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IRS Releases Tax Equity Structuring Guidance for Carbon Capture Projects

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The IRS released much-anticipated guidance for the carbon sequestration tax credit under section 45Q of the Internal Revenue Code on February 19, 2020. The guidance sets the foundation for "tax equity" transactions involving the credit, which until this point had too many open questions to be financeable. Although questions remain, this guidance is a significant step toward unlocking a tax equity market for carbon capture. The guidance is in Revenue Procedure 2020-12, and is effective for transactions entered into after March 8, 2020.

Background on Carbon Sequestration Credits and Tax Equity Transactions

The carbon sequestration credit provides a dollar-for-dollar reduction in federal income tax liability for each metric ton of "qualified carbon oxide" captured at a qualifying plant and then permanently buried, used as a tertiary injectant in an enhanced oil or natural gas recovery project, or used in another commercial process that would result in the permanent disposal of the carbon oxide. For projects placed in service after February 8, 2018, the credits are available annually over a 12-year period beginning in the year in which the equipment is placed in service. The construction of the facility that includes the carbon capture equipment must begin by the end of 2023 to qualify. The credit amount ranges from $10–50 per metric ton, depending on when the carbon capture equipment is placed in service and what is done with the carbon oxide after it is captured. The credit is worth more if the carbon oxide is permanently buried as opposed to put to a different use.

A "tax equity" transaction is effectively a bartering transaction in which a sponsor forms a partnership with an investor (a "tax equity investor") who is allocated a disproportionate share (usually 99%) of the tax benefits from a project in exchange for cash capital contributions. The tax benefits are tax credits and depreciation, as explained below. Tax equity investors are typically entities like banks, other financial institutions and corporations with large amounts of taxable income that they can offset with tax credits and depreciation deductions from a project.

Revenue Procedure 2020-12

Rev. Proc. 2020-12 is significant for the development of the tax equity market for carbon capture because it establishes a framework for how tax equity transactions should be structured to ensure that the tax equity investor will be entitled to claim the credit. The general structure is very similar to existing guidance for wind transactions that the IRS released in Rev. Proc. 2007-65, and also borrows a few ideas from tax guidance for historic tax credit transactions in Rev. Proc. 2014-12.

Carbon sequestration transactions will take the form of a "partnership flip," a structure that is common in the U.S. renewables market. In such transactions, the tax equity investor is typically allocated 99% of the tax benefits and a negotiated portion of the cash until the tax equity investor reaches a target after-tax yield. Once that occurs, the tax equity investor's share of tax items will decrease (but not below 5%), along with its share of cash. Rev. Proc. 2020-12 reflects the IRS's expectation that the tax equity partnership in this context will typically be the entity that owns the carbon capture equipment. Section 45Q also permits the owner of the carbon capture equipment to transfer the credits to the entity that disposes of the carbon oxide, but that mechanic is not addressed in the guidance.

In addition to confirming the general partnership flip structure for carbon sequestration, Rev. Proc. 2020-12 establishes a safe harbor framework in which, if all of the requirements are met, the IRS will treat the tax equity investor as a partner in the tax equity partnership with the sponsor, and will treat the partnership as properly allocating the tax credit to the tax equity investor in accordance with section 704(b) of the Internal Revenue Code.

There are 11 substantive requirements under the Rev. Proc. Safe Harbor:

1. The developer of the carbon capture project must have no less than a 1% interest in each material item of partnership income, gain, loss, deduction and credit at all times during the existence of the partnership.

2. The tax equity investor must maintain an interest in each material item of partnership income, gain, loss, deduction and credit equal to at least 5% of the largest percentage share of income or gain it holds in the partnership at any time.

   Combining the two rules above, a typical tax allocation structure in a two-partner partnership will start at 99/1% in favor of the tax equity investor and eventually "flip" to 95/5% in favor of the developer.

3. The tax equity investor's partnership interest must constitute a "bona fide equity investment with a reasonably anticipated value commensurate with the [tax equity investor's] overall percentage interest in the [tax equity partnership]," separate from its allocation of tax benefits. Further, the tax equity investor must not be substantially protected against losses, and its return must not be limited in a manner comparable to a preferred return representing a payment for capital.
4. The value of the tax equity investor's interest cannot be reduced through fees or other arrangements that are unreasonable compared to the market, and may not be reduced by disproportionate rights to distributions or issuances of interests in the partnership for less than fair market value consideration.

   The rules in the third and fourth requirements above originated in Rev. Proc. 2014-12, which was a reaction to a historic tax credit transaction in which a U.S. appeals court concluded that the purported investor was not a true partner for federal income tax purposes and was not entitled to an allocation of historic tax credits.[1] The purpose of these additional requirements is generally to ensure that the tax equity investor has true upside potential and downside risk.

5. The tax equity investor must unconditionally invest into the partnership at least 20% of the sum of all fixed and reasonably contingent amounts it is anticipated to make over the term of the agreement.
6. At least 50% of the tax equity investor's total capital contributions must be fixed and determinable and not contingent in amount or certainty of payment. In a helpful clarification, contributions to the partnership to pay ongoing operating expenses will not be treated as contingent.
7. The developer, the tax equity investor or any related party may not have a call option to purchase the carbon capture equipment or an interest in the partnership at a future date regardless of price.
8. The tax equity investor may have a put right to require someone involved in the carbon capture project to purchase its partnership interest at a future date as long as the exercise price is no more than fair market value determined at the time the option is exercised. For this purpose, fair market value may only take into account contracts or other arrangements creating rights or obligations with

respect to the tax equity investor's partnership interest if they are entered into in the ordinary course of business and are negotiated at arm's length.

9. No person involved in the partnership can directly or indirectly (a) guarantee the tax equity investor's ability to claim carbon sequestration tax credits if the IRS challenges the transactional structure of the partnership, or (b) guarantee the cash distributions that the tax equity investor expects to receive. However, the tax equity investor may obtain insurance, including tax credit recapture insurance, from third parties that are not involved in the carbon capture transaction. Further, the developer is permitted to guarantee the performance of acts necessary to claim the tax credit (e.g., ensuring proper storage of the carbon oxide) and the avoidance of any act or omission that would cause the partnership to fail to qualify for the tax credit or that would result in its recapture. The guidance also clarifies that a long-term carbon oxide purchase agreement or lease of equipment entered into by the partnership does not constitute a prohibited guarantee.
10. Neither the developer nor any related person may lend a tax equity investor the funds to acquire its interest in the partnership.
11. The partnership's tax allocations must satisfy the requirements of section 704(b) and its underlying regulations, and the carbon oxide sequestration tax credits and any recapture of such tax credits must be allocated in accordance with Treasury Regulations § 1.704-1(b)(4)(ii). If the partnership generates revenues from its carbon capture activities (e.g., payments for capturing or selling carbon oxide), and those receipts give rise to valid allocations of income, then the tax credits are allocated in proportion to the partners' respective shares of such income. However, if the partnership does not receive payments for its carbon capture activities, the credits are allocated in proportion to the partners' shares of the loss or deductions associated with the capture and disposal or other use of the carbon oxide.

The guidance also provides an example of a partnership flip structure that largely matches a similar example in Rev. Proc. 2007-65. There is a two-partner partnership between a developer and a tax equity investor. The investor is allocated 99% of partnership tax items (including credits) until it hits a target yield, after which point its share drops to 5% and the developer's share increases to 95%. Cash is allocated in varying ways throughout the different tax allocation periods, but after the "flip" point the cash is shared 95%/5% in favor of the developer.

Although Rev. Proc. 2020-12 generally follows the framework of Rev. Proc. 2007-65 for wind partnership flip transactions, there are a few key differences. One difference is that up to 50% of the tax equity investor's commitment can be contingent on project performance or other factors. These performance-based payments are commonly referred to as "paygo" contributions. The wind guidance limited paygo contributions to 25% of the total commitment. Another key difference is that sponsors are not permitted to have a call option, but investors are permitted to have a put option to require sponsors to buy their interests, as long as the option is not more than fair market value at the time of exercise. (This is consistent with historic tax credit guidance, but is the exact opposite of the wind guidance, which prohibits puts but allows sponsor call options that are exercisable at fair market value.)

Overall, it is helpful that the IRS borrowed so liberally from established rules with which many in the project finance market are already familiar. Sponsors, investors and lenders with renewables finance experience will have less of a learning curve in evaluating carbon capture opportunities.

Open Questions

Rev. Proc. 2020-12 is a critical step forward for the financeability of carbon capture projects with tax equity, but a number of open questions remain. Recapture rules for the credit have yet to be fleshed out, and there is also a lack of guidance about how the owner of the carbon capture equipment may transfer the credit to the entity that is disposing of the carbon oxide. Presumably, the principles described in Rev. Proc. 2020-12 would apply equally to the transferee in that circumstance, but it is not clear in the guidance.

It is also unclear whether the tax equity partnership needs a cash income stream to support the allocation of tax credits. In renewables transactions, it is generally thought that the tax equity investor should receive a minimum pre-tax return consisting of both cash and tax credits so that the investment has economic substance apart from tax benefits. However, the tax credit allocation portion of Rev. Proc. 2020-12 suggests that there may be circumstances in which the tax equity vehicle does not receive cash revenues from its carbon capture activities.

Despite these open questions, the release of this initial guidance is a significant first step toward establishing this nascent market. Sponsors and investors can now explore financing opportunities with confidence about how transactions should be structured.

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1. The case is *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012).↩

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