



Legal and Tax Issues of Carbon Credit Trading

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1) Introduction.

Just as the concepts of “cap and trade” and “carbon credits” are relatively new, the legal consequences and tax ramifications of this proposed new currency for dealing with global warming are likewise new, unsettled and, in many cases, untested. A recent article analyzing the current state of affairs in Canada (Kennett, Kwaskniak & Lucas, *Property Rights and the Legal Framework for Carbon Sequestration on Agricultural Land*, 37 *Ottawa L. Rev.* 171-213 (2006), referred to herein as the “Kennett Article”) does a comprehensive job highlighting the questions which need to be answered in establishing a legal and institutional framework necessary to facilitate investment in carbon sequestration projects on agricultural land. As illustrated in the Kennett article, in light of the fact that there is virtually no legal precedent on point, it is incumbent upon parties wishing to participate in this emerging business opportunity to seek competent counsel and address as many issues as possible in a well crafted contract. While this outline will not be exhaustive of all of the issues, we will attempt to highlight some of the more important issues that we feel need to be addressed.

On June 12, 2009, the Joint Committee on Taxation published a white paper entitled “Climate Change Legislation: Tax Considerations” (JCX-29-09, referred to herein as the

“Joint Committee Report”) which provides a detailed discussion of Federal income tax issues relating to cap-and-trade proposals at the Federal level. Since that time, there has been nothing new from Congress on the taxation of carbon credits. Congress has been focused on the health care reform bill, and we will not know what the next focus will be until Congress gets back in session. Therefore, although we have some knowledge of how legislation may be shaped based on the climate bill that passed the House in 2009, the exact parameters of any legislation are still up in the air, and this outline is based upon the best information we have available at this time.

We have attached Environmental Services, Inc. entitled “Carbon Credits from Managed Forests: Current Market and Future Developments” in order to give you a comprehensive overview of the current carbon market.

- 2) What is a “carbon credit” for legal purposes?
 - a) Definition. Generally, one carbon credit is equal to one metric ton of carbon dioxide emission reduction or sequestration. In new biomass growth, this equals approximately 1.205 wet tons (English) of wood. The classification of the carbon credit for legal purposes is important for determining its tax treatment and possible tax planning opportunities. Therefore, determining whether the carbon credit is real or personal property, tangible or intangible, is significant.
 - b) Is a carbon credit an interest in real property or personal property?
Because no legislation has yet been enacted, there is no controlling law in Florida as to whether a carbon credit is an interest in real property or

personal property. Environmental resource credits in Florida, under Section 62-341.215 of the Florida Administrative Code, specifically provide that the general permit provided for preservation of environmental resources does not convey or create any property right or interest in real property. If carbon credit sequestration is created through a permitting process similar to the environmental resource credits, it is possible that the credits will not be deemed real property interests under Florida law.

However, there is some case law in other jurisdictions which suggests otherwise. In *Roseland Plantation LLC v. United States Fish and Wildlife Service et al.* (2006 U.S. Dist. LEXIS 29334), a federal court in Louisiana held that “right to report, transfer, or sell carbon credits is part of the bundle of rights associated with property ownership,” suggesting that the credits are a real property interest. Additionally, in an unpublished opinion out of California, the court found that a claimant had a claim to emission reduction credits generated from its use of leased equipment, because the possessory interest in the leased equipment entitled the claimant to operate the equipment, which operation produced the emissions. *Kaiser International Corporation v. Hearing Board of the South Coast Air Quality Management District, et al.* (2006 Cal. Unpub. LEXIS 3135).

If the determination of the nature of a carbon credit as real property or personal property is not resolved legislatively when the carbon cap and trade is put into place, then some administrative guidance will be needed

to settle the issue. However, based upon the aforementioned case law and administrative interpretations, the nature of a carbon credit will more than likely derive its character from the character of the asset or activity from which it is created. If a carbon credit is created from management of or sequestration upon real property, then likely the carbon credit will be an interest in real property. If a carbon credit is created from activities arising out of the use of personal property, then likely the carbon credit will be personal property.

c) Is a carbon credit a mineral right? A mineral right is an interest in minerals in land, often coupled with a right to remove the minerals or a right to receive a royalty. *Black's Law Dictionary*. The following are factors courts have used to determine whether a substance is a mineral:

- i) does the instrument granting the mineral right imply that the parties originally intended to convey the substance; or
- ii) was the substance considered a mineral by the vernacular of the mining world, the commercial world, and landowners at the time the mineral right was granted. *United States Smelting, Refining & Mining Co. v. Wigger*, 684 P.2d 850 (Alaska 1984).

We believe that carbon credits created through agricultural sequestration are not mineral rights. There has been some legislation in the Midwest involving sequestration of carbon by injecting carbon dioxide into the earth, and the legislation suggests that this geological sequestration does

not give rise to a “mineral right.” Although not completely comparable to agricultural sequestration, the legislation does suggest that carbon dioxide and sequestration activities are a right that belongs to the surface owner of property.

- d) Is a carbon credit tangible or intangible? Apparent from the nature of a carbon credit is that it has more of the characteristics of an intangible asset than a tangible asset. Because the carbon credit is something that can be owned and traded but has no physical existence, comparable to a stock or commodity that can be traded on a market, it is more like an intangible asset. The Internal Revenue Service addressed the nature of carbon emission allowances traded on the European Climate Exchange in Private Letter Ruling 200825009. In that Ruling, the I.R.S. concluded that carbon credits were intangible property used in the trade or business. Based on this ruling, it is possible that carbon credits under a federal cap and trade program in the United States would also be treated by the I.R.S. as intangible assets.

3) How is a carbon credit created?

- a) Registry. Under the current model, carbon credits are created when landowners enter into a carbon registry and exchange. Only verified emission reductions or sequestration are eligible to participate in an exchange. Sequestration occurs when carbon is stored long-term, for instance the photosynthesis process of trees or geological storage

(underground). For small projects, the landowners may use an Offset Aggregator, who will sell bundles of credits from various small landowners.

For a more detailed explanation of how the current carbon credit market works, please see the attached summary prepared by Environmental Services, Inc. entitled “Carbon Credits from Managed Forests: Current Market and Future Developments.” As this summary demonstrates, the carbon credit market has been and continues to be a rapidly evolving industry.

- b) Verification. To document the amount of carbon credits to which a landowner is entitled, the sequestration project must be verified by an independent third party who analyzes the amount of carbon being sequestered by the project. The landowner generally must enter into a contract detailing the activities the landowner will undertake to maximize the carbon sequestration, in exchange for a set number of carbon credits. Additionally, as part of the project, the landowner may be called upon to grant a conservation easement over the property. The job of the verifier is to accurately assess the project’s actual annual carbon sequestration.

- c) Additionality/permanence. A number of issues arise in forestry and other agricultural sequestration processes relating to the specific nature of the sequestration activity.

The issue of additionality refers to the requirement that the sequestration project not generate credits from the status quo of the activity otherwise being performed on the land. That is, the sequestration activity must create additional sequestration beyond what would otherwise occur under the land management practices in place prior to the sequestration project being undertaken. The additionality issue is one of hot debate in current legislation.

Permanence refers to the concept that carbon sequestration is subject to the effect of natural events and management actions. To address the permanence issue, many verifiers require a reserve pool of credits, or purchase of insurance to cover any losses.

- d) Encumbrance on real estate. Generally, most contracts we have reviewed have not required that anything be placed in the public record that would create an encumbrance. But, we are aware of situations where, in assuring permanence, a conservation easement was required. The Climate Action Reserve, a national offsets program initially established in California and which most experts expect Federal legislation to mirror, requires qualified conservation easements for avoided conversion forestry projects, and allows voluntary conservation easements for reforestation projects and improved forest management projects in order to reduce obligations to maintain buffer credits.

- 4) What are the potential tax consequences of the creation and subsequent sale of a

“carbon credit”?

- a) Realization event. Inclusion of the value of allocated carbon credits in income upon receipt would be consistent with the general rules under current law, because generally gross income includes income from whatever source derived, and income as defined as any accession to wealth. *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955). Barring future guidance, this general rule should be followed. In this case, the landowner would have a basis in the carbon credits equal to the income recognized. If this approach is followed, it is likely that offsets created by contract would be treated consistently (i.e. taxable upon creation).

However, it is possible that the IRS may chose to follow prior guidance issued on sulfur emissions, wherein the receipt of emission allowances by grant from the government is a non-taxable event, comparable to the sulfur emissions regime established by the Clean Air Act. Rev. Rul. 92-16, 1992-01 C.B. 15. If this is the case, the grantee would take a zero dollar (cost) basis in the allowance, and recognize gain when the excess carbon credits are sold.

The issue is less clear under the sulfur emissions regime where the offset is created by contract. For sulfur emissions allowances, the I.R.S. ruled that if a taxpayer acquires allowances other than through a grant from the government , the costs of acquiring and holding the allowances constitute the holder’s (cost) basis. However, there is nothing in the sulfur emissions

regime that is comparable to the creation of carbon credits through sequestration activities.

In an article that we published in the February 2009 issue of *The Journal of Passthrough Entities*, we went into a detailed analysis of mitigation banks, which analysis may be similarly applied to carbon credits. In our article, we conclude that in the mitigation banking world, where mitigation credits are created under contract, with the mitigation banker granting a conservation easement in exchange for immediately marketable mitigation credits, the I.R.S. may argue that the receipt of the mitigation credits is a taxable event. A similar analysis could apply in the world of carbon credits if the receipt of carbon credits follows a similar pattern of exchanging a promise to perform some activity in return for the immediately marketable carbon credits. We believe that the I.R.S. may take the position that the contractual agreement to undertake sequestration activity, in exchange for immediately marketable carbon credits, is a taxable event. In that case, the landowner would recognize gain each year in which carbon credits are awarded for sequestration activities. In order to prevent “phantom income” (because the receipt of the carbon credits is a taxable event despite the lack of cash proceeds), the landowner should attempt to time receipt of the carbon credits to resale of the carbon credits on the market.

- b) Recognition. There may be some avenue for nonrecognition of the realized gain from the creation of the carbon credits, such as a Section

1031 exchange. Based upon Private Letter Ruling 200649028, which dealt with the creation of rural land stewardship areas, the I.R.S. allowed for the grant of an easement for land use credits to qualify for like-kind exchange treatment under Section 1031, where certain fact-specific timing requirements were met. If carbon credits are deemed to be interests in real property and the contract to create the credits is a disposition of some underlying interest in the real property, then with the correct structuring, carbon credit transactions may qualify for Section 1031 treatment. However, because of the complicated timing restrictions for like-kind exchanges, it is important to think through the process carefully.

If the carbon credits are not an interest in real property, then these non-recognition provisions are not available, and the landowner must determine how to deal with the tax impact of receiving the credits, especially if the credits are not immediately liquidated.

- c) Expenses of Offset Production. Transaction costs in creating carbon credits may include costs incurred in measuring, monitoring, and verifying reduced, avoided or sequestered emissions, and costs to obtain certification from a regulatory agency. The tax treatment of the production of offsets will depend upon the nature of the project and whether the generation of offsets is the primary objective of the project. The Joint Committee Report gives a specific example of a taxpayer who engages in a reforestation project in order to generate offsets to be sold to firms who are required to meet a cap. In conjunction with the project, the

taxpayer incurs costs to acquire land, raw materials (trees, soil, fertilizer, etc.), labor, as well as costs in obtaining certification for the project (and the correspondingly tradable offsets). Because the production of offsets for subsequent sale is the primary objective of the project, the offsets could be considered inventory for tax purposes, in which case the direct and indirect costs of production will be subject to capitalization and recognized under the taxpayer's inventory method when the produced property is sold.

- d) Consumption of Credits. Some entities may create carbon credits to offset their own emissions. If the project is treated as the production of property used in the taxpayer's trade or business, then under present law the direct and indirect costs of the project generally would be capitalized and recovered through depreciation under Code Sec. 263A (although no depreciation would be allowed for the purchase of any land).
- e) Character. If carbon credits are deemed to be either an interest in real property or an intangible pursuant to Private Letter Ruling 200825009, then the sale of the carbon credits may be eligible for capital gain treatment. Otherwise, the sale of the credits may lead to ordinary income treatment.

If production of carbon credits for subsequent sale is the primary objective of a project (i.e. the landowner is a "dealer" in carbon credits), then the

credits may be considered inventory for tax purposes, and taxed as ordinary income upon sale.

- f) Recent Developments at the Federal Level. On June 26, 2009, the House of Representatives passed the American Clean Energy and Security Act of 2009 (the “Waxman-Markey Bill” which would establish a variant of a cap-and-trade system for greenhouse gases. Generally under the Waxman-Markey Bill, the federal government would set a limit on the total number of greenhouse gases that can be emitted nationally. Companies would be allocated a certain amount of emission allowances, and face penalties if they fail to bring their emissions below this cap. The cap-and-trade program under the Waxman-Markey bill would allocate 85 percent of allowances to regulated industries for free, while auctioning the remainder. The bill is still in consideration in the Senate.

In April of 2007, the Supreme Court concluded that greenhouse gases meet the Clean Air Act definition of an air pollutant. In the absence of federal legislation, the Environmental Protection Agency has the power, and is legally mandated by the Supreme Court, to address greenhouse gas emissions. The EPA issued an advance notice of proposed rulemaking to regulate greenhouse gas emissions under the Clean Air Act in 2008 (EOA-HQ-OAR-2009-0318, July 11, 2008). Although it is far from clear how the EPA would regulate emissions, it is widely accepted that this is the least desirable method of enacting climate reform.

Charles Egerton, one of the named shareholders at our firm, has been named chair elect of the American Bar Association Tax Section. One of the important projects that the Tax Section is working on this year is to give advice to the Legislature on the tax consequences of a carbon cap and trade program at the Federal level. Because of our firm's involvement with the Tax Section we are closely monitoring all developments in this area.

- 5) Importance of contracts until the law becomes settled, issues to address in contracts in order to protect interests in carbon credits:
 - a) Definitions. In light of the fact that this is a new, untested area, there are few generally accepted definitions or industry standards. Therefore, it is important in all contracts to clearly and tightly define all terms.
 - b) Choice of law/venue. In drafting contracts dealing with carbon credits, it is important to consider the contract's controlling law, so that the landowner does not get stuck in an unfriendly foreign jurisdiction.
 - c) Title to property. Before undertaking any sequestration projects, it is important to do a thorough review of the title of the property, identifying any other parties whose interests may be impacted by the sequestration (i.e. creditors, lessees, etc.) These entities must be dealt with prior to starting the project so that later disagreement as to the rights to the carbon credit revenues do not arise. Additionally, in any contracts related to property which might one day be used for a sequestration project, we recommend the use of specific language to deal with which party has the

rights to carbon credits. Where contracts for mineral rights are entered into, despite the fact that we conclude carbon credits are not minerals, it is still advisable in an abundance of caution to specifically reserve the right to carbon sequestration.

- d) Chain of title/ownership issues. Because carbon credits have a potentially long life span, and where sequestration is within a particular vessel, the vessel in which the carbon is sequestered may be severed (i.e. forestry and trees), it is important to consider chain of title and ownership beyond the creation of the carbon credit itself. For instance, if a forestry company sells trees which had been used to create carbon credits to another individual (i.e. for lumber or paper), it is important to address whether the right to the carbon credits goes with the trees, or whether it is retained by the landowner. Although it is possible (and desirable) for legislation creating cap-and-trade to address the issue of a property rights regime for sequestered carbon, pending such legal clarification, contractual clarification is recommended.
- e) Intellectual property issues if using a new technology. Whenever a new technology is developed, such as a new method for sequestering carbon, it is important to consult with legal counsel regarding potential intellectual property issues.
- f) Liability and insurance issues. Because of the issue of permanence, it is important to consider the value of carbon credits when obtaining crop or

other insurance on agriculture products being used to generate carbon credits. Who bears the risk of loss of natural disasters such as floods, fire, or wind?

- g) Anticipating Changes in Legislation. Any contracts entered into prior to the enactment of federal or state level legislation run the risk of being adversely effected by the legislation. Therefore, contracts may want to be drafted to allow for amendment or termination in the event that any subsequently enacted legislation materially alters the arrangement which was anticipated when the contract was effected. This may be hard to do because most contracts for carbon credits are for very long terms, necessitated by the permanence requirement.
- h) Brokers/Aggregators. Many smaller landowners, whose projects would yield smaller amounts of carbon credits, will work with brokers or aggregators in bundling and marketing their credits. It is important when working with third parties to clearly define who is performing what role related to the project, and how each party is to be compensated. The risks and responsibilities of each party must be clearly spelled out.
- i) Preserving Flexibility for Use of Property. It is important that the carbon credit project not restrict the landowner's ability to participate in other revenue raising projects. For instance, endangered species habitat incentives, wetland mitigation credits, and the potential to be involved in

future renewable energy projects. The possibility of this enhanced value, and who should benefit therefrom, should be addressed in any contracts.

6) Conclusion.

As you can see from the above-discussed issues, the legal ramifications for carbon credits are largely unsettled. Until more conclusive information is available, it is important to address the issues in well drafted contracts which protect your interests and clearly define all of the rights and obligations of the parties.

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