CLIMATE CHANGE LEGISLATION: TAX CONSIDERATIONS

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on June 16, 2009

Prepared by the Staff
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INTRODUCTION AND SUMMARY

The Senate Committee on Finance has scheduled a public hearing on June 16, 2009, on the Federal tax implications of cap-and-trade legislation. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of Federal income tax issues relating to cap-and-trade proposals.

The first section describes the basic design features common to cap-and-trade proposals. The sections that follow discuss the fundamental income tax issues raised by cap and trade proposals, including (1) taxation of allocated emission allowances; (2) recovery of basis in emission allowances; (3) taxation of offset producers; and (4) taxation of the sale or exchange of emission allowances. The remaining sections discuss the tax aspects of trading emission allowances and emission allowance derivatives, international tax considerations, sales and exchanges of emission allowances by tax exempt organizations, and the imposition of penalties.

[1] This document may be cited as follows: Joint Committee on Taxation, *Climate Change Legislation: Tax Considerations*, (JCX-29-09), June 12, 2009. This document can also be found on our website at www.jct.gov.

I. OVERVIEW OF CAP AND TRADE

A. Cap and Trade: Explanation and Design Issues[2]

This section summarizes briefly some of the key design elements of cap-and-trade proposals.[3] First, all cap-and-trade proposals set an emissions target (this is the "cap") on greenhouse gas emissions from the emission sources covered by the program. The cap can be expressed in terms of a percentage reduction below a prior year's emissions level. For example, the Administration's proposal is to reduce emissions "14 percent below 2005 levels by 2020."[4]

The emissions cap is partitioned into emission allowances. Typically, one emission allowance represents the authority to emit one (metric) ton of carbon dioxide-equivalent. The "equivalent" is necessary, because greenhouse gases other than carbon dioxide--methane, nitrous oxide, sulfur hexafluoride, hydrofluorocarbons, and perfluorocarbons--vary in their global warming potential (GWP).[5] Thus, greenhouse gas emissions are presented in a standard form of measure. The emission allowances and offsets (described below) are designed to be freely tradable. Proponents of cap and trade envision an active market in emission allowance and offset trading, much like a commodity market.

Next, the proposals identify covered sectors of the economy, that is, the types of businesses or activities that must acquire emission allowances. The covered sources are likely to include major emitting sectors (e.g., power plants and carbon-intensive industries), fuel producers/processors (e.g., coal mines or petroleum refineries), or some combination of both. In almost every case, electric power producers are a covered sector. But other sectors of the economy that emit greenhouse gases (agriculture, for example) may not be covered.

In general, policymakers may decide to distribute the emission allowances to covered entities at no cost (based on, for example, previous years' emissions), sell the allowances through

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[2] Portions of this discussion are taken from Jonathan L. Ramseur, *Emission Allowance Allocation in a Cap-and-Trade Program: Options and Considerations*, CRS Report RL34502, June 2, 2008, Appendix A.

[3] A summary of all the current cap-and-trade proposals is beyond the scope of this pamphlet. For a summary of proposals introduced in the 111th Congress, see Jonathan L. Ramseur et. al., *Market-Based Greenhouse Gas Control: Selected Proposals in the 111th Congress*, CRS Report R40556, May 27, 2009; for proposals introduced in the 110th Congress see Larry Parker et. al., *Greenhouse Gas Reduction: Cap-and-Trade Bills in the 110th Congress*, CRS Report RL33846, June 27, 2008. The Obama Administration's proposal is outlined in its budget overview, *A New Era of Responsibility: Renewing America's Promise*, February 26, 2009, p. 29 (http://www.gpoaccess.gov/usbudget/fy10/pdf/fy10-newera.pdf).

[4] *Id.*

[5] GWPs are used to compare gases to carbon dioxide, which has a GWP of 1. For example, methane's GWP is 25, and is thus 25 times more potent a greenhouse gas than carbon dioxide. GWPs are typically based on estimates provided by the Intergovernmental Panel on Climate Change.

an auction, or use some combination of these strategies. For tax purposes, this design decision is perhaps the most important. Emission allocations can be distributed to entities in covered sectors at no cost (sometimes referred to as a "gratis allocation"). Alternatively, a gratis allocation can be made to persons that do not emit greenhouse gases but are likely to be affected by increased energy costs. For instance, emission allocations can be distributed to local distribution companies, which purchase and distribute electric power. In theory, the local distribution companies can sell the emission allowances and use the proceeds to offset the higher cost of electricity from generators. Instead of a gratis allocation, some proposals envision the sale of some or all emission allocations (typically through an auction mechanism).

Covered entities that face relatively low emission-reduction costs would have an incentive to make reductions whenever it costs the entity less to reduce emissions by one metric ton of carbon dioxide equivalent than it does to buy an emission allowance (the right to emit one metric ton of carbon dioxide equivalent). Other mechanisms, such as banking and offsets (explained below), may be included to increase the flexibility of the program.

At the end of each established compliance period (e.g., a calendar year), covered sources would be required to surrender emission allowances to cover the number of tons emitted. If a source did not have enough allowances to cover its emissions, the source would be subject to penalties.

Another important design decision is whether to permit emission allowances to be "banked" and carried forward to a future year. As discussed below, whether banking is permitted is also a crucial question for the tax analysis of cap-and-trade programs. For tax purposes, emission allowances that must be used, sold, or lost in a particular year could be treated differently than emission allowances that have a multi-year or indefinite useful life.

Finally, the proposals vary in their treatment of offsets, whether they are permitted and how they are certified. An offset is a measurable reduction, avoidance, or sequestration of greenhouse-gas emissions from a source not covered by an emission reduction program.[6] If a cap-and-trade program includes offsets, covered sources have the opportunity to purchase them to help meet compliance obligations.[7] In this way, offsets would complement the more traditional emission allowance trading that can occur between two covered sources.[8] For example, an organization could plant trees on previously non-forested land. Because trees sequester carbon, removing it from the atmosphere, the activity could constitute an offset. If the resulting carbon reduction were quantified, the organization planting the trees could be given a number of tradable offsets (essentially the equivalent of emission allowances) equal to the number of metric tons of carbon dioxide equivalent sequestered by the activity. These offsets could then be sold to a covered entity, allowing it to emit one metric ton of carbon dioxide

[6] Jonathan L. Ramseur, *The Role of Offsets in a Greenhouse Gas Emissions Cap-and-Trade Program: Potential Benefits and Concerns*, CRS Report RL34436, May 18, 2009.

[7] *Id.*

[8] *Id.*

equivalent. Some proposals limit offsets to domestic activities but others allow international activities (e.g., planting trees outside the United States) to create an offset.

B. Tax Questions Raised By a Cap-and-Trade System

Systematically determining the Federal tax treatment of the above-outlined features of a cap-and-trade program would serve to reduce uncertainty and disputes between taxpayers and the government. Both the Internal Revenue Service and the participants in a cap-and-trade program for greenhouse gas reduction will want clear guidance regarding several fundamental income tax questions. With respect to the emission allowances themselves, participants will expect to know (1) how and when any gratis allocations of emission allowances will be taxed; (2) the tax basis of emission allowances; (3) whether the cost of acquiring an emission allowance should be capitalized or deducted; (4) when and how any capitalized costs are to be recovered; and (5) the character of any gains and losses recognized on sale or exchange of allowances. Taxpayers undertaking activities that generate offsets also will need guidance regarding the tax treatment of income and expenditures related to such projects. Traders and dealers in emission allowances as well as the IRS would benefit from clarity in the law regarding any special rules that will apply to them, as will non-U.S. participants and tax-exempt participants in the U.S. emission allowance markets.

Though emission allowances would be a creature of new law, there may be relatively close analogies in existing law. Creating a new system of tax rules from scratch may not be necessary or appropriate if a set of tax rules already in the law that govern similar situations could be appropriately applied. Applying existing rules, if appropriate, could simplify the determination of tax results under a cap-and-trade program, particularly if there is a well developed body of law in the area. If an appropriate analogy can be identified, familiar present law rules could govern the issues identified above.[9]

In investigating the options for an appropriate starting analogy, it is helpful to recognize that emission allowances in a cap-and-trade system are expected to be "valuable financial instruments."[10] Moreover, provided the trading aspect of cap and trade results in the creation of a large and liquid market for the emission allowances, they could be almost "cash-like" in nature.[11] In this sense, emission allowances are like commodities. In fact, sulfur dioxide and nitrogen oxide emission allowances created by the Clean Air Act and several types of carbon

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[9] See generally, Matthew P. Haskins, *Tax Issues Relating to Trading in Carbon Emissions Rights*, Tax Notes, January 19, 2009, p. 381 (noting that "the technical [tax] result that seems most persuasive may depend on the starting analogy"). See also Karla W. Simon, Joseph G. Giannola, and Scott L. Landsbaum, Tax Treatment of Sulfur Dioxide Emissions Allowances, 55 Tax Notes 1397 (June 8, 1992), for a discussion of certain of these issues in relation to the sulfur dioxide emissions allowance program implemented by the Environmental Protection Agency under Title IV of the Clean Air Act Amendments of 1990.

[10] The allowances were described in this way in a May 15 letter from Congressional Budget Office Director Douglas Elmendorf to House Energy and Commerce Committee Chairman Henry Waxman. The letter is available on the CBO's website: http://www.cbo.gov/ftpdocs/102xx/doc10232/5-15-WaxmanLetter.pdf.

[11] *Id.*

credits (along with derivatives based on allowances and credits) already trade on commodities markets.

At the same time, emission allowances bear some resemblance to licenses that the government grants in other contexts, e.g., television broadcast licenses granted by the Federal Communications Commission, liquor licenses granted by State and local governments, and certain agricultural production quotas. Like these licenses, emission allowances are transferable, intangible assets, the useful life of which can be limited by statute.

The application of different analogies can lead to very different answers to the most basic tax questions presented by cap and trade. For example, whereas allocations of certain licenses by the government have been deemed to be nonrecognition events (i.e., no tax is imposed at the time the license is granted),[12] few would argue that a governmental distribution of a commodity, such as gold, oil, or pork bellies, should not be taxable to the recipient.

The discussion that follows addresses the fundamental income tax questions likely to be raised by a cap-and-trade program. Possible answers to these questions are proposed, based on the application of present law in analogous situations.

[12] See Andrew F. Dana, *Clear as Mud -- Taxation of Wetland Mitigation Banks*, 36 Journal of Real Estate Taxation 14, 16 (2008) (listing instances in which licensing and other regulatory schemes are not treated as producing income).

II. APPLICATION OF TAX PRINCIPLES TO A CAP-AND-TRADE SYSTEM

A. Taxation of Allocated Emission Allowances

A cap-and-trade system may provide for allocation of all or some portion of the emission allowances to certain firms in particular industries to compensate those firms for the potential costs of compliance with emission reduction requirements or the effects of increased energy costs. Firms that do not need all or a portion of their allocated allowances to comply with the emissions reduction requirements may sell unused allowances to other firms.

There are three alternatives for the tax treatment of allocated emission allowances. The allowances may be (1) included in income by the recipient upon receipt, (2) included in income by the recipient in the year the allowances are available to be surrendered for the right to emit, or (3) excluded from income of the recipient unless they are sold.

Inclusion in income upon receipt

Inclusion of the value of the emission allowances in income upon receipt would be consistent with the general rule under present law, which provides that gross income includes income from whatever source derived and defines income as any accession to wealth.[13] As indicated previously, the emission allowances are expected to be valuable financial instruments for which a market will exist. The prices of transactions in that market could therefore serve as a basis for determining the value of the emission allowances and the amount includible in income upon receipt. Alternatively, if a market for the allowances is slow to develop, or not as liquid as expected, a uniform valuation methodology may need to be established.

Under general income tax principles, a taxpayer that is required to recognize income upon the receipt of allocated emission allowances should have a corresponding increase in its basis in the allowances equal to the income recognized. This basis increase will reduce any gain that the taxpayer might realize upon a subsequent sale of the allowances and prevent the taxpayer from being taxed twice on the value of the allowances. If a taxpayer's emission allowances are surrendered in the year received, the taxpayer generally should have an offsetting deduction in the amount of its basis and thus have no net income with respect to such allowances. If, however, the allowances were not surrendered until a subsequent year, the taxpayer would recognize income in the year of allocation and might have net income attributable to the allowances (depending on the application of the basis recovery rules, discussed below).[14]

One potential issue with this initial-inclusion approach is the effect on the taxpayer's cash flows (particularly if the taxpayer banks and carries forward allocated allowances, but incurs a current tax liability on the receipt of such allowances). A similar problem could also occur if the allocated allowances are taxed at the time of allocation but can only be surrendered against

[13] Sec. 61; *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

[14] However, under present law, the basis in allowances surrendered would be capitalized under Sec. 263A if treated as a production cost of inventory or certain self-constructed property.

future years' emissions. However, this problem would be mitigated by the ability to sell the allowances, particularly if there is a large, liquid secondary market for the allowances.

Inclusion in income when first available for use

Another alternative would be to require inclusion of the value of the emission allowances in income in the year the allowances are first available for use (i.e., in the first year in which they may be surrendered). The tax outcomes discussed above generally would be applicable under this option, except that allowances that were not available for use in the year received (e.g., because they may by their terms be used only in a later year) and that are banked for future use or sale would not be taxed upon receipt. A taxpayer would recognize income equal to the value of the allowances available for use and increase its basis in those allowances by a corresponding amount. If the allowances were surrendered to meet its obligations under the cap-and-trade system, the taxpayer would receive a deduction equal to its basis in the surrendered allowances in the year of surrender.

This approach would be inconsistent with the expectation that the allowances will have a determinable value from the time of allocation, even if they can be used only in a future year. Its principal advantage is that it avoids the cash-flow issue that could be presented by taxing the value of an allowance upon receipt, as the tax year of income inclusion would generally be the tax year in which the allowances may be first utilized by the taxpayer. However, if a taxpayer sells allowances prior to the year in which such allowances are first eligible for surrender, the taxpayer generally would be required to recognize gain equal to the amount of the sales proceeds.[15]

Exclusion from income

The third approach would be to exclude allocated emission allowances from income of the taxpayer.[16] Under this option, the taxpayer would not have a basis in allocated emission allowances (although a taxpayer who purchased emission allowances would have a basis equal to its cost).[17] As a result, upon surrender of the allocated allowances in satisfaction of its obligation

[15] This assumes that no transaction costs paid in obtaining the allocated allowances were capitalized, and that any transaction costs on the sale reduce the sales proceeds.

[16] Limited exceptions are available under current law to exclude cash or the value of property received from gross income. One such exclusion is allowed under section 118, under which nonshareholder contributions to capital are excluded from income and reduce the basis of property acquired by such contribution. The exclusion applies only if the contribution (1) becomes a permanent part of the recipient's working capital structure, (2) is not compensation, such as a direct payment for a specific, quantifiable service provided by the recipient to the transferor, (3) is bargained for, (4) foreseeably results in benefit to the recipient in an amount commensurate with its value, and (5) is employed in or contributes to the production of additional income. See *United States v. Chicago, Burlington, & Quincy R.R.*, 412 U.S. 401, 413 (1973). This exclusion applies only to corporations.

[17] This assumes the taxpayer paid no transaction costs for the allocated emission allowances or, alternatively, that such costs were currently deductible.

under the cap-and-trade system, the taxpayer would claim no deduction. If the taxpayer sold all or some portion of the allocated allowances, the taxpayer would recognize gain equal to the difference between its basis (zero, in the case of an allocated allowance) and the proceeds received.

Excluding the allowances from income would be consistent with the holding of Revenue Ruling 92-16 on the treatment of sulfur dioxide and nitrogen oxide emission allowances issued by the Environmental Protection Agency under Title IV of the Clean Air Act Amendments of 1990.[18] That ruling does not include an explanation of its conclusion, and it is possible that the Internal Revenue Service simply viewed this approach as the simplest and most administrable. Alternatively, the ruling may reflect a determination that the allocation of emission allowances to the utilities participating in the sulfur dioxide allowance program simply compensated those utilities for a portion of the additional costs they would incur as a result of the emissions cap -- costs that they might not be able to pass through to consumers. As a result, the Internal Revenue Service may have determined that the free allocation of the sulfur dioxide allowances did not clearly result in a net accession to the wealth of the participating utilities.[19]

A reasonable argument for the lack of any accession to wealth could exist in the case of an entity with a regulated rate of return, such as a utility, that is required to pass through to its customers the benefits of any freely allocated allowances. However, in the case of an entity not subject to rate of return regulation that produces carbon intensive goods, the market prices of its products will be expected to rise as a result of cap and trade, regardless of whether it receives allowances for free.[20] Such a firm would in effect be compensated twice in a cap-and-trade regime in which it both receives higher prices for its products and receives its emission allowances for free. In such a case, the argument that there is no accession to wealth from the receipt of free allowances is more difficult to sustain.

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[18] 1992-1 C.B. 15 (allocated sulfur dioxide and nitrogen oxide emission allowances not included in gross income upon receipt).

[19] In the context of the sulfur dioxide allowance program, the argument was made that the grant of limited rights by a governmental agency to a taxpayer as a mechanism to ration previously unrestricted rights held by the taxpayer does not produce an accession to wealth for the taxpayer, and therefore the value of the allocated rights should not be includible in income by the taxpayer upon receipt. See, e.g., letter from George B. Javaras and Donald E. Rocap, Kirkland & Ellis, to Glenn A. Carrington, Internal Revenue Service, dated September 18, 1992, reprinted at 92 TNT 208-46.

[20] See Gilbert E. Metcalf, *Market-based Policy Options to Control U.S. Greenhouse Gas Emissions*, Journal of Economic Perspectives, Vol. 3, No. 2 (Spring 2009), at 19-20. See also Lans Bovenber and Lawrence Goulder, *Neutralizing the Adverse Industry Impacts of CO2 Abatement Policies: What does it cost?* In Distributional and Behavioral Effects of Environmental Policy, ed. C. Carraro and G.E. Metcalf, Chicago: University of Chicago Press, 2001. Bovenber and Goulder find in their analysis of a possible U.S. cap-and-trade system that free allocation of more than four percent of allowances in the coal industry and 15 percent in the oil and gas industry would overcompensate these industries for their losses.

Moreover, in other cases where a Federal and/or State government effectively reimburses taxpayers to offset increased statutory or regulatory compliance costs, the courts have required that such payments be included in income.[21] The cap-and-trade programs currently under consideration are also expected to be much broader in scope than the sulfur dioxide allowance program and, in particular, generally contemplate the allocation of allowances to persons who do not emit greenhouse gases. In that context, the relationship of the allocations to increased costs may be significantly less precise.

In addition, the number of utilities who received allowances under the sulfur dioxide program was relatively limited, and the market for trading the allowances was slow to develop. As a result, the sulfur dioxide allowances were arguably more difficult to value upon receipt, and were less readily convertible into cash. In contrast, the emission allowances allocated under a cap-and-trade program are expected to be readily marketable by both emitters and non-emitters and, in that respect, they are more clearly an "accession to wealth."

If, contrary to expectations, allocated emission allowances were restricted by the cap-and-trade legislation in a manner that rendered them more closely analogous to a governmental license or similar right, exclusion from income might be more appropriate. It is worth noting that exclusion would be consistent with other instances where the Internal Revenue Service has found that the receipt of property rights created under Federal, State, and local licensing and other regulatory schemes does not give rise to gross income upon receipt.[22] In those cases, however, those rights are generally nontransferable, or at least are not actively traded. As indicated above, present law concepts would suggest income inclusion for allocated allowances that are readily convertible into cash or cash equivalents and, in that respect, more closely resemble commodities.

Finally, a taxpayer who has a zero basis in an unused allocated emission allowance (because it was not required to include the value of the allowance in income on receipt) may have an increased incentive to bank the allowance, rather than sell it and reinvest the proceeds, because banking will defer payment of the tax on sale.[23] In other words, the existence of a zero

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[21] See, e.g., *United States v. Coastal Utilities, Inc.*, 483 F. Supp. 2d 1231 (S.D. Ga. 2007), aff'd, 514 F.3d 1184 (11th Cir. 2008) (universal service fund payments from State and Federal government were not nonshareholder contributions to capital, but were gross income upon receipt).

[22] Rev. Rul. 67-135, 1967-1 C.B. 20 (difference between fair market value and cost of lease obtained from Bureau of Land Management is not income); G.C.M. 38237 (Jan. 10, 1980) (value of gas rationing coupons excluded from income of recipient); Notice 2002-67, 2002-2 C.B. 715 (marketing quota holder who holds a quota that is derived from an original grant by the Federal government of an acreage allotment has a basis of zero in the quota); Notice 2005-51, 2005-2 C.B. 74 (same). See also, Andrew F. Dana, *Clear as Mud--Taxation of Wetland Mitigation Banks*, 36 Journal of Real Estate Taxation 14 (2008).

[23] See, e.g., Ethan Yale, *Taxing Cap-and-Trade Environmental Regulation*, 37 J. Legal Stud. 535 (June 2008), noting that where an emission allowance holder has a basis in the allowance that is less than its fair market value (so there is an unrealized gain), "sale and reinvestment is tax disadvantaged compared with banking because banking defers (without interest) the tax on sale. Forsaking the tax deferral makes sense only if the return on whatever replacement asset would be purchased with the

basis may exacerbate the "lock-in" effect that arises in many contexts by virtue of the realization requirement, i.e., the fact that the imposition of tax under the Code is predicated in most cases on a realization event, such as the sale or exchange of an asset. Some have argued that the "lock-in effect" could reduce the supply of allowances offered for sale and distort trading in the allowances. While such a lock-in effect might be expected to increase the price at which allowances trade (because those with unrealized gains are relatively reluctant to sell at prices insufficient to compensate them for the tax consequences of realizing those gains), it is not apparent that this effect presents any special distortion in this market as compared to any other market in which participants' gains are taxed on a realization basis. A Congressional Research Service analysis of the implications of transaction costs and taxes on sulfur dioxide allowance trading found only limited reasons to expect any influence of the tax system on allowance trading. The study suggested that the limitations on deduction of capital losses by speculators in allowances could result in somewhat fewer allowances being held for sale in future years (i.e., the opposite of a hoarding effect), concluding "with this fairly minor exception regarding capital losses on purchased allowances held for future sale, the tax system does not impose additional costs on the allowance trading system." [24]

[allowance] sale proceeds is high enough to compensate for the lost benefit." See also, Jacob Kreutzer, *Cap and Trade: A Behavioral Analysis of the Sulfur Dioxide Emissions Market*, 62 NYU Ann. Surv. Am. L. 125 (2006).

[24] Larry B. Parker and Donald W. Kiefer, *Implementing Sulfur Dioxide Allowance Trading: Implications of Transaction Costs and Taxes,* CRS Report 93-313, March 12, 1993.

B. Basis Recovery

A taxpayer that receives allocated emission allowances generally will have basis in such allowances equal to the amount of any income recognized upon receipt (or subsequently if recognition is delayed to a later year) plus any capitalized transaction costs. A taxpayer's basis in purchased allowances (including purchased offsets) generally equals the purchase price, increased by any transaction costs. With respect to allowances acquired in a tax-free exchange, the taxpayer's basis is generally equal to the basis in the property exchanged plus any additional consideration paid and any transaction costs.

Under present law, basis recovery generally would depend upon the characterization of the allowance by the holder. Allowances could be characterized as (1) inventory, (2) materials or supplies, (3) ordinary and necessary business expenses (other than supplies), (4) amortizable intangible property, or (5) nonamortizable intangible property.

Treating allowances as inventory would be appropriate if the holder of the allowances were a dealer in the allowances. However, for a taxpayer that is holding the allowance for surrender or investment, inventory treatment generally would not be appropriate under present law, which requires a taxpayer to maintain inventories where the sale of merchandise is an income producing factor.[25]

Emission allowances could be characterized as nonincidental materials or supplies, which under present law are deductible when consumed.[26] Under this approach, the basis in an allowance generally would be recovered upon surrender (i.e., when surrendering the allowance is the equivalent of consumption).[27] However, the Internal Revenue Service generally interprets the present-law definition of materials and supplies as including only tangible property.[28]

A similar result (deduction upon surrender of the allowance) may be achieved by treating the allowances as an ordinary and necessary business expense deductible in the taxable year such allowance would be taken into account under the taxpayer's normal method of accounting. For example, an accrual method taxpayer generally takes a liability into account when all events have occurred that fixed the fact of the liability, the amount of the liability is determinable with

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[25] Sec. 471.

[26] Treas. Reg. sec. 1.162-3. Note, however, that in TAM 200728032 (July 13, 2007), the Internal Revenue Service concluded that sulfur dioxide emission allowances are not supplies consumed in a taxpayer's trade or business, but instead are capital assets because the allowances are not tangible property.

[27] However, under present law, the basis in allowances surrendered should be capitalized under Sec. 263A if treated as a production cost of inventory or certain self-constructed property.

[28] See TAM 200728032 (July 13, 2007), wherein the Internal Revenue Service concluded that sulfur dioxide emission allowances are not supplies consumed in a taxpayer's trade or business, but instead are capital assets because the allowances are not tangible property. See also, G.C.M. 38237 (Jan. 10, 1980).

reasonable accuracy, and economic performance has occurred.[29] In the context of an emission allowance, these requirements typically would be met not later than when the allowance is surrendered in satisfaction of its obligation under the cap-and-trade system.[30]

Alternatively, if the allowances are characterized as an intangible property right, under present law the basis would be recovered either upon surrender, through amortization, or upon sale. The basis of a purchased intangible that is used in a taxpayer's trade or business and that has a definable useful life or is a section 197 amortizable intangible generally would be recovered through amortization.[31] If an intangible is not eligible for amortization, the basis generally would be recovered upon sale or other disposition (such as, for example, surrender).[32]

Where a deduction is permitted only in the year emission allowances are surrendered or sold, the opportunity for timing differences in income and deduction are eliminated.[33] Arguably, such an alternative would not influence a firm's decision to use or bank allowances. Additionally, the tax treatment would be the same under this approach if a taxpayer uses or sells the allowances. This is the approach the Internal Revenue Service has taken in the context of sulfur dioxide emission allowances.[34]

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[29] Sec. 461.

[30] However, as noted above, the basis in allowances surrendered would be capitalized under section 263A if treated as a production cost of inventory or certain self-constructed property. Note also, that in a cap-and-trade system that permits the surrender of allowances in a tax year subsequent to the year the taxpayer's activities generate covered emissions, the all-events test and economic performance possibly could be met in the earlier year.

[31] Sec. 167(a); Reg. Sec. 1.167(a)-3; Sec. 197(d)(1)(D). This assumes that the duration of the right is not less than 15 years or is not fixed as to amount and (without regard to Sec. 197) would be recoverable through a units-of-production or similar method. See section 197(e)(4)(D). See also, section 167 and Reg. Sec. 1.167(a)-3.

[32] However, if the taxpayer acquired an emission allowance as part of the acquisition of a trade or business or substantial portion thereof, no deduction would be allowed upon surrender unless the taxpayer held no other intangibles acquired in such acquisition at the time of surrender. Sec. 197(f).

[33] This is equally true if the emission allowances are characterized as supplies deductible when consumed or if allowed as a deduction in the year the Sec. 461 requirements are met and such requirements are met in the year surrendered.

[34] Rev. Proc. 92-91, 1992-2 C.B. 503. The Service has taken a similar approach with respect to gas rationing coupons (G.C.M. 38237 (Jan. 10, 1980)), and airport slots (G.C.M. 39606 (Feb. 16, 1987).

Sec. 197 was enacted subsequent to the issuance of Rev. Proc. 92-21. However, based on the legislative history, a sulfur dioxide emission allowance is considered a right that is fixed as to amount because each allowance grants the holder the right to a fixed amount of emissions and accordingly would not be a section 197 amortizable intangible if separately acquired. See H.R. Rep. 103-213, (August 4, 1993) at 683.

If, alternatively, the allowances are treated as amortizable intangibles, a taxpayer that banks allowances to be used in the future would claim amortization on the allowances effectively treating them as an intangible right used in the operation of its trade or business.[35] Treating the allowances as amortizable could affect the character of the gain or loss upon sale or exchange, which may bias a firm's decision to hold, use, or sell its allowances.

[35] This assumes that the banked allowances would be considered property used in the taxpayer's trade or business when acquired.

C. Tax Treatment of Offset Production

A cap-and-trade system may permit a firm to meet its obligations under such system in part through the use of offsets. An offset is a measurable reduction, avoidance, or sequestration of greenhouse gas emissions from a source not covered by an emission reduction program.[36]

Offsets typically are generated through projects whose primary objective is to reduce, avoid, or sequester emissions.[37] The types and locations of the projects may vary, and entities may be permitted to surrender international offsets to comply with domestic cap-and-trade system obligations. Projects involving sequestration of emissions may include planting trees on previously non-forested land, planting trees on formerly forested land, purchasing and preserving forested lands to limit deforestation, setting aside croplands from agricultural production to rebuild carbon in the soil, and performing soil conservation and erosion control activities.[38] Projects that avoid greenhouse gas emissions include renewable energy projects such as constructing wind farms for electricity generation, installing solar panels, installing methane digesters at livestock operations, and retrofitting boilers to accommodate biomass fuels, as well as projects that promote energy efficiency such as upgrading appliances and equipment to more efficient models, supporting construction of energy efficient buildings, and replacing incandescent light bulbs with fluorescent bulbs.[39] Finally, projects undertaken to reduce non-carbon dioxide greenhouse gas emissions are generally specific to the type of emission being reduced and typically relate to emission control technology. These projects might include reduction of methane emissions from coal mines, landfills or livestock operations.[40]

If offsets are permitted under a cap-and-trade system, the offset project would typically generate the equivalent of an emission allowance, which could be sold and traded in the same manner as emission allowances allocated or sold by a governmental agency.[41] In addition to the costs incurred in carrying out the project, a firm will typically incur transaction costs to obtain certification for the offsets. Transaction costs may include costs for investigating offset

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[36] Jonathan L. Ramseur, *The Role of Offsets in a Greenhouse Gas Emissions Cap-and-Trade Program: Potential Benefits and Concerns*, CRS Report RL34436, May 18, 2009. See also, Overview at A.2.

[37] *Id*.

[38] *Id*.

[39] *Id*.

[40] *Id*.

[41] Under the European Union's Emission Trading Scheme, offsets are "certified emission reductions ("CERs") if they originate from the Clean Development Mechanism and "emission reduction units" ("ERUs") if they originate from Joint Implementation projects. See Matthew P. Haskins, *Tax Issues Relating to Trading in Carbon Emissions Rights*, 2009 TNT 12-62 (Jan. 19, 2009).

opportunities, costs incurred in measuring, monitoring, and verifying reduced, avoided, or sequestered emissions, and costs to obtain certification/allowances from a regulatory agency.[42]

A firm contemplating a project with the primary objective of generating offsets will typically take into consideration the after-tax costs of the project. Similarly, the ability to generate offsets will be a consideration in evaluating the economic feasibility of projects (e.g., development of renewable energy sources), even where the generation of such offsets is not the primary purpose of the project.

The tax treatment of the production of offsets will depend upon, among other things, the nature of the project and whether the generation of offsets is the primary objective of the project. For example, a taxpayer may engage in a reforestation project in order to generate offsets that can be sold to firms required to meet greenhouse gas emissions reduction requirements. In conjunction with the project, the taxpayer may incur costs to acquire land, raw materials (trees, soil, fertilizer, etc.), labor, as well as costs in obtaining certification for the project (and the correspondingly tradable offsets) from the applicable regulatory authority, among other costs. Alternatively, a taxpayer may engage in the production of renewable energy (e.g., wind-turbine electricity generation). The taxpayer may incur costs for capital expenditures and current production, as well as costs to certify the project (and obtain tradable offsets). Similarly, a taxpayer may change an input in its production process that leads to a reduction in greenhouse gas emissions eligible for offset certification. The taxpayer may incur incremental costs for the change in input, as well as costs to certify the project (and obtain tradable offsets).

Each of these examples raises questions as to the appropriate tax treatment of the offset production, including, but not limited to the following: How does the taxpayer determine its basis in the offsets? Are all costs incurred with respect to the project included in the basis of the offset where the principal purpose of the project is to obtain the offset? If allocation is required, how is such allocation determined? When are such costs recognized (e.g., expensed as incurred, included in basis and recognized when the offset is sold)? What is the character of any gain or loss realized on the disposition of offsets received for a project, the principal purpose of which is to generate offsets (e.g., would the taxpayer be considered a dealer in offsets)? Are the continued maintenance costs of a project undertaken primarily to generate offsets deductible as incurred? Is the character determined with reference to the character of gain or loss on the disposition of the offsets generated by the project? If the production of offsets is not a primary purpose of the project, is the taxpayer required to allocate any costs to the offsets other than the direct costs of obtaining the offsets?

If, for example, the production of offsets for subsequent sale is the primary objective of a project, the offsets could be considered inventory for tax purposes. Under present law, a taxpayer that produces property for sale generally would use an inventory accounting method for such

[42] Jonathan L. Ramseur, *The Role of Offsets in a Greenhouse Gas Emissions Cap-and-Trade Program: Potential Benefits and Concerns,* CRS Report RL34436, May 18, 2009.

property.[43] Direct and indirect costs of production generally would be subject to capitalization and recognized under the taxpayer's inventory method when the produced property is sold.[44]

If the production of offsets is not the primary objective of the project, the taxpayer may be required to allocate its production costs to the offsets. In general, if a common production process produces multiple products, a taxpayer allocates the shared production costs among the products produced based on the products' relative sales values.[45] If the products produced have significantly different values, the products with lower values are commonly treated as by-products. Cost accounting principles may also support alternative allocation methods. For example, all common production costs could be allocated to the principal products, and no costs allocated to the by-products, and any revenue derived from the sale of the by-products treated as a reduction of the primary products' costs.[46] Alternatively, by-products could be allocated common production costs equal to their sales values with the result that any profit on the sale of by-products is effectively assigned to the primary products.[47]

If the project were treated as the production of property used in the taxpayer's trade or business, under present law the direct and indirect costs of the project generally would be capitalized and recovered through depreciation.[48] In such a case, the taxpayer's basis in the offsets could be limited to the direct costs of certifying the project.

The rules governing the treatment of offset production costs would need to be coordinated with the rules governing income inclusion upon receipt of allocated emission allowances. In particular, if the receipt of an allocated emission allowance were generally taxable, the amount includible in income in respect of any allowance received for an offset should be reduced by the amount of any offset production costs allocated to the allowance, in the same manner as if the taxpayer had paid that amount to purchase the allowance. In other words, the amount includible (and the taxpayer's basis in the allowance) would represent only the excess of the value of the allowance over the amount of the allocated offset production costs. If, on the other hand, allocated emission allowances were generally excludible from income, the taxpayer should receive basis in the allowance in an amount equal to the amount of the allocated offset production costs.

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[43] Sec. 471.

[44] Sec. 263A; sec. 471.

[45] See Treas. Reg. sec. 1.471-7. This is typically referred to as "joint product costing".

[46] See generally, Leslie J. Schneider, *Federal Income Taxation of Inventories*, LexisNexis (2008), at 8.03[2].

[47] Id.

[48] Sec. 263A; sec. 168. However, no depreciation would be allowed for the cost of land.

D. Sale or Exchange of Emission Allowances

Cap-and-trade systems typically provide for the sale and exchange of emission allowances (including offsets) -- the "trade" aspect of such system -- in addition to providing for the surrender of allowances to meet the holder's own obligations under the cap-and-trade system.[49] The trading aspect generally allows firms to profit from their ability to reduce emissions. It is believed that the trading aspect of a cap-and-trade system leads to overall cost savings because it provides flexibility in where and how emissions reductions are achieved.[50]

Under present law, the treatment of a sale of emission allowances generally depends upon the character of the allowance in the hands of the seller at the time of the sale. A taxpayer may hold allowances to satisfy its emissions reduction requirements for the current period or a future period, or may hold the allowances for investment. Additionally, certain taxpayers may purchase allowances as a dealer in such allowances.[51] It is also possible that a taxpayer's initial purpose for holding the allowance might change by the time of disposition; for example, from a purpose of use by surrendering the allowance to meet the taxpayer's own obligations in its business, to a purpose of resale, banking, or investment.[52]

Present law analogies may be considered in determining the potential tax consequences of a taxpayer's sale of allowances. A taxpayer typically recognizes gain or loss on the sale of property in an amount equal to the difference between the taxpayer's basis in the property sold and the fair market value of consideration received in exchange for the property.[53] The character of the gain or loss depends on the character of the property being disposed of and the nature of the taxpayer's interest in the property. For example, if the allowances are characterized as a commodity and the taxpayer is a dealer in the allowances, any gain or loss on the sale of the allowances would be ordinary. If the allowances are considered a commodity, but the taxpayer is not a dealer, the character of any gain or loss would likely depend on whether the allowances are held for use in the taxpayer's business and whether they are treated as depreciable or are held for investment.

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[49] This discussion presumes that the surrender of emission allowances (including offsets) is not a sale or exchange transaction. Similarly, acquisition of allowances or offsets for a business purpose other than to meet an obligation to reduce emissions, is not a sale or exchange transaction (for example, where a taxpayer purchases allowances for marketing purposes).

[50] Statement of Peter R. Orszag, Director, Congressional Budget Office, Testimony Before the House Committee on Ways and Means, September 18, 2008, available at http://waysandmeans.house.gov/media/pdf/110/orszag.pdf.

[51] See the discussion in section II.E. of this document.

[52] A taxpayer also might purchase allowances or create or purchase offsets as a marketing tool, to promote the taxpayer's commitment to carbon emissions reduction.

[53] Sec. 1001.

If the emission allowances are treated as an amortizable intangible used by the taxpayer in its trade or business, the recapture rules of section 1245 generally would require that any gain on the sale of the allowances be treated as ordinary income (to the extent of previous depreciation deductions), notwithstanding other income tax rules. Gain in excess of the recapture amount is generally capital gain under section 1231, which applies to the disposition of property used in a trade or business, held for more than one year, and subject to depreciation. If a taxpayer has net gains from the disposition of section 1231 property for any taxable year that exceed its losses, then such net gains are generally treated as long-term capital gains; if a taxpayer has net losses on the disposition of section 1231 property for any taxable year, such net losses are not treated as capital losses. A taxpayer may be required to recharacterize a portion of section 1231 gains as ordinary income to the extent the taxpayer recognized section 1231 losses during the prior five tax years.

Emission allowances characterized as nonamortizable intangibles or held for investment by a taxpayer are typically capital assets.[54] The disposition of a capital asset will generate a capital gain or a capital loss.[55]

As indicated above, treating the allowances as a nonamortizable intangible would cause any gain or loss on the sale of the allowances to be capital for all taxpayers except a dealer. This is the approach the Internal Revenue Service has taken with respect to sulfur dioxide emission allowances and emission allowances issued by the European Union.[56] This approach would not provide parity between taxpayers (non-dealers) that sell allowances and those that surrender allowances to meet their obligations under a cap-and-trade system, because the latter would receive an ordinary deduction equal to their basis in the surrendered allowances.

Another option would be the creation of a new regime for emission allowances that would treat all transactions involving such allowances in as similar a manner as possible, so as to

[54] A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies.

[55] Capital losses generally may only offset capital gains; however, an individual may deduct capital losses against up to $3,000 of ordinary income in each year. Unused capital losses generally may be carried back three years and forward five years by a corporation, and carried forward indefinitely by an individual. See Secs. 1211 and 1212.

[56] Rev. Proc. 92-91, 1992-2 C.B. 503; Priv. Ltr. Rul. 200825009 (June 20, 2008). See also, Priv. Ltr. Rul. 200728032 (July 13, 2007), wherein the Internal Revenue Service concluded that sulfur dioxide emission allowances were not supplies of a type regularly consumed by the taxpayer in its trade or business because the allowances are not tangible property.

reduce uncertainty (for example, to provide ordinary treatment for all gains and losses in allowances).[57]

It would also be possible to consider whether there are mechanisms that might make allowances more liquid, by reducing incentives to hold allowances rather than sell them.[58] One such approach might be to assure matching of the deduction for the cost of the allowance against income recognition at the time of the recognition event, so as to discourage possible beneficial early deductions followed by a later disincentive to sell at a gain (and at the same time encourage acquisition of allowances for their most beneficial use, without regard to whether such use might otherwise require capitalization and amortization of the cost over time).

Another approach might be to provide a mark-to-market system for all taxpayers, so that the decision whether to hold or to sell an allowance would be more tax-neutral. One issue with respect to a mark-to-market system is that some taxpayers could owe tax due to appreciation without having received cash; an issue that would be exacerbated under volatile market conditions. Some options to address such concerns might include permitting an averaging of income, or simply relying upon market liquidity to permit sales of allowances if necessary to generate cash.

Like-kind exchange

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" which is also to be held for productive use in a trade or business or for investment.[59] If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the taxpayer, and further adjusted for any gain or loss recognized on the exchange.

In general, any kind of real estate is treated as of a like-kind with other real property as long as the properties in an exchange are both located either within or outside the United States. Similarly, certain intangibles are treated as like-kind with other intangibles (e.g., FCC licenses).[60] By contrast, different kinds of personal property (e.g., equipment and vehicles) are not treated as of like kind. In addition, certain types of property, such as inventory, stocks, bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031.

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[57] See, e.g., Australian Government Carbon Pollution Reduction Scheme Green Paper (July 2008) www.climate change.gov.au. (Chapter 11).

[58] *Id*.

[59] Sec. 1031.

[60] See, e.g., TAM 200224004 (June 14, 2002); TAM 200035005 (Sep. 5, 2000).

The Internal Revenue Service has ruled that emission allowances issued by the Environmental Protection Agency under Title IV of the Clean Air Act Amendments of 1990 are like-kind property regardless of the year to which the allowances are allocated, such that an exchange of allowances qualifies for nonrecognition treatment under section 1031.[61] Treatment of emission allowances as like-kind property eligible for tax-free exchange treatment could encourage the exchange of current and future-dated emission allowances by removing the tax cost of disposing of the emission allowance.[62]

[61] Rev. Proc. 92-91, 1992-2 C.B. 503.

[62] This presumes that the allowances eligible for like-kind exchange treatment are not marked-to-market.

E. Tax Aspects of Trading Emission Allowances and Emission Allowance Derivatives

There likely will be two primary categories of emissions instruments trading in a greenhouse gas market: allowances (including verified offset allowances) and allowance derivatives (primarily futures and options).[63] Such allowances may trade on an existing exchange, on a new exchange, and/or "over the counter" (meaning, no exchange facilitates the transaction). Consequently, it is not clear who the primary market regulator will be. Possible regulators include the Commodity Futures Trading Commission ("CFTC"), the Securities Exchange Commission, the Federal Energy Regulatory Commission, the Environmental Protection Agency, or a new agency.[64]

The trading of sulfur dioxide and nitrogen oxide emission allowances (in particular, derivatives based on these allowances), provides a possible indication of what trading in greenhouse gas allowances might look like. Sulfur dioxide and nitrogen oxide emission allowance futures are now traded on the Chicago Climate Futures Exchange;[65] similarly, sulfur dioxide and nitrogen oxide emission allowance futures and options trade on the New York Mercantile Exchange ("NYMEX").[66] Both exchanges are "designated contract markets," regulated by the CFTC. Thus, at least for regulatory purposes, Congress will need to determine whether by analogy greenhouse gas emission allowances should be treated as commodities, and whether futures and options with respect to greenhouse gas emission allowances will be treated as commodities derivatives. If Congress decided on this treatment, it may be reasonable to extend special tax rules that apply to commodities dealers and traders to dealers and traders in greenhouse gas allowances.

Special rules for commodities dealers and traders

Under present law, dealers and traders in commodities can elect to be taxed under the mark-to-market accounting method described in section 475.[67] In general, where an eligible commodities dealer or trader elects mark-to-market treatment, commodities held by such person at the close of any taxable year are treated as if they were sold for fair market value, and the gain

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[63] Jonas Monast et. al., U.S. Carbon Market Design: Regulating Emission Allowances as Financial Instruments, Nicholas Institute for Environmental Policy Solutions Climate Change Policy Partnership Duke University, working paper, p. 6 http://www.nicholas.duke.edu/ccpp/ccpp_pdfs/carbon_market_primer.pdf, (accessed June 2009).

[64] See *id*. at 3.

[65] See Chicago Climate Futures Exchange Corporate Overview Brochure, available at http://www.ccfe.com/about_ccfe/ccfe_overview_brochure.pdf.

[66] See NYMEX press release (undated) at http://nymex.greenfutures.com/notices/ntm138.php; *see also* http://nymex.greenfutures.com/markets/.

[67] See Sec. 475(e) (mark-to-market election for dealers in commodities); Sec. 475(f) (mark-to-market election for traders in commodities).

or loss on such commodities is taken into account, generally as ordinary income or loss. Dealers and traders in commodities that do not make a mark-to-market election are taxed on a realization basis, that is, tax is imposed only when commodities are sold or exchanged.

Congress may want to encourage or require mark-to-market elections for dealers and traders of emission allowances, because the requirement to mark to market results in a clear reflection of income and in particular eliminates the ability to recognize losses while deferring gains. A common objection to the expansion of mark-to-market rules is that it can be difficult to measure the "fair market value" of certain illiquid assets, making it difficult for a taxpayer to calculate accurately gains and losses from such assets. But in the case of standardized greenhouse gas emission allowances under proposed cap-and-trade programs, the secondary market is likely to be large and liquid.[68]

Commodities derivatives

Regulated futures contracts and listed nonequity options

Commodities derivatives often trade in the form of commodities futures contracts and options to buy or sell commodities.[69] Certain "regulated futures contracts," i.e., contracts that are traded on an exchange that serves as a clearinghouse and requires participants to post variation margin, are subject to special tax rules under section 1256.[70] These rules also apply to "nonequity options," i.e., any options that are traded on a qualified board or exchange (other than options to buy or sell stock).[71]

The rules in section 1256 typically apply to futures and options with respect to physical commodities, but they also can apply to futures and options with respect to indexes and algorithms that are not themselves physical assets. For example, a futures contract, the value of which is based on a broad-based index of stocks or securities, can be a section 1256 contract

[68] In contrast, the market for sulfur dioxide and nitrogen oxide emission allowances was much more limited and not very liquid. The acid rain reduction program was phased in over time; initially, only 110 facilities were covered by emission reduction requirements. *See* Jeffrey M. Hirsch, *Emissions Allowance Trading Under The Clean Air Act: A Model For Future Environmental Regulations?*, 7 NYU Environmental Law Journal 353, 361 at fn. 54 (1999).

[69] A commodities futures contract is "an agreement to purchase or sell a commodity for delivery in the future: (1) at a price that is determined at initiation of the contract; (2) that obligates each party to the contract to fulfill the contract at the specified price; (3) that is used to assume or shift price risk; and (4) that may be satisfied by delivery or offset." U.S. Commodity Futures Trading Commission, Glossary, available at http://www.cftc.gov/educationcenter/glossary/glossary_f.html.

[70] See section 1256(g), defining the term "regulated futures contract" as a contract "(A) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and (B) which is traded on or subject to the rules of a qualified board or exchange."

[71] See *id.*

(provided the other requirements of section 1256 are met). The application of the special rules in section 1256 to emission allowance futures and options thus would not, absent any decision to revise those rules, be contingent upon a determination that emission allowances are commodities. Rather, the application of the rules will depend on whether the contracts are "regulated futures contracts" or "nonequity options."

In general, section 1256 requires taxpayers to treat each section 1256 contract as if it were sold (and repurchased) for its fair market value on the last day of the year (i.e., "marked to market"). Any gain or loss with respect to a section 1256 contract that is subject to the mark-to-market rule is treated as short-term capital gain or loss, to the extent of 40 percent of the gain or loss, and long-term capital gain or loss, to the extent of the remaining 60 percent of the gain or loss. Gains and losses upon the termination (or transfer) of a section 1256 contract, by offsetting, taking or making delivery, by exercise or by being exercised, by assignment or being assigned, by lapse, or otherwise, also generally are treated as 40 percent short-term and 60 percent long-term capital gains or losses.

The special rule in 1256(a) treating gains and losses as 60 percent long-term capital gains and losses and 40 percent short-term capital gains and losses (the "60/40 rule") does not apply to (i) hedging transactions (as defined in section 1221(b)(2)(a)), (ii) a section 1256 contract that is part of a mixed straddle if the taxpayer elects to have section 1256 not apply to the section 1256 contract, or (iii) any section 1256 contract held by a dealer in commodities or by a trader in commodities that makes the mark-to-market election in section 475.[72]

In general, the 60/40 rule in section 1256 provides a significant tax benefit to certain commodities traders and dealers, allowing them to convert 60 percent of gains from frequent trading that otherwise would be short-term capital gains or ordinary income into long-term capital gains that are taxed at a lower rate. Congress may want to consider whether this benefit should be available for dealers and traders of emission allowances under a cap-and-trade program.[73]

Other commodities derivatives

A number of complex rules apply to the taxation of commodities derivatives that are not section 1256 contracts. Such derivatives include over-the-counter commodity options and forward contracts (i.e., options and forward contracts not traded on a regulated exchange) and notional principal contracts with respect to commodities.[74]

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[72] See Sec. 475(d)(1).

[73] The Administration's 2010 budget proposes to change the rule in section 1256 to require certain dealers of equity options and commodities to treat their gains and losses from 1256 contracts as ordinary income. *See General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* at 110 (available at http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf).

[74] Joint Committee on Taxation, *Present Law and Analysis Relating to the Tax Treatment of Derivatives*, (JCX-21-08), March 4, 2008.

One issue that has been raised recently with respect to commodities trading and commodities derivatives trading is whether the participation of institutional investors and arbitrageurs in certain commodities markets (in addition to the commodities' end-users) inflates prices for end users of the commodities.[75] To the extent one believes that the participation of institutional investors and arbitrageurs distorts commodities markets, a tax policy that discourages their participation might be justified. Such a policy might include tax rules that impose a relatively lower tax burden on end users and a higher tax burden on speculators. On the other hand, to the extent that institutional investors and arbitragers make the market more efficient and more liquid, discouraging their participation could damage the market's price-discovery function, make the market less transparent and less liquid. In the context of markets for greenhouse gas emission allowances, tax rules that make a secondary market less transparent and or less liquid could undermine the efficacy of the cap-and-trade program, which relies on the secondary markets to allocate the emission allowances efficiently.

[75] See Michael W. Masters, testimony before the Senate Committee on Homeland Security and Governmental Affairs, May 20, 2008 (arguing that institutional investors contribute to price inflation in food and energy markets). A number of other experts took issue with Master's argument. For example, Jeffrey H. Harris, Chief Economist of the Commodity Futures Trading Commission, argued in his testimony at the same hearing that commodity price increases at the time of the hearing were largely unrelated to trading by index funds, hedge funds, or commodity pools.

F. International Tax Considerations

Background

Potential U.S. tax issues related to a cap-and-trade system include a number of considerations related to cross-border activities of U.S. and foreign taxpayers. Foreign affiliates of U.S. companies may engage in activities abroad that generate offsets (tradable as emission allowances), and those affiliates may sell those allowances on the open market or to their U.S. owners. Foreign affiliates of U.S. companies also may operate as traders or investors by buying and selling emission allowances on the open market. Foreign companies with U.S. business operations similarly may conduct offset producing activities in the United States, and those companies may buy and sell offset and emission allowances to related parties or on the open market. These and other activities raise several issues under the present U.S. international tax regime, including whether any income derived from a foreign affiliate's activities would be taxed under the anti-deferral rules; whether a foreign person's U.S. activities would be treated as part of a U.S. trade or business giving rise to income taxed in the United States on a net basis; and whether related-party transactions would be respected under the arm's-length standard of the transfer pricing rules. This section summarizes the U.S. tax rules related to cross-border activities of U.S. and foreign persons and provides an overview of questions that may arise under those rules in a cap-and-trade system.

Present law

U.S. persons with foreign activities

The United States employs a "worldwide" tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income whether derived in the United States or abroad. Income earned directly or through a pass-through entity such as a partnership is taxed on a current basis. By contrast, active foreign business earnings that a U.S. person derives indirectly through a foreign corporation generally are not subject to U.S. tax until the U.S. person receives a dividend distribution of those earnings. This favorable rule in turn is circumscribed by regimes intended to restrict or eliminate the benefit of tax deferral. These regimes apply to certain categories of passive or highly mobile income (the subpart F rules) or when the foreign corporation through which income is derived has substantially passive income or assets (the passive foreign investment company, or "PFIC" rules).

In general, the subpart F regime taxes on a current basis a 10-percent U.S. shareholder's pro rata share of certain earnings of a foreign corporation that is majority owned by five or fewer 10-percent U.S. shareholders (a "controlled foreign corporation").[76] The income to which the subpart F rules apply includes dividends, interest, rents, and royalties (collectively referred to as "foreign personal holding company income"), and sales or services income from certain related-party transactions ("foreign base company sales income" and "foreign base company services

[76] See secs. 951-964.

income"). Subpart F also generally imposes tax when a controlled foreign corporation invests its earnings in U.S. property.[77]

The PFIC regime applies when a U.S. individual or corporation owns any amount of stock of a foreign corporation that has predominantly passive income (foreign personal holding company income) or passive assets.[78] To eliminate the U.S. shareholder's benefit from deferring U.S. tax, the PFIC rules assess an interest charge on certain dividend distributions by a PFIC to the shareholder. In certain circumstances a U.S. shareholder of a PFIC instead may elect under one of two alternative regimes to be taxed on a current basis in respect of its ownership of PFIC stock.

Foreign persons with U.S. activities

The United States has two alternative regimes for taxing foreign persons with U.S. activities. A foreign person is taxed on income that is "effectively connected" with the conduct of a U.S. trade or business (or income attributable to a U.S. permanent establishment if the foreign person were eligible for benefits of a U.S. income tax treaty) under the same net income tax rules that apply to U.S. individuals. Income that is not connected with a U.S. trade or business is taxed, if at all, under a gross-basis withholding tax imposed at a 30-percent rate (subject to possible reduction under an income tax treaty between the United States and the foreign person's country of residence). A foreign person's capital gains not connected with a U.S. trade or business generally are not subject to U.S. tax, and most interest income (referred to as "portfolio interest") of foreign investors also is not taxed in the United States.

Various rules govern whether a foreign person is considered to be engaged in a U.S. trade or business, including provisions for determining whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.[79] Under these rules, a foreign person's trading in stock or securities or commodities through an independent agent generally is not treated as the conduct of a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which the trades are made. Trading in stock or securities or commodities for the foreign person's own account also generally is not treated as the conduct of a U.S. business provided that the foreign person is not a dealer in stock or securities or commodities.

Transfer pricing

Because tax rates vary from one country to another, a multinational enterprise may have an incentive to shift income, deductions, or tax credits among commonly controlled entities to arrive at a reduced overall tax burden. This shifting of items between commonly controlled entities could be accomplished by setting artificial transfer prices for transactions between group

[77] Sec. 956.

[78] See secs. 1291-1298.

[79] Sec. 864(b)(2).

members. The Treasury Secretary is authorized to redetermine the income of an entity subject to U.S. taxation when it appears that an improper shifting of income between that entity and a commonly controlled entity in another country has occurred.[80] In particular, the Secretary has broad authority to allocate income, deductions, credits, or allowances between any commonly controlled organizations, trades, or businesses to prevent evasion of taxes or clearly to reflect income. The statute does not prescribe specific reallocation rules; detail is left to regulations. Regulations adopt the concept of an arm's length standard as the method for determining whether reallocations are appropriate. The regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated.

Cross-border tax issues related to a cap-and-trade system

Foreign and domestic offset producing activities

A cap-and-trade system might permit offset production abroad as well as in the United States. A U.S. firm's foreign offset producing activities and a foreign firm's U.S offset production activities would raise U.S. international tax questions.

If a U.S. company owned or invested in a foreign corporation that engaged in projects to reduce, avoid, or sequester emissions, those projects could generate offsets that a cap-and-trade system might permit to be traded in the same manner as emission allowances or might permit to be sold to a U.S. affiliate that is a covered entity under the U.S. cap-and-trade system. If a foreign corporation had income from the production or sale of offsets, a question would be whether the income should be treated as foreign personal holding company income under the subpart F or PFIC rules, thereby subjecting the U.S. shareholder of the corporation to current U.S. tax or to an interest charge on distributions, or instead should be viewed as some form of active business income not subject to anti-deferral rules.[81]

There is little guidance on this question of income characterization. In a ruling concerning a controlled foreign corporation's and controlled foreign partnership's sales to unrelated purchasers of surplus emission allowances under the European Union's Emissions Trading Scheme, the IRS concluded that the income from the sales was not foreign personal holding company income.[82] In ruling as it did, the IRS declined to adopt the taxpayer's argument that the income from the sale of surplus emission allowances avoided treatment as foreign personal holding income by reason of the exception for active business gains or losses from the sale of commodities.[83] Instead, citing applicable Treasury regulations, the IRS held

[80] Sec. 482.

[81] If a U.S. person invested in a foreign branch or partnership rather than in a foreign corporation, the U.S. person would be taxed currently in the United States on any offset-related income derived by those branches or partnerships.

[82] PLR 912825207 (June 20, 2008).

[83] Sec. 954(c)(1)(C)(ii).

that, solely for purposes of the ruling, the allowances were intangible property used in the sellers' active businesses, and income from the sales, therefore, was not foreign personal holding company income.[84] Offset production and sale under a U.S. cap-and-trade system might raise similar questions of whether resulting income is from intangibles, from commodities, or from some other activity such as manufacturing. Treating income related to the sale of offsets by offset producers as passive income under the subpart F or PFIC rules might create a tax disincentive for U.S. multinational firms to engage in offset production activities abroad. Congress may want to consider whether such a disincentive is appropriate and whether new tax rules should be developed to address the question.

Just as a U.S. firm might engage in offset production activities abroad through a foreign corporation, a foreign firm might engage in offset production activities in the United States. The foreign firm then could sell offsets to related parties or in the open market. A question would be whether the foreign person's activities in the United States constituted the conduct of a U.S. trade or business and gave rise to income effectively connected with that business (or, if the foreign person were eligible for benefits of a U.S. income tax treaty, whether the foreign person had income attributable to a U.S. permanent establishment). Any effectively connected income (or income attributable to a permanent establishment) generally would be taxed by the United States on a net basis. If the foreign person's offset producing activities in the United States did not constitute a U.S. trade or business or permanent establishment because they were more in the nature of an investment, payments from the United States to the foreign person generally would be subject to U.S. gross-basis withholding tax unless the payments represented capital gains or portfolio interest or benefited from an exemption from withholding tax under a U.S. income tax treaty. A question in this context might be whether the foreign person's trading of offsets would benefit from the securities or commodities trading safe harbor (described below).

Purchase and sale of emission allowances as an investor or trader

Rather than engaging in offset production activities, a foreign corporation with U.S. or foreign owners might simply buy and sell emission allowances on the open market.

A U.S.-owned firm's purchase and sale of emission allowances would raise the same question of income characterization described previously in the context of offset production activities: would income from the sale of emission allowances be subject to the U.S. anti-deferral rules? If the U.S.-owned firm qualified as a dealer and the emission allowances were treated as dealer property, the associated income would not be subject to the U.S. anti-deferral rules.[85] This exception for dealer property, however, would not apply to any purchase and sale of emission allowances held for investment or speculative purposes on the firm's own behalf or on behalf of a related person.[86]

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[84] Treas. Reg. sec. 1.954-2(e)(3)(iv).

[85] Treas. Reg. sec. 1.954-2(e)(1)(ii)(B).

[86] Treas. Reg. sec. 1.954-2(a)(4)(v)(A)(2).

If a foreign-owned foreign firm engaged in the trading of emission allowances in the United States (and did not engage in other business activities), the securities or commodities trading safe harbors might permit the firm to avoid having a U.S. trade or business. These safe harbors would be available only if, among other requirements, the (1) foreign firm's trading activities were not extensive enough that the firm would be treated as a dealer in emission allowances, and (2) the emission allowances themselves were treated as securities or commodities. In considering a cap-and-trade system, Congress may want to consider whether the favorable securities and commodities trading rules should be extended explicitly to apply to trading in emission (and offset) allowances. A question is whether the rationale for the present law safe harbors -- to encourage foreign investors to supply capital and liquidity to the U.S. markets -- would apply equally to an emissions trading scheme.

Related party transactions

Whenever a multinational corporation with U.S. operations has intercompany transactions between its U.S. operations and other members of its worldwide group, U.S. and foreign transfer pricing issues may arise. Thus, a multinational corporation subject to a U.S. cap-and-trade regime may have transfer pricing questions when it undertakes offset producing activities in one jurisdiction and sells offsets to a related party in another jurisdiction for use or resale there. For example, if a foreign affiliate of the worldwide group engages in offset producing activities in its home country and sells the offsets it receives to a related U.S. operating affiliate ("U.S. affiliate"), it will be necessary to determine the appropriate intercompany price between the U.S. affiliate and the foreign member. If there is a liquid market for offsets and emission allowances, the appropriate transfer price may simply be the market price of the offsets sold by the foreign affiliate to the U.S. affiliate. If, however, a multinational corporation engaged in offset producing activities itself instead of acquiring offsets and emission allowances in the open market because it was able to produce offsets more cheaply than it could buy them on the market,[87] the multinational group may derive excess profits that would need to be allocated across two or more jurisdictions under transfer pricing rules. Possible transfer pricing approaches may include the following:

- The U.S. affiliate purchasing the offsets from the foreign affiliate at the same price at which the offsets could be sold on the market;
- The U.S. affiliate purchasing the offsets from the foreign affiliate based on the market price of the offsets less a discount to reflect certain functions performed or risks borne by the U.S. affiliate that would otherwise have to be undertaken by the foreign affiliate if it sold the offsets in the markets; or,
- The U.S. affiliate bearing the economic risks for the offset production activities undertaken by the foreign affiliate and then compensating that foreign affiliate as a service provider based on the foreign affiliate's costs incurred plus an appropriate mark-up.

[87] This scenario -- producing offsets more cheaply than the price at which they could be bought on the U.S. market -- could be realistic for a U.S. company with operations in less developed countries.

To the extent a transfer pricing approach is based on the price of an emission allowance in the open market, additional transfer pricing issues may arise if there are changes in the market price of offsets between the time when they are purchased from the foreign affiliate and when they are sold in the market.

In certain circumstances, however, a multinational's desire to minimize U.S. tax liability may be in tension with a desire to minimize other non-tax financial risks. For example, if less developed countries in which a multinational group operates have hyperinflationary risks or exchange control provisions that make it difficult to access cash, entering into a transfer pricing methodology that minimizes the amount of excess cash remaining within the less developed country could be important.

Tax arbitrage

Differences in timing of income recognition and characterization of receipts and expenses under U.S. and foreign tax laws related to cap-and-trade activities may present tax arbitrage concerns. For example, one jurisdiction could treat the emission allowances and offsets as intangible property and another jurisdiction may treat them as commodities. Differing treatment under the tax laws of different countries could create planning opportunities for taxpayers and administrative concerns for governments. To the extent the current tax rules of foreign countries clearly address issues that might arise under a U.S. cap-and-trade system, Congress may want to consider whether the U.S. tax rules should conform to or diverge from the rules of other countries.

G. Sales of Offsets by Tax-Exempt Organizations

In some cases, the program activities of a tax-exempt organization, such as a section 501(c)(3) conservation organization, might make the organization eligible to obtain offsets. A tax-exempt conservation organization, for example, might purchase forested land and protect the forests from destruction using easements or other legal mechanisms.[88] An ancillary effect of this tax-exempt activity might be the sequestration of carbon that otherwise would have been released.[89] This sequestration of carbon, in turn, might qualify the organization to obtain offsets under certain cap-and-trade programs. If the tax-exempt organization obtains and later sells these offsets, the question may arise whether the income from the sale is exempt from tax or is taxable as unrelated business taxable income ("UBTI").[90]

The Code imposes a tax, at ordinary corporate rates, on the income that a tax-exempt organization realizes from an "unrelated trade or business . . . regularly carried on by it."[91] Generally, an "unrelated trade or business" is "any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose."[92] The Code thus sets up a three-part test for determining whether income from an activity is subject to the unrelated business income tax: (1) the activity constitutes a trade or business; (2) the activity is regularly carried on; and (3) the activity is not substantially related to the organization's tax-exempt purposes. The fact that a charity requires revenues to accomplish its charitable mission does not make a revenue raising activity (e.g., fund raising) related to its exempt purposes.[93]

Section 512(b)(5) of the Code excludes from UBTI "all gains or losses from the sale, exchange, or other disposition of property, "other than: (1) stock in trade or other property of a kind that ordinarily would be included in inventory, or (2) property held primarily for sale to customers in the ordinary course of the trade or business."[94] A threshold question, therefore, is whether income from the sale of offsets by a tax-exempt organization would constitute gain from the sale of property within the meaning of section 512(b)(5). If so, the gain generally would be excludable from the organization's UBTI, unless, for example, the organization is regarded as a dealer in such offsets.

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[88] See Congressional Research Service, *The Role of Offsets in a Greenhouse Gas Emissions Cap-and-Trade Program: Potential Benefits and Concerns* (May 18, 2009), at 3-4.

[89] See *id.*

[90] See secs. 511-514.

[91] Secs. 512(a)(1), 511(a)(1).

[92] Sec. 513(a).

[93] Treas. Reg. sec. 1.513-1(a).

[94] Sec. 512(b)(5); Treas. Reg. sec. 1.512(b)-1(d).

Even if proceeds from the sale of offsets would not be treated as excludable gain under section 512(b)(5), proceeds from a tax-exempt organization's acquisition and sale of offsets would be taxable as UBTI only if such activities are "regularly carried on" by the organization.[95] One-time sales of offsets or intermittent sales that occur infrequently, for example, generally should not be regarded as regularly carried on. On the other hand, sales of offsets that are conducted with a frequency and continuity similar to commercial activities of non-exempt organizations are more likely to be viewed as being regularly carried on.[96] Therefore, the frequency and continuity with which sales of offsets are made likely would be a key factor in determining whether proceeds from such sales are taxable as UBTI.

An additional question might be whether obtaining and selling offsets that result from a tax-exempt organization's program-related (e.g., conservation) activities would be regarded as related to the organization's exempt purposes, such that income from such activities would be non-taxable. Treasury regulations provide generally that the sale of a product that results from the performance of exempt functions will be treated as substantially related to the organization's exempt functions if the product is sold in substantially the same state it is in on the completion of the exempt functions.[97] If, on the other hand, a product that results from exempt functions is utilized or exploited in a further business endeavor beyond that reasonably necessary or appropriate for its disposition in the state it is in upon completion of the exempt functions, the sale would not be considered substantially related to the organization's exempt purposes.[98] As an example, the regulations provide that the sale of milk and cream by a section 501(c)(3) scientific research organization produced in the ordinary course of maintaining an experimental dairy herd for scientific purposes would not generate gross income from an unrelated trade or business; if, on the other hand, the organization were to use the milk and cream for the further manufacture of food items such as ice cream, income from the sale of such food items would generate gross income from an unrelated trade or business.[99]

The above-described regulation appears to assume the creation of a tangible asset as a result of an exempt function; it is unclear whether the same principles would apply in the case of the creation of a marketable intangible asset such as an offset. Even assuming the same principles would apply, it is not clear how they would apply in the specific example described in this subsection. Where, for example, an organization's exempt functions cause it to *qualify for* offsets, the offsets likely would not arise automatically as a result of the exempt functions. Although the organization's actions would result in the sequestration of carbon, the organization would have to take further steps, such as tracking its activities and filing an application, to obtain something salable, *i.e.*, the offsets. It is not clear whether such further steps should be viewed as simply taking actions reasonable and necessary to ready for disposition a product of an exempt

[95] Sec. 512(a)(1).

[96] See Treas. Reg. sec. 1.513-1(c).

[97] Treas. Reg. sec. 1.513-1(d)(4)(ii).

[98] Treas. Reg. sec. 1.513-1(d)(4)(ii).

[99] Treas. Reg. sec. 1.513-1(d)(4)(ii).

function (such that the sale of the offset would be treated as related to exempt purposes), or whether such further steps instead should be viewed as exploiting the product of an exempt function in a business endeavor (such that the sale would be treated as unrelated to exempt purposes).[100]

[100] An exempt organization that purchases emission allowances as an investment activity might incur UBTI on the subsequent sale of such allowances if the purchases were debt-financed, even where income from the sales otherwise might have been treated as gain from the sale, exchange, or other disposition of property excludable from UBTI under section 512(b)(5). *See* secs. 512(b)(4) and 514.

H. Penalties

Cap-and-trade systems typically impose a civil penalty on emissions not offset by allowances. In general, these penalties are set at an amount that is expected to exceed the cost of compliance, in order to ensure that entities subject to the regime do not choose to incur the penalty rather than to comply.

The effective cost of the penalty to an entity that would otherwise pay Federal tax depends in part on whether the penalty is or is not deductible for tax purposes. For example, in the case of a taxpayer paying tax at the highest Federal corporate tax rate of 35 percent, a nondeductible penalty of $100 reduces the taxpayer's after-tax income by the full $100, while a deductible penalty would reduce the taxpayer's after-tax income by only $65 (after considering only the Federal tax effect).[101]

Under present law, no business expense deduction is allowed for any "fine or similar penalty paid to a government for the violation of any law."[102] Treasury regulations provide that a fine or similar penalty includes, among other things, an amount paid as a civil penalty imposed by Federal, State, or local law, and also an amount paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal).[103] On their face, the statute and regulations would appear to cover a penalty designated as such by the government entity to which it is paid, as well as a settlement of a potential liability for such a penalty.[104]

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[101] The value of a deduction is reduced if a taxpayer has significant current net operating losses or loss carryovers, or is in a lower marginal tax bracket. State taxes would also affect the after-tax cost.

[102] Sec. 162(f). The enactment of section 162(f) in 1969 codified existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that "allowance of the deduction would frustrate sharply defined national or state policies proscribing the particular types of conduct evidenced by some governmental declaration thereof". S. Rep. No. 91-552, 91st Cong, 1st Sess., 273-74 (1969), referring to *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

[103] Treas. Reg. sec. 1. 162-21(b).

[104] Payments to a government are deductible if they are compensatory (Treas. Reg. sec. 1.162-21(b)), or if they are not punitive but are an "alternative means of compliance" or are to "encourage compliance." See Rev. Rul. 88-46, 1988-1 C.B. 76 (certain manufacturers of nonconforming vehicles allowed to pay a fee intended to eliminate their "competitive advantage" from noncompliance, and obtain a certificate of compliance to continue operation of the vehicles, so long as nonconforming emissions did not exceed a certain level). Excess emissions penalties under a cap-and-trade system are unlikely to be viewed as compensation to the government for having exceeded the allowable emissions limits, or to fall within any of the other areas deemed to be "non-punitive." *See, e.g.*, Treas. Reg. sec. 1.162-21(c)(example 2) (penalties under Water Pollution Control Act not deductible); *True v. United States*, 894 F. 2d 1197 (10th Cir 1990) (same); *Colt Industries v. United States*, 880 F. 2d 1131 (Fed. Cir. 1989 (penalties under Clean Air Act and Clean Water Act not deductible); Rev. Proc. 92-91, 1992-2 C.B. 503 (monetary penalties under Clean Air Act Amendments of 1990 not deductible; however, reduction of future emission allowances as a result of excess emissions is not a penalty).

Some uncertainty exists, however, with respect to the treatment of settlements of potential penalty liabilities. A 2005 Government Accountability Office (GAO) report on tax administration aspects of the deductibility of fines and penalties notes that some taxpayers may take the position that a payment under a settlement agreement that does not specifically admit liability for wrongdoing is deductible.[105] Also, that report notes that there have been situations in which the Environmental Protection Agency or other enforcement agencies have accepted or required certain actions to be taken by the taxpayer, instead of imposing a full penalty to be paid to the government, and taxpayers have deducted (or capitalized and amortized, depending on the normal tax rules applicable to the particular undertaking) the cost of such actions.[106] More recently, in 2008, IRS field guidance has indicated that the IRS will challenge the capitalization or deduction of the portion of such costs that is analogous to a fine.[107]

Depending on how penalties are administered under a cap-and-trade regime, it is possible that similar situations may occur involving settlements that do not admit fault or that involve alternative taxpayer actions not designated as penalty payments to a government agency. If the administrative agency implementing the penalty system concludes that significant compliance (or possibly even greater emissions reduction) has been obtained through non-penalty-designated actions whose cost is ultimately deductible, the fact that a penalty would have been non-deductible if designated as such arguably is not a cause for concern.

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[105] U.S. Government Accountability Office, *Tax Administration: Systematic Information Sharing Would Help IRS Determine the Deductibility of Civil Settlement Payments, GAO-05-747* (September 2005), at18-21.

[106] *Id.* at 11, 13.

[107] See, e.g., LMSB-04-0608-036, an IRS coordinated issue paper stating that the IRS would take the position that a taxpayer may not include in the basis of the assets it produces (under section 263A) or as the basis of property (under section 1012) the portion of any Supplemental (Beneficial) Environmental Project (SEP) cost that is analogous to a fine. The issue paper states that SEP costs should be viewed as analogous to a nondeductible fine or penalty because taxpayers who agree to perform these supplemental projects generally do so as part of a governmental environmental law enforcement settlement, and the projects, such as the purchase and donation of land for conservation or the building of water treatment plants, frequently result in smaller penalties than those imposed on taxpayers who do not agree to SEPs.

On the other hand, if a requirement of non-deductibility is considered desirable in all settlement situations involving emissions, or if greater transparency regarding cases in which settlements are deductible is desired, then consideration could be given to developing limitations on the flexibility of any enforcement agency to permit deductible substitute actions in a settlement context, or to modifying the settlement deduction rules.[108]

[108] In 2007, the Senate passed several bills that included a proposal to further expand the non-deductibility of certain amounts paid in settlement proceedings generally, and require expanded reporting to taxpayers and the IRS. See The Fair Minimum Wage Act of 2007 (Senate Amendment to H.R. 2, sec. 224, 110th Cong.); Food and Energy Security Act of 2007, (Senate Amendment to H.R. 2419, sec. 12507, 100th Cong.); U.S. Troop Readiness, Veterans' Health, and Iraq Accountability Act, 2007 (Senate Amendment to H.R. 1591, sec. 534, 110th Cong.). A similar proposal passed the Senate in 2005, in the Tax Relief Act of 2005, sec. 533 (S. 2020, 109th Cong.). These proposals have been the subject of controversy. For example, some have expressed concern about the potential to further limit deductibility in situations where no guilt has been determined, or to affect other actions not previously treated by the taxpayers as fines. See, e.g., Statement of the Working Group for Certainty in Settlements, submitted to the Committee on Ways and Means, Hearing on the Revenue Increasing Measures in the "Small Business and Work Opportunity Act of 2007" (March 14, 2007).