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INSIGHT: Impact of Proposed IRS Regulations Under Section 45Q for Carbon Capture Credit

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The IRS recently released proposed regulations for the carbon capture credit. Crowell attorneys walk through the history of the credit and what taxpayers need to know to claim the credit and situations that will result in recapture of the credit.

On May 28, 2020, the IRS released long-awaited *proposed regulations* under tax code Section 45Q, which provides the credit for carbon capture utilization and storage (CCUS).

The proposed regulations address some key technical issues regarding how the credit will apply, including standards for the following: secure geological storage; recapture; how taxpayers investing in CCUS equipment can contract with others to ensure capture and disposal of qualified carbon dioxide and other carbon oxide (qualified CO); definition of “carbon capture equipment;” and elections to transfer the credit. The announcement states that taxpayers may rely on the proposed regulations until such time as the final regulations are published.

Congress originally enacted Section 45Q in 2008 and substantially enhanced it in 2018. Under Section 45Q, taxpayers receive a credit for capturing qualified CO using carbon capture equipment at a qualified facility and permanently disposing of the CO, including through injection into a disposal well or use as a tertiary injectant in enhanced oil or natural gas recovery (EOR) projects.

Before the Internal Revenue Service announced the proposed regulations, it issued sub-regulatory guidance in February 2020 on two issues related to Section 45Q: Revenue Procedure 2020-12, which provided guidance for partnerships investing in CCUS, and Notice 2020-12, which provides guidance on beginning of construction for purposes of meeting the effective dates for the credit.

Secure Geological Storage

Taxpayers claiming the Section 45Q credit based on disposal, or use as a tertiary injectant followed by disposal, must establish that their qualified CO was disposed of in "secure geological storage." The statute further prescribes that this term includes storage in deep saline formations, oil and gas reservoirs, and unminable coal seams. Both the original 2008 version of Section 45Q and the 2018 amended version directed Treasury, in consultation with the Environmental Protection Agency (EPA) and the Departments of Energy and Interior, to establish regulations for determining adequate security measures for secure geological storage of qualified CO so that it does not leak into the atmosphere. The IRS never issued regulations on secure geological storage under the 2008 statute, although it released Notice 2009-83, which referred to EPA regulations on underground injection control (UIC) and greenhouse gas reporting (GHGR). Nevertheless, the question of what qualifies as secure geological storage remained a source of controversy. Meanwhile, the International Organization for Standardization (ISO) and American National Standards Institute (ANSI) developed their own protocols for establishing and quantifying the secure geological CO storage: CAS/ANSI ISO 27916:19.

Section 1.45Q-3 of the proposed regulations includes rules for establishing secure geological storage of qualified CO. The proposed regulations require compliance with the EPA's UIC regulations, which determine the type of well permit required for injecting into the subsurface: Class II for most EOR projects, and Class VI for disposal not in connection with EOR. If taxpayers are disposing of qualified CO without use in an EOR project, they also must comply with Subpart RR of the EPA's GHGR regulations, which requires an EPA-approved monitoring reporting and verification (MRV) plan. Taxpayers that use the qualified CO in an EOR project and thereby store the qualified CO have two options: (1) compliance with Subpart RR of the GHGR regulations and getting an EPA-approved MRV plan; or (2) compliance with Subpart UU of the GHGR regulations, which does not require an EPA-approved MRV plan, and compliance with the CAS/ANSI ISO 27916:19.

Taxpayers must report and certify the amount of qualified CO disposed of in secure geological storage on Form 8893. Taxpayers that comply with Subpart RR of the GHGR regulations can self-certify the amount of qualified CO disposed of in secure geological storage. Taxpayers opting to comply with Subpart UU of the GHGR regulations and CAS/ANSI ISO 27916:19 must obtain from a qualified independent engineer or geologist annual certifications of their documentation, computations, and monitoring and containment assurance. Although some comments argued for adopting state standards on secure geological storage, the proposed regulations reject this suggestion on the ground that incorporating multiple state standards would be difficult to administer.

Credit Recapture

Congress directed the IRS to promulgate regulations providing for recapture of credits in the event that qualified CO ceases to be captured, disposed of, or used as a tertiary injectant. Section 1.45Q-5 of the proposed regulations addresses recapture. The proposed regulations specify a "recapture period" during which a recapture event, such as a leak of qualified CO, can lead to recapture liability. They also address quantifying leaked qualified CO, calculating and reporting recapture liability, and allocating the liability among multiple credit claimants. The rules governing calculation of recapture liability include a lookback period that effectively limits exposure to recapture to the credits claimed in the prior five years. The proposed regulations also provide that leakage resulting from actions not related to selection, operation, or maintenance of the storage facility, such as volcanic activity or a terrorist attack, do not trigger recapture.

A recapture event occurs when qualified CO for which a credit has been claimed ceases to be captured, disposed of or used as a tertiary injectant during the "recapture period." The recapture period begins on the date of the first injection of qualified CO for disposal in secure geological storage or use as a tertiary injectant, and ends on the earlier of five years after the last taxable year in which the taxpayer claimed a section 45Q credit, or the date monitoring ends under subpart RR of the EPA's GHGR regulations or under the CSA/ANSI ISO 27916:19 standard. The preamble to the proposed regulations describes critical two sub-portions of the recapture period: the "post-credit-claiming period," and the "lookback period." The "post-credit-claiming period" is the five year period after the taxpayer's last credit. A leak during this period can lead to recapture. Recapture is computed by allocating the leaked qualified CO to previously claimed credits on a LIFO basis, going back no more than five years, which is the "lookback period."

If qualified CO leaks to the atmosphere during the recapture period, the taxpayer may have recapture liability. Taxpayers must quantify the leak using the standards in Subpart RR or CSA/ANSI ISO 27916:19. If the taxpayer elects to quantify using CSA/ANSI ISO 27916:19, an independent engineer or geologist must certify the quantity leaked. If the leaked quantity does not exceed the amount of qualified CO that the taxpayer disposed of in secure geological storage or used as a tertiary injectant during the year, then there is no recapture liability. Instead, the taxpayer simply claims a credit for the net amount of qualified CO disposed of or used as a tertiary injectant during the year. To the extent that the leaked qualified CO exceeds the amount disposed of or used as a tertiary injectant during the year, the taxpayer is liable for recapture. The recapture liability is computed based on the net amount leaked and the statutory credit rate. Because the credit rate changes from year to year, leaked qualified CO is attributed to credits claimed in prior years on a LIFO basis. That is, the net amount leaked will be attributed first to the first preceding year, then to the second preceding year, and so on, up to a maximum of the fifth preceding year (*i.e.*, the five-year lookback period).

If an amount is required to be recaptured, the taxpayer must add the recapture amount to its tax due in the taxable year of the leak. Accordingly, there is no need to file amended returns for prior years when the taxpayer initially claimed the credits that are being recaptured. If the leaked qualified CO was captured by multiple units of carbon capture equipment that are not commonly owned, the recapture liability is allocated among the equipment on a pro rata basis, and each owner must report its portion of the recapture liability. Similarly, if the leak is attributable to qualified CO for which multiple taxpayers claimed credits, such as where ownership of the carbon capture equipment changed, or the owner elected to transfer a portion of its credit, the recapture liability is allocated on a pro rata basis among the taxpayers that claimed the credits. This pro rata allocation approach treated qualified CO as fungible. The proposed regulations include a number of examples to illustrate operation of the recapture provisions.

The IRS requested comments on how to apply the recapture provisions to Section 45Q credits that are carried forward to future taxable years due to insufficient income tax liability in the current taxable year.

Contracting for Capture, Disposal, Injection, and Utilization

The 2018 amendments to the credit significantly increased the pool of potential investors by allowing taxpayers to claim the credit if they installed carbon capture equipment on an industrial facility owned by a third party. Taxpayers may claim the Section 45Q credit if the credit is “attributable to” them under tax code Section 45Q(f)(3)(A) and Proposed Treasury Regulation Section 1.45Q-1(h) of the proposed regulations. For carbon capture equipment placed in service before Feb. 18, 2018 (i.e., before the amendments), the credit is attributable to the person who themselves captures qualified CO, and either physically or contractually ensures the disposal, injection and disposal, or utilization of the qualified CO. For equipment placed in service after that date, the credit is attributable to the person who owns the carbon capture equipment and physically or contractually ensures the capture and disposal, injection and disposal, or utilization of the qualified CO.

The proposed regulations provide that taxpayers need not carry out the disposal, injection, or utilization of qualified CO themselves. They may also claim the credit if they enter into a binding written contract with another party under which that party (disposing party) commits to physically carry out the disposal, injection and disposal, or utilization of the qualified CO in compliance with the proposed regulations. A taxpayer may contract with multiple disposing parties. The proposed regulations specify criteria that contracts must meet. Contracts must be in writing, binding against both parties, and not limited in money damages. Contracts must provide for enforcement of the disposal obligations and require the disposing party to comply with the secure geological storage requirements and notify the taxpayer of leakage that could trigger credit recapture. Contracts, may, but are not required to include long-term liability, indemnity, and liquidated damages provisions, agreements on the amount of qualified CO to be disposed of, including agreed minimum quantities.

Election to Transfer Credit

Tax code Section 45Q(f)(3)(B) provides that the taxpayer to whom the credit is attributable can elect to transfer the credit to the disposing party. The proposed regulations include fairly flexible rules for electing to make such a transfer of the credit. Elections are made annually, can be for all or only a portion of the credit, and can be for the benefit of multiple disposing parties. A disposing party can receive credits from multiple electing taxpayers. For example, a taxpayer with an EOR project can conduct disposal and claim credits from qualified CO capture projects owned by multiple electing taxpayers. The proposed regulations also prescribe rules for both electing and receiving parties to coordinate the reporting of elections on each party's return.

Carbon Capture Equipment

Tax code Section 45Q does not define "carbon capture equipment." Comments noted the CCUS projects require a number of interrelated components to capture and process qualified CO so that it can be transported by pipeline to a disposal point. The proposed regulations define carbon capture equipment to include all components of property used to capture or process qualified CO until the qualified CO is transported for disposal, injection and disposal, or utilization. This includes property used for separating, purifying, drying and capturing qualified CO at an industrial facility, property used to remove qualified CO from the atmosphere via direct air capture, and property used to pressurize qualified CO. The proposed regulations include a fairly detailed list with specific examples of the types of equipment that may fall within the definition of carbon capture equipment.

Observations and Next Steps

Although the Section 45Q credit has been available for over 10 years, the lack of technical guidance has hindered investment in CCUS projects. The proposed regulations include welcome clarifications on critical technical issues, including in particular the rules governing secure geological storage and recapture. Along with the safe harbor partnership guidance in Rev. Proc. 2020-12 and the beginning of construction guidance in Notice 2020-12, the proposed regulations should help potential investors evaluate the potential risks and benefits of proposed CCUS projects. Interested parties with continuing concerns should consider submitting comments on the proposed regulations. Taxpayers have 60 days from publication in the Federal Register to submit comments.

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