

# A Guide To Proposed Carbon Capture Tax Credit Regs: Part 1

By **Hunter Johnston, Lisa Zarlenga and John Cobb**

On May 28, the U.S. Department of the Treasury and the Internal Revenue Service issued proposed regulations under Section 45Q, the credit for carbon oxide sequestration. The proposed regulations are comprehensive and detailed, addressing many issues on which commenters have requested clarification and explanation.

However, some questions remain, and will hopefully be addressed in final regulations. Key guidance in the proposed regulations, and some of these open questions, are discussed in this two-part article.

## **Additional Pathway for Secure Geologic Storage**

Notice 2009-83, the key guidance under the old Section 45Q credit program, was issued while the U.S. Environmental Protection Agency was still writing its greenhouse gas reporting rules. This has created some uncertainty as to the precise requirements for adequate security measures that must be adopted to demonstrate secure geologic storage.

In general, operators who inject carbon oxide must do so under an appropriate EPA underground injection control, or UIC, well permit. Class II permits generally are used for wells that inject fluids (including carbon oxides) for enhanced recovery of oil or natural gas. Class VI permits generally are used for wells which inject carbon oxides for the purpose of geologic sequestration, and not for use in enhanced recovery of oil or natural gas.

Class VI wells are required to comply with the more stringent rules under Subpart RR of the EPA's greenhouse gas reporting rules. Class II wells are permitted to comply with the less stringent rules under Subpart UU, but may opt into Subpart RR reporting.

The Subpart RR rules require an EPA-approved site-specific monitoring, reporting and verification, or MRV, plan, but the Subpart UU rules do not require an MRV plan. Historically, some taxpayers have taken the position that reporting under Subpart RR is not required to claim a Section 45Q credit in the context of injection of qualified carbon oxides in enhanced oil recovery at a Class II well.

The IRS has taken the position that an approved MRV plan is required in order to demonstrate secure geologic storage — but this position has only been expressed in the instructions to Form 8933, which are not binding guidance. In addition, some taxpayers have been concerned that being required to opt into Subpart RR may



Hunter Johnston



Lisa Zarlenga



John Cobb

create a misalignment with state mineral property and natural resource conservation laws, as well as accepted industry practices and commercial arrangements.

The proposed regulations clarify the meaning of secure geologic storage, and provide an additional pathway beyond compliance with Subpart RR. Under the proposed regulations, the International Organization for Standardization, or ISO, standard on sequestration — endorsed by the American National Standards Institute — can be used as an alternative for UIC Class II wells.

Both Subpart RR and the ISO standard require an assessment and monitoring of potential leakage pathways; quantification of inputs, losses and storage through a mass balance approach; and documentation of steps and approaches. Under the proposed regulations, operators of UIC Class II wells that follow the ISO standard could elect to report under Subpart RR — but would not be required to do so.

Rather, they could continue to report to the EPA under Subpart UU. The proposed regulations do not provide for an alternative to Subpart RR reporting for UIC Class VI, wells because all UIC Class VI wells are already subject to Subpart RR reporting requirements.

Taxpayers that rely on the ISO standard must satisfy additional certification requirements. A taxpayer that reports volumes of carbon oxide to the EPA pursuant to Subpart RR may self-certify the volume of carbon oxide claimed for purposes of Section 45Q.

In contrast, if a taxpayer determines volumes pursuant to the ISO standard, the taxpayer may prepare documentation as outlined in the ISO standard internally — but such documentation must be provided to a qualified independent engineer or geologist, who then must certify that the documentation provided, including the mass balance calculations as well as information regarding monitoring and containment assurance, is accurate and complete.

Some of the commenters advocating for the application of the ISO standard suggested that the proposed regulations require that all relevant documentation of the amount of qualified carbon oxide stored for purposes of the Section 45Q credit be retained and made available for public review, and the total quantity of qualified carbon oxide stored for long-term containment be reported annually.

However, the Treasury Department explained in the preamble to the proposed regulations that while it appreciates the importance of shared and open information in this context and encourages transparency, congressional action would be required to mandate this kind of disclosure. The preamble explains that there is no statutory requirement in Section 45Q for taxpayers, federal agencies or industry groups to publicly display this information or otherwise make it available.

In addition, the Treasury itself is limited in what it can disclose, because of the rules prohibiting the public disclosure of taxpayer information under Section 6103.

### **Parameters Laid Out for Contractual Assurance**

The proposed regulations clarify which contract provisions are necessary to contractually ensure capture and disposal in secure geologic storage; use as a tertiary injectant in enhanced oil recovery; or utilization as described in Section 45Q(f)(5).

This is important because a taxpayer is not required to physically carry out the disposal,

injection or utilization of qualified carbon oxide to claim the Section 45Q credit if the taxpayer contractually ensures, in a binding written contract, that the party that physically carries out the disposal, injection or utilization of the qualified carbon oxide does so in the manner required under Section 45Q and the regulations.

In particular — in the absence of a section 45Q(f)(3)(B) election, discussed below — the person who may claim the Section 45Q credit is: (1) for facilities placed in service before Feb. 9, 2018, the person that captures and physically or contractually ensures the disposal, injection or utilization of qualified carbon oxide; and (2) for facilities placed in service after Feb. 8, 2018, the person that owns the carbon capture equipment and physically or contractually ensures the capture and disposal, injection or utilization of qualified carbon oxide.

Under the proposed regulations, in order to contractually ensure disposal, injection or utilization of qualified carbon oxide, a taxpayer must enter into a binding written contract. A written contract will be considered binding only if it is enforceable under state law against both the taxpayer and the party that physically carries out the disposal, injection or utilization of the qualified carbon oxide, or a predecessor or successor of either, and does not limit damages to a specified amount.

A taxpayer may enter into multiple binding written contracts with multiple parties for the disposal, injection or utilization of qualified carbon oxide. In addition, several contract provisions are required or permitted. Contracts must:

- Include commercially reasonable terms, and provide for enforcement of the party's obligation to perform the disposal, injection or utilization of the qualified carbon oxide;
- For qualified carbon oxide that is intended to be disposed or injected, obligate the disposing party to:
  - Comply with the Subpart RR rules, or, in the case of qualified carbon dioxide injected in enhanced oil recovery, the ISO standards;
  - Comply with the documentation requirements on IRS Form 8933; and
  - In the case of a recapture event, promptly inform the capturing party of all information that is pertinent to the recapture (i.e., location of leak, quantity of qualified carbon oxide leaked, dollar value of Section 45Q credit attributable to leaked qualified carbon oxide) of Section 45Q credits under the regulations; and
- For qualified carbon oxide that is intended to be utilized, obligate the utilizing party to comply with the regulations governing utilization.

Contracts ensuring the disposal, injection or utilization of qualified carbon oxide may — but are not required to — include:

- Long-term liability provisions, indemnity provisions, penalties for breach of contract, or liquidated damages provisions;

- Information including how many metric tons of qualified carbon oxide the parties agree to dispose of, inject or utilize; and
- Minimum quantities that the parties agree to dispose of, inject or utilize.

These rules will help guide taxpayers in drafting contracts that will meet the contractual assurance standard. As a result, the rules will help enhance the certainty regarding which taxpayers can claim Section 45Q credits.

However, at least one key gap remains in these rules. Many commenters requested flexibility in allowing a chain of contractual assurance so that, for example, the taxpayer who owns carbon capture equipment could contract with a person who transports qualified carbon oxide, who in turn could contract with a third person who physically carries out disposal, injection or utilization.

The proposed regulations do not directly address this issue. It would be helpful if final regulations clarified (with an example) that direct contractual privity between the taxpayer to which the credit is attributable and the person who physically disposes, injects or utilizes the qualified carbon oxide is not required, so long as there is a chain of contractual privity.

### **Broad Definition of Carbon Capture Equipment May Cause Confusion**

The proposed regulations include definitions of certain key terms that were left undefined in the statute, including "carbon capture equipment." The proposed regulations provide that, in general, carbon capture equipment includes all components of property that are used to capture or process carbon oxide until the carbon oxide is transported for disposal, injection or utilization.

Further, the proposed regulations list specific items that are included in, or excluded from, the definition of carbon capture equipment. Components of property related to the function of capturing carbon oxides, such as components of property necessary to compress, treat, process, liquefy or pump carbon oxides, are included within the definition of carbon capture equipment.

Components of property related to transporting carbon oxides for disposal, injection or utilization, such as pipelines or transport vessels, are not included in the general definition. However, a single gathering and distribution system that collects and transports carbon oxide to a pipeline is considered carbon capture equipment.

This broad definition means that multiple distinct pieces of equipment that produce a single stream of qualified carbon oxide may all be treated as carbon capture equipment. For example, one piece of equipment might separate carbon oxide from other gases, while another piece of equipment might compress the separated carbon oxide, while a third piece of equipment might treat the carbon oxide.

This may create confusion, because a Section 45Q credit generally is attributable to the owner of carbon capture equipment at a qualified facility, for equipment placed in service after Feb. 9, 2018. The proposed regulations do not address the consequences if more than one taxpayer owns distinct pieces of equipment that all produce a single stream of qualified carbon oxide.

Is a taxpayer required to own all of the carbon capture equipment that produces a single stream of qualified carbon oxide in order to claim a Section 45Q credit, or is the taxpayer

only required to own a portion of such equipment? If the latter, does the credit need to be apportioned among different taxpayers that own different portions — and, if so, how will the credit be apportioned?

### **Additional Guidance Provided on Industrial Facilities**

Section 45Q also does not define the term "industrial facility." In general, in order to be a qualified facility under Section 45Q, a facility must be either a direct air capture facility or an industrial facility. The proposed regulations generally follow prior subregulatory guidance on the definition of an industrial facility.

Consistent with prior guidance, the proposed regulations provide that an industrial facility is a facility that produces a carbon oxide stream from a fuel combustion source or fuel cell, a manufacturing process, or a fugitive carbon oxide emission source that, absent capture and disposal, would otherwise be released into the atmosphere as industrial emission of greenhouse gas or lead to such release.

Also consistent with this guidance, the proposed regulations provide that an industrial facility does not include a facility that produces carbon dioxide from carbon dioxide production wells at natural carbon dioxide-bearing formations or a naturally occurring subsurface spring.

However, the proposed regulations expand on this prior guidance. The proposed regulations provide that a deposit of natural gas that contains less than 10% carbon dioxide by volume is not a natural carbon dioxide-bearing formation.

For other deposits, whether a well is producing from a natural carbon dioxide-bearing formation is based on all the facts and circumstances. The proposed regulations also define the term "manufacturing process" as "a process involving the manufacture of products, other than carbon oxide, that are intended to be sold at a profit, or are used for a commercial purpose."

All facts and circumstances with respect to the process and products are to be taken into account. As illustrated by the proposed regulations, if a natural gas reservoir contains both carbon dioxide and methane, and the taxpayer constructs equipment to separate the two and enters a contract to sell only the carbon dioxide, the separation process is not a manufacturing process. But if the taxpayer separates and sells both gases, it would be a manufacturing process.

In the second installment of this article, we will discuss how the proposed regulations under Section 45Q adapt the 80/20 rule to the context of carbon sequestration, provide guidance on the transfer election under Section 45Q(f)(3)(B), lay out an initial framework for utilization projects, and introduce a five-year lookback period for credit recapture.

*Correction: A previous version of this article had a headline which incorrectly describing the proposed regulations discussed in the article. This error has been corrected.*

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*N. Hunter Johnston and Lisa M. Zarlenga are partners, and John Cobb is an associate, at Steptoe & Johnson LLP.*

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