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Treasury and IRS Issue Final Regulations for Section 45Q Credits for Carbon Sequestration

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Treasury and the IRS have published final regulations (Final Regulations) under Section 45Q of the Internal Revenue Code, which provides for a production tax credit for persons who physically or contractually ensure the capture and disposal of qualified carbon oxide. The Final Regulations address the requirements for capture and disposal, the use of qualified carbon oxide as a tertiary injectant in a qualified enhanced oil or natural gas recovery project, and the utilization of qualified carbon oxide in a manner that qualifies for the credit. Treasury and the IRS published proposed regulations under Section 45Q on May 28, 2020 (Proposed Regulations). The IRS previously requested comments on issues arising under Section 45Q in Notice 2019-32. On March 9, 2020, the IRS published Revenue Procedure 2020-12, which provides a safe harbor for allocating Section 45Q credits in a partnership flip structure and Notice 2020-12, which provides guidance on when construction of a carbon capture facility or carbon capture equipment has begun.

This alert addresses the key changes made by the Final Regulations. Our analysis of the Proposed Regulations is available here.

Credit Amounts

For certain large carbon capture facilities (no less than 500,000 metric tons of carbon capture per taxable year) that have not previously claimed Section 45Q credits, the taxpayer can elect to have the facility and applicable carbon capture equipment treated as placed in service on February 9, 2018, thereby qualifying for the larger credit amounts. The Final Regulations allow taxpayers to apply the rules of Section 8.01 of Notice 2020-12 to treat multiple facilities as a single facility for this purpose.

Contractual Assurance of Disposal, Injection, or Utilization of Qualified Carbon Oxide

The Final Regulations provide a framework for the types of contracts, terms, and reporting requirements that will demonstrate the contractual assurance of the capture and disposal, injection, or utilization of qualified carbon oxide. Resolving some uncertainty created by conflicting provisions in the Proposed Regulations, the Final Regulations provide that a binding written contract is a contract enforceable under state law that does not limit damages to less than 5% of the total contract price. A taxpayer may enter into a binding written contract with a general contractor who hires subcontractors to physically carry out the capture, disposal, injection, or utilization of the qualified carbon oxide, but the contract must bind the subcontractors to the requirements of the Final Regulations. If a taxpayer has pre-existing contracts that do not satisfy the requirements of the Final Regulations, the taxpayer has until July 12, 2021 to amend the contracts or execute new contracts and maintain eligibility for

the Section 45Q credit.

Election to Transfer the Credit

Under Section 45Q(f)(3)(B), the taxpayer that is eligible to claim the Section 45Q credit may elect to allow the person that disposes of, injects, or utilizes the qualified carbon oxide to claim the credit. The Final Regulations provide that the disposer, injector, or utilizer that enters into the contract with the electing taxpayer is the party that may qualify as a credit claimant pursuant to the election. If that person enters into a subcontract with a third party to carry out the disposal, injection, or utilization, the subcontractor may not be a credit claimant.

The Final Regulations require both parties to a contract to report their contract information to the IRS on a Form 8933. They also require the party that contracts with the taxpayer claiming the Section 45Q credit (counterparty) to provide that taxpayer with a copy of its Form 8933. The taxpayer claiming the Section 45Q credit must attach and file the Form 8933 received from the counterparty to its own signed Form 8933. If the taxpayer claiming the Section 45Q credit fails to satisfy this reporting requirement, it may not claim the Section 45Q credit. However, the failure of the counterparty to file its Form 8933 will not impact the taxpayer's ability to claim the Section 45Q credit.

Carbon Capture Equipment

Section 45Q does not define the term "carbon capture equipment." The Proposed Regulations included a functional definition, as well as lists of specific included and excluded components, which caused confusion among commenters. The Final Regulations retain a functionality-based definition but eliminate the lists of specific components to provide flexibility. "Carbon capture equipment" generally 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. The term generally does not include components used for transporting qualified carbon oxide for disposal, injection, or utilization, but does include a system of gathering and distribution lines that collect carbon oxide captured from a qualified facility (or multiple qualified facilities that constitute a single project). All components that make up an independently functioning process train capable of capturing, processing, and preparing carbon oxide for transport should be treated as one unit of carbon capture equipment.

The Final Regulations also clarify that with respect to carbon capture equipment originally placed in service on or after February 9, 2018 (but not for equipment placed in service before that date), the carbon capture equipment may be owned by a taxpayer other than the taxpayer that owns the industrial facility at which the carbon capture equipment is placed in service and still be eligible for the Section 45Q credit.

For each single process train of carbon capture equipment, the Section 45Q credit may be claimed by only one taxpayer (either the taxpayer who physically ensures the capture and disposal, injection, or utilization of qualified carbon oxide or the taxpayer that contracts with others who capture and dispose of, inject, or utilize qualified carbon oxide). However, multiple owners of carbon capture equipment may form a partnership to allocate Section 45Q credits among themselves pursuant to Revenue Procedure 2020-12.

Qualified Facility

The Proposed Regulations adopted the so-called “80/20 rule” familiar from the Section 45 production tax credit context, pursuant to which a qualified facility or carbon capture equipment may qualify as originally placed in service even though it contains some used components, so long as the fair market value of the used components does not exceed 20% of the total value of the qualified facility or carbon capture equipment. For this purpose, the cost of a qualified facility or carbon capture equipment includes all properly capitalized costs, and at the option of the taxpayer, may include the cost of new equipment for a pipeline owned and used exclusively by the taxpayer to transport carbon oxide captured from the qualified facility that would otherwise be emitted into the atmosphere. Despite requests from commenters, Treasury and the IRS declined to eliminate the exclusivity requirement for pipelines. The Final Regulations clarify that in determining the value of the used components compared to the new components, the general principles of Rev. Rul. 94-31 apply, and that an independently functioning process train is the appropriate unit of carbon capture equipment for purposes of the 80/20 test.

The Final Regulations allow taxpayers to apply the single project rule in Section 8.01 of Notice 2020-12 so that taxpayers may aggregate carbon capture amounts from various facilities to meet the minimum capture requirements of Section 45Q(d).

Industrial Facility

Under the Proposed Regulations, an industrial facility did 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. Responding to comments, Treasury and the IRS replaced the facts and circumstances standard and the 10% safe harbor from the Proposed Regulations with a rule that excludes carbon dioxide production wells at natural carbon dioxide-bearing formations, or at naturally occurring subsurface springs, with greater than 90% carbon dioxide by volume. The Final Regulations also provide an exception for wells at natural carbon dioxide-bearing formations or naturally occurring subsurface springs that contain a product other than carbon dioxide.

The Final Regulations also revise the definition of “industrial facility” to include electricity generating facilities. However, to be a qualified facility, an electricity generating facility must capture at least 500,000 metric tons of qualified carbon oxide during the taxable year.

Secure Geological Storage

The Proposed Regulations provided two options for a taxpayer to establish compliance with the secure geological storage requirement: (1) compliance with the EPA’s Greenhouse Gas Reporting Program under 40 CFR Part 98 Subpart RR (Subpart RR), or (2) compliance with the International Standard Organization (ISO) standard endorsed by the American National Standards Institute (ANSI) under CSA/ANSI ISO 27916:19. A taxpayer that reports volumes to the EPA pursuant to Subpart RR may self-certify the volume of carbon oxide claimed for purposes of Section 45Q. If a taxpayer determines such volumes pursuant to the ISO standard, a qualified independent engineer or geologist must certify annually that the taxpayer’s internally prepared documentation of compliance with the ISO standard is accurate and complete. The Final Regulations clarify that the qualified independent engineer or geologist must be duly certified or registered in any state, and the certification must be accompanied by an affidavit from the engineer or geologist under penalty of perjury that the engineer or geologist is independent from the taxpayer, electing taxpayer, or credit claimant (as applicable).

Utilization of Qualified Carbon Oxide

The Final Regulations address numerous questions concerning applicable requirements for the analysis of lifecycle greenhouse gas emissions (LCA). Although all greenhouse gas emissions (which include but are not limited to carbon oxides) are taken into account by an LCA, which provides its results as cardon dioxide equivalence (CO_2-e), the Section 45Q credit may be calculated only on the qualified carbon oxides that are captured and utilized. The Final Regulations reconcile this by requiring the use of an LCA to measure CO_2-e but limiting the Section 45Q credit to the amount of qualified carbon oxide measured at the source of capture. The Final Regulations also clarify that LCAs must be prepared and documented in conformance with applicable ISO standards and that generally an LCA must take into account emissions from cradle to grave, unless the deletion of lifecycle stages is permitted by applicable ISO standards. The LCA and LCA report must be performed by an independent third party, and the LCA report must provide a statement documenting the qualifications of the third party. The LCA report and third-party statement must be submitted to the IRS and the DOE, and the LCA must be approved before the taxpayer may claim the Section 45Q credits for the applicable taxable year on its federal income tax return.

Credit Recapture

The Proposed Regulations provide guidance with respect to the recapture of any Section 45Q credit allowable for qualified carbon oxide that ceases to be captured, disposed of, or used as a tertiary injectant, during the period beginning on the date of the first injection and ending 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 or the ISO standard. The Final Regulations revise the recapture period to end on the earlier of three years after the last taxable year in which the taxpayer claimed a Section 45Q credit or the date monitoring ends. Treasury and the IRS noted in the preamble that the risk of leakage is greatest in the years in which the qualified carbon oxide is injected. Treasury and the IRS believe that the three-year period sufficiently accounts for risk and reduces the compliance burden that would be imposed with a five-year recapture period. The Final Regulations clarify that recapture does not apply when qualified carbon oxide is utilized according to Section 45Q(f)(5)(A).

Applicability Dates

The Final Regulations apply to taxable years beginning on or after January 13, 2021. However, a taxpayer may choose to apply the Final Regulations for taxable years beginning on or after January 1, 2018, if applied in their entirety and in a consistent manner.

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