How To Help Realize A Tax Equity Market For Carbon Capture

By Hunter Johnston (December 10, 2018, 4:19 PM EST)

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In February of this year Congress expanded and extended Section 45Q of the Internal Revenue Code[1] to provide more effective incentives for carbon capture of industrial emissions. The substance of the Furthering carbon capture, Utilization, Technology, Underground storage, and Reduced Emissions Act, or FUTURE Act, constituted Section 41119 of the Bipartisan Budget Act of 2018.[2] The purpose of the FUTURE Act was to create a statutory and regulatory foundation for the creation of a tax equity market that will support investment in projects that will capture and store carbon oxide emissions from the atmosphere.

While the Internal Revenue Service has already established guidance under the previously enacted Section 45Q that can guide investment decisions, further clarification of certain issues is necessary to unlock tax equity investment to take full advantage of Section 45Q and to resolve some legacy issues related to secure geologic storage.

Recently, the Carbon Capture Coalition provided the IRS with suggested model guidance containing recommendations, dealing with a number of key subject matter areas, that will be helpful to project developers seeking to obtain the benefit of Section 45Q tax credits to support project finance. The Carbon Capture Coalition, formerly known as the National Enhanced Oil Recovery Initiative, was launched in 2011 to help realize the full potential of carbon capture as a national energy, economic and environmental strategy. The coalition is made up by a diverse set of energy, industrial and technology companies, environmental organizations, and labor unions and was a major force behind passage of revised Section 45Q.

Steptoe & Johnson LLP was counsel to the coalition in preparation of the proposed model guidance. The coalition works on a consensus basis so only issues that reached full endorsements of the coalition were included in the proposed guidance. In determining which clarifications were the most important for the IRS to address, the coalition was governed by the principals of reducing risk and uncertainty in accepted tax equity finance structures. Accordingly, the coalition focused much of its attention on models and precedents in the tax equity structures that have been implemented in the wind and solar industries, as well as other related guidance. Central to those structures are the various safe harbors that have been established through guidance in the years after the passage and modifications of the wind production tax credit, for instance.

This begs the question of what appropriate safe harbors should apply for Section 45Q. Two of the biggest questions concerning the tax credit are the meaning of the term “secure geologic storage” and the question of how the principles of “recapture” should apply. Current IRS guidance requires that an enhanced oil recovery operator must report under Subpart RR of the Greenhouse Gas Reporting Program, or GHGRP,[3] in order for a person who captures carbon oxide to claim a tax credit through enhanced oil recovery, or EOR. Since some EOR operators report under Subpart UU of the GHGRP, which governs the injection of carbon oxide underground for facilities for any reason, including enhanced oil and gas recovery, the requirement that EOR operators must report under Subpart RR to claim the tax credit has created controversy with some EOR operators who currently report under Subpart UU.

The Carbon Capture Coalition proposal to the IRS seeks to produce flexibility in resolving the secure geologic storage issue by creating a framework under which a safe harbor is created around Subpart RR while leaving open the possibility of additional regulatory pathways to claim the credit. Specifically, the proposal recommends that the U.S. Department of the Treasury and the IRS adopt a safe harbor for credit claimants that physically or contractually ensure disposal of qualified carbon oxide through projects that comply with Subpart RR of the GHGRP or an "Equivalent Program." The equivalent program would permit relevant agencies to determine additional pathways for claiming the credit if a state or the Environmental Protection Agency has an approved comparable regulatory program.

The benefits of meeting the requirements of the safe harbor would be to reduce the period for recapture of the tax credit to any two year period during which, using a mass balance comparison of the carbon oxide injected and the carbon oxide sequestered, the net amount is a negative number. The safe harbor would therefore create certainty for taxpayers in valuing the tax credit investment, since a tax equity investor would not be willing to take the risk of recapture if there is a long tail risk that the tax equity investment could be forfeited.

Additional recommendations of the Carbon Capture Coalition proposal are related to credit transferability, timing and flexibility in determining transfers of the credit. One key recommendation is that the IRS clarify that the credit can be transferred to a person that has "contractual responsibility" to dispose of the carbon oxide even if that person is not the person that actually disposes of the carbon oxide. This clarification has important implications for the possibilities of forming tax equity partnerships around entities that transport carbon oxide for secure geologic storage.

The Carbon Capture Coalition did not address other issues that have a direct bearing on potential structures for tax equity partnerships, such as issues related to at-risk rules and factors related to entrepreneurial risk and reward. While these partnership rules are critically important in structuring tax equity transactions, these concepts and rules are not specific to carbon capture and sequestration. The IRS released a memorandum related to this subject in February 2018 in the context of refined coal credit transactions. While the carbon capture industry is not as mature as the refined coal industry, and there are not many transactions that are known to the market to inform market participants, it would be helpful for the IRS to publish a similar memorandum that would outline parameters of carbon capture related tax equity transactions and the extent to which guidance and rules from refined coal and other industries to provide more clarity to Section 45Q claimants.

While prior Section 45Q credits were not typically monetized through tax equity partnerships, the amendments to the section provide the statutory basis for creating a multi-billion dollar tax equity market for the carbon capture industry. The clarifications suggested by the Carbon Capture Coalition would go a long way towards building a strong foundation for this exciting new carbon capture industry and a potential tax equity market. Issuance of guidance and other supporting memoranda by the IRS can provide the tools that project developers need to advance 45Q value to be used in project finance transactions. Now is the time for stakeholders to engage to ensure that this opportunity is brought to fruition.

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public policy. He has represented the Carbon Capture Coalition and other companies interested in monetizing Section 45Q tax credits.

Disclosure: The author represented the Carbon Capture Coalition in connection with drafting the model guidance discussed in this article.

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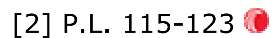
[1] IRC Section 45Q

[2] P.L. 115-123 

[3] 40 CFR part 98, subpart RR