HUNTON ANDREWS KURTH

Client Alert

February 2020

IRS Issues Guidance on the Section 45Q Tax Credit for Carbon Capture and Sequestration

The Internal Revenue Service (the "IRS") has released long-awaited guidance on the Section 45Q tax credit for carbon capture and sequestration. In Notice 2020-12, the IRS provides guidance to help businesses determine when construction has begun on a qualified facility or on carbon capture equipment that may be eligible for the carbon capture credit. In Revenue Procedure 2020-12, the IRS creates a safe harbor for carbon capture partnerships (the "Partnership-Flip Safe Harbor") similar to the safe harbors developed for partnerships receiving the wind energy production tax credit and the rehabilitation credit. The IRS anticipates issuing further guidance in the near future on issues ranging from secure geological storage to utilization to recapture of the credit for those claiming credits for carbon capture.

Section 45Q generally allows a credit of an amount per metric ton of qualified carbon oxide captured by the taxpayer that is either: (i) disposed of in secure geological storage; (ii) used as a tertiary injectant in a qualified enhanced oil or natural gas recovery project and disposed of in secure geological storage; or (iii) utilized in certain ways described in section 45Q(f)(5). The amount of the credit depends on the date the carbon capture equipment is placed in service and whether the qualified carbon oxide is disposed of in secure storage, used, or utilized as a tertiary injectant in enhanced oil recovery ("EOR"). In the case of carbon oxide captured using carbon capture equipment that is originally placed in service at a qualified facility on or after February 9, 2018, the Section 45Q Credit is available during the 12-year period beginning on the date the equipment was originally placed in service. In order for carbon capture equipment placed in service after February 9, 2018 to qualify, construction on that equipment must begin before January 1, 2024.

Revenue Procedure 2020-12 – Partnership-Flip Safe Harbor

The Partnership-Flip Safe Harbor provided in Revenue Procedure 2020-12 generally follows the partnership-flip safe harbor provided for the Section 45 tax credit for wind facilities found in Revenue Procedure 2007-65 (hereinafter referred to as the "Wind Safe Harbor") with certain modifications to better address certain of the issues associated with carbon capture and Section 45Q. Some of those modifications are consistent with guidelines for structuring transactions to take advantage of the Section 47 rehabilitation tax credit. The Wind Safe Harbor and general rules for what are commonly referred to as "partnership flip transactions" are well understood in the tax equity marketplace. We summarize the key requirements of the Partnership-Flip Safe Harbor for Section 45Q below.

Bona Fide Partnership. Many taxpayers urged the IRS to address directly the economic substance doctrine in providing guidance on partnership structures for the Section 45Q tax credit. In short, the economic substance doctrine holds that a transaction structured solely to take advantage of tax benefits will not be respected for tax purposes. A concern with respect to carbon capture projects is that certain projects may not generate any cash return and that the tax credits may constitute the sole economic return for the project. The IRS has generally been loath to take on the economic substance doctrine directly in the case of tax credits because of concerns that any loosening of the rules in one area may be argued against it in other areas.

In Revenue Procedure 2020-12, the IRS fails to address the issue directly while referring to certain authorities on bona fide partnerships. The IRS cites to authorities holding that a partnership exists where "parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise" *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949). The IRS cites *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 231 and 241 (2d Cir. 2006), for the proposition that a partner must have a "meaningful stake in the success or failure" of the enterprise. The IRS also cites *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425, 455 (3d Cir. 2012) with respect to a partner having downside risk and upside potential in the partnership. The IRS' citation of these general rules is its apparent attempt to give some comfort on economic substance without addressing it directly. The IRS goes into greater detail on how a bona fide partnership interest is established in the Partnership-Flip Safe Harbor requirements.

Partnership-Flip Safe Harbor Requirements

01. *Investors Defined*. The guidance simply states that an investor holds its interest as a partner as described in the other Partnership-Flip Safe Harbor provisions in section 4.02(2). This is a reference to how the guidance defines a bona fide partnership interest.

02. *Partner's Partnership Interests*. Consistent with the Wind Safe Harbor, a developer must have a minimum 1 percent partnership interest in each material item of partnership income, gain, loss, deduction, and credit at all times during the existence of the Partnership (or Project Company). The investor must have a minimum 5 percent partnership interest in each material item of partnership income, gain, loss, deduction, and credit at all times during the existence of the Partnership. These minimum partnership interest requirements mean that the investor may receive allocations of up to 99 percent of tax items, which would generally occur during the period that tax credits are being generated. After the investor hits its target return or the tax credit period ends, the investor's interest typically would "flip down" to 5 percent and the developer's interest would be increased to 95 percent. This structure leaves the developer with the majority of the residual interest in the project following the tax credit period.

The guidance then describes the requirements for an investor to be treated as a bona fide partner. The requirement can be broken down into three separate but related requirements. First, the investor's partnership interest must constitute a bona fide equity investment with a reasonably anticipated value commensurate with the investor's overall percentage interest in the Project Company, separate from any federal, state, and local tax attributes to be allocated by the Project Company to the investor. Second, an investor's partnership interest is a bona fide equity investment only if that reasonably anticipated value is contingent upon the Project Company's net income, gain, and loss, and is not substantially fixed in amount. Third, the investor must not be substantially protected from losses from the Project Company's activities. In other words, the investor must have some downside risk, and its economic return must not be limited in a manner comparable to a preferred return representing a payment for capital.

The guidance also prohibits arrangements that would reduce the investor's economic return through the structuring of fees (including developer, management, and incentive fees), or other arrangements, that are unreasonable compared with fees or other arrangements for a carbon oxide capture and utilization project that does not qualify for the Section 45Q credit, and may not be reduced by disproportionate rights to distributions or by issuances of interests in the Project Company (or rights to acquire interests in the Project Company) for less than fair market value consideration. Here, the IRS apparently is trying to prevent situations where a developer tries to limit the investor's economic return by having the project pay the developer or related parties unreasonable fees or tries to dilute the investor's interest for less than fair market value.

These requirements to establish a bona fide partnership interest will require careful analysis and consideration in putting together a carbon capture investment partnership especially in the case of a project that sequesters the carbon oxides and is relying solely on the tax credit as economic support for the endeavor.

03. *Investor's Minimum Unconditional Investment*. On the date the investor acquires an interest in the partnership or Project Company, the investor must make a minimum unconditional investment with respect to the Project Company equal to at least 20 percent of the sum of the fixed capital investment plus any reasonably anticipated contingent contributions. The investor must maintain the investor minimum investment throughout the duration of its ownership of its partnership interest, except that the investor minimum investment may be reduced as a result of distributions of cash flow from the Project Company's operations. This requirement is consistent with the requirement for the Wind Safe Harbor. The requirement is well understood in the energy tax credit marketplace and should not create any structuring issues.

04. *Contingent Consideration*. An investor's total consideration for its partnership interest must be more than 50 percent fixed and determinable obligations that are not contingent in amount or certainty of payment. This allows the remainder of the investor's total consideration to be contingent. In tax equity transactions, contingent consideration is often referred to as "pay-go" and is contributed to the partnership as tax credits are generated. Pay-go allows flexibility in structuring the consideration paid for an interest where there are uncertainties with respect to issues like production levels.

Partnership interest contributions to the Project Company to pay ongoing operating expenses will not be treated as part of the investor's contingent investment for purposes of this requirement. This provision excluding contributions for payment of on-going operating expenses from contingent contributions is favorable and was requested in comments submitted to the IRS by a number of taxpayers.

05. *Purchase Rights*. Neither the developer, the investors, nor any related person may have a call option or other contractual right or agreement to purchase, at any time, the Equipment, any property included in the Equipment, or a partnership interest at a future date (other than a contractual right or agreement for a present sale).

This restriction on purchase options is different from the Wind Safe Harbor. In tax equity transactions structured under the Wind Safe Harbor, it is common for the developer to have a purchase option to purchase the investor's partnership interest when the investor has reached its target return, the investor's interest flips down, or at a specified time in the future, such as the end of the tax credit period. Here, instead of allowing the developer a purchase option, the guidance permits the investor to have a right to put its interest to the developer as described in the "Sale Rights" section below.

06. *Sale Rights*. An investor may not have a contractual right or other agreement to require any person involved in any part of the carbon capture transaction to purchase or liquidate the investor's partnership interest at a future date at a price that is more than its fair market value determined at the time of exercise of the contractual right to sell.

Providing a put right in lieu of a call option is consistent with the IRS guidance on the rehabilitation tax credit under Section 47. As noted above, the investor may have the right to put its interest to the developer at fair market value. It may not put its interest to the developer at an amount in excess of fair market value. This restriction prevents the investor from receiving a guaranteed return by putting its interest to the developer for its specified return. It also means that the investor bears the downside market value risk on its partnership interest, which is required to have a bona fide partnership interest. The fair market value of the interest will have to be determined at the time the put is exercised. A put right may be seen by some tax equity investors as favorable because it may allow the investor greater certainty as to when it can exit the transaction.

07. *Determination of Fair Market Value*. Solely for the purposes of the Partnership-Flip Safe Harbor, any determination of the fair market value of the equipment or a partnership interest may take into account contracts or other arrangements creating rights or obligations only if such contracts or other arrangements creating rights or obligations are entered into in the ordinary course of the Project Company's business and are negotiated at arm's length.

08. *Guarantees and Loans*. The guidance provides favorable rules on the type of guarantees that an investor or the partnership may receive. As a general rule, no person involved in any part of the Project Company may directly or indirectly guarantee or otherwise insure the investor's ability to claim the Section 45Q credit in the event that the IRS challenges all or a portion of the *transactional structure of the partnership*. This provision requires the investor to assume the "structural risk" with respect to the structure of the transaction and the partnership, such as whether there is a bona fide partnership for tax purposes. Assumption of structural risk generally is well understood and accepted as an investor risk in tax equity transactions involving energy tax credits.

Further, no person may guarantee that the investor will receive distributions from the Project Company or consideration in exchange for its interest in the Project Company except for the right of the investor to put its interest to the developer at fair market value. In other words, no person may guarantee a return to the investor. Importantly, this requirement does not prohibit the investor from procuring insurance, including recapture insurance, from persons not related to the developer or other parties to the transaction. As is the case for other tax credits, an investor must assume the structural risk associated with the transaction but can insure that risk with an insurer. Although this guidance does not go into detail, it is generally understood with respect to other tax credits that the investor must obtain the insurance and that it cannot be provided by the developer. The IRS also approves insurance against tax credit recapture. As the risk of recapture of the tax credit is a concern to potential investors, the ability to insure against that risk should be viewed favorably.

The guidance also specifically permits certain guarantees against commercial risks: (i) guarantees for the performance of any acts necessary to claim the Section 45Q credit, including ensuring proper secure geological storage of the qualified carbon oxide through disposal, or use as a tertiary injectant; and (ii) guarantees for the avoidance of any act (or omissions) that would cause the Project Company to fail to qualify for the Section 45Q Credit or that would result in a recapture of the Section 45Q Credit. Examples of guarantees permitted include completion guarantees, operating deficit guarantees, environmental indemnities, and financial covenants.

A long-term carbon oxide purchase agreement entered into on arm's-length terms between the Project Company and an Emitter, between the Project Company and an offtaker, or between an emitter and an offtaker, does not constitute a guarantee even if the emitter or the offtaker is related to the Project Company, and even if such contracts contain "supply all," "supply-or-pay," "take all," "take-or-pay," or "securely-store-or-pay" provisions. This provision should allow the Project Company to receive damages from an emitter that guarantees a certain level of production or a contract with an offtaker that contracts to take all of the production but then fails to do so.

09. *Allocation of the Section 45Q Credit*. Allocations under the Project Company's partnership agreement must satisfy the requirements of section 704(b) and the regulations thereunder. In short, if the Project Company generates receipts from its activities relating to carbon oxide sequestration, such as payments for capturing qualified carbon oxide or for the sale of qualified carbon oxide, the credit will be allocated in accordance with a valid allocation of those receipts. If the Project Company does not receive payments for its activities relating to carbon oxide sequestration, an allocation of the Section 45Q Credit will occur in the same proportion as the partners' respective distributive shares of the loss or deduction associated with the cost of the capture and disposal.

Request for Comments. Treasury and the IRS have requested comments on the requirements of the Partnership-Flip Safe Harbor. Taxpayers who have concerns about any of the provisions should consider commenting.

Summary and Takeaways

In all, the Partnership-Flip Safe Harbor provided for Section 45Q is largely consistent with taxpayer recommendations to the IRS. The IRS has provided favorable rules and modifications to the Wind Safe

Harbor on a number of fronts to accommodate the commercial realities of carbon capture, including 50 percent contingent payments, an investor put right, and clarity around permissible guarantees. The rules around establishing a bona fide partnership interest will require more analysis and careful consideration. The Partnership-Flip Safe Harbor guidelines should provide a boost to getting carbon capture and sequestration transactions off the ground.

Notice 2020-12 – Beginning of Construction Guidance

The second piece of guidance issued by the IRS for Section 45Q is Notice 2020-12 (the "Notice"), which provides guidelines and a safe harbor for purposes of determining when construction has begun on a qualified facility or on carbon capture equipment that may be eligible for the Section 45Q credit. For facilities placed in service after February 9, 2018, Section 45Q defines the term "qualified facility" as any industrial facility or direct air capture facility 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. To qualify, the construction of the qualified facility must begin before January 1, 2024, and either (i) construction of the carbon capture equipment begins before such date, or (ii) the original planning and design for such facility includes installation of carbon capture equipment. Under this definition, the "qualified facility" is the facility that emits the qualified carbon oxide and incorporates carbon capture equipment. Since many facilities that are targeted for carbon capture will be existing industrial facilities that are retrofitted with "carbon capture equipment," those facilities will have begun construction prior to the required date, and the focus will be on beginning construction of the carbon capture equipment before January 1, 2024.

As expected, the Notice provides rules substantially similar to the "beginning of construction" rules applicable to production tax credits for wind energy projects and the investment tax credit for solar projects. Similar to the "beginning of construction" rules for other energy tax credits, the Notice generally provides two methods for establishing that construction has begun: a taxpayer may establish the beginning of construction by either (i) starting physical work of a significant nature (the "Physical Work Test"), or (ii) paying or incurring 5 percent or more of the total cost of the qualified facility or carbon capture equipment (the "5% Safe Harbor"). Both methods require a taxpayer to make continuous progress towards completion once construction has begun under one of the above tests (the "Continuity Requirement"). The Notice provides a safe harbor for meeting the Continuity Requirement providing that a facility will be deemed to meet the Continuity Requirement if the facility is placed in service within 6 calendar years from the year in which construction first began (the "Continuity Safe Harbor").

The Notice provides that construction will be deemed to have begun on the date the taxpayer first satisfies one of the two methods. The Notice further provides that a taxpayer that fails to satisfy the 5% Safe Harbor in one year due to cost overruns (as described below) will not be prevented from using the Physical Work Test in a later year to establish beginning of construction, provided it satisfies the 5% Safe Harbor before January 1, 2024.

Key Definitions

The Notice provides that "carbon capture equipment" includes all components of property that are used to capture or process (for example, separation, purification, drying, and/or compression) carbon oxide until it is transported away from the qualified facility for disposal, utilization, or use as a tertiary injectant. For these purposes, carbon capture equipment includes a system of gathering lines that collect carbon oxide captured from a qualified facility or multiple qualified facilities that constitute a single project (as described in more detail below) for the purpose of transporting that carbon oxide away from the qualified facility or single project to a pipeline used to transport carbon oxide from multiple taxpayers and projects.

The definition of "carbon capture equipment" is important because the tax credit is attributable to "the person that <u>owns the carbon capture equipment</u> and physically or contractually ensures the capture and disposal, utilization, or use as a tertiary injectant of such qualified carbon oxide" Section 45Q(f)(3)(A)(ii) (emphasis added). The carbon capture equipment is separate and distinct from the qualified facility. The taxpayer claiming the tax credit does *not* need to have any ownership or other interest in the qualified facility. Indeed, ownership of the qualified facility and the carbon capture equipment typically will be by separate legal entities. Further, financial investors in a carbon capture project generally will not want to have any interest in the qualified facility or source of carbon emissions that could result in any potential environmental or other liability associated with the ownership or operation of such a facility.

The definition adopted in the Notice appears to define carbon capture equipment based on the function of the equipment to capture or process (for example, separation, purification, drying, and/or compression) carbon oxide until it is transported away from the qualified facility for disposal, utilization, or use. Carbon capture equipment would not include a commercial pipeline used to transport the carbon oxide to a well field or place where it is sequestered or used. On the other hand, if a taxpayer specially constructs a pipeline for the sole use of the carbon capture project, then such a pipeline would be part of the carbon capture equipment. Pipe systems that act as a gathering system for a single project also qualify as carbon capture equipment.

Physical Work Test

Similar to the "beginning of construction" rules for wind energy projects, to satisfy the Physical Work Test, a taxpayer must:

- start physical work of a significant nature, and
- maintain a continuous program of construction (the "Continuous Construction Test").

The Physical Work Test focuses on the nature of the work performed, not the amount or cost. If the physical work is of a significant nature, there is no fixed minimum amount of work or monetary threshold necessary to satisfy the Physical Work Test. Work performed by the taxpayer and work performed for the taxpayer by other persons under a binding written contract that is entered into before the work starts is taken into account. A contract is binding only if it is enforceable under local law against the taxpayer (or a predecessor) and does not limit damages to an amount equal to at least 5 percent of the total contract price. Both on-site work and off-site work can be used to demonstrate that physical work of a significant nature has begun.

The Notice provides some specific examples of the type of off-site work of a significant nature that may qualify. Such off-site work may include the manufacture of components, including, but not limited to: mounting equipment; support structures such as racks and rails; components necessary for carbon capture processes such as membranes, sorbent vessels, absorbers, compressors and other types of gas separation, liquification, or processing equipment; and the manufacture of equipment necessary for disposal of qualified carbon oxide in secure geological storage (as described in section 45Q(a)(1)(B) and (a)(3)(B)) such as wellhead equipment, booster compressors, and monitoring equipment for storage.

In short, a taxpayer may satisfy Physical Work Test by having a manufacturer fabricate equipment for use at a carbon capture project. That work may be performed off-site at the manufacturer's facility provided (i) the manufacturer's off-site work is performed pursuant to a binding written contract, and (ii) the equipment manufactured is not existing in inventory or held in inventory by a vendor. In other words, the equipment must be manufactured specifically for the taxpayer under a binding written contract.

Similar to the "beginning of construction" rules for wind energy projects, the Notice contains a "Master Contract Rule." Under this rule, if a taxpayer enters into a binding written contract for a specific number of components to be manufactured, constructed, or produced by another person for the taxpayer and then, through a new binding written contract, assigns its right to certain components of property to an affiliated special purpose entity that will own the qualified facility or carbon capture equipment for which such components of property are to be used, the work under the master contract may be taken into account in determining whether the taxpayer satisfies the Physical Work Test.

The Master Contract Rule effectively allows a developer to order a number of equipment components from a manufacturer for a number of projects, which do not have to be identified at the time the order is placed or the components manufactured, and later assign those components to different projects owned by different special purpose entities set up to develop the projects.

In addition to off-site work, the Notice provides a non-exclusive list of on-site work that is considered significant in nature with respect to a qualified facility or carbon capture equipment, including:

- the excavation for and installation of foundations (for the project as well as for buildings to house equipment necessary to the project), including the setting of anchor bolts into the ground and the pouring of the concrete pads of the foundation;
- the installation of a system of gathering lines necessary to connect the industrial facility to the carbon capture equipment or other equipment necessary to the qualified facility before transportation away from the qualified facility for disposal, utilization, or use as a tertiary injectant;
- the installation of components necessary for carbon capture processes such as membranes, sorbent vessels, adsorbers, compressors, engines, motors, power generators and regenerators, reboilers, turbines, pressure vessels and other vessels, piping and pipelines, pumps, heat exchangers, solvent pumps, filters, recycling units, electrostatic filtration, water wash equipment, lube oil systems, dehydration systems, glycol contractors, specially designed flue gas ducts, conditioners, cooling towers, absorber units, and other types of gas separation, liquification, or processing equipment; and
- the installation of equipment and other work necessary for the disposal of qualified carbon oxide in secure geological storage (as described in section 45Q(a)(1)(B) and (a)(3)(B)) at the geological storage site, which may be at a different location than the qualified facility or carbon capture equipment.

Physical work of a significant nature does not include preliminary activities such as securing financing, exploring, researching, conducting test drilling to determine soil condition (including to test the strength of a foundation), clearing a site, obtaining permits and licenses, excavating to change the contour of the land (as distinguished from excavation for a foundation), or 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).

Of special note, the above description of on-site physical work includes the installation of equipment and other work necessary for the disposal of qualified carbon oxide in secure geological storage. The equipment or work at the sequestration site does not seem to fall within the definition of carbon capture equipment. Nevertheless, work on the sequestration site, such as drilling a well, will satisfy the beginning of construction requirement for carbon capture equipment because sequestration is integral to the overall carbon capture project.

5 Percent Safe Harbor

The Notice contains the same general 5% Safe Harbor rule as contained within the "beginning of construction" rules for wind energy projects. To satisfy the 5% Safe Harbor, a taxpayer must:

- pay or incur (within the meaning of Treas. Reg. § 1.461-1(a)(1) and (2)) 5 percent or more of the total cost of the qualified facility or carbon capture equipment before January 1, 2024; and
- make "continuous efforts" to advance towards completion of the qualified facility or carbon capture equipment (the "Continuous Efforts Test"), as described in more detail in the Continuity Requirement section below.

Similar to the Physical Work Test applying to work performed off-site by a manufacturer, the Notice allows a "look through" for "costs incurred" to those costs incurred by a contractor or manufacturer for property that is manufactured, constructed, or produced for the taxpayer by another person under a binding written contract with the taxpayer. Pursuant to the example provided in the Notice, only one level of "look through" is allowed, i.e., costs paid or incurred by a subcontractor to a contractor under a binding written contract with the taxpayer do not count.

All costs properly included in the depreciable basis of a qualified facility or carbon capture equipment are taken into account to determine whether the 5% Safe Harbor has been met. Costs associated with Front-End Engineering and Design ("FEED") activities or other approaches for front-end planning (e.g., the Front-End Loading ("FEL") approach) common to projects of similar scope and complexity may also be considered when determining whether the 5% Safe Harbor has been met.

The Master Contract Rule, as described in the Physical Work Test above, applies for purposes of satisfying the 5% Safe Harbor. In other words, a developer can have various pieces of equipment manufactured and later assign that equipment to different projects for purposes of satisfying the 5% Safe Harbor.

Continuity Requirement and Continuity Safe Harbor

To satisfy the Continuity Requirement for the Physical Work Test, a taxpayer must maintain a continuous program of construction, i.e., the Continuous Construction Test. A continuous program of construction involves continuing work of a significant nature, which will be determined by relevant facts and circumstances. The Notice provides a non-exclusive list of examples of when disruptions in the taxpayer's program of construction will not affect satisfaction of the Continuous Construction Test, including:

- delays due to severe weather conditions or natural disasters;
- licensing and permitting delays (including delays at the written request of a governmental agency regarding matters of safety, security, or similar concerns);
- labor stoppages;
- interconnection-related delays (such as those relating to the completion of construction on a new carbon dioxide pipeline or necessary upgrades to resolve capacity or congestion issues that may be associated with a project's planned interconnection);
- delays in the manufacture of custom components and the inability to obtain specialized equipment;
- presence of endangered species; and
- financing delays and delays due to supply shortages.

To satisfy the Continuity Requirement for the 5% Safe Harbor, a taxpayer must meet the Continuous Efforts Test. The Continuous Efforts Test is similar to the Continuous Construction Test but is broader in that it is not limited to physical work. "Continuous efforts" include paying or incurring additional amounts included in the total cost of the qualified facility or carbon capture equipment; entering into binding written contracts for the manufacture, construction, or production of components of a qualified facility or carbon capture equipment or for future work to construct a qualified facility or carbon capture equipment; obtaining necessary permits; and performing physical work of a significant nature. The taxpayer may endure similar disruptions as provided under the Continuous Construction Test in respect of the Continuous Efforts Test.

While the Notice goes into detail about the Continuous Construction and Continuous Efforts Tests, our experience in the tax equity market is that potential investors will not rely on a facts and circumstances test when there are delays in the construction or development process. To address the uncertainty associated with a general facts and circumstances test, the IRS has provided the Continuity Safe Harbor for satisfaction of the Continuous Construction and Continuous Efforts Tests.

The Continuity Safe Harbor is met if a taxpayer places a qualified facility or carbon capture equipment in service by the end of a calendar year that is no more than 6 calendar years after the calendar year during which construction of the qualified facility or carbon capture equipment began. If a qualified facility or carbon capture equipment is not placed in service before the end of the sixth calendar year, whether the taxpayer satisfies the Continuity Requirement will be determined by relevant facts and circumstances. At 6 years, the Continuity Safe Harbor provided for Section 45Q under the Notice is longer than the 4-year period provided for renewable energy tax credits and generally is consistent with the period suggested by taxpayers.

Single Project

Solely for purposes of the "beginning of construction" rules, multiple qualified facilities or multiple units of carbon capture equipment that operate as part of a single project (along with any components of property that serve some or all such qualified facilities or units of carbon capture equipment) may be treated as a single qualified facility or unit of carbon capture equipment, taking into account various facts and circumstances. The single project rules are consistent with the single project rules for renewable energy tax credits.

Transfer of Energy Property

Once a project satisfies the beginning of construction requirements, the project generally can be transferred to a new owner. The Notice provides a taxpayer that owns a qualified facility or unit of carbon capture equipment on its original placed in service date may elect to claim the Section 45Q credit with respect to the qualified facility or unit of carbon capture equipment, even if the taxpayer did not own the qualified facility or unit of carbon capture equipment at the time construction began. A fully or partially developed qualified facility or unit of carbon capture equipment may be transferred without losing its qualification under the Physical Work Test or 5% Safe Harbor.

A taxpayer may also begin construction at one site and thereafter transfer or relocate components of the qualified facility or unit of carbon capture equipment to a different site or project, complete the development, and place it in service. The work performed or amounts paid or incurred prior to the transfer or relocation may be taken into account for either the Physical Work Test or the 5% Safe Harbor.

While a fully or partially developed qualified facility or unit of carbon capture equipment may be transferred without losing its qualification under the Physical Work Test or the 5% Safe Harbor, the Notice does not allow a transfer of *solely* personal property to an unrelated taxpayer. This means that a developer cannot purchase components of carbon capture equipment, claim that such components satisfy either the Physical Work Test or the 5% Safe Harbor, and then sell or transfer only the components to an unrelated person as "safe harbored" equipment. On the other hand, if the developer has assets other than tangible personal property that are transferred with the components, such as lease rights, licenses, permits, etc., then the safe harbored components can be transferred to an unrelated party and retain their qualification under either the Physical Work Test or the 5% Safe Harbor. In that case, the developer is considered to be transferring a partially developed project.

Summary and Takeaways

In all, the Beginning of Construction guidance provided for Section 45Q is largely consistent with existing beginning of construction rules for other energy tax credits and taxpayer recommendations to the IRS. The rules for establishing beginning of construction are favorable and provide clear standards for taxpayers seeking to begin construction on carbon capture and sequestration projects prior to the required statutory date.

Hunton Andrews Kurth has been working with clients on numerous issues associated with the Section 45Q tax credit and carbon capture and sequestration. Our comments and recommendations to Treasury and the IRS in advance of this guidance were largely incorporated into the guidance. If you have any questions about the IRS guidance or Section 45Q generally, contact us.

Contacts

David S. Lowman, Jr.
dlowman@HuntonAK.com

Hilary B. Lefko
hlefko@HuntonAK.com