Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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PLR-114463-17

Date:
September 14, 2017

LEGEND:

Taxpayer	=
Company A	=
Company B	=
State X	=
Country Y	=
Country Z	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=

Year 1 =

Year 2 =

Year 3 =

a =

b =

c =

Dear :

This letter revokes and modifies parts of PLR 201123003 (PLR-103021-10) issued to Taxpayer on March 4, 2011, regarding the treatment of Carbon Emission Units ("Units") under sections 856 and 857 of the Internal Revenue Code ("Code"). On August 31, 2016, the Internal Revenue Service ("Service") notified your authorized representative that the Service was proposing to revoke and modify PLR 201123003. In response to a request from your authorized representative dated November 2, 2016, this letter limits the retroactive effect of such revocation and modification pursuant to section 7805(b) of Code.

In PLR 201123003, the Service issued the following rulings:

Ruling 1. The Units allocated to Company A by the Country Z government qualify as real estate assets for purposes of sections 856(c)(5) and 856(c)(4)(A).

Ruling 2. To the extent any amounts are included by Taxpayer in gross income by reason of the allocation of Units to Company A by the Country Z government, such amounts are considered as qualifying income under section 856(c)(5)(J) for purposes of satisfying sections 856(c)(2) and 856(c)(3).

Ruling 3. Gain from the sale of Units allocated to Company A by the Country Z government is gain from the sale or other disposition of real property for purposes of sections 856(c)(2) and 856(c)(3).

Ruling 4. Gain from the sale of Units allocated to Company A by the Country Z government is not income from a prohibited transaction for purposes of section 857(b)(6).

Under section 1.856-10(f) of the Income Tax Regulations, the Units allocated to

Company A by the Country Z government no longer qualify as real estate assets for purposes of sections 856(c)(5) and 856(c)(4)(A) because the Units can be sold separately from the forest land to which the Units relate. Section 1.856-10(f) was published on August 31, 2016, and is applicable for taxable years beginning after August 31, 2016. Ruling 1 is inconsistent with Section 1.856-10(f) and was revoked on the first day of Taxpayer's first taxable year beginning after August 31, 2016. See Rev. Proc. 2016-1, 2016-1 I.R.B. 1, section 11.04 (stating "[a] letter ruling may be revoked or modified by . . . the issuance of temporary or final regulations"); see also Definition of Real Estate Investment Trust Real Property, 81 Fed. Reg. 59849, 59855 (August 31, 2016) (stating "to the extent a previously issued letter ruling is inconsistent with these final regulations, the letter ruling is revoked prospectively from the applicability date of these final regulations").

Because the Units no longer qualify as real estate assets, the Service has reconsidered Rulings 2, 3, and 4 in PLR 201123003. The Service has determined that these rulings are not in accord with the current views of the Service. Section 11.04 of Rev. Proc. 2017-1, 2017-1 I.R.B. 1 provides, in part, that a letter ruling found to be in error or not in accordance with the current views of the Service may be revoked or modified. Accordingly, Rulings 3 and 4 in PLR 201123003 are revoked and Ruling 2 in PLR 201123003 is modified.

Section 11.04 of Rev. Proc. 2017-1 also provides that if a private letter ruling is revoked or modified, the revocation or modification applies to all years open under the period of limitation unless the Service uses its discretionary authority under section 7805(b) to limit the retroactive effect of the revocation or modification.

Taxpayer requested that the modification of Ruling 2 be effective prospectively. With respect to Units Taxpayer held on August 31, 2016 ("Existing Units"), Taxpayer requested that the revocation of Rulings 3 and 4 in PLR 201123003 not be effective until Date 1, so that Taxpayer may liquidate the Existing Units in an orderly manner that does not result in a significant loss of the economic value of the Existing Units. In accordance with Taxpayer's request, the Service has decided to grant relief under section 7805(b). Rulings 2, 3, and 4 in PLR 201123003 are revoked or modified prospectively, beginning with Taxpayer's first taxable year beginning after August 31, 2016. The revocation of Rulings 3 and 4 in PLR 201123003, however, will not apply to Existing Units until Date 1.

FACTS

Taxpayer is a State X corporation that has elected to be treated as a real estate investment trust ("REIT") beginning with its taxable year that ended Date 2. Taxpayer is an international forest products company that is primarily engaged in activities associated with timberland operation and management. Taxpayer represents that Taxpayer's non-REIT qualifying operations are conducted through a wholly owned

taxable REIT subsidiary.

Taxpayer owns, leases, or manages timberland and real estate located in Country Y and Country Z. Taxpayer's Country Z timber operations are conducted through Company A, a Country Z unlimited company in which Taxpayer has an interest of a percent. Company A has elected to be treated as a partnership for U.S. federal income tax purposes. Company A, through one of its wholly owned subsidiaries, Company B, a Country Z unlimited company that has elected to be a disregarded entity for U.S. federal income tax purposes, owns or leases timberland.

Company A is a participant in the Country Z Emissions Trading Program (the "Program"). The Program is a regulatory program established by the Country Z government that sets a price on greenhouse gas ("GHG") emissions in Country Z to create incentives to reduce such emissions. The portion of the Program pertaining to the forestry sector (the "Forestry Program") was implemented on Date 3 with a retroactive effective date of Date 4.

The Forestry Program is premised on the fact that carbon dioxide, one of the GHGs that the Program seeks to reduce, can be temporarily removed from the atmosphere by forests and other woody vegetation. Specifically, growing trees remove carbon dioxide present in the atmosphere through photosynthesis and store the carbon dioxide in their trunks, branches, leaves, and roots. When trees are harvested, the carbon dioxide they have stored is returned to the atmosphere. Consequently, the Forestry Program is designed to create incentives for forest owners to not harvest trees without planting replacements.

Under the Forestry Program, the Country Z government allocates Units, each of which represents one metric ton of carbon dioxide removed from the atmosphere, to certain forest owners to account for the carbon their forests have captured. The Forestry Program effectively imposes land use restrictions on the forest owner by requiring the forest owner to surrender Units if the forest owner harvests its trees and does not plant sufficient replacement trees. The Units serve as an offset for the loss in the value of the forest owner's land as a result of the restrictions imposed by the Program.

Forest owners may hold allocated Units for use in future compliance periods, or sell the Units in the Country Z market or in an international market. Allocated Units are issued at no cost to the forest owner. Under the International Financial Reporting Standards adopted by Country Z, Units are recorded as intangible assets of Company A.

The Forestry Program has two different sets of rules: one for owners of forests that were established before Date 5 ("Pre-Year 1 Forests"), and another for owners of forests established after Date 6 ("Post-Year 2 Forests"). Owners of Pre-Year 1 Forests

are mandatorily subject to the Forestry Program. The number of Units that each Pre-Year 1 Forest owner will receive per acre of forest land is dependent on various factors, such as the year the land on which the trees are grown was purchased and whether Units were required to be retained to cover certain specified statutory exemptions. If an owner of Pre-Year 1 Forests deforests more than b acres of trees without replanting trees, the owner must calculate and report the amount of carbon dioxide released into the environment and surrender an adequate number of Units. The Units that the owner surrenders may be those previously allocated to such owner by the Country Z government or they may be purchased on the open market. If an owner of Pre-Year 1 Forests sells its forest land, the owner may not retain the Units attributable to such forests; the owner will be treated as transferring to the purchaser any Units that were allocated to the owner that have not previously been sold or surrendered.

With respect to owners of Post-Year 2 Forests, participation in the Forestry Program is elective. The number of Units that will be allocated to an owner of Post-Year 2 Forests that elects to participate in the Forestry Program ("Electing Post-Year 2 Forest Owners") will be equivalent to the tons of carbon dioxide the owner's trees have captured since Date 4 if the owner elects to join the Forestry Program by the end of Year 3, and since Date 7 if the owner elects to join the Forestry Program after Year 3. Every c years, an Electing Post-Year 2 Forest Owner must file an emissions return that reports the amount of carbon dioxide currently sequestered by its trees. If the amount of the carbon dioxide reported falls below a previously reported level, the Electing Post-Year 2 Forest Owner must surrender an adequate number of Units to compensate for the decrease in the amount of carbon dioxide sequestered by the forest owner's trees. The Units that the Electing Post-Year 2 Forest Owner surrenders may be those previously allocated to the owner by the Country Z government or they may be purchased on the open market. If an Electing Post-Year 2 Forest Owner sells its forest land, the owner may not retain the Units attributable to those forests; the owner will be treated as transferring any Units that were allocated to it from the Country Z government that have not previously been sold or surrendered, and the purchaser takes responsibility for any decrease in the amount of carbon dioxide sequestered by the trees on the land since the seller filed its last emissions return.

Company A will be allocated Units from the Country Z government attributable to its Pre-Year 1 Forests. Company A also elected to participate in the Forestry Program with respect to its Post-Year 2 Forests, pursuant to which Company A will be allocated additional Units from the Country Z government. To monetize the Units allocated to Company A, Company A would open an account with the Country Z Emission Unit Registry (the "Registry") which operates like a stock share registry. The Registry records entities that hold Units and the number of Units held, the transfer of Units between holders both within the Registry and between international unit registries, and the surrender of Units by participants to meet their obligations under the Program. Existing Units are tracked by unique serial numbers through the Registry. The Registry allows Taxpayer to track the sales of Existing Units. The sale of Units can be made

directly to companies that need to acquire Units to surrender to the government (outside of any market), or Units can be traded on a secondary market to brokers who hold and trade Units or to parties that need Units to comply with the Program.

LAW AND ANALYSIS

Allocation of Units is qualifying income (Ruling 2)

Section 61(a) provides that except as otherwise provided by law, gross income means all income from whatever source derived. Under section 61, Congress intends to tax all gains or undeniable accessions to wealth, clearly realized, over which taxpayers have complete dominion. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 477 (1955).

Section 856(c)(2) provides that for a corporation to qualify as a REIT, at least 95 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from sources that include dividends, interest, rents from real property, and 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, commitment fees, and gain from certain sales or other dispositions of real estate assets.

Section 856(c)(3) provides that for a corporation to qualify as a REIT, at least 75 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from 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), dividends from REIT stock and gain from the sale of REIT stock, abatements and refunds of taxes on real property, income and gain derived from foreclosure property, commitment fees to make loans secured by mortgages on real property or to purchase or lease real property, gain from certain sales or other dispositions of real estate assets, and qualified temporary investment income.

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 tax year attributable to both the real and personal property leased under, or in connection with, the lease.

Section 856(c)(5)(J) provides that to the extent necessary to carry out the purposes of Part II of Subchapter M of the Code, the Secretary is authorized to

determine, solely for purposes of such part, (i) whether any item of income or gain that does not otherwise qualify under sections 856(c)(2) or (c)(3) may be considered as not constituting gross income for purposes of sections 856(c)(2) or (c)(3), or (ii) whether any item of income or gain that otherwise constitutes gross income not qualifying under sections 856(c)(2) or (c)(3) may be considered as gross income that qualifies under sections 856(c)(2) or (c)(3).

Section 1.856-4(a)(1) 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.

Section 1.451-1(a) provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Generally, all events that fix the right to receive income occur upon the earliest of the following events to take place: the payment is received, the payment is due, or the income is earned by performance. See Schlude v. Commissioner, 372 U.S. 128 (1963); Rev. Rul. 2003-10, 2003-1 C.B. 288.

The legislative history underlying the tax treatment of REITs indicates that a central concern behind the gross income restrictions is that a REIT's gross income should largely be composed of passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-23 states, "[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business."

Company A is allocated Units by the Country Z government to account for the carbon its forests have captured. The Forestry Program effectively imposes land use restrictions on the forest owner by requiring the forest owner to surrender Units if the forest owner harvests its trees and does not plant sufficient replacement trees. The Units serve as an offset for the loss in the value of the forest owner's land as a result of the restrictions imposed by the Program. For these reasons, the Units are akin to receiving payment for granting an easement for a term of years with respect to Taxpayer's real property. Cf. Wineberg v. Commissioner, 326 F.2d 157, 169-70 (9th Cir. 1963) (holding amount received for granting 10-year right to use a road was rent rather than sale of an interest in land), aff'g T.C. Memo. 1961-336; Nay v. Commissioner, 19 T.C. 114, 119 (1952) (concluding amount received for granting a "right of way" for a term not to exceed three years is ordinary income because such a "limited easement" does not constitute sale of real property). Under these circumstances, treating the Units as qualifying income does not interfere with or impede the objectives of Congress in enacting sections 856(c)(2) and (c)(3).

With respect to the issuance of the Units, Taxpayer will include the fair market value of the Units in Taxpayer's gross income in accordance with section 1.451-1(a). Taxpayer's basis in a Unit will be equal to its fair market value when accrued as income. Cf. Philadelphia Park Amusement Co. v. United States, 126 F.Supp. 184, 188-189 (1954).

Taxpayer will accrue income with respect to the issuance of the Units and properly recognize such income upon the earliest of the following events to take place: the Units are earned, the Units are received, or the Units are due. Pursuant to the authority of section 856(c)(5)(J), income from the issuance of the Units will be considered as qualifying income under sections 856(c)(2) and (c)(3).

Accordingly, Ruling 2 in PLR 201123003 is modified prospectively, beginning with Taxpayer's first taxable year beginning after August 31, 2016.

Sale of Units is not qualifying income (Ruling 3)

Under section 1.856-10(f), beginning with Taxpayer's first taxable year beginning after August 31, 2016, the Units do not qualify as real property, interests in real property, or real estate assets for purposes of sections 856(c)(4)(A) and 856(c)(5). Thus any income realized upon the sale of the Units is income from the sale of an asset that is not real property, an interest in real property, or a real estate asset. Therefore, any gain from the sale of the Units is not qualifying income under sections 856(c)(2) and (c)(3).

Accordingly, Ruling 3 in PLR 201123003 is revoked prospectively beginning with Taxpayer's first taxable year beginning after August 31, 2016.

No ruling on Prohibited Transactions (Ruling 4)

Section 857(b)(6)(A) provides that a tax will be imposed upon a REIT equal to 100 percent of the net income derived by the REIT from prohibited transactions. Section 857(b)(6)(B)(iii) defines the term "prohibited transaction" as a sale or other disposition of property described in section 1221(a)(1) which is not foreclosure property.

Section 1221(a)(1) provides that for federal income tax purposes, the term "capital asset" means property held by the taxpayer (whether or not connected with the taxpayer's trade or business) but does not include stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the tax year, or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

Section 4.02(5) of Rev. Proc. 2017-3, 2017-1 I.R.B. 130, provides that the Service will not ordinarily rule on any matter dealing with the question of whether

property is held primarily for sale to customers in the ordinary course of a trade or business.

Consistent with Rev. Proc. 2017-3, Ruling 4 in PLR 201123003 is revoked prospectively, beginning with Taxpayer's first taxable year beginning after August 31, 2016.

CONCLUSIONS

As discussed above, we conclude that Rulings 3 and 4 in PLR 201123003 are revoked, and Ruling 2 in PLR 201123003 is modified, prospectively beginning with Taxpayer's first taxable year beginning after August 31, 2016. The revocation of Rulings 3 and 4 in PLR 201123003, however, will not apply to Existing Units until Date 1.

This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed concerning whether Taxpayer otherwise qualifies as a REIT under Subchapter M, Part II of Chapter 1 of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code 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 is being sent to your authorized representatives.

Sincerely,

/S/

_____

K. Scott Brown
Branch Chief, Branch 3
Office of the Associate Chief Counsel
(Financial Institutions & Products)

Enclosure:
Copy for section 6110 purposes

cc: