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CLIENT ALERT

IRS Issues Welcomed Guidance on Carbon Capture Tax Credit

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The IRS has issued much-awaited guidance regarding the Section 45Q credit. In Revenue Procedure 2020-12, the IRS provided a safe harbor under which the IRS will treat partnerships as properly allocating the Section 45Q credit to investor-partners. In Notice 2020-12, the IRS issued guidance and safe harbors on the beginning of construction under Section 45Q, which permits credits only for projects for which construction begins before January 1, 2024. Taxpayers await proposed regulations on Section 45Q, which are expected to cover technical issues such as recapture and alternatives for secure geological storage.

Section 45Q Background

As amended by the Bipartisan Budget Act of 2018, Section 45Q provides tax credits for (1) the capture and sequestration of carbon dioxide and other carbon oxides from industrial sources that, absent capture and utilization or sequestration, would be vented to the atmosphere, and (2) the capture and utilization or sequestration of carbon oxides directly from ambient air. New Section 45Q provides enhanced credits for carbon oxides captured using carbon capture equipment and sequestered in secure geologic storage. The carbon capture equipment must be placed in service at a qualified facility on or after February 9, 2018 and the qualified facility's construction must begin before January 1, 2024. Credits are also allowed at a lower level for carbon oxide used as a tertiary injectant in a qualified enhanced oil recovery (EOR) project and disposed of in secure geological storage.

By encouraging both CO2 emitters to capture and sequester CO2 and EOR operators to use CO2 from industrial sources, the credits incentivize the capture and sequestration of CO2 from industrial sources, which would otherwise escape into the atmosphere.

Carbon capture projects require significant investments in capture equipment and infrastructure. Absent Section 45Q credits, it is often non-economic for taxpayers to capture and sequester CO2 or other carbon oxides. Moreover, sequestration of CO2, other than through EOR or other industrial uses, may have no associated revenue stream. Permitting emitters and EOR operators to partner with investors that are willing to invest as a result of the Section 45Q credit may encourage owners of capital to fund significant carbon capture projects that would otherwise be non-economic. The Revenue Procedure provides a welcomed safe harbor to assure investor partners that otherwise qualifying Section 45Q credits will be available.

Investors may struggle to complete carbon capture projects before the January 1, 2024 deadline and will need to establish that they have begun construction before that date. The Notice provides welcomed guidance and a safe harbor concerning the beginning of construction so that large carbon capture projects may be assured of qualification for Section 45Q credits, even if the project is not completed by January 1, 2024.

The Notice permits taxpayers to rely on the secure geological storage provisions of Notice 2009-83, as modified by Notice 2011-25, until additional guidance is issued. Effectively, this means that EOR operators may establish secure geological storage by using Class II oil wells and satisfying Subpart RRof the Environmental Protection Agency Greenhouse Gas Reporting Regulations, usually by obtaining an EPA-approved Monitoring, Reporting, and Verification (MRV) plan. Non-EOR sequesterers must use Class VI wells and satisfy the Subpart RR requirements.

The Revenue Procedure and Notice are a good start toward making large investor-funded projects a reality.

Revenue Procedure 2020-12

Investors have been reluctant to invest in carbon capture projects because of the risk that, even if the project qualified for the Section 45Q credit, the IRS would disallow the allocation of the credit to investor-partners. Generally, to be recognized for tax purposes, a partner must make an investment in the partnership, bear economic risks, and have a reasonable expectation of pre-tax profit. Tax professionals expected investors to be recognized as bona fide partners even without the expectation of pre-tax profit, similar to investor-partners in wind and solar energy projects, but such recognition was nonetheless uncertain. Without guidance, investor-partners have remained wary of committing significant capital.

Revenue Procedure 2020-12 responds to these concerns. The Revenue Procedure provides a safe harbor for investors—that is, if the carbon capture project and its investors follow the Revenue Procedure, the IRS will respect the investors as partners and allocations of Section 45Q credits to the investors. The Revenue Procedure is similar to the safe harbor for wind energy projects in Revenue Procedure 2007-65.

The safe harbor contemplates that there will be (i) a partnership (the Project Company) that owns the carbon capture equipment and claims the credit, (ii) a developer, and (iii) investors. Additionally, the safe harbor acknowledges that other parties may also be present, including lenders, emitters, construction contractors, and offtakers of processed carbon oxide who sequester the carbon oxide in secure geological storage.

Rules for developers

The safe harbor requires that the developer have, at a minimum, a one percent interest in the material items of the Project Company's income, gain, loss, deduction, and credit throughout the existence of the Project Company. Additionally, the developer cannot lend the investor funds or guarantee the investor's debt, which would allow the investor to acquire an interest in the Project Company.

Rules for investors

Most of the safe harbor rules relate to investors. Investors may be initial partners or may join later, either by acquiring an interest directly from the Project Company or from another partner. During their period of ownership, the investor's interest in partnership items of income, gain, loss, deduction, and credit must remain at least five percent of the interest that it holds when its interest is the largest.

The investor must make a minimum unconditional investment in the Project Company equal to at least 20 percent of the sum of the investor's fixed capital investment plus any reasonably anticipated contingent investment required under the partnership agreement. More than 50 percent of the sum of the fixed investment plus reasonably anticipated contingent investments must be fixed and non-contingent (down from a 75 percent requirement for wind and solar projects). Contributions to pay ongoing operating expenses will not be treated as part of the contingent investment for these purposes.

The investor's interest must be a bona fide equity interest, not contingent on tax benefits, and must be contingent on the partnership's net income, gain, and loss. The investor may not be protected against loss by the developer, other investors, an emitter, an offtaker, or related persons to the same.

Under the safe harbor, no one may have a call option on the investor's interest; the investor may have a put right so long as the put price does not exceed the fair market value of the investor's interest at the time of exercise.

Rules re guarantees

As expected, Revenue Procedure 2020-12 prohibits anyone from guaranteeing the investor's Section 45Q credits. Likewise, no one can guarantee repayment of the investor's contributions due to an inability to claim the credit. However, the safe harbor does allow certain project-related guarantees: (i) performance of acts necessary to claim the credit; (ii) avoidance of acts or omissions that would prevent claiming the credit or would cause recapture; and (iii) supply-or-pay, take-or-pay, supply-all, take-all, and securely-store-or-pay provisions in long-term contracts on arm's-length terms with emitters and offtakers.

Given the mid-stream nature of many anticipated carbon oxide capture projects, the ability to assure supply and offtake of carbon oxide is a critical difference from the wind project safe harbor. Carbon capture equipment must be installed long-term at an emitter's site and that site may be located near a single offtaker. There is no established market for carbon oxide sequestration. Without the ability to contract for long-term supply and offtake, investments in carbon capture projects at industrial facilities would not be economically feasible.

Rules re partnership allocations

To be respected under the safe harbor, the Project Company's allocation of Section 45Q credits must comply with Section 704(b) and Treas. Reg. § 1.704-1(b)(4)(ii). If the Project Company generates income from its carbon capture project, it must allocate the Section 45Q credit in the same proportion as the partners' respective distributive shares of the income. If the Project Company does not generate income from its carbon capture project, it must allocate the Section 45Q credit in the same proportion as the partners' respective distributive shares of the losses and deductions.

Example

The Revenue Procedure includes an example of qualified partnership allocations under a so-called "flip structure." The interests of the developer and investor shift over three periods: (i) the period until the developer recovers its investment; (ii) the period after the developer has recovered its investment but before the investor reaches the agreed after-tax internal rate of return (i.e., the flip point); and (iii) the period after the flip-point. The safe harbor permits the following allocations in this example:

	Developer		**Investor**	
	Cash	**Gross Income/Loss and Section 45Q Credits**	**Cash**	**Gross Income/Loss and Section 45Q Credits**
Period 1	100%	1%	0%	99%

Period 2	0%	1%	100%	99%
Period 3	95%	95%	5%	5%

Permitting a "flip" after the investor reaches an agreed after-tax rate of return is significant because it recognizes that tax benefits will be included in determining the return to the investor.

Notice 2020-12

The IRS simultaneously issued Notice 2020-12 to provide specific guidance as to what constitutes the beginning of construction for the Section 45Q Credit. This guidance is critical due to the long lead time for large-scale infrastructure projects like carbon capture and utilization and the limited window for beginning of construction under Section 45Q.

Section 45Q provides a credit only for qualified facilities for which construction begins before January 1, 2024. Specifically, Section 45Q(d) provides that a qualified facility is an industrial facility or a direct air capture facility "the construction of which begins before January 1, 2024, and – (A) construction of carbon capture equipment begins before such date, or (B) the original planning and design for such facility includes installation of carbon capture equipment."

As expected, the much-awaited Notice provides two tests to determine the beginning of construction for the purposes of Section 45Q: the "Physical Work Test" and the "Five Percent Safe Harbor," both with "Continuity Requirements," which require the taxpayer to continually work towards completion of the qualified facility. The Physical Work Test, the Five Percent Safe Harbor, and Continuity Requirement are similar, although not identical, to the wind and solar test and safe harbor of Notice 2018-59. Notably, the Section 45Q Five Percent Safe Harbor permits the facility or equipment to be placed in service up to the end of the sixth year following the beginning of construction (compared to the fourth year for wind and solar).

Physical Work Test

The Physical Work Test requires "physical work of a significant nature" to establish construction has begun. Specifically, the Physical Work Test depends on the relevant facts and circumstances and focuses on the nature of the work performed, not the amount or cost. The Physical Work Test takes into account both onsite and offsite work, but does not include preliminary activities such as planning or designing the facility. Allowable activities include manufacture of mounting equipment, manufacture of necessary components, manufacture of necessary equipment, excavation for and installation of foundations, installation of gathering lines, etc. Taxpayers may include work performed by other persons if the work is pursuant to a binding written contract.

Five Percent Safe Harbor

A taxpayer meets the Five Percent Safe Harbor when the taxpayer pays or incurs five percent or more of the total cost of the qualified facility or carbon capture equipment, and makes a continuous effort to advance toward completion of that facility or equipment. The total cost includes all costs included in the depreciable basis of the facility or equipment. The total cost also includes costs associated with Front-End Engineering and Design (FEED) or other approaches to front-end planning. Specific rules apply to determine what constitutes a single project for purposes of the Five Percent Safe Harbor. The Notice provides relief from failure to meet the Five Percent Safe Harbor due to cost overruns for a portion of projects with multiple facilities or multiple units of carbon capture equipment.

Continuity Requirements

The Physical Work Test requires a taxpayer to maintain a continuous program of construction. The Five Percent Safe Harbor requires a taxpayer to make continuous efforts toward completion of the qualified facility or carbon capture equipment. The Notice provides that disruptions beyond the taxpayer's control will not cause the taxpayer to fail the Continuity Requirements, and provides a non-exhaustive list of permitted disruptions. This list includes weather and natural disasters, but also includes, for example, permit delays, pipeline interconnection-related delays, delays in the manufacture of custom components, delays due to labor stoppages, and financing delays.

The Notice also provides a safe harbor that the Continuity Requirements will be deemed satisfied if the taxpayer places the qualified facility or carbon capture equipment in service by the end of the calendar year that is no more than six years after construction began. The Notice does not extend the six-year safe harbor for permitted disruptions.

If the taxpayer satisfies both the Physical Work Test and the Five-Percent Safe Harbor, the IRS will deem the beginning of construction date to be the date of the earlier (i.e. first satisfied) completed method for purposes of the six-year safe harbor. Taxpayers that began construction on a qualified facility or carbon capture equipment satisfying either the Physical Work Test or the Five Percent Safe Harbor before the effective date of the Notice, March 9, 2020, may use March 9, 2020 as the date of beginning of construction. This may help taxpayers with the six-year completion requirement.

What This Means for Taxpayers

The Revenue Procedure and Notice are good news for investors, providing necessary assurances that their partnership interest will be respected and their projects will satisfy the beginning of construction requirement. The guidance is investor-friendly. The Revenue Procedure recognizes the reality of carbon capture projects, allowing investors to look to tax credits for a portion of their returns and allowing supply-all, supply-or-pay, take all, take-or-pay, securely-store-or-pay contracts, and long-term leases to an emitter or offtaker. This was a key condition for mid-stream projects like carbon capture that must be installed at an emitter's site and have a committed offtaker. The Revenue Procedure permits up to 50 percent of an investor's consideration to be contingent, a favorable change from the 75 percent minimum for wind and solar projects. Similarly, the Notice provides both guidance and a safe harbor for the beginning of construction, and recognizes the large scale of carbon capture projects by allowing the taxpayer up to six years to place the facility or capture equipment in service, compared to four year for wind projects.

Although the Notice confirms that taxpayers may continue to rely on EPA Greenhouse Gas Subpart RR for secure geological storage under Notice 2009-83, taxpayers are anxiously awaiting additional guidance on secure geological storage, recapture, and converting carbon capture into products. The IRS has said proposed regulations are forthcoming and has solicited and received initial comments concerning many aspects of such regulations.

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