



By **BILL Hoover**

As promised in my last column (May/June 2009), here I discuss the contractual provisions that might provide capital gains treatment for payments received by Tree Farmers to sequester carbon. I hope you'll forgive me for going technical on you. Rather than picking one type of contract and analyzing it in detail, I outline the tax principles involved in analyzing contracts. Maybe you'll be fascinated by the legal nuances involved — or not. If not, please forgive me and pass this column on to your tax advisor. I promise to go back to my old "make it practical" mode in the next column. So here goes!

### The Essence of Capital Gains vs. Ordinary Income

Capital gains (losses) from an economic standpoint are realized by acquiring an asset, holding it for some period of time, and disposing of it. The gain (loss) is the difference between the value received when it's disposed of and its cost or other basis at the time of disposal. While the asset is held, there

# Carbon Sequestration Payments:

## Assessing Capital Gains Treatment

may be costs to maintain title to it, such as property taxes, and its physical condition may change naturally or because of improvements or wear-and-tear and depletion. While it's held, it also might throw off income, such as rental or royalty payments for use of the asset. Any gain (loss) on the disposal of the asset is by definition capital in nature.

That said, all income, whether earned or unearned, is ordinary income unless a specific provision of the Internal Revenue Code (IRC) qualifies it for capital gains treatment. I'll return to this later.

### Can't Dispose of Something That Doesn't Exist on Contract Date

This principle is the foundation of the tax treatment applied to long-term timberland and timber leases. These are rare these days, but their well-settled tax treatment informs the treatment of long-term carbon sequestration contracts. Note that I'm not referring to the typical pay-as-cut contract (also a type of lease in legal terms), under which the "buyer" has a relatively short time period to cut the timber and pay for it based on the volume cut. Think of "short" in the context of a lump-sum contract. The pay-as-cut contract is an alternative to a lump-sum contract, so the time periods typically allowed for one apply to the other. A timber contract would generally be considered long term if the timber growth and associated increase in value is substantial

enough to have changed contract provisions, for example, indexing the unit price for inflation.

The primary tax authorities for the tax treatment of long-term timber contracts are IRS Revenue Rulings 62-81 and 62-82. Capital gains may apply to payments received by the owner equivalent to the fair market value of the timber existing on date of the contract. I'll call this the DOC-FMV. Any payments in excess of the DOC-FMV are not for the disposal of timber, but are for the right to grow additional timber. You can think of this as rent for the land to grow more timber, and in some circumstances rent of the timber-growing stock to grow more timber. Contract provisions specifying the timing and amount of payments may affect whether payments qualify for capital gains treatment, but not the total amount that may qualify.

This principle can be applied to the two basic types of carbon contracts. In the case of a contract paying a Tree Farmer to plant trees on land to which the Tree Farmer retains fee title, there's no timber to dispose of. In the case of contracts for existing stands, there are two components. To the extent of "a disposal" of the DOC-FMV of exist-



William L. "Bill" Hoover is forestry professor, Extension coordinator, and assistant head for the Department of Forestry and Natural Resources, Purdue University 1159, W. Lafayette, IN 47907-1159; <whoover@purdue.edu>.

ing timber, capital gains may apply. If the contract also disposes of the Tree Farmer's rights to future growth, there's no DOC-FMV and therefore nothing to dispose of. In this case, the Tree Farmer has leased his timber for additional growth. Within this framework there are many combinations of contractual provisions, and astute legal minds can work the nuances to achieve favorable tax treatment.

### What Constitutes a Disposal?

Only the "owner" of an asset or one with a partial interest in it can dispose of the asset. My previous column dealing with carbon payments as rent was based on the premise that no disposal took place. If someone buys an asset that you own outright and takes possession of it, it has been disposed of. But what if the ownership interest you dispose of is not an outright interest, not fee simple in legal terms, or the asset remains on your land but a second party has rights in it? There is an extensive body of timber tax law on this issue. It harkens back to the days when it was necessary to dispose of timber but retain an economic interest in the timber disposed of to get long-term capital gains treatment. IRC Section 631(b) still requires that an owner dispose of an ownership interest, but it's no longer necessary to retain an economic interest in the timber disposed of.

Existing tax law deals with the disposal of timber to be severed (harvested) by the buyer (lessee). What constitutes a disposal of timber is in this context. The purpose of carbon contracts is to eliminate or reduce harvesting on contracted acreage. It could extinguish in perpetuity a Tree Farmer's rights to existing timber and future growth. Or it could lock-up a specified volume in perpetuity or for a specified period. A question that will most likely need to be handled by the IRS or courts is how long existing timber must be under contract for a disposal to have occurred, as opposed to a mere leasehold interest.

In some states the trend is for permanent "lock-up" of carbon in timber by

restricting all harvesting of the timber stock under contract. In this case, the tax law applicable to the sale of a conservation easement should apply.

### IRC Requirements for Capital Gains Treatment to Apply

Capital gains tax treatment applies to "capital assets." These are all assets not specifically excluded by law. One of the exclusions is property held "primarily for sale to customers" in the ordinary course of a trade or business. Also qualifying are assets used in a trade or business, but not held primarily for sale. The purpose of IRC Section 631(b) is to qualify timber for capital gains treatment even if held primarily for sale. This section treats it like an asset used in a trade or business.

Thus, a "disposal" of existing timber that is a capital asset in the hands of the owner, or is disposed of under a contract to which IRC Section 631(b) applies, would result in capital gains treatment. The timber must have been held for more than one year to qualify under Section 631(b) and receive long-term capital gains treatment.

There are other nuances that may come into play. Why not frame the discussion in terms of tons of carbon instead of timber volume? This could bring into the discussion carbon sequestered in tree roots. Current tax law applies only to above-ground portions of trees. Also, how would carbon depletion accounts be handled for contracts that allow some harvesting, assuming that when Tree Farms are purchased in the future their total carbon sequestration capacity becomes a valuation factor and is thus reflected in the tax basis.

### Sale of Carbon Contracts on a Secondary Market

Someone who has an existing contract right to receive a stream of payments can sell this contract for a lump-sum amount. The contract is reassigned to the buyer and future payments go to the new owner. Yes, this is the basis of the secondary mortgage market and

the market for rights to the payments to be received by lottery winners. As the carbon market grows, a secondary market will develop to the extent that periodic payments are used, not just lump-sum payments. Tree Farmers "stuck" with a periodic payment contract subject to ordinary income tax treatment might want to sell it if allowed under the original contract. The sales price would be the market-based present value of the stream of future payments. Under some circumstances, this sale might convert ordinary income into a capital gain.

Capital gains treatment doesn't apply to a sale by a lottery winner. The so-called "substitute for ordinary income doctrine" applies. This doctrine is based on case law, not legislation. Thus it is not entirely settled, but the courts' analyses provide a firm foundation for assessing the circumstances under which capital gains treatment for sale of a carbon payments contract might apply. The key most likely will be the continuing role of the Tree Farmer in the management of the land and timber. A lottery winner's rights to payments carries no further obligation once he is declared the winner. One of the courts put it this way: Assets that constitute a right to earn income qualify for capital gains treatment, while assets that constitute a right to earned income merit ordinary income treatment [Lattera v. Commissioner, 437 F.3d 399, 4/5/2006 (3rd Cir. Court of Appeals)]. Thus, the "substitute for ordinary income doctrine" should not apply to lump-sum contracts requiring a Tree Farmer's continued management of the land and timber under contract. If the contract relieved a Tree Farmer of all further management obligations other than maintaining title to the land, the doctrine most likely would apply, resulting in ordinary income tax treatment.

### Let's Continue the Discussion

If you're interested in a dialogue on the tax treatment of carbon sequestration contracts, go to the timber tax blog at <[www.timbertaxadvice.com](http://www.timbertaxadvice.com)>. 