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Investors Primed To Act On Carbon Tax Credit Guidance

By **Joshua Rosenberg**

Law360 (March 17, 2021, 5:55 PM EDT) -- The Internal Revenue Service's final guidance on the carbon capture tax credit appears to have provided enough certainty to move tax equity investors off the sidelines, although the scale and timing of investments remain to be seen.

Competition in the tax equity market can be vigorous, as there's a finite amount of tax capacity — or the extent to which corporations possess tax liability exposure — from which to draw. Investors also have more familiarity with other renewable energy tax credits, namely those for wind and solar.

Yet practitioners say the IRS' final guidance has proved decisive in attracting investors' interest to the carbon capture and sequestration credit under the recently revised Internal Revenue Code Section 45Q, even as some issues remain unresolved. The question appears to be when, and not if, capital will move off the sidelines en masse, practitioners say.

Two factors that may temper investors' enthusiasm for the credit are competition with other renewable energy tax credits and the extent to which questions involving the Section 45Q credit remain unanswered.

"Next year, I believe deals will get done whether the IRS further clarifies the regulations or not," Michael Masri, partner at Orrick Herrington & Sutcliffe LLP, told Law360. "But hopefully the IRS will clarify some of the questions and complaints that are holding up deals at the moment."

Section 45Q is intended to reduce atmospheric greenhouse gases that contribute to climate change by encouraging companies to seize carbon oxides at the point of emission — at power plants, for example — and then permanently store them deep underground in saline reservoirs or in oil and gas fields.

The Internal Revenue Service in January released final regulations for the tax credit of up to $50 per metric ton of carbon captured in qualified facilities.

The credit was revised under the Bipartisan Budget Act of 2018, allowing companies to claim varying degrees of the credit if they engage in carbon capture and sequestration in association with enhanced oil recovery activities or in other contexts.

There are three discrete ways in which taxpayers may qualify for the credit: sequestration, enhanced oil recovery and utilization. Sequestration refers to a process by which extracted carbon is stored, permanently and securely, deep underground. In enhanced oil recovery, captured carbon is used to further extract additional oil and then stored. Utilization is a process by which captured carbon is used in commercial contexts, broadly defined.

According to the Carbon Capture Coalition, approximately 30 projects are underway in the U.S. that already make use of the Section 45Q tax credit.

"There's something of a stampede going on for interest in the Section 45Q credit," Keith Martin, co-head of projects, U.S., at Norton Rose Fulbright US LLP, told Law360.

Martin said a diverse set of interested parties, including ethanol plants, coal plants, power plants and others, have reached out to his firm. However, the deals he's working on are on hold for the time being, he said, a consequence of the agency's leaving some questions unanswered in its final regulations. One stumbling block involves instances in which industrial equipment that separates gases doesn't actually capture and sequester carbon, he said.

Still, the final regulations addressed many important issues. For instance, the IRS spelled out the circumstances under which owners of carbon capture and sequestration equipment may transfer the value of a tax credit to third parties, and shortened the recapture period from five years to three years.

David Blair, partner and chair of Crowell & Moring LLP's tax group, told Law360 that the final regulations' answering of numerous important questions, along with Congress' decision to extend the deadline for beginning construction to 2026, will help propel capital off the sidelines.

"These are very large scale investments that require an awful lot of planning," he said. "So the combination of the final regulations and that change in the underlying statute will be very helpful in terms of getting some of these projects actually up and running."

In releasing its final regulations, the IRS further attracted the attention of the tax equity market to the carbon capture credit, which among other things allows corporations, mainly financial institutions, to offset their tax exposure.

The tax equity market, in which the rights to tax credits are swapped for equity investments in a company, has been a key driver in directing investments toward programs that are meant to benefit society more generally.

The Section 45Q credit would essentially be competing for tax capacity with other tax credits, such as those for wind and solar. Congress extended both the production tax credit and investment tax credit for wind and solar at the end of 2020.

"There's inertia on the policy side to support traditional renewables like wind and solar in the form of PTCs and ITCs, and there's also inertia in the sense that banks like to invest in technologies and projects with which they're familiar," Henry Scott, partner at Milbank LLP, told Law360.

But the carbon capture credit's profit potential is undeniably attractive, Martin told Law360.

"The dollar amounts here are so large: If you have a new facility that produces 3 million metric tons of CO_2 a year, you're talking $150 million a year in tax credits," Martin said. "That's a never-ending number."

And interest cuts widely across the market, Jeff Hoffner, partner at O'Melveny & Myers LLP, told Law360, with large and small firms alike educating themselves and perhaps preparing to invest.

"It's not just the big two who would be interested in this; it would be many of the others," he said, referring to JPMorgan Chase and Bank of America.

"I think at this point, 45Q is a fait accompli," Hoffner said. "Folks are going to try to do some of those deals."

JPMorgan Chase and Bank of America declined to comment for this article.

--Editing by Robert Rudinger and Neil Cohen.