Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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PLR-103655-18
Date:
September 09, 2019

Legend

Taxpayer =

Subsidiary =

Partnership A =

Partnership B =

Partnership C =

Partnership D =

Partnership E =

Partnership F =

Manager =

Agency =

Act =

Protocol =

Country =

State A =

State B =

States =

Year 1 =

Year 2 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

Dear :

This responds to a letter dated February 7, 2018, and subsequent correspondence, submitted on behalf of Taxpayer. Taxpayer requests certain rulings regarding the treatment of income from credits issued by Agency, pursuant to the State B Program, beginning in Year 2 and subsequently thereafter ("Credits") for purposes of

its status as a real estate investment trust ("REIT") under section 856 of the Internal Revenue Code ("Code"):

(1) Unless section 451(b)(1)(A) requires earlier inclusion, income with respect to the issuance of Credits accrues under section 451 upon the earliest of the following events to take place: Credits are earned, Credits are received, or Credits are due, and

(2) Pursuant to section 856(c)(5)(J)(ii), Taxpayer's proportionate share of income from the issuance of Credits will be considered as qualifying income under section 856(c)(2) and (c)(3).

FACTS

Taxpayer is a State A limited liability company that has elected under section 856 to be treated as a REIT for federal income tax purposes.

Taxpayer owns an a percent limited partnership interest in Subsidiary, a State A limited partnership classified as a partnership for federal income tax purposes. Manager owns a b percent general partnership interest in Subsidiary. Subsidiary owns (including through limited liability companies classified as either partnerships or disregarded entities for federal income tax purposes) approximately c acres of timberlands located in Country and States with an aggregate estimated fair market value of approximately $d. Manager directly or indirectly manages Subsidiary, which realizes income and gain through timber sales and occasional sales of timberlands.

Subsidiary indirectly owns a j percent membership interest in each of Partnership A, Partnership B, Partnership C, Partnership D, and Partnership E. Partnership E, in turn, owns an a percent membership interest in Partnership F. Partnerships A through F are limited liability companies classified as partnerships for federal income tax purposes (collectively referred to as "Partnerships", and collectively with Subsidiary referred to as "Entities"). Manager owns the remaining membership interests in Partnerships. Taxpayer and Entities each employ the accrual method of accounting, and the taxable year of each is the calendar year.

Taxpayer represents that Entities have e projects under development on certain portions of their existing U.S. landholdings that will qualify under the carbon offset program described below.

State B Program

In Year 1, State B enacted Act in an effort to reduce greenhouse gas ("GHG") emissions. Act created State B's cap-and-trade program whereby State B sets a hard cap on overall GHG emissions but allows certain businesses to buy, sell, and trade the rights to produce emissions (the "State B Program").

Agency administers the State B Program on behalf of State B. Under the State B Program, Agency issues Credits in exchange for a project developer engaging in activities on U.S. landholdings that affirmatively reduce GHG emissions. Agency's protocol describes the standards that each carbon offset project must satisfy ("Protocol"). Each of Entities' carbon offset projects is predicated on the use of a specified parcel of Entities' timberlands located in States to reduce atmospheric carbon dioxide.

Per the Protocol, Agency will issue to Entities one Credit for each metric ton of carbon dioxide removed from the atmosphere by each project. To ensure that its timberlands will process a sufficient amount of carbon dioxide to meet the requirements of the State B Program, Entities must continuously monitor their compliance with the Protocol. Agency holds each of Entities' projects to rigorous reporting standards to demonstrate that Entities' efforts are effective. Thus, to qualify for Credits, Entities must undertake certain affirmative obligations and agree to certain restrictions on the use of the specified parcels of each project's timberlands for f years, including:

1. Demonstrating that the committed timberland is of a specified composition of tree species and ages, and the tree canopy covers at least k percent of any l-acre section of the committed timberland at all times;

2. Submitting plans to Agency to show that the practices are sustainable;

3. Demonstrating continuous compliance with the Protocol by conducting a complete forest inventory every g years that is fully verified by independent third parties authorized by State B;

4. Conducting full verification of carbon sequestration by independent third parties in the h year between the complete inventories; and

5. Obtaining less-intensive verifications of carbon sequestration annually.

If the total stock of trees in a project decreases over any consecutive i-year period, Entities are obligated to return some or all Credits they received for that project (or acquire Credits to be relinquished). Land-use restrictions to which Entities agreed to abide by under the State B Program are restrictions that could be recorded as easements under local law, although Entities are not presently contemplating doing so.

In Year 2, Agency issued Credits to Partnership D. The other Entities expect to be issued Credits in years beginning after Year 2.

Taxpayer represents that Entities intend either to sell Credits in one or more transactions to unrelated third-party purchasers or to transfer Credits to a taxable REIT subsidiary of Taxpayer that will sell them to unrelated third-party purchasers. Taxpayer further represents that neither Taxpayer nor Entities intend to hold Credits for purposes of speculating on future appreciation.

LAW AND ANALYSIS

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

Section 451 and the regulations thereunder provide rules for determining the taxable year of inclusion for items of gross income.

Under an accrual method of accounting, unless section 451(b)(1)(A) requires earlier inclusion, an item of gross income is generally includible when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. All the events that fix the right to receive income generally occur upon the earliest of the following: (1) the required performance takes place, (2) payment is due, or (3) payment is made. See Schlude v. Commissioner, 372 U.S. 128 (1963); Rev. Rul. 2003-10, 2003-1 C.B. 288. However, section 451(b)(1)(A) sets forth special rules requiring earlier inclusion in the case of certain accrual-method taxpayers.

Section 856(c)(2) provides that for a corporation to qualify as a REIT for any taxable year, at least 95 percent of its gross income (excluding gross income from prohibited transactions) must be derived from sources that 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, certain 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 for any taxable year, 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, certain commitment fees, 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 taxable 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 Chapter 1 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, subject to the exceptions of section 856(d) and § 1.856-4(b), 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.

Under § 1.856-3(g), a REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership and to be entitled to the income of the partnership attributable to that share. For purposes of section 856, the interest of a partner in the partnership's assets is determined in accordance with the partner's capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership retain the same character in the hands of the partners for all purposes of section 856.

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."

Unless section 451(b)(1)(A) requires earlier inclusion, income with respect to the issuance of Credits will accrue under section 451 upon the earliest of the following events to take place: Credits are earned, Credits are received, or Credits are due. Taxpayer's proportionate share of an Entity's basis in a Credit will equal the proportionate share of the fair market value of such Credit accrued as income by Taxpayer. Cf. Philadelphia Park Amusement Co. v. United States, 126 F.Supp. 184, 188-189 (Ct. Cl. 1954). However, Taxpayer's proportionate share of income with respect to the issuance of Credits by the State B Program constitutes gross income that is not listed as qualifying income under sections 856(c)(2) or (c)(3).

Entities will earn Credits by agreeing to certain restrictions on the use of their land for a specified term of years. The State B Program imposes land-use restrictions by requiring Entities to abstain from certain uses of their land as well as to perform certain actions on their land. Such land-use restrictions are restrictions that could be recorded as easements under local law. Under the State B Program, Entities will incur significant penalties if they do not abide by the restrictions to which they have agreed. For these reasons, Credits are akin to receiving payment for granting an easement for a term of years with respect to the 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 Taxpayer's proportionate share of income with respect to the issuance of Credits as qualifying income does not interfere with or impede the objectives of Congress in enacting section 856(c)(2) and (c)(3).

CONCLUSIONS

Based on the information submitted and the representation made, we hereby rule as follows:

(1) Unless section 451(b)(1)(A) requires earlier inclusion, income with respect to the issuance of Credits will accrue under section 451 upon the earliest of the following events to take place: Credits are earned, Credits are received, or Credits are due; and

(2) Pursuant to section 856(c)(5)(J)(ii), Taxpayer's proportionate share of income from the issuance of Credits will be considered as qualifying income under section 856(c)(2) and (c)(3).

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 with regard to whether Taxpayer otherwise qualifes as a REIT under subchapter M of the Code. Nor is any opinion expressed with respect to the tax consequences of any dispositions of Credits , including whether a sale of the Credits constitutes a prohibited transaction as described in section 857(b)(6)(B)(iii). This letter ruling is prospective and does not provide guidance regarding Credits issued directly or indirectly prior to Year 2. Additionally, no opinion is expressed regarding whether Taxpayer or any Entity has established a method of accounting through consistent treatment or whether application of the rulings set forth above without obtaining the Commissioner's consent for a change of accounting method will result in an impermissible change of accounting method. See Rev. Rul. 90-38, 1990-1 C.B. 57.

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,

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Andrea M. Hoffenson
Branch Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)

Enclosure:
A copy of this letter

cc: