



August 3, 2020

CC:PA:LPD:PR (REG-112339-19)  
Room 5203  
Internal Revenue Service  
P.O. Box 7604  
Ben Franklin Station  
Washington, DC 20044

Via Federal eRulemaking Portal at: [www.regulations.gov](http://www.regulations.gov) (REG-112339-19)

Re: API Comments on Proposed Regulations Pertaining to IRC Section 45Q

Dear Sir/Madam:

On behalf of the over 600 member companies of the American Petroleum Institute (“API”) I write in response to the Notice of Proposed Rulemaking (REG-112339-19) concerning the credit for carbon oxide sequestration under section 45Q of the Internal Revenue Code. Section 45Q is seen by API as an important incentive for Carbon, Capture, Sequestration, and Use projects which enable the reduction of the emissions of greenhouse gases (“GHGs”). As such, our members wish to ensure that the final rules accomplish the legislative intent of the statute and provide efficient ways to ensure its goals are achieved. We submit these comments to the Department of the Treasury and Internal Revenue Service (“Treasury and IRS”) in an attempt to assist in developing those goals.

### **80/20 Rule Applied to Carbon Capture Equipment**

API supports the inclusion of the 80/20 rule to assist with determining the placed in service date of a qualified facility or carbon capture equipment.<sup>1</sup> Although API and its members recognize the need to address the placed in service date for equipment, without further guidance on the application of the 80/20 rule, including defining distinct or separate carbon capture equipment, uncertainty continues in determining the proper credit amounts.

The proposed regulations infer that the 80/20 rule should be applied to distinct or separate units of carbon capture equipment at a common facility by the examples provided in Prop. Treas. Reg.

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<sup>1</sup> Prop. Treas. Reg. § 1.45Q-2(g)(5).

§ 1.45Q-1(g)(4). However, the proposed regulations do not detail when equipment is sufficiently distinct or separate that the application of the 80/20 rule is not required.<sup>2</sup> Additionally, the broad discussion of carbon capture equipment creates uncertainty whether any shared equipment components or systems would necessitate the application of the 80/20 rule. In proposing the regulations, Treasury and the IRS state that the rule was adopted to assist with determining whether carbon capture equipment is placed in service before February 9, 2018, or on or after that date. The 80/20 rule as drafted, however, is not limited to that specific circumstance. Taxpayers would also apply the 80/20 rule to “retrofitted” carbon capture equipment placed in service on or after February 9, 2018 and, thus, may also need to determine whether equipment is distinct or separate for this purpose.

API and its members request that Treasury provide that the relevant unit of carbon capture equipment is an independently functioning process train for purposes of both the 80/20 rule and retrofitted carbon capture equipment. API believes Examples 1-3 in Prop. Treas. Reg. § 1.45Q-1(g)(4) support this clarification. In these examples, taxpayer owns a qualifying facility with three units of carbon capture equipment. Each unit is apparently capable of functioning independently from the other two units to capture, process, and prepare for transport 50,000 metric tons of CO<sub>2</sub> per year. API supports this approach of treating each independently functioning process train as the relevant unit for purposes of applying the 80/20 rule.

Treasury should provide guidance on the 80/20 rule in a manner that provides certainty in making investment decisions. Treasury and the IRS also should consider adjusting the point at which the proper asset value (or fair market value) for used equipment is determined for purposes of an 80/20 Rule calculation. Prop. Treas. Reg. § 1.45Q-2(g)(5) requires this test be performed for both pre-existing and new assets. Previous applications of the 80/20 test measure these asset values at the time the improved equipment is placed in service. This may require the taxpayer have an extremely accurate pricing projection if there is some doubt as to whether the facility will meet the 80/20 Rule.

A better solution is for the fair value assessment to take place at the start of construction. At this point in time the taxpayer will have an accurate assessment of the value of all equipment to be used at the facility. Furthermore, the start of construction tests permits a taxpayer up to six years to complete a project. Requiring a taxpayer to project asset value six years in the future will be difficult and imprecise whereas a valuation as of the start of construction will be simpler and more accurate. A further simplifying rule would be to permit taxpayers to calculate the fair market value of the used property by determining replacement cost new and subtracting for physical depreciation.

### **Contracting Requirements**

Section 45Q provides that the owner of the carbon capture equipment is attributed the credit as long as the owner “contractually ensures” the disposal, utilization or injection of the carbon oxide.<sup>3</sup> The proposed

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<sup>2</sup> The proposed regulations reference “unit of carbon capture equipment” in Prop. Treas. Reg. § 1.45Q-5(g), however, no definition is provided.

<sup>3</sup> Internal Revenue Code § 45Q(f)(3).

regulations require that a contract must be “enforceable under State law against both the taxpayer and the party that physically carries out the disposal, injection, or utilization.” It is not clear whether this requirement would be satisfied if the actual disposal, injection, or utilization is subcontracted to a third party. For instance, if the owner of the carbon capture equipment contracts with one party to dispose, use or inject the carbon oxide and then there is a further subcontracting of that disposal, use or injection to a third party subcontractor, the subcontractor would be the party that “physically” carries out the activity (and there would be no direct contractual relationship between the owner and the subcontractor).<sup>4</sup> API and its member companies request that Treasury and the IRS clarify that a direct contractual relationship is not required between the carbon capture equipment owner and the party that ultimately carries out the required disposal, utilization, and injection activity, as long as the regulations’ contracting requirements are satisfied in each relevant contractual arrangement regarding the disposal, injection or utilization of the carbon oxide.

With respect to the proposed regulations on required terms for a binding written contract ensuring disposal, injection, or utilization, API does not believe it is commercially reasonable to prohibit all limitations on damages. Specifically, Prop. Treas. Reg. § 1.45Q-1(h)(2)(i) provides that a binding written contract cannot limit damages to a specified amount. Commercial practice in long-term supply and offtake contracts is to allocate risk among the parties through negotiated liability and damages provisions. API notes that Prop. Treas. Reg. § 1.45Q-1(h)(2)(iii)(B) recognizes that parties to contracts ensuring disposal, injection or utilization may negotiate long-term liability, indemnity, penalty, and liquidated damages provisions. Such provisions may in some circumstances have the effect of limiting damages. API recommends that Prop. Treas. Reg. § 1.45Q-1(h)(2)(i) be modified to reflect commercial practice and avoid any potential conflict with Prop. Treas. Reg. § 1.45Q-1(h)(2)(iii)(B). Treasury should strike the requirement in Prop. Treas. Reg. § 1.45Q-1(h)(2)(i) or clarify that the prohibition of liquidated damages applies only to aggregate damages.

API and its member companies support limiting the contracting parameters in the proposed regulations to only the most critical elements in order to provide further certainty to taxpayers.

### **Facts and Circumstances Test Applied to Defining Industrial Facilities**

The definition of a “qualified facility” for purposes of claiming the credit includes an “industrial facility.”<sup>5</sup> The proposed regulations state that the term “industrial facility” means 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 an industrial emission of greenhouse gas or lead to such release. The proposed regulations further define a “manufacturing process” as “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.”<sup>6</sup> The regulation

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<sup>4</sup> Prop. Treas. Reg. § 1.45Q-1(h)(2)(i).

<sup>5</sup> See Prop. Treas. Reg. § 1.45Q-2(g) (electricity generating facilities and direct air capture facilities also are qualified facilities).

<sup>6</sup> Prop. Treas. Reg. § 1.45Q-2(d)(3).

goes on to exclude facilities that produce “carbon dioxide from carbon dioxide production wells at natural carbon dioxide-bearing formations...”<sup>7</sup> The proposed regulations include a safe harbor under which deposits of natural gas that contain less than 10 percent by volume of CO<sub>2</sub> are not considered natural carbon dioxide-bearing formations and are not within the exclusion. API supports the policy objective of preventing formations, where CO<sub>2</sub> is the only commercial product, from qualifying for the 45Q credit. However, it should be noted that the concentration of CO<sub>2</sub> will likely need to be 90% or greater to produce a viable stand-alone commercial product.

Therefore, API and its members request that the arbitrary 10% cut-off be eliminated in favor of a more objective standard consistent with Congressional intent and the definitions in the proposed regulations. Prop. Treas. Reg. § 1.45Q-2(d)(1) merely states that a facts and circumstances test applies in making this determination. It does not list the specific facts and circumstances which will be evaluated in determining whether a well is producing from a carbon dioxide-bearing formation. Congress intended only to exclude volumes from section 45Q if the carbon oxide is being produced for its stand-alone value. The presumption should be in favor of allowing the credit and Treasury should simplify the rule. Any facility which (1) produces a commercial product, other than CO<sub>2</sub>, intended to be sold for profit or used for a commercial purpose (meaning that the taxpayer meets the manufacturing test in Prop. Treas. Reg. § 1.45Q-2(d)(3)), and (2) captures CO<sub>2</sub> as a by-product should be per se deemed an industrial facility.

Without such additional clarification as to what facts and circumstances are to be analyzed taxpayers and the government will be left to attempt to determine whether an industrial facility meets the proposed standard without sufficient guidance as what benchmarks they must meet.

### **Required Annual Certification Under International Organization for Standardization (“ISO”) Reporting Regime**

API and its members appreciate the proposed regulations providing clarifying guidance on the demonstration of secure geologic storage of CO<sub>2</sub> for purposes of determining the section 45Q credit, but we do not take any formal position on which demonstration process is more appropriate. We do wish to submit a comment in response to the rules applied to the permissible ISO reporting regime.

Prop. Treas. Reg. § 1.45Q-3(d) requires that taxpayers, utilizing the ISO form of reporting, to must include an annual certification from a qualified independent engineer or geologist, confirming that the document provided, including the mass balance calculation as well as information regarding monitoring and containment assurance, is accurate and complete. API and its members understand the need to provide accurate and auditable information regarding the mass balance calculation, monitoring and containment assurance, and potential leakage pathways to the IRS in order to appropriately claim the credit on IRS Form 8933. We also understand the provision directing an annual certification of the ISO plan, but we do not believe that there is a need for such annual certification to only be conducted by a 3rd party. Company Professional Engineers (“PE”) have significant capacity to provide this type of support and have in other instances, such as with the section 43 credit. A PE is an engineer licensed by a state board to practice

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<sup>7</sup> Prop. Treas. Reg. § 1.45Q-2(d)(1).

engineering. The PE license is the engineering profession's highest standard of competence and ethical standards. We believe that taxpayers should be able to use these qualified company PEs that can accurately and objectively provide the technical information and analysis requested for yearly certification of ISO plans if they are used.

### **Utilization of Qualified Carbon Oxide – Lifecycle Analysis of Greenhouse Gas Emissions (“LCA”)**

The proposed regulations require a taxpayer utilizing qualified carbon oxide measure the amount capture and utilized. These measurements must be done via a combination of direct measure and LCAs. API and its members request further clarity on the scope of the LCAs taxpayers will be required to submit by the proposed regulations. Prop. Treas. Reg. § 1.45Q-4(c)(2) only states that the LCAs must be consistent with the ISO 14044:2006, “Environmental management – Life cycle assessment – Requirements and Guidelines.” The statute clearly envisions that direct measurement of the qualified carbon oxide captured and utilized must be reported under a contractual agreement. This can be done by all companies claiming this credit. However, the entity that captures the carbon oxide and contractually ensures it is permanently isolated from the atmosphere should not be responsible for products sold to third parties that are used outside the intended use. Use of these products outside their intended purpose should not be required to be captured and accounted for by the LCA submitted by taxpayers.

Prop. Treas. Reg. § 1.45Q-4(c)(3) requires the LCA be submitted and approved by the Department of Energy (“DOE”), and the IRS in consultation with the DOE and Environmental Protection Agency (“EPA”). Such an approval process will likely prove to be protracted and deter taxpayers from undertaking CCUS projects. Additionally, this approval process is arguably unnecessary given that Prop. Treas. Reg. § 1.45Q-4(c)(3) requires that such LCA be performed and/or verified by an independent third party. Lastly, requiring the LCA to be “approved” also deviates from statutory intent. Section 45Q does not state that such an approval be required. For all the foregoing reasons, the final regulations should not condition a taxpayer's claiming of 45Q credits on pre-approval of the project LCA. Alternatively, if Treasury and the IRS insist on such an approval process Treasury and the IRS should provide required timelines and details on the process for approval or rejection by the aforementioned agencies.

### **Application of Recapture Rules to Intentional Removal and Subsequent Recapture of Qualified Carbon Oxide**

The proposed regulations make clear that the recapture rules apply to the intentional removal of qualified carbon oxide from secure storage.<sup>8</sup> API and its members request further clarity on the applicability of the proposed rules to the intentional removal of securely stored qualified carbon oxide and carbon dioxide, and the subsequent recapture and secure storage of that same qualified carbon oxide and carbon dioxide. The total net release in this process is zero. An example of when a natural gas and oil company might undertake this process occurs when enhanced oil recovery (“EOR”) users will intentionally remove

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<sup>8</sup> Prop. Treas. Reg. § 1.45Q-5(h).

previously secured carbon dioxide for use and then subsequently reinject it into the ground after having completed the extraction of all commercially viable natural gas and oil. Treasury and the IRS clearly believe that any recapture event should be measured on a net basis as Prop. Treas. Reg. § 1.45Q-5(g)(1) contemplates no recapture will have been deemed to have occurred if the leaked amount of qualified carbon oxide does not exceed the amount of qualified carbon oxide disposed of. Applying this rule to Prop. Treas. Reg. § 1.45Q-5(h) and to the hypothetical situation described, suggests that it should result in no recapture. API and its members request that this be explicitly stated in the final rules and an example be provided which clearly applies the net calculation yielding in no recapture event occurring.

### **Definition of “Other Qualified Carbon Oxide”**

The Bipartisan Budget Act of 2018 (“BBA”) amended section 45Q(c) to include any carbon dioxide or other carbon oxide which is captured from an industrial source on or after February 9, 2018. API and its members request that Treasury release additional guidance on what constitutes qualified carbon oxide.

The preamble to the proposed regulations states, “the statutory definition of qualified carbon oxide is clear due to the broad acceptance and use of the term by industry participants, environmental groups, and stakeholders.” However, API disagrees with this assessment of the term. While a universal definition for carbon dioxide does exist, no such agreement exists for carbon oxide. Furthermore, the current language under Prop. Treas. Reg. § 1.45Q-2(a)(2) has the potential to only allow carbon dioxide to qualify post-February 9, 2018. However, section 45Q clearly contemplates that molecules other than carbon dioxide should qualify for the credit as it explicitly references both carbon dioxide and other carbon oxide. Therefore, API and its members request further guidance and clarifications regarding the definition of qualified carbon oxide and its applicability to other carbon oxides.

### **Definition of Capacity for Existing Facilities**

The BBA provides that facilities in service prior to expansion of the section 45Q program are eligible to claim the revised credit when the taxpayer installs additional carbon capture equipment to existing qualified facilities. If the taxpayer expands a qualified facility<sup>9</sup>, the taxpayer determines the volumes eligible for the expanded credit by taking the total amount of credits captured in a post-BBA year and comparing that to the carbon dioxide capture capacity of the carbon capture equipment in service at such facility as of the day before the BBA enactment. Treasury should provide guidance on the appropriate measure of carbon dioxide capture capacity. Such guidance should (1) confirm that the pre-BBA capacity should be an annual calculation and (2) provide appropriate adjustments reflecting real world constraints on capacity such as maintenance, typical scheduled and unscheduled downtime, output of industrial process, and turnarounds.

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<sup>9</sup> Assuming the taxpayer is ineligible for the 80/20 rule.

We again appreciate the comment and look forward to continued interaction as this process moves forward. To the extent you have any questions, please do not hesitate to contact me at [comstocks@api.org](mailto:comstocks@api.org) or 202-682-8455.

Sincerely,

A handwritten signature in black ink, appearing to read 'S. Comstock', with a horizontal line extending to the right.

Stephen Comstock  
Vice President – Corporate Policy