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Section 45Q Tax Credit- Final Treasury Regulations

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Section 45Q Final Regulations

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- The Treasury Department and IRS have issued long-awaited Final Regulations regarding the tax credit for carbon capture and sequestration under Section 45Q of the Code (the "section 45Q credit").

- Proposed Regulations issued on June 2, 2020 were the subject of over 80 taxpayer comments and a public hearing on August 26, 2020. The Final Regulations modify and clarify the Proposed Regulations on a number of issues.

Section 45Q Final Regulations

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- Generally, the amount of the section 45Q credit and the party that is eligible to claim the credit depend on whether the taxpayer captures qualified carbon oxide using carbon capture equipment originally placed in service at a qualified facility before February 9, 2018 ("Old 45Q Facility"), or on or after February 9, 2018 ("New 45Q Facility"), and whether the taxpayer disposes of the qualified carbon oxide in geological storage ("sequestration"), uses it as a tertiary injectant in a qualified enhanced oil or natural gas recovery project ("EOR"), or utilizes the carbon oxide in certain specified ways ("utilization").

Section 45Q Final Regulations

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- Treasury and the IRS have previously issued Notice 2020-12, providing guidance on when construction has begun on a qualified facility or on carbon capture equipment that may be eligible for the carbon capture credit, and
- Revenue Procedure 2020-12, creating a safe harbor for carbon capture partnerships formed to invest in projects qualifying for the section 45Q credit.
- The Final Regulations cross reference this guidance on certain issues

Section 45Q Final Regulations

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- Tax Credit is attributable to the Owner of Carbon Capture Equipment and physically or contractually ensures the capture and disposal, injection, or utilization of such qualified carbon oxide
- The Final Regulations clarify that a taxpayer that owns the carbon capture equipment does not need to own the industrial facility that emits the carbon oxide that is captured by the carbon capture equipment

Contracts to Ensure Capture and Disposal

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- 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.
- The Final Regulations provide that a taxpayer may enter into multiple contracts with multiple parties for the disposal, injection, or utilization of qualified carbon oxide.
- For example, a taxpayer who captures qualified carbon oxide may contract with one party to dispose of a portion of its captured qualified carbon oxide through sequestration and with another party to use a portion of its captured qualified carbon oxide as a tertiary injectant for EOR.

Contracts to Ensure Capture and Disposal

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- A contract to ensure the disposal, injection, or utilization of qualified carbon oxide must be a "written binding contract" that includes commercially reasonable terms that provides for enforcement.
- A written binding contract is a binding under state law and does not limit damages to an amount less than 5 percent of the total contract amount.
- Taxpayers may include information regarding how much carbon oxide the parties agree to dispose of, inject, or utilize in their contracts.
- Contracts also may include various other specific provisions relating to enforcement, such as long-term liability provisions, indemnity provisions, or penalties for breach of contract or liquidated damages.

Contracts to Ensure Capture and Disposal

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- A taxpayer may enter into a binding written contract with a general contractor that 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 set forth in the Final Regulations.
- The Final Regulations also provide that as long as all contractual requirements are met, parties to these contracts may be related.

Carbon Capture Equipment

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- The Final Regulations define "carbon capture equipment" generally in terms of its functionality.
- 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 Final Regulations also remove the proposed list of qualifying carbon capture components and the excluded components to provide flexibility without limiting the definition of carbon equipment solely to a list of components.

Carbon Capture Equipment

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- Carbon capture equipment generally does not include components of property used for transporting qualified carbon oxide for disposal, injection, or utilization, such as pipelines, branch lines, or land and marine transport vessels.
- The carbon capture equipment ends at the delivery point to a pipeline.
- Carbon capture equipment includes 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.

Carbon Capture Equipment

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- The Final Regulations also clarify that 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.

Qualified Facility

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- Section 45Q requires that a qualified facility capture a specified amount of carbon oxide each taxable year- the Minimum Threshold Requirements.
- In general, a qualified facility that is not an electric generating plant and the captured carbon is not for "utilization" must capture 100,000 metric tons per year.
- The Final Regulations allow taxpayers to apply the "single project" rule of Notice 2020-12 to treat multiple facilities as a single facility for purposes of the Minimum Threshold Requirements, i.e., Aggregation.

Qualified Facility- Single Project

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Factors indicating that multiple qualified facilities or units of carbon capture equipment are operated as part of a "single project" include, but are not limited to:

1. owned by the same legal entity;
2. commonly managed or operated;
3. operated under similar operations and maintenance protocols established by the owner of the equipment, considering differences attributable in resource utilization and expected use of captured carbon oxides;
4. constructed pursuant to a single plan for Front-End Engineering and Design (FEED) or other approaches for front-end planning (e.g., the Front-End Loading (FEL) approach);

Qualified Facility- Single Project

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5. the carbon oxide is transported, disposed of, utilized, or used as a tertiary injectant pursuant to a shared contract;
6. the carbon capture equipment was constructed pursuant to a single construction management contract; and
7. construction of all units of carbon capture equipment is financed pursuant to a single loan agreement.

Whether multiple qualified facilities or units of carbon capture equipment are operated as part of a single project will depend on the relevant facts and circumstances. Each of the listed factors may or may not be relevant in a particular case.

Industrial Facility

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- An industrial facility is a facility that produces a carbon oxide stream from -
  - a fuel combustion source or fuel cell,
  - a manufacturing process, or
  - a fugitive carbon oxide emission source
- that, absent capture and disposal, would otherwise be released into the atmosphere as an industrial emission of greenhouse gas or lead to such release into the atmosphere.

Industrial Facility

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- An industrial facility does 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.
- The Final Regulations were modified from the Proposed Regulations to define a natural carbon dioxide-bearing formation as one that has greater than 90 percent carbon dioxide by volume.

Transfer of Section 45Q Credit

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- The Code provides that a person entitled to claim the credit, *i.e.,* the owner of the carbon capture equipment, may elect to transfer the section 45Q credit to the person that disposes of the qualified carbon oxide through sequestration, utilizes the qualified carbon oxide, or uses the qualified carbon oxide as a tertiary injectant for EOR (a "Transfer Election").
- The Final Regulations provide that the disposer, injector, or utilizer that enters into the contract with the electing taxpayer, i.e., the taxpayer that owns the carbon capture equipment, for the disposal, injection, or utilization of the electing taxpayer's qualified carbon oxide is the party that may qualify as a credit claimant pursuant to a Transfer Election.

Transfer of Section 45Q Credit

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- If such disposer, injector, or utilizer enters into a subcontract with a third-party to carry out the disposal, injection, or utilization, then the subcontractor may not be a credit claimant.
- The provision is premised on the fact that the third party who hires subcontractors is the party that has contractual privity with the taxpayer that owns the carbon capture equipment for the disposal, injection, or utilization of the qualified carbon.

Transfer of Section 45Q Credit

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- The Final Regulations provide that a Transfer Election may be made for all or a portion of the available section 45Q credit and may be made for a single or multiple credit transferees.
- If a person entitled to claim the credit elects to transfer the credit to multiple credit transferees, the maximum amount of section 45Q credits allowable to each credit transferee is proportional to the amount of qualified carbon oxide disposed of, utilized, or used as a tertiary injectant by such transferee.

Recapture

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- Recapture of the tax credit applies with respect to any qualified carbon oxide which ceases to be captured, disposed of, or used as a tertiary injectant in a manner consistent with the requirements of section 45Q.
- Treasury has reduced the period for any potential recapture from five-years in the Proposed Regulations to three years in the Final Regulations.
- Treasury explained that a three-year recapture period sufficiently accounts for risk and reduces the compliance burden that would be imposed by a five-year recapture period.

Recapture

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- Any recapture amount will be accounted for in the taxable year that it is identified and is reported as an addition to tax for such year.
- Netting: If, during the recapture period, 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 for EOR in that taxable year.