CLIENT ALERT

Treasury and the IRS Release Final Regulations Regarding Section 45Q Carbon Capture and Sequestration Tax Credit

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On January 6, 2021, Treasury and the IRS released final regulations providing guidance regarding the credit for carbon oxide sequestration under section 45Q. The final regulations, together with the two-year extension of the deadline for beginning construction of carbon capture projects in the COVID-19 relief legislation signed into law on December 27, 2020, are welcome developments for taxpayers contemplating investments in carbon capture, utilization and storage projects. Treasury Decision 9944 includes both the final regulations and a preamble, addressing comments and explaining the regulations. Both the preamble and the final regulations are important to review, as Treasury and the IRS provided some important clarifications that appear only in the preamble. In this client alert, we will discuss some of the key issues addressed in the preamble and final regulations.

Recapture

Section 45Q directs Treasury to adopt regulations requiring taxpayers to recapture credits when qualified carbon oxide ceases to be captured, disposed of, or used as a tertiary injectant in a manner consistent with Section 45Q. The final regulations governing calculation of recapture liabilities include a lookback period that effectively limits exposure to recapture to the credits claimed during a specified recapture period. Recognizing that the risk of qualified carbon oxide leakage leading to a recapture event is greatest in the years in which the qualified carbon oxide is injected, and decreases over time as the qualified carbon oxide becomes stable and the likelihood of leakage decreases, as suggested by commenters, the final regulations reduce the recapture period to three years from five years in the proposed regulations. The final regulations clarify that recapture does not occur when qualified carbon oxide is utilized, but note that carbon oxide emissions from products are taken into account in the lifecycle analysis.

Secure Geological Storage

Taxpayers claiming the section 45Q credit based on disposal, or use as a tertiary injectant for enhanced oil recovery (EOR) followed by disposal, must establish that their qualified carbon oxide was disposed of in "secure geological storage." The final regulations, like the proposed regulations, establish that taxpayers who use qualified carbon oxide as part of an EOR project and in the process store qualified carbon oxide, have two options to demonstrate secure geological storage: (1) opt into compliance with subpart RR of the EPA's Greenhouse Gas Reporting (GHGR) regulations and get an EPA-approved Monitoring Reporting and Verification (MRV) plan; or (2) comply with both subpart UU of the GHGR regulations, which did not require an EPA-approved MRV plan, and CAS/ANSI ISO 27916:19, issued by the International Organization for Standardization. Taxpayers choosing to follow EPA's Subpart RR rules may self-certify amounts of carbon oxide securely stored, relying on their reports to EPA; those who follow Subpart UU and the ISO standard must obtain an independent certification of amounts securely stored. Several commenters requested clarity or changes to the rules for certifying secure geological storage. The final regulations clarify that the qualified independent engineer or geologist certifying a project must be duly registered or certified in a state. The

certification must be accompanied by an affidavit from the qualified independent engineer or geologist under penalty of perjury that they are independent from the taxpayer, electing taxpayer, and/or credit claimants as applicable. The final regulations also revised the definition of qualified independent engineer or geologist to incorporate the same standard as for an independent third party in the regulations. This will provide some assurance to the public and stakeholders regarding the efficacy of taxpayers' secure geological storage.

Aggregation

Section 45Q(d)(2) sets forth carbon oxide capture thresholds, which must be met for a facility to be a "qualified facility" under the statute. Section 45Q(f)(6) also has a carbon oxide capture threshold which must be met for a taxpayer to elect under Section 45Q(f)(6) to treat carbon capture equipment at the facility as eligible for higher credits under the 2018 changes to Section 45Q. A commenter on the proposed regulations recommended that the Treasury and the IRS clarify what constitutes a single applicable facility for purposes of making an election under section 45Q(f)(6). The final regulations were amended to allow taxpayers to apply the rules of section 8.01 of Notice 2020-12 to treat multiple facilities as a single facility to meet the carbon oxide capture thresholds in both sections 45Q(d)(2) and 45Q(f)(6). Section 8.01 of Notice 2020-12 defines the term "single project" for purposes of determining whether construction of a qualified facility or carbon capture equipment had begun. Section 8.01 states "multiple qualified facilities or units of carbon capture equipment that are operated as part of a single project (along with any components of property that serve some or all such qualified facilities or units of carbon capture equipment) may be treated as a single qualified facility or unit of carbon capture equipment."

Fungibility

The preamble clarifies that carbon dioxide transported or stored in shared pipelines is fungible, and therefore meets the definition of qualified carbon oxide, so long as the amount of carbon dioxide (as opposed to the particular molecules) is measured at the source of capture and verified at the point of disposal, injection, or utilization. Treasury and the IRS explained that the methods for accounting for qualified carbon oxide expressly provide for mass balance, which recognizes the fungibility of carbon dioxide. For this reason, the Treasury and the IRS did not think it was necessary to add this clarification to the final regulations. The recognition that carbon dioxide will be treated as fungible is necessary in an industry where carbon dioxide is commonly transported via a shared pipeline and stored at facilities where it commingles with carbon dioxide from other sources.

Definition of Carbon Capture Equipment

Section 45Q does not define the term "carbon capture equipment." The proposed regulations generally provided a functional definition of carbon capture equipment, which included all components of property that were used to capture or process carbon oxide until the carbon oxide is transported for disposal, injection, or utilization. However, the proposed regulations went on to list specific types of equipment that were either in or out of the definition of carbon capture equipment. Commenters on the proposed regulations found the lists to be confusing and suggested removing the lists. In response to these suggestions, Treasury and the IRS removed the lists of qualifying capture components and excluded components from the final regulations. The final regulations maintain the functional definition of carbon capture equipment from the proposed regulations.

The final regulations, together with the extension of the beginning of construction date signed into law at the end of 2020, are welcome news to the industry and investors. More coverage on Section 45Q, including the extension of the beginning of construction date and other guidance issued by the IRS, is available here:

- Crowell & Moring Alert: Congress Extends Section 45Q Beginning of Construction Date by Two Years in COVID-Relief Bill
- Crowell & Moring Alert: IRS Issues Welcomed Guidance on Carbon Capture Tax Credit
- *Tax Notes* Article: A Primer on the Tax Credit for Carbon Oxide Sequestration
- Bloomberg Law Article: INSIGHT: Impact Of Proposed IRS Regulations Under Section 45Q For Carbon Capture Credit

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