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Legal Update

IRS Issues First Batch of Long-Awaited Carbon Capture Tax Credit Guidance

On February 19, 2020, the US Internal Revenue Service ("IRS") issued IRS Notice 2020-12 (the "Notice") and Revenue Procedure 2020-12 (the "Revenue Procedure") to address two key aspects of the carbon capture tax credit (the "Carbon Credit") under section 45Q of the Internal Revenue Code of 1986 (the "Code"). Specifically, the Notice provides guidance with respect to the "start of construction" requirement under the Code, and the Revenue Procedure establishes a safe harbor under which partnership allocations of the Carbon Credit will be respected. Although the new guidance is largely similar to corresponding guidance issued with respect to the production tax credit for wind energy (the "PTC"), the investment tax credit for solar energy ("ITC") and the historic rehabilitation tax credit ("HTC"), there are some notable differences that appear to reflect industry-specific concerns raised by stakeholders.

Background

The Carbon Credit was first enacted in 2008 but was significantly expanded in 2018. Broadly speaking, the Carbon Credit is available on a per metric ton basis for carbon oxides that are injected, sequestered or otherwise used in a qualifying way using carbon capture equipment which is originally placed in service at a qualified facility. Among other things, the 2018 expansion of the Carbon Credit replaced the outside date for placing in service carbon capture equipment with a start-of-construction requirement and expanded the method by which the Carbon Credit may be attributable to a taxpayer. Specifically, under the 2018 expansion, an industrial or direct air facility is a "qualified facility" if, among other things, the construction of the facility begins before January 1, 2024, and either (i) the construction of the carbon capture equipment begins before such date or (ii) the original planning and design of the facility includes carbon capture equipment. Furthermore, pursuant to the 2018 expansion, the Carbon Credit is attributed to the taxpayer that (i) owns the carbon capture equipment and (ii) physically or contractually ensures the capture and disposal, utilization or use as a tertiary injectant of the qualified carbon oxide. Although this expansion made the Carbon Credit more accessible to taxpayers as a technical matter, the lack of guidance around the start-of-construction standard and partnership structuring has hamstrung the industry.

The Notice

The Notice provides start-of-construction guidance with respect to a qualified facility or carbon capture equipment (each individually, "Qualifying Equipment") that is very similar to the start-of-construction guidance issued with respect to the PTC and the ITC (the "Wind/Solar Guidance"), with a few notable exceptions. For these purposes, the Notice defines carbon capture equipment to include 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. This includes a system of gathering lines that collect carbon oxide captured from a qualified facility or multiple qualified facilities that constitute a single project for the purpose of transporting that carbon oxide away from the qualified facility or single project to a pipeline used to transport carbon oxide from multiple taxpayers and projects.

Like the Wind/Solar Guidance, the Notice provides two methods for establishing the beginning of construction: (i) starting physical work of a significant nature either directly or by contract (the "Physical Work Test") or (ii) paying or incurring (depending on the taxpayer's method of accounting) 5% of the ultimate tax basis of the project (the "Five Percent Safe Harbor"). Both methods require that a taxpayer make continuous progress towards completion once construction has begun (the "Continuity Requirement").

CONTINUITY REQUIREMENT

One of the most significant differences between the Notice and the Wind/Solar Guidance is with respect to the Continuity Requirement. Similar to the Wind/Solar Guidance, the Notice provides a safe harbor for establishing satisfaction of the Continuity Requirement (the "Continuity Safe Harbor"). Under the Continuity Safe Harbor, Qualifying Equipment will be treated as satisfying the Continuity Requirement if it is placed in service by the end of the sixth calendar year after the calendar year in which construction of the Qualifying Equipment began. This six-year window is more generous than the four-year window for the PTC and ITC under the Wind/Solar Guidance and is consistent with a number of stakeholder comments that requested a longer period due to the longer construction timelines for carbon capture projects.

PHYSICAL WORK TEST

The Physical Work Test focuses on the nature of the work performed not the amount or cost. Unlike the Wind/Solar Guidance, there is no express requirement that the work be performed with respect to property used as an integral part of the activity of the Qualified Equipment. However, preliminary activities do not count toward satisfaction of the Physical Work Test. Generally, preliminary activities include activities such as securing financing, exploring, researching, obtaining permits and licenses, conducting test drilling to determine soil condition (including to test the strength of a foundation), clearing a site, excavating to change the contour of the land (as distinguished from excavation for a foundation) and removing existing foundations or any components that are not part of the Qualified Equipment (including those on or attached to building structures).

Both off-site and on-site work may be taken into account for purposes of satisfying the Physical Work Test.

Generally, qualifying off-site physical work includes the manufacture of components. The Notice provides a non-exclusive list of examples that includes, among other things: (a) mounting equipment and support structures such as racks, skids, and rails; (b) components necessary for carbon capture processes such as membranes, sorbent

vessels, adsorbers, compressors, engines, motors, power generators and regenerators, reboilers, turbines, pressure vessels and other vessels, piping and pipelines, pumps, heat exchangers, solvent pumps, filters, recycling units, electrostatic filtration, water wash equipment, lube oil systems, dehydration systems, glycol contractors, specially designed flue gas ducts, conditioners, cooling towers, absorber units, and other types of gas separation, liquification, or processing equipment; and (c) components necessary for disposal of qualified carbon oxide in secure geological storage, such as valves, specialized casing, or other components of a wellhead or well, booster compressors, and monitoring equipment for a storage site.

The Notice also provides a non-exclusive list of examples of qualifying on-site physical work that includes, among other things: (a) the excavation for and installation of foundations (for the project as well as for buildings to house equipment necessary to the project) including the setting of anchor bolts into the ground and the pouring of the concrete pads of the foundation; (b) the installation of a system of gathering lines necessary to connect the industrial facility to the carbon capture equipment or other equipment necessary to the qualified facility before transportation away from the qualified facility for disposal, utilization or use as a tertiary injectant; (c) the installation of components necessary for carbon capture processes, such as membranes, sorbent vessels, adsorbers, compressors, engines, motors, power generators and regenerators, reboilers, turbines, pressure vessels and other vessels, piping and pipelines, pumps, heat exchangers, solvent pumps, filters, recycling units, electrostatic filtration, water wash equipment, lube oil systems, dehydration systems, glycol contractors, specially designed flue gas ducts, conditioners, cooling towers, absorber units, and other types of gas separation, liquification, or processing equipment; and (d) the installation of equipment and other work necessary for the disposal of qualified carbon oxide in secure geological storage at the geological storage site, which may be at a different location than the qualified facility or carbon capture equipment.

There are two important caveats with respect to satisfaction of the Physical Work Test. First, the manufacture of items that are either "in existing inventory or are normally held in inventory by a vendor" does not satisfy the requirement. Second, work not directly performed by the taxpayer must be performed pursuant to a "binding written contract" that is executed prior to the work being started. As related parties in many instances are separate taxpayers (e.g., a corporate parent and its wholly owned corporate subsidiary), project owners need to use care to ensure that work done by a related party that is a separate taxpayer is performed under a binding written contract between the project owner and its affiliate.

To be treated as binding, the contract has to be binding under state law (i.e., not an option agreement) and damages cannot be *capped* at less than 5% of the contract value. That does not mean the project owner must always pay at least 5% of the contract value. For instance, if the contractor's actual damages were only 1% of the contract value, it would be sufficient that in the case of a breach that the project owner would owe the actual damages (i.e., 1%). That is, the words "five percent" do not have to be included at all in the contract so long as the contract does not have any cap on the damages the project owner would owe the contractor for a breach.

FIVE PERCENT SAFE HARBOR

Under the Five Percent Safe Harbor, a taxpayer can establish that construction has begun by paying or incurring at least 5% of the total cost of the project. Whether an amount is treated as paid or incurred is determined under the Code. Only costs included in the depreciable basis of the project are taken into

account to determine whether the Five Percent Safe Harbor is satisfied. The Notice explicitly allows costs associated with Front-End Engineering and Design (FEED) activities or other approaches for front-end planning (e.g., the Front-End Loading (FEL) approach) common to projects of similar scope and complexity to be considered when determining whether the Five Percent Safe Harbor has been met. Unlike the Wind/Solar Guidance, the costs do not have to be incurred with respect to property integral to the qualified facility or a carbon credit equipment. Although this expands the costs that are eligible to be taken into account in determining whether 5% of the total cost of the project has been paid or incurred (i.e., the numerator), it likewise increases the total cost of the facility (i.e., the denominator), making the Five Percent Safe Harbor potentially more difficult to satisfy. Unlike the Physical Work Test, costs paid or incurred with respect to property that is inventory or normally held in inventory by a vendor would count toward satisfaction of the Five Percent Safe Harbor.

In the event of a cost overrun such that that the amount incurred toward satisfaction of the Five Percent Safe Harbor with respect to a project comprising multiple Qualifying Properties is less than 5% of the actual project spend, the Notice provides that the taxpayer can opt to not claim tax credits with respect to some of the Qualifying Properties of the project until the remaining Qualifying Properties for which the tax credits are claimed have a “total cost” that is not more than 20 times the amount incurred toward satisfaction of the Five Percent Safe Harbor. Furthermore, if a taxpayer fails to satisfy the Five Percent Safe Harbor in one year due to cost overruns, the taxpayer may use the Physical Work Test in a later year to establish beginning of construction. This flexibility between methods is a taxpayer-friendly deviation from the Wind/Solar Guidance.

SINGLE PROJECT

Multiple units of Qualified Equipment that are operated as part of a single project are treated as a single unit of Qualified Equipment for purposes of determining the beginning of construction. So, if construction begins on one unit of Qualifying Equipment in 2020 (e.g., physical work is performed, or costs are incurred, with respect to a unit of Qualifying Equipment), all units of Qualifying Equipment that are operated together with such unit of Qualifying Equipment will have a 2020 beginning-of-construction date.

Whether multiple energy properties are operated as a single project is a factual determination that is made as of the date the project is placed in service. The nonexclusive factors identified in the Notice that indicate that multiple units of Qualifying Equipment are operated as part of a single project include that: (a) the units of Qualifying Equipment are owned by a single legal entity; (b) the units of Qualifying Equipment are constructed in the same general geographic location or on adjacent or contiguous pieces of land; (c) a single system of gathering lines or a single off-take operation is used to collect and deliver carbon oxide to a transportation pipeline; (d) carbon oxide captured from the units of Qualifying Equipment is disposed of, utilized or used as a tertiary injectant pursuant to a shared contract; (e) the units of Qualifying Equipment are described in one or more common environmental or other regulatory permits or their activities are required to be collectively reported; (f) the units of Qualifying Equipment were constructed pursuant to a single contract providing FEED or similar services covering the full scope of the single project; (g) the units of Qualifying Equipment were constructed pursuant to a single master construction contract; and (h) the construction of the units of Qualifying Equipment was financed pursuant to the same loan agreement.

Multiple units of Qualifying Equipment that are operated as a single project may be disaggregated and treated as multiple separate units of Qualifying Property for purposes of determining whether a separate unit of Qualifying Property satisfies the Continuity Requirement as discussed above.

TRANSFERS

The Notice contains the same transfer rules that apply to wind and solar projects under the Wind/Solar Guidance. These rules are premised on the fact that there is no statutory requirement that the taxpayer that starts the construction of the project be the taxpayer that places it in service. However, although this is not addressed in the statute, the IRS has a policy to discourage "trafficking" in equipment that qualifies a project under the Physical Work Test or the Five Percent Safe Harbor. Under these rules, a transfer of a "project" from one taxpayer to another does not cause a loss of begun construction status so long as either (i) the transferred assets are more than equipment and contracts to acquire equipment (e.g., the transferred assets include a power contract and land rights) or (ii) the transferor before or after the transfer is more than 20% related to the transferee.

In a partnership context, this second prong can be satisfied with either a "profits" interest (i.e., a partner's share of the profits (which may or may not be matched by current cash distributions) and losses) *or* a "capital" interest (i.e., what a partner is entitled to in a liquidation). So, for instance, a transferor that receives a 20.1% capital interest and a 1% profits interest in the transferee would satisfy this requirement.

EFFECTIVE DATE

The Notice is effective on March 9, 2020. However, taxpayers that began construction on Qualified Equipment prior to that date may nevertheless use March 9th as the date upon which construction started.

The Revenue Procedure

The Revenue Procedure establishes a safe harbor under which the IRS will treat partnerships as properly allocating the Carbon Credit. The safe harbor under the Revenue Procedure is very similar to the revenue procedures issued with respect to the PTC and the HTC (the "Wind/Rehabilitation Guidance") and explicitly contemplates a partnership "flip" structure. However, there are a number of notable differences. Some of the key requirements under the safe harbor include the following:

1. **Sponsor's Minimum Interest.** The developer/sponsor must have a minimum 1% partnership interest in each material item of partnership income, gain, loss, deduction and credit at all times during the existence of the project company.
2. **Investor's Minimum Interest.** Each investor must have, throughout the lifetime of its investment, a minimum interest in each material item of partnership income, gain, loss, deduction and credit equal to at least 5% of such investor's largest percentage interest at any time during the course of its investment. For example, assuming the tax equity investor has a 99% interest during the initial 12-year operating period of the project, the investor will need to maintain a 4.95% interest throughout the lifetime of its investment.
3. **Investor's Minimum Unconditional Investment.** On the date the investor acquires its interest in the tax equity partnership, the investor must make 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 under the partnership agreement.

4. **Contingent Consideration.** More than 50% of the sum of the fixed investment plus reasonably anticipated contingent investment to be made by an investor must be fixed and determinable obligations that are not contingent in amount or certainty of payment. Significantly, contributions to pay ongoing operating expenses are not treated as part of the investor's contingent investment for these purposes. The "more than 50%" requirement is a taxpayer-friendly deviation from the Wind/Rehabilitation Guidance, which imposed a 75% standard on this requirement. This feature may allow investors to structure their investment with a smaller up-front contribution in exchange for paying a greater share of operating expenses.
5. **Bona Fide Interest.** The investor's interest must constitute a bona fide equity investment with a reasonably anticipated value commensurate with the investor's overall investment, separate from any tax benefits. Although there is similar language in the guidance with respect to the HTC, there is no bright-line test for determining whether an investor's interest is bona fide. This requirement may take on more significance with respect to a carbon capture project, which may not have positive cash flows. We note, however, that the industry may take some comfort from the fact that the Notice, in the context of detailing the technical requirements for partnership allocations of the Carbon Credit conforming to Section 704(b) of the Code, specifically contemplates that a project company may not receive payments for its activities relating to carbon oxide sequestration.
6. **Guarantees.** As a general matter, no person involved in any part of the project company may directly or indirectly guarantee or otherwise insure the tax equity investor's ability to claim the Carbon Capture Credit or to receive distributions from or consideration in exchange for its partnership interest. However, certain guarantees are permitted, including completion guarantees, operating deficit guarantees, environmental indemnities and financial covenants. Notably, in contrast to the guidance with respect to the HTC, these permitted guarantees are not required to be unfunded. Furthermore, a long-term related-party offtake agreement is permitted even if the agreement contains "supply all," "supply-or-pay," "take all," "take-or-pay," or "securely-store-or-pay" provisions. This is in contrast to the guidance with respect to the PTC, which would treat such agreements as impermissible guarantees.

In an example in the Revenue Procedure, the IRS applies these requirements to a typical tax equity "flip" partnership in which the "flip" point occurs upon the investor achieving a specified internal rate of return and respects the following allocations:

	DEVELOPER		INVESTOR	
	Cash	Gross Income/Loss and Carbon Capture Credits	Cash	Gross Income/Loss and Carbon Capture Credits
Period 1	100%	1%	0%	99%
Period 2	0%	1%	100%	99%
Period 3	95%	95%	5%	5%

The Revenue Procedure is effective for transactions entered into on or after March 9, 2020; however, the IRS will provide the benefit of the Revenue Procedure to transactions entered into before such date that satisfy the requirements of the safe harbor.

Conclusion

The guidance is an important first step in providing certainty to the carbon capture industry. However, additional guidance is necessary with respect to a number of critical issues including the measurement of net carbon oxide utilization, standards of secure geological storage, credit recapture, the "contractually ensure" standard and credit transferability.

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