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Blog Post

IRS Releases First Wave of Carbon Sequestration Tax Equity Guidance

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The IRS issued much-anticipated guidance for the carbon sequestration tax credit under section 45Q of the Internal Revenue Code on February 19, 2020, a critical step towards unlocking a potential multibillion-dollar new tax equity market for carbon capture. The guidelines establish a framework that will be very familiar to sponsors and investors in renewable energy projects.

Background: What is the Carbon Sequestration Tax Credit?

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 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.

IRS Guidance on Structuring Transactions (Rev. Proc. 2020-12)

The first set of guidance is Rev. Proc. 2020-12, which sets up a safe harbor 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 partnership flips for wind transactions that the IRS released in Rev. Proc. 2007-65. Rev. Proc. 2020-12 also borrows a few ideas from tax guidance for historic tax credit transactions in Rev. Proc. 2014-12.

Under the guidance, carbon sequestration transactions will take the form of a "partnership flip" that is common in the U.S. renewables market. In such transactions, a 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 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.

The guidance discusses a number of factors that must be present in order for the allocation of tax credits to be respected. The factors are similar to the wind guidance, with a handful of 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 distinction is that sponsors are not permitted to have a call option, but a put option to require sponsors to buy the investor interest is allowed, 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.)

IRS Guidance on when Projects Have "Begun Construction" (Notice 2020-12)

The second set of guidance the IRS released is in Notice 2020-12, which provides rules for when carbon sequestration projects are deemed to have "begun construction." Carbon sequestration projects must begin before the end of 2023 to qualify for credits. Here the rules are also very similar to existing rules for renewables projects.

Construction begins when a taxpayer either performs physical work of a significant nature or incurs 5% of the total cost of a project. There are a number of nuances to these general rules, but it is helpful that the IRS has decided to incorporate guidance that is familiar for existing tax equity investors for renewables — many of whom have spent years analyzing detailed fact patterns on start of construction and are familiar with the existing guidance.

Open Questions

The guidance does not address a number of open questions about how the carbon sequestration credit is supposed to work. The recapture rules will require some clarification and there is also a lack of guidance on 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.

It is also unclear whether the tax equity partnership will need a cash income stream to support the allocation of the credits. The general market approach in renewables transactions is that tax equity investors should receive some amount of cash in addition to tax benefits so that the transaction has economic substance. However, there is language in Rev. Proc. 2020-12 suggesting that there may be circumstances in which the tax equity partnership would not be required to receive cash revenues from its carbon capture activities.

Next Steps

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

We encourage you to bookmark this blog for further updates on carbon sequestration tax credit guidance, or read our *Kirkland Alerts* with more in-depth analysis of the guidance's tax equity structuring considerations and start of construction rules.

Read more insights on Kirkland's Energy & Infrastructure blog.

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