

Internal Revenue Service

Department of the Treasury
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Legend

Taxpayer =
EIN =

LLC =

FC =

State =
Country =

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Date 1 =
Date 2 =

Year 1 =
Year 2 =

Dear :

This is in response to a letter dated October 19, 2011 submitted by your authorized representative that requested rulings as to the Federal income tax consequences of the receipt and sale of government-allocated carbon credits.

The rulings contained in this letter are based upon information and representations submitted on behalf of Taxpayer by its authorized representatives, and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has

not verified any of the material submitted in support of this request for ruling, such material is subject to verification on examination. The information submitted in the request is substantially as set forth below.

FACTS

Taxpayer is a corporation organized under the laws of State that elected to be taxed as a real estate investment trust for Federal income tax purposes. Taxpayer was organized for the purpose of making direct and indirect investments in commercial timberland businesses. Taxpayer has been structured to realize profits from the harvest and sale of timber and the long term appreciation of the underlying timber properties.

Taxpayer wholly-owns LLC, a single member limited liability company formed under the laws of State that is treated as a disregarded entity for Federal income tax purposes. LLC, in turn, wholly-owns FC, an entity organized under the laws of Country that is treated as a corporation for Federal income tax purposes. FC is a controlled foreign corporation (CFC) within the meaning of I.R.C. § 957(a).

FC's principal business activity is the ownership and operation of commercial timber plantations located in Country. FC owns approximately z acres of timberland. FC is in the business of harvesting timber and holds its timberland and standing timber for use in its business. Harvested timber on the plantations is sold to both domestic and export log customers. Log sales are negotiated between a specific buyer and seller due to the significant varieties in the types of logs and the conditions in which they are grown. Putting aside consideration of any carbon credits, FC does not hold any commodities (within the meaning of I.R.C. § 954(c)(1)(C)) and Taxpayer represents that FC will not hold any commodities during a year in which FC holds carbon credits (described below).

FC is a participant in Country's emissions trading program (Program), which is a regulatory program recently established by the government of Country. The objective of the Program is to reduce net greenhouse gas (GHG) emissions and to comply with Country's obligations under the Kyoto Protocol, an international agreement ratified by Country that sets targets for reducing GHG emissions.

GHGs can be removed from the environment through "sinks." Country's forestry sector has a major effect on Country's GHG emissions profile because the forestry sector is a significant sink for carbon dioxide, which is a type of GHG. Specifically, as trees grow, carbon dioxide is removed from the environment through the process of photosynthesis and stored as carbon in the trunks, branches, leaves and roots of the trees. The stored up carbon is released back into the environment when trees are harvested or deforested. Thus, deforestation, in effect, turns forests into sources of carbon dioxide.

The Program has two different sets of rules: one that generally applies to forests that were established on or before Date 1 (pre-Date 1 forests), and one that generally

applies to forests that were established after Date 1. Participation is mandatory for owners of pre-Date 1 forests, but is voluntary for owners of forests that were established after Date 1. FC owns forests that were established before Date 1 and forests that were established after Date 1. FC chose not to participate in the Program with respect to its forests that were established after Date 1. However, FC is obligated to participate in the Program with respect to its pre-Date 1 forests.

Participants in the Program must surrender carbon credits if there is deforestation of their forest land. Deforestation is treated as having occurred if the forest land is not replanted, or if the forest land is replanted but does not meet certain specified minimum growth requirements or crown cover. If a participant does not have sufficient carbon credits, the participant must acquire additional carbon credits to meet its emissions liability that occurs as a result of the deforestation.

Under the Program, Country will grant a one-time allocation of carbon credits to owners of pre-Date 1 forests. The allocation of carbon credits is at no cost to the participants. The deadline for submitting applications for allocations of carbon credit was Date 2. FC submitted a valid and timely application for an allocation of carbon credits, and expects to receive its credits during Year 1 and Year 2.

The Program allows participants to: (i) hold carbon credits to meet future emissions liabilities; (ii) surrender carbon credits to meet an emissions liability; (iii) buy carbon credits to meet an emissions liability; or (iv) sell carbon credits to other Program participants or to an offshore buyer.

Carbon credits are held in accounts at a central registry, which tracks the ownership, surrender and sale of carbon credits. FC intends to open an account with the central registry through which it will sell any of its allocated carbon credits that it ultimately determines it will not use.

Generally, carbon credits can be traded in “secondary” markets using a brokerage or an organized trading exchange. While carbon credits are the primary unit of trade in Country, carbon credits are convertible into Assigned Amount Units (AAUs), which can be traded in international markets. The Kyoto Protocol enables AAUs to be utilized by any country to meet any of their obligations; however, AAUs are not automatically allowed into every country’s domestic emissions trading program.

FC is in the business of harvesting timber. However, FC has a general policy of replanting forest land after it harvests timber. Notwithstanding FC’s policy of replanting, FC may need to relinquish carbon credits under the Program. For instance, if there is an unexpected infestation of insects that damages the replanted trees such that the minimum growth standards set forth in the Program are not met, FC will need carbon credits to pay the corresponding emissions liability.

RULINGS REQUESTED

Taxpayer requests the following rulings with respect to the one-time allocation of carbon credits by Country to Taxpayer: (i) the allocation and receipt of the carbon credits will not cause FC to realize gross income under I.R.C. § 61; and (ii) the gain from the disposition of the allocated carbon credits will not constitute foreign personal holding company income within the meaning of I.R.C. § 954(c).

LAW

I.R.C. § 61 generally defines gross income as “income from whatever source derived”, except as otherwise provided by law. Gross income includes income realized in any form, whether in money, property or services. Treas. Reg. § 1.61-1(a). This definition encompasses all “accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.” Comm’r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

Generally, the granting of a transferable right by a government does not cause the realization of income. Rev. Rul. 92-16, 1992-1 C.B. 15 (allocation of emissions rights by the U.S. Environmental Protection Agency under 42 U.S.C. § 7651b(a) does not cause a utility to realize gross income); Rev. Rul. 67-135, 1967-1 C.B. 20 (difference between the fair market value and the cost of obtaining an oil and gas lease from the federal government under 30 U.S.C. §181 is not includible in income).

I.R.C. § 1012 provides, generally, that the basis of property shall be the cost of such property.

I.R.C. § 951(a) requires a U.S. shareholder of a CFC to include in gross income its pro rata share of the CFC’s subpart F income for the taxable year.

I.R.C. § 951(b) defines a U.S. shareholder for CFC purposes as a U.S. person who owns (directly, indirectly or constructively) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation.

I.R.C. § 957 defines a CFC as a foreign corporation with regard to which more than 50 percent of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of the corporation is owned (directly, indirectly or constructively) by U.S. shareholders.

I.R.C. § 952(a) defines subpart F income to include, among other things, foreign base company income.

I.R.C. § 954(a) defines four categories of foreign base company income, including foreign personal holding company income (FPHCI).

I.R.C. § 954(c)(1)(B)(iii) provides that FPHCI includes the excess of gains over losses from the sale of property which does not give rise to any income.

Treas. Reg. § 1.954-2(e)(3) provides that “property that does not give rise to income” includes all rights and interests in property (whether or not a capital asset) including, for example, forwards, futures and options. Treas. Reg. § 1.954-2(e)(3)(ii) excludes from “property that does not give rise to income” tangible property (other than real property) used or held for use in the CFC’s trade or business that is of a character that would be subject to the allowance for depreciation under I.R.C. §§ 167 or 168 and the regulations under those sections (including tangible property described in Treas. Reg. § 1.167(a)-2). Treas. Reg. § 1.954-2(e)(3)(iii) excludes from “property that does not give rise to income” real property that does not give rise to rental or similar income, to the extent used or held for use in the CFC’s trade or business. Treas. Reg. § 1.954-2(e)(3)(iv) excludes from “property that does not give rise to income” intangible property (as described in I.R.C. § 936(h)(3)(B)), goodwill or going concern value, to the extent used or held for use in the CFC’s trade or business.

The legislative history to I.R.C. § 954(c)(1)(B) provides “[t]hus, for example, the gain of a regular art dealer on the sale of a painting would not constitute subpart F foreign personal holding company income. On the other hand, the gain of a company on the sale of a painting held as an investment property generally would be subpart F foreign personal holding company income (at least before application of subpart F’s de minimis exception); if, prior to its disposition, the painting merely was displayed in the corporate offices or held in storage, it would not have given rise to any income” S. Rep. No. 313, 99th Cong., 2d Sess, (May 29, 1986) at 367.

The Joint Committee report to I.R.C. § 954(c)(1)(B) states that “[t]he provision also is not intended to apply to gain on the sale of land, buildings, or equipment used by the seller in an active trade or business of the seller at the time of the sale.” General Explanation of the Tax Reform Act of 1986, Staff of Joint Committee on Taxation, 100th Cong., 1st Sess. (May 4, 1987) at 974.

I.R.C. § 954(c)(1)(C) provides, in part, that FPHCI includes the excess of gains over losses from transactions (including futures, forward and similar transactions) in any commodity.

I.R.C. § 954(c)(1)(C)(ii) excludes from I.R.C. § 954(c)(1)(C) active business gains and losses from the sale of commodities, but only if substantially all of the CFC’s commodities are property described in paragraph (1), (2) or (8) of I.R.C. § 1221(a).

The property described in I.R.C. § 1221(a)(1) is stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale

to customers in the ordinary course of the taxpayer's trade or business.

The property described in I.R.C. § 1221(a)(2) is property, used in the taxpayer's trade or business, of a character which is subject to the allowance for depreciation provided in I.R.C. § 167, or real property used in the taxpayer's trade or business.

The property described in I.R.C. § 1221(a)(8) is supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

Treas. Reg. § 1.954-2(f)(2)(i) defines the term "commodity" for purposes of I.R.C. § 954 to include tangible personal property of a kind that is actively traded or with respect to which contractual interests are actively traded.

Treas. Reg. § 1.954-2(f)(2)(v)(C) sets forth examples that illustrate Treas. Reg. § 1.954-2(f)(2)(v), which defines qualified hedging transaction as a bona fide hedging transaction with respect to one or more commodities transactions reasonably necessary to the conduct of any business by a producer, processor, merchant or handler of commodities in a manner in which such business is customarily and usually conducted by others.¹ Example 2 states: CFC2 is a controlled foreign corporation located in country B. CFC2 operates an airline business within country B in a manner in which such business is customarily and usually conducted by others. To protect itself against increases in the price of aviation fuel, CFC2 enters into forward contracts for the purchase of aviation fuel. These forward purchase contracts are bona fide hedging transactions. As CFC2 purchases aviation fuel in the spot market for use in its business, it closes out an equivalent amount of its forward purchase contracts for cash pursuant to a contractual provision that permits CFC2 to terminate the contract and make or receive a one-time payment representing the contract's fair market value. The aviation fuel forward purchase contracts are qualified hedging transactions as defined in Treas. Reg. § 1.954-2(f)(2)(v)(A). Accordingly, any gain or loss on such aviation fuel forward purchase contracts is excluded from the computation of foreign personal holding company income.

Treas. Reg. § 1.954-2(a)(2) provides coordination rules for overlapping categories under the FPHCI provisions. Under those rules, gain or loss from commodities transactions under I.R.C. § 954(c)(1)(C) take priority over gain or loss from certain property transactions under I.R.C. § 954(c)(1)(B).

RULINGS

Based on the information submitted and representations made with Taxpayer's ruling request, we conclude that: (i) FC will not realize income when it receives the carbon credits from the government of Country and will have a basis of zero in the credits; and

¹ Treas. Reg. § 1.954-2(f)(2)(v) was published prior to the amendment of I.R.C. § 954(c)(1)(C) by the American Jobs Creation Act of 2004 (P.L. 108-357).

(ii) any gain derived by FC from its disposition of the allocated carbon credits will not constitute FPHCI within the meaning of I.R.C. § 954(c).

Except as specifically set forth above, no opinion is expressed or implied concerning the Federal tax consequences of the facts described above under any other I.R.C. provision.

No inference is intended as to whether carbon credits are properly considered commodities or another type of property for purposes of I.R.C. § 954 or any other I.R.C. provision.

This private letter ruling is directed only to the taxpayer requesting it. I.R.C. § 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter ruling is being sent to your authorized representative.

A copy of this letter ruling must be attached to any Federal income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Sincerely,

Jeffery G. Mitchell
Branch Chief, Branch 2
(International)

cc: