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Blog Post

Carbon Sequestration Tax Credit FAQ #3: How do the Recapture Rules Work?

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This is part of an ongoing series of blog posts that answer frequently asked questions about the carbon sequestration tax credit under section 45Q of the Internal Revenue Code. See [prior posts](#) for additional background on the tax credit.

Carbon capture tax credits are subject to clawback by the IRS if the carbon oxide for which the credits are claimed leaks into the atmosphere (a “recapture event”) during a five-year period after the initial storage, injection or use of the carbon oxide in a commercial process. The taxpayer would be required to repay the credits as additional tax due for the year in which the recapture event occurs. There is a limited exception for leaks due to issues outside of the taxpayer’s control, like volcanic activity or terrorist attacks. Recapture events are determined separately for each project.

Recapture is measured on a net basis, meaning that a recapture event would only occur in a taxable year to the extent the amount of carbon oxide that leaks into the atmosphere exceed the amount that is newly stored or used in such year. The amount of recapture is calculated on a last-in-first-out basis, which means the amount leaked is first deemed attributable to the immediately prior taxable year, then the second, and so on up to the fifth preceding year.

To give an example, assume a taxpayer captured 1,000 tons of carbon oxide in each of years 1, 2 and 3, and the relevant credit rates for those years are \$25, \$30 and \$35, respectively. If in year 4 there is a recapture event of 1,500 tons, then the recapture amount would assume that the year 3 qualified carbon oxide leaked first and the recapture amount would be \$50,000 (year 3’s 1,000 tons * \$35 = \$35,000, plus year 2 500 tons * \$30 = \$15,000). The tax credits are taken into income in year 4, when the recapture event occurs.

Monitoring Obligations

A taxpayer's monitoring obligation under proposed U.S. Treasury Regulations begins on the date the carbon is first stored or used as an injectant and ends on the earlier of (i) five years after the last taxable year in which the taxpayer claims tax credits, or (ii) the date monitoring ends under applicable federal environmental regulations. Note that certain states may impose longer monitoring requirements for non-tax purposes, but these are not relevant for tax credit recapture purposes.

Looking Ahead

The U.S. Treasury Regulations that provide the framework for the recapture rules described above are still in proposed form and subject to change before they become final.¹ The Department of the Treasury and the IRS held a public hearing on the proposed regulations on August 26, 2020, where comments to the recapture rules and other aspects of the proposed regulations were discussed. Among other comments, some advocated for a shortening of the recapture period, out of concern that it could dissuade tax equity investment in carbon capture equipment.

1. Taxpayers are permitted to rely on the proposed regulations immediately for taxable years beginning on or after February 9, 2018, as long as the rules are applied consistently and in their entirety.↩

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