A Guide To Proposed Carbon Capture Tax Credit Regs: Part 2

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.

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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.

In the first installment, we considered how the proposed regulations under Section 45Q adopt an additional pathway for demonstrating secure geologic storage; lay out parameters for contractual assurance; and define certain key statutory terms.

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

Helpful Guidance Provided on Transfer Election

Section 45Q(f)(3)(B) provides that the taxpayer to which the credit is attributable may elect to allow the person that disposes of the qualified carbon oxide, utilizes the qualified carbon oxide or injects the qualified carbon oxide as a tertiary injectant to instead claim the credit. The proposed regulations provide guidance regarding who may make such a Section 45Q(f)(3)(B) election, and the time and manner for making an election.

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The proposed regulations provide that Section 45Q(f)(3)(B) elections may be made for all or a portion of the available Section 45Q credit, and may be made for single or multiple credit claimants. The electing taxpayer must provide a copy of the taxpayer's Form 8933 to each claimant, and each claimant must attach that copy to its own Form 8933.

The proposed regulations also provide that Section 45Q(f)(3)(B) elections must be made on an annual basis. These provisions should allow greater flexibility for taxpayers who wish to change a Section 45Q(f)(3)(B) election from year to year, or transfer portions of the credit to multiple parties.

Moving forward, taxpayers will not be able to change their Section 45Q(f)(3)(B) elections on amended returns. The proposed regulations provide that a Section 45Q(f)(3)(B) election must be made no later than the due date (including extensions) for filing the taxpayer's federal income tax return or Form 1065 (in the case of partnerships), and may not be made on an amended federal income tax return.

An exception exists for amended returns (or administrative adjustment requests) for taxable years ending after Feb. 9, 2018, but on or before the date of publication of the proposed regulations.

Guidance regarding the interaction of a transfer election and the guidance on partnership allocations of Section 45Q credits provided in Revenue Procedure 2020-12 would be helpful. The guidance in this revenue procedure, including the safe harbor provided by Section 4, generally appears to be premised on the ownership of the carbon capture equipment by the partnership that claims the Section 45Q credit — referred to as the project company in the guidance.

However, when a Section 45Q(f)(3)(B) election is made, the project company generally will not be the owner of the carbon capture equipment. It is not clear how or whether the Treasury Department would expect the guidance in Revenue Procedure 2020-12 to apply in such a situation.

Regulations Adopt 80/20 Rule

The 80/20 rule has long been a mainstay of renewable energy projects. The rule provides that a facility that contains some used property generally can still qualify as originally placed in service, so long as the fair market value of the used property is not more than 20% of the facility's total value (the cost of the new property plus the fair market value of the used property).

In general, the 80/20 rule permits taxpayers to qualify for a new credit period for qualified facilities when they make very substantial capital expenditures. The proposed regulations adapt the 80/20 rule to the context of the Section 45Q credit.

The proposed regulations provide that a qualified facility or carbon capture equipment may 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 (the cost of the new components of property plus the value of the used components of property).

For purposes of the 80/20 rule, the cost of a new qualified facility or carbon capture equipment includes all properly capitalized costs of the new qualified facility or carbon capture equipment. Solely for purposes of the 80/20 rule, properly capitalized costs of a new qualified facility or carbon capture equipment may, at the option of the taxpayer, include the cost of new equipment for a pipeline owned and used exclusively by that taxpayer to transport carbon oxides captured from that taxpayer's qualified facility that would otherwise be emitted into the atmosphere.

By adopting the 80/20 rule, the proposed regulations will allow existing facilities that make substantial investments in retrofitting their equipment to claim Section 45Q credits under the new post-Bipartisan Budget Act provisions. This welcome addition will help incentivize taxpayers to improve carbon capture on existing facilities.

Initial Framework for Utilization Laid Out

The Bipartisan Budget Act added carbon oxide utilization, described in Section 45Q(f)(5), as an additional avenue for claiming Section 45Q credits. Section 45Q(f)(5)(A) provides that "utilization of qualified carbon oxide" means:

- The fixation of such qualified carbon oxide through photosynthesis or chemosynthesis, such as through the growing of algae or bacteria;

- The chemical conversion of such qualified carbon oxide to a material or chemical compound in which such qualified carbon oxide is securely stored; or

- The use of such qualified carbon oxide for any other purpose for which a commercial market exists (with the exception of use as a tertiary injectant in a qualified enhanced oil or natural gas recovery project), as determined by the Treasury secretary.

Section 45Q(f)(5)(B) provides a methodology to determine the amount of qualified carbon oxide utilized by the taxpayer. Such amount is equal to the metric tons of qualified carbon oxide which the taxpayer demonstrates, based upon an analysis of lifecycle greenhouse gas emissions and subject to such requirements as the Treasury secretary, in consultation with the secretary of energy and the administrator of the U.S. Environmental Protection Agency, determines appropriate, were:

- Captured and permanently isolated from the atmosphere; or

- Displaced from being emitted into the atmosphere, through use of a process described in section 45Q(f)(5)(A).

The term "lifecycle greenhouse gas emissions" in Section 45Q is given the same meaning as the term under the Clean Air Act, as in effect on Feb. 9, 2018, except that "product" is substituted for "fuel" each place it appears in the Clean Air Act. Under the Clean Air Act, net emissions of all greenhouse gases (and not just carbon oxides) must be taken into account with the mass values for each greenhouse gas is adjusted to account to reflect its relative global warming potential.

The Treasury Department, in consultation with the EPA and the U.S. Department of Energy, concluded that a lifecycle analysis, or LCA, must be in writing and either performed or verified by a professionally licensed third party that uses generally accepted standard practices of quantifying the greenhouse gas emissions of a product or process and comparing that impact to a baseline.

In particular, the analysis must contain documentation consistent with ISO standard 14044:2006 — which lays out requirements and guidelines for lifecycle assessment in an environmental management context — as well as a statement documenting the qualifications of the third party.

The proposed regulations further require a taxpayer to submit an LCA report to the IRS and the DOE. The LCA will be subject to a technical review by the DOE — and the IRS, in consultation with the DOE and the EPA, will determine whether to approve the LCA.

The Treasury Department requested comments on how to achieve consistency in boundaries

and baselines, so that similarly situated taxpayers will be treated consistently. The preamble also states that Treasury is willing to consider issuing guidance on particular fact patterns.

The Treasury Department did not comprehensively address all issues related to carbon utilization, reserving several complex issues for further regulation, including standards for an LCA and the definition of a commercial market. Importantly, the regulations include the recognition that, in an LCA, "greenhouse gas emissions" means the aggregate quantity of emissions, where the mass values for all greenhouse gases are adjusted to account for relative global warming potential.

Five-Year Lookback Period Introduced for Credit Recapture

Section 45Q credits have always been subject to recapture (although carbon utilization under the post-Bipartisan Budget Act is not subject to the recapture provision) for carbon oxides that cease to be captured and disposed of consistent with the requirements of Section 45Q.

Although Notice 2009-83 provided some guidance on the recapture provision, the absence of comprehensive guidance and the open-ended nature of recapture risk has been an impediment to the incentive provided by Section 45Q credits. The proposed regulations address this prior uncertainty by providing comprehensive guidance and a five-year lookback period.

The proposed regulations provide that any recapture amount will be accounted for in the taxable year that it is identified and reported. If, during the recapture period, a taxpayer, operator or regulatory agency determines that qualified carbon oxide has leaked to the atmosphere, the taxpayer will have a recapture amount if the leaked amount of qualified carbon oxide exceeds the amount of qualified carbon dioxide disposed of in secure geological storage or used as a tertiary injectant in that taxable year.

If the leaked amount does not exceed the amount captured, it will reduce the amount stored or injected for purposes of claiming the credit in the current year. The excess amount of leaked qualified carbon oxide will be recaptured at a credit rate calculated on a LIFO basis (that is, the excess leaked qualified carbon oxide will be deemed attributable initially to the first preceding year, then to second preceding year, and then up to the fifth preceding year) to simplify the calculation of the recapture amount.

The taxpayer must add the amount of the recaptured Section 45Q tax credit to the amount of tax due in the taxable year in which the recapture event occurs. Consistent with this five-year lookback period, the proposed regulations provide that the recapture period will end on the earlier of: (1) five years after the last taxable year in which the taxpayer claimed a Section 45Q credit (the post-credit-claiming period); or (2) the date monitoring ends under the Subpart RR rules or the ISO standard.

The Treasury Department requested comments on how to apply the recapture provisions to Section 45Q credits that are carried forward to future tax years due to insufficient tax liability in the current tax year. Some taxpayers may be concerned that a five-year lookback period (and/or a five-year post-credit-claiming period) may be too long.

Many commenters suggested shorter periods. For example, a submission by the Carbon Capture Coalition written and reviewed by leading experts in subsurface geologic storage of carbon dioxide explained how, taken together, physics and flow mechanics, and experience

with and tools for subsurface management of buoyant fluids, combined with regulatory requirements suggest that:

- Cases of loss of volumes of carbon dioxide that would approach the commercial volumes sequestered during a two-year period are highly improbable; and

- Potential carbon dioxide losses occur principally during injection and/or early in a project, while a field is being actively monitored for injection pressures and conformance.

This kind of evidence tends to support a substantially shorter lookback period and post-credit-claiming period. Treasury did, however, request comments on the length of the lookback period.

The proposed regulations also include rules for allocating a recapture amount among taxpayers that own multiple units of carbon capture equipment, or among taxpayers that claimed Section 45Q credits generated by a single unit of carbon capture equipment. And the proposed regulations provide a limited exception to recapture in the event of a leakage of qualified carbon oxide resulting from actions not related to the selection, operation or maintenance of the storage facility, such as volcanic activity or a terrorist attack.

Finally, the proposed regulations provide that if qualified carbon oxide is deliberately removed from a secure storage site, a recapture event occurs in the year in which the qualified carbon oxide is removed from its original storage.

Conclusion

While some questions remain, the proposed regulations are an important step forward in providing investors in carbon capture projects with the certainty that is needed for the robust development of the carbon capture industry.

Importantly, the government permitted reliance on the proposed regulations. Comments on the proposed regulations must be received within 60 days of the date of publication in the Federal Register.

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