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TAX NOTES

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BUDGET 2022: GETTING CAPTURED BY THE NEW CCUS TAX CREDIT

Budget 2022 released details of the much-anticipated carbon capture, utilization, and storage ("**CCUS**") federal investment tax credit. The Government appears to have accepted a number, although not all, of the recommendations made by interested parties during the consultation period and the energy industry has generally received the release of the CCUS credit as a positive first step. In this Tax Note, we summarize the fundamentals of the CCUS credit and highlight some of the noteworthy aspects of the CCUS credit as it impacts the energy industry.

<u>CCUS Tax Credit - Fundamentals</u>

Taxpayers that invest in "eligible equipment" (*i.e.*, equipment used solely to capture, transport, store or use CO_2) used in "eligible projects" (*i.e.*, projects which capture CO_2 in Canada that would otherwise be released into the atmosphere, or capture CO_2 directly from the ambient air and store or use the captured CO_2) may claim a refundable investment tax credit ("**CCUS Tax Credit**") valued at up to 60% of "eligible expenses" (*i.e.*, costs incurred to purchase and install "eligible equipment" used solely in the project).

Eligible expenses incurred during 2022 through 2030 would be subject to the following CCUS Tax Credit rates:

- 60% for eligible capture equipment used in a direct air capture project;
- 50% for all other eligible capture equipment; and
- 37.5% for eligible transportation, storage, and use equipment.

The CCUS Tax Credit rates are reduced by half for eligible expenses incurred after 2030 through 2040. Budget 2022 contains additional detail on what constitutes "eligible equipment" and "eligible projects". Of note, an eligible project must be a "new project" and the CCUS project must be in Canada and the CO_2 must be captured in Canada (although it can be stored or used outside of Canada).

Unfortunately, enhanced oil recovery projects are ineligible, which is consistent with the original proposals but a significant missed opportunity. Enhanced oil recovery is one of the very few commercial uses for CO_2 and its exclusion from the CCUS Tax Credit effectively means that less CO_2 will be captured for more money than otherwise would be the case. The exclusion of

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enhanced oil recovery is also in marked contrast to the US federal tax credit for CCUS, leaving Canadian industry at a continuing competitive disadvantage when it comes to CO_2 policies. Nevertheless, Budget 2022 appears to leave the door open a crack for some enhanced recovery projects, in noting that other CO_2 uses could become eligible in the future if permanence of storage can be demonstrated and no incremental emissions result from the use of the product that is produced (*e.g.*, presumably to make plastics and other products that will not be combusted).

CCA Classes – Eligible Equipment

In addition to the CCUS Tax Credit, taxpayers are also eligible to claim capital cost allowance ("**CCA**") on eligible equipment. Eligible equipment plus equipment for monitoring and tracking CO_2, buildings or other structures that solely support an eligible project, and costs of converting existing equipment for use in an eligible project or refurbishing eligible equipment will be included in two new CCA classes which also benefit from the accelerated investment incentive (*i.e.*, enhanced first year CCA). The first new CCA class will include capture, transportation and storage equipment with an 8% rate on a declining-balance basis and the second new CCA class will include equipment using CO_2 in an eligible use with a 20% rate on a declining-balance basis. It is not clear from the budget materials if or how the credit will impact available depreciable pool balances or interact with other existing tax rules relating to other tax credits.

CCA Classes – Exploration and Development Expenses

Exploration and development expenses associated with storing CO_2 will also have their own amortization pools (referred to in the budget materials as CCA classes but described in terms that are reminiscent of the existing resource pool rules). Although these expenses are not eligible expenses for purposes of the CCUS Tax Credit, intangible exploration expenses will be fully deductible and development expenses will be deductible at a rate of 30% on a declining-balance basis.

<u>CCUS Tax Credit – Notable Design Features</u>

- **Refundable Up Front.** The CCUS Tax Credit is refundable and can be claimed in taxation years when the expenses are incurred, regardless of when the eligible equipment becomes available for use. The eligible project does not need to be operating and capturing CO_2 before a taxpayer is eligible for the CCUS Tax Credit. This feature addresses one of the key submissions of numerous stakeholders and is expected to make the credit an important financing consideration for potential CCUS projects, even though it remains unclear to what extent projects will be financially viable without additional federal or provincial support and/or certainty with respect to long-term carbon pricing.

- **Greater Certainty.** Proposed projects may (and must if they are expected to have eligible expenses of $100 million or more) undergo an initial review process. After the initial review, and as soon as possible after each year-end, eligible expenses are to be verified by Natural Resources Canada in order for the refund to be provided upon filing the tax return for the year. These features appear to be intended to address another key submission of numerous stakeholders, although it remains to be seen how effective it will be in practice, in providing the degree of certainty required for projects to proceed. Providing additional certainty with respect to the economics of these long-term projects also aligns with the Government's 2030 Emissions Reduction Plan released in March.

- **Eligible Jurisdictions.** Except for CO_2 stored in concrete, initially, the CCUS Tax Credit will only be available to eligible projects that store the CO_2 in Alberta or Saskatchewan, being the most advanced provinces with respect to CCUS from a regulatory perspective. Eligibility is expected to expand to other provinces as their regulations catch up.

- **Knowledge Sharing and Climate Risk Disclosure.** Larger CCUS projects will be required to contribute to public knowledge sharing to be eligible for the CCUS Tax Credit. Further, a climate-related financial disclosure report, describing (among other things) how the taxpayer will help to achieve net zero by 2050, will be required in order to be eligible for the credit. Details on these processes are to be provided at a later date.

- **Clawback of CCUS Tax Credit Amounts.** Taxpayers may have to repay CCUS Tax Credit amounts where the portion of CO_2 put towards an ineligible use is more than what was in the initial project plans. Eligible projects will be assessed at five-year intervals, to a maximum of 20 years, and will be based on the total amount of CO_2 going to an ineligible use over the five-year period under assessment. Taxpayers will be required to track and account for CO_2 being captured and the portions that end up going to eligible and ineligible uses. Details of the recovery mechanism were not included in Budget 2022 and are to be released at a later date.

- **Transfers of Eligible Equipment.** Subsequent owners of eligible equipment for which the CCUS Tax Credit has been claimed by a previous owner are unable to claim the CCUS Tax Credit.

The proposed CCUS Tax Credit is an important first step in providing the project funding and certainty required for many large scale CCUS projects in the energy industry to proceed. Those interested in the economics and feasibility of potential CCUS projects will be keenly interested in the additional detail surrounding the issues noted above to fully understand its potential impact and benefit.

If you have any questions about the new CCUS credit or any other proposed measures in Budget 2022 and their impact, please contact one of our lawyers.