BUDGET 2021: IMMEDIATE EXPENSING FOR CCPCS, ACCELERATED CCA FOR CLEAN ENERGY EQUIPMENT, AND RATE REDUCTIONS FOR ZERO-EMISSION TECHNOLOGY MANUFACTURERS

Posted on April 23, 2021

Categories: Insights, Publications

The Federal Government announced a number of tax proposals in Budget 2021 attempting to encourage targeted business investment in discrete sectors, particularly in the so-called "green economy". Three such proposals in Budget 2021 relate to: (i) the right of qualifying "Canadian-controlled private corporations" ("**CCPCs**"), as defined in the *Income Tax Act* (Canada) (the "**Tax Act**"), to immediately expense certain depreciable capital property, (ii) the right to claim accelerated capital cost allowance deductions (i.e., tax depreciation) in respect of certain clean energy equipment, and (iii) tax rate reductions for certain manufacturers of zero-emission technology.

Immediate Expensing of Certain Depreciable Capital Property

The Tax Act and the *Income Tax Regulations* (Canada) (the "**Tax Regulations**") currently impose a regime, referred to as the "capital cost allowance" regime, that permits qualifying taxpayers to depreciate all or a portion of the capital cost of certain depreciable capital property for tax purposes, typically over the course of the useful life of the property. The regime allocates depreciable capital property among a number of distinct classes set out in Schedule II to the Tax Regulations. The Tax Regulations specify the methodology and rate for computing the permissible capital cost allowance deductions that may be claimed in respect of each class of depreciable capital property for a particular taxation year.

The Government announced proposed revisions to the capital cost allowance regime in November 2018 to authorize a temporarily enhanced deduction for depreciable capital property acquired by a taxpayer in a year, referred to as the "Accelerated Investment Incentive". In most circumstances, the Accelerated Investment Incentive permits a capital cost allowance deduction in the year of acquisition of depreciable capital property that is three times larger than the deduction that would otherwise have been available. In addition, the Government's November 2018 announcement also permitted the full expensing of certain machinery and equipment used for the manufacturing or processing of goods, as well as for specified clean energy generation equipment.

Budget 2021 proposes to extend, on a temporary basis, the immediate expensing of “eligible property” acquired by a CCPC after April 18, 2021 and that is available for use before January 1, 2024, to a maximum of $1.5 million per year. Such immediate expensing is proposed to only be available in the year the property becomes available for use for purposes of the Tax Regulations. It is proposed that the $1.5 million limit be shared amongst members of an associated group of CCPCs. Such immediate expensing shall be pro-rated for taxation years that are less than 365 days. The so-called “half year rule” under subsection 1100(2) of the Tax Regulations will be suspended for property for which an immediate expense is claimed.

Budget 2021 indicates that there will be no carryforward opportunity for CCPCs that incur less than $1.5 million on eligible property in a year. Accordingly, CCPCs may have an incentive to manage any discretionary capital expenditures to maximize the right to claim immediate deductions.

Eligible property for these purposes generally includes all depreciable capital property, except depreciable capital property described in Classes 1 to 6, 14.1, 17, 47, 49 and 51 of Schedule II to the Tax Regulations. Notable exclusions found in Classes 1 to 6, 14.1, 17, 47, 49 and 51 include most buildings and related structures, certain electrical and telecommunication equipment and goodwill.

A CCPC that has more than $1.5 million of eligible property become available for use in a year will generally have discretion to allocate the $1.5 million of available immediate expenses among its eligible property, with any amounts in excess of $1.5 million being subject to the normal capital cost allowance rules.

Notwithstanding the foregoing, the availability of an immediate deduction in respect of the capital cost of eligible property, as announced in Budget 2021, is generally limited to such property as was (i) at no previous time owned by the CCPC or a party not dealing at arm's length with the CCPC, and (ii) not transferred to the CCPC on a tax-deferred rollover basis.

Deductions claimed under this new proposal would not detract or otherwise reduce the availability of other enhanced deductions. For example, it would generally be possible for a qualifying CCPC to access $1.5 million of immediate depreciation in respect of eligible property under the Budget 2021 proposals, as well as claiming an immediate deduction in respect of qualifying machinery and equipment used in a manufacturing or processing business under the November 2018 proposals described above.

The capital cost allowance regime set out in the Tax Act and Tax Regulations contains a number of detailed provisions to account for more complex transaction structures, specified energy properties and complex leasing / rental regimes, among others. Such provisions generally limit the scope of capital cost allowance deductions that can be claimed by a taxpayer (or limit the losses that would otherwise arise from claiming such deductions). It is expected that such restrictions will be applied to the new immediate expensing provisions introduced in Budget 2021.

It should be noted that immediate expensing does not generally change the overall tax liability of a taxpayer. Rather, it accelerates the rate at which depreciation expenses can be claimed for tax purposes, resulting in a tax-deferral to an eligible taxpayer. Accordingly, a taxpayer availing itself of the proposed immediate expensing regime would effectively accelerate the timing of when such capital cost allowance deductions are claimed, thereby reducing taxable income in the year such eligible property becomes available for use, but increasing taxable income in subsequent years since capital cost allowance deductions that would otherwise have applied in such subsequent years are unavailable (because the entire capital cost was expensed in the year in which the depreciable capital property became available for use). Moreover, a taxpayer that sells depreciable property in a year after the capital cost of such property has been expensed will generally be subject to taxation on “recaptured depreciation” in respect of previously claimed capital cost allowance deductions.

As a consequence of the timing of such deductions, the Government estimates that these measures will reduce tax revenue in each of the next three fiscal years, but increase government tax revenue in each of the two following taxation years, for a net cost to the federal treasury of approximately $2.25 billion between the 2022 and 2026 fiscal years. Such measures would also be expected to give rise to a corresponding reduction in provincial corporate tax revenues.

The Budget 2021 materials state that the measures relating to the immediate expensing of depreciable capital property are to come into force as of April 19, 2021; however, the Government has not yet released draft legislation to implement such measures.

Accelerated Capital Cost Allowance Deductions for Certain Clean Energy Equipment

In addition to the November 2018 proposals for accelerated depreciation discussed above, the Tax Act and Tax Regulations also include various accelerated depreciation regimes to incentivize investment in certain projects that have been identified / targeted by previous governments as desirable from a public policy perspective.

In particular, Classes 43.1 and 43.2 of Schedule II to the Tax Regulations provide tax depreciation regimes for specified clean energy generation and energy conservation equipment where the annual tax depreciation (generally, 30% and 50% per annum, respectively, on a declining balance basis) exceeds the anticipated annual economic depreciation, such that the specified clean energy generation and energy conservation equipment is depreciated for tax purposes at a rate that is more rapid than the anticipated useful life of the property, effectively resulting in a tax deferral to the owner of the equipment.

As noted above, property acquired in Classes 43.1 and 43.2 of Schedule II to the Tax Regulations that is acquired after November 20, 2018 and that becomes available for use before 2024 is generally eligible for immediate expensing, which results in an even faster rate of deduction than that proposed in Budget 2021. [1]

Budget 2021 aims to further incentivize investments in selected green technologies by expanding the scope of Classes 43.1 and 43.2 of Schedule II to the Tax Regulations to include:

- pumped hydroelectric storage equipment;
- electricity generation equipment that uses physical barriers or dam-like structures to harness the kinetic energy of flowing water or wave or tidal energy;
- active solar heating systems, ground source heat pump systems, and geothermal energy systems that are used to heat water for a swimming pool;
- equipment used to produce solid and liquid fuels (e.g., wood pellets and renewable diesel) from specified waste material or carbon dioxide;
- a broader range of equipment used for the production of hydrogen by electrolysis of water; and
- equipment used to dispense hydrogen for use in hydrogen-powered automotive equipment and vehicles.

Accelerated tax depreciation in respect of such properties will only be available under the Budget 2021 proposals if, at the time the property becomes available for use, the requirements of all Canadian environmental laws, by-laws and regulations applicable to the property have been satisfied.

In addition, Budget 2021 proposes to remove from Classes 43.1 and 43.2 of Schedule II to the Tax Regulations certain systems that burn fossil fuels and / or waste fuels to produce electricity, heat or both, as well as certain items of property that derive up to one half of their fuel energy input from fossil fuels. The Government asserts that such items of property were added to Classes 43.1 and 43.2 of Schedule II to the Tax Regulations approximately 15 to 25 years ago and no longer reflect the current Government's climate and environmental priorities. The categories of property being removed consist of:

- fossil-fuelled cogeneration systems;
- fossil-fuelled enhanced combined cycle systems;
- specified waste-fuelled electrical generation systems with an electrical capacity greater than 3 megawatts;
- specified waste-fuelled heat production equipment for which more than one quarter of the total fuel energy input is from fossil fuels; and
- producer gas generating equipment for which more than one quarter of the total fuel energy input is from fossil fuels.

Budget 2021 describes in greater details the nature of the inclusions and exclusions from Classes 43.1 and 43.2 of Schedule II to the Tax Regulations. Such details can be found here.

The expansion of Classes 43.1 and 43.2 of Schedule II to the Tax Regulations will apply in respect of property that is acquired and that becomes available for use after April 18, 2021, where it has not been used or acquired for use for any purpose before such date. Conversely, the removal of the above-described property from Classes 43.1 and 43.2 of Schedule II to the Tax Regulations, as well as the application of a new heat rate threshold for specified waste-fuelled electrical generation systems, will apply in respect of property that becomes available for use after 2024.

Tax Rate Reductions for Certain Manufacturers of Zero-Emission Technology

Budget 2021 proposes to introduce measures to temporarily reduce by half the applicable federal corporate income tax rate applicable to qualifying corporations engaged in eligible manufacturing and processing activities of qualifying zero-emission technologies.

Accordingly, qualifying corporations otherwise subject to the "general" federal corporate tax rate of 15% will only be subject to an applicable tax rate of 7.5% on eligible manufacturing and processing activities, while those corporations otherwise subject to the small business tax rate of 9% will only be subject to an applicable federal tax rate of 4.5% on eligible manufacturing and processing activities.

Budget 2021 identifies income derived from the following zero-emission technology manufacturing or processing activities by a qualifying corporation as eligible for the rate reduction:

- manufacturing of solar energy conversion equipment, such as solar thermal collectors, photovoltaic solar arrays and bespoke supporting structures or frames, but excluding passive solar heating equipment (e.g., a masonry wall installed to absorb solar energy);
- manufacturing of wind energy conversion equipment, such as wind turbine towers, nacelles and rotor blades;
- manufacturing of water energy conversion equipment, such as hydroelectric, water current, tidal and wave energy conversion equipment;
- manufacturing of geothermal energy equipment;
- manufacturing of equipment for a ground source heat pump system;
- manufacturing of electrical energy storage equipment used for storage of renewable energy or for providing grid-scale storage or other ancillary services (e.g., voltage regulation), including battery, compressed air and flywheel storage systems;
- manufacturing of zero-emission vehicles (i.e., plug-in hybrid vehicles with a battery capacity of at least seven kilowatt-hours, electric vehicles and hydrogen-powered vehicles) and the conversion of vehicles

into zero-emission vehicles;

- manufacturing of batteries and fuel cells for zero-emission vehicles;
- manufacturing of electric vehicle charging systems and hydrogen refuelling stations for vehicles;
- manufacturing of equipment used for the production of hydrogen by electrolysis of water;
- production of hydrogen by electrolysis of water; and
- production of solid, liquid or gaseous fuel (e.g., wood pellets, renewable diesel and biogas) from either carbon dioxide or specified waste material (i.e., wood waste, municipal waste, sludge from an eligible sewage treatment facility, plant residue, spent pulping liquor , food and animal waste, manure, pulp and paper by-product and separated organics), but excluding the production of by-products which is a standard part of another industrial or manufacturing process (e.g., the production of wood chips, black liquor or hog fuel as part of another wood transformation process).

Budget 2021 clarifies that the manufacture of components or sub-assemblies in respect of the above activities would only be eligible for the zero-emissions rate reduction to the extent such components or sub-assemblies are purpose-built or designed exclusively to form an integral part of the relevant system.

In addition, Budget 2021 indicates that the existing capital cost allowance provisions relating to what constitutes manufacturing or processing activity will apply to determine whether the above activities are eligible for the rate reduction.

In computing the eligible income of a taxpayer that is subject to the reduced rate applicable to eligible zero-emission manufacturing and processing activities, the Budget 2021 materials indicate that a taxpayer's "adjusted business income" will be multiplied by the portion of its total labour and capital costs that are used in eligible activities. For this purpose, the Government anticipates that "adjusted business income", and the manner of allocating labour and capital costs, will be substantially based on the existing rules relating to the computation of manufacturing and processing profits.

Budget 2021 indicates that in order to qualify for the zero-emission rate reduction, a taxpayer will need to establish that at least 10% of its gross revenue from all active businesses carried on in Canada is attributable to eligible activities.

Where a taxpayer pays tax at both the general rate and the small business rate (e.g., because the taxpayer earns more than $500,000 of income in the year), the taxpayer will be eligible to choose whether to have the eligible income taxed at the reduced rate of 4.5% (to the extent otherwise eligible for the small business rate) or at 7.5%.

The Government has indicated in Budget 2021 that the dividend gross-up and dividend tax credit mechanisms set out in the Tax Act will not be modified to reflect the rate reductions applicable to qualifying manufactures of eligible zero-emission activities (given the temporary nature and limited scope of such tax rate reductions). As the Government is only projecting the program to cost an aggregate of $46 million between the 2022 and 2026 fiscal years, this seems like a reasonable trade-off against the complexity of introducing new dividend gross-up rates, dividend tax credit rates, and the formation of a new refundable dividend tax pool to ensure consistent integration across different domestic business activities.

The reduced tax rates are stated to apply to taxation years that begin after 2021, and with the reductions starting to be phased out in 2029 (and fully phased out by 2031).

The Government has not yet released draft legislation in respect of the measures, but is seeking input from interested parties on or before June 18, 2021, particularly as it relates to allocating income between eligible manufacturing and processing activities and those activities ineligible for the reduced zero-emission taxation rates.

[1] [ps2id id = '1' target = '' /] The Tax Act contains other measures addressing “Canadian Renewable and Conservation Expenses”, which generally permit certain intangible project start-up expenses incurred in respect of specified clean energy generation and energy conservation projects (e.g., engineering and design work, and feasibility studies) to be deducted in the year incurred (or, depending on the circumstances, carried forward or renounced to flow-through investors).

by Andrew Stirling

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.