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The 2018 Federal Fall Economic Statement and the Oil and Gas Sector

December 27, 2018

The Government of Canada released the 2018 Fall Economic Statement on November 20, 2018, which included tax proposals to accelerate deductions on capital assets in response to U.S. tax reform.

The 2018 Fall Economic Statement released measures focused on increasing Canadian competitiveness in the wake of deep corporate tax cuts by the United States. On November 20, 2018 the Government of Canada proposed the following changes to the tax treatment of capital investment:

1. Allowing for the immediate 100 per cent write-off of newly acquired equipment used in manufacturing and processing (M&P) and specified clean energy equipment; and
2. Introducing the “Accelerated Investment Incentive” (AII), which allows an accelerated capital cost allowance (CCA) for capital investments made by businesses, including Canadian development expense (CDE) and Canadian oil and gas property expense (COGPE).

The intention of these measures is to encourage businesses to invest in assets that drive business growth and free up capital.

The tax proposals have been met with some criticism within Canada’s oil and gas sector because the newly available tax deductions are useful only to the extent that the applicable taxpayer has current or near-term taxable income against which to offset the deduction. Given the challenges of low Canadian oil and gas prices, many oil and gas companies are not currently taxable. Many feel the government could have done more to incentivize investment, such as broadening the flow-through share program to allow companies in a loss position to flow enhanced deductions up to their taxable investors. The tax proposals also do not directly address the broad-based reduction in U.S. corporate tax rates.

That being said, we considered the rules in an effort to reveal some opportunities for those in the oil and gas sector. Of particular note are the following:

1. Companies involved in manufacturing and processing within the oil and gas sector may be able to take advantage of the 100 per cent first year deduction for M&P equipment.
2. The AII provides enhanced deductibility for most other capital assets (*e.g.* trucks, buildings, infrastructure and equipment). The AII provides an additional tax incentive for many mid-stream and downstream oil and gas companies that are currently in a taxable position.
3. The AII also includes an additional 15 per cent deduction for CDE incurred in the development of oil and gas properties. Investors in flow-through shares can take advantage of this enhanced deduction, resulting in a 45 per cent deduction in year-1. Combined with the significant increases to personal tax rates over the past several years, the tax savings resulting from CDE flow-through shares are now much more significant than several years ago.
4. Purchasers of assets from oil and gas companies may be able to take advantage of the AII on acquired depreciable capital property, including certain intellectual property, as well as slightly increased COGPE deductions. The enhanced tax deductions should work their way into the buyer's financial model and may make investment opportunities more attractive. This may incentivize profitable companies (*e.g*. more mature or integrated companies) to acquire assets from companies that are not currently taxable (*e.g.*, early stage companies).

Some of these rules are described in more detail below.

Immediate Write-off for Newly-acquired M&P or Clean Energy Equipment

While certain M&P equipment and clean energy equipment already have accelerated CCA rates, the new rules dramatically accelerate the timeline for deductibility with full first-year expensing for the cost of: (a) machinery and equipment used for the manufacturing and processing of goods; and (b) specified clean energy equipment.

The new rules apply to eligible M&P and specified clean energy equipment acquired after November 20, 2018, and available for use before 2028. The enhanced CCA deduction available to companies in the first year such property becomes available for use will be 100 per cent for property which is available for use before 2024. The first-year deduction allowance will gradually be phased out after 2023, with a rate of 75 per cent for 2024 and 2025, and a rate of 55 per cent for 2026 and 2027.

Companies in the resource sector can benefit from these rules by immediately depreciating certain investments they make in the clean energy sector as well as certain assets purchased for manufacturing or processing of goods where oil and gas, or a by-product thereof, is an input. Similarly, manufacturers of equipment for the oil and gas sector may qualify for enhanced deductions with respect to their capital assets. Oil and gas companies that have a "green energy" component to their activities, such as co-generation and specified-waste fueled systems, may also qualify for immediate 100 per cent tax deductions under the tax proposals.

Accelerated Investment Incentive (AII)

The new AII rules provide an increased first-year CCA deduction for most other depreciable property acquired after November 20, 2018, and available for use prior to

2028. A similar incentive was provided for CDE and COGPE investments in the oil and gas sector.

For eligible property which becomes available for use before 2024, the AII provides for a first-year deduction of 1.5 times the standard CCA deduction for any given CCA class on the net additions to that class. The proposals also suspend the half-year rule, which reduced the deduction by 50 per cent for the year that the capital asset was acquired. As a result, most capital assets will get **three times** the previously permissible first-year deduction.

For example, on a $1,000,000 depreciable property in a class with a 30 per cent deduction, the first-year deduction prior to the 2018 Fall Economic Statement would be $1,000,000 x 30 per cent x 0.5 = **$150,000**. However, under the proposed rules, the first-year deduction would be increased $1,000,000 x 30 per cent x 1.5 = **$450,000**.

The accelerated deduction is pro-rated for short taxation years. The AII also includes a phase-out period for property which becomes available for use after 2023 but before 2028. The suspension of the half-year rule also applies to the phase-out period.

Specific to the oil and gas sector, the tax proposals include additional first-year deductions for CDE and COGPE. CDE has historically been deductible at a rate of 30 per cent per year on a declining balance basis, but the accelerated incentive will provide an additional 15 per cent deduction in year-1 for expenses incurred after November 20, 2018 and before 2024, and an additional 7.5 per cent deduction in year-1 for expenses incurred after 2023. Similarly, COGPE has historically been deductible at a rate of 10 per cent per year on a declining balance basis, but the accelerated deduction provides an additional 5 per cent for expenses incurred between November 20, 2018 and before 2024, or an additional 2.5 per cent after 2023. Although this only provides one and a half times the previous deduction rather than three times the previous deduction, oil and gas expenses are not subject to the half-year rule. Notably, CDE with the enhanced 45 per cent year-1 deduction can be renounced to investors under flow-through share agreements entered into after November 20, 2018. This may help exploration and development companies that are not currently in a taxable position raise capital for investment purposes.

Companies engaged in mid-stream and downstream activities should consider whether the accelerated depreciation can be of use to them. Specifically, the deduction may be useful for capital-intensive projects, such as pipelines and other energy infrastructure projects. Producers and services companies may be able to take advantage of enhanced tax deductibility on new capital assets, such as trucks and buildings. Strategic investors may also be able to take advantage of these deductions when purchasing assets, including certain intellectual property, from another arm’s length entity.

Restrictions

In using these deductions, it is important to note that they can only be claimed in the first year that a property becomes available for use. Also, the property cannot be purchased from a non-arm’s length vendor or on a rollover basis, and the CDE and COGPE incentives do not apply to successored CDE and COGPE. Further, the total amount of depreciation which can be taken over the useful life of the property does not change, so the advantage of the new incentives comes from freeing up capital, through reduced taxes, much earlier than would otherwise be possible.

Conclusions

Although the new immediate write-off and AII credits were not expressly targeted to the oil and gas sector and are only partially useful to companies that are not in a taxable position, and other factors (*e.g*. additional pipeline capacity) may be necessary to ultimately change an investor's decision, the new tax measures may be a step in the right direction to making Canada a more attractive place to invest in the oil and gas sector than it was prior to November 20, 2018.

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