Tax Alert

Akin Gump
STRAUSS HAUER & FELD LLP

Carbon Capture Tax Credit Gets a Boost From IRS Guidance – A Practical Guide for Investors

February 21, 2020

The Internal Revenue Service (IRS) has issued the first round of guidance regarding the tax credit for carbon oxide sequestration under Internal Revenue Code Section 45Q. This guidance is divided between two documents: Revenue Procedure 2020-12 and Notice 2020-12. These documents provide a practical guide for investors to evaluate the commercial implications and requirements to structure investments in a manner that the IRS will respect. A separate practice alert will provide practical tools for complying with the start of construction requirements.

The first document establishes a safe harbor under which the IRS will respect a carbon sequestration partnership's allocations of carbon credits. Importantly, and consistent with Congressional intent, the guidance recognizes that allocations may be respected even though a partnership's activities would not be profitable without carbon credits, which suggests the safe harbor may contemplate deals where a tax credit is priced at less than $1, at least for the operations that do not generate revenue. Thus, two commercial arrangements appear to be contemplated by the guidance: (1) a tax equity investor investing in a sequestration facility that will earn income and potentially negotiate to receive a pass through allocation of tax credits from parties that sequester carbon, and (2) a tax equity investor investing directly in a sequestration facility that must pay a storage facility to take its captured carbon. The commercial difference between these arrangements is presumably a fundamental driver for why the latter activity provides a significantly higher credit than the former. Commercial negotiations will likely in large part be driven by this important differential. A third scenario, based on the "utilization" of carbon which can give rise to a revenue stream (in exchange for a lower credit), would be a hybrid of the two scenarios, and it appears further guidance on the meaning of utilization is needed before evaluating how to structure an investment in those ventures.

The second document provides two familiar methods for developers to establish that they have begun construction of a carbon sequestration project: the "5 percent test" and the "physical work" test used for wind and solar projects. As with wind and solar projects, the guidance requires work to be continuous after starting, but unlike the similar wind and solar guidance, where a developer must place its project in service by end of the fourth year after beginning construction, carbon project developers may

Contact Information

If you have any questions concerning this alert, please contact:

Sam Kamyans
Partner
skamyans@akingump.com
Washington, D.C.
+1 202.887.4460

John J. Marciano III
Partner
jmarciano@akingump.com
Washington, D.C.
+1 202.887.4450

Sam B. Guthrie
Counsel
guthries@akingump.com
Washington, D.C.
+1 202.887.4478

place their projects in service up to the end of the sixth calendar year after beginning construction to avoid having to show continuous work.

Key Partnership Guidance Takeaways

- **Partial PAYGO Contributions Permitted**. As an initial matter, an investor must make a minimum 20 percent investment measured based off the total fixed capital commitment, which is separate from the PAYGO ("pay as you go") optionality. More specifically, the guidance does permit an investor to invest over time, which is known as PAYGO in the industry. More than 50 percent of the expected contributions (consisting of fixed and reasonably anticipated contingent investments) must be fixed and determinable, meaning it can be paid over time, but it must still be paid even if the tax credits are not generated. This is more lenient than similar wind partnership guidance which permits only 25 percent of payments to be subject to the performance of a wind farm. It is important to note that an investor's capital contributions to pay ongoing operating expenses are not treated as contingent, thus are excluded from the fixed and determinable obligations. This means an investor can make an investment to fix a problem without blowing up the structure, although most tax-motivated investors would only do that in an absolute worst case scenario, or if a venture is non-profitable (i.e., only pays to take carbon) to fund maintenance and operational expenditures.
  - *Akin Gump Practice Pointer*. The guidance treats investments to fund operating expenses as "fixed and determinable," so an investor that can model the operating expenses of the partnership, and include that amount in its fixed contributions, frees up capital for its PAYGO contributions.

    As a practical point, if an investor is in a carbon capture only venture, and pays for an offtake to sequester its carbon, the projected operational expenditures to pay for that offtake can potentially be modeled and included as part of the fixed investment. Additional amounts that the venture would need separate from this modeled investment would be permissible PAYGO contributions. For example, funding overproduction of captured carbon to get more credits (e.g., through technology enhancements and design changes enabling more efficient capture) could be paid from the PAYGO bucket enabling very efficient capital deployment and credit monetization. This feature can perhaps be toggled to provide some optionality as to how large of a fixed versus PAYGO bucket the investor seeks.
- **Loss-Only, Capital Intensive Ventures Appear Presumptively Valid if Partnership Guidance Followed**. The guidance recognizes that some carbon capture activities may be commercially profitable (e.g., sale of carbon to an enhanced oil recovery activity), while some may not generate any income based on the economic arrangement (e.g., partnership pays a storage facility owner to sequester captured carbon). Accordingly, the guidance divides acceptable allocation schema among (1) ventures that generate income and (2) ventures for which the partnership is not paid and thus generate loss. Thus, allocations of carbon credits should follow allocations of bottom line net income or loss (i.e., positive or negative income related to the carbon sales).
  - *Akin Gump Observation*. Partnerships that capture carbon and pay a third party to securely store the carbon are essentially loss generators made viable by the carbon credit. The guidance rightfully recognizes this reality and respects

partnership allocations so long as the carbon credits are allocated in accordance with a partner's share of the bottom line loss, which is likely a sunk cost.

- **Contracts with Guaranteed Revenue Streams, Including From Related Parties, Are Permissible**. In general, under the guidance, no person involved with the partnership may directly or indirectly guarantee an investor's ability to claim the carbon credit. However, arm's-length, long-term carbon purchase agreements that provide for guaranteed payments (e.g., take-or-pay, supply-or-pay and other full-capacity contracts with associated payment streams), even if the contracting parties are related, are not treated as guarantees.
  - *Akin Gump Practice Pointer*. This is a significant departure from the wind partnership guidance, which prohibited related party take or pay contracts. While there is no explicit prohibition on a credit availability guarantee, a conservative read suggests that an investor cannot have a credit guarantee, though the guidance stops short of blocking commercial arrangements (e.g., a cash sweep for lost credits due to under-production) from the structure. Commercially, these contracts will guarantee a revenue stream for investors, but without actual sequestration, the projects will not generate carbon credits. As a result, contract termination values should take into account shortfalls in projected carbon credits. The flip side is that the contract's base price could be lower for the project company if the project company passes along part of the carbon credit value to its counterparty. A lower base price would preserve cash to pay any termination fees for credit shortfalls on the back end.
  - *Akin Gump Practice Pointer*. Many carbon purchase agreements are, or can be, priced using the West Texas Intermediate (WTI) index enabling price fluctuation with the precision of a liquid market. Price risks under carbon purchase contracts keyed off WTI can be hedged (or fixed) due to WTI liquidity.
- **Investors' Permitted Return Profile Appears Flexible, but Uncertainty Looms**. The guidance suggests equity investments, and returns thereon, are per se acceptable so long as the returns roughly reflect the investor's proportionate equity investment in the partnership, taking into account the investor's anticipated share of net income, gain and loss. However, the return profile cannot be limited in a manner comparable to a preferred return representing a payment for capital.
  - *Akin Gump Observation*. It appears the IRS is echoing its common refrain that equity investments should not look like debt instruments. This makes sense for investors in receipt-generating ventures, but makes less sense for ventures that do not generate income, where the venture's return is inherently limited by the amount and availability of the carbon credit. In the latter case, since the carbon credit is the only source of return, it appears that the IRS is suggesting a safe harbor deal excludes those investments that terminate as soon as the investor achieves their intended preferred return. Accordingly, an investor should have a tail that enables a return in excess of their preference. An alternative is to pass upside of over-production, at least in part, to the tax equity investor so as not to fix its return.

The Beginning of Construction Guidance Takeaway

- **The Beginning of Construction Guidance Provides Familiar Concepts and a Helpful Six-Year Runway to Place Projects in Service**. Consistent with prior guidance in the tax credit space, the guidance provides two methods to start construction. Taxpayers can either (1) pay (for cash method taxpayers) or incur (for accrual method taxpayers) five percent of the total cost of the project, or (2) start physical work of a significant nature on the project.

– *Akin Gump Observation*. Commercially, investors in tax credit projects have internal criteria for ensuring a project has begun construction before they invest. The beginning of construction guidance utilizes many of those existing principles, while adding many more terms and definitions of equipment specific to carbon capture.

Significant Open Items

While this round of guidance provides critical tools to enable investments in carbon sequestration projects, many legal issues remain open.

Notably, the guidance does not address potential recapture of the carbon credit (e.g., if a carbon storage facility leaks after the investors claim the carbon credit). Pursuant to Section 45Q, authority to provide guidance on recapture is delegated to the Treasury Department, which suggests only a regulation can address this point. Guidance has been said to be imminent in that regard. Until then, legal and commercial solutions (e.g., insurance policies covering specific sequestration risks like leaks) will have to stand in lieu of guidance to fully enable projects to commence operations in an economically viable manner.

In the geothermal world, where you have similar technological questions, we often see independent engineers providing guidance to insurers to cover this risk.

In some circumstances, the guidance allows taxpayers to aggregate multiple facilities to determine when construction begins. However, the guidance leaves open the question of whether the aggregation of multiple qualified facilities can satisfy the minimum capture thresholds under the carbon credit rules. Specifically, to generate a credit, a facility, which can presumably consist of multiple carbon capture equipment assets, must capture at least 25,000, 100,000 or 500,000 metric tons of carbon, depending on the technology and carbon capture technique. The carbon credit rules do not address whether a facility must meet these thresholds in its individual capacity, or taxpayers can instead combine multiple facilities for this purpose, as they can (in some circumstances) to determine whether construction has begun. Logically, the "beginning construction" aggregation factors would apply if aggregation were also permitted for meeting the carbon capture thresholds. Until the IRS releases additional guidance, however, taxpayers should not aggregate individual facilities to meet these thresholds.

Additionally, the guidance does not fully address "utilization" of captured carbon. In general, the Internal Revenue Code allows a carbon credit for "utilization" of carbon for "any…purpose for which a commercial market exists, *as determined by the Secretary*." To spur investment in nascent technology that uses carbon, the IRS will need to define the contours of "utilization."

akingump.com