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Department of the Treasury
Washington, DC 20224

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Person To Contact:
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CC:FIP:B01
PLR-116839-22

Date:
March 06, 2023

Legend:

Taxpayer =

State A =

State B =

Date 1 =

a =

b =

c =

d =

Factor 1 =

Factor 2 =

Dear :

This letter is in reply to a letter dated August 31, 2022, in which Taxpayer requests a ruling that certain payments to be received by Taxpayer for the use of space on and below the surface of the Taxpayer's timberlands constitute qualifying income for purposes of Sections 856(c)(2) and (3).

Facts:

Taxpayer is a State A corporation that elected under section 856(c) to be a real estate investment trust ("REIT") beginning with its taxable year ended Date 1.

Taxpayer owns or controls approximately a acres of timberlands in the United States. Taxpayer has entered into an agreement (the "Agreement") with an unrelated party (the "Storage User") under which the Storage User pays Taxpayer for the right to use a specified area of the timberlands in State B (the "Premises") in connection with the underground storage of carbon dioxide ("CO₂"). Taxpayer represents that the Premises constitutes real property within the meaning of section 1.856-10 of the Income Tax Regulations.

Storage User intends to capture CO₂ from emitters in an area near the Premises and transport the CO₂ via pipeline from the points of emission to a facility to be located on the Premises (the "Carbon Injection Facility"). The Carbon Injection Facility will maintain the gaseous CO₂ as a supercritical fluid and inject it underground. The CO₂ may then move through the subsurface but will be prevented from escaping into the atmosphere by various trapping mechanisms. Injected CO₂ may migrate through porous rock until the CO₂ reaches an impermeable layer of rock. Some droplets of CO₂ will become permanently trapped in the pore space in porous rock. If the CO₂ encounters brine water within the pore space, a portion of the CO₂ will dissolve in the brine.

The Agreement grants the Storage User (i) the right to survey, construct, own, and operate the Carbon Injection Facility on the surface of the Premises; (ii) the right to inject, sequester, and permanently store CO₂ in the pore space at a specified depth in the subsurface of the Premises; (iii) the right to construct and maintain pipeline facilities from the boundaries of the Premises in, along, and over certain adjacent areas of the Premises; and (iv) rights of ingress and egress necessary to access and operate the Carbon Injection Facility and pipelines.

The Agreement provides for an "Exploratory Term" and an "Operational Term." The Exploratory Term generally lasts for one year and may be extended for additional one-year terms up to a total term of b years. In consideration for an upfront payment and fixed annual payments, Taxpayer will grant the Storage User the right to enter onto the surface of the Premises and conduct exploratory activities. If the Storage User determines that the Premises is suitable for its storage of CO₂, it will begin constructing the Carbon Injection Facility. Taxpayer will treat the payments for the Exploratory Term as rents from real property and is not seeking a ruling to that effect.

At the end of the Exploratory Term, the Storage User may elect to enter into an Operational Term. The initial Operational Term will be c years from the date the Carbon Injection Facility is placed in service (the "Commencement Date") and, with extensions, the Operational Term may last up to d years. During the Operational Term, the Storage

User will commit to storing in pore space under the Premises CO₂ that the Storage User obtains from emitters within a specified geographic area.

Upon the Commencement Date, the Storage User will begin making monthly payments for the use of the Premises based on the volume of pore space used each year, or, if the amount based on such use would be less than a specified minimum payment amount, based on such minimum payment amount (the "Injection Payments"). The Injection Payments will be calculated using a schedule based on Factor 1 and Factor 2. The Injection Payments will be adjusted annually for inflation and may be increased following any change in applicable law that provides additional federal, state, or local government benefits with respect to the capture and storage of CO₂. The Storage User will also be responsible for the payment of all taxes or government charges that may be imposed on Taxpayer in connection with the injection or storage of CO₂ in the pore space (together with the Injection Payments, the "Subsurface Payments"). In addition, the Storage User will make a fixed one-time payment with respect to its rights to use the surface of the Premises (the "Surface Payments," and together with the Subsurface Payments, the "Operational Term Payments"). Taxpayer represents that no portion of the Operational Term Payments will be based upon the income or profits of any person.

At all times after the termination of the Agreement, the Storage User will have the right to permanently store previously injected CO₂ in the pore space, bear exclusive risk of loss with respect to CO₂ transported through the Carbon Injection Facility and stored in the pore space, and hold all right, title, interest, and ownership of CO₂ injected into the pore space pursuant to the Agreement.

Under the Agreement, Taxpayer reserves the right to use the Premises for its own purposes through the term of the Agreement and thereafter. Subject to the Storage User's right of first offer, the Agreement reserves Taxpayer's right to grant other third parties rights with respect to subsurface space at any depth (other than the depth of the pore space used by Storage User) for any purpose that will not unreasonably interfere with the Storage User's use of the pore space at the depth specified in the Agreement.

Taxpayer represents that Taxpayer will not capture the CO₂ and will only provide the use of its real property to the person who injects the CO₂ underground and who owns and operates the relevant equipment. Taxpayer represents that it will not own or operate any pipeline used to transport the CO₂ or any equipment used to convert CO₂ into a supercritical fluid or to inject the CO₂ underground.

Taxpayer does not intend to provide, directly or indirectly, any services to Storage User. Taxpayer represents that, if any services are provided to Storage User, they will be services customarily provided to third parties engaged in similar CO₂ storage. Taxpayer represents that (A) Taxpayer will only undertake activities or services (i) consistent with its fiduciary functions, as provided in section 1.856-4(b)(5)(ii), or (ii) that would not result in unrelated business taxable income under section 512(b)(3) if received by an organizations described in section 511(a)(2), and (B) any other services will be undertaken by an independent contractor from whom Taxpayer does not derive or receive any income, or a taxable REIT subsidiary.

Taxpayer requests a ruling that the Operational Term Payments constitute qualifying income for purposes of section 856(c)(2) and (3).

Law and Analysis:

Section 856(c)(2) provides that, for a corporation to qualify as a REIT for a taxable year, at least 95 percent of the corporation's gross income for the year (excluding gross income from prohibited transactions) must be derived from certain enumerated sources, which include dividends, interest, rents from real property, gain from the sale or other disposition of stock, securities, and real property (other than property in which the corporation is a dealer), abatements and refunds of taxes on real property, income and gain derived from foreclosure property, and certain commitment fees.

Section 856(c)(3) provides that, for a corporation to qualify as a REIT for a taxable year, at least 75 percent of the corporation's gross income for the year (excluding gross income from prohibited transactions) must be derived from certain enumerated sources, which include rents from real property, interest on obligations secured by real property, gain from the sale or other disposition of real property (other than property in which the corporation is a dealer), distributions on and gain from the sale of REIT stock, abatements and refunds of taxes on real property, income and gain derived from foreclosure property, certain commitment fees, and qualified temporary investment income.

Section 856(c)(5)(C) and section 1.856-3(c) define the term "interests in real property" to include fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, and options to acquire such interests in land or improvements thereon.

Section 1.856-10(b) defines the term "real property" to mean land or improvements to land. Section 1.856-10(c) defines "land" to include water and air space superjacent to land and natural products and deposits that are unsevered from the land. Natural products and deposits, such as crops, water, ores, and minerals, cease to be real property when they are severed, extracted, or removed from the land. The storage of severed or extracted natural products or deposits, such as crops, water,

ores, and minerals, in or upon real property does not cause the stored property to be recharacterized as real property.

Section 856(d)(1) provides that rents from real property include (subject to exclusions provided in section 856(d)(2)): (A) rents from interests in real property; (B) charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated; and (C) rent attributable to personal property leased under, or in connection with, a lease of real property, but only if the rent attributable to the personal property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.

Subject to certain exceptions, section 856(d)(2)(A) provides that the term “rents from real property” does not include any amount received or accrued, directly or indirectly, with respect to any real or personal property, if the determination of such amount depends in whole or in part on the income or profits derived by any person from such property (except that any amount so received or accrued shall not be excluded from the term rents from real property solely by reason of being based on a fixed percentage or percentages of receipts of sales).

Section 1.856-4(a)(1) of the Income Tax Regulations provides that the term “rents from real property” means, generally, the gross amounts received for the use of, or the right to use, real property of the REIT.

Revenue Ruling 73-426, 1973-2 C.B. 223, provides that if a REIT obligates a lessee under the terms of the lease agreement to pay the amount of state and local real property taxes imposed on the REIT’s property, such amount is for the use of, or right to use the property, and therefore, constitutes additional rental income to the REIT and qualifies as rents from real property within the meaning of section 856(d).

Revenue Ruling 68-291, 1968-1 C.B. 351, clarifying Revenue Ruling 59-121, 1959-1 C.B. 212, provides generally that the consideration received for the granting of a permanent easement constitutes the proceeds from the sale of an interest in real property and should be applied as a reduction of the cost or other basis of the portion of the land subject to the easement, with any excess treated as gain.

Each Operational Term Payment is a payment for the use of the Premises during the term of the Agreement, a payment for a permanent interest in the Premises, or a combination of both. The surface and subsurface of the Premises are land and therefore real property for purposes of section 1.856-10(b). Thus, to the extent an Operational Term Payment is for a permanent interest in the Premises, akin to a permanent easement, the Operational Term Payment is a payment for a sale of an interest in real property. To the extent an Operational Term Payment is for the use of the Premises during the term of the Agreement, the payment meets the general definition of rents from real property in section 1.856-4(a)(1). The Operational Term Payments include amounts that are fixed, amounts that are determined by reference to

volumes of CO₂, and amounts that are determined by reference to government charges and benefits, but no amounts determined by reference to the income or profits of any person.

Conclusion:

Based on the facts submitted and representations made by Taxpayer, we conclude that (a) Taxpayer's gross income attributable to any Operational Term Payment that is for a permanent interest in the Premises is gain from the sale or other disposition of an interest in real property for purposes of section 856(c)(2)(D) and (3)(C), and (b) Taxpayer's gross income attributable to Operational Term Payments that are not for a permanent interest in the Premises is rents from real property described in section 856(c)(2)(C) and (3)(A).

This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. Except as specifically ruled upon above, no opinion is expressed concerning any Federal income tax consequences related to the facts herein under any other provisions of the Code. Specifically, we express no opinion whether any sale or disposition of property is a prohibited transaction for purposes of section 857(b)(6) or whether Taxpayer qualifies as a REIT under part II of subchapter M of chapter 1 of the Code.

This ruling is directed only at the taxpayer that requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. In accordance with the provisions of a Power of Attorney on file, we are sending a copy of this letter ruling to your authorized representatives.

The rulings in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. Although this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Steven Harrison
Chief, Branch 1
Office of Associate Chief Counsel
(Financial Institutions & Products)

cc: