Hearing Before U.S. Senate Committee on Finance
on
Climate Change Legislation: Tax Considerations
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Mr. Chairman, Ranking Member Grassley, Members of the Committee:

Good morning. My name is Mark Price. I am a principal in the Washington National Tax office of KPMG LLP. I am pleased to have the opportunity to testify as an invited witness before the Committee this morning on the topic of the tax considerations associated with climate change legislation. I will take the next several minutes to summarize the points in the written testimony submitted to the Committee

In my remarks this morning, I will discuss the tax treatment of a system of tradable CO2 allowances under current law and identify issues that may be considered in developing an appropriate tax regime for such a system. The tax treatment of the grant, distribution, and disposition of the allowances may materially affect the cost and efficiency of the system. The key issues raised by a cap and trade system relate to a determination of the amount of income or expense arising from CO2 allowances, the timing of that income and expense, and the character of that income or expense. Given current-law limitations on claiming capital losses against ordinary income the character of income from CO2 allowances is one of the most significant federal income tax issues. Under current law, capital losses can only be applied against capital gains. A capital loss cannot be used to offset ordinary business income. This could affect an entity's cash flow. The recognition of income in advance of expense could also affect an entity's cash flow.

The tax treatment of a transaction is fact dependent. The observations in this paper are based on provisions of existing cap and trade systems (e.g., the Regional Greenhouse Gas Initiative and the European Union Emissions Trading Scheme) and different current and past proposals. The observations are also based on a synthesis of existing authority that may be subject to different interpretation by different taxpayers, particularly in different situations or industries.

The treatment of a cap and trade regime under current U.S. tax law should be based on analogies to similar types of allowances and government permits and on general tax law principles. Thus, the tax treatment of cap and trade under current law would be based primarily on authorities issued by the Internal Revenue Service (the "IRS") on the treatment of the sulfur dioxide emissions allowances established pursuant to Title IV of the Clean Air Act Amendments of 1990, Pub. L. No. 101-549, 104 Stat. 2584 (1990); 42 U.S.C. section 7651 et seq. *See* Revenue Procedure 92-91, 1992-2 C.B. 503; Revenue Ruling 92-16, 1992-1 C.B. 15. The IRS has also ruled privately on certain U.S. international tax issues related to the European Union's Emissions Trading Scheme. *See*

Priv. Ltr. Rul. 200850009. These authorities, in conjunction with general principles of tax law, form the basis for how to tax the allowances and related contracts under a cap and trade system under current law.

Tax Treatment of the Acquisition of CO2 Allowances:

The first issue in the tax analysis of a cap and trade system is to determine what happens when an allowance is acquired. Most cap and trade systems envision two means of acquiring allowances – by purchase (either on the open market or through an auction mechanism) or by grant from the government. When an allowance is acquired through auction or through sale in the open market, the allowance will have a tax basis equal to cost, or the amount paid to acquire the allowance. 26 U.S.C. section 1012. Some entities may be granted allowances from the federal government. Based on current IRS guidance, those entities would have no income on receipt of the allowance and no basis in the allowance. In Revenue Ruling 92-16, 1992-1 C.B. 15, the IRS ruled that utilities and non-utility participants in the sulfur dioxide emissions allowance program did not have income upon the receipt of sulfur dioxide emissions allowances. In Revenue Ruling 67-135, 1967-1 C.B. 20, the IRS ruled that the winners of drawings to award leases of oil and gas rights to certain federal land did not have income equal to the difference, if any, between the fair market value and the cost of the lease. It follows from these authorities that, under current law, entities granted allowances from the federal government do not have income upon receipt. Because the recipients of allowance grants will not pay anything to acquire the allowances, their basis in these allowances is zero. 26 U.S.C. section 1012.

Tax Treatment of CO2 Allowances Used in the Trade or Business

The next issue in the tax analysis of a cap and trade system is to determine when the initial cost, if any, is recovered and how to calculate income on the disposition or use of a CO2 allowance. The question of cost recovery is unclear under current law. In Revenue Procedure 92-91, 1992-2 C.B. 503, the IRS ruled that the cost of acquiring sulfur dioxide emissions allowances could not be depreciated because: (i) the allowances were used only in a single year and (ii) they did not have a limited useful life. In 1993, Congress enacted Internal Revenue Code section 197, which generally provides a 15-year life for the amortization of intangibles. A license, permit, or other right granted by the government is generally an intangible subject to this rule if: (i) it is acquired as part of the acquisition of a trade or business, (ii) it is not fixed as to amount, and (iii) it has a duration of at least 15 years. *See* 26 U.S.C. section 197(e)(4)(D); 26 C.F.R. section 1.167(a)-14(c)(2); 26 C.F.R. section 1.197-2(c)(13). If CO2 allowances are viewed as a permit granted by the government to emit a specified amount of CO2, the cost of a CO2 allowance that is used to cover an entity's CO2 emissions for the year appears to be recoverable in the year it is used. *See* 26 C.F.R. section 1.167(a)-14(c)(2). The basis would be recoverable as a deduction against ordinary income and, depending on the industry, may be taken into account under the relevant rules for capitalizing expenses to the property being produced by the industry. *See* 26 C.F.R. section 263A. There is likely to be some uncertainty in this area as a result of the IRS's conclusion with respect to sulfur dioxide emissions allowances.

Character of CO2 Allowances:

If the CO2 allowance is sold, rather than used, the cost is used to determine gain or loss on the sale of the CO2 allowance. 26 U.S.C. section 1001(a). The character of the gain or the loss will depend on the relationship of the CO2 allowance to the entity's business. The sale of a CO2 allowance will generally produce capital gain or loss unless an exception applies, in which case the gain or loss would be ordinary. *See* 26 C.F.R. section 1221(a). The IRS concluded that gain from the sale of sulfur dioxide emission allowances is capital. *See* Revenue Procedure 92-91.

The first relevant exception is for allowances that are held for sale to customers or as inventory. Under current law, this inventory rule would only apply to entities that make a market in CO2 allowances. Depending on the structure of the market for CO2 allowances, this rule may be limited to registered dealers or market makers in CO2 allowances. Alternatively, the application of this exception may depend on a collection of cases interpreting this provision in the context of everything from real estate to diners. Under current law, this rule would not apply to entities that occasionally have excess CO2 allowances and choose to sell them.

The second relevant exception to capital asset treatment would be if the allowances were held for use in the taxpayer's trade or business and subject to depreciation. *See* 26 U.S.C. section 1221(a)(2). It is unclear whether this exception would apply under current law. As discussed above, there is a statutory provision that says it might and IRS guidance that says it does not. Even if the general rule were clear, it is unclear whether allowances that are not used to satisfy the entity's CO2 obligations are held for use and subject to depreciation. The answer may depend on the specific facts of the entity, including the reason for acquiring the allowance and how the allowance was recorded in the books and records. If this "depreciable property" exception applies, and the CO2 allowance is held for more than one year, the CO2 allowance would be "section 1231 property," which generally means that gains would be capital and losses would be ordinary. *See* 26 U.S.C. section 1231.

The third exception to capital asset treatment that could apply to CO2 allowances is for property that is a supply of a type regularly used or consumed by the taxpayer in the ordinary course of trade or business. The IRS ruled privately in 2007 that sulfur dioxide emissions allowances are not supplies because they are not tangible personal property. *See* Priv. Ltr. Rul. 200728032. This is consistent with the concept of a "supply" found elsewhere in the tax law. *See* 26 C.F.R. section 1.162-3; 26 C.F.R. section 1.471-1. The 'supply" exception, therefore, would not appear to apply to CO2 allowances under current law.

There could be uncertainty under current law with respect to the character of CO2 allowances. The character will depend on what is done with the CO2 allowances. An entity's purpose for holding a CO_2 allowance may change. That is, an allowance acquired for use in the business may end up being sold. Similarly, an entity may need to use allowances it intended to sell to satisfy its requirements under the cap and trade system. It may be unclear in these situations whether the disposition of the CO_2 allowance produces capital or ordinary gain or loss. Such uncertainty may cause entities not to sell their CO_2 allowances. This could impact the liquidity of the cap and trade regime and may distort the pricing of CO_2 allowances.

<u>CO2 Allowances as Commodities</u>

Another question that is raised in the cap and trade analysis is whether the allowances are commodities. The IRS stated in a private letter ruling issued in 2008 that they are still studying whether allowances are commodities. *See* Priv. Ltr. Rul. 200850009. The Treasury Regulations under the Internal Revenue Code sections dealing with subpart F income explain that commodities have to be tangible personal property. *See* 26 C.F.R. section 1.954-2(f)(2). Emissions allowances and offsets would not be commodities under this definition.

Not classifying allowances and offsets as commodities would have international tax consequences. There would also be some consequences for taxpayers who might want to mark-to-market their allowances. If allowances and offsets are not classified as a commodity, taxpayers could not elect to mark its allowances and offsets to market. Classification as not a commodity would also affect whether or not the offsets are amortizable. These limitations may make entities more reluctant to engage in the purchase and sale of CO_2 allowances beyond their business need.

<u>Like-kind Exchange Treatment</u>:

Some entities may be subject to multiple cap and trade systems, either because some regional or state programs are not preempted or because the entities operate in foreign countries that have their own national or regional cap and trade systems. Under current law, CO_2 allowances appear to be eligible for like-kind exchange treatment for federal income tax purposes. *See* 26 U.S.C. section 1031.

<u>Tax Treatment of Offsets</u>

Most cap and trade proposals allow entities to purchase or generate offsets that may be used to satisfy the entity's requirement for allowances. Under current law, purchasers of offsets would treat offsets in the same manner as CO_2 allowances, and domestic offsets would be treated the same as international offsets. If a taxpayer is a generator of offsets as part of its core business, then the generation of those offsets would be treated as ordinary business activity giving rise to ordinary income.

Observations

Under current law, different fact patterns may produce different tax results. Here are some examples of what may be common fact patterns:

- Entities that receive grants and use their CO_2 allowances in their trade or business will likely have no income or expense from CO_2 allowances, except for deductions arising from the use of purchased CO_2 allowances.

- Entities that purchase CO_2 allowances and use them in their trade or business will likely have no deduction for the cost until the year the CO_2 allowance is used. The cost may, however, be recovered over 15 years if the CO_2 allowances are acquired as part of the acquisition of a trade or business.

- Entities that sell a portion of the CO_2 allowances they receive from grants or purchase will likely have capital gain or loss on the sale of excess CO_2 allowances. The likelihood of losses will depend on whether the CO_2 allowances that were sold were purchased or received by grant. CO_2 allowances held for more than one year may produce capital gain or ordinary loss.

- Entities that regularly sell a portion of the CO_2 allowances may realize ordinary income or loss if the property is treated as held for sale. The character will not depend on the reason for the excess allowances, just the actions taken by the entity in selling the allowances.

- Entities that are not subject to the cap and trade system, but that purchase and sell CO_2 allowances likely realize capital gain or loss on the sale of CO_2 allowances, unless they hold the allowances for sale to customers. This rule could also apply to covered entities or affiliates of covered entities that establish operations to purchase and sell CO_2 allowances.

Some entities may fall into multiple categories above or may set up different businesses subject to different rules.

Considerations for Tax Legislation

There are several tax issues that should be considered if the Senate were to consider legislation on the tax treatment of CO_2 allowances. The sulfur dioxide emissions allowance analogies are useful. That guidance, however, is over 15 years old.

First, it would be appropriate to consider whether the current law rules above are appropriate, both as a matter of tax policy and, to the extent the Committee deems it appropriate, as a matter of energy policy. For example, if entities are expected to have excess credits as a result of accelerated carbon reduction, would it be appropriate to ensure that such credits do not create capital losses when sold? If such sales result in capital losses, the seller may be limited in its ability to apply the loss to offset its business income, thus increasing the after-tax cost of the CO_2 allowance.

It would also be appropriate to clarify whether there is income on the receipt of a CO_2 allowance. The existing rule is based on IRS guidance applicable to specific government programs. Given the increased scope of the cap and trade regime, clearer authority on the topic is warranted.

In addition to addressing the issues discussed above, there are a number of issues that are raised by a cap and trade system that might be appropriate to consider.

Borrowing Emissions Allowances

Some cap and trade systems allow entities to borrow CO_2 allowances from future years. A fee may be charged for borrowing potentially in the form of reduced value for the CO_2 allowance. It is unclear whether this should be viewed as a loan from the Federal government or as a reduction in the value of future allowances. If it is legally in the nature of an advance from the Federal government, it would be necessary to consider the deductibility and the characterization of the "fee."
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Treatment of Fees for Failing to Deliver Allowances

Each cap and trade system has some form of fee payable by an entity if it fails to obtain and deliver a sufficient number of CO_2 allowances. The characterization of this fee could affect whether it is deductible by the entity.

Treatment of Allowances as Commodities

Under current law, the classification of a commodity affects several different sets of rules. It affects the analysis used to determine whether foreign subsidiaries of U.S. companies must pay tax on gains from transactions in foreign CO_2 allowances. It affects the analysis used to determine whether foreign investors are subject to tax on their investment in U.S. CO_2 allowances. It also affects whether market makers can adopt a mark-to-method method of accounting for CO_2 allowances. Finally, it may affect the character of a CO_2 allowance and how cost is recovered. It may be appropriate to consider special rules in some or all of these areas for CO_2 allowances in lieu of relying on whether a CO_2 allowance is classified as a commodity.

Specific Identification of Allowances

Under current law, entities would be required to identify and track the basis of each CO_2 allowance separately for purposes of determining gain or loss on sale and for purposes of determining the amount of cost recovery. It may be appropriate to consider whether entities should be allowed to track basis differently.

Treatment of Carbon Derivatives

Entities are expected to manage price risk with respect to CO2 allowances. Under current law, derivatives used to hedge this price risk may be capital assets, even though the risk being hedged is an ordinary business risk. It may be appropriate to consider whether it is appropriate or possible to develop rules that match the character of carbon derivatives to their use as hedges.

Treatment of Tax-Exempt Entities and Donations

Entities may either develop and sell offsets or purchase CO2 allowances for the purpose of retiring them from circulation. The tax treatment of these entities and actions should be considered. For example, should the generation and sale of an offset qualify as tax-exempt income, or should it be unrelated business taxable income? Should the retirement of a CO2 allowance give rise to a charitable deduction, or will it be necessary to purchase and donate such CO2 allowances to a charitable organization to qualify for a tax deduction?

Interaction with Federal Renewable Energy Certificates

It is possible that Federal energy legislation will include a renewable energy standard for utilities. This renewable energy standard may involve the creation of another government grant, the renewable energy certificate. These renewable energy certificates will likely have similarities to the CO2 allowances (e.g., they may be tradable and must be provided to satisfy the federal standard) and differences (e.g., they may be created as a result of the production of renewable energy, not granted by the Federal government). Any tax provisions drafted to address CO2 allowances may impact the tax treatment of Federal renewable energy certificates.

Conclusion

A cap and trade system raises familiar tax issues of timing, character, and amount. It also raises more difficult questions as a result of its sweep across multiple industries and its potential interoperability with systems on multiple continents. In some areas, existing law provides reasonable certainty. In other areas, existing law leaves open questions and creates fact-specific determinations, such as determining whether a CO2 allowance is depreciable or whether an entity is a dealer in CO2 allowances. Finally, in other areas, conclusions in the current law drive other tax results in ways that are worth considering, such as the linkage between classifying a CO2 allowance as a commodity and various other rules in the Internal Revenue Code.

Thank you again for the opportunity to testify. I look forward to your questions.