Vinson&Elkins

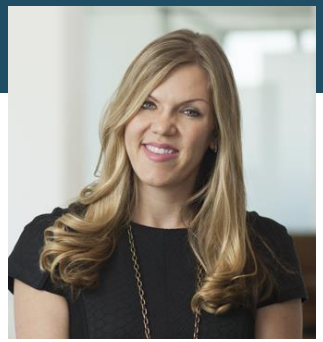
July 30, 2020

Energy Series

Quarantining Carbon Oxide

Structural and Tax Considerations for Carbon Capture Projects

Presenters



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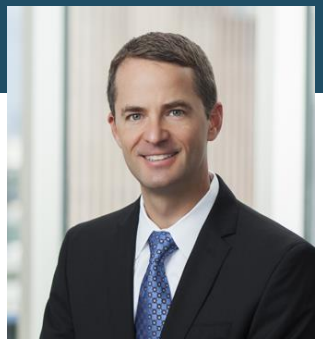

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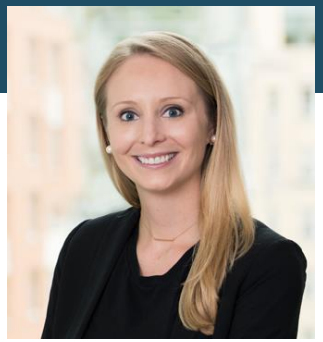

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Energy Series

Save the Date

Thursday, August 13, 2020

12 P.M. CT; 1 P.M. ET | Webcast

In this presentation, we will discuss SPACs and recent transactions. The presenters will discuss considerations for target companies and their equity owners and management teams involved in M&A transactions with SPACs, and considerations for the post SPAC M&A public company. The presenters will also discuss considerations for financial sponsors or management teams at IPO of a SPAC.

Speakers

Neil Shah (Evercore)
Ramey Layne (V&E)
Sarah Morgan (V&E)

- *CLE Pending*

Background on Tax Credits

Background on Tax Credits

- Who can claim credits?
- Allocation of credits to equity holders in a partnership/LLC
  - Equity holders have a "meaningful stake in the success or failure of the partnership"
  - Contrast to secured lenders or purchasers of credits
- In structures with tax equity investors, concern is ensuring those investors will be treated as equity holders
- History of partnerships and tax shelters
- Key cases
  - *Virginia Historic Tax Credit Fund 2001 LP v. Comm'r*, 639 F.3d 129 (4th Cir. 2011)
  - *Historic Boardwalk Hall, LLC v. Comm'r*, 694 F.3d 425 (3d. Cir. 2012)
- IRS response

Section 45Q Basics

Section 45Q Basics

- Section 45Q of the Internal Revenue Code, as amended in 2018, provides a tax credit for qualified carbon oxide that is captured using carbon capture equipment placed in service on or after February 9, 2018 and:
  - Used as a tertiary injectant in an enhanced oil or natural gas recovery (EOR) project and disposed of in secure geological storage,
  - Disposed of in secure geological storage and not used in EOR, or
  - Utilized in certain specified activities such as fixation through photosynthesis or chemical synthesis and chemical conversion of the carbon oxide
- The Section 45Q credit is available for carbon oxide captured during the 12-year period beginning on the date the equipment was originally placed in service
- The Section 45Q credit for calendar years 2017-2026 equals –
  - Between $22.66 and $50 for each calendar year per metric ton of carbon oxide that goes to secure storage and is NOT used for EOR; and
  - Between $12.83 and $35 for each calendar year per metric ton of carbon oxide that is used in EOR
- The equipment owner has the option of either keeping the Section 45Q credit or passing it on to the EOR user or storage provider

Carbon Capture Credit Eligibility

- To claim the Section 45Q credit, a taxpayer must –
  - Own carbon capture equipment that:
    - Begins construction before January 1, 2024,
    - Is placed in service at a “qualified facility” on or after February 9, 2018, and
    - Captures qualified carbon oxide from an industrial source or from the air
  - Physically or contractually ensure capture and secure storage of the carbon oxide, includinga;
    - *Measurement* of carbon oxide at the source of capture, and
    - *Verification* at the point of disposal in secure geological storage or use as a tertiary injectant and disposal in secure geological storage
  - Section 45Q credit benefits will be “recaptured” with respect to any carbon oxide that ceases to be disposed of in secure storage

Qualified Facility

- A “qualified facility” is an industrial facility or direct air capture facility –
  - Construction of which begins before January 1, 2024
  - And either –
    - Construction of carbon capture equipment begins before January 1, 2024, or
    - The original planning and design for the facility includes installation of carbon capture equipment
- An “industrial facility” is generally a facility that produces a CO stream from a fuel combustion source, a manufacturing process, or a fugitive CO emission source that, absent capture and disposal, would otherwise be released into the atmosphere as industrial emission of greenhouse gas
- Qualified facilities must satisfy minimum capture requirements –
  - Facilities that do not emit more than 500,000 metric tons of carbon oxide annually must capture at least 25,000 tons, but the tonnage must be utilized in a Section 45Q(f)(5) Activity
  - Electric generating facilities that emit more than 500,000 metric tons annually must capture at least 500,000 metric tons
  - All other facilities must capture at least 100,000 metric tons of carbon oxide

Guidance Under Section 45Q

- Notice 2020-12, released February 19, 2020, provides “beginning construction” safe harbors for purposes of applying statutory deadlines for Section 45Q credit eligibility
- Revenue Procedure 2020-12, released February 19, 2020, provides a “safe harbor” for partnerships that own carbon capture equipment under which the IRS will respect allocations of Section 45Q credits to the partners
  - Up to 50% of investor’s consideration may be contingent (“pay-go”)
  - Permits the investor to have a right to put its interest to the developer
- Proposed regulations, issued May 28, 2020, include requirements for secure geological storage, reporting requirements, and recapture parameters
  - The Proposed Regulations will not be effective until issued in final form, but taxpayers may choose to apply them prior to finalization, provided they are applied in their entirety and consistently

Requirements for Secure Storage

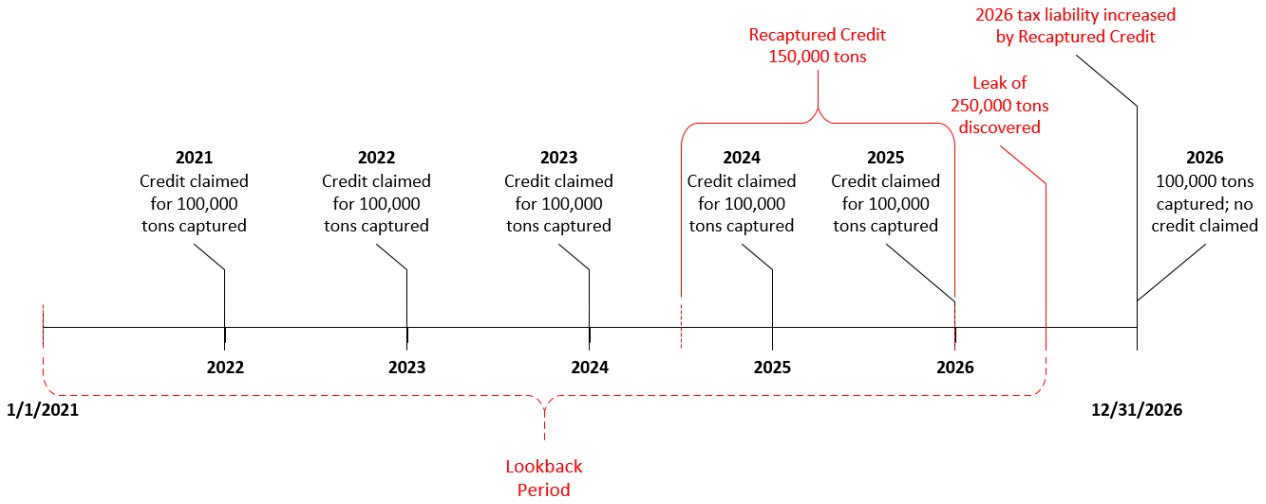
- Under IRS proposed regulations:
  - Carbon oxide sequestered in secure geological storage and *not* used in EOR must be stored in compliance with EPA's Underground Injection Control ("UIC") regulations under Subpart RR for Class VI wells
  - Carbon oxide used in EOR and subsequently stored must comply with either:
    - EPA's Subpart RR reporting requirements for Class II wells, provided the operator submits and receives EPA approval of a monitoring, reporting and verification (MRV) plan
    - The CSA/ANSI ISO 27916:19 standard developed by the International Organization for Standardization (ISO) and endorsed by the American National Standards Institute (ANSI) governing carbon dioxide capture, transportation and geological storage using enhanced oil recovery (the "ANSI ISO standard")

Section 45Q Credit Recapture

- IRS Proposed Regulations limit recapture liability in two ways:
  - The recapture period is limited to the 5 years preceding the date a leak is discovered (the lookback period)
  - The recapture period ends on the earlier of (i) 5 years after the end of the last taxable period for which credits were claimed, or (ii) the date monitoring is no longer required under Subpart RR or the ANSI ISO standard
- The amount of the recaptured Section 45Q credit is treated as an increase in tax liability for the year in which the recapture occurs
- The IRS has made clear that taxpayers may obtain third-party recapture insurance to protect against the recapture of tax credits

Lookback Rule Example

- For example, assume that a taxpayer claimed credits for 100,000 tons of captured carbon oxide each year from 2021 to 2026 and a leak of 250,000 tons is discovered in 2026
  - First the 2026 credit for 100,000 tons is eliminated (because the leaked carbon oxide exceeds the otherwise claimed carbon oxide for 2026)
  - Next, the remaining 150,000 tons of escaped carbon oxide offsets the 100,000 tons claimed in 2025
  - The remaining 50,000 tons of escaped carbon oxide offsets half the carbon oxide claimed in 2024



Structuring Section 45Q Transactions

Key Benefits of New Section 45Q

- Credit amount is substantially higher
- Credit applies to the capture of carbon oxide
- Minimum capture requirement of 100,000 metric tons of carbon oxide per year (except for electric generating facilities)
- Owner of carbon capture equipment may pass on credit to the EOR user or storage provider
- Credits are available for 12 years beginning on the date the carbon capture equipment is placed in service
- The taxpayer no longer needs to own the industrial facility

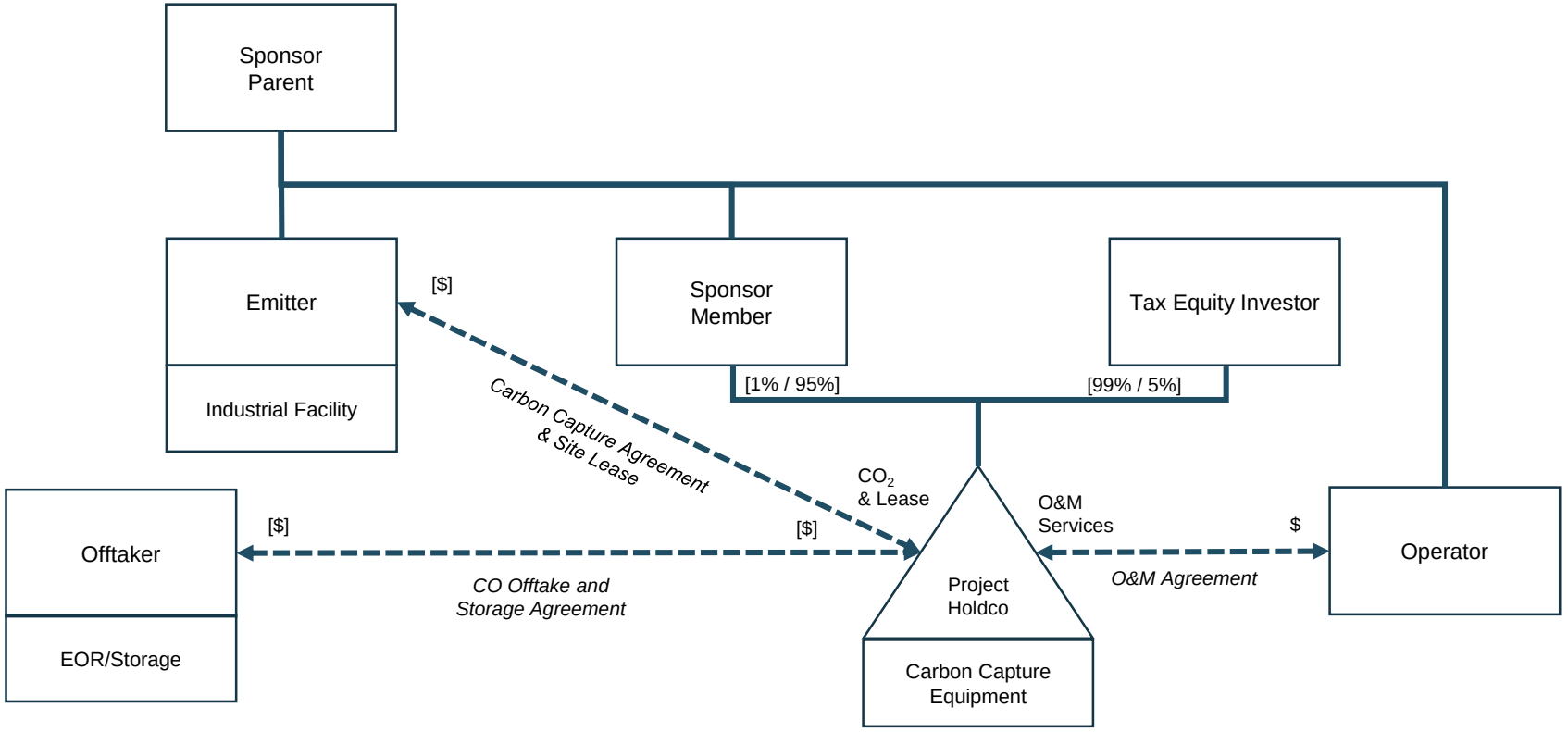
Parties to Section 45Q Transactions

- Parties to all carbon capture and disposal operations :
  - Emitter – owner of industrial facility that emits carbon oxide into the atmosphere
  - Equipment Supplier – supplies carbon capture equipment (“Equipment”)
  - Equipment Owner – owns the Equipment
  - Offtaker
    - EOR User – uses captured carbon oxide in EOR
    - Storage Provider – maintains captured carbon oxide in secure storage (may be the same person as EOR User)

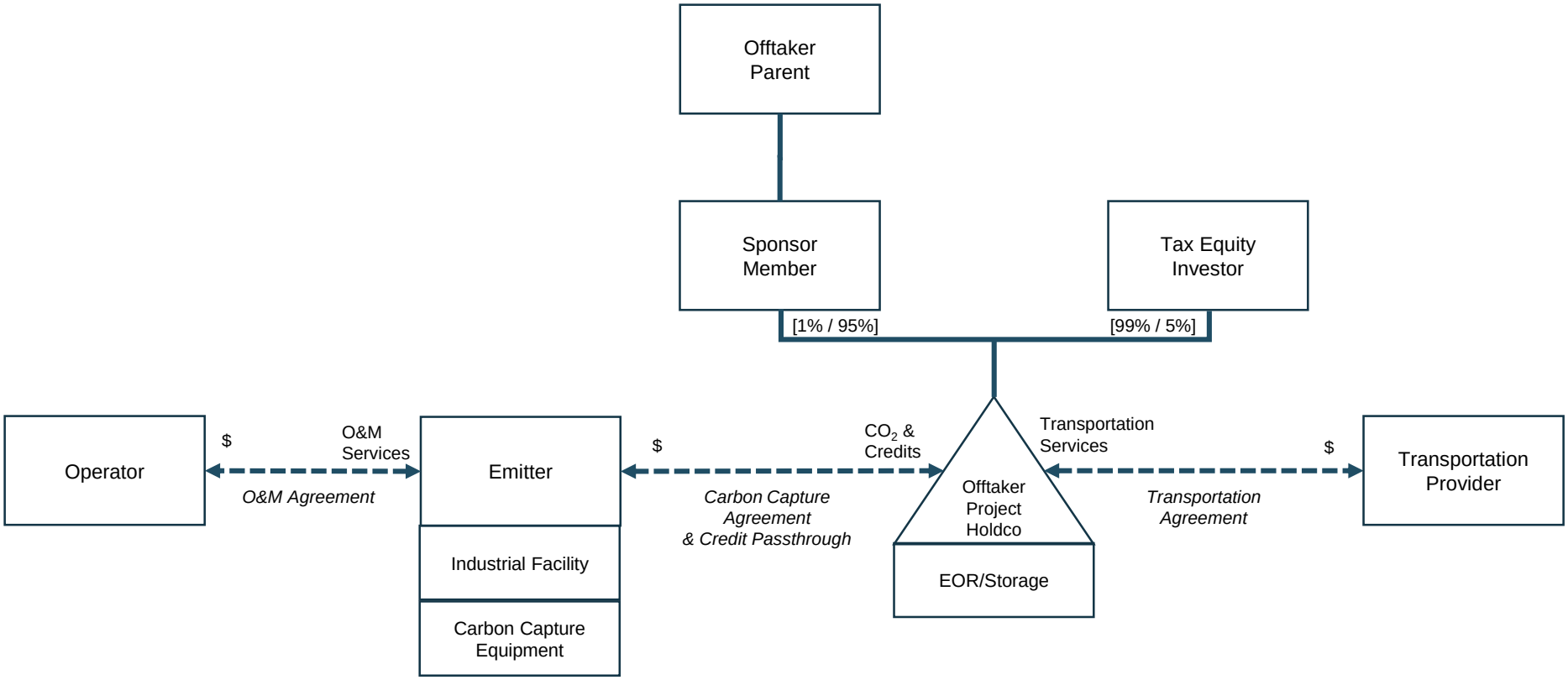
Parties to Section 45Q Transactions

- Other possible parties to carbon capture and disposal operations:
  - Tax Equity Investor – typically a large institutional or corporate investor with tax capacity to use the Section 45Q credits that invests in Equipment (or storage wells), likely through a partnership with affiliates of Emitter, EOR User or Storage Provider
  - Sponsor – develops project to own and operate Equipment
  - Lenders – Finance construction of Equipment or storage wells
  - EPC Contractor – Constructs Equipment
  - O&M Provider – operates and maintains Equipment in exchange for a fee
  - Carbon Oxide Transporter – owns/operates pipeline that transports captured carbon oxide from industrial facility to point of disposal or injection

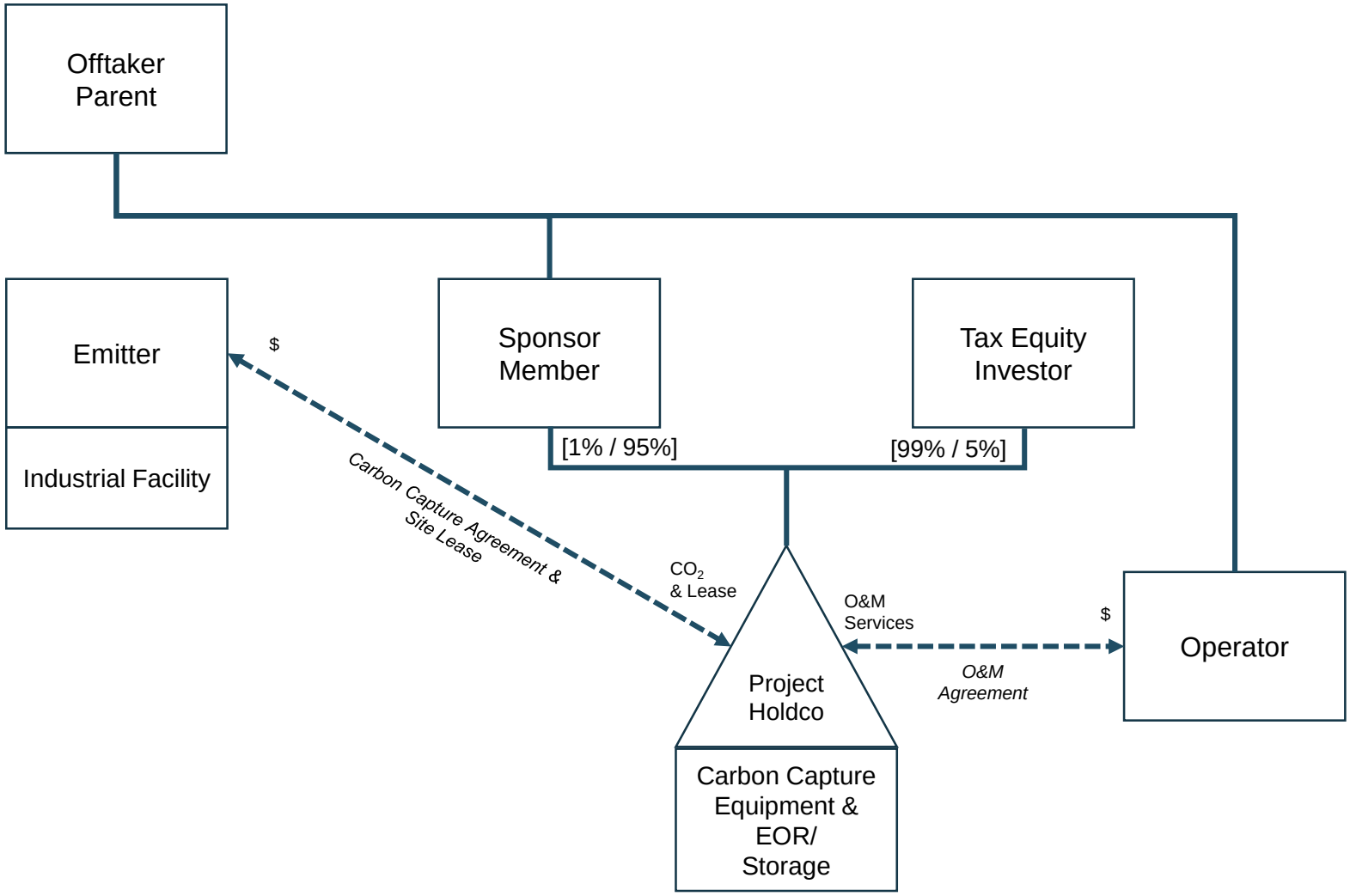
Co-Investment in Capture Equipment



Co-Investment in Storage



Co-Investment in Capture & Storage



THANK YOU

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