted for Class 43.1 Assets and Class 43.2 Assets used in CRCE projects; and

3. A "flow-through" share mechanism which allows "principal-business corporations" to adequately finance their operations and also to allocate certain expenditures to their shareholders for the purposes of assisting shareholders in sheltering their personal income.

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