Tax Dimensions of Forest Carbon Management

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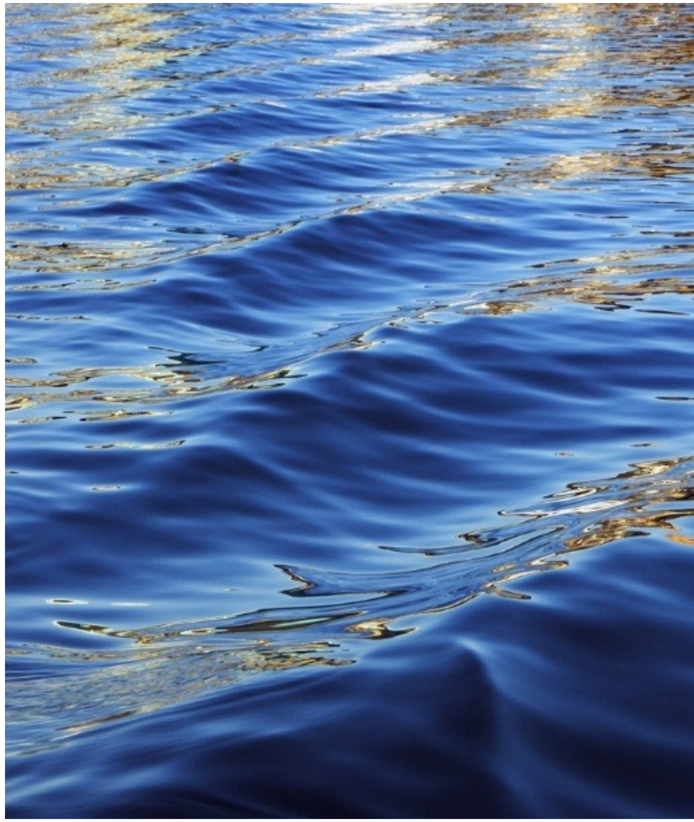
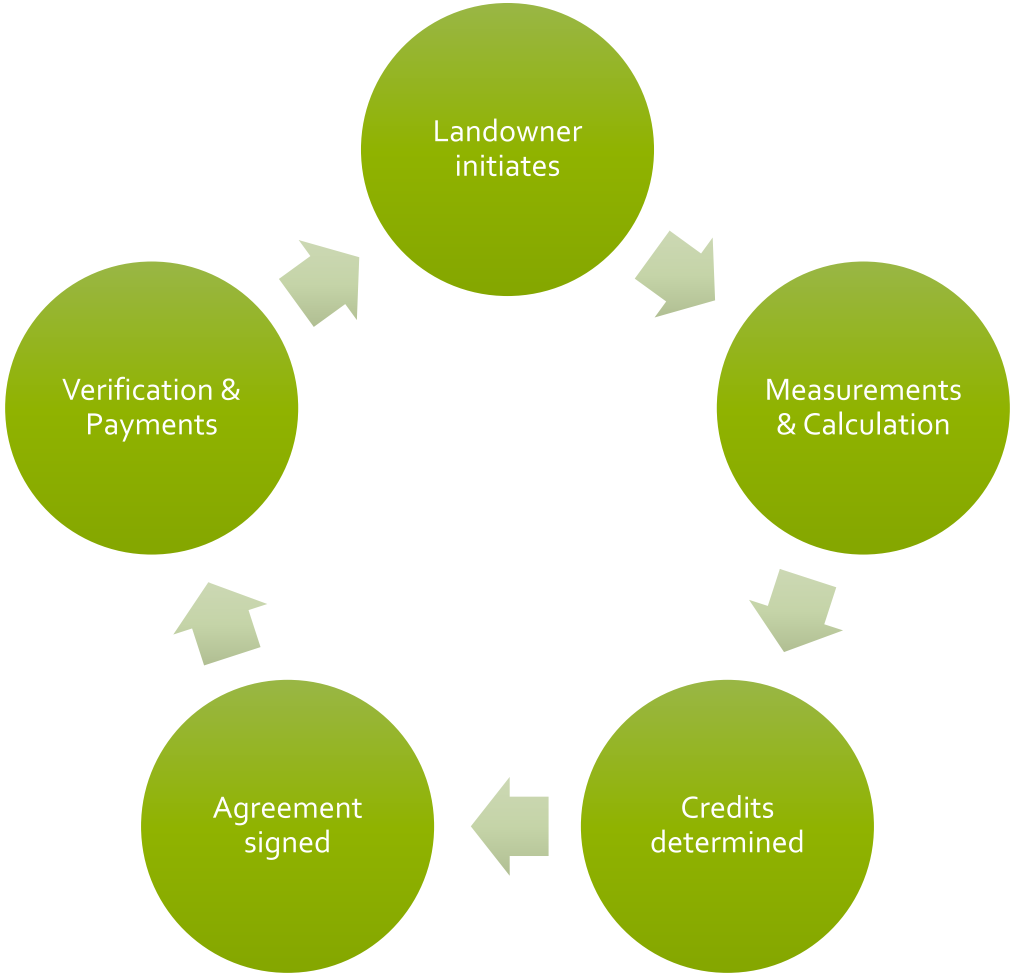


Today's list of disclaimers…

- Tax law is very complex and this is an overview
- Presentation is for educational purposes
- Information is current as of today
- Carbon programs are evolving
- IRS isn't talking ☺, state officials??

Sample carbon credit lifecycle



Tax-related questions

Is income taxable?

When is income/wealth realized?

How is income taxed?

What about expenses?

What else should I consider??

Is income taxable?

Income (per the IRS):

- All income from whatever source derived is taxable unless..
- Also includes increase in wealth
- Answer: YES income is taxable

When is income/wealth realized?

Good question!

Look to rulings…

- US District Court (Roseland Plantation LLC vs. US FWS) – bundle of rights, real property
- REITS (ruled one then two) – not real property or interest in real property
- Sulfur emissions – one taxable event, capital unless inventory – different market

Consensus appears to indicate two taxable events.

- When credits are issued
- When credits are sold

Complicated by aggregators, simultaneous issue/sale

Will depend on wording in contract as to how transaction structured

Ultimately – no definitive answer

How is income taxed?

What kind of income is it?

- Two kinds of income
  - Ordinary
  - Capital gains

- Character is determined by:
  - Holding period
  - Reason for holding
    - Primarily for sale? Ordinary
    - Investment? Capital

What difference does it make?

- Different rates
- Ability to offset gains with losses
- Self-employment tax

How is income taxed (cont.)?

- It depends! (are you tired of me yet?)
- With no federal guidance, no clear answer.
- Easement test: does it give up a right for an extended period of time or does it appear more like a short-term rental?
- Short-term carbon contract (1 year): akin to a short-term rental and likely to be considered ordinary income.
- Mid-term carbon contract (20 years): possibly capital gain income
- Long-term carbon contract (100 years): likely equivalent to an easement or sale of an interest and considered capital gain income
- If deemed real property, should be capital gain treatment

What about expenses?

Generally, three ways we handle expenses

- Subtract from proceeds
- Deduct immediately
- Capitalize to deduct later

Deduction: reduces income and results in a tax benefit equal to

- Expense x tax rate

Capitalized expenses are added to the basis and used to later reduce gain

- Basis: cost to acquire plus non-deductible expenses minus amount used to offset gain or taken as casualty/depreciation/etc.

Carbon expenses

- Exploratory expenses (if no agreement signed): deduct immediately
- Expenses associated with enrollment: part of the cost basis
- Direct sale expenses: subtract from sale proceeds
- Basis
  - Recovered when asset is sold
  - If receipt of credits is taxable event, recover expenses. New basis created at FMV of issued credits
  - When credits are sold, basis is recovered as income is received and taxed (similar to depletion)

What else should I consider?

State Income Taxes

- Piggy-back
  - 40 have linkage
  - Depends on which point they piggy on to
  - Most link to taxable income or adjusted gross. 31 use Federal itemized
- Stand-alone
  - Do not use the Federal return as a starting point
- Check

Property Taxes

- Concern regarding special use programs
- Programs with harvest/management requirements
- Review of 3 programs
  - North Carolina
  - Vermont
  - Oregon

Example: North Carolina

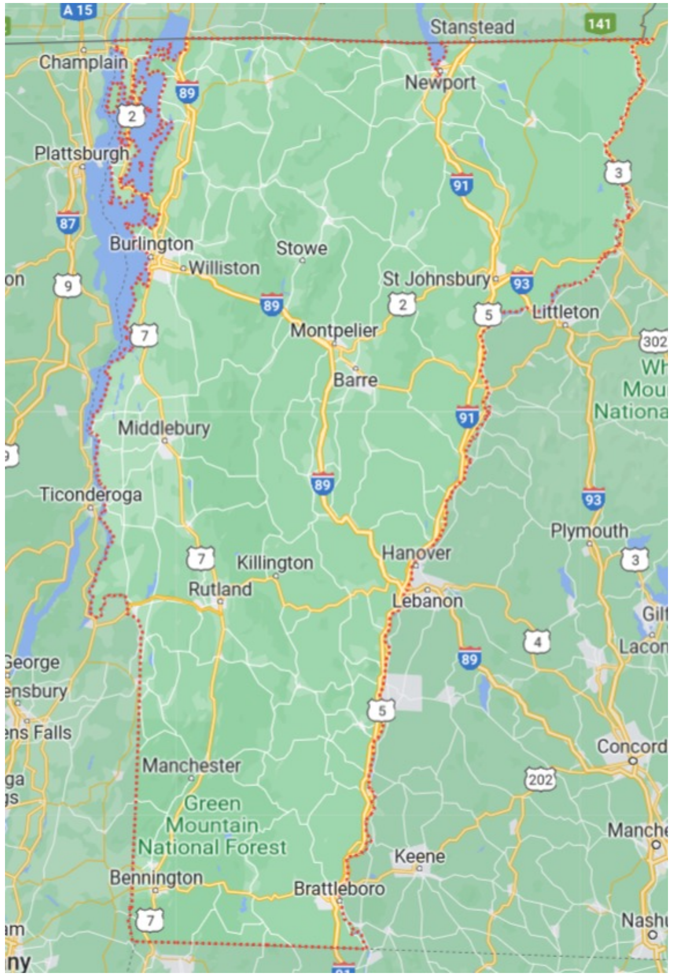
- Forestry PUV -- value of a tract of land used as forestland, based solely on its ability to produce income from timber growth assuming an average level of management (not required to produce annual income)
- Minimum 20 acres of forestland in timber production
- Tax officials review landowner objectives to ensure that commercial timber production is the primary goal. Written plan must set forth management practices to be used in producing commercial timber and must be implemented.

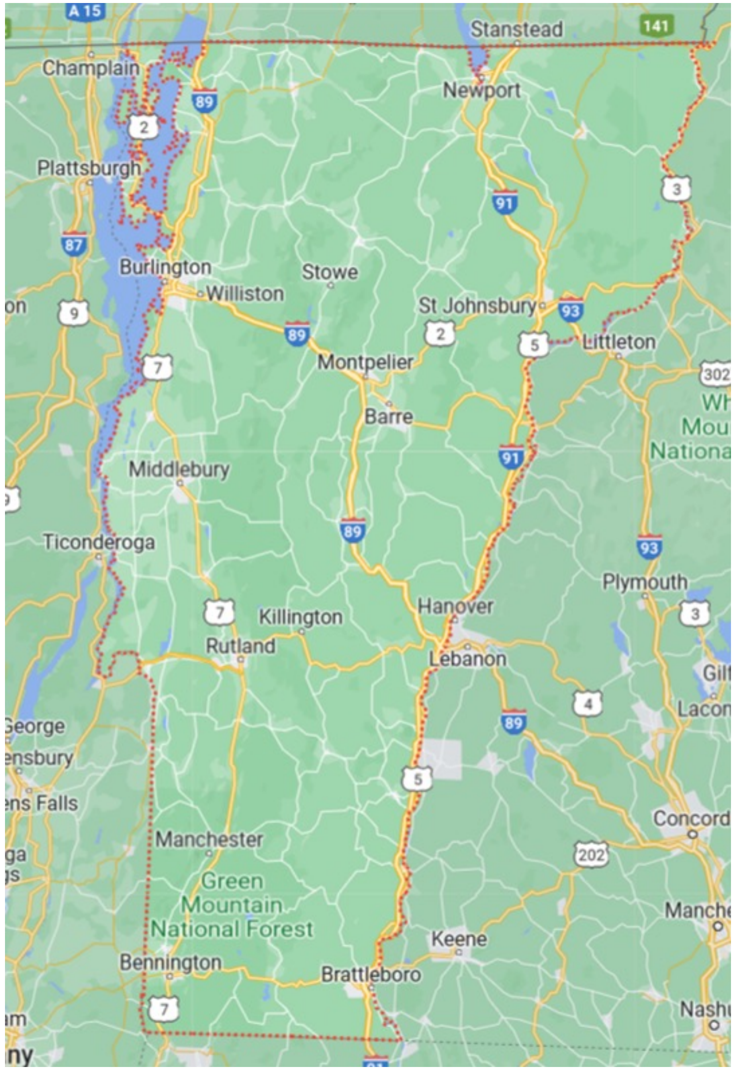
North Carolina (cont).

- If plan modified, a copy of the amended document should be sent to the county assessor's office.
- Common reasons for disqualification: Landowner is unable or **unwilling** to follow the recommendations in the forest management plan—**especially pertaining to the harvesting of timber**
- If property disqualified, a "rollback" provision is triggered. Deferred taxes plus interest on past 3 years

Example: Vermont

- Current Use, enables farm and forest landowners who practice long-term management to have land appraised for its "use value" rather than at fair market value.
- Current Use is a tax equity program and the single most important tool to preserve Vermont's working landscape.
- All land enrolled in this tax program must be managed productively: all woodlands enrolled in current use must have a management plan that includes harvesting timber. This does not require annual harvests.
- You must have 25 contiguous acres of forestland and an approved forest management plan that is updated every 10 years
- Primary forest management objective must be long-term production of forest products in accordance with established forest practices. Wildlife habitat, aesthetics, recreation, watershed protection, etc. **are acceptable** objectives **when consistent with and complementary to timber management**



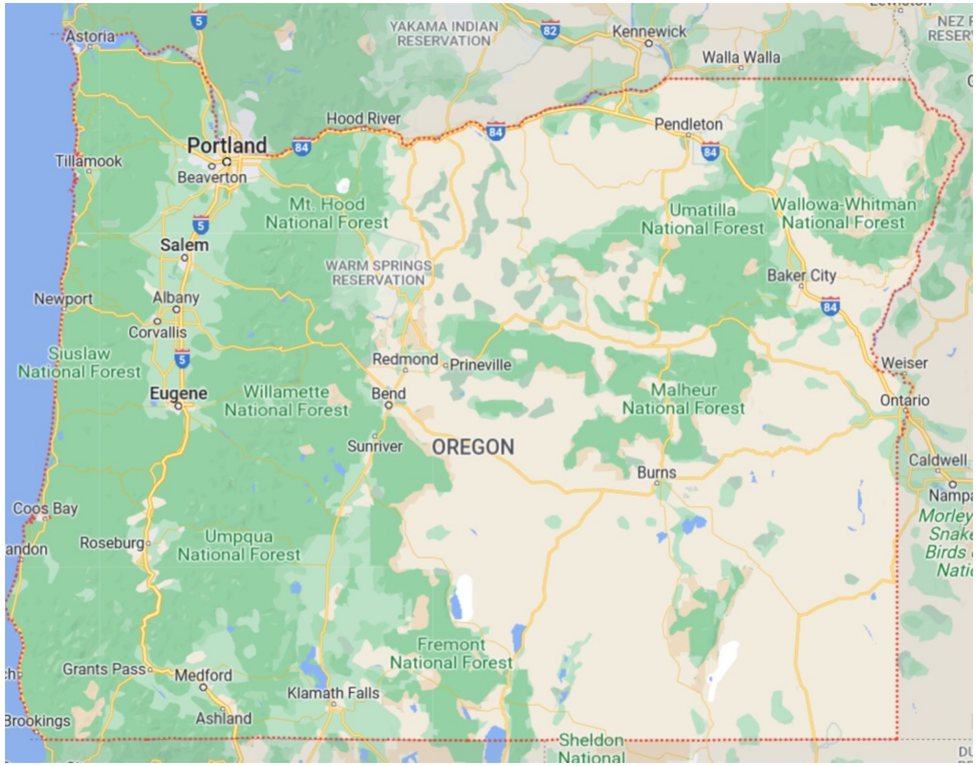


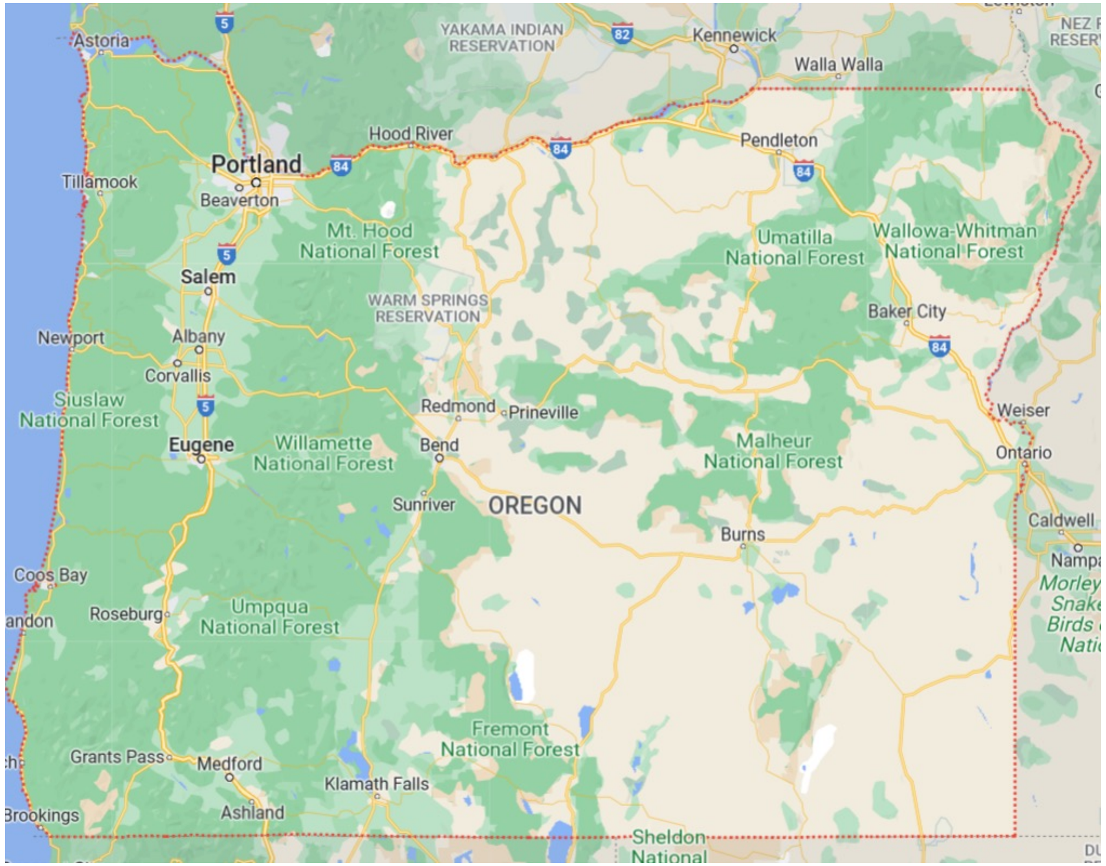
Vermont (cont).

- Any forested areas where the landowner chooses not to harvest trees is ineligible, unless enrolled as an ESTA
- Any changes to objectives or prescribed activities in the plan require submission and approval of an amendment to the forest management plan.
- The parcel may lose its eligibility if the landowner fails to follow his/her forest management plan or other ongoing program responsibilities listed above

Example: Oregon

- Two programs: Designated Forestland and Small-tract Forestland
- These programs reduce the property tax the landowner pays if they agree to manage the property primarily for growing and harvesting timber.
- Eligibility: 2+ acres (DF), 10-5,000 (STF)
- DF: The landowner is required to be actively growing a marketable species of trees on the property or have a plan for growing trees that will eventually be harvested
- STF: Known as the “deferral program”
- The land must contain enough trees to meet the stocking standards of the Oregon Forest Practices Act





Oregon (cont.)

- STF: To account for the annual property tax reduction, the landowner pays a severance tax when they harvest the timber from the property
- When the designation of forest- land is removed, an additional tax will be extended against the land
- The county assessor may disqualify lands that don't continue to meet the standards for this program. The owner of the disqualified lands will be required to pay an additional tax assessment. This additional assessment recaptures the amount of tax that was deferred while land was under the STF Option (up to 10 years).
- Is any portion of the land subject to a lease, option, or easement which permits it to be used for a purpose other than the growing and harvesting of trees?

Property tax programs: bottom line

- Understand what program you are in
- BEFORE signing a carbon contract, talk to your assessor
- This is evolving for them
- A complete restriction on harvests will likely result in removal from some programs
- Convey concerns to carbon program as their agreements are evolving

Tax Implications

- Certain:
  - Carbon payments are taxable
- Uncertain:
  1. Whether one or two taxable events
  2. Whether it is ordinary or capital gains
  3. Impact on property tax programs focused on timber
- Stay tuned…
  - But don't hold your breath

Thank You!

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