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Client Alert

Section 45Q Guidance

February 21, 2020

Executive Summary

- On February 19, 2020, the Internal Revenue Service ("IRS") issued two guidances, Notice 2020-12 and Rev. Proc. 2020-12, related to the tax credit allowed for the sequestration of qualified carbon oxide (the "Section 45Q Credit").
- Notice 2020-12 sets forth the methods by which taxpayers may establish "beginning of construction" for purposes of the Section 45Q Credit.
- Rev. Proc. 2020-12 establishes a safe harbor to treat project companies as partnerships and as properly allocating Section 45Q Credits in accordance with Section 704(b) of the Code.
- Both the notice and the revenue procedure generally follow principles similar to those for the production tax credit ("PTC") and the investment tax credit ("ITC"), with some differences discussed in this alert.
- The new guidance does not discuss other outstanding concerns related to the Section 45Q Credit, including rules on recapture of the Section 45Q Credit for leakage or release of carbon oxide or the election under Section 45Q(f)(3)(B) for the transfer of Section 45Q Credits.

General Background

- The Section 45Q Credit originated in 2008 as part of the Energy Improvement and Extension Act of 2008.
- In Notice 2009-83, the IRS provided interim guidance on determining eligibility for the credit, the amount of the credit, adequate security measures for secure geological storage of CO2, and reporting requirements.
- The Section 45Q Credit was revised as part of the Bipartisan Budget Act of 2018 and signed into law in February 2018. As part of the 2018 amendment, the rules were clarified to add that the credit under Section 45Q applies to qualified carbon oxide (as supposed to qualified carbon dioxide that was previously the subject of the credit) and that construction of a qualified facility that includes carbon capture equipment must begin before January 1, 2024.
- The Department of the Treasury and the IRS published Notice 2019-32 in May 2019, requesting comments related to the Section 45Q Credit. Commentators requested guidance regarding the beginning of construction requirements for the Section 45Q Credit in response to such notice. In response, the IRS has provided Notice 2020-12 and Rev. Proc. 2020-12.

Notice 2020-12

- The IRS has released a series of notices relating to the beginning of construction rules under Sections 45 and 48 of the Code for the PTC and ITC. (See Notices 2013-29, 2013-60, 2014-46, 2015-25, 2016-31, 2017-04, 2018-59, and 2019-43). Notice 2020-12 generally adopts similar principles and guidelines from these prior notices for purposes of the Section 45Q Credit beginning of construction requirements.
- Under Notice 2020-12, a taxpayer can establish beginning of construction by starting physical work of a significant nature (the "Physical Work Test") or meeting a safe harbor by paying or incurring 5% or more of the total depreciable cost of the qualified facility or carbon capture equipment (the "5% Safe Harbor"). There is a continuity requirement for both methods to satisfy the beginning of construction requirement (i.e., the continuous construction requirement for the Physical Work Test and the continuous efforts test for the 5% Safe Harbor). Similar to the PTC and ITC beginning of construction guidance, construction will be deemed to have begun on the date the taxpayer satisfies either method.
- **Physical Work Test for Construction of a Qualified Facility or Carbon Capture Equipment**
  - Satisfied when construction of physical work of a significant nature begins. There is no fixed minimum amount of work or cost associated with satisfying the test for physical work of a significant nature, and the following examples illustrate physical work of a significant nature:
    - Off-site physical work of a significant nature generally includes the manufacture of components, including, but not limited to, mounting equipment and support structures, components necessary for carbon capture processes, and components and equipment necessary for disposal of qualified carbon oxide in secure geological storage.
    - On-site physical work of a significant nature includes, but is not limited to, the excavation for and installation of foundations; 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 for disposal, utilization, or use as a tertiary injectant; the installation of components necessary for carbon capture processes; and the installation of equipment and other work necessary for the disposal of qualified carbon oxide in secure geological storage.
  - Preliminary activities (such as securing financing or obtaining permits) or work to produce components that are considered inventory by a vendor are not considered physical work of a significant nature.
  - There must be continuous construction in order to meet the physical work test.
- **5% Safe Harbor for Construction of a Qualified Facility or Carbon Capture Equipment**
  - Satisfied if a taxpayer pays or incurs 5% or more of the total costs properly includible in the depreciable basis of the qualified facility or carbon capture equipment and the taxpayer makes continuous efforts to complete the qualified facility or carbon capture equipment.
- **Excusable Disruptions to Continuity Requirements**
  - As discussed above, both the Physical Work Test and the 5% Safe Harbor are subject to their respective continuity requirements. The IRS provides a non-exclusive list of construction

disruptions that offers relief to a taxpayer who has failed the continuity requirement, which is near-identical to the corresponding list in Notice 2016-31 for the PTC and ITC:

- severe weather conditions;
- natural disasters;
- delays in obtaining permits or licenses from any federal, state, local, or Indian tribal government;
- delays at the written request of a federal, state, local, or Indian tribal government regarding matters of public safety, security, or similar concerns;
- interconnection-related delays, such as those relating to the completion of construction on a new carbon dioxide pipeline or necessary upgrades to resolve capacity or congestion issues that may be associated with a project's planned interconnection;
- delays in the manufacture of custom components;
- labor stoppages;
- the inability to obtain specialized equipment of limited availability;
- the presence of endangered species;
- financing delays; and
- supply shortages.

- **Continuity Safe Harbor**
  - If a taxpayer places a qualified facility or carbon capture equipment in service by the end of the calendar year that is no more than six calendar years after the calendar year during which construction began, the taxpayer will be deemed to satisfy the continuity safe harbor. This six-year continuity safe harbor for Section 45Q Credit is notably longer than the four-year safe harbor for PTC and ITC.
  - For example, if construction of a qualified facility or carbon capture equipment begins on June 15, 2021 and such facility or equipment is placed in service by December 31, 2027, the continuity safe harbor will be satisfied.

- **Other**
  - The notice provides definitions for "qualified carbon oxide," "qualified facility," "industrial facility," "direct air capture facility," and "carbon capture equipment."
  - Additional guidance on retrofitted facilities and the determination of a single project or multiple qualified facilities also largely mirror the same principles that apply to the PTC/ITC.
  - The notice also provides rules related to the transfer of qualified facility or carbon capture equipment and the relocation or transfer of components for such qualified facility or carbon capture equipment.
  - While Notice 2020-12 is effective for transactions entered into on or after March 9, 2020, the IRS will treat transactions as having met the beginning of construction requirements for Section 45Q if such transactions meet the requirements above.

Rev. Proc. 2020-12

- Similar to the wind PTC safe harbor found in Rev. Proc. 2007-65 (the "Wind Safe Harbor"), Rev. Proc. 2020-12 establishes a safe harbor under which the IRS will respect the partnership allocations of Section 45Q Credits in accordance with Section 704(b) of the Code for tax equity flip-structures.
- Section 45Q allows a credit of an amount per metric ton of qualified carbon oxide captured by the taxpayer, which may vary depending on the date the carbon capture equipment is placed in service and whether the qualified carbon oxide is disposed of in secure storage, used, or utilized.
- Where carbon oxide is captured using equipment that is originally placed in service at a qualified facility on or after February 9, 2019, the Section 45Q Credit is available during the 12-year period beginning on the date the equipment was originally placed in service.
    - For purposes of the "placed in service" rules, the IRS notes that the term will have the same meaning as the term has been defined for purposes of the ITC and deductions for depreciation.
- Section 704(a) provides rules regarding a partner's distributive share of income, gain, loss, deduction, or credit. Section 704(b) provides that a partner's distributive share of such items is determined in accordance with the partner's interest in the partnership if (a) the partnership agreement does not provide the allocations; or (b) the allocation to a partner under the partnership agreement does not have substantial economic effect.
- Under Treas. Reg. Section 1.704-1(b)(4)(ii) generally, allocations of tax credits and related recapture are not reflected in the partners' capital accounts and, thus, these allocations cannot have economic effect under Treas. Reg. Section 1.704-1(b)(2)(ii)(b)(1). The tax credits and related recapture must be allocated in accordance with the partners' interests in the partnership at the time the tax credit or credit recapture arises.
- **Scope of Application:** The Safe Harbor applies to any partnership that validly claims the Section 45Q Credit. As is the case with the Wind Safe Harbor, if Developers, Investors, and the Project Company satisfy all the requirements of the Safe Harbor, the IRS will treat the Investor as a partner in the Project Company and will treat the Project Company as properly allocating the Section 45Q Credit in accordance with Section 704(b).
- **Safe Harbor Requirements**
    - **Developer:** Each Developer 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.
    - **Investors:**
        - Each Investor must have a minimum interest in each material item of partnership income, gain, loss, deduction, and credit equal to at least five percent of the Investor's percentage interest in each such item for the taxable year for which the Investor's percentage share of that item is the largest (as adjusted for sales, redemptions, or dilutions of its interest). Investors include partners who are initial partners or partners who subsequently acquire an interest in the Project Company by contribution or purchase of partnership interests. Such partnership interest must constitute a bona fide equity investment, and the Investor's partnership interest must not be reduced through fees or other arrangements.

Similar to requirements set forth in Notice 2007-65, the Investor's minimum unconditional investment must equal at least 20% of the sum of the fixed capital contributions plus reasonably anticipated contingent investment required to be made under the partnership agreement, and the Investor must not be protected against loss of any portion of its investment through any arrangement with the Developer, any other Investor, carbon oxide emitter, offtaker, or any person related to any of the foregoing.

- Unlike the Wind Safe Harbor, which requires that at least 75% of the sum of the fixed capital contributions plus reasonably anticipated contingent capital contributions to be contributed by the Investor be fixed and determinable obligations that are not contingent in amount or certainty of payment, Notice 2020-12 requires that the capital contributions that are fixed and determinable must only exceed 50% of the sum of the fixed investment plus reasonably anticipated contingent investments.

- **Purchase Rights**: Unlike the Wind Safe Harbor, which allowed the Developer to have a contractual right to purchase the wind farm or an interest in the Project Company five years after the qualified facility was placed into service, Rev. Proc. 2020-12 does not allow the Developer, the Investors, or any related person to have a contractual right to purchase the carbon capture equipment or an interest in the Project Company.
- **Sale Rights:** Unlike the Wind Safe Harbor, which disallowed both the Project Company and the Investors from having a contractual right to cause any party to purchase the wind farm or any interest in the Project Company, Rev. Proc. 2020-12 only limits the Investor's ability to have a sale right in excess of the FMV of such interest at the time of the sale.
- **Guarantees and Loans:** No person involved in any part of the Project Company may directly or indirectly guarantee or otherwise insure the Investor's ability to claim the Section 45Q Credit in the event the IRS challenges the structure of the partnership. Notably, while "take or pay" contracts between related parties were considered guarantees for PTC investments, such arrangements will not be treated as guarantees for purposes of Section 45Q Credits.

- **Allocation of the Section 45Q Credit under the Safe Harbor**. Allocations of the Section 45Q Credit and any recapture thereof under the Project Company's partnership agreement must satisfy the requirements of section 704(b) and § 1.704-1(b)(4)(ii).
- **Application of Rev. Proc. 2020-12.** While Rev. Proc. 2020-12 is effective for transactions entered into on or after March 9, 2020, the IRS will treat an Investor as a partner in the Project Company and treat the Project Company as properly allocating Section 45Q Credits in accordance with the Safe Harbor in the case of transactions that meet the requirements above.

Remaining Uncertainty

- While the new guidance clarifies previous uncertainty regarding beginning of construction and the allocation of the Section 45Q Credit, uncertainty remains with respect to a number of issues, including the calculation of the credit, the regulatory scheme that will apply for purposes of qualifying for the Section 45Q Credit, how and when recapture of the Section 45Q Credit is applicable, clarification or need for defined terms (such as, tertiary injectant utilization, secure geological storage, etc.), reporting guidelines (if any), guidance related to the commercial "use" of sequestered carbon, or further details regarding the election under Section 45Q(f)(3)(B) for the transfer of Section 45Q Credits.

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