

2024 Issue No. 52
31 October 2024

Tax Alert – Canada

Investment tax credit for carbon capture, utilization and storage: Update

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.

The legislation implementing the investment tax credit (ITC) for carbon capture, utilization and storage (CCUS) was enacted in June 2024 as part of Bill C-59, *Fall Economic Statement Implementation Act, 2023*.

The CCUS ITC was first announced in the 2021 federal budget and subsequently updated in the 2022 and 2023 federal budgets. The amendments included in Bill C-59 were generally consistent with previous announcements and most notably incorporated the latest changes proposed in the 2023 federal budget. The evolution of the draft legislative proposals has been summarized in EY Tax Alert 2022 Issue No. 31, [Proposed federal investment tax credit for CCUS](#); EY Tax Alert 2022 Issue No. 41, [Proposed federal investment tax credit for carbon capture, utilization and storage - update](#); EY Tax Alert 2023 Issue No. 20, [Federal budget 2023-24](#); and EY Tax Alert 2023 Issue No. 34, [Legislative update for the CCUS investment tax credit](#).

In addition, Bill C-69, *Budget Implementation Act, 2024, No. 1*, which was also enacted in June 2024, included some technical amendments to the CCUS ITC.

This Tax Alert highlights certain updates contained in Bill C-59, Bill C-69 and in the latest round of draft legislative proposals released on 12 August 2024 with respect to the CCUS ITC.

Background

The CCUS ITC in section 127.44 and Part XII.7 of the *Income Tax Act* (the Act) is refundable and available to businesses that incur qualified CCUS expenditures after 2021 and before 2041. Qualified CCUS expenditures include the cost of acquiring eligible equipment used in qualified CCUS projects.

Eligible equipment, as described in our previous Tax Alerts noted above, includes equipment that is situated in Canada and used solely to capture, transport, store or use carbon dioxide (CO₂) as part of a qualified CCUS project. This equipment is included in new capital cost allowance (CCA) Classes 57 and 58, which have 8% and 20% declining-balance-basis CCA rates, respectively, and is eligible for enhanced first-year depreciation under the accelerated investment incentive.

For qualified CCUS expenditures incurred after 2021 and before 2031, credit rates are 60% for qualified carbon capture expenditures used to capture carbon directly from ambient air, 50% for other qualified carbon capture expenditures and 37.5% for qualified carbon transportation, storage or use expenditures. These credit rates are reduced by half for eligible expenses incurred after 2030 and before 2041. Also, the credit rates are reduced by 10 percentage points if certain labour conditions are not met. For general information on the labour conditions, refer to EY Tax Alert 2023 Issue No. 34, [Legislative update for the CCUS investment tax credit](#). Also, see EY Tax Alert 2024 Issue No. 6, [Canada's new clean technology investment tax credit](#), for details on the amendments implemented by Bill C-59.

The tax credit may be claimed for the taxation year in which qualified CCUS expenditures are incurred, regardless of when the related equipment becomes available for use. The extent to which the tax credit is available is also dependent on the projected eligible use percentage of the CO₂ being captured. Part XII.7 recovery taxes may be imposed to recoup any excess tax credits claimed where the projected eligible use percentage is not met at the end of each of the four project periods.

Changes enacted by Bill C-59 and Bill C-69 and the proposed amendments

Various changes announced in the 2023 federal budget, including the separation of the credit into a cumulative CCUS development tax credit (for qualified CCUS expenditures incurred before the first day of commercial operations of a CCUS project) and a CCUS refurbishment tax credit (for qualified CCUS expenditures incurred during the total CCUS project review period) as well as various technical amendments are included in Bill C-59, Bill C-69 and the August 2024 draft legislative amendments.

Addition of a definition for dual-use equipment

A portion of expenditures related to dual-use equipment may qualify for the CCUS ITC in certain circumstances.

The definition of dual-use equipment in subsection 127.44(1) includes certain property, other than property described in Class 57 or 58, that is part of a CCUS project of the taxpayer and that is not used for natural gas processing or acid gas injection. Broadly speaking, the definition includes four categories of equipment:

- ▶ **Energy generation equipment** - Equipment that generates electrical energy, heat energy or a combination of electrical and heat energy, if more than 50% of either the electrical energy or heat energy that is expected to be produced over the total CCUS project review period is expected to directly support a qualified CCUS project or a qualified clean hydrogen project. This category excludes equipment that uses fossil fuels and emits carbon dioxide that is not subject to capture by a qualified CCUS project. Moreover, if such equipment is used for a qualified clean hydrogen project, any emissions produced must be abated by a qualified CCUS project. This category also excludes equipment that supports the qualified CCUS project indirectly by way of an electrical utility grid.

The August 2024 draft legislative proposals include an amendment to clarify that the 50% test may be satisfied through a combination of direct support of a qualified CCUS project and direct support of a qualified clean hydrogen project.

- ▶ **Water supply equipment** - Equipment that delivers, collects, recovers, treats or recirculates water (or a combination of any of those activities) in support of a qualified CCUS project.
- ▶ **Electrical transmission equipment** - Equipment that directly transmits electrical energy generated by energy generation equipment, as described above, to a qualified CCUS project if more than 50% of the electrical energy to be transmitted by the equipment over the total CCUS project review period is expected to support the qualified CCUS project or qualified clean hydrogen project. Any emissions produced by such equipment must be abated by a qualified CCUS project.
- ▶ **Energy distribution equipment** - Equipment that is part of a CCUS project that distributes electrical or heat energy.

The definition of dual-use equipment also includes integrated ancillary equipment. The ancillary equipment must be physically and functionally integrated with the equipment categories described above. It must also be solely used to support such equipment within the CCUS process as part of a supporting subsystem. The supporting subsystems include an electrical system, fuel supply system, liquid delivery and distribution system, cooling system, process material storage and handling and distribution system, process venting system, process waste management system, or utility air or nitrogen distribution system. However, the integrated ancillary equipment excludes construction equipment, furniture, office equipment and vehicles.

Dual-use equipment also includes the following components that are solely used in support of the equipment noted above:

- ▶ Control, monitoring and safety equipment;
- ▶ Buildings used for installation and operations;
- ▶ Conversion property used solely to convert another property; and
- ▶ Property used solely to refurbish other property described above.

The definition of dual-use equipment is generally deemed to have come into force on 1 January 2022.

Definition of *first day of commercial operations* and *project start-up date*

The definition of *first day of commercial operations* was added by Bill C-59, and the term is defined as the day that occurs 120 days after the day on which captured carbon dioxide is first delivered – on an ongoing operational basis – to a carbon transportation, carbon storage or carbon use system for storage or use. Delivering a small amount of captured carbon as a part of preliminary testing is not considered to be the start of commercial operations. The phrase “120 days after” is intended to provide a grace period with respect to any expenditures that might overlap with the commencement of commercial operations.

The definition is important to establish when project expenditures cease to qualify for the CCUS development tax credit and may begin to qualify for the CCUS refurbishment tax credit. This determination is significant because refurbishment expenditures of a qualified CCUS project are limited to 10% of the total qualified CCUS expenditures incurred prior to the first day of commercial operations. It is also relevant for determining when the first project period begins for purposes of the compliance and reporting obligations in Part XII.7 of the Act.

Further, new subsection 211.92(1) provides various definitions relevant for the purpose of determining the CCUS tax credit recovery liability and for the reporting requirements in new section 211.93 of the Act. The definitions apply for the purposes of Part XII.7 and section 127.44, which contain the main provisions for the CCUS tax credit rules. For purposes of section 211.92, Bill C-59 introduced the definition of *project start-up date*, which is defined as the day that is 120 days before the first day of commercial operations. This definition is relevant for the purposes of determining certain reporting requirements in respect of knowledge sharing.

Non-government assistance

Non-government assistance is defined in subsection 127(9) of the Act. Bill C-59 amended the definition to exclude amounts received directly from a government, municipality or other public authority from non-government assistance. This amendment has an impact on the CCUS ITC since eligible expenditures are only reduced by non-government assistance and not by government assistance. As a result, the receipt of funding from a government, municipality or other public authority should not effectively reduce the CCUS ITC. This amendment came into force on 20 June 2024.

Rules with respect to partnerships

Subsection 127.44(11) of the Act, which was enacted in Bill C-59, applies if a qualifying taxpayer is a member of a partnership and a CCUS tax credit would be determined in respect of the partnership if the partnership were a taxable Canadian corporation (and its fiscal period were its taxation year). Subsection 127.44(11) contains a rule that effectively flows the portion of a CCUS tax credit that can reasonably be considered to be a member's share of the credit to the member, which is similar to the rule in subsection 127(8).

New subsection 127.44(11) is subject to section 127.47, which 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.

In particular, subsection 127.47(3) restricts a partnership from allocating to a limited partner a share of the CCUS ITCs that exceeds the limited partner's "at-risk" amount in respect of the partnership, as defined in subsection 96(2.2) of the Act. Furthermore, the amount of ITCs allocated to each partner must be based on a reasonable pro-rata methodology having regard to the capital invested in or work performed for the partnership by each member.

In addition, the draft legislative proposals released on 12 August 2024 include proposed subsection 127.47(4.1), 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.

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.

Delaying recognition of expenditures

New paragraph 127.44(9)(e) introduced as part of Bill C-59 addresses circumstances where an expenditure is incurred in relation to a property before the property is acquired by the taxpayer. For example, this situation could occur if the expenditure is incurred in one taxation year, but the property is not acquired until a subsequent taxation year due to a delivery delay.

In such situations, both the incurring of the expenditure and the acquisition of the property is deemed to occur in the later of the two taxation years. It is also possible that new subsection 127.44(12) could apply to deem an expenditure to be incurred when it is paid. More specifically, subsection 127.44(12) provides that if an expenditure remains unpaid after 180 days from the end of the taxation year in which the expenditure was incurred, the expenditure is deemed to have been incurred in the year in which it is paid. Paragraph 127.44(9) is not overridden, meaning that subsection 127.44(12) will be applied first to determine when an affected expenditure (involving unpaid amounts) is initially deemed to have been incurred. Such expenditure could be further delayed under paragraph 127.44(9)(e) if the property is not acquired until a subsequent year.

Qualified CCUS project determination and revised project evaluation

Bill C-59 and Bill C-69 introduced some restrictions related to the Minister of National Revenue's discretion under new subsection 127.44(8). Specifically, the Minister of National Revenue (in consultation with the Minister of Natural Resources) can only exercise its discretion to redesignate a CCUS project as a single project or multiple projects at the following times:

- ▶ Before the initial project evaluation is issued by the Minister of Natural Resources for the project; or
- ▶ If a revised project plan is submitted as a result of subsection 127.44(6), after the revised project plan has been submitted but before a revised project evaluation is issued by the Minister of Natural Resources.

New subsection 127.44(6) was introduced in Bill C-59 to require a taxpayer to submit a revised project plan with the Minister of Natural Resources in certain circumstances. A revised project plan is required if the Minister of Natural Resources determines that there has been a material change to the project or if certain captured carbon thresholds are not reached compared to the most recent project plan.

In addition, subsection 127.44(7) provides that if a taxpayer files a revised project plan in accordance with subsection 127.44(6), the Minister of Natural Resources is required to issue a revised project evaluation with all due dispatch.

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

Rod Hynes

+1 604 891 8301 | rod.s.hynes@ca.ey.com

Sean Verret

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

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation is available via ey.com/privacy. For more information about our organization, please visit ey.com.

About EY's Tax Services

EY's tax professionals across Canada provide you with deep technical knowledge, both global and local, combined with practical, commercial and industry experience. We offer a range of tax-saving services backed by in-depth industry knowledge. Our talented people, consistent methodologies and unwavering commitment to quality service help you build the strong compliance and reporting foundations and sustainable tax strategies that help your business achieve its potential. It's how we make a difference.

For more information, visit ey.com/ca/tax.

About EY Law LLP

EY Law LLP is a national law firm affiliated with EY in Canada, specializing in tax law services, business immigration services and business law services.

For more information, visit eylaw.ca.

About EY Law's Tax Law Services

EY Law has one of the largest practices dedicated to tax planning and tax controversy in the country. EY Law has experience in all areas of tax, including corporate tax, human capital, international tax, transaction tax, sales tax, customs and excise.

For more information, visit <http://www.eylaw.ca/taxlaw>

© 2024 Ernst & Young LLP. All Rights Reserved.

A member firm of Ernst & Young Global Limited.

This publication contains information in summary form, current as of the date of publication, and is intended for general guidance only. It should not be regarded as comprehensive or a substitute for professional advice. Before taking any particular course of action, contact EY or another professional advisor to discuss these matters in the context of your particular circumstances. We accept no responsibility for any loss or damage occasioned by your reliance on information contained in this publication.

ey.com/ca