KIRKLAND & ELLIS

Blog Post

Carbon Sequestration Tax Credit FAQ #1: Who is Eligible for the Credit?

10 July 2020

This is the first in an ongoing series of blog posts that will answer frequently asked questions about the carbon sequestration tax credit under section 45Q of the Internal Revenue Code. We have seen a significant uptick in interest in carbon capture projects since the release of additional IRS guidance this year, and we hope this series will be useful for those interested in learning more about the carbon capture market. This first post will explain eligibility for the credit.

Background

The carbon sequestration tax credit provides a dollar-for-dollar reduction in federal income tax liability for each metric ton of “quali ed carbon oxide” captured at a qualifying plant and then (1) permanently buried, (2) used as a tertiary injectant in an enhanced oil or natural gas recovery project or (3) 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 carbon capture equipment is placed in service.[1] The credit 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 is permanently buried as opposed to being used in an enhanced recovery project or put to another commercial use. For additional background, see our previous blog posts about IRS guidance that was issued in February 2020 and proposed U.S. Treasury regulations that were issued in May 2020.

Question #1: Who is Eligible to Claim the Credit?

Assuming the relevant carbon capture equipment is placed in service on or after February 9, 2018, the default rule is that the credit is available to the person that (1) owns the carbon capture equipment and (2) physically or contractually ensures the capture and disposal, injection or utilization of the carbon. This could be either the owner of the carbon-emitting facility, or a third party that contracts with the facility owner to install carbon capture equipment and offload the carbon.

If the person that owns the equipment also physically ensures capture and disposal, injection or utilization of the carbon, then this rule is fairly straightforward. It becomes more complicated if the equipment owner contracts with someone else to offload the carbon (a "carbon offtaker"). In that case, the offtake arrangement needs to be documented under a "binding written contract," which is a written contract that is enforceable under state law against both parties and that does not limit damages to a specified amount (e.g., through a liquidated damages provision). Although analogous "binding written contract" rules for when carbon capture and renewables projects begin construction provide that a contract that limits damages to at least 5% of the contract price is still binding, there is no minimum damages floor in this context. However, it is possible the regulations will include a similar rule before they are finalized.[2]

In addition to meeting the binding written contract requirement, U.S. Treasury regulations prescribe the following provisions that contracts may, or in some cases must, have:

For qualified carbon oxide that is intended to be utilized in a non-EOR commercial process, obligate the utilizing party to comply with measurement and reporting requirements in U.S. Treasury regulations.

Contract may:	Contract must:
Include long-term liability provisions, indemnity provisions, penalties for breach of contract or liquidated damages provisions.	Include commercially reasonable terms and provide for enforcement of the carbon offtaker's obligation to perform the disposal, injection or utilization of the qualified carbon oxide.
Include information including how many metric tons of qualified carbon oxide the parties agree to dispose of, inject or utilize.	In the case of carbon that is intended to be disposed of in secure geological storage, obligate the carbon offtaker to comply with secure storage criteria set

	forth in U.S. Treasury regulations (which borrow from EPA rules) and, in the case of a leak, promptly inform the equipment owner of all information that is pertinent to tax credit recapture (i.e., location of leak, quantity leaked, dollar value of tax credit attributable to leaked carbon).
Include minimum quantities that the parties agree to dispose of, inject or utilize.	For qualified carbon oxide that is intended to be used as a tertiary injectant in enhanced oil or natural gas recovery, obligate the carbon offtaker to comply with geological storage requirements in U.S. Treasury regulations (which borrow from EPA rules), and in the case of a leak, promptly inform the equipment owner of all information pertinent to tax credit recapture. For qualified carbon oxide that is intended to be utilized in a non-EOR commercial process, obligate the utilizing party to comply with measurement and reporting requirements in US Treasury regulations.

Note that there is an alternative set of rules in section 45Q whereby the taxpayer who would normally be entitled to the credit under the circumstances described above can elect to allow the carbon offtaker to claim the credit. The next blog post in this series will discuss the mechanics of this election and the ways the credit can be allocated to different transaction parties.

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1. Credits are also available for carbon capture projects that were placed in service earlier, but at a reduced rate and subject to a phase out after 75,000,000 metric tons are sequestered nationwide.↩

2. Both the taxpayer claiming the credit and the carbon offtaker have an annual obligation to disclose the contract to the IRS by filing a Form 8933 and providing additional reporting information prescribed in U.S. Treasury regulations. ↩

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