

Treasury Finalizes Carbon Capture Tax Credit Regulations

The US Treasury Department and the IRS provided practical administrative rules for the carbon capture and sequestration tax credit.

Key Points:

- The IRS finalized the third set of rules in a series of regulatory guidance intended to propel the growth of the carbon capture and sequestration industry in the US.
- The rules cover topics of great importance to the industry, including how to comply with the secure geological storage and utilization requirements, how to transfer tax credits from the capturing party to the sequestering party, and the scope of potential tax credit recapture in the event of a leak of carbon oxide.

On January 6, 2021, the IRS finalized the long-awaited third piece of carbon capture and sequestration (CCS) tax credit guidance in the form of final Treasury Regulations (Final Regulations). This guidance supplements a Notice and a Revenue Procedure issued in 2020 (discussed below), and addresses many remaining issues applicable to the tax credit for CCS under Section 45Q (45Q Credit). The Final Regulations adopt, with modification, the proposed regulations released on May 28, 2020 (Proposed Regulations).

The CCS industry has been poised for significant growth since the overhaul of Section 45Q in 2018. However, many CCS project developers have struggled to realize the value of the 45Q Credits that their projects have generated as they waited for the Treasury to finalize some important aspects of the rules. The Final Regulations fill in many of the important details that Congress delegated to the IRS when the 45Q Credit rules were expanded in February 2018.

The Final Regulations adopt a number of recommendations made by industry stakeholders through a public comment process that followed the release of the Proposed Regulations last year. In response to these comments, the Final Regulations:

- Adopt a three-year recapture period for carbon oxide that leaks out of storage, down from the five-year period in the Proposed Regulations
- Permit taxpayers to aggregate certain facilities to meet the capture quantity thresholds needed to qualify for 45Q Credits

- Provide a broad definition of eligible “commercial markets” in which captured carbon oxide may be used and qualify for 45Q Credits
- Clarify the types of contracts that qualify as “binding written contracts” that may be used as part of the process for disposing carbon oxide in a 45Q Credit qualifying activity

The Final Regulations supplement the guidance provided in Notice 2020-12, which outlines the requirements for establishing the year in which construction begins on a carbon capture facility, and Revenue Procedure 2020-12, which provides a safe harbor template for allocating the 45Q Credit in tax equity partnerships. The magnitude of 45Q Credits now available to the carbon capture industry is likely to lead many projects to seek tax equity investors to monetize the 45Q Credit. (For more information, see Latham’s *Client Alert* [Carbon Capture Industry Receives Long-Awaited 45Q Tax Credit Guidance.](#)) Taken as a whole, the Final Regulations, Notice 2020-12, and Revenue Procedure 2020-12 should provide developers and financiers the clarity needed to successfully bring carbon capture and sequestration projects to market.

CCS is not new, and a number of companies in the United States have been actively capturing and sequestering carbon dioxide for more than three decades — including, most notably, large oil and gas producers as part of a process referred to as enhanced oil recovery (EOR). Most of the near-term opportunities in the market are expected to involve carbon capture used as part of EOR, as the required technology is mature. However, the Final Regulations should pave the way for projects that sequester carbon without an EOR component, as well as projects that use captured carbon oxide in other commercial processes.

45Q Credit for CCS

The 45Q Credit is a per-metric-ton tax credit available to owners of carbon capture equipment who capture carbon oxide from an industrial facility or directly from the atmosphere and then sequester it, or first use it as a tertiary injectant in EOR and then sequester it as part of that process. The captured carbon oxide may also be used in certain other commercial processes that result in the permanent removal of the carbon oxide.

While the 45Q Credit has been available since 2008, the credit was significantly expanded by Congress in February 2018 for carbon capture projects treated as placed in service after February 8, 2018. This *Client Alert* addresses rules for the expanded 45Q Credit that is available to carbon capture projects placed in service after February 8, 2018.

Owners of carbon capture equipment may claim tax credits over a 12-year period starting when the carbon capture equipment is first put into service. There is no limit on the amount of 45Q Credits that may be claimed from any individual project or from the industry as a whole.

The amount of the 45Q Credit is based on the net quantity of carbon oxide captured (as measured in metric tons), and generally depends on how the carbon oxide is used after it is captured.

The 45Q Credit increases each year through 2026 on a linear basis and generally depends on whether the carbon oxide is sequestered in secure geological storage (Disposed), used as a tertiary injectant in an EOR project (Injected), or otherwise used as part of a commercial process (Utilized). After 2026, the amount of the available 45Q Credit will increase by an inflation adjustment factor. The largest credit is awarded for captured carbon oxide that is Disposed of without putting it to a commercial use, while a smaller but still significant tax credit is available for captured carbon oxide that is Injected or Utilized.

This table shows the credit available (in US dollars per metric ton) by activity in each year through 2026:

ACTIVITY	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Disposal	22.66	25.70	28.74	31.77	34.81	37.85	40.89	43.92	46.96	50.00
Injection	12.83	15.29	17.76	20.22	22.68	25.15	27.61	30.07	32.54	35.00
Utilization	12.83	15.29	17.76	20.22	22.68	25.15	27.61	30.07	32.54	35.00

Qualified Carbon Oxide

“Qualified carbon oxide” refers to carbon oxide that meets the following two requirements:

- It is measured at the source of capture and verified at the point where carbon oxide is Disposed of, Injected, or Utilized in accordance with the Final Regulations.
- It is captured either at an industrial source or directly from the ambient air.

Industrial Facility

Qualified carbon oxide includes carbon oxide captured at an industrial source, which is an emission of carbon oxide from an industrial facility. An industrial facility is a facility that emits carbon oxide from a combustion source or fuel cell, manufacturing process, or fugitive carbon oxide source that, absent capture and disposal, would otherwise be released into the atmosphere as industrial emission of greenhouse gas. A manufacturing process is one involving the manufacture of any product (other than carbon oxide) that is intended to be sold at a profit or used for a commercial purpose. Industrial facilities include “electricity generating facilities” (Power Plants), refineries, fuel cells, cement plants, and other industrial or manufacturing sources that produce carbon oxide. Industrial facilities do not include carbon dioxide production from wells containing 90% or more carbon dioxide by volume, unless certain specific requirements are satisfied. Notably, the well must contain a product other than carbon oxide that is commercially viable to extract and sell without taking into account the commercial and 45Q Credit value of the extracted carbon oxide.

Direct Air Capture

Qualified carbon oxide also includes carbon oxide captured directly from the ambient air at so-called “direct air capture facilities.”

Qualified Carbon Capture Facilities

To qualify for the 45Q Credit, carbon oxide must be captured at a qualifying facility. A facility is qualified if it meets the following two requirements:

- Construction on both the facility and the carbon capture equipment must begin before January 1, 2026, or, if the original planning and design of the facility includes carbon capture equipment, construction on the facility itself must begin before January 1, 2026.

- The industrial facility must meet a minimum capture threshold (subject to the aggregation rules discussed below).

The beginning of construction rule was largely adopted from the tax credit rules in the renewable energy sector. It liberally considers construction to have begun when physical work starts on the carbon capture equipment, or when 5% of the cost of the carbon capture equipment is incurred. (For more information on the beginning of construction requirements, see Latham's *Client Alert* [Carbon Capture Industry Receives Long-Awaited 45Q Tax Credit Guidance](#).)

Depending on the type of facility, certain carbon oxide capture thresholds must be met on an annual basis:

- Power Plants that emit more than 500,000 metric tons must capture at least 500,000 metric tons to qualify.
- Other Power Plants, industrial facilities, and direct air capture facilities may qualify if they capture at least 100,000 metric tons.
- Alternatively, Power Plants and industrial facilities (but not direct air capture facilities) that emit no more than 500,000 metric tons may qualify if they capture and Utilize at least 25,000 metric tons.

The minimum thresholds are annualized for partial years, such as the first year in which the facility is commissioned or the last year of the 45Q Credit period.

Taxpayers that own multiple carbon capture facilities may aggregate them together to satisfy the minimum thresholds if the facilities share common attributes, such as those held by the same legal entity, or if they operated and financed together.

Who Claims the 45Q Credit?

Generally, the 45Q Credit is claimed by the taxpayer that both:

- Owns the carbon capture equipment
- Physically or contractually ensures the capture and disposal, injection, or utilization of the carbon oxide

The owner of the carbon capture equipment does not need to own the industrial facility where the equipment is located to qualify for 45Q Credits. The 45Q Credit may also be transferred by election from the owner of the carbon capture equipment to another party that Disposes of, Injects, or Utilizes the carbon oxide. If carbon capture equipment is owned by multiple parties through undivided interests, only one taxpayer is permitted to claim the 45Q Credit. Multiple owners of carbon capture equipment may instead choose to hold their interests through partnerships, or to treat undivided ownership arrangements as partnerships for tax purposes, in which case the 45Q Credit is allocated among the partners based on their partnership agreement.

The Final Regulations address a number of important questions regarding the application of the default rule and the election, including clarifying:

- The meaning of carbon capture equipment
- The meaning of contractually Disposing of, Injecting, or Utilizing the carbon oxide
- The mechanics of the election to transfer the 45Q Credit

Carbon Capture Equipment

As the taxpayer that owns carbon capture equipment is entitled to the 45Q Credit, the most immediate question is: What is the carbon capture equipment? This question is particularly important as developers are likely to structure projects in a manner that limits the ownership of third-party tax equity investors to the equipment necessary to generate 45Q Credits.

The delineation of carbon capture equipment is also important because construction of the carbon capture equipment must begin before 2026 to qualify for 45Q Credits. Notice 2020-12 provides two methods by which a taxpayer can begin construction on a qualified facility or on carbon capture equipment: by beginning physical work of a significant nature on the qualified facility or carbon capture equipment, or by incurring more than 5% of the costs of the qualified facility or carbon capture equipment. Notice 2020-12 generally defines “carbon capture equipment” as property used to capture or process carbon oxide until it is transported away from the qualified facility.

The Final Regulations clarify that carbon capture equipment includes all components of property necessary to compress, treat, process, liquefy, pump, or perform some other physical action to capture carbon oxide. Carbon capture equipment includes a system of gathering and distribution lines that collect captured carbon oxide from a qualified facility or facilities that make up a single project, but generally excludes components of property used for transporting carbon oxide for Disposal, Injection, or Utilization. The Final Regulations clarify that a single unit of carbon capture equipment includes all components that make up an independently functioning process train capable of capturing, processing, and preparing carbon oxide for transport. This treatment is consistent with the IRS’ approach in the context of wind facilities, for which each independently functioning wind turbine is considered a separate facility. As such, the pipelines used to connect the source and the use of the carbon can generally be considered out of the scope of carbon capture equipment for developers linking industrial facilities to carbon sinks, such as saline formations for disposal, or oil fields for injection.

The Final Regulations provide additional flexibility to developers by removing a list of specific components that was included in the Proposed Regulations and instead define carbon capture equipment by reference to the functionality of the component part.

As mentioned previously, carbon capture equipment that is placed in service after February 8, 2018 qualifies for an increased 45Q Credit. The Final Regulations contemplate that facilities that were operational before February 9, 2018 might install carbon capture equipment that is placed in service after that date, and in such cases, draw a distinction between “new” and “additional” carbon capture equipment. Taxpayers will want to install new carbon capture equipment to ensure that all of the captured carbon oxide is not subject to the limitations that apply to carbon capture equipment placed in service before February 9, 2018. The Final Regulations provide that a facility upgrade will result in new carbon capture equipment if the upgrade satisfies the “80/20 rule,” which permits a qualified facility or carbon capture equipment to qualify as originally placed in service even though it contains some used property if

the fair market value of the used components does not exceed 20% of the total value of the qualified facility or carbon capture equipment. For the purposes of this rule, the cost of the qualified facility or carbon capture equipment includes all properly capitalized costs of such facility or equipment. Solely for the purposes of this rule, the taxpayer may include the cost of new equipment for a new pipeline owned and used exclusively by that taxpayer to transport captured carbon oxide from the taxpayer's qualified facility. Taxpayers compute the 80/20 rule as of the placed in service date of the facility by calculating the fair market value of the used property, and confirming that this amount does not exceed 20% of the cost of the new property (including new pipelines) plus the value of the used property.

Contracting for Capture, Disposal, Injection, and Utilization

The owner of the carbon capture equipment is not required to capture, Dispose of, Inject, or Utilize the carbon oxide itself. Instead, it may qualify for 45Q Credits by contractually ensuring capture, Disposal, Injection, or Utilization through one or more binding written contracts (including contracts with related parties). The Final Regulations clarify that the carbon capture equipment owner may enter into a binding written contract with a general contractor, who in turn subcontracts the capture, Disposal, Injection, or Utilization of carbon oxide. The contract between the general contractor and the subcontractor must also be a binding written contract.

The Final Regulations define the term "binding written contract" consistently with the definition of that term in Notice 2020-12 and the bonus depreciation Treasury Regulations. A binding written contract generally requires that the contract be enforceable under state law and that it not limit damages to a specified amount. Damages are not considered limited to a specific amount so long as damages are not limited to less than 5% of the total contract price. Binding written contracts must include commercially reasonable terms and provide for enforcement of the obligation to Dispose of, Inject, or Utilize the carbon oxide. The contract must also include terms obligating compliance with the requirements and documentation for secure geological storage or utilization, as applicable, (including for subcontractors), and require that the sequestering party provide prompt notice to the capturing party if a 45Q recapture event occurs. Information relating to these contracts must be reported to the IRS on an annual basis.

Taxpayers with existing contracts signed before January 13, 2021, that do not conform to these requirements may amend them or execute new conforming contracts by July 12, 2021. The Final Regulations do not explain how to determine whether contractual terms are "commercially reasonable terms," and this requirement may be particularly important when the party ensuring disposal of the carbon oxide is affiliated with the carbon capture equipment owner.

Transferring 45Q Credits

The taxpayer entitled to claim the 45Q Credit may elect to allow parties contracted to Dispose of, Inject, or Utilize the carbon oxide to claim some or all of the 45Q Credit. To qualify for 45Q Credits, the contractor who is Disposing of or Injecting the carbon oxide must be the party that obtains the permit to store the carbon oxide in secure geological storage. The Final Regulations adopt a commonsense approach that permits transfers of the credits to multiple parties through an express election filed by both the transferor and the transferees. Thus, a project can function as a single source of carbon oxide, and in doing so, satisfy the qualified facility thresholds, while effectively offering carbon oxide offtakers the ability to claim 45Q Credits based on the volume of carbon oxide Disposed of, Injected, or Utilized. Moreover, because the election to transfer 45Q Credits may be made on a partial basis, the capturing party may retain a portion of the 45Q Credits, or may transfer different portions to transferees conducting different disposal activities (e.g., a portion of the credits may be retained, a portion transferred to an oil and gas company for Injection, and a portion transferred to an owner of a saline formation for Disposal). If an electing taxpayer has multiple qualified facilities, a separate election must be made for each qualified

facility. Finally, the transfer election is made on an annual basis, which allows for significant commercial flexibility to react to changing market conditions or taxable income projections.

Disposal and Injection: Secure Geological Storage

To qualify for 45Q Credits, a taxpayer must contractually or physically Dispose of or Inject captured carbon oxide in secure geological storage (as discussed in this section) or Utilize carbon oxide (as discussed in the next section).

Secure geological storage includes storage in deep saline formations, oil and gas reservoirs, and unminable coal seams. The Final Regulations set forth the conditions taxpayers must meet to demonstrate that carbon oxide is securely stored and will not escape to the atmosphere.

As this *Client Alert* will go on to discuss, the applicable requirements depend on whether the carbon oxide is Injected or Disposed of. This distinction arises because injection wells used for EOR require a Class II Underground Injection Control (UIC) permit under the Safe Drinking Water Act, whereas injection for geological storage requires a Class VI permit. The Class II UIC program is well established, whereas the Class VI UIC program is novel and generally more stringent.

UIC Class II and Class VI Permits

Under the UIC program, the Environmental Protection Agency (EPA) regulates six classes of underground injection wells. Some of these wells, including the Class II wells, have existed for years alongside the 45Q Credit. Class II wells are used to inject fluids associated with oil and natural gas production into geological formations, including wastewater from hydraulic fracturing and fluids used for EOR. Operators have used Class II wells for years to inject naturally occurring carbon dioxide. About 180,000 Class II wells are currently in operation throughout the United States, and as discussed below, a majority of states have been awarded primary enforcement authority over Class II well regulation. Class VI is the newest class of UIC permits, and was developed specifically for non-EOR geological sequestration of carbon dioxide. In contrast to Class II, the EPA has approved only two Class VI well permits to date.

Because the Class VI program is newer and contemplates permanent storage of injected fluids, the Class VI permit requires the operator to provide a significant volume of geological and hydrological data, a computational model of the area of review based on that data, and detailed plans for well construction, testing, monitoring, post-injection site care, and well closure. Applications must be evaluated and updated with substantial additional testing and monitoring data in an iterative process after submission. The applicant works closely with the EPA and, if applicable, those states awarded primary enforcement authority over Class VI well regulation (to date, North Dakota and Wyoming) during the application review process, which may take up to 18 months.

A final UIC permit authorizes construction of the well but not injection of carbon oxide. After constructing the well, the permittee must submit additional testing and drilling information acquired during construction, and provide updates to associated plans, before the EPA will authorize injection. The EPA must be satisfied that the permittee has met the applicable requirements for injection. Moreover, in addition to the general requirements for all UIC permits, the EPA must evaluate a Class VI well under technical requirements specific to Class VI permits. Those EPA regulations set forth requirements for geological site characterization, area of review and corrective action, financial responsibility, well construction, operation, mechanical integrity testing, monitoring, well plugging, post-injection site care, and site closure of Class VI wells.

Greenhouse Gas Reporting Requirements

Both Class II and Class VI permit holders are subject to the EPA's greenhouse gas reporting requirements set forth at 40 CFR part 98. However, Class II permit holders are subject to subpart UU of 40 CFR 98 (Subpart UU), which requires only reporting of basic information on carbon dioxide received for injection. In contrast, the Class VI program requires permit holders to comply with 40 CFR part 98 subpart RR (Subpart RR) and develop a Monitoring, Reporting, and Verification (MRV) plan that provides for reporting, monitoring, and verification of the amount of carbon dioxide sequestered using a mass balance approach. In addition, the MRV plan must include a delineation of the maximum monitoring area and active monitoring areas, identification of potential surface leakage pathways for carbon dioxide, a strategy for detecting and quantifying surface leakage, a strategy for establishing the expected baselines for monitoring carbon dioxide leakage, and a summary of considerations used in calculating a mass balance equation.

Under the Final Regulations, taxpayers must have an MRV plan approved by the EPA to qualify for 45Q Credits. Class VI permit holders will have obtained such a plan as part of the permit application process, but Class II holders will need to obtain an MRV plan under Subpart RR in addition to the Class II permit. In the public comment period following the issuance of the Proposed Regulations, some stakeholders argued that compliance with Subpart RR was excessively burdensome, and may not align with state and local regulations or industry practices. Because Subpart RR was viewed as excessively burdensome, the Treasury permitted Class II permit holders the choice to demonstrate secure geological storage by complying *either* with Subpart RR *or* with standards issued by the International Organization for Standardization (ISO) for carbon dioxide sequestration under CSA/ANSI ISO 27916:2019.

ISO 27916:2019 was developed for the purpose of quantifying volumes of carbon dioxide sequestered through EOR. Like Subpart RR, ISO 27916:2019 also employs mass balance accounting, and includes requirements for annual reporting, recordkeeping, monitoring, and leak prevention. However, Subpart RR makes reported data public. ISO 27916:2019 contains no such requirement, although taxpayers complying with ISO 27916:2019 will still need to report basic information under Subpart UU. The Treasury declined requests to make public the initial ISO plans and annual reports, deciding that the Treasury Department and the IRS did not have the authority to disclose taxpayer information or to require taxpayers to self-disclose taxpayer information as a condition of using the ISO standards.

One advantage of Subpart RR is that taxpayers may self-certify the volume of carbon oxide claimed for purposes of 45Q Credits. Taxpayers who rely on the ISO 27916:2019 standards, however, must have ISO 27916:2019 reporting documentation certified as accurate and complete by a qualified independent engineer or geologist. The approach taken by the Final Regulations is intended to provide taxpayers using carbon oxide as a tertiary injectant more flexibility by not requiring an EPA-approved MRV plan.

State Programs

In the Final Regulations, the Treasury declined to adopt suggestions by commenters that would allow use of state-level programs, such as California's Low Carbon Fuel Standard (LCFS), as a compliance alternative to Subpart RR and the ISO 27916:2019. Many CCS project developers are expected to attempt to leverage both the 45Q Tax Credit and LCFS program to maximize revenue streams. Accordingly, developers will have to comply separately with the requirements of the Final Regulations and those contained in the LCFS protocol.

Utilization

In addition to geological storage, a taxpayer may qualify for 45Q Credits by using the captured carbon dioxide in commercial processes outside the traditional oil and gas sectors. The Final Regulations define “utilization” of carbon oxide as either:

- Fixation through photosynthesis or chemosynthesis, such as through the growing of algae or bacteria
- Chemical conversion to a compound in which such carbon oxide is securely stored
- Use for any other purpose for which a commercial market exists (with the exception of use in tertiary injection for purposes of an EOR project, which falls under the secure geological storage rules discussed above)

Despite comments advocating for a narrower definition, the Final Regulations define the term “commercial market” broadly to mean any market in which a product, process, or service that utilizes carbon oxide is sold or transacted on commercial terms. To qualify under this approach, a taxpayer must verify the amount of qualified carbon oxide utilized through a Life Cycle Assessment (LCA), which must demonstrate that the proposed Utilization process results in a net reduction of carbon dioxide equivalents.

The LCA must conform to ISO 14040:2006 (Environmental management — Life cycle assessment — Principles and framework) and ISO 14044:2006 (Environmental management — Life cycle assessment). Additionally, an independent third party must perform or verify the LCA. The taxpayer must submit the LCA report together with a third-party independent statement to the Department of Energy (DOE) for a technical review and must receive IRS approval of its LCA before claiming 45Q Credits.

45Q Credit Recapture

Section 45Q provides that previously claimed 45Q Credits will be subject to recapture to the extent carbon oxide ceases to be Disposed of or Injected, within the meaning of Section 45Q. Utilized carbon oxide are not subject to recapture if the LCA accounts for all emissions throughout the life cycle of the product, process, or service.

The 45Q Credits are subject to recapture when they cease to be captured, Disposed of, or Injected during the recapture period (including by intentional removal, but excluding certain recycling or reinjection by a single EOR project). This occurs when the amount of carbon oxide leaked exceeds the amount Disposed of or Injected in a given year. The Final Regulations require leakage to the atmosphere to trigger recapture, in contrast to the LCFS protocol that employs a broader definition of leakage (e.g., including solely subsurface migration of carbon dioxide outside of the delineated storage complex). Emissions caused by force majeure-type events, such as volcanic activity or a terrorist attack, do not result in the recapture of the 45Q Credits. Noting that the two-item list is illustrative only, the Treasury chose not to enumerate additional exceptions requested by commentators, such as seismic activity not caused by injection operations.

The period during which a taxpayer is subject to recapture extends from the date of first injection for which a 45Q Credit was claimed, and ends on the earlier of: (i) three years after the last taxable year the 45Q Credit was claimed (or the taxpayer was eligible to claim the credit, but elected to carry it forward), and (ii) the date monitoring ends under Subpart RR or ISO 27916:2019. The recapture period for 45Q Credits is limited to a rolling lookback period of the prior three tax years. This three-year recapture period is shorter than the investment tax credit recapture period of five years, and should be well received by potential investors and financing parties in carbon capture projects.

The Final Regulations provide a number of mechanical rules to help taxpayers calculate recapture amounts. Perhaps most notably, recapture is deemed to occur on a last-in, first-out (LIFO) basis — that is, leaked carbon oxide are first netted against amounts stored in the current year, then any remaining leaked amounts are applied to the most recent prior taxable year, and so on, up until the third preceding year. Therefore, the 45Q Credits of the highest value are reduced or recaptured first.

Conclusion

The Final Regulations address many of the open questions that needed answers to attract investment capital to carbon capture and sequestration projects, and address many comments made to the Proposed Regulations. Together with Notice 2020-12 and Revenue Procedure 2020-12, the Treasury Department and the IRS have provided a workable framework under which carbon capture projects can be developed and financed. The Final Regulations apply to taxable years beginning on or after January 13, 2021, although taxpayers may elect for them to apply to taxable years beginning on or after January 1, 2018.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Jean-Philippe Brisson

jp.brisson@lw.com
+1.212.906.1316
New York

Jim Cole

james.cole@lw.com
+1.713.546.7435
Houston

Eli M. Katz

eli.katz@lw.com
+1.212.906.1620
New York

Justin T. Stolte

justin.stolte@lw.com
+1.713.546.7966
Houston

Joshua T. Bledsoe

joshua.bledsoe@lw.com
+1.714.755.8049
Orange County

Ben A. Cheatham

ben.cheatham@lw.com
+1.212.906.4595
Washington, D.C.

Chelsea M. Muñoz-Patchen

chelsea.munoz-patchen@lw.com
+1.713.546.7591
Houston

R. Andrew Westgate

andrew.westgate@lw.com
+1.212.906.2919
New York

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