



How to Treat Carbon Sequestration Income

By **BILL Hoover**

The compensation of Tree Farmers for the environmental services you provide is long overdue. The first major advance since conservation easements is payments for sequestering carbon, usually referred to as selling carbon credits. This is now possible in most regions of the United States. As with any new economic activity, existing contract and tax law applies until modified by legislation, the courts, and rulings of the IRS and state revenue agencies. The lack of definitive rules during the intervening years makes taxpayers uncomfortable.

This article presents my analysis of how the costs and revenues associated with carbon sequestration contracts should be treated for federal income tax purposes. Since the IRS has provided no guidance on this topic and no published analyses were found, my conclusions are meant to fulfill the immediate need of Tree Farmers incurring costs and receiving payments to report them on their tax returns. Your personal tax and legal advisors must be consulted to determine the treatment in your specific circumstances. My analysis does not constitute legal advice and has not been reviewed. Your comments and criticism of it are welcome.

Form of Contract for Tax Purposes

Except for very large ownerships, Tree Farmers contract with an aggregator. This is an organization that accumulates a bundle of carbon contracts large enough in the aggregate to meet the minimum tonnage requirement to constitute a unit that can be traded on the Chicago Climate Exchange (CCX). The base amount of the payments received by the Tree Farmer is deter-

mined by the actual sale price of the unit, but otherwise tax treatment is determined by the terms of the contract between the Tree Farmer and the aggregator.

These contracts do not use the language typically associated with leasehold interests in real property, but the end result appears to be the same. The Tree Farmer is contractually obligated to let grow and manage a designated mix of tree species according to standardized management practices on a defined area of land for a specified period of time. Most contracts are for trees planted on land that was not forested prior to afforestation or was a highly degraded forest. The Tree Farmer retains title to the land and the trees under contract and is obligated to provide the management and cover the costs necessary for the trees to grow as projected. In legal terms these contracts appear to establish a negative servitude, that is, an obligation for the owner of real property not to do something—not cut the trees in this case. As the holder of the servitude, the aggregator has the right to enter

the property to verify that the terms of the contract are met.

The Tree Farmer has not made an outright disposal of real property, but has in effect leased trees for a designated period of time and remains responsible for the management of the property.

Tax Treatment of Rental Property

The tax treatment of rental property is well established. Costs of acquisition and major repairs are capital and recovered by depreciation or amortization in the case of improvements made by lessees. The costs of maintenance and provision of services associated with the rental activity are deductible against rental income. Rent payments are ordinary income.



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Application to the "Sale" of Carbon Credits

The first issue is whether or not the typical contract results in a fundamental change in the tax treatment of a Tree Farm enterprise. If the production of timber for eventual commercial sale or use in the business remains the primary purpose of the enterprise, it's unlikely that it would be considered to have been converted to primarily a rental activity. The terms of a carbon sequestration contract also should not negate a Tree Farmer from qualifying for the reforestation/afforestation deduction and amortization provisions of the Internal Revenue Code. Carbon contracts generally require that the timber be managed in a sustainable manner. This should allow a Tree Farmer to manage the timber in a manner consistent with accepted practices, including thinnings to maximize the growth of crop trees under a management plan based on the generation of an eventual profit from the overall enterprise. Unless the length of the contract substantially extends the rotation age for the timber, it's also unlikely that the IRS would take the position that the timber is not being held for eventual commercial sale or use.

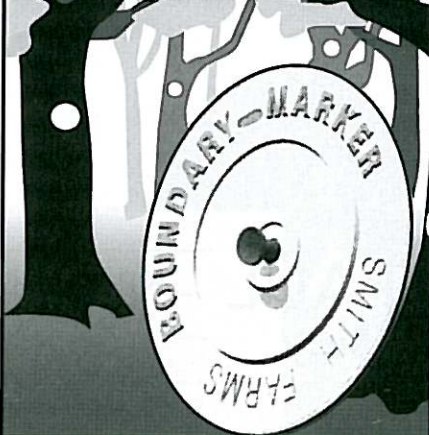
The carbon credit payments actually received by a Tree Farmer are net of the fees taken off the top by the aggregator and the CCX. Since these fees do not pass through the books of the Tree Farmer, only the amount actually received should be reported as ordinary income on the business'

tax return, or as other income on Form 1040 if the enterprise is treated as an investment for tax purposes. If the enterprise is otherwise treated as a rental activity, as in the case of land leased to a hunt club, the net payments would be reported on Schedule E of Form 1040.

In order to qualify for capital gains treatment, the payments would need to be for the disposal in whole or in part of a capital or business asset, or, as in the case of timber, to qualify as such under a specific provision of the Internal Revenue Code, Section 631(a) and (b). It's also not apparent that Section 631(c), which provides capital gains treatment for royalty payments from mineral leases, applies to carbon credit payments. Legislation to expand Section 631 treatment to include carbon credit payments would, of course, be desirable. The Emergency Economic Stabilization Act of 2008, and the Heartland, Habitat, Harvest, and Horticulture Act of 2008 both provide for the National Academy of Science to analyze the impact of the Internal Revenue Code on carbon emissions and sequestration.

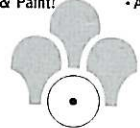
There is also a periodic verification fee prorated among the contracted landowners included in a unit, based on their enrolled acreage or carbon tonnage. This fee is also apparently taken off the top by the aggregator, but owners of large tracts may pay it directly. In either case, this should qualify as an ordinary and necessary business expense deducted currently.

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A remaining issue is the treatment of upfront costs incurred by landowners in legal fees and to hire consultants to provide land and timber inventory data. These costs are capital in nature and should be amortized over the life of the carbon contract. However, if the amount of these costs is incidental to the total cost of operations for the Tree Farm, deducting them currently may be acceptable.

Amend Your Return If Interpretation Changes

If a taxpayer files a return reporting carbon income and expenses under my or another interpretation of the law and these change due to IRS or other rulings, an amended return can be filed for up to three prior years. If you have a reasonable basis for the position you take in filing a return, and you learn later that a different interpretation applies that increases your tax liability, you would at most be liable for the tax and interest. 🌿