

Akin Gump

STRAUSS HAUER & FELD LLP

SAM KAMYANS

August 3, 2020

VIA FEDERAL E-RULEMAKING PORTAL AT WWW.REGULATIONS.GOV

Internal Revenue Service, Courier's Desk
1111 Constitution Avenue, N.W.
Washington, D.C. 20224
Attn: CC:PA:LPD:PR (REG-112339-19)
Room 5203

Re: Comments to REG-112339-19

Ladies and Gentlemen:

On behalf of Akin Gump, please find attached comments in response to the request for comments on the proposed regulations contained in Notice of Proposed Rulemaking REG-112339-19 (the “*Proposed Regulations*”) regarding section 45Q of the Internal Revenue Code of 1986, as amended (the “*Code*”).

We commend Treasury and the IRS for crafting well-reasoned comments that retain the integrity of the statute while recognizing the commercial realities that any regulations must accommodate in order to get projects off the ground. The Proposed Regulations provide significant clarity to taxpayers developing carbon capture and sequestration technologies. Recognizing the Proposed Regulations are a starting point, this letter suggests discrete areas for clarification, drawing from issues that taxpayers are currently considering in connection with projects for which they seek legal certainty.

Respectfully submitted,

Sam Kamyans

August 3, 2020

Page 2

Attachment: Comments in Response to the Proposed Regulations

Cc: David Kautter, Assistant Secretary for Tax Policy, Department of Treasury

Michael Desmond, Chief Counsel, Internal Revenue Service

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August 3, 2020
Page 3

Comments of Akin Gump Strauss Hauer & Feld LLP in Response to Notice of Proposed Rulemaking REG-112339-19 Regarding Code Section 45Q

This comments set forth in this letter suggest (1) clarifying and coordinating the three categories of qualified facilities that enable credit eligibility, particularly as relates to “electricity generating facilities” including providing additional examples of qualifying facilities, (2) providing additional detail as relates to the defined terms “industrial facility” and “manufacturing process”, and (3) adopting an aggregation principle for satisfying the minimum capture requirements.

I. Coordinating Categories for Qualification and Electricity Generating Facilities

Section 45Q(d) provides, in relevant part, that the term “qualified facility” means any industrial or direct air capture facility...which captures:

- In the case of a facility that emits no more than 500,000 metric tons of carbon oxide during the taxable year, capture at least 25,000 metric tons of qualified carbon oxide during the taxable year, and utilize said carbon oxide in accordance with Code section 45Q(f)(5) (“**Category 1 Facility**”).
- An electricity generating facility which is not a Category 1 Facility that captures at least 500,000 metric tons of qualified carbon oxide during the taxable year (“**Category 2 Facility**”).
- Direct air capture or other facilities (other than Category 1 Facilities and Category 2 Facilities) that capture at least 100,000 metric tons of qualified carbon oxide during the taxable year (“**Category 3 Facility**”).

Proposed Treasury Regulation section § 1.45Q–2 supplies additional definitional constructs for “industrial facility” and “electricity generating facility” and provides several examples illustrating these requirements.

Electricity Generating Facility

The Proposed Regulations provide that an electricity generating facility is a Category 1 Facility or a Category 2 Facility and is subject to depreciation under MACRS Asset Class 49.11(Electric Utility Hydraulic Production Plant), 49.12 (Electric Utility Nuclear Production

August 3, 2020
Page 4

Plant), 49.13 (Electric Utility Steam Production Plant), or 49.15 (Electric Utility Combustion Turbine Production Plant).

The preamble to the Proposed Regulations does not explain the reasoning behind this definition, though a close examination of the MACRS categories suggests IRS and Treasury intended to identify large scale facilities utilizing traditional feedstock (e.g., fossil fuels, hydraulic features, and nuclear) and that enter into utility offtake arrangements. Moreover, these facilities appear to have the capability of *only* generating electricity. However, by utilizing the MACRS classifications, certain small scale facilities that have lower, albeit material carbon emissions, may inadvertently get caught within the meaning of “electricity generating facility” by virtue of having components that fit within multiple categories, and because the facilities produce electricity while having the capability of producing other items. This would disable those facilities from benefitting from carbon capture incentives even though the congressional record suggests they should qualify.¹

As an example, a biomass facility can generate electricity, but typically, biomass facilities emit less than 500,000 metric tons of carbon. Per Revenue Procedure 87-56, biomass facilities can qualify as MACRS asset class 49.5 (Waste Reduction Plant), and the IRS has confirmed this classification in at least one private letter ruling wherein the biomass generated and sold electricity. See Priv. Ltr. Rul. 8924032 (March 17, 2989). However, certain components of biomass facilities are also referenced in MACRS asset class 49.13 (Electric Utility Steam Production Plant), raising uncertainty as to its classification, and consequently its credit eligibility. It would not be sensible to include a biomass in MACRS asset class 49.13, particularly if that biomass plant is capable of producing other products.

Another example is a large chemical production facility that, in addition to chemical processing, generates electricity for sale to end users, and to power its own operations. To the extent the power generation segment of the facility fits within the MACRS classifications, there is an ambiguity as to whether the entire facility must now qualify as a Category 2 facility. If so,

¹ Statements to Congress by industry leaders discussed biomass-to-power as one of the types of facilities that will benefit from an expanded 45Q regime due to its carbon emissions. See e.g., statement of Dan Reicher on January 9, 2018 (Executive Director, Steyer-Taylor Center for Energy Policy & Finance, Stanford University) before the Committee on House Energy and Commerce Subcommittee on Energy, where he testified, in part, that biomass is an important participant in the energy and chemical production space that would benefit from carbon capture; see also statement of Roger Aines on July 17, 2018 (Senior Scientist, Atmospheric, Earth and Energy Division Lawrence Livermore National Laboratory) before the Committee on House Science, Space and Technology, Subcommittee on Energy, Subcommittee on Environment.

August 3, 2020

Page 5

and the overall emissions are less than 500,000 metric tons of carbon, then there is a risk that an otherwise qualifying industrial facility cannot access section 45Q because of its power generation activities.

Recommendation

We recommend the IRS clarify Proposed Treasury Regulation section § 1.45Q–2E to specify that the four MACRS asset classes are the only categories in which a facility may be treated as an “electricity generating facility.” Moreover, the meaning of electricity generating facility should be narrowed to encompass a facility that “only” or “predominantly” produces electricity, and is not capable, based on its existing design, to produce anything other than electricity. However, in recognition of the fact that some facilities that primarily generate electricity may fall into these asset classes, we further recommend that a facility whose classification is not clear, and that does not satisfy the 500,000 metric ton requirement, have the optionality to qualify as a Category 3 Facility. In this manner, the integrity of the statute is retained because facilities that are clearly within the prescribed MACRS classifications are subject to the higher tonnage requirement, while more diversified, less clear cut facilities are not at risk of being precluded from tax credits when they are providing the capture activities congress intended. Moreover, section 45Q does not state that a qualified facility must be defined to fit within only a single category.

Examples illustrating the foregoing would provide additional clarity, and appear to be at least one method whereby the Proposed Regulations intended to provide guidance. Proposed Treasury Regulation section 1.45Q–2G-2(iii) provides an example of a cement manufacturing plant that would qualify as a Category 1 Facility or a Category 3 Facility. We believe this example helps provide justification as to why a facility primarily generating electricity would also qualify as a Category 3 Facility. The cement manufacturing plant in question would likely qualify as a Category 1 Facility if not for the fact that it is not utilizing 25,000 or more metric tons of qualified carbon oxide in a manner consistent with Code section 45(Q)(f)(5) and Treasury Regulation section 1.45Q–4, as it otherwise meets the total emissions requirements (e.g., the plant emits 110,000 metric tons of carbon dioxide, in line with the requirement not to emit more than 500,000 metric tons of carbon oxide). The plant, does, however, capture a total of 100,000 metric tons of carbon dioxide, enabling it to qualify as a Category 3 Facility. The flexibility of accessing two separate categories enables the plant to still receive the tax credit, thereby accomplishing the congressional objective of incentivizing capture activities.

Similarly, a facility primarily generating electricity that is not a Category 1 Facility could also capture and emit fewer than 500,000 metric tons of qualified carbon oxide, precluding it

August 3, 2020
Page 6

from qualifying for as a Category 2 Facility. We request that in the way that the cement manufacturing plant captures 100,000 metric tons of carbon dioxide and qualifies as a Category 3 Facility, a facility primarily generating electricity may capture at least 100,000 metric tons of qualified carbon oxide and qualify as a Category 3 Facility.

To extend the flexibility of the Category 3 Facility to cement manufacturing, but not a facility generating electricity, suggests that Treasury may view a cement manufacturing plant as preferred to receive tax credits based purely on its function. We do not believe that Treasury holds this view, nor does it believe that a cement manufacturing plant is inherently preferential to a facility primarily generating electricity. Additionally, we understand that Treasury seeks to accomplish Congress' objective of incentivizing taxpayers to reduce carbon emissions as much as possible. Allowing a facility that produces electricity to qualify as a Category 3 Facility would only further this objective. Therefore, we recommend that a facility which produces electricity may also qualify as a Category 3 Facility if its MACRS classification is unclear and does not satisfy the 500,000 metric ton threshold of Proposed Treasury Regulation section § 1.45Q-2G-1(ii).

Based on the foregoing, in addition to providing the clarifications in the text of the regulations, we respectfully submit two examples for your consideration.

Example 1. Taxpayer A owns and operates a biomass-to-power facility. The facility uses organic waste products that it transfers into large containers to which heat is applied that breaks down the waste into its constituent chemical components in the form of a syngas. The facility also produces, at this stage, biochar, a byproduct that can be separately sold to farmers for use in agricultural activities. The facility, via a combustion process, combines the syngas with a pure stream of oxygen that results in a high pressure, high temperature steam-CO₂ gas that is then run through a turbine which spins a generator to produce electricity for sale. The steam-CO₂ gas is subsequently transferred through a heat exchanger into a condenser at which point carbon oxide is separated from the condensed gas, and transported to a secure geological storage area. In addition to sequestering carbon, at this stage, the plant also has the capability of separating out a stream of pure hydrogen that can be sold to offtakers utilizing renewable hydrogen, but currently is not producing this product because it is not commercially viable. Taxpayer A expects to sequester between 300,000 and 400,000 metric tons of carbon per year. Taxpayer A's plant is an industrial facility engaged in the manufacture of products that are intended to be sold at a profit, and is therefore classified as a 45Q(d)(2)(C) Facility.

Example 2. Taxpayer B owns and operates a petrochemical plant that has an internal power generation facility. Taxpayer B drills natural gas wells, which produce liquids in addition

August 3, 2020
Page 7

to natural gas that the Taxpayer runs through a series of separation facilities and associated pipelines. Some of that natural gas is utilized in an electricity generating facility that emits less than 500,000 metric tons of carbon oxides. The balance of the chemicals are processed into a stream of petrochemicals for sale to third parties. These activities generate 300,000 to 400,000 metric tons of carbon oxide. The Taxpayer transports all of the carbon oxide into secure geological storage. Although the electricity generating facility component does not satisfy the definition of a 45Q(d)(2)(B) Facility, the Taxpayer is not precluded from treating the overall facility as a 45Q(d)(2)(C) Facility because the facility is also an industrial facility engaged in a manufacturing process.

II. Additional Detail as to “Industrial Facility” and “Manufacturing Process”

Overview

Proposed Treasury Regulation section 1.45Q-2(d) provides that an industrial facility is a facility that produces a carbon oxide stream from a fuel combustion source or fuel cell, a manufacturing process, or a fugitive carbon oxide emission source that, absent capture and disposal, would otherwise be released into the atmosphere as industrial emission of greenhouse gas or lead to such release. Supplementing this definition, Proposed Treasury Regulation § 1.45Q-2(d)(3) provides that a manufacturing process is a process involving the manufacture of products, other than carbon oxide, that are intended to be sold at a profit, or are used for a commercial purpose.

We commend Treasury and IRS for providing broad definitions for industrial facilities and manufacturing process. Indeed, the apparent limitation placed on these definitions is to exclude facilities that produce significant carbon oxides, which is a sensible way to prevent taxpayers from otherwise mining and re-injecting carbon oxides as a credit generating activity.

Consistent with our above recommendation, and solely for purposes of parties engaged in sequestration of carbon oxides, we request a clarification to the meaning of manufacturing process to include “electricity” within the meaning of products so as to coordinate the industrial facility with a facility that primarily generates electricity and is not clearly an “electricity generating facility.” Alternatively, we recommend revising the definition of “industrial facility” to provide that the separation of carbon oxides for the purpose of secure geological storage in connection with the activity of generating electricity is a qualifying activity, excluding from this meaning electricity generating facilities that are subject to the higher emissions thresholds.

August 3, 2020

Page 8

Legal support exists for the foregoing principle under Code sections 263A and 471. Specifically, the IRS and the courts have determined that electricity generation constitutes the production of tangible personal property. See Chief Counsel Advice 200152013 (“CCA”). See also *Helvey v. Wabash County REMC*, 278 N.E.2d 608 (Ind. App. 1972); *Minnesota Power & Light Company v. Taxing District*, 182 N.W.2d 685 (Minn. 1970); *Curry v. Alabama Power Co.*, 8 So.2d 521 (Ala. 1942); *State Tax Commission v. Marcus J. Lawrence Mem. Hosp.*, 495 P.2d 129 (Ariz. 1972). In the CCA, the IRS concluded, based on the case law, that “all direct and indirect costs attributable to the production of electricity for sale to customers are subject to capitalization” under Code section 263A. Separately, the IRS, in Technical Advice Memorandum 9523001 (the “TAM”), and in part citing to the cases in the CCA, set forth the proposition that Code section 471 and Treasury Regulation section 1.471-1 require treating electricity as merchandise, thereby requiring the taxpayer to utilize the inventory method of accounting that applies to the manufacture of other products. The TAM cites to the proposition that Code section 471 and the regulations grant to the IRS significant latitude for applying the inventory method and evaluating whether a taxpayer is engaged in production of goods for sale.

As the CCA and TAM note, under Code sections 263A and 471, producers and resellers of electricity are treated as manufacturing a product for resale, among other taxpayers, are subject to mandatory capitalization principles. To suggest that production for Code section 45Q purposes has a different definition puts strain on timing and accounting considerations for reasons not clearly required under section 45Q.

Based on the foregoing, we recommend including electricity as a product in the manufacturing process and industrial facility framework as detailed above.

III. Aggregation Principles

In Notice 2020-12 (the “Notice”), the IRS provided guidance as to the steps a taxpayer must take in order to access safe harbor that it has begun construction on a qualified facility. Section 8 of the Notice allows taxpayers to aggregate multiple facilities or units of carbon capture equipment solely for determining whether the taxpayer has satisfied the start of construction for each of those facilities.

While the Notice provides helpful guidance for starting construction in a multi-facility scenario, it leaves open the question of how the emissions of that multiple facility are considered for purposes of whether the facility will be a Category 1 Facility, Category 2 Facility, Category 3 Facility, or a mixture of the foregoing. Specifically, an example in the Notice confirms that starting construction on one of five capture units is sufficient to have started construction for a

August 3, 2020
Page 9

project in which five separate capture units will be installed. It leaves open the question of whether each facility on which each capture unit is installed satisfies, or must independently satisfy, the emissions and capture thresholds. Conceivably, a single project, per the aggregation principles in the Notice, may consist of multiple facilities that, taken together, satisfy the definition of a qualified facility. However, it is also conceivable that, considered separately, none of the facilities individually satisfy the requirements of a qualified facility.

To address this ambiguity, we propose a safe harbor whereby a series of projects that are treated as a single project within the meaning of the Notice be able to aggregate the capture capabilities of each capture unit for purposes of testing whether the project is treated as a qualified facility. In support of this recommendation, we note that the factors set forth in the Notice suggest the aggregation principle requires a fairly well circumscribed series of facilities that are dependent on one another, both commercially and geographically. From a commercial perspective, a taxpayer that owns multiple facilities in the manner set forth in the Notice is likely to view those facilities as a single commercial enterprise, even if the separate capture units relate to discrete activities. There is a high likelihood those discrete activities are part of a larger commercial operation, each part of which complements, or depends on, each other part. Even in the unlikely instance where multiple taxpayers affirmatively use the safe harbor to aggregate projects to earn the credit, we note that such activity achieves the presumptive congressional objective underlying 45Q. That multiple facilities, in the aggregate, are capturing, for example, 250,000 metric tons of carbon oxide, is inherently the same a single facility capturing the same amount of carbon oxides. There is no reason for one activity to qualify simply by virtue of being a larger physical project.

We appreciate the opportunity to provide commentary on the Proposed Regulations, and hope that Treasury will take its suggestions into consideration.