

August 9, 2019

CC:PA:LPD:PR (Notice 2019-32)  
Internal Revenue Service  
Room 5203  
P.O. Box 7604  
Ben Franklin Station  
Washington, D.C. 20044

Dear Sir or Madam:

This letter is responsive to the request for comments contained in Notice 2019-32. In preparing these comments, we draw on our experience in the tax equity financing of solar and wind projects that routinely monetize tax benefits under Internal Revenue Code Section 48<sup>1</sup> (Investment Tax Credit) and Section 45 (Production Tax Credit).

Given the legislative objective behind Section 45Q of utilizing tax credits to incentivize developers to invest in carbon capture equipment, we believe that it would be prudent to look to the IRS guidance in the wind and solar area for ways to ensure that tax equity investors will consider investing in these projects. We have observed first-hand watching the solar and wind industry grow and succeed that small tweaks to the IRS guidance often resulted in either shifting the tax equity market into full gear or bringing the market to a halt.

We highlight a few areas below that we believe will likely be pressure points for tax equity investors with the goal of making changes that will result in a more robust and liquid tax equity market, which we believe is essential for the success of carbon capture projects.

### **Recapture**

You have requested comments on the standard for triggering and measuring recapture. We believe that this will be a very sensitive point for tax equity investors who will likely be reluctant to finance these projects unless there is a very high level of certainty that there will not be a recapture of the tax credits received for their investment. For the investment tax credit, recapture only arises if there is a disposition of the project or the project is taken out of service and abandoned. These are very concrete requirements that investors can understand and ensure that there are appropriate measures to mitigate a recapture.

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<sup>1</sup> All "Section" references are to the Internal Revenue Code of 1986, as amended.

We would suggest that the IRS consider implementing a safe harbor using the EPA's Mandatory Greenhouse Gas Reporting Standard, 40 CFR Part 98 ("Subpart RR"), or an equivalent program approved by the EPA to provide that so long as taxpayer can demonstrate that carbon dioxide is sequestered or stored in secure geologic storage using the Subpart RR standard which is filed in the year following the taxable year that tax credits were claimed, then there will be no recapture for such taxable year. There could be recapture if leakage is discovered in the following year, but that would be only where there was negative storage and it would be limited to the credits generated in the prior year. Using the Subpart RR standard will ensure that investors are at most exposed to recapture of one year of credits if no leakage is found when the site is tested in the following year.

### **Start of Construction**

You requested guidance on what constitutes the start of construction for purposes of Section 45Q(d). We believe that the guidance that currently exists for wind projects which was recently adopted for solar projects (IRS Notice 2018-39) is a sensible starting point. However, the statute provides for a two-prong test: (A) starting construction on any industrial facility or direct air capture facility before January 1, 2024 and (B) construction of carbon capture equipment prior to January 1, 2024 or the original planning and design for such facility includes installation of carbon capture equipment. In other words, once construction of the facility is started, the credit is available if the original planning and design includes installation of carbon capture equipment, or if construction of the carbon capture equipment begins prior to January 1, 2024.

If the solar and wind guidance standard is adopted, this will allow taxpayers to either start physical work or satisfy the 5% safe harbor on an industrial or direct air capture facility prior to January 1, 2024. If a taxpayer starts construction on a direct air capture facility, that should satisfy prong (B) as well. If a taxpayer starts construction on an industrial facility but does not start construction of carbon capture equipment, then the taxpayer will need to show "that the original planning and design for such facility includes installation of carbon capture equipment." We would recommend providing specific examples in the guidance of what is sufficient to satisfy this requirement. For example, specifying that an engineering report that provides the specifications for the carbon capture equipment that is intended to be added to the industrial facility is sufficient would be very helpful.

Under the solar and wind guidance, the IRS included a requirement that taxpayers that start construction must satisfy a continuity requirement, "continuous efforts" in the case of the 5% safe harbor and "continuous construction" in the case of the physical work test. When this guidance was initially issued for wind projects, the tax equity market was concerned that there was not enough certainty in satisfying these tests, which are based on all the facts and circumstances. The IRS responded by providing a safe harbor that taxpayers that begin construction and complete the project by the 4<sup>th</sup> anniversary from the end of the year that construction began will be deemed to satisfy the continuity requirement. We believe this safe harbor should be adopted for carbon sequestration, but that the 4-year window should be extended to 6 years because this technology is more complex and the typical time frame for developing and constructing

carbon capture equipment is longer than for wind and solar projects. It is our understanding that projects (for example, a thermal retrofit) will take two years longer to complete than comparable renewable projects.

### **The Section 45Q(f)(3)(B) Election**

For projects that are constructed after the Bipartisan Budget Act of 2018, taxpayers must own the carbon capture equipment and physically or contractually ensure the capture and disposal, utilization, or use of tertiary injectant of such carbon oxide. As enacted in 2008, Section 45Q did not have an ownership requirement. Section 45Q(f)(3)(B) provides that a taxpayer may elect to transfer the credit to a person that disposes of the qualified carbon oxide, utilizes the qualified carbon oxide or uses the qualified carbon oxide as a tertiary injectant. Some advisors have suggested the only tax equity financing structure available to these transactions is the “partnership flip” (which is described in Revenue Procedure 2007-65) because of the requirement that the taxpayer must own the carbon capture equipment and physically or contractually ensure the capture.

Tax equity financings for solar projects currently utilize three financing structures: 1) the partnership flip, 2) the sale lease-back and 3) the inverted lease structure. Under the partnership flip structure, the sponsor and tax equity invest in a partnership and the tax equity investor is typically allocated 99% of the profit and loss and tax credits for each taxable year until the tax equity investor reaches a certain yield, after which the tax equity investor is allocated only 5% of the profit and loss (i.e., the allocation flips down). Under the sale-leaseback structure, the sponsor sells the equipment to a special purpose entity owned by the tax equity investor, which in turn leases it back to the sponsor. The tax equity investor is the owner and claims the tax credit. Under the inverted lease structure, the sponsor leases the equipment to a tax equity investor, which contracts with the sponsor to operate the project. The sponsor elects to pass-through the investment tax credits to the lessee, effectively passing the credit to the tax equity investor. The latter two structures would not be available to finance these projects because in any lease structure the owner of the recapture equipment (i.e., the lessor) is different from the operator (i.e., the lessee), who will operate the equipment and physically or contractually ensure recapture.

We believe it would be beneficial to broaden the scope of available transactions by making the election flexible enough to permit the owner in a lease structure to require the lessee contractually to provide sequestration of the carbon. If that clarification were provided, then the owner would be eligible for the credit and, therefore, the sale lease-back structure and inverted lease structure would be available financing options for these projects. Further, similar to the case for solar projects, the election could be used to pass the credit through to the lessee in the inverted lease structure.

### **Revenue Procedure 2007-65**

The renewable energy market relies heavily on Revenue Procedure 2007-65 which provides a safe harbor for structuring partnership flip transactions for wind projects. One question often raised by tax equity investors is whether there is a certain amount of operating cash flow that must be distributed to the tax equity investor as part of their return. Revenue Procedure 2007-65 does not contain any such requirement,

but the examples include periods of time where the tax equity investor is receiving 100% of the cash flow. We are concerned that tax equity investors may be reluctant to invest in direct air capture facilities because those facilities may not have any material income or cash flow and may be almost solely relying on the tax credits to finance the project. We believe it would be very beneficial if the guidance includes confirmation that a tax equity investor's return may be solely from tax credits and depreciation, at least in cases where there is limited income at the project company level. See *Sachs v. Comm'r.*, 277 F. 2d 879 (8th Cir. 1960), *affirming* 32 T.C. 815 (1959). Revenue Procedure 2007-65 also provides that only 25% of a tax equity investor's capital contribution may be contingent. As a result, wind deals that use a "pay as you go" structure, typically tie up to 25% of the tax equity investor's contribution to the receipt of production tax credits in the future. We understand that it is difficult to satisfy the 25% requirement in carbon sequestration deals primarily because tax equity's entire investment is tied to the credits, which results because there is very little cash flow. We would recommend raising the portion of tax equity's investment that may be contingent to 60% to make carbon sequestration deals more viable. In revising the safe harbor, we would also recommend excluding capital contributions for operating expenses from the capital contributions that are considered contingent. Finally, it would be helpful to issue guidance that is specific to carbon sequestration or at least confirm that the principles established in Revenue Procedure 2007-65 also apply to Section 45Q.

Thank you in advance for considering our comments. If you have any questions or would like to discuss, please contact Peter Connors at 212 506-5120 (pconnors@orrick.com) or Mike Masri at 212 506-5361 (mmasri@orrick.com).

Sincerely yours,

cc: David J. Kautter, Assistant Secretary for Tax Policy  
Michael J. Desmond, IRS Chief Counsel  
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