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CURC CARBON UTILIZATION RESEARCH COUNCIL
ADVANCING FOSSIL ENERGY SOLUTIONS

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 (REG-112339-19)

Re: Comments on Proposed Regulations for IRC §45Q

Dear Sir/Madam:

This letter is submitted on behalf of the Carbon Utilization Research Council (CURC) in response to the publication of the Notice of Proposed Rulemaking on the §45Q, Credit for Carbon Oxide Sequestration in the Federal Register. CURC (see www.curc.net) is an industry coalition focused on technology solutions for the responsible use of our fossil energy resources in a balanced, low carbon generation portfolio. CURC's members include electric utilities and power generators that rely upon diverse sources for their electricity production, equipment manufacturers and technology innovators, national associations that represent the power generating industry, labor unions, fossil energy producers, and state, university and technology research organizations. Members of CURC believe that American fossil fuels and ingenuity in technology innovation will satisfy the world's growing appetite for affordable energy, improve energy security, improve trade through increasing exports of U.S. resources and manufactured energy equipment, create high-paying jobs, and improve environmental quality.

CURC members commend the IRS and Treasury for the countless hours dedicated to reviewing all of the comments submitted in response to IRS Notice -2019-32, holding meetings with interested parties, and developing proposed regulations that address many of the proposals we discussed in CURC's comments and meetings with IRS and Treasury personnel. We believe it is very important the IRS and Treasury issue final regulations, as soon as possible, providing technical guidance on the new section 45Q tax credit program to create the investment certainty needed for robust utilization of carbon capture technology and these credits. In addition, guidance is necessary to accomplish the key policy objectives of Congress in enacting changes to the eligibility and other key requirements for the issuance of this new tax credit program. These comments are submitted to assist in developing final regulations that will help achieve these goals.

Recapture

The proposed regulations adopt a recapture period that begins on the date the first qualified carbon oxide (QCO) is injected into the reservoir and ends at the earlier of five years after the last taxable year in which the taxpayer claimed a section 45Q credit or the date monitoring ends under the secure geologic storage requirement. In addition, the proposed regulations limit recapture to a five-year look-back period for releases of previously sequestered carbon oxides and utilize the CURC recommended LIFO basis to account for any release.

A recapture event occurs when the QCO "ceases to be captured, disposed of, or used as a tertiary injectant." The leaked amount of QCO is quantified when the QCO has "leaked to the atmosphere." Does this mean that a "recapture event" occurs when the QCO has escaped from the containment zone and has not escaped into the atmosphere? If that is the case, we believe this is confusing and should be clarified to make it clear that the QCO ceases to be captured, disposed of, or used as a tertiary injectant when it has leaked to the atmosphere, not when it has migrated from the containment zone.

CURC encourages IRS to reconsider the five-year lookback period in the proposed rule, as we are concerned from conversations with tax equity investors that the length of the lookback period will deter tax equity investment in projects, which defeats the purpose of the tax credit itself. We refer you to comments we submitted with Clean Air Task Force, ClearPath, Environmental Defense Fund, Oxy Low Carbon Ventures, Shell, and The Nature Conservancy, requesting a shorter lookback period with a justification for that request.

Definition of Carbon Capture Equipment

The proposed regulations provide that in general, carbon capture equipment includes all components of property that are used to capture or process carbon oxide until the carbon oxide is transported for disposal, injection, or utilization, including property necessary to compress, treat, process, liquefy, or pump carbon oxides. Excluded from the definition are components of property related to transporting carbon oxides for disposal, injection, or utilization. The definition does not include any language to address how the 45Q credit would be allocated if multiple entities own different pieces of equipment within a single carbon capture project. CURC's comments in response to Notice 2019-32 provided that the credit would go to the entity that owns the equipment that separates and/or captures the QCO. Language to this effect should be included in the final regulations to provide clarity on the party that will earn the tax credits in this situation.

Election to Allow the 45Q Credits to Another Taxpayer

The proposed regulations provide most of the guidance necessary for the taxpayer that owns the carbon capture equipment to be able to make the election to transfer the credit to the "person that disposes of the qualified carbon oxide, utilizes the qualified carbon oxide, or uses the qualified carbon oxide as a tertiary injectant." The guidance, however, only repeats the statutory language and does not provide any additional information on the definition of the qualifying transferee. A question has been raised about whether that person is required to physically dispose of, utilize, or use the qualified carbon oxide or can they contractually perform those tasks since the carbon capture owner can do that contractually.

The statutory language in 45Q for this election says the credit may be transferred "to the person that disposes of the qualified carbon oxide, utilizes the qualified carbon oxide, or uses the qualified carbon oxide as a tertiary injectant." It does not require the transferee to physically do those activities. CURC proposes that the language in this section of the final regulations make it clear that the capture owner may transfer the credits to the person that contracts with the capture owner to dispose of, utilize, or use for EOR the qualified carbon oxide even if that person does not physically perform those tasks and contracts with a third party to physically perform those tasks on their behalf.

Taxability of Transferring the 45Q Credits.

The transfer of any 45Q credits from the owner of the capture equipment to the disposer, EOR operator, or utilizing party is effectively a sale of those credits and would, more than likely, be negotiated as part of the sale of the QCO to that same party. The IRS should provide guidance that says the owner of the carbon capture equipment does not have to recognize income upon the transfer of the credits. The receipt and use of the 45Q credits by the capture owner does not create additional taxable income for the capture owner. As a result, the capture owner should be recognized as having a basis in those credits equal to the original value of those credits. Any proceeds received by the capture owner for the transfer of those credits should be reduced by that basis in determining the taxable income of the capture owner. This should result in the capture owner not having to pay tax on the transfer of the credits.

Begin Construction – Continuous Construction Safe Harbor

In Notice 2020-12, the IRS provided guidance on when companies have begun construction on a 45Q carbon capture project by starting physical work of a significant nature or by incurring five percent or more of the total cost of the facility or property. These project must also demonstrate continuous efforts to complete construction and are deemed to fulfill this requirement if the facility or property is in service within six years.

The impact of COVID-19 on the economy, combined with the fact the IRS has not finalized the regulatory guidance, has deterred many companies from making critical investments and starting construction on carbon capture and sequestration projects. In fact, the Energy Department's top fossil energy official recently said there were "billions of dollars" of projects stuck waiting.

On May 27, 2020, the Treasury Department granted a one-year extension of the continuous construction safe harbor for renewable energy projects beginning construction in 2016 or 2017 under the federal Investment Tax Credit and Production Tax Credit due to issues companies are experiencing because of the impacts of COVID-19. In light of the wide-ranging impacts COVID-19 continues to have on the American economy, the construction safe harbor for 45Q projects should be extended to provide as much administrative flexibility as possible. Extending the safe harbor to qualify for the 45Q tax credit will create and protect thousands of jobs, provide regulatory certainty, and further incentivize carbon capture projects to reduce emissions.

Economic Substance Doctrine

In order to fulfill Congressional intent for enacting Section 45Q, IRS guidance should provide that the economic substance test will not apply to projects earning Section 45Q tax credits. Many of these projects will only be economically viable as a result of the tax credits. We recommend Treasury and the IRS issue guidance clarifying that the economic substance doctrine and section 7701(o) of the Code involving Codification of the Economic Substance Doctrine do not apply to carbon capture projects eligible for the carbon sequestration tax credit under section 45Q of the Code.

Notice 2010-62 and Notice 2014-58 (the "Notices") provide guidance regarding the codification of the economic substance doctrine under section 7701(o) of the Code. These Notices do not provide substantive guidance on how codification of the economic substance doctrine will apply to investments in carbon capture projects.

Section 7701(o) provides that, in the case of any transaction to which the economic substance doctrine is relevant, the transaction shall be treated as having economic substance only if the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction. An accuracy-related, strict liability penalty of 40 percent (reduced to 20 percent for an adequate disclosure) applies to any portion of an underpayment of tax attributable to the disallowance of a claimed tax benefit because of a transaction lacking economic substance.

Section 45Q provides a tax credit for capturing and sequestering carbon oxides in the amount of $35 per ton for projects sequestering the COx in an enhanced oil recovery project or through a utilization project and $50 per ton for COx sequestered in secure geologic storage not as part of an EOR project. These Congressionally authorized tax benefits will generally exceed the income generated by a carbon capture project.

Because the economics of carbon capture projects will rely heavily on the applicable tax benefits, a transaction or investment involving the capture of COx from an industrial facility arguably may lack economic substance as defined in section 7701(o) (unless the tax benefits are taken into account in the same manner as other cash generated by the transaction or investment). Given the large increase in the dollar amount of the 45Q tax credit in the 2018 amendment and the large differential in the amount of the credit for secure geologic storage with and without enhanced oil recovery, it is clear that Congress intends 45Q to provide tax benefits to carbon capture projects that would be uneconomic without the credit in order to encourage the development of commercial scale carbon capture and storage.

In addition, Congressional intent was clearly discussed in the attached letter from Senators Whitehouse, Barrasso and Capito to make clear the Congressional intent regarding the credit. According to the letter, “We wish to make a clear statement that congressional intent is for the tax credits to provide an economic incentive for investments in carbon capture projects that otherwise would not be made.“

Treasury/IRS guidance on 45Q should provide that section 7701(o) will not apply to disallow any tax benefits associated with a carbon capture project, such as the 45Q tax credit or accelerated/bonus depreciation that may apply to a carbon capture project, unless the use of such benefits violates some other Internal Revenue Code provision or tax law principle.

The legislative history to the codification of the economic substance doctrine directly supports promulgation of the requested guidance. In explaining the intended scope of section 7701(o), the Technical Explanation of the Revenue Provisions of the “Reconciliation Act of 2010”, as amended, in combination with the “Patient Protection and Affordable Care Act” as prepared by the staff of the Joint Committee on Taxation , says: “Thus, for example, it is not intended that a tax credit (e.g., section 42 (low-income housing credit), section 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.”

This legislative history also is consistent with prior case law. The courts have examined energy tax incentives and have found that an economic substance analysis is not applicable. In Sacks v. Commissioner, 69 F. 3d 982 (9th Cir., 1995), the IRS challenged depreciation deductions and investment tax credits claimed by the taxpayer with respect to certain solar energy devices. The 9th Circuit upheld the taxpayer's claims. The court reviewed the applicable tax cases regarding economic substance and sham transactions and found them inapplicable to the case at hand because the taxpayer was claiming Congressionally authorized tax benefits in the manner intended by Congress.

Both Congress and the Administration strongly support the development of carbon capture projects on industrial facilities. The Treasury/IRS should not hinder such investment by failing to provide clear guidance that the economic substance doctrine and Section 7701 (o) do not apply to taxpayers that invest in carbon capture projects.

If you have any questions regarding this submission, please contact Shannon Angielski (202-298-1825 or sma@vnf.com) or Michael Platner (202-298-1988 or mlp@vnf.com).

Respectfully submitted,

Shannon Angielski

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Executive Director

CC: Mr. David Selig, via email
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