

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also: §§ 45Q, 704, 1.704-1)

Rev. Proc. 2020-12

SECTION 1. PURPOSE

This revenue procedure establishes a safe harbor (Safe Harbor) under which the Internal Revenue Service (IRS) will treat partnerships as properly allocating, in accordance with section 704(b) of the Internal Revenue Code (Code), the credit for carbon oxide sequestration under section 45Q of the Code (Section 45Q Credit). The Department of the Treasury (Treasury Department) and the IRS intend for the Safe Harbor to simplify the application of section 45Q to partnerships that are eligible to claim the Section 45Q Credit.

SECTION 2. BACKGROUND

.01 Section 45Q generally allows a credit of an amount per metric ton of qualified carbon oxide captured by the taxpayer that is either: (i) disposed of in secure geological storage; (ii) used as a tertiary injectant in a qualified enhanced oil or natural gas recovery project and disposed of in secure geological storage; or (iii) utilized in certain ways described in section 45Q(f)(5). The amount of the credit depends on the date the carbon capture equipment is placed in service and whether the qualified carbon oxide is disposed of in secure storage, used, or utilized.

.02 In the case of carbon oxide captured using carbon capture equipment that is originally placed in service at a qualified facility on or after February 9, 2018, the Section 45Q Credit is available during the 12-year period beginning on the date the equipment was originally placed in service. Although section 45Q does not define “placed in service,” the term has been defined for purposes of the investment tax credit and the deduction for depreciation. For these purposes, property is considered to be placed in service in the taxable year that the property is placed in a condition or state of readiness and availability for a specifically assigned function. See §§ 1.46-3(d)(1)(ii) and 1.167(a)-11(e)(1)(i) of the Income Tax Regulations.

.03 Section 704(a) provides that a partner’s distributive share of income, gain, loss, deduction, or credit is, except as otherwise provided in chapter 1 of subtitle A of the Code, determined by the partnership agreement. Section 704(b) provides that a partner’s distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the partner’s interest in the partnership (determined by taking into account all facts and circumstances), if: (i) the partnership agreement does

not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof); or (ii) the allocation to a partner under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

.04 Section 1.704-1(b)(4)(ii) provides that allocations of tax credits and tax credit recapture are not reflected by adjustments to the partners' capital accounts (except with respect to certain investment tax credit property under section 38 of the Code). Thus, these allocations cannot have economic effect under § 1.704-1(b)(2)(ii)(b)(1), and the tax credits and tax credit recapture must be allocated in accordance with the partners' interests in the partnership as of the time the tax credit or credit recapture arises. With respect to tax credits other than the investment tax credit provided by section 38, if a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for the year, then the partners' interests in the partnership with respect to the credit (or the cost giving rise to it) are in the same proportion as the partners' respective distributive shares of the loss or deduction (and adjustments). See § 1.704-1(b)(5), Example 11. Section 1.704-1(b)(4)(ii) further provides that identical principles apply in determining the partners' interests in the partnership regarding tax credits that arise from receipts of the partnership (whether or not taxable).

.05 A partnership exists when two or more "parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949). In making this determination,

courts “look not so much at the labels used by the partnership but at true facts and circumstances” to determine whether a partner has a “meaningful stake in the success or failure” of the enterprise. *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 231 and 241 (2d Cir. 2006). A purported partner in a partnership may in substance be more properly viewed as a lender to the partnership or purchaser of partnership assets if the purported partner lacks “any meaningful downside risk or any meaningful upside potential in” the partnership. *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425, 455 (3d Cir. 2012).

SECTION 3. SCOPE

.01 The Safe Harbor provided in section 4 of this revenue procedure applies to any partnership (Project Company) that validly claims the Section 45Q Credit. Partners in a Project Company may include a project developer (Developer) and one or more investors, as defined in section 4.01 of this revenue procedure (Investors). The Project Company typically owns the carbon capture equipment (Equipment). In addition to the Project Company, the Developer, and the Investors, carbon oxide capture and sequestration transactions may involve lenders, one or more carbon oxide emitters (Emitters), one or more construction contractors, one or more qualified carbon oxide purchasers (Offtakers), and one or more project operators.

.02 If a Project Company, Developer, and Investor(s) satisfy all of the requirements of the Safe Harbor provided in section 4 of this revenue procedure, the IRS will treat the Investor as a partner in the Project Company and will treat the Project Company as properly allocating the Section 45Q Credit in accordance with section 704(b).

.03 The federal income tax treatment described in section 3.02 of this revenue procedure applies solely with respect to carbon oxide capture and sequestration transactions described in sections 3.01 and 3.02 of this revenue procedure and should not be viewed as precedent for any other federal tax credit transaction. Taxpayers should not infer that compliance with the Safe Harbor ensures that they are otherwise entitled to validly claim the Section 45Q Credit. A Project Company and its partners that do not satisfy each of the requirements in section 4 of this revenue procedure do not qualify for the Safe Harbor.

.04 This revenue procedure applies only to partnerships with a Section 45Q Credit and partners in such partnerships. This revenue procedure does not apply to any other tax credits and may not be cited as precedent for any other federal tax credit allocation.

.05 The Safe Harbor in this revenue procedure provides guidance on partnership allocations of the Section 45Q Credit to taxpayers establishing or participating in carbon capture partnerships in lieu of such taxpayers requesting letter rulings. Therefore, the IRS will not issue letter rulings on any issues under subchapter K of chapter 1 of subtitle A of the Code for partnerships claiming or seeking to claim the Section 45Q Credit.

SECTION 4. SAFE HARBOR

This section 4 sets forth the Safe Harbor under which the IRS will treat partnerships as properly allocating the Section 45Q Credit in accordance with section 704(b). If a Project Company and its partners do not satisfy each of the requirements in this section 4, the Project Company and its partners do not qualify for the Safe Harbor.

.01 Investors Defined. Investors hold an interest in the Project Company (Partnership Interest) as described in section 4.02(2) of this revenue procedure. An Investor may be an initial partner in the Project Company or may later become an Investor by acquiring an interest in the Project Company either directly from the Project Company by contribution or from another partner by purchase.

.02 Partners' Partnership Interests.

(1) *Developer's Minimum Partnership Interest.* The Developer must have a minimum one percent Partnership Interest in each material item of partnership income, gain, loss, deduction, and credit at all times during the existence of the Project Company.

(2) *Investor's Partnership Interest.*

(a) *Investor's Minimum Partnership Interest.* Each Investor must have, at all times during the period it owns a Partnership Interest, a minimum interest in each material item of partnership income, gain, loss, deduction, and credit equal to at least five percent of the Investor's percentage interest in each such item for the taxable year for which the Investor's percentage share of that item is the largest (as adjusted for sales, redemptions, or dilutions of its interest).

(b) *Requirements Regarding the Investor's Partnership Interest.* The Investor's Partnership Interest must constitute a bona fide equity investment with a reasonably anticipated value commensurate with the Investor's overall percentage interest in the Project Company, separate from any federal, state, and local tax deductions, allowances, credits, and other tax attributes to be allocated by the Project Company to the Investor. An Investor's Partnership Interest is a bona fide equity investment only if

that reasonably anticipated value is contingent upon the Project Company's net income, gain, and loss, and is not substantially fixed in amount. Likewise, the Investor must not be substantially protected from losses from the Project Company's activities. The Investor's return from its investment in the Project Company must not be limited in a manner comparable to a preferred return representing a payment for capital.

(c) Arrangements to Reduce the Value of the Investor's Partnership Interest or the Investor's Economic Return. The value of the Investor's Partnership Interest may not be reduced through fees (including developer, management, and incentive fees), or other arrangements, that are unreasonable compared with fees or other arrangements for a carbon oxide capture and utilization or sequestration project that does not qualify for the Section 45Q Credit, and may not be reduced by disproportionate rights to distributions or by issuances of interests in the Project Company (or rights to acquire interests in the Project Company) for less than fair market value consideration.

.03 Investor's Minimum Unconditional Investment. On the date the Investor acquires a Partnership Interest, the Investor must make a minimum unconditional investment with respect to the Project Company (Investor Minimum Investment). The Investor must maintain the Investor Minimum Investment throughout the duration of its ownership of its Partnership Interest, except that the Investor Minimum Investment may be reduced as a result of distributions of cash flow from the Project Company's operation of the Equipment. Investments required to be made by the Investor in the future will not be included in the Investor Minimum Investment until the investment is actually made with respect to the partnership. The Investor Minimum Investment must be equal to at least 20 percent of the sum of the fixed capital investment plus any reasonably anticipated

contingent investment required to be made by the Investor under the partnership agreement. The Investor must not be protected against loss of any portion of the Investor Minimum Investment through any arrangement, directly or indirectly, with: the Developer; any other Investor; an Emitter; an Offtaker; or any person related to the Developer, other Investors, an Emitter, or an Offtaker.

.04 Contingent Consideration. More than 50 percent of the sum of the fixed investment plus reasonably anticipated contingent investment to be made by an Investor with respect to a Partnership Interest must be fixed and determinable obligations that are not contingent in amount or certainty of payment. Contributions to the Project Company to pay ongoing operating expenses will not be treated as part of the Investor's contingent investment for purposes of this requirement.

.05 Purchase Rights. Neither the Developer, the Investors, nor any related person may have a call option or other contractual right or agreement to purchase, at any time, the Equipment, any property included in the Equipment, or a Partnership Interest at a future date (other than a contractual right or agreement for a present sale).

.06 Sale Rights. An Investor may not have a contractual right or other agreement to require any person involved in any part of the carbon capture transaction to purchase or liquidate the Investor's Partnership Interest at a future date at a price that is more than its fair market value determined at the time of exercise of the contractual right to sell.

.07 Determination of Fair Market Value. Solely for the purposes of this revenue procedure, any determination of the fair market value of the Equipment or a Partnership Interest may take into account contracts or other arrangements creating rights or obligations only if such contracts or other arrangements creating rights or obligations

are entered into in the ordinary course of the Project Company's business and are negotiated at arm's length.

.08 Guarantees and Loans.

(1) No person involved in any part of the Project Company may directly or indirectly guarantee or otherwise insure the Investor's ability to claim the Section 45Q Credit, the cash equivalent of the credits, or the repayment of any portion of the Investor's contribution due to inability to claim the Section 45Q Credit, in the event that the IRS challenges all or a portion of the transactional structure of the partnership. Further, no person involved in any part of the Project Company (or any related person) may guarantee that the Investor will receive distributions from the Project Company or consideration in exchange for its interest in the Project Company (except for a fair market value sale right described in section 4.06 of this revenue procedure). This requirement does not prohibit the Investor from procuring insurance, including recapture insurance, from persons not related to the Developer, any other Investor, an Emitter, or an Offtaker.

(2) The following guarantees may be provided to the Investor or the Project Company: (i) guarantees for the performance of any acts necessary to claim the Section 45Q Credit (including ensuring proper secure geological storage of the qualified carbon oxide through disposal, or use as a tertiary injectant, or utilization); and (ii) guarantees for the avoidance of any act (or omissions) that would cause the Project Company to fail to qualify for the Section 45Q Credit or that would result in a recapture of the Section 45Q Credit. Examples of guarantees permitted under this section include

completion guarantees, operating deficit guarantees, environmental indemnities, and financial covenants.

(3) A long-term carbon oxide purchase agreement entered into on arm's-length terms between the Project Company and an Emitter, between the Project Company and an Offtaker, or between an Emitter and an Offtaker, does not constitute a guarantee even if the Emitter or the Offtaker is related to the Project Company, and even if such contracts contain "supply all," "supply-or-pay," "take all," "take-or-pay," or "securely-store-or-pay" provisions. A long-term contract between the Project Company and the Emitter or the Offtaker pursuant to which the Project Company leases the equipment to the Emitter or the Offtaker or agrees to use the Equipment to perform services for the Emitter or the Offtaker also does not constitute a guarantee even if the Emitter or the Offtaker is related to the Project Company.

(4) The Developer (or a person related to the Developer) may not lend any Investor the funds to acquire any part of the Investor's interest in the Project Company or guarantee any indebtedness incurred or created in connection with the acquisition of such Investor's interest in the Project Company.

.09 Allocation of the Section 45Q Credit. Allocations under the Project Company's partnership agreement must satisfy the requirements of section 704(b) and the regulations thereunder. The Section 45Q Credit and any recapture of the Section 45Q Credit must be allocated in accordance with § 1.704-1(b)(4)(ii). If the Project Company generates receipts from its activities relating to carbon oxide sequestration (such as payments for capturing qualified carbon oxide or for the sale of qualified carbon oxide), and those receipts give rise to valid allocations of partnership income, an allocation of

the Section 45Q Credit in the same proportion as the partners' respective distributive shares of such income will be treated as in accordance with the partners' interests in the partnership for this purpose. If the Project Company does not receive payments for its activities relating to carbon oxide sequestration, an allocation of the Section 45Q Credit in the same proportion as the partners' respective distributive shares of the loss or deduction (or other downward capital account adjustments) associated with the cost of the capture and disposal, use as a tertiary injectant, or utilization of the qualified carbon oxide will be treated as in accordance with the partners' interests in the partnership for this purpose.

SECTION 5. EXAMPLE

This section 5 provides an example of a valid allocation of the Section 45Q Credit by a limited liability company (LLC) that is classified as a partnership for federal income tax purposes.

.01 Facts.

(1) The Developer is a C corporation for federal income tax purposes that owns and operates carbon capture projects. The Developer may also use carbon oxide for enhanced oil recovery. The Project Company is an LLC classified as a partnership for federal income tax purposes that has been formed by the Developer to own and manage a carbon capture project that: (i) owns Equipment; (ii) has rights to capture carbon oxide from an Emitter; and (iii) sells the carbon oxide to an Offtaker (which may be the Developer and may be a partner). The Investor is a C corporation for federal income tax purposes that invests in carbon capture projects primarily to benefit from the

Section 45Q Credit. The Developer will assign to the Project Company a number of contracts or agreements relating to the development of the carbon capture project.

(2) The Developer will cause the Equipment to be constructed and placed in service. Construction of the Equipment will be financed with \$100x of construction financing. At some point before the Equipment is placed in service, the Developer will contribute the Equipment to the Project Company. The Investor will contribute \$10x to the Project Company in exchange for an interest in the Project Company. The Investor's contribution of \$10x is 20 percent of the Investor's total agreed investment of \$50x.

(3) The Project Company will be a party to a long-term contract with the Emitter, pursuant to which the Project Company will install the carbon capture equipment on or adjacent to the Emitter's facility and will have rights to capture carbon oxide emissions. The contract with the Emitter may provide for either a fixed or variable payment for the right to capture or purchase the carbon oxide emissions. The contract may also permit the Project Company to capture the Emitter's entire emission stream or may specify a minimum amount of carbon oxide that the Emitter must supply to the Project Company. The Project Company will also be party to a long-term contract with the Offtaker, pursuant to which the Offtaker will undertake to purchase carbon oxide from the Project Company. That contract may be at a fixed or variable price and may provide a commitment from the Offtaker to purchase all of the Project Company's carbon oxide. The Offtaker will also agree to use the carbon oxide as a tertiary injectant in enhanced oil recovery and store it in secure geological storage, and avoid any release of the stored carbon oxide. These agreements will provide for remedies

for breach of contract. Neither the Developer nor any person involved in the Project Company will provide a guarantee or otherwise insure the Investor's ability to claim the Section 45Q Credit, the cash equivalent of the credit, or the repayment of any portion of the Investor's contribution due to inability to claim the Section 45Q Credit, or guarantee that the Investor will receive distributions from the Project Company or consideration in exchange for its interest in the Project Company (except for a sale right, described in section 4.06 of this revenue procedure, at fair market value, as described in section 4.07 of this revenue procedure).

(4) Pursuant to the Project Company operating agreement (Operating Agreement), the Developer will have the right to manage the Project Company, subject to the right of the Investor to consent to certain activities. The Operating Agreement also provides that all allocations must satisfy the requirements of section 704(b) and the regulations thereunder.

(5) Below are a chart and an explanation that describe the distribution and allocation provisions applicable to Developer and Investor over various time periods.

	Developer		Investor	
	Cash	Gross Income/Loss and Section 45Q Credits	Cash	Gross Income/Loss and Section 45Q Credits
Period 1	100%	1%	0%	99%
Period 2	0%	1%	100%	99%
Period 3	95%	95%	5%	5%

(a) During Period 1, 99 percent of the Project Company's gross income or loss and the Section 45Q Credit will be allocated to the Investor, and the remainder will be allocated to the Developer, and 100 percent of the Project Company's cash flows will be

distributed to the Developer. Period 1 will continue until the earlier of: (i) the date that the Developer receives an agreed cash return, which may be an amount equal to the aggregate contributions made by the Developer; or (ii) a fixed outside date. When Period 1 ends, Period 2 begins.

(b) During Period 2, 99 percent of the Project Company's gross income or loss and the Section 45Q Credit will be allocated to the Investor, the remainder will be allocated to the Developer, and 100 percent of the Project Company's cash flows will be distributed to the Investor. Period 2 will continue until the Investor achieves an agreed after-tax internal rate of return (Flip Point). When Period 2 ends, Period 3 begins. If the Flip Point occurs before Period 1 ends, Period 1 ends at that time, and Period 3 begins.

(c) During Period 3, five percent of the Project Company's gross income or loss and the Section 45Q Credit will be allocated to, and five percent of the Project Company's cash flows will be distributed to, the Investor, and 95 percent of the Project Company's gross income or loss and the Section 45Q Credit will be allocated to, and 95 percent of the Project Company's cash flows will be distributed to, the Developer. Period 3 will continue for the remaining life of the project.

.02 Conclusion. Under the facts set forth in section 5.01 of this revenue procedure, the IRS will treat the Investor as a partner in the Project Company and will treat the Project Company as properly allocating the Section 45Q Credit in accordance with section 704(b) and the regulations thereunder.

SECTION 6. REQUEST FOR COMMENTS

The Treasury Department and the IRS request comments on the requirements of the Safe Harbor.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for transactions entered into on or after March 9, 2020. If a Project Company, Developer, and Investor satisfy all the requirements of the Safe Harbor provided in section 4 of this revenue procedure for transactions entered into before March 9, 2020, the IRS will treat the Investor as a partner in the Project Company and treat the Project Company as properly allocating the Section 45Q Credit in accordance with the Safe Harbor, and therefore section 704(b) and the regulations thereunder, for such taxable year(s). However, taxpayers should not infer that compliance with the Safe Harbor ensures that they are otherwise entitled to validly claim the Section 45Q Credit.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Sonia K. Kothari of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Sonia K. Kothari at (202) 317-6850.