TAX ISSUES ASSOCIATED WITH CARBON TRADING ASSETS AND THE IMPACT OF PROPOSED LEGISLATION

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I. Overview

Although the environmental and economic implications of climate change and pollution reduction strategies are frequently discussed, the tax issues associated with such strategies are seldom acknowledged or addressed. A lack of understanding of the tax impacts and issues can lead to serious unintended consequences, as was demonstrated by Europol's recent revelation of tax "fraudsters" in the European Union Emission Trading System. According to Europol, after France, the Netherlands, the U.K., and Spain changed their tax rules on the transactions to prevent further losses, the market volume in those countries dropped significantly (Ashley Seager**,** *European Taxpayers Lose €5bn in Carbon Trading Fraud*, guardian.co.uk (Dec. 14, 2009)).

The European fraudsters' exploitation of tax collection provisions demonstrates the need to understand fully the tax consequences of carbon trading legislation prior to enactment. The failure to fully consider the tax implications can substantially shift the value or costs of the program to interested parties in ways not contemplated as part of the program development.

II. Pending Legislation

Currently, climate change legislation is pending in both the House and the Senate. The Clean Energy Jobs and American Power Act, S.1733 (also known as the Kerry-Boxer bill) was introduced in the Senate (Senate bill), along with other legislation, and the Waxman-Markey bill, H.R. 2454, was passed in the House (House bill).

Both the House and Senate carbon trading or climate change legislation are cap-and-trade programs which are based on three fundamental concepts: (1) the existence of government-created "allowances" for carbon emissions, along with the ability to sell, exchange, or trade the allowances; (2) limits on emissions for certain activities, like the production of electricity; and (3) the ability to create offsets through certain emission reduction activities. How a transaction is treated for tax purposes may differ based on program design and future IRS guidance, and that treatment will incentivize or discourage certain actions. (*See, e.g.*, *Juliet Eilperin*, *Post Carbon: A New Carbon Audit*, http://views.washingtonpost.com/climate-change/post-carbon/2009/12/a_new_carbon_audit.html (Dec. 10, 2009) and J. Comm. on Tax'n, 111th Cong., Climate Change Legislation: Tax Considerations (JCX-29-09)).

III. Impact on Market Liquidity

The existence of a strong trading market in allowances, offsets, and their derivatives is key to achieving the objectives of a cap-and-trade program. The goal is to include the cost of carbon emissions in a business's bottom line, resulting in the consideration of greenhouse gas emissions in the business's planning. A cap-and-trade program is meant to efficiently monetize an entity's carbon usage or savings.

The primary goal of a cap-and-trade program is to reduce emissions in the most economically efficient manner, promoting the greatest economic benefit to whoever can reduce or offset a unit of emission at the lowest cost. For this system to operate efficiently, the cost to transfer rights to emit (i.e., allowances) has to be as low as possible. Higher transaction costs reduce the value of the economic incentive for all market participants except those that need to hold allowances to meet regulatory targets. Uncertainty in the tax treatment under the program adds transactional risk, which will impact the value for both buyers and sellers, and reduce the efficiency of the market. This could lead to less interest in the domestic offset market, forcing up costs or pushing activity abroad. Additionally, to the extent that auction revenue is intended to reduce the cost for consumers and help fund other environmental and energy programs, there would be less funds available.

IV. Existing Tax Guidance

There is limited existing guidance with respect to how many aspects of a carbon trading program would be treated under the Internal Revenue Code (Code).

Further, existing tax provisions do not adequately address certain issues raised by carbon trading programs. While the IRS has previously addressed certain tax consequences associated with similar programs in the context of the sulfur dioxide (SOX) emission allowance program established under the Clean Air Act Amendments of 1990 (*see*, *Rev. Rul. 92-16* and *Rev. Proc. 92-91*), there are significant differences between the proposed programs and the SOX program.

V. Tax Issues

Tax issues are principally present in three aspects of a carbon trading program: (1) first, the receipt of an allowance or the creation of an offset; (2) second, the holding of an allowance or offset; and (3) third, the sale, exchange, or retirement of an allowance or offset.

A. Receipt of Allowances and Offsets

The fundamental question that exists with respect to the receipt of an allowance or the creation of an offset is whether it results in taxable income to the recipient/ holder. Under all of the pending legislation, an entity can receive an allowance by either (1) being allocated the allowance directly by the government at no charge or (2) purchasing the allowance in the open market. Without further guidance, it is unclear whether being allocated an allowance would be a taxable event to the recipient/holder. If the IRS does not follow the same treatment for carbon emission allowances as they do with SOX allowances, then an allowance would be included in the recipient's taxable income upon receipt. However, if the IRS does follow the SOX treatment, the receipt of an allocated allowance would not result in taxable income to the recipient, much like the receipt of a gift. The determination of the taxability of the receipt of an allowance also impacts the tax that would be paid by the holder on the sale of an allowance (i.e., if no income is recognized upon receipt of an allocated allowance, the basis in the allowance should be zero).

In addition, the House bill includes an allocation of allowances for entities that created offsets prior to the bill being enacted. The question then arises as to whether the receipt of an allocation of allowances based on previously created offsets would be considered a sale of the offsets in exchange for the allocated allowances, or simply a method for determining the amount of allowances allocated to a particular entity.

The creation of an offset should not be a taxable event to an entity. However, if an entity purchases an offset (or an allowance, for that matter), is it able to deduct the cost or must it wait until it sells or retires the offset to recover that cost?

B. Holding Allowances and Offsets

The primary tax issue associated with holding an allowance or offset is whether it is considered an asset that may be depreciated or amortized. If an allowance or offset could be depreciated, the holder of the allowance or offset would be able to recover the cost of the asset while it is held (i.e., through annual depreciation deductions determined by the basis of the allowance or offset) and not have to wait until a sale, exchange, or retirement in order to recover its cost. Further, even if it is determined to be a depreciable asset, the method of depreciation would affect how quickly the cost would be recovered and it is unclear which method would apply to an allowance and to an offset. The method may be different because of the nature of the two assets. The fundamental difference between allowances and offsets is that offsets may be self-created, whereas allowances would always be acquired.

Finally, there is language in both the Senate and House bills that could affect whether an allowance may be depreciated. The Kerry-Boxer bill contains the statement that an allowance is not property. If an allowance is not property for tax purposes, then depreciation or amortization may not be allowable. We believe that the intent of the bill is that an allowance should not be considered property for purposes that have nothing to do with the tax treatment of the allowance, but the uncertainty remains because of the language used.

It is also important to note that the House bill provides for term offset credits, which are not in the Senate bill. Term offset credits have a number of characteristics that could result in different tax treatment compared to

permanent offsets. Unlike permanent offsets, term offsets are expected to expire. The existence of an expiration date may make it possible to depreciate the cost of the term offset over its lifetime, which may not be possible for permanent offsets.

C. Retirements, Sales, and Exchanges

Under both bills, allowances and offsets are retired only when an entity asks the government to retire it. Typically, this occurs at the end of a year based on the number of tons of carbon dioxide equivalent GHGs that were either emitted by the entity or emitted downstream in the economy in the previous year. If an entity has not been able to depreciate or amortize the basis of the allowance or offset while it was held, it has just retired an asset that has a remaining tax basis and value. The tax system contemplates that the taxpayer should be able to account for the loss of that value in its income calculation; however, there are different ways that the retirement could be taken into account. The treatment of the retirement of the asset for tax purposes could affect both the timing of when the lost value is recognized and whether the loss can be used against ordinary income or capital gain. The amount of the deduction when the allowance is retired would presumably be its tax basis in the hands of the holder, and not its fair market value.

Further, the identity of the holder could affect the tax treatment. For example, if an allowance or offset is retired by a manufacturer, the value of the retired allowance may be included in the cost of goods sold. This would result in the loss being recognized as inventory is sold and the loss could be used against ordinary income. If the allowance or offset is retired by an electricity generator, it may be able to be deducted as a necessary cost of doing business. This would result in an immediate deduction against the generator's ordinary income. However, it is possible that the offset could be capitalized into the cost of energy generated, which would have a result that is similar to a manufacturer in the prior example.

In addition, allowances and offsets may be retired without being "used." There are organizations and companies that purchase allowances or offsets for the sole purpose of retiring them in order to reduce the aggregate allowances and offsets available to offset emissions. When these groups retire the allowance or offset, each such group reduces its own overall asset value; however, it's not clear how that reduction in value would be treated for tax purposes. If the organization is an exempt organization, then the tax treatment is immaterial; however, if it is not, it should be able to recognize a loss for the value reduction. The retirement could possibly be treated as either a charitable contribution deduction or a basic deduction as a cost of doing business.

As noted in the discussion above, there are further issues with term offset credits. Term offset credits are essentially temporary assets that will eventually have to be replaced by cash or other allowances or offsets. Therefore, when they are retired, there is a requirement that they be replaced with another asset. The retirement of a term offset credit could either result in a deduction to the holder or the value of the credit could be carried over to the asset that replaces it. The tax consequences of the retirement could be dependent on what asset replaces it.

It is also possible that emission reductions that generated offsets are reversed in the future. The reversal raises a number of issues, particularly if the offsets that were generated have been retired. While the reversal should have tax consequences, those consequences may depend on how the retirement of the offset was originally treated for tax purposes. In addition, it may be desirable to permit a taxpayer who purchased an offset on the market that is reversed while it is being held to be able to treat the reversal as a retirement or other loss.

Finally, there are significant tax issues related to the sale and exchange of allowances and offsets. Generally, when property is sold, the seller is taxed on the difference between the amount the property was sold for and the "basis" of the property. A property's basis is initially the cost of the property to the seller. It can be increased by non-deductible amounts invested in the property and decreased by any depreciation allowable with respect to the property. Other than the cost of an allowance or offset to a purchaser, it is

uncertain how other costs and values with respect to allowances and offsets affect basis.

Once the amount of any gain on a sale is determined, it still is not clear at what rate the gain would be taxed. Would the gain be treated as ordinary income or would it be capital gain? As noted above, allowances may not be considered property for tax purposes. In such case, the allowances presumably would not qualify as capital assets entitled to capital gain treatment. Rather, any gain would be ordinary income. It is also possible that allowances would be analogized to either financial instruments and commodities or intellectual property. The treatment chosen affects the tax consequences, including whether they may be exchanged for other climate assets without tax.

D. Dealers and Non-Dealers

The consequences to a holder may change if the holder is considered to be a dealer for tax purposes. Gain from the sale of an allowance or offset would always be ordinary income in the hands of a dealer, while it may qualify as capital gains income in the hands of a non-dealer. In addition, the manner in which the dealer and the non-dealer compute the gain from the sale of specific allowances may differ. A non-dealer may be able to specifically identify the tax basis of the allowance that was sold, while a dealer may have to use the average cost of its allowances as the tax basis for the allowance that was sold.

The determination of whether a holder is a dealer or not is based upon whether the person regularly purchases allowances from or sells allowances to customers in the regular course of a trade or business. A holder may sell allowances from time to time and not become a dealer, or may set up a trading operation and become a dealer.

E. Other Issues

Although the principal tax issues are set forth above, there are other provisions present in both the House bill and Senate bill that have their own tax issues. For example, the following items contained in the bills could be subject to different treatment, depending on how the provisions are drafted and what Congress or the IRS determines:

- **Fees.** Fees that could be imposed on an entity to participate in certain programs may be either deducted, or capitalized into the basis of the allowances and offsets acquired in the program.

- **Borrowing from Future Years.** The possibility of "borrowing" allowances from future years to satisfy a current year obligation has a number of issues. Is the purchase of allowances or offsets on the market in order to satisfy the "repayment" of borrowed amounts deductible or does the loss or deduction occur at the time of repayment? Is the treatment different if the holder does not have to purchase allowances or credits and simply retires allowances that have been allocated to it or offsets which it generated? What if an "interest" amount had to be included in the repaid allowances?

- **International Offsets and Allowances.** Both bills provide for the use of international offsets and allowances. The impact of foreign allowances on the tax consequences of trading in any carbon market is another area of uncertainty.

Taxpayers like certainty in their transactions. Consequently, while the actual tax treatment of the particular asset or transaction will certainly impact a person's carbon trading activity, the uncertainty that currently exists will likely decrease interest in participating in a carbon trading market, and thus decrease the liquidity in the market place.

Further, if the tax consequences are not considered as part of any climate change legislation, the tax and economic impact of a program may not follow Congress's intent. If Congress does not resolve the uncertainty of the tax treatment in legislation that is ultimately enacted, the issues are left to the IRS and, ultimately, the courts to resolve. Delay in resolving the issues is not in anyone's best interest and will adversely affect the overall liquidity of the market for allowances and offsets.

VI. Conclusion

In conclusion, there are numerous and significant unresolved tax issues present in any cap-and-trade system for carbon emissions that would be enacted by Congress. If the issues are not resolved or at least considered in connection with climate change legislation, the enacted provisions could have unintended tax consequences. Failure to address the tax consequences of cap-and-trade legislation in the actual bill could lead to limited liquidity and market attractiveness for allowances and offsets and, ultimately, to providing economic benefits to unintended stakeholders.