

June 23, 2011

Elizabeth McDonald
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Dear Ms. McDonald:

Re: Eligibility of Input Tax Credits

You have asked us to provide our opinion on whether certain micro producers of electric power who construct and install solar photovoltaic equipment attached to their homes (“Homeowner Micro Producers”) are eligible for input tax credits (“ITCs”) pursuant to the *Excise Tax Act* (Canada) (the “ETA”) in respect of harmonized sales tax (“HST”) paid by such Homeowner Micro Producers on certain taxable supplies acquired in the course of supplying power under Ontario’s MicroFIT Program (the “MicroFIT Program”).

We understand that certain of your members, who are participants in the MicroFIT Program and who construct and install solar photovoltaic equipment attached to their houses, have been reassessed or are proposed to be reassessed to deny ITCs essentially on the basis that the solar panels are an improvement to the participant’s property and therefore certain input tax credit denial rules apply to deny HST ITCs to the Homeowner Micro Producer.

It is important to note that the MicroFIT Program involves direct sales by the consumer into the power grid on which HST is charged and even if the Homeowner Micro Producer is producing electricity at the site, all of the electricity they are using for their own enjoyment is purchased from the power authority on which the Homeowner Micro Producer is paying full HST. There is no circumstance in which the power that is produced on the site is being used directly by the Homeowner Micro Producer unless that power has first been sold to the power authority and then repurchased from the power authority as a taxable supply to the user. Accordingly, in the proposed audit there is an incidence of double taxation which occurs because the Homeowner Micro Producer does not obtain ITCs on equipment which is 100% used in a commercial activity carried on by the Homeowner Micro Producer. This is not only contrary to the policy of the ETA as a whole as a value added tax, but it also results in a significant disincentive for adopters of renewable energy to buy and produce electricity.

I. OPINION

We are of the opinion that the Homeowner Micro Producers should be entitled to ITCs pursuant to the ETA in respect of HST paid on taxable supplies acquired by the Homeowner Micro Producers under the facts and circumstances described below.

II. FACTS

1. Homeowner Micro Producers are participants in the Ontario Power Authority's ("OPA") MicroFIT Program for renewable energy in Ontario .
2. The MicroFIT Program encourages the development of "microscale" renewable energy projects across Ontario.
3. Rather than build and develop electricity infrastructure directly in Ontario, Ontario has been pursuing programs that will provide incentives for the private sector to build and invest in such technology to increase the amount of power that can be produced in Ontario. The electricity which is produced will all be sold to Ontario under taxable transactions. These programs are not intended to assist Homeowner Micro Producers to produce for their own use.
4. Solar photovoltaic equipment ("Solar Panel") installations on homes and small businesses is expected to be the most common MicroFIT project, however the program is available to other types of renewable technologies.
5. The renewable energy projects that qualify for the MicroFIT Program produce electricity which is sold to the OPA and which is connected to the province of Ontario's electricity distribution system (the "Grid").
6. The MicroFIT Program is based upon the OPA providing a fixed price of electricity to the Homeowner Micro Producer. Thus, only projects in which the power (all the power) is sold to the OPA are eligible for the MicroFIT Program.
7. Projects eligible for the MicroFIT Program will receive:
 - (a) a long-term contract for the payment of electricity produced from the renewable energy project; and
 - (b) a fixed price for the full term of the contract.
8. Since the sale of electricity is a supply of a commercial service and sellers would be required to be registered for HST (unless they otherwise meet the small supplier requirements), we have assumed, for the purposes of this opinion, that each of the Homeowner Micro Producers is registered for the purposes of HST and is collecting and remitting HST in respect of all electricity produced by the Solar Panels.
9. Each Homeowner Micro Producer collects HST on the supply of electricity to the Grid and remits such HST to the Minister in accordance with the provisions of the ETA. The supply of electricity is a "taxable supply" and not an "exempt supply", as each of these terms is defined under the ETA.

10. All the electricity that is produced by the Project is sent into the Grid and none of the electricity is used for the personal consumption and use of the Homeowner Micro Producer.
11. Homeowner Micro Producers may incur any of the following costs in developing, installing and operating the project: cost of Solar Panels, installation, inspection, permits and approvals, connection costs, account charges and metering fees and legal, accounting and insurance costs (“Input Costs”).
12. Homeowner Micro Producers pay any applicable HST on their Input Costs.
13. Homeowner Micro Producers have the option of owning their own Solar Panels or leasing the equipment required for their project. In either case, Homeowner Micro Producers are responsible for any Input Costs incurred, including any applicable HST.
14. According to the “Micro Feed-In Tariff Program, Program Overview”¹ published by the OPA (“MicroFIT Overview”), prices are set at a level intended to enable project owners to recover the costs of the projects, as well as to earn a reasonable return on their investment over the term of the contract. This is similar to any other power producer in the province of Ontario who is intending to sell electricity into the Grid and earn sufficient return to cover their costs of production.
15. Solar Panels are often associated with buildings: either integrated into them, mounted on them or mounted nearby on the ground. Solar Panels are most often retrofitted into existing buildings, usually mounted on top of the existing roof structure or on the existing walls. Alternatively, Solar Panels can be located separately from the building but connected by cable to supply power for the building.
16. We understand that the degree of affixation of the equipment to the building or contiguous land is low and that the equipment can be unbolted in a very short period of time with minimal use of tools to remove it. Removing the equipment would not diminish the use or enjoyment of the building or contiguous land to which the equipment is attached. We also understand that under the MicroFIT Program, there is no obligation on the Homeowner Micro Producer to maintain the equipment in place and they could, at any time, remove the equipment and stop producing.

III. ISSUE

Are Homeowner Micro Producers eligible to claim ITCs pursuant to the ETA in respect of HST paid on Input Costs to develop and install the Solar Panels?

IV. LEGISLATION AND CRA STATEMENTS

We understand that the Canada Revenue Agency (the “CRA”) has been denying and/or proposing to deny ITC claims on the basis of subsection 208(4) of the ETA. We discuss the application of subsection 208(4) below. However, we first discuss whether, in the absence of subsection 208(4), such Input Costs are eligible for ITCs.

¹ <http://microfit.powerauthority.on.ca/pdf/microFIT-Program-Overview.pdf>.

The general rule for ITCs, pursuant to subsection 169(1), is that a person is entitled to an ITC in respect of HST paid on a property or service to the extent of the percentage that the property or service is used in making a supply in the course of the commercial activities of the person. However, special rules apply where the property or service is for use, either wholly or partially, to improve capital property of the person. In such case, paragraph 169(1)(b) of the ETA limits the ITCs to the proportion that the person used the improved capital property in the course of commercial activities of the person immediately after the property was acquired. Subsection 169(1.1) provides for a pro-rating between the improvement to the capital property and the portion that was not treated as an improvement.

Pursuant to subsection 169(1) of the ETA, in order for a person to claim an ITC in respect of HST on a supply acquired during a particular reporting period of the person, among other things, the person must have been registered for the HST pursuant to the ETA, the HST in respect of the supply must have been paid or become payable and the HST must have been incurred as part of the person's commercial activities. As outlined in the Facts listed above, the Homeowner Micro Producers are registered for HST purposes for the reporting periods in question and HST was paid or became payable in respect of property and services acquired during such reporting periods.

The term "Commercial activities" is broad and generally includes any business carried on with a reasonable expectation of profit, except the extent to which the business involves the making of exempt supplies. As noted above, the supply of electricity is a taxable supply pursuant to the ETA. Therefore, the supply of electricity to the Grid should be considered to be a commercial activity within the meaning of the ETA. Accordingly, but for the application of subsection 208(4) as described below, the Homeowner Micro Producer would be entitled to ITCs on expenses incurred in respect of its "commercial activities". In this case, the charging for electricity delivered (and sold) to the grid.

Application of Subsection 208(4)

Subsection 208(4) of the ETA is an anti-avoidance rule to limit ITCs for property added to real property (i.e., an improvement) where the real property is used more than 50% for personal use. Subsection 208(4) will apply to limit an ITC on equipment purchased if the Homeowner Micro Producer has paid tax for the acquisition of an "improvement" to a personal use property - in this case, the Homeowner Micro Producer's house and contiguous land that relates to the use and enjoyment of the house. Consequently, so long as the Solar Panels are not an improvement to the house or continuous land, ITCs are available. Subsection 208(4) provides:

Where an individual who is a registrant acquires, imports or brings into a participating province an improvement to real property that is capital property of the individual, the tax payable by the individual in respect of the improvement shall not be included in determining an input tax credit of the individual if, at the time that tax becomes payable or is paid without having become payable, the property is primarily for the personal use and enjoyment of the individual or a related individual.

The issue raised by the proposed assessment is whether the Solar Panels are an "improvement" to the Homeowner Micro Producer's house or contiguous land so that ITCs are denied pursuant to subsection 208(4) of the ETA. Our analysis of this issue is described below.

For the purposes of the ETA, the term “improvement” is defined as follows:

“improvement”, in respect of property of a person, means any property or service supplied to, or goods imported by, the person **for the purpose of improving the property**, to the extent that the consideration paid or payable by the person for the property or service or the value of the goods is, or would be if the person were a taxpayer under the *Income Tax Act*, included in determining the cost or, in the case of property that is capital property of the person, the adjusted cost base to the person of the property for the purposes of that Act.

We have assumed, for the purposes of this opinion, that the properties in issue are all capital properties to the Homeowner Micro Producer. In the application of subsection 208(4) of the ETA, the reference to property (i.e., the property being used personally) must be a reference to Homeowner Micro Producer’s home or residence and the contiguous land to such house. As we understand, Solar Panels may be installed on the house or attached to a concrete pad on the contiguous land. The house and the contiguous land are real property and, for a homeowner will almost always be capital property. The issue, therefore, is whether or not the equipment is an improvement.

The definition of “improvement” referred to above has two parts - the property must “improve” another property and if it does, to the extent that it is added to the cost of the improved property, it is an improvement for the purposes of the ETA. As stated above, for the purpose of subsection 208(4), the properties that are relevant are the house and the contiguous land.

In its ordinary context, an improvement would connote a “betterment” or to increase the value of a property. From this, the issue raised is: does the Solar Panel better the house or contiguous land? Does it increase its value as a house or land? In other contexts, CRA has analogized the test to whether the expense creates a fixture. In the context of GST on capital borrowings, CRA stated in Headquarters Letter 11950-1 — GST/HST Interpretation — GST on Capital Building Construction:

An item that would ordinarily be considered to be personal property would generally be considered to be an improvement to capital real property only if it becomes a fixture to the real property.

In this context, Solar Panels that are used in the MicroFIT Program are not intended by the Homeowner Micro Producer to enhance their own use or enjoyment of their real property; rather, they are placed on the property as a business asset to produce income from the equipment directly. This is to be contrasted with the Solar Panels, which might be used in the use or operation of the Homeowner Micro Producer’s own home or business. For example, in a remote area which is not connected to the Grid, a homeowner may purchase Solar Panels which they use to produce electricity for their own use on their property. Where this is the source of electricity for the property, this type of equipment appears to be intended to enhance the use and enjoyment of the house or business property similar to installing a furnace or an air conditioner. However, in the MicroFIT Program where the electricity is being sold in a commercial activity to the power Grid and is not directly being used for the purposes of the consumer’s home and, in fact, could be removed without any change in the function or operation of the person’s home or business, we view the intent of installing that equipment as not to improve the value of the real property (i.e., the land and building), but to gain or produce income from stand alone equipment.

We are not aware of any specific statement by the CRA either in the income tax context or that of the GST/HST with respect to the characterization of electrical generation equipment - either photovoltaic equipment or wind turbines as either being personal property or a fixture.

The law of fixtures in Canada is generally that equipment that becomes affixed to the land is treated as a fixture and therefore part of the underlying fee simple of the land. Thus, vis-à-vis the rights of a third party purchaser for value or a mortgagee, fixtures which are attached to the land would be conveyed with the land and, therefore, be considered to be an interest in real property to such persons. However, as between a landlord and tenant, it is permissible for the landlord and tenant to contract between the two of them to treat something which has become affixed to the land as remaining as personalty. Moreover, something that is affixed to the land can by contract be sold to a person by giving them the right to remove the thing from the land which would normally not be considered to be an interest in land but rather a contractual right to remove the property.

The case law that relates to fixtures in Canada is uncertain. Cases go in different directions depending on the facts and circumstances, and even cases which would appear to be very similar have been decided for and against the conclusion of being a fixture. Some of the cases are also based upon specific statutory provisions (such as those relating to provincial retail sales taxes and provincial land transfer taxes). Factors that have been considered include the degree of permanence, the degree of affixation, the intention of the parties as to whether the equipment that is located is intended to improve the value of the land or is to benefit the person who places it on the land, the relative ease of removal and the amount of damage that might be done in removing such property. The result can be different in different settings — cases dealing with personal use property in residential real estate (and the intentions of such persons) may not equally apply to commercial settings. In its simplest form, a painting which is bolted to a wall and is, therefore, affixed would not usually be considered to lose its character of personal property and become an interest in real property. On the other hand, a fan similarly affixed likely would be considered a fixture.

Stack v. T. Eaton Co. (1902), 9 O.L.R. 335, is the seminal case in Ontario governing whether a given object is a chattel or a fixture. In *Stack v. Eaton*, a case involving shelving and lighting fixtures in a convenience store, the Ontario Divisional Court enunciated a five part test. Although the five part test formulated in *Stack v. Eaton* is routinely cited in many Ontario decisions and textbook treatments on point that have come after that decision, the formulation of the test in *Stack v. Eaton* has been criticized as being “unhelpful”. Instead, most of the Ontario cases that have been decided after *Stack v. Eaton*, although expressly citing *Stack v. Eaton*, have adopted, instead, the following two-branch version of the test:

1. The degree of affixation: The more portable and less permanently affixed the object is to the building, the greater the object’s likelihood of remaining a chattel instead of becoming a fixture. Conversely, the less portable and more permanently affixed the object is to the building, the greater the object’s likelihood of becoming a fixture rather than remaining a chattel.
2. The purpose of affixation: The more it appears as if the object was affixed to the building for the purposes of making the object function better, then the greater the object’s likelihood of remaining a chattel instead of becoming a fixture. Conversely, the more it appears as if the object was affixed to the building for the purposes of making the building itself more suitable for the building’s intended purpose, then the greater the object’s likelihood of becoming a fixture rather than remaining a chattel.

In the context of the Solar Panels, we think that the better view is that these amounts would not be considered to be fixtures. A significant aspect of the test of being a fixture is the intention of the parties with respect to whether they are to enhance the use or function of the property. These particular Solar Panels which are being used as part of the MicroFIT Program are not intended to enhance the use or value of the real estate as real estate. Instead, the taxpayer is intending to earn income from the equipment as standalone equipment.

In the case of *Ontario Hydro v. Ministry of Revenue* (1996) 5008 E.T.C., one of the issues was the characterization of microwave telecommunication systems at a hydro reactor. The equipment consisted of components secured to metal rails and bolted to the floor of a small building which could be easily disassembled, but were also connected to two exterior mounted antennae. The equipment and antennae were considered not to be fixtures even though they were attached to a building on the basis that the intention that the person placing them on the land was to earn income from the equipment and they did not improve the function or use of the real property. The court stated:

In this case, the microwave equipment did not improve the building in which it was installed. It was installed to enable Hydro to carry out its business of producing and distributing electricity. Therefore, it constitutes a chattel. The retail sales tax was properly paid.

Even if the property is considered to be a fixture, the second and, in this case, more important, issue is to what extent is the cost of the Solar Panels added to the adjusted cost base of the Homeowner Micro Producer of the property (i.e., the building and contiguous lands) for the purposes of the *Income Tax Act* (Canada). In this case, the cost of the Solar Panels is not added to the cost of the building or the contiguous land and hence the equipment is not an “improvement” as defined for the purposes of the ETA.

A Solar Panel is Class 43.2 property because:

1. it was acquired after February 22, 2005 and before 2020;
2. it is not reconditioned or remanufactured equipment;
3. it is electrical generating equipment under Class 43.1.;
4. it is situated in Canada as required by Class 43.1;
5. it is acquired by use of the taxpayer to produce income;
6. it has not been used for any other purposes before being acquired by the taxpayer;
7. it is part of a system being used by the taxpayer to generate electrical energy; and
8. it is a fixed location for the Solar Panels used by the Homeowner Micro Producer for the purpose of generating electric energy from solar energy.

The CRA has provided clarification with respect to Solar Panels on its website page entitled “Ontario’s FIT/microFIT Programs”², in which it states as follows:

5. Can a Participant deduct any costs associated with the purchase and installation of the renewable energy property?

Generally, costs associated with the purchase and installation of renewable energy property are considered as capital costs of depreciable property, which are deducted over a period of several years, based on a prescribed percentage. This deduction is referred to as capital cost allowance (CCA). Generally, amounts paid for legal, engineering, installation, and other fees that relate to the acquisition of the renewable energy property, would be included as part of the capital cost of the property.

In general, a Participant would include the capital costs of a renewable energy property in Class 43.1 or 43.2 for CCA purposes, provided that the property meets the requirements of these Classes. These classes provide an accelerated CCA rate for specified clean energy generation equipment, as discussed in Question 6 below.

The renewable energy property included in these Classes is generally the same with the exception that renewable energy property acquired after February 22, 2005 and before 2020 is classified as Class 43.2 property.

As a Class 43.2 property, the value of the Solar Panels would not form part of the capital cost allowance for the building, which would be under Class 1 (which includes within it a building or other structure or a part of it including any component parts, such as electric wiring, plumbing, sprinkler systems, air conditioning equipment, heating equipment, lighting fixtures, elevators and escalators, but specifically excluding in paragraph (k) electrical generating equipment). Electrical generating equipment could also fall under Class 8 if the taxpayer is not a person whose business is the production of electrical energy for the use of or distribution to others. However, under these circumstances, the taxpayer is selling this electricity into the Grid and, as a consequence, the taxpayer is using it in a business. This, the cost of the Solar Panels will not form part of Class 8.

The only property relevant to subsection 208(4) of the ETA that is used personally is the Homeowner Micro Producer’s house or contiguous land, and no part of the cost of the Solar Panels is added to the cost of either such property.

VI. CONCLUSION


Based on the foregoing, we are of the opinion that it is more likely than not that the Solar Panels are not fixtures at all on the basis that the intention of the Solar Panels is not to improve the land or building of the Homeowner Micro Producer. Moreover, and more importantly, we are of the view that within the definition of improvement, even if it were a fixture, the cost of the Solar Panels is not added to the cost of the Homeowner Micro Producer’s house or contiguous land within the definition of improvement and therefore subsection 208(4) of the ETA does not apply and the ITCs should be allowed.

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² <http://www.cra-arc.gc.ca/tx/bsnss/thrtpcs/nt-ft/q1-eng.html>.

This opinion is solely for the benefit of the Canadian Solar Industries Association ("CanSIA") for the purpose of assisting its members with respect to audits by the CRA of CanSIA members and their existing customers who have installed equipment under the MicroFIT Program ("Customers"). No reference may be made of this opinion in any marketing material, prospective summary or otherwise with the intent to indicate to any prospective investor in a solar project as to the tax treatment of such investment. The opinion may, however, be shared by CanSIA with its members and by its members to Customers and their legal and accounting advisors with respect to a tax audit of such Customer. This opinion is not a substitute for legal advice to any particular Customer or CanSIA member.

Yours truly,



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