NATIONAL WOODLANDS

Tax news you can use
Timber and Taxes

Tax Dimensions of Forest Carbon Contracts

By now most of you have heard all the buzz about carbon payments. This is a very intriguing income stream for forest landowners. As a professional concerned with helping landowners make decisions, I feel it is important to understand contracts, payments and the tax implications of the payments. Carbon programs are evolving and as a result there are questions about the programs, the contract terms and ultimately how the payment will be viewed by the IRS. This article is an exploration of the issues to consider when determining the tax implications of accepting carbon payments.

The carbon credit lifecycle generally consists of five stages. Initially the landowner will reach out to one of the carbon programs (1). In some cases, carbon programs are working in the state and are contacting landowners affiliated with a specific group to gauge interest. Next, the interested landowner will work with the carbon program to take measurements (2) and perform calculations needed to determine potential carbon sequestration and ultimately determine the number of credits to be issued (3). An agreement (the contract) is then signed (4). Finally, verification and payment for credits occurs (5). Payments may occur over time with a final payment or only occur at the end for shorter contract periods. Not all carbon programs fit into this neat little description but this is generally what occurs in a carbon credit program. The process, payments and the underlying "service" that is produced (carbon storage), raise five questions for me regarding the tax treatment of carbon.

Is income from carbon credits taxable?

The general rule is that ALL income from ANY source is taxable unless otherwise excluded. Without some action to the contrary by either the legislature (in the form of revision to the Internal Revenue Code) or by the IRS (in the form of Treasury Regulations or Revenue Rulings), income received from carbon credits will be taxable income.

When is income realized?

While this may seem like a straightforward question to some, a look at timing and some rulings will provide insight. There is evidence from previous discussions on wetland mitigation banks that when a landowner is issued a credit for the promise of doing something under a contract, the marketable credit has value and therefore a taxable event has occurred. Then when the credit is sold a second taxable event has occurred. Prior rulings related to sulfur emission credits produced conflicting guidance. I'll spare you the details but discussions included whether the credits were real property or an interest in real property (that's a good question for carbon) and whether it could be treated under section 1031 to defer recognition of gain. I leave this point with a big "it depends". Determining whether there is one or two taxable events will depend on the language within the contract.

How is the income taxed?

In the United States we have two different tax rate structures for income. The first is our ordinary income rates which apply to wages, salaries, tips, bonuses, commissions, rents, royalties, short-term capital gains, unqualified dividends, and interest income. The ordinary income tax rates for 2023 range from 10-37%. The second rate structure is for capital gain income. This applies to income earned from the sale of a capital asset. Capital assets are usually significant pieces of property such as land, homes, cars, investment properties, stocks, bonds, and even collectibles or art. For a business, a capital asset is an asset with a useful life longer than a year that is not intended for sale in the regular course of the business's operation. Timber held for sale in a

business is not a capital asset but can be treated as such (that's another discussion though). Capital gains are taxed at rates ranging from 0-20%. To use these rates the property must have been held for more than a year.

The determination of type of income has a couple of implications. First, the rate on income that is capital in nature is substantially lower than ordinary income. A second important implication is whether or not the income will incur a second tax. For income that is ordinary in nature a self-employment tax may be assessed. This is an additional 15.3% tax.

So back to carbon payments and why we care. It isn't really clear at this time whether carbon payments will be considered ordinary or capital in nature. Walking through some considerations we can start with the holding period. Most of the current contracts are for more than a year. However, it could be easy for the IRS to argue that an annual payment is for the additional carbon generated that year. Again, the contract language will be key here. The next hurdle is determining if the carbon payment is for real property (which is eligible for capital gains treatment). In a private letter ruling issued by the IRS (revoking a previous letter ruling to the contrary), it was stated that since the carbon credits can be sold separately from the forest land the credits are not considered real estate and thus are not real property. A different ruling compared carbon credits to a piece of the "bundle of rights" for property and thus suggested carbon credits are an interest in real property. If however the IRS views the carbon payments as a form of rent then the payment would be ordinary income. So there is no clear answer here about whether the payment will be considered ordinary or capital gains income. There has been no guidance from the IRS at this time.

How should I treat expenses associated with carbon?

Some of the answers to this question will go back to whether this is one taxable event or two. Let's assume for a minute that we have only one taxable event (the sale of the credit). Most of the carbon programs are paying for the credit over time with some having a larger payment up front and then scheduled payments over time. My inclination would be to recover any of the expenses attributable to the carbon contract (that aren't normal forest management expenses) proportionate to the recognition of income from the contract. So for each payment a portion of the expenses (making up the basis) would be deducted as with depletion. If the determination is that there are two taxable events then the tax implications are more complicated and will include a basis for each part of the transaction. We'll leave that for later.

What else should be considered?

For landowners in the 43 states (and District of Columbia) where there is a state income tax, it will be important to understand if the state looks at carbon payments differently than the Federal government. Some states link pretty directly to the Federal income tax while others do not at all. I'm not sure I would expect that many states have even thought about carbon payments so this may be a challenge.

Many states have special property tax rules for forest land. For a few of those states the ability to participate in those programs is related to the landowner's intention to produce timber. The question is if the carbon contract restricts the landowner's ability to harvest timber will this run afoul of the property tax program? A related question is how much restriction of harvest will be deemed acceptable if it is for a set number of years?

I did a little exploring of the Vermont property tax program. The program is based on current use allowing farm and forest landowners who practice long-term management to have land appraised for its "use value" rather than at fair market value. As stated by the program it is "the single most important tool to preserve Vermont's working landscape". All land enrolled in this program must be managed productively with a management plan that includes harvesting timber. However, this does not imply annual harvests are required. The primary forest management objective must be long-term production of forest products in accordance with established forest practices. Wildlife habitat, aesthetics, recreation, watershed protection, etc. are acceptable objectives when consistent with and complementary to timber management. This last part seems to allow for carbon sequestration as long as it is consistent and complementary. The question is how much harvest restriction and for how long before it isn't consistent and complementary. My bottom line on property tax is for landowners to understand what program you are in. Realize that this is a new and evolving question and that the state and local assessors may not know and understand what is happening. I'd suggest communicating with them prior to signing a contract that limits harvests.

The bottom line

I am certain that carbon payments will be taxed as income. I'm not certain whether they will ultimately be deemed one or two taxable events. As long as there isn't a long time between credit determination and sale, it shouldn't matter. I am also uncertain whether it will be ordinary or capital gain income. Obviously it would be best if it were capital gains but ultimately it may come down to rulings on whether it is real property or not. The impact on property tax programs will depend on the individual programs. I realize this won't be a satisfactory answer but so many of these questions have no clear answer right now and it may be a while before we have any. My best advice is to report the income, consider the nature of what is being sold when claiming as ordinary or capital, and be consistent from year to year with how you report.

Dr. Tammy Cushing is an Extension Forest Business & Economics Specialist at University of Florida, Gainesville, FL. She serves as an At-Large Director for National Woodland Owners Association Board of Directors. She is also a Past President of the Society of American Foresters.

THE ORIGINAL
PORTABLE WINCH™

PORTABLE WINCHES
BATTERY POWERED
PCW3000-Li-FK

SINGLE LINE PULLING FORCE
2,200 LB

SPEED
SPEED1 : 26.6 FT/MIN
SPEED2 : 32.8 FT/MIN
SPEED3 : 38 FT/MIN

WEIGHT
20 LB

This kit includes all the accessories you need to work in the forest in addition for the battery-powered winch the most efficient ever invented!

No compromise over power:the PCW3000-Li gives you a ton of pulling power in a single line at the push of a button.

FIND OUT MORE
OR FIND A DEALER AT
WWW.PORTABLEWINCH.COM
1 888 388-7855

80/82 VOLT
82V max