



**CANADIAN RENEWABLE & CONSERVATION EXPENSE ("CRCE")
"CLEAN" ENERGY TAX INCENTIVES
MARCH 31, 2016**

This updated article is an overview of the Canadian income tax considerations relevant to Canadian renewable and conservation expenses ("CRCE") which were originally introduced in the March 6, 1996 Federal Budget as a new category of deductible expenses under Schedule II to the Income Tax Regulations and updated by the March 29, 2012 Federal Budget ("Budget 2012"), the February 11, 2014 Federal Budget ("Budget 2014") and as most recently updated by the March 22, 2016 Federal Budget ("Budget 2016").

CRCE was invoked to place the "renewable energy sector" on an equal footing and a level playing field with the non-renewable resource sector namely, the oil, 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" or renewable or next generation energy generation projects (such as wind, solar, run-of-river, high efficiency, cogeneration systems, environmentally friendly biofuels from landfill gas, wood waste or manures, etc.).

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 taxation system for capital cost allowance ("CCA") under Schedule II to the Income Tax Regulations (the "Regulations").

In step with the Federal Sustainable Development Strategy objectives, Budget 2016 proposes to expand the types of equipment eligible for certain accelerated CCA rates to include certain electric vehicle charging stations and certain electrical energy storage properties. Electric vehicle charging stations have to date been generally depreciated at a rate of 20%, in Class 8 of the CCA regime. Budget 2016 expands Class 43.1 and Class 43.2 to include electric vehicle charging stations that meet certain power thresholds. Charging stations set-up to supply at least 90 kilowatts of continuous power shall be eligible for inclusion in Class 43.2, and charging stations set-up to supply more than 10 kilowatts, but less than 90 kilowatts of continuous power, shall be eligible for inclusion in Class 43.1. This measure will apply in respect to property acquired for use on or after March 22, 2016 that has not been used or acquired for use before March 22, 2016.

Budget 2016 proposes two changes to electrical energy storage equipment and property eligible for accelerated CCA including, but not limited to, equipment such as batteries, flywheels and compressed air energy storage. However, eligible electrical energy storage properties will not include pumped hydroelectric storage, hydroelectric dams and reservoirs or a fuel cell system where hydrogen is produced via steam reformation of methane. Accelerated CCA will only be available in respective eligible stand-alone property if, at any time the property first becomes available for use, the requirements for all Canadian environmental laws, by-laws and regulations applicable in respect of the property have been met. Once again, these measures will apply in respect of property acquired for use on or after March 22, 2016, and has not been used or acquired for use before March 22, 2016.

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. 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% on a declining basis. Providing accelerated CCA in this context is an exception to the general practice of setting CCA rates based on the useful length of assets. Accelerated CCA provides a financial benefit by deferring taxation. This incentive for investment is premised on the environmental benefits of low-emission or no-emission energy generation equipment.

Budget 2012 further expanded Class 43.2 Assets with respect to waste-fuelled thermal energy equipment and equipment of a district energy system that uses thermal energy provided primarily by eligible waste-fuelled thermal energy equipment. Budget 2012 also expanded Class 43.2 Assets to include equipment that uses the residue of plants, generally produced by the agricultural sector, to generate electricity and heat (bio-waste). These measures did encourage investment in technologies that contributed to a reduction in emissions of greenhouse gasses and air pollutants in support of Canada's targets as set forth in the Federal Sustainable Development Strategy. These measures may also contribute to the diversification of Canada's energy supply.

Budget 2014 further expanded Class 43.2 Assets to include water-current energy equipment and a broader range of equipment used to gasify eligible waste. It was estimated that these proposed measures would reduce federal revenues by approximately \$1,000,000 by 2016.

Budget 2016 proposes that eligible generation sources will be expanded to include electricity generated by certain other renewable energy sources currently included in Class 43.2, namely: geothermal, waves, tides, and the kinetic energy of flowing water. This measure will encourage investment in technologies that can contribute to a reduction in emissions of greenhouse gases and air pollutants in support of targets as set forth in the federal sustainable development strategy.

Waste-Fuelled Thermal Energy Equipment

Waste-fuelled thermal energy equipment produces heat using wastes (eg. wood waste) and fuels from other natural waste (eg. bio-gas and bio-oil) subject to the requirement of the heat energy generated from the equipment is used in an industrial process or a greenhouse qualified for a Class 43.2 status. Budget 2012 expanded Class 43.2 Assets by removing this requirement, which such change may allow waste-fuelled thermal energy equipment to be used in a broad range of applications, including but not limited to space and water heating and wood waste could be used as an alternative to heating oil for space and water heating in commercial complexes such as shopping centres, hospitals and government buildings.

Equipment of a District Energy System

District energy systems transfer thermal energy between a central generation plant and a group of buildings by circulating steam, hot water or cold water through a system of underground piping, and said thermal energy is then distributed by a district energy system that can be used for heating, cooling or industrial processing. Certain equipment that is part of such district energy system is a Class 43.2 Asset if the system distributes thermal energy primarily generated by one or more of an eligible co-generation systems, a ground source heat pump, active solar heating equipment and/or heat recovery equipment. Budget 2012 expanded Class 43.2 Assets by adding equipment that is part of a district energy system that distributes thermal energy primarily generated by waste-fuelled thermal energy equipment.

Energy Generation from Residue of Plants

The residue of plants (eg. straw, corn cobs, leaves and similar organic waste produced in the agricultural sector), can be used in a number of ways including the production of heat, electricity, bio-fuels and other bio products. Budget 2012 added the residue of plants to the list of eligible waste fuels (eg. bio-gas, bio-oil, digester gas, landfill gas, municipal waste, pulp and paper waste, and wood waste) that can be used in waste-fuelled thermal energy equipment included in Class 43.2 or a co-generation system included in Class 43.1 or 43.2, provided however that users must do so in an environmentally responsible manner and abide by all applicable environmental laws and regulations in Canada or of a province, territory, municipality or a public or regulatory body.

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 or Class 43.2 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 or 43.2 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" or "renewable" energy generation projects are as follows:

1. The immediate deduction available for certain expenses incurred in the development of CRCE-related "clean energy" or "green energy" generation projects;
2. The accelerated CCA (at a rate of 50% per year on a declining balance basis) permitted for all Class 43.1 Assets and Class 43.2 Assets used in CRCE projects; and
3. A "flow-through share" mechanism which permits "principal-business corporations" to adequately finance their business operations and also to effectively allocate certain expenditures to their shareholders for the purposes of assisting shareholders in sheltering their personal income.

Greg P. Shannon, Q.C., ICD.D., TEP
Miller Thomson LLP
3000, 700 – 9th Avenue S.W.
Calgary, AB T2P 3V4
Direct Line: (403) 298-2482
gshannon@millerthomson.com