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KPMG report: Section 45Q credit for carbon oxide sequestration; considerations for equipment upgrades and the 80/20 Rule

Prior to the enactment of the “Bipartisan Budget Act of 2018” (BBA), the section 45Q credit for carbon oxide sequestration provided a tax credit for qualified carbon dioxide captured by the taxpayer at a qualified facility and disposed of in secure geological storage or used as a tertiary injectant in an enhanced oil or gas recovery (EOR) project. The credit was capped at a total of 75 million metric tons of qualified carbon oxide captured by all taxpayers. With the enactment of the BBA, the section 45Q credit for carbon capture equipment was significantly expanded to include higher credit rates and no cap, among other favorable changes.

The IRS has not certified that the aggregate amount of qualified carbon oxide taken into account for purposes of section 45Q has reached 75 million metric tons. In fact, although it was widely expected that the IRS would certify that the cap had been met in 2021, the IRS in Notice 2021-35 explicitly stated that such a certification had not yet been made. Read [TaxNewsFlash](#). Nevertheless, many anticipate that the cap will be met in 2022, and there is also language in the proposed “Build Back Better Act” that would eliminate the credit for pre-BBA equipment, regardless of whether IRS makes the certification.

After the IRS certifies that the cap has been met, or enactment of proposed language in the Build Back Better Act occurs, the section 45Q credit will generally not be available for qualified carbon oxide captured using carbon capture equipment placed in service prior to the date of the enactment of the BBA (February 9, 2018).^[1] This applies regardless of the use of the qualified carbon oxide (injection for EOR, secure geological storage, or utilization).

^[1] One exception is the election for applicable facilities under section 45Q(f)(6), which allows to a facility placed in service prior to BBA that captures not less than 500,000 metric tons of qualified carbon oxide to make an election to be deemed as placed in service on February 9, 2018, as long as no taxpayer has claimed the section 45Q credit with regards to the facility for any taxable year ending before February 9, 2018.

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Upgrading carbon capture equipment

Treasury regulations permit carbon capture equipment to qualify as originally placed in service, even if it contains some used components of property, as long as the fair market value of the used components is not more than 20% of the qualified facility or carbon capture equipment's total value ("80/20 Rule").^[2]

Taxpayers with pre-BBA carbon capture equipment may be considering making upgrades to the equipment for various technological and economic reasons and these taxpayers need to consider whether and how to make these upgrades such that they are treated as newly placed in service under the 80/20 Rule, and therefore eligible to claim section 45Q credits for a 12-year period starting in the year the equipment is newly placed in service. This is especially true because post-BBA section 45Q offers higher credits rates. In addition, recent legislative proposals (including the Build Back Better Act) would further increase the section 45Q credit rates and make the credits refundable through a direct pay election, for carbon capture equipment placed in service after December 31, 2021.

Applying the 80/20 Rule typically involves an analysis of the fair market value of the used components of property using various valuation approaches to arrive at the most representative fair market value. The fair market value of the used equipment is then compared to the total value (fair market value of the used equipment plus cost of the new equipment) of all the carbon capture equipment. For purposes of the 80/20 Rule, the cost of the new equipment includes all properly capitalized costs. The preamble for the section 45Q regulations indicates that the relevant valuation date for the 80/20 Rule is the value as of the date the equipment is placed in service.

In order to undertake the valuation of the used equipment, the appropriate unit or units of existing carbon capture equipment must be identified. For purposes of section 45Q, and for the 80/20 Rule, the regulations provide a broad, functionality-based definition of carbon capture equipment. In general, under the regulations, carbon capture equipment includes all components of property that are used to capture or process CO₂ until it is transported for disposal, injection, or utilization. The regulations note that carbon capture equipment is used for the purpose of separating, purifying, drying, and/or capturing CO₂ that would otherwise be released into the atmosphere, and also includes equipment used for the purpose of compressing or otherwise increasing the pressure of the CO₂.^[3] Importantly though, the Treasury regulations provide that, solely for purposes of the 80/20 Rule, the costs of the new facility may include the cost of a new pipeline as long it is used exclusively by that taxpayer to transport carbon oxides from that taxpayer's facility.^[4]

The regulations further state that all components that make up an independently functioning process train capable of capturing, processing, and preparing CO₂ for transport is to be treated as one unit of carbon capture equipment.^[5] Identifying which components are included in the carbon capture equipment will be a key part of the analysis for the 80/20 Rule.

The 80/20 Rule is frequently used to determine whether a wind facility is eligible for a new placed-in-service date for purposes of claiming the section 45 production tax credit. IRS guidance specifically addressing the applicability of the 80/20 Rule to a wind facility was provided in Rev. Rul. 94-31. However, there is very little other IRS guidance applying the 80/20 Rule to different factual scenarios, and there is no IRS guidance applying the 80/20 Rule to fact patterns involving carbon capture equipment. With potential increasing interest in applying the 80/20 Rule to carbon capture equipment, as well as continued interest in repowering wind and other types of facilities, taxpayers will continue to consider making capital investments into existing projects and seek to access additional tax credits to help finance those investments. In the absence of detailed IRS guidance, when applying the 80/20 Rule, taxpayers need to take care in planning equipment upgrades and carefully document relevant tax

^[2] Treas. Reg. § 1.45Q-2(g)(5).

^[3] Treas. Reg. § 1.45Q-2(c)(1).

^[4] Treas. Reg. § 1.45Q-2(g).

^[5] Treas. Reg. § 1.45Q-2(c)(3).

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credit eligibility positions, valuation reports, and cost capitalization analyses. Finally, as activity in the space increases, additional IRS guidance may be needed to address questions that will continue to arise.

KPMG observation

There are certain best practices for taxpayers considering investments in existing carbon capture equipment. For instance, a comprehensive valuation analysis is needed to establish the fair market value of property that is subject to the 80/20 Rule. As a part of this valuation analysis, an illustrative calculation of the 80/20 Rule can further provide information for taxpayers to use in assessing whether or not a project qualifies as newly placed in service and eligible for section 45Q credits. In addition, there may be special circumstances relating to the application of section 45Q that will require additional analysis and documentation, including whether the 80/20 Rule analysis and the carbon capture project as a whole meets statutory and regulatory requirements.

For more information, contact a KPMG tax professional with experience concerning 80/20 Rule analysis in KPMG's Economic and Valuation Services group or KPMG's Washington National Tax:

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