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Tax Alert – Canada

Canada's new clean electricity investment tax credit

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

Draft legislative proposals for the introduction of Canada's clean electricity investment tax credit (ITC), which was first announced in the 2023 federal budget,[1] were released for public consultation on 12 August 2024.[2]

The new 15% refundable tax credit is intended to support clean electricity technologies and proponents to expand the capacity of Canada's clean electricity grid and accelerate our progress towards a net-zero grid.

In this Tax Alert, we provide an overview of the proposed legislation, including the key design features included in proposed section 127.491 of the *Income Tax Act* (the Act), which are generally consistent with the design features included in the 2024 federal budget,[3] and the associated labour requirements included in section 127.46 of the Act.

The proposals described below may undergo further amendments before they are tabled in a bill.

[1] See EY Tax Alert 2023 Issue No. 20, *Federal budget 2023-24*.
[2] The consultation period ended on 11 September 2024.
[3] See EY Tax Alert 2024 Issue No. 24, *Federal budget 2024*.

Building a better working world

Overview of the clean electricity ITC

The clean electricity ITC legislative proposals are designed to encourage the investment of capital in the deployment of clean electricity property in Canada, as noted in proposed subsection 127.491(38).

The ITC will be available to qualifying entities that make eligible investments in clean electricity property on or after 16 April 2024 and before 1 January 2035 provided that the property is not part of a construction project that began before 28 March 2023. The tax credit rate is set at 15% in respect of the capital cost of certain eligible equipment that qualifies as clean electricity property. The ITC rate may be reduced by 10 percentage points if certain labour requirements are not met (see "Labour requirements" below).

Eligible equipment will include properties primarily used for the generation of clean electricity. The draft legislative proposals provide a clear definition and set the standards for what constitutes clean electricity property, including environmental compliance and emission intensity thresholds.

While the clean electricity ITC rules are similar to the rules for the clean technology ITC[4] from a technical perspective, there are key differences with respect to the credit rate, eligible properties and eligible credit recipients.

The clean electricity ITC could be claimed in addition to the Atlantic ITC but generally not with any other federal ITC.

Qualifying entity

While many of the clean economy ITCs focus mainly on taxable Canadian corporations, including those that are members of partnerships, the legislative proposals for the clean electricity ITC also extend to qualifying trusts and eligible investments made by designated provincial Crown corporations, and corporations owned by Canadian municipalities or Indigenous governing bodies.

A "qualifying entity" as it relates to the clean electricity ITC means a *qualifying corporation* or *qualifying trust*, as defined in proposed subsection 127.491(1). In addition, pursuant to proposed subsection 127.491(13), qualifying entities that are members of a partnership that acquires eligible property may also qualify for the clean electricity ITC.

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[4] See EY Tax Alert 2024 Issue No. 6, *Canada's new clean technology investment tax credit*.

A qualifying corporation includes:

- A taxable Canadian corporation;
- A designated provincial Crown corporation, as defined in proposed subsection 127.491(1);
- A corporation of which not less than 90% of the shares, or the capital, is owned by one or more municipalities in Canada or an Aboriginal government (or similar Indigenous governing bodies);
- The subsidiary of a corporation of which all of the shares (except directors' qualifying shares), or the capital, are owned by one or more municipalities in Canada or an Aboriginal government (or similar Indigenous governing bodies); and
- A pension investment corporation, as defined in paragraph 149(1)(o.2).

To be a qualifying trust, the trust must, at all relevant times, satisfy the following three conditions:

- Each beneficiary is a pension corporation, as described in paragraph 149(1)(o.2);
- The trust is a limited partner of a partnership; and
- The sole undertaking of the trust is holding its interest in the partnership.

Clean electricity property

To qualify for the clean electricity ITC, an investment must be made for eligible equipment that qualifies as clean electricity property. The draft legislative proposals define what constitutes clean electricity property in proposed subsection 127.491(1), which includes several property types, many of which share eligibility with property included in the clean technology ITC,[4] while others are unique to the clean electricity ITC (e.g., qualified natural gas energy equipment).

- Certain specified hydro-electric installations and property used in the generation of clean electricity from solar, wind or water energy. These properties are described in Class 43.1 (d)(ii), (d)(v), (d)(vi) and (d)(xiv) in Schedule II of the *Income Tax Regulations*, with some exclusions and modifications.
- *Concentrated solar energy equipment* (as defined in subsection 127.45(1)) that is part of a system used solely to generate electrical energy, exclusively from concentrated sunlight.

[4] See EY Tax Alert 2024 Issue No. 6, *Canada's new clean technology investment tax credit*.

- *Nuclear energy equipment*, which is equipment used all or substantially all to generate electrical energy (or a combination of electrical energy and heat energy) from nuclear fission, subject to certain conditions, including reactors, reactor vessels, reactor control rods, moderators, cooling systems, control systems, nuclear fission fuel handling equipment, containment structures, electrical generating equipment and equipment for the distribution of heat energy.

- *Geothermal equipment* described in Class 43.1 (d)(vii) that is part of a system that exports more electrical energy than heat energy on an annual net basis (without extracting fossil fuels for sale) and is used exclusively for the purpose of generating electrical energy (or a combination of electrical energy and heat energy), solely from geothermal energy.

- *Waste biomass electricity generation equipment* (as defined in subsection 127.45(1)) that is part of a system that exports more electrical energy than heat energy on an annual net basis.

- Fixed location energy storage property or pumped hydroelectric energy storage property described in Class 43.1 (d)(xviii) or (xix), excluding equipment that uses any fossil fuel in operation.

- *Qualified natural gas energy equipment*, as defined in proposed subsection 127.491(1), which generally includes certain electrical generating equipment, heat generating equipment used primarily for the purpose of producing heat energy to operate the electrical generating equipment, equipment that generates both electrical and heat energy, and equipment used solely for capturing carbon dioxide that is generated by the system, subject to various conditions.

- Qualified interprovincial transmission equipment, as defined in proposed subsection 127.491(1).

- Property incorporated into another property as part of a *refurbishment* (as defined in proposed subsection 127.491(1)) of the other property, if the other property is described in any of the above properties and continues to be so described once the refurbishment is completed. In this context, refurbishment means significant alterations, renovations, improvements or additions to a property that are intended to substantially extend its useful life, increase its capacity or improve its efficiency.

The eligible equipment described above must also generally meet the following conditions to qualify as clean electricity property that is eligible for the ITC:

- It must not be part of a project for which construction commenced before 28 March 2023. Pre-construction activities, such as obtaining permits or regulatory approvals, or similar activities are excluded for this purpose. If a major project is undertaken in discrete phases for business or engineering reasons, the Minister may determine that each phase is a separate project.

- It must be situated in Canada and intended for use exclusively in Canada.

- It must not have been used, or acquired for use or lease, before it was acquired by the entity.
- If it is to be leased by the taxpayer to another person or partnership, it must be leased to a qualifying entity, or a partnership where all members are qualifying entities, and must be leased in the ordinary course of carrying on a business in Canada by the qualifying entity whose principal business is selling or servicing property of that type or is a leasing or moneylending (or similar) business.

A property that would otherwise qualify as clean electricity property will be deemed to be ineligible if, at the time the property becomes available for use, there is substantial non-compliance by the entity with the requirements of any environmental law, by-law or regulation of Canada, a province, a municipality, or a municipal or public body performing a function of government in Canada that is applicable in respect of the property. A similar requirement applies for purposes of the clean technology ITC.

The Department of Natural Resources has the final authority on engineering and scientific matters concerning the eligibility of a property as clean electricity property. Any technical guide published by the Department of Natural Resources, including periodic updates, is to apply conclusively for the purpose of determining whether a property is a clean electricity property.

Clean electricity ITC rates

Qualifying clean electricity property is eligible for the ITC at a rate of 15% for property acquired on or after 16 April 2024 and before 1 January 2035. Designated provincial Crown corporations located in areas that were not recognized as eligible jurisdictions by the Minister on or before 31 March 2025 are not eligible for the clean electricity ITC for any property acquired prior to the date when their jurisdiction is designated as eligible.

Similar to other clean economy ITCs included in section 127 of the Act, property is deemed to have been acquired by the taxpayer when the property becomes available for use. However, this deeming rule is not applicable for property acquired before 16 April 2024.

The rate could be reduced by 10 percentage points if the claimant does not elect to meet the labour requirements set out in section 127.46 of the Act; these requirements are detailed further in the "Labour Requirements" section below.

Calculating the ITC base

The capital cost base on which the ITC is calculated must be reduced for any property for which any of the *clean economy tax credits*, as defined under section 127.47(1), were deducted. More specifically, in addition to the clean electricity ITC, the other clean economy tax credits are:

- The carbon capture, utilization and storage (CCUS) tax credit;
- The clean technology investment tax credit;
- The clean hydrogen tax credit; and
- The clean technology manufacturing tax credit.

When a taxpayer has received assistance, whether from government or non-government organizations, the ITC is calculated on the cost base of the equipment net of any financial assistance received. If the assistance is subsequently repaid or the taxpayer is no longer eligible for the assistance, the amount by which the cost of the property was reduced is added back to the capital cost of the property for the purpose of calculating the ITC. Since a property must be acquired in the year to obtain an ITC (as required under the definition of "clean electricity investment tax credit" in proposed subsection 127.491(1)), a separate property is deemed to have been acquired to enable the ITC to be claimed in respect of the later year.

If a portion of the cost of the property capitalized remains unpaid after 180 days from the end of the fiscal year in which the property became available for use, the capital cost of the property must be reduced by the unpaid amount. This amount can later be added back to the capital cost upon payment of the outstanding balance.

Proposed subsection 127.491(10) lists other exclusions and rules applicable in computing the capital cost of clean electricity property. In particular, expenditures related to preliminary work activities cannot be included in the capital cost of clean energy property pursuant to proposed subparagraph 127.491(10)(a)(v). Broadly speaking, a preliminary work activity (defined in proposed subsection 127.45(1)) is an activity that is preliminary to the acquisition, construction, fabrication or installation by or on behalf of a taxpayer of eligible property.

Time limit for ITC application

Proposed subsection 127.491(7) places a time limit on filing the prescribed form necessary to be eligible for the clean electricity ITC. Specifically, the prescribed form must be filed on or before the day that is one year after the taxpayer's filing due date for the year.

Recapture of credit

The recapture of the credit will apply if the property is converted to an ineligible use, disposed of or exported from Canada within 10 calendar years of the date it was acquired, unless the clean electricity property is qualified natural gas energy equipment, in which case the recapture period is 20 years.

The amount of the credit repayable is calculated using a specific formula that takes into account the amount of the taxpayer's clean electricity ITC for the property (less any amount previously paid by the taxpayer for recovery related to a qualified natural gas energy system in respect of the property[5]), the proceeds of disposition of the property or its fair market value (if the property is disposed of to a non-arm's length party, converted to an ineligible use or exported), and the capital cost of the particular property on which the clean electricity ITC was deducted.

For partnerships, recapture rules apply as if the partnership were a taxable Canadian corporation. The amount of tax determined because of recapture in respect of the partnership is added to the tax payable of the partnership members for the taxation year. An election is available to allow a member of a partnership to elect to pay the total amount of recapture or recovery tax that would otherwise have to be allocated to each member of the partnership for payment.

Proposed subsection 127.491(24) provides for a deferral of the recapture if clean electricity property is transferred to a related qualifying entity where certain conditions are met. This relieving provision is intended to facilitate bona fide transfers of clean electricity property within corporate groups.

Taxpayers are required to notify the Minister in prescribed form and manner if the recapture rules apply, or the recapture is deferred as a result of the related party relief, on or before the taxpayer's filing due date for that year.

A note on partnerships

Section 127.47 of the Act provides rules that apply to partnerships with respect to certain clean economy ITCs, including rules regarding the allocation of ITCs from a partnership to its members.

[5] Also, see proposed subsection 127.491(19), which provides that a qualifying entity may be required to pay a recovery amount if, at the end of the compliance period of its qualified natural gas energy system, the average actual emission intensity of the electricity produced exceeds certain limits.

The draft legislative proposals released on 12 August 2024 include proposed subsection 127.47(4.1) of the Act, which provides rules to clarify the amount that a taxpayer who is a member of a partnership is deemed to have paid on account of its tax payable under Part I of the Act under each of the clean economy tax credits. A qualifying taxpayer is generally restricted to claiming only one of the clean economy tax credits if the property is eligible for more than one clean economy tax credit.

If property is eligible for more than one clean economy ITC, a qualifying taxpayer is generally limited to one of the tax credits on the cost of the property. Proposed subsection 127.47(4.1) generally provides that where property is owned at the partnership level, each member of the partnership may generally claim any one — but not more than one — credit that they have been allocated by a partnership. The rules provide an exception to ensure that the dual-use equipment rules in the CCUS and clean hydrogen ITC context still allow each portion of the property to support a credit claim.

The Finance Explanatory Notes provide an example of this rule. In the scenario provided, Partner A and Partner B are limited partners of a limited partnership and Partner C is the general partner. All three partners are taxable Canadian corporations. Partner A and Partner B have each made a $10,000 contribution to the partnership. The partnership acquires a $20,000 property that qualifies as both clean electricity property and clean technology property.

The clean electricity and clean technology ITC are calculated at the partnership level, as if the partnership were a taxable Canadian corporation. At the partnership level, the notional clean electricity ITC on this property is $3,000 (assuming a specified percentage of 15%) and the notional clean technology ITC is $6,000 (assuming a specified percentage of 30%).

Due to making equal partnership contributions, each of Partner A and Partner B has a 50% share of these ITCs. Partner A can decide if it wants to claim its $1,500 share of the clean electricity ITC or its $3,000 share of the clean technology ITC, unless Partner A is ineligible for either of the ITCs.

Partner B can also decide which of the ITCs it wants to claim, regardless of which ITCs Partner A has chosen to claim, provided that Partner B is eligible for both ITCs.

The partnership will be deemed to have received the amount of the ITC claimed by each partner for the purposes of subsection 13(7.1) of the Act.

This rule is important in partnerships that are composed of entities that do not qualify for the clean technology ITC but do qualify for the clean electricity ITC.

Labour requirements

As detailed below, the 15% refundable ITC rate could be reduced by 10 percentage points if the claimant does not elect to meet the labour requirements set out in section 127.46 of the Act.

To meet the labour requirements, the ITC claimant must elect in prescribed form and manner for each installation taxation year (i.e., a taxation year during which preparation or installation of the clean electricity property occurs). The reduced ITC rate will automatically apply in situations where the taxpayer has not elected in the prescribed manner to meet the prevailing wage and apprenticeship requirements for an installation taxation year.

Prevailing wage requirements

The taxpayer must meet the following labour requirements to qualify for the full incentive:

- Each covered worker must be compensated for their labour in accordance with the worker's relevant collective agreement (e.g., a labour agreement with a trade union in agreement with provincial laws). If no collective agreement exists, the amount of compensation (including benefits) must be at least equal to the amount specified in the most comparable agreement that is relevant to the given worker's experience level, tasks and location (calculated on a per-hour or similar basis). This condition is referred to hereinafter as the "prevailing wage requirement". Compensation excludes overtime.
- The ITC claimant must attest in prescribed form and manner that the prevailing wage requirement (described above) is met with respect to their own covered workers and that a reasonable effort was taken to verify that covered workers employed by others involved in the installation of clean electricity property also meet the prevailing wage requirement.
- The ITC claimant is also required to take steps to ensure that all covered workers are aware of the requirements by posting notices that are clearly visible and accessible or by electronic means. The ITC claimant must also provide a plain language explanation of what the prevailing wage requirements mean for workers and instructions as to how to report any failures to meet these standards to the Minister.

For these purposes, a covered worker means an individual:

- Who is engaged in the installation of the clean electricity property at the designated work site;
- Whose work duties are primarily manual or physical in nature; and
- Who is not an administrative, clerical or executive employee, or a business visitor to Canada (within the meaning of section 187 of the *Immigration and Refugee Protection Regulations*).

Apprenticeship requirements

In addition to the prevailing wage requirements set out above, the ITC claimant must make reasonable efforts to ensure that apprentices registered in a Red Seal trade work at least 10% of the total work performed by Red Seal workers on the installation of the clean electricity property. If a labour law or other agreement restricts the use of apprentices, then the ITC claimant must make every effort to ensure the highest percentage of labour hours is achieved. Red Seal worker is defined as a covered worker whose duties are, or are equivalent to, duties normally performed by workers in a Red Seal trade.

A Red Seal trade is defined as a designation managed by the Canadian Council of Directors of Apprenticeship under the Red Seal Program and, in any other case, an equivalent provincially registered trade.

In addition, the ITC claimant must attest in prescribed form and manner that it has met the apprenticeship requirements in respect of covered workers at the designated work site.

Subsection 127.46(16) provides specific steps required by the ITC claimant to demonstrate that the ITC claimant is deemed to satisfy the reasonable efforts requirement noted above. According to the Finance Explanatory Notes, the steps are intended to be illustrative of a means of meeting the reasonable efforts tests, as such variations to take into account the ITC claimant's specific circumstances may also be considered reasonable efforts.

Certain steps must be taken at least every four months in respect of the installation year. These steps are mainly in respect of satisfying specific job posting requirements, communicating with the trade unions and various educational institutions, and confirming the availability of apprentices at designated work sites. The remaining steps require the ITC claimant to review and duly consider all applications received and to attest compliance of the requirements in prescribed form and manner.

Penalties for non-compliance with labour requirements

The legislation includes a penalty in the form of an additional tax amount payable when the taxpayer has claimed the ITC based on electing to satisfy the labour conditions but fails to meet the requirements. The penalty is calculated as $20 for every day a covered person was not paid the prevailing wage rate during the installation year and, with respect to the apprenticeship requirements, $50 for every hour the total apprenticeship time falls below the specified hours.

The amounts used to calculate the penalty will be indexed to inflation after 2023. In addition, subsection 127.46(17) addresses the allocation of any additional tax or penalties imposed where the incentive claimant is a partnership.

Gross negligence

If the incentive claimant has claimed the regular ITC rate based on meeting the labour requirements and it is later determined that the claimant knowingly (or in circumstances amounting to gross negligence) did not satisfy the conditions, the taxpayer must pay back the portion of the incentive they were not eligible for, as well as a penalty equal to half of that ineligible amount.

Corrective measure

If the ITC claimant receives a notification from the Minister specifying that it did not meet the prevailing wage requirement set out above, the claimant may provide a "top-up" amount, plus interest, to each covered worker for the shortfall in pay to remain in compliance with the requirements. The claimant must pay the top-up amount (including interest) within one year after receipt of the notification, unless the Canada Revenue Agency considers a longer period to be acceptable in the circumstances. The top-up amount would be considered salaries paid in the year and deductible from income tax purposes, but it will not qualify for the ITC.

If the top-up amount is not paid to any particular covered worker, a penalty equal to 120% of the top-up amount will apply.

Conclusion

The clean electricity ITC, along with other previously legislated and proposed clean economy ITCs, is intended to help Canada transition to a clean economy by encouraging the investment of capital in the development of these projects in Canada.

The public consultation period for the draft legislative proposals for the clean electricity ITC closed on 11 September 2024. As noted above, the proposals may undergo further amendments before they are tabled in a bill to take into account stakeholder feedback.

Learn more

For more information, contact your EY or EY Law tax advisor, or one of the following professionals:

Toronto

Dharmesh Gandhi
+1 416 932 5755 | dharmesh.gandhi@ca.ey.com

Martin McLaughlin
+1 416 932 5751 | martin.mclaughlin@ca.ey.com

Atlantic Canada

Brett Copeland
+1 902 421 6261 | brett.copeland@ca.ey.com

Quebec

Julia Bolpois
+1 514 879 2709 | julia.bolpois@ca.ey.com

Prairies

Korey Conroy
+1 403 956 5778 | korey.conroy@ca.ey.com

British Columbia

Sean Verret
+1 604 365 7326 | sean.verret@ca.ey.com

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