LATHAM&WATKINS

Client Alert Commentary

Latham & Watkins Transactional Tax Practice

February 28, 2020 | Number 2602

Carbon Capture Industry Receives Long-Awaited 45Q Tax Credit Guidance

The IRS addressed key commercial and technical issues regarding the development and financing of carbon capture and sequestration projects.

Key Points:

- The IRS released the first two of three anticipated guidance packages designed to answer important questions about the carbon capture tax credit.
- Revenue Procedure 2020-12 establishes a safe harbor template for allocating tax credits among investors and developers in carbon capture equipment. An IRS safe harbor is often a prerequisite for attracting tax credit investors to a new market.
- Notice 2020-12 provides guidance on when construction has begun on a qualified facility or carbon capture equipment.
- Further guidance is anticipated to address other important questions, such as when tax credits may be recaptured and how to properly sequester carbon oxide for tax credit qualification purposes.

On February 19, 2020, the Internal Revenue Service (IRS) issued long-awaited guidance relating to the tax credit for the capture and sequestration of carbon oxide (the 45Q Credit). The 45Q Credit is available to taxpayers who capture carbon oxide from certain sources and then sequester it in secure geological formations. A tax credit is also available to taxpayers who use the captured carbon oxide as a tertiary injectant in a qualified oil or natural gas well and then dispose of it in a secure geological formation. The tax credit is based on the quantity of captured qualified oxide and is available for the first 12 years after new carbon capture equipment is placed into service.

In order to accelerate the growth of the carbon capture industry, the generous tax credits available to owners of carbon capture equipment must be combined with a mechanism to transfer those tax credits to the taxpayers who can most efficiently use them. Investors who seek their return predominantly in the form of tax credits, commonly referred to as tax equity investors, often prefer to structure their investments as preferred equity investments and generally require a high level of certainty that the IRS will permit them to claim the tax credits. Revenue Procedure 2012-20 is the IRS's attempt to grant this certainty in the form of a safe harbor, and describes the key features of an investment in a carbon capture project that will allow 45Q Credits to be allocated to an investor.

The newly issued guidance includes two components: (1) Revenue Procedure 2020-12 establishes a safe harbor under which the IRS will treat partnerships as properly allocating the 45Q Credit in accordance with Section 704(b) of the Internal Revenue Code (the Code), and (2) Notice 2020-12 provides guidance for taxpayers to determine when construction has begun on a qualified facility or carbon capture equipment that may be eligible for the 45Q Credit. This *Client Alert* highlights the key provisions of this guidance, particularly as it compares to analogous guidance applicable to renewable energy and other tax credit transactions.

Safe Harbor for Partnership Allocations of the 45Q Tax Credit

Revenue Procedure 2020-12 provides a useful template for developers to tax-equity finance carbon capture projects with the 45Q Credit, though taxpayers could still benefit from some clarity around the margins. Revenue Procedure 2020-12 appears to take inspiration from two existing Revenue Procedures: (1) Revenue Procedure 2007-65, which provides a safe harbor for the allocation of production tax credits for wind projects, and (2) Revenue Procedure 2014-12, which provides a safe harbor for the allocation of rehabilitation credits. Revenue Procedure 2020-12 lays out a commercial framework for carbon capture "flip" partnerships between a project developer (Developer) and a tax equity investor (Investor), which includes the following features:

Minimum Interest

Both the Developer and Investor must have a minimum interest in partnership items of income, gain, loss, deduction, and credit to comply with Revenue Procedure 2020-12. The Developer is required to maintain, at all times during the partnership's existence, a minimum partnership interest of 1% in each material item of partnership income, gain, loss, deduction, and credit, and the Investor is required to maintain a minimum partnership interest of 5% in each of the above material items for the taxable year when the Investor's share of such material item is the largest. These minimum interests generally permit up to 99% of the 45Q Credits to be allocated to a tax equity investor and are consistent with the wind tax credit guidance.

The Investor's partnership interest must also be a "bona fide equity investment" with a value proportionate to the Investor's interest, without including the value of tax credits or other tax benefits. This conceptual requirement — appropriately not included in the wind tax credit guidance — was adopted from the rehabilitation tax credit guidance and introduces highly subjective criteria that may prove difficult to apply in practice. Fortunately, Revenue Procedure 2020-12 offers some helpful context on how to apply these standards. It says the Investor's expected return must not be fixed or limited, for example, to a preferred return to compensate the Investor for the use of capital. Instead the return must depend on the financial performance of the partnership. Nor can the Investor be substantially protected from their risk of loss in the venture. Lastly, the Investor's interest cannot be reduced through unreasonable fees. Carbon capture joint ventures will have to be carefully structured to comply with these standards, particularly if an investor requires contractual performance assurances that are otherwise permissible under this guidance.

Minimum Unconditional Investment

At the investment's inception, the Investor must make a minimum unconditional investment in the partnership equal to at least 20% of the fixed capital investment, plus reasonably anticipated contingent investments required under the partnership agreement — and maintain this investment threshold for the duration of the investment. The investment may, however, be reduced by distributions of cash flow from the partnership.

Contingent Consideration

In contrast to the wind and rehabilitation tax credit guidance, which permit no more than 25% of the Investor's contribution to be contingent, Revenue Procedure 2020-12 permits up to 50% of the Investor's contribution in a carbon capture flip partnership to be contingent. This feature should provide investors with substantial flexibility to structure "pay-go" provisions that enable an Investor to adjust its investment commitment based on the tax credits generated by the project or the achievement of other economic metrics.

Rights to Purchase and Sell

Revenue Procedure 2020-12 permits an Investor the contractual right to put its partnership interest to the Developer or the partnership for fair market value, but does not otherwise permit puts or calls to be structured at the time the partnership agreement is entered into. This differs from the wind tax credit guidance (which permits fair market value call options). Call options have provided a valuable structural mechanism for Investors and Developers to manage exit strategies in tax equity transactions. Given the strong case law support for fair market value call options in many other contexts throughout the tax law, the IRS's decision to remove this flexibility from Revenue Procedure 2020-12 is unfortunate and may pose a challenge to Investors and Developers seeking a clean exit path from the investment once the tax credit period is over.

Guarantees and Loans

The Investor generally cannot be guaranteed the ability to receive the 45Q Credits, cash payments for the 45Q Credits, or other distributions, if the IRS challenges the transactional structure of the partnership. Certain similar guaranties in favor of the Investor are permitted, however, such as completion guarantees, operating deficit guarantees, environmental indemnities, and financial covenants.

Importantly, Revenue Procedure 2020-12 provides a favorable framework that permits certain common commercial contracts that will not be considered impermissible investor guaranties. Long-term purchase agreements made at arm's length for carbon oxides will not be considered guarantees even if the agreements include "supply all," "supply-or-pay," "take all," "take-or-pay," or "securely-store-or-pay" provisions. These contracting structures will be particularly familiar to participants in the oil and gas space and should provide welcome flexibility to finance carbon capture projects.

Allocations of Credits

Revenue Procedure 2020-12 requires that allocations under the partnership agreement of the project company satisfy Section 704(b) and the regulations thereunder, which generally require such credits to be allocated in accordance with the partnership's receipts relating to carbon capture activities, or in the absence of receipts, the deductions associated with the cost of capture and disposal.

Request for Comments

The IRS has requested comments from taxpayers with respect to the features addressed (or not addressed) in Revenue Procedure 2020-12. Interested taxpayers should consider commenting with respect to any concerning aspects of the guidance.

Beginning of Construction Guidance for Section 45Q

The 45Q Credit is generally available for qualified carbon capture facilities the construction of which begins before January 1, 2024, and either (1) on which the construction of the carbon capture equipment has or will begin before January 1, 2024, or (2) the original planning or design for the facility includes the carbon capture equipment. Notice 2020-12 provides key guidance to determine whether construction has begun before January 1, 2024. This guidance closely mirrors the beginning of construction guidance for wind projects contained in a series of IRS Notices issued from 2013 through 2019.

Notice 2020-12 offers two alternatives for taxpayers to establish that construction has begun: the Physical Work Test and the Five Percent Safe Harbor.

Physical Work Test

The Physical Work Test generally requires that work of a significant nature is performed by the taxpayer or performed on behalf of the taxpayer by another person under a binding written contract. Both off-site and on-site work count, and the test focuses on the nature of the work, not the amount or cost. Notice 2020-12 lists examples of on- and off-site work that are unique to carbon capture projects, such as the manufacture of components necessary for the carbon capture process.

Five Percent Safe Harbor

Under the Five Percent Safe Harbor, construction is generally considered to have begun when the taxpayer pays or incurs 5% or more of the total cost of the qualified facility or carbon capture equipment. This includes amounts paid or incurred by another person under a binding written contract with the taxpayer.

Regardless of the method used to satisfy the beginning of construction, a taxpayer must satisfy a continuity test. In the case of Physical Work projects, the taxpayer must undertake a continuous program of construction, and in the case of Five Percent Safe Harbor projects, the taxpayer must make continuous efforts to advance toward completion. Regardless of the method chosen, taxpayers will automatically satisfy this continuity test if the project is placed in service by the end of the sixth year following the year in which construction began. This six-year safe harbor is more generous than the four-year safe harbor applicable to wind projects, and is a welcome relief considering the scale and complexity of many carbon capture projects.

What's Next?

Revenue Procedure 2020-12 and Notice 2020-12 are a helpful first step from the IRS toward the efficient development and financing of carbon capture projects. To fully develop, however, the industry still needs clarity on number of other areas, including the meaning of "secure geological storage" and the parameters of tax credit recapture in the event of a leak of sequestered carbon. Additional guidance, expected to come shortly in the form of Treasury Regulations, should help bridge the gap to an efficient market for the tax equity financing of carbon capture projects.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Jim Cole
james.cole@lw.com
+1.713.546.7435
Houston

Eli M. Katz
eli.katz@lw.com
+1.212.906.1620
New York

Chelsea M. Muñoz-Patchen
chelsea.munoz-patchen@lw.com
+1.713.546.7591
Houston

You Might Also Be Interested In

What's Next for the Carbon Capture Industry After New 45Q Credit Guidance (Webcast)

New Law Extends Tax Credits for Wind and Other Renewable Power Plants

Key Considerations for Back-Leverage Financings of Renewable Energy Projects

Carbon Capture Updates From the COP 25

The Rise of the Renewable Energy Fund