Key Clarifications In IRS Carbon Capture Tax Credit Guidance

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On Feb. 19, the Internal Revenue Service issued two important pieces of guidance relating to the credit under Section 45Q of the Internal Revenue Code for carbon oxide sequestration, addressing the beginning of construction requirement for qualified facilities or carbon capture equipment and partnership allocations of Section 45Q credits.[1]

This guidance builds off of prior guidance issued in the context of renewable energy production tax credits, investment tax credits and historic rehabilitation tax credits. By drawing on these existing precedents, the guidance should provide greater certainty to project developers and investors structuring carbon capture projects.

However, this guidance is only part of a larger picture and regulatory scheme. More comprehensive proposed regulations are expected to be released by the IRS that will address other necessary rules for taxpayers, such as definitions related to secure geologic storage, recapture, transfer of the Section 45Q credit, and the measurement of qualified carbon oxides through a lifecycle greenhouse gas emissions analysis.

Guidance on these issues will be equally important for taxpayers to have the confidence to claim Section 45Q tax credits in new carbon capture projects.

Beginning of Construction Guidance

The first piece of guidance is Notice 2020-12, which provides guidance on the beginning of construction requirement under Section 45Q. In general, in order to qualify for the enhanced credit under Section 45Q as amended by the Bipartisan Budget Act of 2018, the construction of a qualified facility that includes the relevant carbon capture equipment must begin before Jan. 1, 2024. The guidance in Notice 2020-12 generally follows similar guidance that has been previously issued on the beginning of construction requirement with respect to Section 45 renewable energy production tax credits and Section 48[2] renewable energy investment tax credits.

In particular, Notice 2020-12 provides the following methods and requirements with respect to the beginning of construction requirement:

Establishing That Construction Has Begun

There are two methods by which a taxpayer may establish that construction of a qualified facility or carbon capture equipment has begun for purposes of the Section 45Q credit. First, a taxpayer may establish the beginning of construction by starting physical work of a significant nature. Both on-site and off-site work may qualify as physical work of a significant nature, but preliminary activities, such as securing financing or clearing a site, do not qualify.

Alternatively, a taxpayer may establish the beginning of construction by meeting a safe harbor based on having paid or incurred 5% or more of the total cost of the qualified facility or carbon capture equipment.

Continuity Requirement

There is a requirement under both methods that a taxpayer make continuous progress towards completion once construction has begun.

Excusable Disruptions

The notice includes exceptions for specified excusable disruptions, including delays due to severe weather conditions or natural disasters; delays in obtaining permits or licenses; delays at the written request of a government due to public safety, security, or similar concerns; interconnection-related delays, such as those related to the completion of construction on a new carbon dioxide pipeline; delays in the manufacture of custom components; labor stoppages; the inability to obtain specialized equipment of limited availability; the presence of endangered species; financing delays; and supply shortages.

Continuity Safe Harbor

The notice provides for a safe harbor to satisfy the continuity requirement for taxpayers that place a qualified facility or carbon capture equipment in service by the end of a calendar year that is no more than six calendar years after the calendar year during which construction of the qualified facility or carbon capture equipment began. Previous guidance under Section 45 and Section 48 included a four-year continuity safe harbor, instead of a six-year safe harbor.

Aggregation and Disaggregation Rules

The guidance permits aggregation of multiple qualified facilities or units of carbon capture equipment that are part of a single project for purposes of satisfying the beginning of construction requirement. The aggregated facilities or units may, however, be disaggregated for purposes of determining whether the continuity safe harbor is satisfied.

80/20 Rule

The guidance permits certain retrofitted facilities or carbon capture equipment to qualify as originally placed in service even though it contains some used components of property, provided the fair market value of the used components of property is not more than 20% of the qualified facility or carbon capture equipment's total value.

Transfer of Ownership

The guidance permits transfers of ownership of a partially developed qualified facility during construction.

Definition of Carbon Capture Equipment

The guidance provides that, for purposes of the beginning of construction requirement, carbon capture equipment includes all components of property that are used to capture or process (for example, separation, purification, drying and/or compression) carbon oxide until it is transported away from the qualified facility for disposal, utilization or use as a tertiary injectant.

Partnership Flip Safe Harbor

The second piece of guidance is Revenue Procedure 2020-12, which provides a safe harbor for partnership allocations of Section 45Q credits that satisfy certain requirements. In general, if a project company, developer and an investor satisfy all of the requirements of the safe harbor provided in Revenue Procedure 2012-12, then the IRS will treat the investor as a partner in the project company and will treat the project company as properly allocating the Section 45Q credit in accordance with the rules governing partnership tax allocations under Section 704(b).[3]

The IRS stated that the guidance in this revenue procedure is in lieu of private letter rulings; thus, the IRS will not issue letter rulings on the partnership tax issues associated with claiming Section 45Q credits.

The safe harbor in Revenue Procedure 2012-12 generally is modeled after similar safe harbors for partnership flip structures that the IRS has issued in the context of Section 45[4] wind production tax credits and Section 47[5] historic rehabilitation tax credits.

A partnership flip structure is frequently used for tax-credit generating activities, particularly where a project developer or sponsor actively involved in the development, operation and management of the activities is unable to make optimal use of the credits and deductions generated by the activities. The sponsor effectively monetizes the future stream of such credits and deductions by attracting equity capital in exchange for many of the credits and deductions, together with some additional economic return.

The principal idea behind a partnership flip structure is that, in the early years of the partnership, most of the income, gains, deductions, losses and credits from the partnership are allocated to the investor partners likely to be able to use them. After a specified economic threshold has been met, the allocations flip, and thereafter the sponsor partner receives most of the income, gains, deductions, losses and credits.

In general to satisfy the requirements of the safe harbor under Revenue Procedure 2012-12:

- The project developer must have a minimum 1% interest in each material partnership tax item during the entire existence of the partnership.

- Each investor must have, at all times during the period it owns a partnership interest in the partnership, a minimum interest in each material partnership tax item equal to at least 5% of the investor's percentage interest in each such item for the taxable year for which the investor's percentage share of that item is the largest (as adjusted for sales, redemptions or dilutions of its interest).

- Each investor's partnership interest must constitute a bona fide equity investment with a reasonably anticipated value that is commensurate with the investor's overall percentage interest in the partnership (separate from any tax benefits) and is contingent upon the partnership's profitability and not substantially fixed in amount or limited to a preferred return. In addition, the investor must not be substantially protected against losses from the partnership's activities.

- The value of the investor's partnership interest may not be reduced through unreasonable fees or through disproportionate rights to distributions or by issuances of interests in the partnership (or rights to acquire interests in the partnership) for less than fair market value.

- The investor must make and maintain a minimum unconditional investment equal to at least 20% of the sum of the fixed capital investment plus any reasonably anticipated contingent investment required to be made by the investor. This minimum investment cannot be protected against loss through arrangements with parties involved in the project or related parties.

- More than 50% of the sum of the fixed investment plus reasonably anticipated contingent investment to be made by the investor must be fixed and determinable obligations. Contributions to pay ongoing operating expenses will not be treated contingent investments for this purpose.

- Neither the developer, the investors, nor any related person may have a call option or other contractual right or agreement to purchase, at any time, the carbon capture equipment, any property included in the carbon equipment, or a partnership interest in the partnership at a future date (other than a contractual right or agreement for a present sale). Furthermore, an investor may not have a contractual right or other agreement to require any person involved in any part of the carbon capture transaction to purchase or liquidate the investor's partnership interest at a future date at a price that is more than its fair market value determined at the time of exercise of the contractual right to sell.

- No person involved in any part of the project may directly or indirectly guarantee or otherwise ensure the investor's ability to claim the Section 45Q credit. Furthermore, the developer (or a person related to the developer) may not lend any investor the funds to acquire any part of the investor's interest in the project or guarantee any indebtedness incurred or created in connection with the acquisition of the investor's interest in the project.

    - An investor is permitted to obtain insurance, including recapture insurance, from persons not related to persons involved in the project. In addition, an investor can obtain (1) a guarantee for the performance of any acts necessary to claim the Section 45Q credit (including ensuring proper secure geological storage of the qualified carbon oxide through disposal, or use as a tertiary injectant or utilization); and (2) a guarantee for the avoidance of any act (or omissions) that would cause the partnership to fail to qualify for the Section 45Q credit or that would result in a recapture of the Section 45Q credit. Examples of permitted guarantees include completion guarantees, operating deficit guarantees, environmental indemnities and financial covenants.

    - In addition, a long-term carbon oxide purchase agreement entered into on arm's-length terms between the partnership and a carbon oxide emitter or offtaker will not be treated as an impermissible guarantee even if such contracts contain so-called supply all, supply-or-pay, take all, take-or-pay or securely-store-or-pay provisions.

- The Section 45Q credits must be allocated in accordance with the regulatory requirements for partnership allocations (i.e., generally in the same proportion as the partners' distributive shares of receipts from the partnership's activities relating to carbon oxide sequestration — such as payments for capturing qualified carbon oxide or for the sale of qualified carbon oxide — or the partners' respective distributive shares of the loss or deduction associated with the cost of the capture and disposal, use as a tertiary injectant or utilization of the qualified carbon oxide).

The guidance is effective for transactions entered into on or after March 9. However, if construction began before then, the IRS will treat construction as beginning on the effective date. Additionally, if partnerships were formed that met the requirements of the safe harbor before the effective date, the IRS will treat the investor as a partner and the allocations as proper for the prior period.

In sum, the two revenue procedures that were issued by the IRS last week are essential building blocks in the creation of a regulatory structure that will support tax equity investments into carbon capture. However, these two important parts of guidance are not enough for 45Q to implement the investment necessary to make carbon capture as successful as other clean energy tax credits that impact carbon emissions.

We continue to wait for a proposed regulation that will address many of the other important issues that require clarification regarding the meaning of recapture of the credit, transfer of the credit, and secure geologic storage.

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

as legal advice.

[1] IRC Section 45Q.

[2] IRC Section 48.

[3] IRC Section 704(b).

[4] IRC Section 45.

[5] IRC Section 47.