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## IRS Unveils Start of Construction Rules for Carbon Capture Projects

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The IRS released important guidance for developers of carbon capture projects that qualify for carbon sequestration tax credits under section 45Q of the Internal Revenue Code on February 19, 2020, saying that such projects will be considered to have begun construction for purposes of qualifying for the credit if their owner commences “physical work of a significant nature,” or pays or incurs (according to its method of accounting) at least 5% of the total cost of the project. The new rules are largely consistent with existing guidance for renewables projects that has been refined over a series of IRS notices dating back to 2013. The guidance is in Notice 2020-12, and is effective for transactions entered into after March 8, 2020.

### Background on Carbon Sequestration Credits and Qualifying Facilities

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.

The types of facilities that qualify for the tax credit include certain industrial facilities or direct air capture facilities. The construction of the carbon capture equipment at a qualifying facility must begin before 2024. Section 45Q defines an industrial facility as one that produces a carbon oxide stream from a fuel combustion source, a manufacturing process or a fugitive carbon oxide-emission source that, absent capture and disposal or utilization, would otherwise be released into the atmosphere as industrial emission of greenhouse gas or lead to such release (not including facilities that produce carbon dioxide through carbon dioxide production wells from natural carbon dioxide-bearing formations). Section 45Q defines a direct air capture facility as any facility that uses carbon capture equipment to capture carbon dioxide directly from the ambient air (not including any facility that captures carbon dioxide deliberately released from naturally occurring subsurface springs or using natural photosynthesis). The facility must also satisfy certain threshold requirements for metric tons of qualified carbon oxide captured during the taxable year. These requirements vary based on numerous factors, such as the nature of the facility and the amount of carbon oxide it emits annually.

## Two Methods to Begin Construction

There are two ways for a carbon sequestration project to be considered to have begun construction. One is by commencing "physical work of a significant nature." However, unless there is a "continuous program of construction," the IRS may decide that construction was not truly underway. The other is by incurring at least 5% of the total cost of the project, but thereafter, the taxpayer must make continuous efforts to advance toward completion of the project.

In addition to clarifying the beginning of construction requirement, the new rules also address ancillary issues such as project transfers and repowerings.

There is significant nuance to these general principles, but in concept they will be familiar to sponsors and investors in renewables projects. The specifics of Notice 2020-12 are discussed in more detail below.

## Physical Work Test

One way to start construction is by performing "physical work of a significant nature." The IRS has consistently maintained that this test focuses on the nature of the work performed as opposed to the amount or cost. There are no bright line rules.

A developer does not have to do the work itself as long as the work is performed under a binding written contract that is entered into before the work starts. A written contract is generally binding if it is enforceable under local law and does not limit damages to less than 5% of the contract price. A termination for convenience provision that permits the buyer to walk away for free, for example, would not be binding. The contract should clearly state the work to be done and the price. Contractual amendments can be dangerous in this area, as a substantial modification would call the binding nature of the original contract into question.

Both on-site and off-site work counts.

Examples of on-site work that would qualify include the excavation and installation of foundations (for the project as well as for buildings to house necessary equipment), including the setting of anchor bolts into the ground and the pouring of the concrete pads of the foundation; the installation of gathering lines necessary to connect to the carbon capture equipment before transportation for disposal or other use; the installation of components necessary for carbon capture processes; and the installation of equipment and other work necessary for the disposal of the carbon oxide in secure geological storage.

Examples of off-site work that would qualify include the manufacture of mounting equipment and support structures such as racks, skids and rails; the manufacture of components necessary for carbon capture processes; and the manufacture of components and equipment necessary for the disposal of carbon oxide in secure geological storage. However, consistent with IRS guidance in the renewables context, physical work is not significant if it includes the manufacturing of components that are either in existing inventory or normally held in inventory of a vendor. It is critical that any off-site work not run afoul of this rule.

Consistent with previous renewables guidance, the IRS clarified that preliminary activities do not count, even if their cost is properly included in the basis of the property. Examples include 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 facility or carbon capture equipment (including those on or attached to building structures).

## Five Percent Test

The other way to start construction is by paying or incurring at least 5% of a project's total cost. The "payment" standard is only available to cash method developers, which are typically individuals. Entities like partnerships and corporations generally use the accrual method of accounting and will only be able to count costs when they are treated as incurred for tax purposes.

"Total cost" means all costs included in a project's depreciable basis and, unlike previous guidance for renewables projects, costs associated with front-end engineering and design may be considered in determining the total cost. Cost overruns can cause a project to fail the 5% test, so it is generally better to aim for something like 6% or 7% to build a cushion.

Accrual method taxpayers cannot incur costs before "economic performance" occurs. Economic performance generally occurs when an item is delivered or accepted, or when title passes. The exact method depends on the taxpayer's method of accounting. An exception to this rule permits a taxpayer to count a payment for property as an immediate cost if the taxpayer can expect delivery or passage of title (preferably both) to occur within three and a half months of the payment. Use of the three and a half month rule is a method of accounting that would have to be used consistently by the taxpayer for all purposes.

Delivery does not necessarily have to be at the project site. It can be at the manufacturer's factory as long as it is clear that the buyer has really taken possession of the property. For example, the equipment should be physically separated from the property of the seller and other buyers, and the buyer should take out insurance covering risk of loss.

If a developer cannot establish that the 5% test is met based on its own costs, the rules permit it to look through to the contractor's costs, provided that the work was performed under a binding written contract.

The guidance is clear that mixing start of construction methods is generally not allowed. A developer is deemed to start construction on the date the first of the two tests is satisfied, and is stuck with that method moving forward.

## Continuity Requirement

Both the physical work test and the 5% test require work to continue once it starts, which is consistent with existing guidance for renewables projects. The guidance calls this a “continuity requirement.”

In the physical work test context, the requirement is for a “continuous program of construction” that involves continuous physical work. It is determined based on facts and circumstances. It is virtually impossible to prove unless physical work is literally happening every day.

The five percent test version of this concept is called “continuous efforts.” It is also based on facts and circumstances, but is theoretically easier to prove. It involves continuing to incur costs, entering into binding contracts to complete the project, obtaining necessary permits and performing physical work of a significant nature.

As with the renewables guidance, there are certain “excusable delays” that will not count against the taxpayer for purposes of determining whether work was continuous. They include things like natural disasters, permitting delays, financing delays and supply shortages.

Fortunately for developers, the rules also include a safe harbor concept imported from renewables guidance that says the continuity requirement will be deemed satisfied as long as a project is placed in service within six calendar years after the year in which construction starts, which is more generous than the four calendar year period provided in renewables guidance. For example, if work starts in 2020, the test is met as long as the project is placed in service by the end of 2026. If the project is not placed in service in time, the developer is stuck having to prove continuous work or continuous efforts based on facts and circumstances.

## Large Projects

Similar to the renewables guidance, multiple facilities or units of carbon capture equipment that are operated as part of a single, integrated project may be treated as a single facility or unit of carbon capture equipment for purposes of testing when construction started.

Whether multiple properties should be considered a single project depends on the facts. Facts that point to a single project include common ownership by a single legal entity, construction on contiguous pieces of land, a single system of gathering lines, disposal of carbon oxide pursuant to a shared contract, common construction

contracting and common financing.

Larger projects are often completed in phases that begin in different years. These kinds of phased projects rarely have enough commonalities (e.g., common financing and common ownership) that would require single project treatment. In such cases, each phase would be its own project with an independent construction start date.

Even if multiple projects are treated as a single project for purposes of the physical work test and 5% safe harbor, the rules permit them to be disaggregated for purposes of applying the continuity requirement. Portions of an otherwise single project that are not placed in service within the six-year window are therefore able to potentially still qualify under a facts and circumstances analysis.

## Transfers

Like the renewables guidance, the rules permit taxpayers to transfer property after construction begins without losing tax credit eligibility. The caveat is that if the transfer consists solely of equipment (as opposed to equipment plus other development rights, like land or an offtake contract), the transferee can only take the transferor's work or costs into account for purposes of the start of construction rules if they are "related." For the parties to be related, there needs to be overlapping ownership between the seller and purchaser of more than 20%. An unrelated purchaser of a project that includes development rights will have no problem.

## Repowerings

The guidance also explains how the start of construction rules work for developers that want to refit old projects with new equipment so that they qualify for tax credits. Property is treated as "new" when at least 80% of the total value of the property's components consist of new components. This is referred to colloquially as the "80/20 rule."

For start of construction purposes, the physical work test or the 5% safe harbor is determined by looking only at the work performed or costs incurred for the new components.

## Open Questions

Generally speaking, the start of construction rules are consistent with the existing body of guidance for renewables projects. This is a helpful development to the extent potential sponsors, investors and lenders are also familiar with such projects. It is also helpful that the IRS has issued start of construction guidance well in advance of the deadline, which facilitates advanced planning and related efficiencies.

Although Notice 2020-12 and the tax equity structuring guidance released in Rev. Proc. 2020-12 address some critical issues with respect to the financeability of carbon capture projects, there are a number of questions that remain unanswered. Recapture rules for the credit have yet to be fleshed out, and there is also a lack of guidance about the mechanics of how the owner of the carbon capture equipment may transfer the credit to the entity that is disposing of the carbon oxide. Hopefully these and other open issues will be resolved by similar IRS guidance in the near term, so as to build on the momentum of this first tranche of February 2020 guidance.

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