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June 5, 2025

LEGEND:

Taxpayer =

Manager =

Act =

Agency =

Regulation =

Registry =

Protocol =

Department =

State A =

State B =

Grant =

Wildfire =

Project =

a =

b =

c =

d =

e =

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h =

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Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Year 1 =

Year 2 =

Year 3 =

Dear :

This ruling responds to a letter dated December 5, 2024, and supplemental correspondence, submitted on behalf of Taxpayer. For purposes of its status as a real estate investment trust (“REIT”) under § 856 of the Internal Revenue Code (the “Code”), Taxpayer requests certain rulings regarding (i) the treatment of income attributable to the issuance of certain carbon offset credits (“Offsets”) by Agency to Taxpayer for purposes of the REIT gross income tests in § 856(c)(2) and (3); and (ii) the treatment of income from certain reforestation grant payments under § 856(c)(2) and (3).

FACTS

Taxpayer is a State A limited liability company that has elected under § 856 to be treated as a REIT for federal income tax purposes beginning with its taxable year ended Date 1. Taxpayer uses an accrual method of accounting for federal income tax purposes, and its taxable year is the calendar year.

Taxpayer owns approximately a acres of commercial forestland in State B (the “Site”). Taxpayer represents that substantially all of the Site is land, including unsevered natural products of land (e.g., trees), within the meaning of § 1.856-10(c) of the Income Tax Regulations, and, therefore, the Site qualifies as real property within the meaning of § 856. Taxpayer further represents that substantially all income derived from the Site (other than income discussed herein) is qualifying income for purposes of § 856(c)(2) and (3).

Taxpayer has engaged Manager, a third-party corporation and its affiliate, to manage the Site.

Carbon Offsets

In Year 1, State B enacted Act in an effort to reduce greenhouse gas (“GHG”) emissions. Act established 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 GHG emissions (“State B Program”).

Pursuant to Act, Agency administers State B Program on behalf of State B. Agency adopted Regulation effective Date 2, which, in relevant part, established requirements for Agency’s issuance of Offsets to owners of carbon offset projects. Each Offset issued by Agency is a tradeable compliance instrument that represents the reduction or removal of one metric ton of carbon dioxide (“CO₂”) from the environment (or an equivalent amount of another GHG with the potential for global warming).

Pursuant to Regulation, Agency approved Registry to serve as a GHG registry and emissions tracking system used by members to transparently register project-based verified GHG emissions reductions and removals as serialized Offsets and to record the issuance, retirement, and cancellation of Offsets. Registry lists carbon offset projects, collects project data reports, facilitates verification of such reports, and issues Offsets for carbon offset projects implemented pursuant to a compliance offset protocol (i.e., a documented set of procedures and requirements) adopted by Agency. A carbon offset project must comply with the applicable protocol in calculating the baseline amount of GHG removal at a site and quantifying the increased amount of GHG removal achieved by the project at such site.

On Date 3, Agency adopted Protocol to quantify GHG reductions and GHG removal enhancements associated with sequestration of carbon achieved by increasing and/or conserving forest carbon stocks. Among other types of forest carbon offset projects, Protocol applies to projects involving forest management activities that maintain or increase carbon stocks on forested land relative to baseline levels of carbon stocks.

On Date 4, Taxpayer submitted to Registry a listing pursuant to Protocol for a carbon sequestration project on a portion of the Site ("Carbon Project"). Carbon Project involves the development and implementation of forestland management parameters on the project site designed to enhance the site's long-term capacity to absorb CO₂ from the atmosphere and store the gas as carbon in tree trunks, limbs, and roots. Carbon Project also involves calculating the estimated quantity of additional carbon above a baseline that can be sequestered at the project site through improved forest management practices.

To be eligible for Offsets under Protocol, a forest carbon sequestration project must meet specified improved forest management requirements. The requirements applicable to a carbon offset project, such as Carbon Project, include the following affirmative obligations and land-use restrictions, which could be incorporated into recordable easements or other restrictive covenant instruments under local law ("Restrictions"):

- The carbon offset project must consist of at least b% native species based on the sum of carbon in standing live tree carbon stocks.
- The relevant forestlands must be (i) certified by a third party that requires adherence to and verification of harvest levels that can be permanently sustained over time; (ii) operated under a long-term management plan that demonstrates harvest levels that can be permanently sustained over time and that is sanctioned and monitored by a state or federal agency; or (iii) subject to uneven-aged silvicultural practices and canopy retention averaging at least c% across the applicable forestlands.

- Limits on standing dead tree carbon stocks that are determined by a verifier and are dependent upon whether portions of the applicable forestlands have recently undergone salvage harvesting.
- The taxpayer or its designee must demonstrate the carbon offset project's continuous compliance with Protocol by undergoing a full verification of the forest inventory every d years conducted by an independent third party authorized by Agency.
- The taxpayer or its designee must submit annual offset project data reports, including updated estimates of the applicable forestland's carbon stocks.

Offsets are intended to compensate a taxpayer for the loss of revenue from otherwise permissible timber sales and the decrease in value and income resulting from Taxpayer's adherence to Restrictions. Taxpayer has committed to Restrictions on Carbon Project for at least e years. Taxpayer will incur significant penalties if it does not abide by Restrictions to which it has agreed. If Taxpayer sells the Site subject to Carbon Project before the term is up, the new owner must either assume Taxpayer's responsibilities and commitment to Restrictions or the new owner must retire a certain amount of Offsets.

Unintentional reversals of Offsets occur when Offsets have been issued for the removal or reduction of GHGs, and such removal or reduction is later determined never to have occurred, or such GHGs are subsequently released or emitted back into the atmosphere, in either case, not as a result of the forest owner's negligence or willful intent. To insure against such unintentional reversals of Offsets, Agency maintains a "buffer account" for holding a portion of Offsets awarded to forest offset projects. Each time Agency awards Offsets to Taxpayer, Agency places a risk-adjusted portion of such Offsets in the buffer account ("Reserved Offsets"). Reserved Offsets are not transferable. In the event of an unintentional reversal of Offsets (e.g., a forest fire), Reserved Offsets will be retired in an amount equal to the total metric tons of CO₂ that were reversed. On the other hand, in the event of an intentional reversal of Offsets, Taxpayer will be required to replace all reversed Offsets by purchasing Offsets in the market and relinquishing them to Agency.

Taxpayer entered into a carbon management project agreement, effective Date 5, with a third party ("Carbon Manager") to develop and implement Carbon Project in accordance with Protocol. Carbon Manager is responsible for management and oversight of Carbon Project, including meeting project timelines, regulatory deadlines, and complying with Restrictions. Carbon Manager will also coordinate and oversee the work of other third-party contractors hired to collect data, perform carbon modeling, and independently verify the expected carbon sequestration for Carbon Project.

Taxpayer expects Agency to begin issuing Offsets to Taxpayer under Carbon Project in Year 2. Taxpayer represents that it will transfer Offsets to a taxable REIT

subsidiary ("TRS") of Taxpayer that will sell Offsets to unrelated third-party purchasers. Taxpayer further represents that Taxpayer does not intend to hold Offsets for purposes of speculating on future appreciation.

Grant Payments

Taxpayer expects to receive reforestation grant payments from Department pursuant to Grant ("Grant Payments"). Taxpayer represents that Grant Payments will reimburse Taxpayer for all or a portion of its actual costs incurred in reforesting and restoring portions of the Site that were damaged by a wildfire but will not exceed Taxpayer's actual costs incurred in the reforestation project. Taxpayer further represents that once the reforested areas of the Site mature, substantially all of the income generated from those areas will constitute qualifying income under § 856(c)(2) and (3).

Department is authorized to provide grants to and enter into contracts or other cooperative agreements with applicants, including private or nongovernmental entities, for the implementation and administration of projects and programs to improve forest health and reduce GHG emissions. With the goal of improving forest health and firefighting capacity throughout the state, Department awards various types of grants to approved applicants. Grant is the type of Department grant that funds reforestation projects in State B following a catastrophic fire. Reforestation activities eligible for grant funds include tree planting, tree shelter installation, site preparation, oak woodland restoration, invasive plant removal, and herbicide treatments. A grant applicant must explain how the proposed reforestation project will restore climate-resilient natural conditions that prioritize native species and a density and distribution of seedlings that address emergency climate conditions such as increased fire and drought.

In awarding reforestation grants, Department looks favorably upon grant applications covering forestlands owned by multiple landowners because such grants are viewed as having a larger community benefit. Grant covers forestlands owned by multiple landowners and, thus, Taxpayer is not listed as the official grantee on the Department application. The official grantee is tasked with coordinating reforestation activities and disbursement of Department Grant Payments to the landowners covered by a Department grant. Taxpayer is a landowner covered by Grant.

Between Date 6 and Date 7, Wildfire burned f acres of forestlands in State B, including approximately g acres of the Site.

As representative of Taxpayer and several small, nonindustrial landowners affected by Wildfire, Manager applied for Grant from Department. Project, funded by Grant, will facilitate the reforestation of the Site that was damaged by Wildfire. Project will regenerate much of the area within Wildfire perimeter by planting over h tree seedlings from native species in a diverse mix designed to mimic the pre-fire species distribution. Further, conducting site preparation operations using hand, mechanical,

and chemical treatments will give the seedlings the best conditions for survival and growth. In addition, selecting a mix of seedling species from local seed sources that simulate pre-fire stands and planting approximately k trees per acre will result in forested stands that will eventually be available for harvest. At that stage, forest management activities will transition the stands to an uneven-age appearance. Project will protect water quality and soil productivity, restore scenic values and wildlife habitats, and regain carbon storage capacity in the timberlands affected by Wildfire.

Following Department's approval of Grant, Department and Manager, as representative of Taxpayer and the other covered landowners, will enter into a grant agreement. Project performance period (or term) is from Date 8 through Date 9.

At least quarterly, Taxpayer and the other landowners covered by Grant will submit to Manager invoices and supporting documentation for actual expenses incurred for Project during such quarter. Manager will combine the invoices into a single invoice for submission to Department. Subject to Department's approval of the submitted expenses, State B will transfer Grant Payments to Manager as reimbursements for such expenses. Upon receipt, Manager will remit allocable portions of Grant Payments directly to Taxpayer and the other landowners based on the submitted expenses of each party. Taxpayer expects to receive Grant Payments in the amount of approximately \$l pursuant to Grant in Year 2 through Year 3.

LAW AND ANALYSIS

Section 61(a) defines gross income as "income from whatever source derived," except as otherwise provided by law. See § 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 § 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. 84-31, 1984-1 C.B. 127; Rev. Rul. 80-308, 1980-2 C.B. 162.

Section 856(c)(2) provides that for a corporation to qualify as a REIT for any taxable year, at least 95% of its gross income (excluding gross income from prohibited transactions) must be derived from dividends, interest, rents from real property, gain from the sale or other disposition of stock, securities, and real property (other than property described in § 1221(a)(1)), 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 certain mineral royalty income.

Section 856(c)(3) provides that for a corporation to qualify as a REIT for any taxable year, at least 75% 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 mortgages on real property or on interests in real property, gain from the sale or other disposition of real property (other than property described in § 1221(a)(1)), dividends or other distributions on, and gains from the sale or disposition of, shares in other REITs, 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 § 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 which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property for the taxable year does not exceed 15% of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.

Section 1.856-4(a)(1) provides that, subject to the exceptions of § 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.

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

Legislative history indicates that Congress intended part II of subchapter M of chapter 1 of the Code to apply to certain “organizations specializing in investments in real estate and real estate mortgages.” H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960), 1960-2 C.B. 819, 820. Congress intended to restrict the beneficial tax treatment

of part II of subchapter M of chapter 1 of the Code to “what is clearly passive income from real estate investments, as contrasted to income from the active operation of businesses involving real estate.” Id.

Carbon Offsets

Taxpayer earns Offsets as a result of agreeing to and complying with Restrictions that satisfy Agency’s standards for carbon sequestration at the Site. Protocol imposes land-use restrictions by requiring Taxpayer to abstain from certain uses of its land and perform certain actions on its land. Taxpayer has represented that such land-use restrictions are restrictions that could be recorded as easements under local law. Under Protocol, Taxpayer will incur penalties if it does not abide by Restrictions to which it has agreed. For these reasons, Offsets 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’d 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 income with respect to the issuance of Offsets as qualifying income for purposes of § 856(c)(2) and (3) is consistent with the purposes of part II of subchapter M of chapter 1 of the Code.

Grant Payments

Income that Taxpayer receives from Grant Payments constitutes gross income not listed as a source of qualifying income under § 856(c)(2) and (3). Taxpayer will earn Grant Payments for reforesting portions of the Site in State B previously destroyed by Wildfire in accordance with Project. Taxpayer represents that Grant Payments are reimbursements of all or a portion of Taxpayer’s actual costs incurred in reforesting and restoring portions of the Site that were damaged by Wildfire. Taxpayer further represents that once the reforested portions of the Site mature, substantially all the income generated from the Site will constitute qualifying income under § 856(c)(2) and (3). Under these circumstances, treating Grant Payments received by Taxpayer as qualifying income for purposes of § 856(c)(2) and (3) is consistent with the purposes of part II of subchapter M of chapter 1 of the Code.

CONCLUSIONS

Based on the information submitted and the representations made by Taxpayer, we rule that:

- 1) Unless § 451(b)(1)(A) requires earlier inclusion, income with respect to the issuance of Offsets will accrue under § 451 upon the earliest of the following events to occur: Offsets are earned, Offsets are received, or Offsets are due;

- 2) Pursuant to § 856(c)(5)(J)(ii), income from the issuance of Offsets will be considered qualifying income under § 856(c)(2) and (3); and
- 3) Pursuant to § 856(c)(5)(J)(ii), income from Grant Payments will be considered qualifying income under § 856(c)(2) and (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 qualifies as a REIT under subchapter M of chapter 1 of the Code. Moreover, no opinion is expressed with respect to the tax consequences of any dispositions of Offsets, including whether a sale of Offsets gives rise to qualifying income under § 856(c)(2) or (3) and whether such a sale constitutes a prohibited transaction as described in § 857(b)(6)(B)(iii). Furthermore, we express no opinion on the inclusion in income of any portion of a Grant Payment which is eligible for deferral under § 1033(a)(2)(A) and the regulations thereunder and for which Taxpayer makes a valid election under the same authorities.

The ruling contained in this letter is based upon information submitted and representations made by Taxpayer and accompanied by penalties of perjury statements executed by the appropriate parties. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination.

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 cite 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,

Andrea M. Hoffenson
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Financial Institutions & Products)

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cc: