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IRS Publishes Guidance on the Carbon Capture Tax Credit

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On February 19, 2020, the IRS issued two guidance items concerning the tax credit for carbon oxide sequestration (COS) under section 45Q: Notice 2020-12 and Revenue Procedure 2020-12. The new guidance is very similar to IRS guidelines established for other tax credit transactions, including in the solar and wind industries.

Section 45Q provides for a tax credit to the owner of carbon capture equipment that is used to capture qualified carbon oxide and:

- disposed of in a secure geological storage;
- used as a tertiary injectant in a qualified enhanced oil or natural gas recovery project and disposed of in a secure geological storage; or
- utilized in certain ways that result in emissions reductions as defined by federal requirements.

The amount of the tax credit depends on when the carbon capture equipment is placed in service and whether the carbon oxide is disposed of in secure storage, used, or utilized. Section 45Q, as amended by the Bipartisan Budget Act of 2018, restricts the credit to qualified facilities that include carbon capture equipment and construction of which begins before January 1, 2024.

Notice 2020-12 provides that taxpayers can demonstrate that construction has begun on a qualified facility by utilizing either the “5% safe harbor” test or the “physical work test” (similar to that used for solar and wind projects). As with solar and wind projects, both the 5% safe harbor and the physical work test require taxpayers to make continuous progress towards completion once construction has begun; however, the continuity requirement is presumed to be met for a COS facility if the facility is placed in service by the end of the sixth calendar year after construction commences (instead of four years for solar and wind projects). Notice 2020-12 also provides clarity on the definition of “carbon capture equipment” and “industrial facility,” both of which are key terms in determining whether a project is eligible for carbon capture tax credits.

Revenue Procedure 2020-12 establishes a safe harbor pursuant to which the IRS will respect partnership allocations of carbon capture tax credits and, thus, provides a framework for tax equity transactions to ensure tax equity investors are entitled to claim the credit. The safe harbor requirements are similar to those established for wind and historic tax credit transactions and allow for a tax equity investor to be allocated 99% of the tax benefits generated by a partnership until a target yield or a date certain is achieved. Once that occurs, the tax equity investor's share of

partnership items can decrease, but not below 5%. Unique features of the section 45Q guidance allow for up to 50% of a tax equity investor's commitment to be contingent on the COS project's performance (as opposed to 25% in wind and historic tax credit transactions) and do not treat contributions to pay ongoing operating expenses as part of an investor's contingent investment.

Concurrent with the release of the guidance, the IRS issued a statement that future guidance under section 45Q is anticipated to address additional issues, including secure geological storage, utilization and recapture of the tax credit.

For more information, please contact Adam M. Cohen or Sarah R. Haradon.

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