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July 27, 2009

Considering the Tax Consequences of Carbon Credits

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On June 26, the House of Representatives passed H.R. 2454, the American Clean Energy and Security Act of 2009 (the "**Waxman-Markey Bill**"). In addition to other climate and environmental protection provisions, the Waxman-Markey Bill would establish a program to cap and reduce greenhouse gas emissions (including carbon dioxide, methane, and nitrous oxide) (the "**Cap and Trade Program**"). Pursuant to the Cap and Trade Program, the Environmental Protection Agency ("**EPA**") would establish specified emission allowances to which certain covered entities, generally utilities and fuel producers and importers, would be subject. Covered entities would then be assessed penalties if they exceeded their emissions allowances and did not acquire sufficient offsets. The Cap and Trade Program would include provisions for trading, banking and borrowing, auctioning, selling, exchanging, transferring, and holding or retiring emission allowances.

On June 16, 2009, the Senate Committee on Finance held a public hearing on the tax considerations of the Waxman-Markey Bill, and in anticipation thereof, the Joint Committee on Taxation prepared a white paper to discuss the fundamental tax issues raised by the Cap and Trade Program (the "**Committee Report**").[i] Because there is no legal precedent directly on point, the Committee Report addresses the tax consequences of the Cap and Trade Program under existing tax law, including analyzing analogous situations, while making recommendations for possible legislative or regulatory action to be considered if Congress decides to alter or specially tailor the tax consequences. Although the Committee Report goes into a great deal of detail about the entire Cap and Trade Program regime, including the tax consequences to covered entities, this article focuses on one area of the Program which practitioners might encounter more immediately: creation and exchange of greenhouse gas offsets (carbon credits).[ii]

Under the Cap and Trade Program, carbon credits are created when taxpayers undertake projects whose primary objective is to reduce, avoid, or sequester greenhouse gas emissions. Generally, the project would involve the taxpayer entering into a contractual arrangement whereby the taxpayer would commit to undertake the particular greenhouse gas reduction activity. Examples of greenhouse gas reducing activities include planting trees, avoiding deforestation, and undertaking soil and fertilizer conservation activities. Because these activities result in a net decrease in greenhouse gases in the atmosphere, they may be deemed sufficient to offset excess emissions made by covered entities. When a taxpayer has committed to undertake a greenhouse gas reducing project, a qualified third party, meeting specifications as set out in the legislation, is required to verify the project and determine the amount of greenhouse gases which would be reduced by the project. This calculation is then used to determine the amount of carbon credits which would be granted to the taxpayer. The carbon credits could then be sold by the taxpayer to covered entities who are unable to reduce emissions below their capped levels.

Because a market for carbon credits already exists[iii], it is important to understand how taxpayers who are currently engaged in sequestration and other carbon removal activities should be reporting the transactions. Additionally, understanding the potential consequences highlights the need for guidance in this area if or when a federal level Cap and Trade Program is instituted.

<u>Tax Consequences from the Generation of Carbon Credits</u>

The threshold issue to address in the carbon credit regime is what tax consequences flow from the generation of the carbon credits themselves. Although there is a relatively healthy voluntary market at present, there is almost no formal guidance regarding the tax consequences to a taxpayer upon the issuance of carbon credits in exchange for undertaking a greenhouse gas reducing project. Without any authority to the contrary, the general rules of tax law should apply.

It is a general principle of tax law that any “undeniable accessions to wealth, clearly realized” is income to a taxpayer.[iv] Carbon credits are readily tradable on a market. Currently, there are several exchanges for trading carbon credits under voluntary or state-imposed restrictions, but in the future, some federally created exchange would exist under the Cap and Trade Program.[v] If passed, the Waxman-Markey Bill would essentially create carbon credits as a form of currency. Therefore, the moment that a taxpayer receives a carbon credit, it may immediately sell or dispose of the credit as it pleases. Consequently, the taxpayer realizes an accession to wealth. Unless some exception is created legislatively or administratively to this general rule, the taxpayer has taxable income measured by the fair market value of the credits received. This income is recognized upon the receipt of the carbon credits. It is likely that this income will be ordinary income, unless the taxpayer is deemed to exchange some capital asset (i.e. a conservation easement in real property) in exchange for the carbon credits.

The Committee Report points out that there is an existing regime for emissions regulations, dealing with sulfur emissions, which suggests that the I.R.S. may deem receipt of offsets non-taxable. In the sulfur emissions regime, the I.R.S. has determined that the receipt of emission allowances by grant from the federal government is a non-taxable event.[vi] However, the Revenue Ruling which provides this guidance contains no analysis or citations to authority to support its conclusions. Under the ruling, the grantee taxpayer takes a zero (cost) basis in the sulfur emissions allowance, and recognizes gain if excess allowances are sold. Some experts have argued that the conclusions set forth in the ruling relating to sulfur emissions should also be applicable to carbon credits.[vii] However, the sulfur emission program is substantially different from the proposed carbon credit regime that would be instituted if the Waxman-Markey Bill is enacted. Under the existing sulfur program, only those entities capped by the legislation may “create” tradable allowances by reducing their emissions below the cap. This is in contrast to the carbon credits, which may created by out-of-market individuals such as landowners who undertake sequestration activities. Because the sulfur emissions regime was never analyzed for the out-of-market participant, it is an imperfect analogy for carbon credits. Additionally, the sulfur emissions program was never intended to lead to substantial trading at the level which is anticipated for carbon credits.

Regardless of the differences between the two systems, without specific authority from either Congress or the I.R.S. indicating that the precedent set for sulfur emissions would be applicable to carbon credits, it would be unwise to rely on the authority established for sulfur emissions in order to diverge from general tax principles for carbon credits. Therefore, pending guidance to the contrary, taxpayers generating carbon credits should operate under the basic principle that the receipt of the carbon credits is a taxable event.

Tax Consequences from the Sale of Carbon Credits

If a taxpayer to whom carbon credits are granted as consideration for undertaking a greenhouse gas reduction project is required to recognize income upon receipt of the credits, then the taxpayer will have an initial basis in the credits equal to the amount of income recognized.[viii] Additionally, offset projects have transactional costs which should be capitalized into the initial basis of the carbon credits. [ix] Examples of transactional costs include the cost of studying/measuring the greenhouse gas impact, negotiating the contract, monitoring the project, and potential insurance costs to cover the risk of loss of sequestration. The taxpayer's initial cost basis in the credits, as augmented by these capitalized additional costs, will offset sales proceeds generated by the subsequent sale of the credits.

Generally, the character of the gain from the sale of the carbon credits will depend upon the taxpayer's principal purpose for holding the credits. If the taxpayer holds the credits as a dealer, then the gain will be ordinary. If the taxpayer holds the credits as an investment, and they are deemed to be intangible assets, then the gain will be capital, either long-term or short-term depending on the holding period.[x]

Some taxpayers may produce carbon credits to use to offset their own capped emissions (i.e. if a utility company undertakes a sequestration project). In this case, because the carbon credits would be property used in the taxpayer's trade or business, the basis of the carbon credits would generally be capitalized and recovered through depreciation or amortization.[xi] On the European market, the I.R.S. has ruled that carbon credits are intangible property,[xii] so it is possible that the credits may be amortizable over a fifteen-year period.[xiii]

Planning Opportunities with Carbon Credits

Currently, the nature of the carbon credit is too amorphous to enable taxpayers and their tax advisors to develop any long-term tax planning strategies for projects entered into prior to the issuance of any guidance. For instance, it is possible that carbon credits derived from activities relating to real property (i.e. sequestration through agricultural activities) may be treated as interests in real property under the law of some states. In that case, it might be possible to exchange such credits for other interests in real property without recognition of gain under Code Sec. 1031. If the taxpayer is deemed to be exchanging an interest in land, such as through the grant of a conservation easement, in return for the carbon credits, and if the carbon credits are interests in real property, the credits themselves may be eligible like kind replacement property.

Alternatively, carbon credits may be considered to be intangible property, so that credits created for use in a trade or business would be amortizable, but which would create recapture issues on the subsequent disposition of the carbon credits.

The Committee Report makes a number of suggestions for carbon credits, including instituting a regime similar to the sulfur emissions where receipt of offsets is a non-taxable event. One point stressed by the Committee Report was that there needs to be consistency of tax treatment across the Cap and Trade program, so that allowances are treated the same as offsets, and all carbon credits, regardless of the project which gave rise to them, are treated the same. Currently, the determination of a number of questions (i.e. nature of the property interest related to the carbon credit) would remain subject to the vicissitudes of state law such that similarly situated taxpayers who enter into identical transactions with respect to carbon credits may have entirely different tax consequences depending upon which state they reside in or in which state the credits were generated.

Taxpayers entering into projects for the creation of carbon credits prior to the issuance of guidance from the I.R.S. or Congress must remain cognizant of the issues involved in structuring the transactions to minimize or eliminate unwanted tax consequences to the extent possible. When engaging in any transaction relating to the generation or exchange of carbon credits under the current hodgepodge regime, or potentially under a more structured regime in the future, taxpayers and their tax advisors must consider the basic tax principles of realization, recognition and character. When assessing these principles, the taxpayer's unique business circumstances, as well as the impact of applicable state law, may control the tax planning strategy. As with many moving targets in the current tax landscape, practitioners and taxpayers alike should regularly revisit their strategies and situations pertaining to the creation, retention or disposition of carbon credits.

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Charles H. Egerton and Christine L. Weingart are members of Dean Mead's Tax Department. Mr. Egerton is Chair-Elect of the American Bar Association Section on Taxation. He is certified as an expert in Tax Law by The Florida Bar Board of Legal Specialization and has been named an Outstanding Tax Attorney by *The Best Lawyers in America*, *Chambers USA - America's Leading Business Lawyers* and *Florida Trend Magazine*. He is a recipient of the Gerald T. Hart Award, which honors the Outstanding Tax Attorney in the State of Florida by The Florida Bar Tax Section.

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[i] JCX-29-09.

[ii] Although the legislation calls these "offsets" this paper will use the more common vernacular "carbon credits." Please note, however, that the removal from the atmosphere of any greenhouse gases, including nitrous oxide, can give rise to offsets.

[iii] Markets currently exist internationally under the Kyoto protocol, and domestically for businesses that have either voluntarily chosen to offset their carbon emissions, or are subject to state-level caps. On the voluntary level, businesses may be seeking to create public goodwill by "going green" and eliminating their carbon footprints. An example of a domestic voluntary market is the Chicago Climate Exchange, where businesses contractually agree to purchase enough credits each year to offset carbon emissions. State-level legislation, such as the Regional Greenhouse Gas Initiative and the Western Climate Initiative, which limits carbon emissions of major emitters, has also given rise to a demand for carbon credits by businesses which need to comply with the state mandates.

[iv] *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).
[v] See note 3.
[vi] Rev. Rul. 92-16, 1992-01 C.B. 15.
[vii] See Witness Statements at the Senate Finance Committee Hearing on "Climate Change Legislation: Tax Considerations" available at http://finance.senate.gov/sitepages/hearings061609.html.
[viii] Code Sec. 1012.
[ix] Code Sec. 263A.
[x] Code Sec. 1211.
[xi] Code Sec. 168.
[xii] Private Letter Ruling 200825009.
[xiii] Code Sec. 197.