S. HRG. 111–936

CLIMATE CHANGE LEGISLATION: TAX CONSIDERATIONS

HEARING

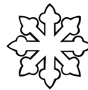
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

JUNE 16, 2009



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

65–230—PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON FINANCE

MAX BAUCUS, Montana, *Chairman*

JOHN D. ROCKEFELLER IV, West Virginia
KENT CONRAD, North Dakota
JEFF BINGAMAN, New Mexico
JOHN F. KERRY, Massachusetts
BLANCHE L. LINCOLN, Arkansas
RON WYDEN, Oregon
CHARLES E. SCHUMER, New York
DEBBIE STABENOW, Michigan
MARIA CANTWELL, Washington
BILL NELSON, Florida
ROBERT MENENDEZ, New Jersey
THOMAS R. CARPER, Delaware

CHUCK GRASSLEY, Iowa
ORRIN G. HATCH, Utah
OLYMPIA J. SNOWE, Maine
JON KYL, Arizona
JIM BUNNING, Kentucky
MIKE CRAPO, Idaho
PAT ROBERTS, Kansas
JOHN ENSIGN, Nevada
MICHAEL B. ENZI, Wyoming
JOHN CORNYN, Texas

RUSSELL SULLIVAN, *Staff Director*
KOLAN DAVIS, *Republican Staff Director and Chief Counsel*

CONTENTS

OPENING STATEMENTS

Page

Baucus, Hon. Max, a U.S. Senator from Montana, chairman, Committee on Finance 1
Grassley, Hon. Chuck, a U.S. Senator from Iowa 3

WITNESSES

Hufbauer, Gary, Reginald Jones senior fellow, Peterson Institute for International Economics, Washington, DC 4
Price, Mark, principal-in-charge, financial institutions and products, Washington National Tax, KPMG LLP, Washington, DC 6
Butler, Keith, senior vice president of tax, Duke Energy, Charlotte, NC 8

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Baucus, Hon. Max:
- Opening statement 1
- Prepared statement 15

Butler, Keith:
- Testimony 8
- Prepared statement 17
- Responses to questions from committee members 24

Grassley, Hon. Chuck:
- Opening statement 3
- Prepared statement 26

Hufbauer, Gary:
- Testimony 4
- Prepared statement 28
- Responses to questions from committee members 32

Price, Mark:
- Testimony 6
- Prepared statement 37

COMMUNICATIONS

Large Public Power Council (LPPC) 45
National Association of Real Estate Investment Trusts (NAREIT) 48

CLIMATE CHANGE LEGISLATION: TAX CONSIDERATIONS

TUESDAY, JUNE 16, 2009

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:20 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Conrad, Cantwell, Nelson, Grassley, Snowe, and Crapo.

Also present: Democratic Staff: Bill Dauster, Deputy Staff Director and General Counsel; Pat Bousliman, Natural Resource Advisor; David Hughes, Senior Business and Accounting Advisor; and Jo-Ellen Darcy, Senior Environmental Advisor. Republican Staff: Jim Lyons, Tax Counsel; and Mark Prater, Deputy Staff Director and Chief Tax Counsel.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

First, I apologize for starting so late. I think this is a record. I think never since I have chaired this committee have I ever commenced a meeting, a hearing, as late as this, and I apologize to all of you. Something came up we had to attend to.

The author Theodore Roszak wrote, "Nature composes some of our loveliest poems for the microscope and the telescope." Today we consider one of the broadest subjects in nature, that of climate change, and we are going to look at it through a particular microscope, that of tax policy.

Today, we will look at the tax implications of legislation on global warming. We will consider the narrow question: How should the tax law treat allowances?

The answer will have broad implications. Most major climate change proposals set an emissions target on greenhouse gas emissions. For example, the Obama administration proposes capping greenhouse gases in 2020 at 14 percent below the level emitted in 2005. The cap is then divided into emission allowances. An allowance is the right to emit one-ton of carbon dioxide or its equivalent. People can then buy or sell those allowances or folks can hold onto them for the future.

Some proposals would distribute allowances free of charge, other proposals would sell the allowances through an auction, still others would combine distributing and auctioning.

Today, we will put questions like these under the microscope. If allocations are distributed for free, should the tax law treat them as income to the recipient? Should the tax code treat an emission allowance as a capital asset subject to depreciation over time, or should the law allow buyers to deduct the cost of buying an allowance as a cost of doing business?

How should the law treat gains and losses associated with allowances? Should the law treat them as capital gains or ordinary income from a sale? And should the system allow emission allowances to be banked and carried forward to future years?

The Treasury Department has provided some approaches to some of these questions through guidance on legislation to eliminate acid rain. The Clean Air Act amendments of 1990 successfully cut sulfur dioxide emissions in the least costly way, and Treasury's guidance was important in determining how the exchange of allowances should be considered from a tax prospective.

Should Congress abide by this same guidance in considering legislation to reduce carbon emissions? It may be appropriate to adopt some past practices on tax treatment allowances, but the scope of the Clean Air Act amendments is much smaller than legislation to cut carbon emissions.

For example, the acid rain program applied to fewer than 120 facilities nationwide; the cap and trade will apply to over 7,000. Moreover, the law has changed since 1992. Congress has enacted major tax legislation, including legislation affecting the amortization of intangible assets, since the Treasury issued its 1992 guidance. I support legislation to reduce carbon emissions. The Finance Committee will play a key role in that law's development.

In a recent hearing, we explored the implications of a carbon auction. In another hearing next month we will look at what climate change legislation means to our trade-exposed industries. We have also been working hard to smooth the transition to a low-carbon economy through other means, especially energy tax incentives.

In the last year we passed more than $38 billion in energy tax incentives for areas ranging from fuels to efficiency to cleaner electricity. We have a great deal more to do, and we will continue our efforts in the coming weeks and months.

I appreciate our distinguished witnesses being here today and I also appreciate the Joint Committee on Taxation for providing yet another solid background pamphlet for today's hearing.*

Now, the tax law is certainly not among the world's loveliest poems, but every now and then it is important to take a look at it under a microscope, and by doing so today we will try to advance one of the broadest goals in nature—that of slowing climate change.

Senator Grassley?

---

* *See* "Climate Change Legislation: Tax Considerations," Joint Committee on Taxation staff report, June 11, 2009 (JCX–29–09), *http://www.jct.gov/publications.html?func=startdown&id=3559.*

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Yes. Thank you, Mr. Chairman.

There are, of course, many technical tax questions that will be addressed. The first point that I should make is that, if cap and trade is not enacted, then we are worrying about these questions for nothing. However, if it is enacted, then a bunch of tax issues need to be dealt with.

For example, if allowances to emit carbon dioxide are given away free, should the corporations that receive these valuable allowances be taxed upon receipt of them? There are various opinions about whether allowances should be given away or auctioned off.

Waxman-Markey initially gives away 85 percent of its allowances for free. These 85 percent of allowances are estimated by CBO to be worth about $693 billion over 10 years.

However, Peter Orszag, the administration's OMB Director, when he was CBO Director in 2007, testified before Congress that, "If you didn't auction the permits, it would represent the largest corporate welfare program that has ever been enacted in the history of the United States."

Similarly, in response to my question for the record from the March 4, 2009 hearing on the administration's budget, Secretary Geithner wrote, "The program will be implemented through an economy-wide cap-and-trade program in which all emission allowances will be auctioned to ensure that the biggest polluters do not enjoy windfall profits."

So, if the administration has its way, we will not even need to consider the tax treatment of allowances given away for free. One thing that concerns me with cap and trade is that the current version appears to be pain and no gain. In other words, the American consumer will pay higher energy prices as well as higher prices for all goods and services. That is the pain part.

But unless there is an agreement with China, which is the largest emitter of greenhouse gases, as well as, for instance, Russia and India, and other large emitters, then there is no gain. We could reduce our greenhouse gas emissions while the rest of the world continues to increase its emissions, resulting in increasing emissions worldwide.

Meanwhile, our consumers and economy then would suffer from our own cap-and-trade program. I have a June 13th *Washington Post* article stating, "Instead, the Special U.S. envoy for climate change said yesterday, he would press for China to reduce the rate at which its emissions grow. Envoy Todd D. Stern said at a news conference that he wants China's emissions to increase less than projected. 'So that's not an absolute reduction below where they are right now,' Stern said, 'because they're not quite at that point to be able to do that.'"

Of course, that sounds a lot like President George Bush's proposal to limit greenhouse gas intensity relative to GDP, which was roundly panned by environmental groups. I am also concerned about the fact that the speculators from Wall Street, Chicago, and San Francisco have been all too eager to embrace cap and trade. Cap and trade would represent a huge new market that hedge

funds and private equity firms are salivating over. In fact, Enron and AIG were two of the early proponents of cap and trade.

Four years ago this committee held a hearing on the activities of the Nature Conservancy. These activities included the organization's receipt of contributions in exchange for emissions credits. The staff report on these arrangements raised a number of tax issues for both the exempt organizations as well as polluters that also need to be addressed.

We will hear today how all of these exotic derivatives on allowances should be taxed. We know if cap and trade is enacted, of course, Wall Street people will be happy to help in designing derivatives based on allowances. Some of these derivatives will be futures, forwards, options, collars, swaps, call spreads, swaptions, and hybrids of the above derivatives. I worry about Wall Street speculators making fortunes off the back of the American taxpayer.

Thank you Mr. Chairman.

THE CHAIRMAN. Thank you, Senator. We will now turn to our witnesses.

The first is Mr. Gary Hufbauer, the Reginald Jones senior fellow at the Peterson Institute for International Economics. Welcome back, Gary. Good to see you. Next, Mark Price, principal-in-charge of financial institutions and products in the Washington National Tax Group at KPMG. And finally, Keith Butler, senior vice president of tax at Duke Energy.

I will ask each of you to summarize your statements. It will all automatically be included in the record.

So why don't you begin, Mr. Hufbauer?

STATEMENT OF GARY HUFBAUER, REGINALD JONES SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Mr. HUFBAUER. I thank you very much, Mr. Chairman and members of the committee.

Recently, I was a co-author of a book, "Global Warming in the World Trading System." I am going to leave some copies. That book does not deal with these tax issues, but it does deal with a lot of the important trading issues which you will be addressing later.

As you have said, Mr. Chairman, this is a very serious problem. In my personal view, a carbon tax system would be vastly superior to a cap-and-trade system on transparency, uniformity, revenue raising, and administration. It could more readily be adjusted at the border. I think the Waxman-Markey bill illustrates the enormous complexity, opacity, and rent-seeking inherent in a permit system.

But that said, the political forces are favoring the cap-and-trade system, so my purpose today is to comment on the tax and trade aspects of this system. And, when I use the word carbon permits, I am referring to all greenhouse gas permits on a carbon dioxide-equivalent basis.

So let me quickly run through some questions and answers in my testimony. Are free allowances of carbon permits income? This is the threshold question. My answer is a very decisive yes. I think it would be an enormous travesty, on top of bills which propose to give away free allowances, and which do not even get to a 50-

percent auction (in the Waxman-Markey bill) until 2029, to then make the allowances tax-exempt.

I think, Mr. Chairman, you have summarized the differences between the SO_2 allowances and the carbon permits in terms of size. In terms of dimension, they are completely different. Further, we learn a lot over time, and I think we have learned about markets for things like these kind of permits. So to draw heavily on the SO_2 analogy, I think, would be quite inappropriate.

And in line with that, I would say that another task for this committee, working with other committees, is to ensure that the permits are tradable and easy to manage so we do not get into the opacity of semi-tradable permits, which would then slide into the realm of non-taxation. Should permits be a business deduction when used? Well, by all means, they should be; I would say in the year purchased and used, as an ordinary and necessary business expense. I would hope that the taxation of permits does not get into the capitalization realm and all of the complexities there.

On trading in carbon permits, I would not make a distinction between the type of holder. As for the type of income, I would hope they would be all treated as ordinary income, again, to get away from any kind of capital gains complexities.

Now let me turn to the oversight and regulation of trading and carbon permits. I am a real believer in financial markets, but I am a very strong disbeliever, an objector, to unregulated over-the-counter markets which got us into so much trouble as part of this financial crisis.

So, if we create a system in this country of tradable permits, there should be a simultaneous authorization of exchanges that handle the permits. All transactions should take place on those exchanges. They should post prices, volumes, and also the parties doing the trading should be disclosed.

One final point I will make, and that is on collars. I think that collars would be a very good idea in a permit system, that is, floors and ceilings. Collars will smooth out price fluctuations and allow a longer horizon for firms to anticipate the prices they are going to face, and therefore the adjustments they have to make. Collars also will enable spikes to be avoided. In my view, the EPA should be the administrator which proposes the collars, but I think carbon will be such an important price for the American economy that Congress should review, and possibly disapprove, anything proposed by way of collars.

Just one final comment. I did have a chance over the weekend to read the Joint Committee's excellent pamphlet, and what I would say is this. The pamphlet points out all sorts of room for complexity in the taxation of offsets and taxation of allowances and deductions and so forth and so on. I do hope that the committee goes for simplicity, not complexity.

Thank you very much.

[The prepared statement of Mr. Hufbauer appears in the appendix.]

Senator GRASSLEY. All right, now we will call on Mr. Price.

STATEMENT OF MARK PRICE, PRINCIPAL-IN-CHARGE, FINANCIAL INSTITUTIONS AND PRODUCTS, WASHINGTON NATIONAL TAX GROUP, KPMG LLP, WASHINGTON, DC

Mr. PRICE. Mr. Chairman, Ranking Member Grassley, members of the committee, good morning. My name is Mark Price. I am a principal at KPMG LLP, a major U.S. accounting firm.

I am pleased to have the opportunity to testify as an invited witness before the committee this morning on the topic of the tax considerations associated with climate change legislation. During my testimony, I will take the next several minutes to summarize the points in the written testimony submitted to the committee. During this summary, I would like to highlight the following points.

First, current law does offer an approach to taxing allowances and offsets, but current law may lack certainty on several issues of significance to the various participants in the cap-and-trade system and to the Internal Revenue Service. Second, current law is based on authorities that have not been updated for changes in tax legislation. And finally, the allowances and offsets in the cap-and-trade proposals raise issues that may be more appropriately addressed through legislation.

The two significant issues raised by cap and trade for covered entities are likely to be the character and timing of gain or loss. Character, because the current rule that corporations can only apply capital losses against capital gains and not ordinary business income may create cash flow issues from any set of rules that could produce ordinary income and capital loss, and timing, because the recognition of income in advance of expense could also affect an entity's cash flow.

The tax treatment of the transactions is fact-dependent. As the chairman has noted, the tax treatment of cap and trade under current law would be based primarily on authorities issued by the Internal Revenue Service on the treatment of sulfur dioxide emissions under the Clean Air Act amendments of 1990. This guidance must be considered in conjunction with current law on other topics.

Now I would like to summarize briefly what I believe is the current tax treatment under current law. First, what happens on acquisition? The covered entities that are granted allowances from the Federal Government likely, under current law, do not have income on the date of grant. That is consistent with the 1992 ruling by the IRS on sulfur dioxide emissions allowances.

Second, what happens when a covered entity uses the allowance in its trader business? Although the answer is not entirely clear, the strongest answer under current law is that the amount paid for the expense, if any, is allowed as an expense in the year the allowance would be used.

Third, if an entity sells an allowance, what is the character of the gain or loss? Now, interestingly, the answer to this will depend on whether or not the allowance is considered depreciable. Allowances not intended to be used in the business are generally going to produce capital gain or loss, but allowances that are intended to be used to satisfy emissions requirements may produce capital gain—may produce ordinary gain or loss—depending on, first, whether those allowances are depreciable and, second, the period of time for which the allowances are held. This uncertainty is cre-

ated in part by the fact that the IRS's guidance on the topic relating to sulfur dioxide emissions, as Mr. Hufbauer and as the chairman noted, predates the enactment of legislation regarding the amortization of intangibles.

Another category of character uncertainty relates to what happens to entities that are considered "dealers" in allowances. I would first note that, under current law, what is a dealer is an uncertain concept. Second, I would say those dealers would have ordinary income or loss, assuming that they qualify as a dealer.

The final thing under current law I would like to point out is what happens to those entities that have to purchase emissions allowances. Entities that purchase emissions allowances will be required, most likely, to manage their price risk for the purchase of these allowances. They will likely have to do this through entering the derivatives market, and in entering the derivatives market there exists an age-old question as to the character of gain or loss from the derivatives.

Obviously, it would be unreasonable for the law to produce capital loss or capital gain on the derivative while producing ordinary gain or loss on the commission's allowance. Unfortunately, under current law, it would appear the likely answer is that those emissions allowances would be capital, creating a character mismatch between the risk management policies that the users will need to undertake and the assets that they will need to purchase to satisfy this new regulatory requirement.

I would also like to take a few minutes, just briefly, to comment on some considerations for tax legislation. First, I think it is appropriate for the committee to consider whether or not the current law rules are appropriate. I have stated that I believe they are. It is still a second question as to whether the right tax policy answer is the answers that I have suggested.

Second, what should the committee do about the borrowing of allowances? This is a new concept not seen in the sulfur dioxide allowance rules. It is also a new concept that has not been developed in great detail, and the tax treatment of it is going to depend on the form and, as the form evolves, it would be appropriate to consider the taxation.

Third, the fees for noncompliance. Are these fees going to be deductable or not? And finally, an oddball comment, whether or not these allowances are characterized as commodities creates a whole web of issues for taxpayers. It affects whether financiers can mark to market, it affects whether or not they are amortizable, and it affects the international tax implications. It would be reasonable for any tax-writing committee to consider whether: (a) it is appropriate to link all of these to the concept of the commodity, and (b) whether the right answer is produced by the conclusion that it is or is not a commodity.

Thank you for the opportunity to testify.

Senator GRASSLEY. Thank you Mr. Price.

[The prepared statement of Mr. Price appears in the appendix.]

Senator GRASSLEY. Mr. Butler?

STATEMENT OF KEITH BUTLER, SENIOR VICE PRESIDENT OF TAX, DUKE ENERGY, CHARLOTTE, NC

Mr. BUTLER. Good morning, Chairman Baucus, Ranking Member Grassley, and other distinguished members of the committee. Thank you for the opportunity to appear before you today to discuss the tax considerations related to climate change.

My name is Keith Butler, and I am senior vice president of tax for Duke Energy Corporation, one of the largest electric utility companies in the United States, supplying and delivering electricity to approximately 4 million U.S. customers in our regulated jurisdictions of North and South Carolina, Indiana, Kentucky, and Ohio.

Duke Energy is also an active developer and owner of an expanding portfolio of renewable energy assets. In considering the direction for the tax treatment of CO_2 allowances, the most logical place to start is with the current treatment for SO_2 and NO_X allowances. These allowances were established under title 4 of the Clean Air Act amendments of 1990. These new and unique allowances at the time opened the door to tax directors and the Internal Revenue Service to establish guidelines, regulations, and interpretations of how these allowances should be treated for tax purposes. The tax treatment for these allowances became dependent on the nature and character of how the taxpayer handled these allowances within their company.

The initial issue that had to be addressed by taxpayers was the tax basis of the allowance. This was the least challenging issue in the sense that, if the allowances were received during allocation from the EPA, these were considered to be at no cost to the taxpayer, and thus the tax basis was zero. As with most acquired assets, if the allowance was obtained through a purchase by the taxpayer, the tax basis is the cost paid plus any incidental costs such as fees to brokers, legal costs, et cetera. With respect to the proposed CO_2 allowances, there are no material issues that would call for a change in this treatment.

A more challenging issue is centered on the recovery of the cost or tax basis of the allowance itself. The least controversial recovery consideration centers on the allowances allocated by the EPA to the taxpayer. Since the taxpayer has a zero basis on these allowances, the taxpayer would not have, or need, the benefit of a tax deduction at the time the allowance is utilized.

The more complex issues center on the treatment when the recovery of the basis is through the sale of the allowance and the determination of the nature of the gain or loss as to whether it is capital or ordinary. The treatment is determined by the characterization of the allowance by the taxpayer and the nature of the activity by the taxpayer with respect to these allowances. This is where there seems to be some ambiguity in the tax guidance.

A typical holder of allowances that is using the allowances for their own offset purposes, and may have the occasional opportunity to sell an allowance, would generally treat the sale as capital, thus resulting in a capital gain or loss.

This is supported by the IRS's Guidance and Revenue Procedure 9291. The taxpayer can have a mismatch in cash flow due to the inability to offset capital losses if the taxpayer does not have sufficient capital gains within the specific tax period. If, however, the

taxpayer, in their ordinary course of business, is regularly dealing in allowances by buying and selling allowances as part of their business, the IRS guidance would imply ordinary treatment in the resulting gains and losses, although there is some lack of clarity in the tax guidance.

And last, if the taxpayer is treating the allowance as a commodity in trading these securities, capital treatment would tend to rule, although, this again is less clear. Clearly, this is one of the areas in which more clarity from the IRS could be useful to the taxpayers, especially if the CO_2 allowance has introduced broader recovery initiatives, including the introduction of international markets, restrictions to transactions only through commodity exchanges, or the consideration of offsets.

Another area to be addressed further is the one method for a taxpayer to recover its basis through a "like-kind" exchange. The guidance under section 1031 of the code is clear on the treatment; the issue is, is an emission an emission or are there unique differences between an SO_2, NO_X, or a CO_2? As you can see from these comments, although the current program of SO_2 and NO_X allowances is working well, there are issues of ambiguity in the tax treatment introduced by the broadness of how these allowances are used, exchanged, and recovered. Flexibility is important, as different taxpayers have varying needs and uses for the allowances, and as the markets evolve over time.

A balance of clarity and flexibility is important to well-functioning markets. The IRS, Department of Treasury, your committee, and other key governmental agencies, working hand in hand with affected taxpayers, will need to factor in past, current, and future activities centering on emission allowances and related programs when formulating the tax treatment.

Thank you, Chairman Baucus, Ranking Member Grassley, and other members of the committee for the opportunity to share these remarks. Duke Energy stands ready to work with you and your colleagues with these initiatives.

[The prepared statement of Mr. Butler appears in the appendix.]

Senator GRASSLEY. I will start by asking questions of Mr. Price and Mr. Butler, at least the first question. I refer to the nonpartisan Joint Committee on Taxation writing in their pamphlet referred to so far: giving away pre-allowances and not taxing these allowances upon receipt, is in effect, compensating those who receive free allowances, and doing it twice. With the exception of the entities with a regulated rate of return such as utilities, Joint Tax says, "The argument that there is no accession to wealth from the receipt of free allowances is more difficult to sustain."

So, Mr. Price, Mr. Butler, do you believe that there is an accession to wealth from the receipt of tax-free allowances? Or I should say free allowances, not tax-free allowances. That is the question.

Mr. PRICE. Senator Grassely, I agree with the statement in the Joint Committee report that, as an economic matter, there is an accession to wealth as a result of the allocation of allowances. I would note that under current law similar accession to wealth has existed for sulfur dioxide allowances and in other cases involving the allocation of favorable leases to oil and gas companies to mine for oil and gas or other mineral rights, and so it seems, at least under

current law, that the policy has been, notwithstanding the fact that as an economic matter there is an accession to wealth, the better answer from perhaps an administrability perspective is not to tax it. As far as whether it ought to be taxed as a tax matter, that is a policy question that I leave for the committee to consider.

Senator GRASSLEY. Mr. Butler?

Mr. BUTLER. Thank you, Senator Grassley. I agree with Mr. Price's response. The issue is, if you tax the allocation as a recognition of wealth, it simply comes back as a deduction, and it potentially could add, ultimately, cost to the end customer.

Senator GRASSLEY. My second question is that we have Wall Streeters lobbying for Congress to enact a cap-and-trade tax regime. This is for all of you. Do you think the speculators from hedge funds and private equity firms should be allowed to participate in the cap-and-trade tax regime?

I will start with you, Mr. Hufbauer.

Mr. HUFBAUER. Thank you. Yes, I do, but only under the condition outlined in my testimony, which is, trading takes place on an organized exchange. For any derivatives, margin and variation margin must be set by the exchange. All participants are revealed, no street names. Quantities are revealed, and there can be no transactions outside the exchange. If there is going to be a market, let's make it a real market that can then provide the basis for taxation, and also prevent all the financial hanky panky which you are so familiar with.

Senator GRASSLEY. All right.

Mr. Price?

Mr. PRICE. Again, I am not in a position necessarily to comment on the regulatory conclusions. I would say as a tax matter, as a general matter, I would observe that to some degree these third party participants will be necessary to ensure some liquidity to the market, and, if one is going to adopt the system of cap and "trade," that one needs to make sure that the trading works efficiently. As a tax matter, I think it is a question that the Joint Committee raised as to how one taxes it, whether one wants to tax that group punitively. Under current law, I think that there are uncertainties that may make those participants uncertain as to how to enter the market in a tax-efficient way.

Senator GRASSLEY. All right, Mr. Butler, do you have anything to add?

Mr. BUTLER. No sir.

Senator GRASSLEY. All right.

My third question to the panel is—well probably my last question because of the time—President Obama has proposed a large number of tax increases in the budget. For example, his carried interest revenue raiser is broader than previous carried interest proposals. Also, he has proposed to repeal the favorable treatment for dealers and traders for futures and options on commodities.

If enacted, how would these proposals affect the tax treatment of allowances and derivatives based on allowances?

Mr. Price? Mr. Butler? Any of you can respond, please.

Mr. PRICE. Well, it is not entirely clear, based on the description the administration put forth on the commodities dealer provision, exactly the scope of it. As best I can tell, it would ensure that enti-

ties that trade and deal in commodities would end up with ordinary income on all of their commodities dealing in trading activities, which goes back to the question, or the comment I raised in my testimony. Under current law, these allowances would not be considered commodities and, therefore, all of that proposed legislation would be inapplicable. Again, whether that is right is a question I think is worth considering.

Mr. HUFBAUER. Mr. Chairman, my view on that very interesting question is that the committee should start with a white slate on this carbon thing. I mean, this is so big, and the numbers are so large, that I do not think that you should be affected by all this SO_2, and what I would regard as these lousy decisions by the IRS in the past, not to be too polite about it. You should start with a blank slate and just write the tax law for carbon, including the derivatives, and do not go on all these old analogies which are inappropriate.

Thank you.

Senator GRASSLEY. Do you have anything to add, Mr. Butler?

All right, I will call on Mr. Conrad.

Senator CONRAD. Thank you.

Senator GRASSLEY. Senator Conrad. [Laughter.]

Senator CONRAD. Thank you, Senator Grassley.

And by the way, Mr. Hufbauer, you are the first person in all the time I have been on this committee who have suggested that Senator Grassley is familiar with hanky panky. [Laughter.]

If there was ever a guy who is not familiar with hanky panky, it is Senator Grassley.

Senator GRASSLEY. I assume that is a compliment. [Laughter.]

Senator CONRAD. It is the highest compliment in North Dakota.

I would like to ask each of the witnesses, have you heard something from the other witnesses that you strongly agree with or strongly disagree with?

I would start with you, Mr. Hufbauer.

Mr. HUFBAUER. Well, as you heard from my remarks, I strongly disagree with Mr. Butler that we ought to resort to these old rulings on SO_2, which is a much smaller market—I will not go through it again—or rely on some of these old revenue rulings on capital treatment, and so on and so forth. I mean, just to use that distant stuff from the past for this new market which is so vast, is, I think, inappropriate. Why not bring over the laws from Amsterdam and apply then in New York today?

Senator CONRAD. All right. Mr. Butler?

Mr. BUTLER. I am not advocating that we look to the old rules and just carry those forward. I am advocating that we look to those rules, and, as I pointed out in my discussion, there is some ambiguity, there is some lack of clarity, this distinguishment of what are these, are these capital or are they ordinary, and I think that needs to be dealt with. I do believe though that these allowances should be granted with zero tax basis and they should not be taxed upon granting, because that just creates an ultimate cost that I do not think we need to create.

Senator CONRAD. Mr. Price?

Mr. PRICE. I guess I agree to some extent with Mr. Butler and disagree with Mr. Hufbauer on the issue of character. I do not

think under current law, whether you are looking at the emissions allowance legislation guidance in particular, or more broadly, at the question of what the character of these assets is, is at all crystal clear. I think there are businesses for which it is appropriate probably as a tax policy matter, as well as just as a matter of tax law, to get capital gain on the disposition. I also think that there are other situations where ordinary is the appropriate answer. So, I guess the item that I may take the most issue with is sort of the black-and-white portrayal of the character.

Senator CONRAD. All right.

Mr. Hufbauer, what would you see as the consequences to the Federal Treasury of following the SO_2 treatment, carrying that over to CO_2?

Mr. HUFBAUER. Thank you, Senator.

The result would be that, not only do we have an inappropriate and excessive system of free allowances in the Waxman-Markey bill going up to 2029, but then you would not get any tax revenue from it. In this time, when the fiscal problems of our Nation are so clear, it is just mind-boggling that we would go down that path. I mean, you look at President Obama's initial budget, at a $600-billion rate, then, when you go through the Waxman-Markey proposal, most of that is consumed by offsets and allowances as far as the eye can see. Then not to have any taxes on that, well, what you are going to do is throw out a couple hundred billion dollars, two or three hundred, who knows, and it is over a period of time when we have extreme fiscal stress. So I just think it is amazing to even be contemplated.

Senator CONRAD. Mr. Price, following up on Mr. Hufbauer's comment, what do you see as the implications for the Federal Treasury of treating CO_2 in the same way SO_2 has been treated?

Mr. PRICE. A lot of it is going to depend on which entities are allocated the allowances. I think if users are allocated the allowances, at least the historic practice of users of SO_2 has been to use those allowances in the same year of grant. So, say their income today means they include income in 2012 or 2014, and then, when they use the allowance to satisfy their obligation, they would end up with a deduction in an equal amount in the same tax year. So I am not sure that the revenue impact would be that great assuming that the allowances are allocated to users of those allowances.

Senator CONRAD. And to the extent that is not the case?

Mr. PRICE. To the extent that is not the case, it depends on who those entities are. If those entities were to sell them, which presumably is the intention of giving them to non-users, they would want to sell them immediately to generate revenue for some purpose, then they would again have a tax consequence in the year in which they were granted. I am not sure there is much incentive for them to bank their allowances and to defer the time at which they would actually recognize the income and pay the tax.

Senator CONRAD. Mr. Butler. How would you respond?

Mr. BUTLER. I think that is the issue. The issue is, is this a timing matter to the Treasury of generating revenue through having them taxed versus the timing of when the deduction is taken? And also the other issue is the nature of the capital versus ordinary. Do you generate capital losses in which you do not have capital gains

and you ultimately have to write off those losses and not be able to utilize them? Well, that could be a revenue generator, but I do not think that is the right answer of what we are looking for in these allowances.

Senator CONRAD. All right.

I thank the Chair.

Senator GRASSLEY. Senator Nelson, it is now your turn.

Senator NELSON. Thank you, Mr. Co-chairman.

What do you think we ought to do to the tax treatment of allowances to keep out the speculators?

Mr. HUFBAUER. Well, Senator, my viewpoint on that, maybe to start with, is that I do not think that speculation is necessarily a bad thing. It can be market smoothing, but I think it is just critical to set the conditions in which markets operate. And I put those in my suggestions, as outlined in my testimony. I do think that, if it turns out to be an over-the-counter type of market, and section 1031-type exchanges were mentioned—that again, is an amazing proposition to me—well then, you are going to get all the kind of nonsense we had in the financial markets recently. So, if it is open, transparent, for example, as the oil market is under the Chicago exchange, then I think it can serve a useful purpose, but if it is a kind of an underground CDO-type of market or one of these credit default types of markets, then all kinds of mischief is going to occur.

Mr. PRICE. I am not sure there is a straightforward way to accomplish that through tax policy, because you will find that many entities that have the need for allowances will also be either optimizing the price for allowances or will have their own separate operations that one might perceive as speculation and one might perceive as trading. It is a matter of, perhaps, semantics.

So it is hard to figure out a way to craft a rule that just says speculators are punished. In terms of things one might mechanically do in a tax code, the only real things you can play with without some form of penalty tax would be character and timing, and it will be hard to draw the line between those entities that are speculators and those entities that are users.

I am not really sure which answer is better. To say they are capital means speculators could have capital losses which are undesirable. To say they are ordinary income means the individuals or the speculators might pay higher taxes, but they can apply it against losses they have on other investments. So it is a very difficult question to resolve through tax policy.

Senator NELSON. A penalty tax, Mr. Butler, for speculators?

Mr. BUTLER. I do not think that is the right answer. I do not think tax policy is the way to achieve it. If speculation is an issue that this committee is trying to deal with and the legislation is trying to deal with, I do not think tax policy is the right way to do it.

Senator NELSON. With regard to the sulfur dioxide trading program, traders and investors are generally treated the same for tax purposes as the users of the credits. There are some exceptions for depreciation, involuntary conversion, and penalties. Under a cap-and-trade carbon program, should we alter the general tax rules that apply under the sulfur emissions trading program?

Mr. BUTLER. As I pointed out in my testimony, I think this is an issue that really needs to be dealt with. It is not clear in the current tax policy as to whether these are treated as ordinary or capital income and can change depending upon how these are dealt with by the taxpayer itself. So I think this is the area that probably is most important to put some real clarity around.

Senator NELSON. Thank you, Senator.

Senator GRASSLEY. I have no further questions. There are other members who cannot come who may submit questions for answer in writing, so the record will stay open for a little while. We would ask you folks, if you get questions, to cooperate by answering them. And I want to apologize for the chairman, Senator Baucus. He had an emergency and had to go and will not be back, so he asked me if I would close the meeting. So we do that by thanking you once again for your expert testimony and your cooperation.

Thank you very much.

Hearing adjourned.

[Whereupon, at 11:02 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding Tax Considerations Under Climate Change Legislation

The author Theodore Roszak wrote:

"Nature composes some of her loveliest poems for the microscope and telescope."

Today, we consider one of the broadest subjects in nature — that of climate change. And we are going to look at it through a particular microscope — that of tax policy.

Today, we'll look at the tax implications of legislation on global warming. We'll consider the narrow question: How should the tax law treat allowances? The answer will have broad implications.

Most major climate change proposals set an emissions target on greenhouse gas emissions. For example, the Obama Administration proposes capping greenhouse gases in 2020 at 14 percent below the level emitted in 2005.

The cap is then divided into emission allowances. An allowance is the right to emit one ton of carbon dioxide or its equivalent. People can then buy or sell those allowances. Or folks can hold onto them for the future.

Some proposals would distribute allowances free of charge. Other proposals would sell the allowances through an auction. Still other plans would combine distributing and auctioning.

Today, we'll put questions like these under the microscope:

If allocations are distributed for free, should the tax law treat them as income to the recipient? Should the tax code treat an emission allowance as a capital asset, subject to depreciation over time? Or should the law allow buyers to deduct the cost of buying an allowance as a cost of doing business?

How should the law treat gains and losses associated with allowances? Should the law treat them as capital gains or ordinary income from a sale?

And should the system allow emission allowances to be banked, and carried forward to future years?

The Treasury Department has provided some approaches to some of these questions, through guidance on legislation to eliminate acid rain. The Clean Air Act amendments of 1990 successfully cut sulfur dioxide emissions, in the least-costly way. And Treasury's guidance was important in determining how the exchange of allowances should be considered from a tax perspective.

Should Congress abide by this same guidance in considering legislation to reduce carbon emissions?

It may be appropriate to adopt some past practices on tax treatment of allowances. But the scope of the Clean Air Act Amendments is much smaller than legislation to cut carbon emissions. For example, the acid rain program applied to fewer than 120 facilities nationwide. Cap and trade will apply to over 7,000 entities.

Moreover, the law has changed since 1992. Congress has enacted major tax legislation, including legislation affecting the amortization of intangible assets, since Treasury issued its 1992 guidance.

I support legislation to reduce carbon emissions. And the Finance Committee will play a key role in that law's development.

In a recent hearing, we explored the implications of a carbon auction. In another hearing next month, we'll look at what climate change legislation means to our trade-exposed industries.

We have also been working hard to smooth the transition to a low-carbon economy through other means, especially energy tax incentives. In the last year, we've passed more than $38 billion in energy tax incentives, for areas ranging from fuels to efficiency to clean electricity.

But we have a great deal more to do. And we'll continue our efforts in the coming weeks and months.

I appreciate our distinguished witnesses being here to help us. I also appreciate the Joint Committee on Taxation for providing yet another solid background pamphlet for today's hearing.

Now the tax law is certainly not among the world's loveliest poems. But every now and then, it's important to take a look at it, under the microscope. By doing so today, we'll try to advance one of the broadest goals in nature — that of slowing climate change.

###

WRITTEN TESTIMONY OF
KEITH G. BUTLER
SENIOR VICE PRESIDENT TAX
DUKE ENERGY CORPORATION

BEFORE

THE UNITED STATES SENATE COMMITTEE ON FINANCE

HEARING ON CLIMATE CHANGE LEGISLATION: TAX CONSIDERATIONS

JUNE 16, 2009

Good morning Chairman Baucus, Ranking Member Grassley and distinguished members of the Committee. Thank you for the opportunity to appear before you today to discuss the tax considerations related to proposed climate change legislation. My name is Keith Butler and I am the Senior Vice President of Tax for Duke Energy Corporation, one of the largest electric power companies in the United States, supplying and delivering electricity to approximately 4 million U.S. customers within our regulated jurisdictions of North and South Carolina, Ohio, Indiana and Kentucky, and a developer and owner of an expanding portfolio of renewable energy assets.

Establishment of the Emission Allowances

Title IV of the Clean Air Act Amendments of 1990, 42 U.S.C. Section 7651 et seq., established a program of sulfur dioxide (SO2) emission allowances to be allocated annually to certain electric generating companies (Generator) beginning in 1995. This program is administered by the Environmental Protection Agency (EPA).

Faced with the establishment of this program of emission allowances, Tax Directors looked to existing guidance from the Department of Treasury with respect to the tax treatment of the emission allowances. There were a number of issues that Tax Directors had to resolve in determining how to treat emission allowances for U.S. Federal tax purpose – since they were a new and unique item. The treatment was also conditional on how and what the taxpayer would do with these emission allowances.

The allowances are issued annually by the EPA and permit a fossil-fuel-fired electric generating unit to emit one ton of SO2 for each allowance, as long as that allowance was for the year in which the emission occurred or a year subsequent to the emission. An allowance may not be applied against an emission occurring in a year prior to the year to which it was allocated by the EPA. An unused allowance could be held for and applied against emissions occurring in a future year. In addition, allowances were deemed to be freely transferable, meaning that the holder of the allowance could freely sell or exchange an allowance to the extent an allowance remained unused. It became the responsibility of the owner or operator of a fossil-fuel-fired electric generating unit to account to the EPA for the total emissions from their units during each calendar year and to account and record with the EPA emission allowances sufficient to offset the level of emissions during that calendar year. If the owner or operator was short allowances relative to the amount of emissions, penalties of $2,000 per ton were imposed by the EPA. These penalties are not permitted deductions under Section 162(f) of the Tax Code.[1]

Tax Considerations and Treatment Under Current Regulations

The mere nature and character of these emission allowances introduced several issues for taxpayers and the Department of Treasury. Since these were granted to Generators, how should these allowances be treated for gross income purposes? What is the nature of the allocated allowance – is it a tangible asset or is it intangible property? Because the emission allowances have, in essence, an indefinite life (if unused in the year allocated, the allowance can be carried forward and used in a future period), over what period should these "assets" be depreciated or if in fact the allowances are intangibles, over what period should these be amortized? Is an allowance allocated for a specific period identical in nature to one allocated for a different time period for purposes of like-kind exchanges? And, lastly, if these allowances are sold and taxable income or loss is created from a sale, what is the nature of that income or loss – ordinary or capital? I will address each of these issues in my testimony.

In Rev. Rul. 92-16, I.R.B.5, issued by the Internal Revenue Service (the Service) on February 27, 1992, the Service ruled that the allocation of emission allowances by the EPA and the receipt by a Generator would not result in the Generator realizing gross income under Section 61 of the Code. It was also concluded by the Service in this revenue ruling, that a Generator's tax basis in

[1] All references within this testimony to the Code means the Internal Revenue Code of 1986, as amended.

the emission allowance is measured by the value of receipt from the EPA and not measured by the then current fair market value of the allowance. Since these allowances were granted "freely" to the Generator, the tax basis at the time of receipt would essentially be zero. With the addition of the extension program of the Clean Air Act, which established a reserve of extension allowances that were subsequently distributed to qualifying applicants through an early ranking program, there was an added complexity in dealing with gross income recognition for tax purposes. The question was whether gross income should be recognized based on the fair market value upon receipt of these specific allowances due to the fact that certain Generators formed pools of applicants to improve their ability to receive an allocation and agreed upon a disbursement of any allowances from the pool. In other words, by introducing another party in the allocation process, did this change the nature of income recognition upon receipt of the allowance? Again, the Service issued guidance on this question in the form of numerous Private Letter Rulings (eighteen sequentially numbered Private Letter Rulings, Rulings 92310104 – 9231033, dated April 30, 1992), by stating that the ultimate recipient of the allowance should treat the receipt as being received directly from the EPA; therefore, it would not result in gross income recognition.

The next determination that had to be made by the taxpayer was to the nature of the emission allowance. Since the allowances had an indefinite life because of the ability to carry these forward to a future period, if not used in the period for which they were allocated, then do the allowances have a measurable life? The Service concluded in Revenue Procedure 92-91, 1992-2 C.B. 503, issued on October 29, 1992, that an emission allowance should be capitalized on the books of the taxpayer: however, because of the indefinite nature of its life, the allowance is not subject to "gradual exhaustion, wear or tear, or obsolescence…" therefore, it should not be depreciated for tax purposes under Section 167 of the Code. The Service concluded that the emission allowances are not supplies, despite the fact that a taxpayer can buy and sell allowances. This determination was made on the basis that the emission allowances are not tangible property. The Service further concluded that the emission allowances are intangible assets, but are not subject to an amortization deduction under Section 197(a). In essence, the Service concluded that the method for a Generator to recover its basis in an allowance is through a deduction upon utilization or upon a sale or exchange of the allowance.

In addition to the ability to use an allowance to offset an emission, the holder of an allowance can freely sell or exchange an allowance to the extent the allowance remains unused. With respect to exchanging an allowance, the "like-kind" exchange rules under Section 1031 of the Code can apply to such exchanges. This is true if the exchange of allowances includes an SO2 allowance for another SO2 allowance, even if for different periods; however, it would not be true if a taxpayer exchanged a nitrogen oxide (NOX) allowance for an SO2 allowance, even if these were for the same time period. In general, in a like kind exchange the taxpayer maintains the tax basis of the asset exchanged and assumes this as the basis for the asset received.

Next, I will address the sales and purchases of emission allowances. Generally, emission allowances will be treated as capital assets of the Generator. The costs of acquiring and holding the allowances, inclusive of any costs to acquire them (fees such as legal, accounting, valuation, etc.), must be capitalized as part of the tax basis in accordance with Section 1012 of the Code. These costs are not permitted as deductions until the point in time an allowance is used, or otherwise are includable as part of tax basis used in the determination of a gain or loss upon the sale of the allowance. If the allowance is sold, the proceeds received, less the tax basis of the allowance, will determine the gain or loss to be realized and recognized. If the proceeds exceed the tax basis, a gain is recognized. Alternatively, if the proceeds are less than the tax basis, a loss is recognized.

The treatment of the income or loss generated by a sale is dependent upon the classification of the allowance by the seller and the nature of the activity of the buying and selling of the emission allowances. Typically, most utilities treat the gains and losses from the sales of emission allowances as capital. Corporate taxpayers are limited in their ability to utilize capital losses in any given tax year only to the extent of their capital gains in that given year or carried over to that year. Capital losses that exceed capital gains generally may be carried back to each of the three years preceding the loss year and carried forward to each of the five tax years succeeding the loss year. Other utilities are buying and selling allowances on a regular basis as an ordinary part of their trade or business or alternatively consider themselves as a dealer in allowances. For these utilities, the gains and losses from sales would qualify for ordinary income treatment and would not have the same limitations imposed by capital treatment under Section 1212(a)(1) of the Code. If, however, the taxpayer treats the allowances as property used in the ordinary course

of its trade or business or considers itself a dealer in allowances, then the gain or loss upon a sale would be considered ordinary income in accordance with Section 1221(a) of the Code.

Emission Allowances at Duke Energy Corporation

Duke Energy Corporation (Duke Energy) actively manages its emission allowances on a regular and periodic basis as an ordinary part of its business of generating and delivering electricity as well as actually managing its portfolio of emission allowances. For income tax purposes, Duke Energy tracks its emission allowances on a specific identification basis as required by tax regulations, such that each allowance can be identified separately in terms of its tax basis (the value on the books for tax purposes). Because of Duke Energy's activity and characterization of its emission allowances, any gains or losses upon the sale of the allowances receive ordinary rather than capital treatment for tax purposes.

The allowances that Duke Energy received as part of the allocation process from the EPA typically have a zero tax basis (any incremental basis above zero would be the result of Duke Energy incurring any fees or other costs to secure these allowances). Therefore, when these allowances are received, Duke Energy does not have taxable income upon receipt, and in the year these allowances are utilized, its tax deduction is equivalent to the tax basis, or essentially, zero. Duke Energy also actively exchanges allowances – SO2 allowances for other SO2 allowances and NOX allowances for other NOX allowances. For tax purposes, these are treated as like-kind exchanges under Section 1031 of the Code. The allowance received in the exchange will take on the tax basis of the allowance that was given in the exchange. Therefore, if an allowance originally allocated by the EPA (and thus have a zero tax basis) is exchanged, the allowance received would assume that same zero tax basis. Under the current tax rules, an exchange of an SO2 allowance would not be recognized as a like-kind exchange if exchanged for a NOX allowance.

Duke Energy actively buys and sells allowances as a part of its ordinary trade and business and manages a portfolio of emission allowances. For tax purposes, each allowance is separately tracked and the tax basis is known. For a purchase transaction, the tax basis assigned to the purchased allowance becomes the price paid, inclusive of any incremental legal, brokerage or other costs directly associated with that purchase. That tax basis remains with that allowance

and is used to determine the deduction in the year utilized, or it becomes the basis for the asset received if used in a like-kind exchange, or it becomes the basis for determining the ordinary gain or loss upon a sale. The buying and selling of allowances by Duke Energy are consummated in over the counter (OTC) transactions through brokers, thus further supporting the ordinary versus capital treatment.

Tax Issues to be Considered in Future Climate Legislation

The concepts that exist within the current emission allowance programs relating to the tax treatment for the allocation of allowances, as well as the utilization, exchange, purchase or sale of these allowances, appear to be reasonable from the taxpayer's perspective. Receiving an allocation of an emission allowance that involves no direct cost to the recipient should not create gross income, nor should the recipient receive a deduction of value when that allowance is utilized. The ability to freely transfer, sell or exchange allowances results in taxable transactions that are supportable by tax legislation and tied to the tax basis of the asset. The tax regulations allow alternative treatment in sale transactions, and whether sales result in capital or ordinary gains or losses is dependent upon the nature of how the emission allowance is held or used by the taxpayer in its trade or business. Under the current view, a like-kind exchange, although not tied to the time period associated with the allocation of the allowance, is restrictive relative to the type of allowance, whether it be for SO2 or NOX. The fact that the allowances have an indefinite life, if not used in the year designated to a specific allocation, seems to support the inability to determine a time period over which to depreciate or amortize the allowance, in spite of it being viewed as a capital asset.

With respect to future climate legislation, consideration should be given as to whether a distinction should be made between a carbon allowance, a sulfur dioxide allowance and a nitrogen oxide allowance in terms of the ability to exchange these assets in a like-kind exchange transaction under Section 1031 of the Code or whether any allowance (carbon, sulfur dioxide or nitrogen oxide) is equal in nature in terms of a like-kind exchange. Additional consideration should be given as to whether there should be an amortization period over which the tax basis of the allowances should be deducted. Would this allow for some level of basis recovery for the taxpayer for the costs incurred (including the value of the allowance itself) in securing this intangible versus having to wait until the allowance is utilized or sold? Lastly, consideration

should be given as to whether the tax treatment would be impacted if the exchange, purchase or sale of the emission allowance is mandated solely through a commodity exchange versus the flexibility under the current programs of transacting directly with counterparties, through brokers or through commodity exchanges.

Conclusion

I want to again thank you Chairman Baucus, Ranking Member Grassley and the other distinguished members of this Committee for holding this hearing and inviting me to share my views on this important matter regarding the federal tax considerations of climate change legislation. I commend each of you for being proactive with respect to these issues and for reaching out to understand the complexities associated with these matters. I look forward to working with you and your colleagues as these issues continue to develop in support of well crafted climate change policy and legislation.

Senate Finance Committee
Climate Change Legislation: Tax Considerations
June 16, 2009

Responses to Questions for Keith Butler, Senior Vice President Tax – Duke Energy Corporation

Questions from Senator Baucus

1. **Your testimony states that most utilities treat gains and losses from the sale of allowances as capital gains and losses. However, you state that Duke Energy treats gains and losses as ordinary. Please explain the reasons that Duke Energy treats its gains and losses as ordinary. Why does Duke treat these gains and losses differently than most other utilities?**

   Response:
   Duke Energy Corporation (Duke Energy) actively manages its emission allowances on a regular and periodic basis as an ordinary part of its business of generating and delivering electricity as well as actively managing a portfolio of emission allowances. For the portion of emission allowances that Duke Energy manages as an ordinary part of its business of generating and delivering electricity, Duke Energy deducts the value in the year the allowance is utilized. The amount of the deduction is based on a specific identification basis in which each and every allowance is tracked individually and its tax basis identified. If the allowance is one which was granted by the EPA, then it is at zero basis and no deduction is taken.

   Duke Energy also actively manages a portfolio of emission allowances in which it actively trades by making a market in order to make a profit. For this portion of its business, any gains and losses recognized from sales transactions would be treated as ordinary gains and losses under the Internal Revenue Code. This portion of activity by Duke Energy is managed through the non-regulated part of its business.

   Most utilities are holding emission allowances with the primary intent of using these in their business to meet their own needs to offset emissions. Occasionally, a utility will choose to sell some of their excess allowances. Although there is some ambiguity in the current tax law regarding whether the treatment of such sales should be capital or ordinary, the guidance from the Internal Revenue Service would seem to point towards capital treatment. [See Revenue Procedure 92-91, TAM 200728032 (July 13, 2007), and Private Letter Ruling 200728032].

2. **Your testimony states that the exchange of an SO2 allowance for another SO2 allowance qualifies as a life-kind exchange under Section 1031, which results in non-recognition of a gain or loss on the exchange. However, you also state in your testimony that this treatment does not apply to the exchange of an SO2 allowance for a nitrogen oxide (NOX) allowance. Please explain the implications of applying Section 1031 treatment to exchanges of any emission allowance, even if the allowances being exchanged are for different types of emissions.**

   Response:
   In Revenue Procedure 92-91, 1992-2 C.B. 503, the Internal Revenue Service ruled that emission allowances issued by the EPA are like-kind property regardless of the year to which the allowances are allocated, such that an exchange of allowances qualifies for non-recognition

treatment under Section 1031. This revenue ruling does not address the issue of the type of emission allowances, such as SO2 or NOX. One SO2 allowance is not equal to one NOX allowance. Duke Energy's interpretation is that an exchange of an SO2 allowance for a NOX allowance would not qualify as like-kind under the guidelines of Section 1031. However, Duke Energy believes that the treatment of emission allowances as like-kind exchange property eligible for tax-free exchange treatment would allow for a more robust trading of allowances and that emission allowances should be treated as equal (in relative proportion to each type) for purposes of like-kind exchange treatment under Section 1031. Although there are different types of emissions and the amount of each type differs in proportion to the other types, these should be treated in a similar manner for purposes of like-kind property.

Questions from Senator Snowe

1. **Mr. Butler, as a utility company tax director, could you discuss for me the issue of capital losses and why, in this whipsaw situation, a utility company carrying forward capital losses from mismatched gains and losses is a problem?**

   Response:
   For corporations, losses from the sales or exchanges of capital assets (which for most utilities, the treatment of sales and exchanges of current emission allowances are treated as such) are allowed only to the extent of capital gains. A corporation may carry back a capital loss to each of the three taxable years preceding the loss year (with certain restrictions) and may carry forward the loss to each of the five taxable years succeeding the loss year. [See Section 1211 and 1212 of the Internal Revenue Code]. If a utility were in a situation in which it did not have capital gains in the three taxable years preceding the loss year and it believed it would not have capital gains in any of the five taxable years succeeding the loss year, under Generally Accepted Accounting Principles, the utility would be required to record a valuation allowance against the capital loss. Unless the utility were able to recover this from its customers, this would result in a negative impact to earnings. If the utility's regulatory body permitted a recovery from its customers, the utility would be able to defer the impact as a regulated asset. The potential mismatch of capital losses and capital gains could result in a real cost to a regulated utility's customers. If the tax treatment from the sales or exchanges of emission allowances were all treated as ordinary, then there would be the ability to recognize any gains and losses in the year incurred without any limitations, thus avoiding this potential incremental cost to a utility's customer. In addition, the inability to offset capital losses against capital gains could result in a permanent loss of cash tax benefits, which could also have a direct impact to a utility company's cash flows if unable to recover this cash loss from its customers.

Statement of Senator Chuck Grassley:
Finance Committee Hearing on Tax Treatment of Cap and Trade
Tuesday, June 16, 2009

There are many technical tax questions that will be addressed at this hearing. The first point I should make is that, if cap and trade isn't enacted, then we're worrying about all these tax questions for nothing. However, if it is enacted, then a bunch of tax issues need to be dealt with. For example, if allowances to emit carbon dioxide are given away for free, should the corporations that receive these valuable allowances be taxed upon receipt of them? There are various opinions about whether allowances should be given away or auctioned off. The Waxman-Markey bill initially gives away 85 percent of its allowances for free. These 85 percent of allowances are estimated by CBO to be worth $693 billion over the first 10 years.

However, Peter Orszag, the Administration's OMB Director, when he was the CBO Director in 2007, testified before Congress that, quote, "If you didn't auction the permits it would represent the largest corporate welfare program that has ever been enacted in the history of the United States."

Similarly, in response to my question for the record from the March 4, 2009 hearing on the Administration's budget, Secretary Geithner wrote: "The program will be implemented through an economy-wide cap-and-trade program in which all emission allowances will be auctioned to ensure that the biggest polluters do not enjoy windfall profits." So, if the Administration has its way, we would not even need to consider the tax treatment of allowances given away for free.

One thing that concerns me with cap and trade is that the current version appears to be all pain but no gain.

In other words, the American consumer will pay higher energy prices, as well as higher prices for all goods and services. That's the pain part. But, unless there's an agreement with China, which is the largest emitter of greenhouse gases, as well as Russia and India and other large emitters, there is no gain. We could reduce our greenhouse gas emissions while the rest of the world continues to increase its emissions, resulting in increasing emissions worldwide.

Meanwhile, our consumers and economy would suffer from our own cap-and-trade program. A June 13 *Washington Post* article stated the following:

"Instead, the special U.S. envoy for climate change said yesterday, he would press for China to reduce the rate at which its emissions grow. Envoy Todd D. Stern said at a news conference that he wants China's emissions to increase less than projected. 'So that's not an absolute reduction below where they are right now,' Stern said, 'because they're not quite at that point to be able to do that.' "

That sounds a lot like former President George W. Bush's proposal to limit greenhouse gas intensity relative to GDP, which was roundly panned by environmental groups.

I'm also concerned about the fact that the speculators from Wall Street, Chicago, and San Francisco have been all too eager to embrace cap and trade. Cap and trade would represent a huge new market that hedge funds and private equity firms are salivating over. In fact, Enron and AIG were two of the early proponents of cap and trade.

Four years ago, this Committee held a hearing on the activities of The Nature Conservancy. These activities included the organization's receipt of contributions in exchange for emissions credits. The staff report on these arrangements raised a number of tax issues for both the exempt organization as well as the polluter that also need to be addressed.

We will hear today how all of these exotic derivatives on allowances should be taxed. We know if cap and trade is enacted, the Wall Street people will be happy to help in designing derivatives based on allowances.

Some of these derivatives will be futures, forwards, options, collars, swaps, call spreads, swaptions, and hybrids of the above derivatives. I worry about the Wall Street speculators making fortunes off the backs of the American taxpayers. I look forward to hearing the testimony today.

U.S. Senate

Committee on Finance

Hearing June 16, 2009

Climate Change Legislation – Tax Considerations

Statement of

Gary Hufbauer, Reginald Jones Senior Fellow

Peterson Institute for International Economics

Washington DC

Mr. Chairman and members of the Finance Committee, thank you for inviting me to testify on this important subject. My name is Gary Hufbauer and I am a Senior Fellow at the Peterson Institute for International Economics and co-author of *Global Warming and the World Trading System.*

Climate change is a serious problem that must be addressed by the United States and other countries. To reduce greenhouse gas (GHG) emissions, a carbon tax system would be vastly superior to a cap-and-trade permit system. Carbon taxes would be more transparent, more uniform across all GHG sources, raise more revenue, easier to administer, and more readily adjusted at the border. The Waxman-Markey draft legislation illustrates the enormous complexity, opacity, and rent-seeking inherent in a permit system.

That said, political forces strongly favor a cap-and-trade permit system. My purpose today is to comment on the tax and trading aspects that arise from system of issuing carbon permits. I use the term "carbon permits" as shorthand for permits covering any GHG source, equated on a carbon dioxide equivalent basis (CO2e).

Are free allowances of carbon permits income? This is the threshold question, and my answer is a decisive "yes". When the US government issues free permits, it is already conferring a big favor on recipient firms. It would be a travesty to double up the favor by exempting these permits from the definition of income for the purposes of the Internal Revenue Code. An analogy to other valuable but untaxed permits, such as zoning decisions or immigration visas, is misplaced. Those permits are inherently non-tradable. A central argument for a cap-and-trade system is to encourage efficient reduction of CO2e through the purchase and sale of permits. Freely allocated carbon permits excuse the recipient firm from purchasing the same; they have an ascertainable value; and if the system is properly designed they may be sold. Accordingly they should be taxed as income at their value on the date of issue. If the permits are sold at a later date and at different values those transactions would give rise to trading income, discussed later. The Committee should reject proposals that would have the effect of making freely allocated carbon permits non-tradable and therefore difficult to value.

Is the purchase of carbon permits a business deduction? When the purchaser uses the permit to satisfy its own GHG obligations, again my answer is a decisive

"yes". This is an "ordinary and necessary" business expense. Two refinements should be noted. If the permit is purchased in year one, but not used until year two, the deduction should be claimed in year two. If the permit is purchased and later resold (not used by the purchasing firm), that transaction would give rise to trading gains or losses, discussed next.

Trading in carbon permits: type of holder. The rules for taxing gains or losses realized on trades in carbon permits should not distinguish between types of holders – industrial firms, banks, hedge funds, etc. Making such distinctions will invite creative arbitrage. If the holder is a tax-exempt entity, such as a pension fund like Calpers or a foreign sovereign wealth fund, it will of course escape any taxation of gains or recognition of losses.

Trading in carbon permits: type of income. My recommendation is to treat all trading income as ordinary income, not capital gains. This means higher tax rates would normally apply to trading gains, but it also means trading losses would be recognized as a deduction against ordinary income. This recommendation reflects my general distaste for extending capital gains treatment to income earned by business firms. I recognize that many capital gains provisions are already embedded in the corporate tax code, but I see no reason to extend a bad practice to new forms of trading income.

LIFO or FIFO? My recommendation is FIFO, on the expectation that the value of carbon permits will rise over time. I see no merit in allowing firms to choose between LIFO and FIFO for fungible permits, or even worse to designate which permits are sold out of a large portfolio of holdings. Of course permits may be issued with different characteristics (expiration date, industry of final use, etc.), and those will be distinct securities.

Oversight and regulation of trading in carbon permits. I am a believer in financial markets. I am not a believer in unregulated, over-the-counter markets. If the United States creates a system of tradable carbon permits, it should simultaneously authorize one or more exchanges to handle trades in these permits. Trading outside the exchanges should be prohibited. The beneficial buyers, sellers, and holders should be regularly disclosed (no street names), and prices and volumes should be posted on a real-time basis. The extinction of permits through

GHG emissions should also be disclosed. In other words, the CFTC should do its job. The same goes for derivatives (futures, options, etc.) which have carbon permits as their foundation. Margin requirements must be set and enforced.

Permits purchased by foreign firms. To the extent permits are required of foreign firms exporting goods into the US market, the permits should be purchased on the authorized exchange. There is no reason to create a wedge between the value of a permit to emit a metric ton of CO2e when acquired for use in the United States and its value when acquired by foreign firms to meet US GHG requirements on production abroad. In this statement, I will not comment further on appropriate approaches for determining the GHG requirements that can be properly applied to US imports of goods produced abroad. That subject is discussed in detail in our book *Global Warming and the World Trading System.*

Offsets purchased by US firms. Offsets purchased from foreign entities that claim to reduce their CO2e emissions must be closely regulated. Offsets should be authorized by the EPA, following a close examination of the foreign program. They should be purchased and sold only on the authorized and regulated US exchange – not on shadowy over-the-counter markets. They should be fungible with US-issued carbon permits. This will foster a single world price per metric ton of CO2e emissions – a goal that the United States should champion.

Collars – floors and ceilings on permit prices. European experience proves that the price of carbon permits can be extremely volatile. Volatility undermines the basic purpose permits are meant to serve – to encourage long-term planning and investment to curb GHG emissions per unit of output, but not to put firms out of business because the price of permits suddenly spikes. Accordingly I favor a system of announced price floors and ceilings, executed by public purchases and sales through the authorized exchanges. The EPA should be entrusted with determining the collars, giving advance notice for review and possible disapproval by Congress, and the trades should be executed by the Treasury.

Thank you.

Senate Finance Committee
Climate Change Legislation: Tax Considerations
June 16, 2009

Answers of Gary Hufbauer to Questions from Senators Baucus, Stabenow, and Snowe

Questions from Senator Baucus

1. **Dr. Hufbauer, you argue that income from the trading of carbon allowances should be taxed as ordinary income. Why should this activity not receive capital gains or losses treatment? And should gains and losses of investors also be treated as ordinary even if these allowances are traded on regulated exchanges like stocks and other securities?**

   My big concern is that free allowances and offsets will either escape taxation altogether, or get mired in complex tax rules that create room for arbitrage and mischief. At this juncture, when the federal government badly needs every tax dollar it can collect, that would be unfortunate. So I am advocating simple and easy to administer rules. A straightforward way to address my concerns is to treat income from the free issuance and trading of carbon allowances as ordinary income, not as capital gain. In general, capital gain is taxed at a preferential rate in comparison to ordinary income. For an individual, long-term capital gain is taxed at a lower rate while the short-term gain is taxed at the same rate as ordinary income. The recognition of capital losses is limited to capital gains. For a corporation, regardless of the holding period, capital gain is taxed at the same rate as ordinary income, but limited to a maximum rate of 35%. The difference in tax treatment between incomes characterized in different ways creates incentives for individuals and firms in high tax brackets to "transform" ordinary income into long-term capital gains, or to transform capital losses into ordinary losses. These incentives can be sharply reduced, if not eliminated, by treating all gains and losses on carbon allowances the same way, and I would prefer that way to be ordinary income.

2. **You have stated that you favor what is known as a price collar – an announced floor and ceiling price for allowances. Could you elaborate on how you think this mechanism would work in a carbon market?**

   Great uncertainties exist over many issues in the climate change debate, including the outcome of Copenhagen talks, the effectiveness of international/national climate policy programs, and links between carbon trading markets. These uncertainties are likely to persist for some time. Consequently, the carbon price is very likely to fluctuate in a wide band. An example can be found in the experience of the EU Emissions Trading Scheme (ETS), the largest existing carbon trading market to date. The price of the EU emissions allowance (EUA), in which each unit equals one ton of CO_2e, fluctuated widely during both Phase I (a trial period, 2005-2007) and Phase II (2008-2012): the spot price ranged from €30 per metric ton of CO_2e to near zero during Phase I; and from €30 to near €10 for Phase II.

Price volatility can easily disrupt efforts to reduce carbon emissions, since it adds to the risk of investment decisions. A very low carbon price will discourage companies from making an effort to reduce their GHG emissions and will slow down their investment in new technologies. A very high carbon price may reward speculators and put some companies out of business. Price collars, in the form of a floor and a ceiling on the carbon price, will help address these concerns.

3. **In your testimony you suggest using the FIFO convention to account for allowances that are used or sold. Why do you believe this method is preferable to one which tracks the cost of each allowance separately, or another inventory method like LIFO?**

   Under the current US GAAP, companies are allowed to choose between LIFO and FIFO (there are some other methods as well) as their inventory accounting method, and they can switch between the methods. For tax purposes, the use of the LIFO is allowed only when companies meet certain requirements, so-called "LIFO conformity requirement." For example, companies need to use LIFO in their financial reporting to use LIFO for tax purposes. The LIFO method is popular for tax purposes in periods of rising prices as it results in lower reported profits (since reported inventory costs are higher).

   As mentioned in my testimony, I prefer the FIFO method since it will collect more revenue if carbon permit prices gradually rise, as seems likely. Moreover, requiring a single method, whether FIFO or LIFO, reduces the scope for tax abuse. Another point to be noted is a global trend in favor of the international financial reporting standards (IFRS). Under IFRS, the LIFO method is not allowed in valuing inventory. Most countries in the world have adopted or have considered adopting IFRS. The United States is also working on converging GAAP to IFRS and IFRS may replace GAAP in near future.

Questions from Senator Stabenow

1. **A cap-and-trade system for greenhouse gases would create a new market, the value of which could be hundreds of billions of dollars each year. In fact, carbon trading is currently being considered at a scale that some believe would create the largest new derivatives market in the world.**

   a. **Given that the overwhelming majority of carbon related instruments are traded in the over-the-counter markets in the mandatory compliance markets (Europe), is it your assessment/observation that such trading patterns would occur here in the United States once mandatory compliance begins – assuming legislation allows it?**

My answer is yes. The worldwide carbon markets can be divided into two segments: the voluntary markets and the regulatory markets. The voluntary carbon markets can be broken down into two markets: the Chicago Climate Exchange (CCX) and the "over-the-counter" (OTC) market. The regulatory markets refer to carbon markets established for compliance such as the EU ETS. According to *Fortifying the Foundation: State of the Voluntary Carbon Markets 2009,* a report by Ecosystem Marketplace and New Carbon Finance, over the past several years, voluntary carbon markets have greatly expanded in both transaction volume and value. In 2008, the United States was the largest single source of carbon credits, providing 28 % by volume on the OTC market as well as the biggest consumer (39% of demand). Given these circumstances, it seems all but certain that the OTC markets will thrive, unless otherwise prohibited, once US mandatory compliance begins.

b. Would it be beneficial to have all carbon related transactions take place on exchanges or over-the-counter reported to one central place, such as a transaction warehouse?

We have witnessed great failures in our financial systems and we are now paying an expensive tuition for those failures. Recently, President Obama released a financial reform plan which includes a call for strong oversight of OTC transactions: all derivatives contracts to be subject to regulation, derivatives dealers subject to supervision, etc.

As mentioned in my testimony, I am not a believer in unregulated, over-the-counter markets. I prefer all carbon transactions to be conducted and regulated in exchanges, not in OTC markets. Given their characteristics, transactions in the OTC markets are very difficult to track and supervise. Prices need not be disclosed; parties can buy and sell in secret; and derivatives can be built up on thin or zero margins. This is no way to establish a global carbon price.

c. We have a tremendous opportunity to design a transparent, efficient carbon market that builds on the best practices for market regulation. What agency or commission do you think is best suited to oversee carbon trading?

There has been debate over which agency should have the authority to regulate and oversee carbon markets. The SEC did not distinguish itself in the run-up to the financial crisis. The Commodity Futures Trading Commission (CFTC) did much better and has emerged as the stronger candidate. I do not foresee problems if the CFTC takes responsibility. However, whether it will be the CFTC, the SEC, the Federal Energy Regulatory Commission (FERC) or the EPA, I prefer a single regulator to multiple regulators. Regulatory arbitrage was another major contributor to the financial crisis.

2. Many analysts are concerned with the lack of international regulation of the futures market. Especially if we create new regulations over carbon markets in the United States, there is concern that participants will just move trading overseas. What do

you believe should be done to increase international cooperation in regulating the carbon markets?

The United States has the power to require that all trades in carbon permits and derivatives must take place on regulated exchanges, and to ensure that the chain of ownership of permits can be verified from the date of issuance to the date of surrender. The United States should use these powers. Permits that do not meet these requirements should be deemed null and void, and derivatives that fail the tests should be declared unenforceable. Once these requirements are put in place the next challenge is how to link different carbon markets. The European Commission has pushed the idea of global carbon market. As a first step, it has sought to link the EU ETS to the upcoming US plan. The shape of a global carbon market and how it meshes with national policy will depend heavily on the outcome of Copenhagen talks on the post-Kyoto regime. US climate change legislation and new US financial regulations should ensure room for open dialogue with other countries.

Questions from Senator Snowe

Offsets are a measureable reduction, avoidance or sequestration of greenhouse gas emissions from a source not covered by the cap and trade system. Offsets may be domestic or elsewhere in the globe – for instance saving a rainforest in Brazil – because each ton of carbon is emitted into the same atmosphere.

1. **Mr. Hufbauer, you are quite clear in your statement that offsets purchased from foreign entities should be closely regulated. Could you describe for me some of the problems you might envision if offsets are not closely regulated?**

   Currently, international offsets are generated from projects mainly under two mechanisms of the Kyoto Protocol: the Clean Development Mechanism (CDM) and Joint Implementation (JI). The CDM offsets accounted for more than 90 % of the project based markets in 2008 (in value). While the CDM has flourished, it has been criticized for loopholes.

   Offsets are sometimes issued for projects that would have been done anyway and for projects that have little or no impact in reducing total carbon emissions. Making use of flawed systems, some companies have earned offset credits from projects in developing countries at low costs and have made a fortune with little effort.

   If international offsets are not well regulated, companies will rush into international offsets rather than make an effort to reduce GHG emissions domestically. In some developing countries, companies delayed their efforts to reduce GHG emissions so that they could claim large CDM credits. In the end, from an environmental standpoint, the mechanism may not contribute to an overall reduction in GHG emissions. It is likely that the post-Kyoto regime will maintain CDM and JI mechanisms to help developing

countries. However, the existing mechanisms need to be reformed before the US offsets play a role in CDM or JI.

2. **Also, could you expand upon the concern in your statement about "shadowy over-the-counter markets" for carbon allowances?**

   Over-the-counter transactions are very difficult to monitor and supervise because they are privately traded. Under current US law, they are largely exempted from regulation. One result is that the price of two transactions undertaken at the same time can differ. Another result is that there is no public record of the chain of ownership. A third result is that highly leveraged transactions may occur. Recently, President Obama proposed a comprehensive regulatory framework for OTC derivatives. I am not sure whether OTC transactions for derivatives and everything else will be effectively regulated by the proposed plan, but if they are, I might be less opposed to trading carbon permits on OTC markets.

Hearing Before U.S. Senate Committee on Finance
on
Climate Change Legislation: Tax Considerations
June 16, 2009

Statement of Mark Price, KPMG LLP

Mr. Chairman, Ranking Member Grassley, Members of the Committee:

Good morning. My name is Mark Price. I am a principal in the Washington National Tax office of KPMG LLP. I am pleased to have the opportunity to testify as an invited witness before the Committee this morning on the topic of the tax considerations associated with climate change legislation. I will take the next several minutes to summarize the points in the written testimony submitted to the Committee

In my remarks this morning, I will discuss the tax treatment of a system of tradable CO2 allowances under current law and identify issues that may be considered in developing an appropriate tax regime for such a system. The tax treatment of the grant, distribution, and disposition of the allowances may materially affect the cost and efficiency of the system. The key issues raised by a cap and trade system relate to a determination of the amount of income or expense arising from CO2 allowances, the timing of that income and expense, and the character of that income or expense. Given current-law limitations on claiming capital losses against ordinary income the character of income from CO2 allowances is one of the most significant federal income tax issues. Under current law, capital losses can only be applied against capital gains. A capital loss cannot be used to offset ordinary business income. This could affect an entity's cash flow. The recognition of income in advance of expense could also affect an entity's cash flow.

The tax treatment of a transaction is fact dependent. The observations in this paper are based on provisions of existing cap and trade systems (e.g., the Regional Greenhouse Gas Initiative and the European Union Emissions Trading Scheme) and different current and past proposals. The observations are also based on a synthesis of existing authority that may be subject to different interpretation by different taxpayers, particularly in different situations or industries.

The treatment of a cap and trade regime under current U.S. tax law should be based on analogies to similar types of allowances and government permits and on general tax law principles. Thus, the tax treatment of cap and trade under current law would be based primarily on authorities issued by the Internal Revenue Service (the "IRS") on the treatment of the sulfur dioxide emissions allowances established pursuant to Title IV of the Clean Air Act Amendments of 1990, Pub. L. No. 101-549, 104 Stat. 2584 (1990); 42 U.S.C. section 7651 et seq. *See* Revenue Procedure 92-91, 1992-2 C.B. 503; Revenue Ruling 92-16, 1992-1 C.B. 15. The IRS has also ruled privately on certain U.S. international tax issues related to the European Union's Emissions Trading Scheme. *See*

Priv. Ltr. Rul. 200850009. These authorities, in conjunction with general principles of tax law, form the basis for how to tax the allowances and related contracts under a cap and trade system under current law.

Tax Treatment of the Acquisition of CO2 Allowances:

The first issue in the tax analysis of a cap and trade system is to determine what happens when an allowance is acquired. Most cap and trade systems envision two means of acquiring allowances – by purchase (either on the open market or through an auction mechanism) or by grant from the government. When an allowance is acquired through auction or through sale in the open market, the allowance will have a tax basis equal to cost, or the amount paid to acquire the allowance. 26 U.S.C. section 1012. Some entities may be granted allowances from the federal government. Based on current IRS guidance, those entities would have no income on receipt of the allowance and no basis in the allowance. In Revenue Ruling 92-16, 1992-1 C.B. 15, the IRS ruled that utilities and non-utility participants in the sulfur dioxide emissions allowance program did not have income upon the receipt of sulfur dioxide emissions allowances. In Revenue Ruling 67-135, 1967-1 C.B. 20, the IRS ruled that the winners of drawings to award leases of oil and gas rights to certain federal land did not have income equal to the difference, if any, between the fair market value and the cost of the lease. It follows from these authorities that, under current law, entities granted allowances from the federal government do not have income upon receipt. Because the recipients of allowance grants will not pay anything to acquire the allowances, their basis in these allowances is zero. 26 U.S.C. section 1012.

Tax Treatment of CO2 Allowances Used in the Trade or Business

The next issue in the tax analysis of a cap and trade system is to determine when the initial cost, if any, is recovered and how to calculate income on the disposition or use of a CO2 allowance. The question of cost recovery is unclear under current law. In Revenue Procedure 92-91, 1992-2 C.B. 503, the IRS ruled that the cost of acquiring sulfur dioxide emissions allowances could not be depreciated because: (i) the allowances were used only in a single year and (ii) they did not have a limited useful life. In 1993, Congress enacted Internal Revenue Code section 197, which generally provides a 15-year life for the amortization of intangibles. A license, permit, or other right granted by the government is generally an intangible subject to this rule if: (i) it is acquired as part of the acquisition of a trade or business, (ii) it is not fixed as to amount, and (iii) it has a duration of at least 15 years. *See* 26 U.S.C. section 197(e)(4)(D); 26 C.F.R. section 1.167(a)-14(c)(2); 26 C.F.R. section 1.197-2(c)(13). If CO2 allowances are viewed as a permit granted by the government to emit a specified amount of CO2, the cost of a CO2 allowance that is used to cover an entity's CO2 emissions for the year appears to be recoverable in the year it is used. *See* 26 C.F.R. section 1.167(a)-14(c)(2). The basis would be recoverable as a deduction against ordinary income and, depending on the industry, may be taken into account under the relevant rules for capitalizing expenses to the property being produced by the industry. *See* 26 C.F.R. section 263A. There is likely

to be some uncertainty in this area as a result of the IRS's conclusion with respect to sulfur dioxide emissions allowances.

Character of CO2 Allowances:

If the CO2 allowance is sold, rather than used, the cost is used to determine gain or loss on the sale of the CO2 allowance. 26 U.S.C. section 1001(a). The character of the gain or the loss will depend on the relationship of the CO2 allowance to the entity's business. The sale of a CO2 allowance will generally produce capital gain or loss unless an exception applies, in which case the gain or loss would be ordinary. *See* 26 C.F.R. section 1221(a). The IRS concluded that gain from the sale of sulfur dioxide emission allowances is capital. *See* Revenue Procedure 92-91.

The first relevant exception is for allowances that are held for sale to customers or as inventory. Under current law, this inventory rule would only apply to entities that make a market in CO2 allowances. Depending on the structure of the market for CO2 allowances, this rule may be limited to registered dealers or market makers in CO2 allowances. Alternatively, the application of this exception may depend on a collection of cases interpreting this provision in the context of everything from real estate to diners. Under current law, this rule would not apply to entities that occasionally have excess CO2 allowances and choose to sell them.

The second relevant exception to capital asset treatment would be if the allowances were held for use in the taxpayer's trade or business and subject to depreciation. *See* 26 U.S.C. section 1221(a)(2). It is unclear whether this exception would apply under current law. As discussed above, there is a statutory provision that says it might and IRS guidance that says it does not. Even if the general rule were clear, it is unclear whether allowances that are not used to satisfy the entity's CO2 obligations are held for use and subject to depreciation. The answer may depend on the specific facts of the entity, including the reason for acquiring the allowance and how the allowance was recorded in the books and records. If this "depreciable property" exception applies, and the CO2 allowance is held for more than one year, the CO2 allowance would be "section 1231 property," which generally means that gains would be capital and losses would be ordinary. *See* 26 U.S.C. section 1231.

The third exception to capital asset treatment that could apply to CO2 allowances is for property that is a supply of a type regularly used or consumed by the taxpayer in the ordinary course of trade or business. The IRS ruled privately in 2007 that sulfur dioxide emissions allowances are not supplies because they are not tangible personal property. *See* Priv. Ltr. Rul. 200728032. This is consistent with the concept of a "supply" found elsewhere in the tax law. *See* 26 C.F.R. section 1.162-3; 26 C.F.R. section 1.471-1. The 'supply" exception, therefore, would not appear to apply to CO2 allowances under current law.

There could be uncertainty under current law with respect to the character of CO2 allowances. The character will depend on what is done with the CO2 allowances. An

entity's purpose for holding a CO_2 allowance may change. That is, an allowance acquired for use in the business may end up being sold. Similarly, an entity may need to use allowances it intended to sell to satisfy its requirements under the cap and trade system. It may be unclear in these situations whether the disposition of the CO_2 allowance produces capital or ordinary gain or loss. Such uncertainty may cause entities not to sell their CO_2 allowances. This could impact the liquidity of the cap and trade regime and may distort the pricing of CO_2 allowances.

CO2 Allowances as Commodities

Another question that is raised in the cap and trade analysis is whether the allowances are commodities. The IRS stated in a private letter ruling issued in 2008 that they are still studying whether allowances are commodities. *See* Priv. Ltr. Rul. 200850009. The Treasury Regulations under the Internal Revenue Code sections dealing with subpart F income explain that commodities have to be tangible personal property. *See* 26 C.F.R. section 1.954-2(f)(2). Emissions allowances and offsets would not be commodities under this definition.

Not classifying allowances and offsets as commodities would have international tax consequences. There would also be some consequences for taxpayers who might want to mark-to-market their allowances. If allowances and offsets are not classified as a commodity, taxpayers could not elect to mark its allowances and offsets to market. Classification as not a commodity would also affect whether or not the offsets are amortizable. These limitations may make entities more reluctant to engage in the purchase and sale of CO_2 allowances beyond their business need.

Like-kind Exchange Treatment:

Some entities may be subject to multiple cap and trade systems, either because some regional or state programs are not preempted or because the entities operate in foreign countries that have their own national or regional cap and trade systems. Under current law, CO_2 allowances appear to be eligible for like-kind exchange treatment for federal income tax purposes. *See* 26 U.S.C. section 1031.

Tax Treatment of Offsets

Most cap and trade proposals allow entities to purchase or generate offsets that may be used to satisfy the entity's requirement for allowances. Under current law, purchasers of offsets would treat offsets in the same manner as CO_2 allowances, and domestic offsets would be treated the same as international offsets. If a taxpayer is a generator of offsets as part of its core business, then the generation of those offsets would be treated as ordinary business activity giving rise to ordinary income.

Observations

Under current law, different fact patterns may produce different tax results. Here are some examples of what may be common fact patterns:

- Entities that receive grants and use their CO2 allowances in their trade or business will likely have no income or expense from CO2 allowances, except for deductions arising from the use of purchased CO2 allowances.

- Entities that purchase CO2 allowances and use them in their trade or business will likely have no deduction for the cost until the year the CO2 allowance is used. The cost may, however, be recovered over 15 years if the CO2 allowances are acquired as part of the acquisition of a trade or business.

- Entities that sell a portion of the CO2 allowances they receive from grants or purchase will likely have capital gain or loss on the sale of excess CO2 allowances. The likelihood of losses will depend on whether the CO2 allowances that were sold were purchased or received by grant. CO2 allowances held for more than one year may produce capital gain or ordinary loss.

- Entities that regularly sell a portion of the CO2 allowances may realize ordinary income or loss if the property is treated as held for sale. The character will not depend on the reason for the excess allowances, just the actions taken by the entity in selling the allowances.

- Entities that are not subject to the cap and trade system, but that purchase and sell CO2 allowances likely realize capital gain or loss on the sale of CO2 allowances, unless they hold the allowances for sale to customers. This rule could also apply to covered entities or affiliates of covered entities that establish operations to purchase and sell CO2 allowances.

Some entities may fall into multiple categories above or may set up different businesses subject to different rules.

Considerations for Tax Legislation

There are several tax issues that should be considered if the Senate were to consider legislation on the tax treatment of CO2 allowances. The sulfur dioxide emissions allowance analogies are useful. That guidance, however, is over 15 years old.

First, it would be appropriate to consider whether the current law rules above are appropriate, both as a matter of tax policy and, to the extent the Committee deems it appropriate, as a matter of energy policy. For example, if entities are expected to have excess credits as a result of accelerated carbon reduction, would it be appropriate to ensure that such credits do not create capital losses when sold? If such sales result in

capital losses, the seller may be limited in its ability to apply the loss to offset its business income, thus increasing the after-tax cost of the CO2 allowance.

It would also be appropriate to clarify whether there is income on the receipt of a CO2 allowance. The existing rule is based on IRS guidance applicable to specific government programs. Given the increased scope of the cap and trade regime, clearer authority on the topic is warranted.

In addition to addressing the issues discussed above, there are a number of issues that are raised by a cap and trade system that might be appropriate to consider.

Borrowing Emissions Allowances

Some cap and trade systems allow entities to borrow CO2 allowances from future years. A fee may be charged for borrowing potentially in the form of reduced value for the CO2 allowance. It is unclear whether this should be viewed as a loan from the Federal government or as a reduction in the value of future allowances. If it is legally in the nature of an advance from the Federal government, it would be necessary to consider the deductibility and the characterization of the "fee."

Treatment of Fees for Failing to Deliver Allowances

Each cap and trade system has some form of fee payable by an entity if it fails to obtain and deliver a sufficient number of CO2 allowances. The characterization of this fee could affect whether it is deductible by the entity.

Treatment of Allowances as Commodities

Under current law, the classification of a commodity affects several different sets of rules. It affects the analysis used to determine whether foreign subsidiaries of U.S. companies must pay tax on gains from transactions in foreign CO2 allowances. It affects the analysis used to determine whether foreign investors are subject to tax on their investment in U.S. CO2 allowances. It also affects whether market makers can adopt a mark-to-method method of accounting for CO2 allowances. Finally, it may affect the character of a CO2 allowance and how cost is recovered. It may be appropriate to consider special rules in some or all of these areas for CO2 allowances in lieu of relying on whether a CO2 allowance is classified as a commodity.

Specific Identification of Allowances

Under current law, entities would be required to identify and track the basis of each CO2 allowance separately for purposes of determining gain or loss on sale and for purposes of determining the amount of cost recovery. It may be appropriate to consider whether entities should be allowed to track basis differently.

Treatment of Carbon Derivatives

Entities are expected to manage price risk with respect to CO_2 allowances. Under current law, derivatives used to hedge this price risk may be capital assets, even though the risk being hedged is an ordinary business risk. It may be appropriate to consider whether it is appropriate or possible to develop rules that match the character of carbon derivatives to their use as hedges.

Treatment of Tax-Exempt Entities and Donations

Entities may either develop and sell offsets or purchase CO_2 allowances for the purpose of retiring them from circulation. The tax treatment of these entities and actions should be considered. For example, should the generation and sale of an offset qualify as tax-exempt income, or should it be unrelated business taxable income? Should the retirement of a CO_2 allowance give rise to a charitable deduction, or will it be necessary to purchase and donate such CO_2 allowances to a charitable organization to qualify for a tax deduction?

Interaction with Federal Renewable Energy Certificates

It is possible that Federal energy legislation will include a renewable energy standard for utilities. This renewable energy standard may involve the creation of another government grant, the renewable energy certificate. These renewable energy certificates will likely have similarities to the CO_2 allowances (e.g., they may be tradable and must be provided to satisfy the federal standard) and differences (e.g., they may be created as a result of the production of renewable energy, not granted by the Federal government). Any tax provisions drafted to address CO_2 allowances may impact the tax treatment of Federal renewable energy certificates.

Conclusion

A cap and trade system raises familiar tax issues of timing, character, and amount. It also raises more difficult questions as a result of its sweep across multiple industries and its potential interoperability with systems on multiple continents. In some areas, existing law provides reasonable certainty. In other areas, existing law leaves open questions and creates fact-specific determinations, such as determining whether a CO_2 allowance is depreciable or whether an entity is a dealer in CO_2 allowances. Finally, in other areas, conclusions in the current law drive other tax results in ways that are worth considering, such as the linkage between classifying a CO_2 allowance as a commodity and various other rules in the Internal Revenue Code.

Thank you again for the opportunity to testify. I look forward to your questions.

COMMUNICATIONS

Testimony of
The Large Public Power Council (LPPC)

Large Public Power Council
300 N. Washington Street
Suite 405
Alexandria, VA 22314

Hearing before the Committee on Finance
United States Senate

"Climate Change Legislation: Tax Considerations"
June 16, 2009

Dear Chairman Baucus and Ranking Member Grassley:

The Large Public Power Council (LPPC) appreciates the opportunity to provide written comments for the record in conjunction with the climate change hearing held by the Senate Finance Committee (the "Committee") on June 16, 2009. We thank the Committee for studying tax considerations as a result of climate change legislation.

LPPC is an association of the nation's largest municipal and state-owned electric utilities. LPPC members are not-for-profit entities located in states and territories representing every region of the country. Our commitment is to provide highly reliable, low cost and environmentally responsible electric service to our citizen-customers

LPPC members are actively pursuing renewable and low carbon electricity alternatives in an effort to reduce our carbon footprint, and comply with current and future policies designed to reduce greenhouse gas emissions. In many cases, these alternative sources of electricity generation are more expensive or present more financial risk than traditional sources. Over the past few years, Congress has enacted into law various tax incentives and financing programs that are assisting electric utilities transition to a low carbon economy while limiting the financial impact of this transition on our customers, the ratepayers. However, because public power is not-for-profit, LPPC's members are not able to access some of the most valuable incentives and programs despite facing the same challenges of added expense and financial risk in the deployment of these technologies

The LPPC respectfully urges the Committee to expand these energy tax incentives (described below), in order to maximize public power's contribution of deploying more low and no carbon emission electricity generation, while at the same time reducing the financial impact to our ratepayers.

Production and Investment Tax Credits

Since passage, the renewable production tax credit (PTC) and the investment tax credit (ITC) have helped incentivize deployment of renewable generation. Earlier this year, the Committee recognized that, as a result of the current economic difficulties, there was no longer a sufficient market for tax credits. Accordingly, as part of the American Recovery and Reinvestment Act (ARRA), Congress modified the PTC and the ITC to allow these tax credits to be converted into federal grants equal to 30 percent of a project's costs (the Treasury "grant program"). **LPPC member companies were extremely disappointed that public power and cooperatives were specifically prohibited from participating in this new grant program.**

As a result of its exclusion from the grant program, public power has often been forced to purchase renewable electricity from privately owned projects rather than build its own. While this structure can result in somewhat lower cost than with no incentives, in most cases only a portion of the value of the federal incentive is realized by the public power entity and its customers. In addition, there is added risk of price volatility as original contracts expire. Direct access to this program would allow LPPC members to pursue more clean renewable projects and moderate the rate impact to all of its customers.

LPPC members have identified numerous projects that could be accelerated or expanded if public power was eligible for the Treasury grant program. The projects identified include a variety of technologies, from solar and wind to geothermal and biomass, and constitute investments of billions of dollars.

Financial Incentives and Clean Renewable Energy Bonds (CREBs)

As part of the ARRA, Congress provided state and local governments, including public power, with a number of new or expanded financing tools to address the disruption in the tax-exempt bond markets. Initial reports from our member companies are quite positive. These new financing tools, particularly "Build America Bonds," appear to be succeeding in providing public power and other State and local governments with an incremental cost reduction in financing, although the level of incentive for renewable energy projects still does not compete with the cost savings of a 30% grant.

Unfortunately, the same result has not been achieved with Clean Renewable Energy Bonds ("CREBs"). As the Committee is well-aware, CREBs were created in an effort to provide public power and cooperatives with an incentive, roughly comparable to PTCs and ITCs, for renewable energy projects. Unfortunately, CREBs have always been subjected to an arbitrary limit or "cap", which severely limits the ability of public power to utilize them.

Although ARRA increased public power's CREBs allocation to $800 million, this cap amount continues to be inadequate to incentivize development of renewable energy generation. For example, the construction cost of one large solar-thermal plant would exceed the entire public power allotment ($800 million). Also consider that$800 million will build only about 400MW of wind generation. That is less than half the size of a single nuclear or coal plant. In its current form and under the current market conditions, CREBs do not provide a sufficient incentive to allow LPPC members to construct and operate renewable projects at a price that is in our stakeholder's best interest. The solution is to remove the cap altogether to allow public power to

accelerate its own development of renewable energy generation. As with PTCs and ITCs, the continued lack of a robust market for tax credits further reduces the value of CREBs as an incentive.

Nuclear Production Tax Credit

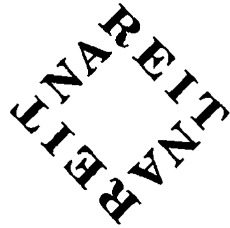
A number of LPPC members that currently own nuclear generation are pursuing new investments in nuclear power as a way to mitigate against price volatility, pollutant emissions and prospective limitations on greenhouse gas emissions. These utilities face identical hurdles to project completion as private investors but do not receive the same incentives provided by the Energy Policy Act of 2005 to promote new nuclear investment.

The tax status of the public power entities prevents them from utilizing the nuclear Production Tax Credit (PTC) authorized in EPAct of 2005, in its current form. The inability of a municipal owner to take advantage of the incentives available to a taxable nuclear plant owner, greatly changes the economic analysis for a municipal system. Because the PTCs are allocated *pro rata* to a facility's owners, the tax credits allocated for the share owned by municipal power providers not only can't be utilized by the municipal partner, but will go unused altogether. This result could be resolved by authorizing and directing the Treasury Department to allocate the municipal partner's share of the PTCs to the taxable entity, up to the taxable entity's ownership stake in the facility. This assumes that there will be more demand for nuclear PTCs than are authorized. Under the current Treasury NOPR, Treasury will assign each qualifying facility a pro-rata share of the authorized credits. Applications for 30,000MW of new nuclear generation capacity have been submitted to the NRC. More applications are expected, indicating that there will likely be more demand for these credits than are currently authorized.

Late in the 110th Congress, Chairman Baucus and Ranking Member Grassley released a draft of an energy tax bill which included changes to the nuclear Production Tax Credit (PTC) that would allow public power entities to take advantage of the PTC when it partners in a nuclear facility with a tax paying entity. LPPC continues to seek these changes to current law. Importantly, last year this provision in the Baucus-Grassley proposal was deemed by CBO to have no effect on the federal budget.

Conclusion

The LPPC appreciates the Committee's work on these issues. As climate legislation is considered, we urge you to 1.) Allow public power and cooperatives to access the 30% grant program; 2.) remove the cap on the CREBs program; and 3.) clarify the nuclear production tax credit to allow full utilization by facilities built in partnerships between public and investor owned utilities. These actions would give public power systems access to the level of incentives that allow reductions in carbon emission without adversely affecting their commercial and residential customers.



NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

Statement of the

National Association of Real Estate Investment Trusts®

to the

Senate Finance Committee

Regarding the Hearing Held on June 16, 2009 Regarding

Climate Change Legislation: Tax Considerations

The National Association of Real Estate Investment Trusts® (NAREIT) respectfully submits these comments in connection with the hearing of the Committee on Finance held on June 16, 2009, regarding "Climate Change Legislation: Tax Considerations." NAREIT thanks the Chairman, the Ranking Member and the Committee for the opportunity to provide these comments. NAREIT supports Congressional efforts to enact comprehensive legislation that encourages greater energy efficiency. To the extent that such legislation authorizes grants for activities designed to encourage greater energy efficiency, and as further described below, NAREIT encourages the adoption of clarifying language to ensure that real estate investment trusts (REITs) are able to fully participate in such activities. Rather than potentially requiring governmental resources to clarify at a later date REITs' ability to participate in the activities encouraged by such grants, it is more efficient for Congress to include such language in any climate change legislation it considers.

NAREIT is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

EXECUTIVE SUMMARY

Recently, Congress has undertaken several efforts to encourage energy efficiency and environmentally responsible retrofitting and development practices in residential and commercial buildings, as well as to promote economic stimulus. NAREIT understands that Section 262 of the energy-related bill recently approved by the Senate Energy Committee currently contains provisions that also would allow for grants to states for state-administered energy efficiency retrofit programs (Retrofitting Grants). These Retrofitting Grants are designed to encourage recipients to make their buildings more energy efficient.

By way of background, REITs are widely held companies that combine the capital of many shareholders to invest in a diversified portfolio of income-producing real estate, such as apartments, hotels, shopping centers, offices, health care facilities, timberlands, and warehouses. If REITs meet a number of requirements designed to ensure that they are focused on long term real estate investment, and if they distribute at least 90% of their income annually, they are entitled to deduct distributions so that their income is taxed only at the shareholder level. As of December 31, 2008, REITs owned an estimated 6 billion square feet of commercial space. Buildings account for 40% of all energy use and almost 70% of all electrical energy use in the United States.

As the 111th Congress continues to consider comprehensive energy legislation that includes grants for energy improvements for commercial and residential buildings, NAREIT encourages the adoption of clarifying language to ensure that REITs, as significant owners of U.S. real estate, are able to undertake fully in such improvements. Specifically, and as further described below, such language would treat Retrofitting Grants as qualifying assets that generate qualifying income under the respective REIT tests. Because REITs own and control a significant

amount of commercial real estate assets in the United States, adoption of these provisions would encourage REITs to retrofit properties for greater energy efficiency, thereby furthering Congressional policy to encourage energy reductions.

DISCUSSION

I. Efforts to Encourage Energy Efficiency

Recently, both the Obama Administration and Congress have indicated their intent to enact legislation that promotes greater energy efficiency. Congress enacted and on February 17, 2009, President Obama signed into law economic stimulus legislation, the *American Recovery and Reinvestment Act of 2009*, which includes a provision that provides an outright grant for companies that invest in certain energy projects (Energy Grants). More recently, the House Energy and Commerce Committee approved H.R. 2454, *The American Clean Energy and Security Act*. Section 202 of this proposal provides for Retrofitting Grants (called "REEP Grants" in the legislation) to facilitate the retrofitting of existing buildings across the United States to achieve cost-effective energy efficiency savings of 20% or more. We understand that Section 262 of legislation recently approved by the Senate Energy Committee also would authorize similar Retrofitting Grants.

II. REITs

A. Background

Congress created the REIT approach to real estate investing in 1960 to facilitate investment in large-scale, significant income-producing real estate by investors from all walks of life. Based in part on the rationale for mutual funds, Congress decided that an appropriate way for the average investor to access investments in larger-scale commercial properties was through pooling arrangements. In much the same ways as shareholders benefit by owning a portfolio of securities in a mutual fund, the shareholders of REITs can unite their capital into a single economic pursuit geared to the production of income through commercial real estate ownership. REITs offer distinct advantages for smaller investors, particularly: greater diversification through investing in portfolios of properties rather than single buildings and expert management by experienced real estate professionals.

B. REIT Income and Asset Test Requirements

In exchange for distributing at least 90% of their annual taxable income to shareholders, and for satisfying a number of other requirements, federal law grants REITs a dividends paid deduction so that their income is taxed at the shareholder level. In 2008, REITs distributed over $17 billion to shareholders. As relevant here, at least 75% of the value of a REIT's assets quarterly must consist of specifically delineated "real estate assets" such as interests in real property and mortgages secured by real property (the Asset Test). Furthermore, at least 75% of a REIT's annual gross income must be from specifically delineated income sources such as "rents from real property" (as such term has been defined) and interest on mortgages secured by real property (75% Income Test). At least 95% of a REIT's annual gross income must be from items that

qualify for the 75% Income Test, as well as other passive types of income like non-real estate interest and dividends (the 95% Income Test, and together with the 75% Income Test, the Income Tests). Failure to satisfy these (and other) requirements can result in the draconian penalty of loss of REIT status.

C. Recent Congressional and IRS Clarification of Income and Asset Test Requirements

Since the authorization of REITs in 1960, Congress and the IRS have refined the definitions of qualifying "real estate assets" under the Asset Test and real estate-related income under the Income Test in order to conform to changes in the real estate marketplace. For example, in last year's *Housing and Economic Recovery Act of 2008* (Pub. L. 110-289) (the 2008 Act), Congress amended the Income Tests so that foreign currency gains incurred as part of a REIT's real estate business overseas would not be taken into account under the Income Tests. Similarly, the 2008 Act treats a REIT's foreign currency owned in connection with its business as a REIT specifically as a good real estate asset. Additionally, Congress provided the IRS with authority in the 2008 Act to determine whether specific types of income not specifically listed as qualifying REIT income are in fact qualifying types of income for the Income Tests. This legislation clarifies that a REIT may earn certain income and hold assets consistent with its core mission as a REIT without having such income and/or assets negatively affect its tax status as a REIT. Finally, while not REIT-specific, Congress provided that the Energy Grants authorized in the 2009 stimulus legislation, the *American Recovery and Reinvestment Act* of 2009, specifically are excluded from the gross income of the recipients of such grants.

Similarly, the IRS also has ruled privately numerous times that real estate-related assets and income not specifically listed in the Tax Code as qualifying REIT gross income or assets, such as refunds of state and local tax credits attributable to real estate investment, nevertheless are considered qualifying income or assets or are not taken into account in analyzing those rules.[1] However, these private rulings cannot be relied upon as precedent. In order to conserve vital IRS resources in the future and prevent the need for additional private rulings, it would be beneficial for Congress to clarify in current legislation that Retrofitting Grants are qualifying REIT assets that generate qualifying REIT income. Retrofitting Grants would be provided to REITs in connection with REITs' core mission of investing in real estate — in order to make their properties more energy efficient and therefore more desirable.

III. Retrofitting Grants: Issue for REITs and Recommendation

A. Tax Issue for REITs: Potential Loss of REIT Status Without Clarifying Language

REITs currently own major commercial and residential real estate assets throughout the nation. As noted above, buildings account for 40% of all energy use and almost 70% of all electrical

[1] *See, e.g.,* PLR 200916014 (a claim for a refund of State taxes based upon State tax credits would not be considered in determining whether a REIT satisfies the REIT asset tests); PLR 200813009 (real estate intangibles were qualifying REIT assets); PLRs 200614024 and 200528004 (a REIT's taxable income associated with the receipt of State tax credits would not be taken into account in determining whether the REIT satisfied the REIT gross income tests).

energy use in the United States, and REITs owned an estimated 6 billion square feet of commercial space as of December 31, 2008. Thus, provisions encouraging REITs to undertake improvements leading to greater energy efficiency would be in furtherance of Administration and Congressional efforts to promote greater energy efficiency.

In order to maintain their tax status, REITs must comply with the Income and Asset Tests. If Congress enacts legislation authorizing Retrofitting Grants without specific provisions clarifying their treatment as qualifying REIT assets that generate qualifying REIT income, REITs may fear that receipt of such grants could jeopardize their status as REITs. As a result, REITs may be less likely to undertake the retrofitting activities these Retrofitting Grants are designed to encourage.

B. Recommendation: Include Language in Energy Legislation Clarifying that Retrofitting Grants Are Qualifying REIT Assets That Generate Qualifying Real Estate Income

Many REITs are undertaking significant steps to improve the energy efficiency of these assets, but more can be done. Grant programs and other direct incentives for energy efficiency would be welcome by the REIT community — but it is critical that these efforts take into account the particular requirements that govern REITs.

The above-described Income and Asset Tests limit the amount of non-qualifying income a REIT can earn and the assets a REIT can hold while still maintaining its tax status as a REIT. NAREIT requests that Congress consider including language to ensure that Retrofitting Grants are considered qualifying REIT assets, and that such grants are considered qualifying REIT income because they would be provided to REITs in furtherance of REITs' core mission of owning and operating professionally managed, income-producing real estate.

Including such clarifying language in any legislation would accelerate REITs' use of the Retrofitting Grants and would simultaneously limit the need to expend scarce governmental resources at a later time to clarify the tax treatment of such grants for REIT tax purposes.[2] To provide complete certainty to REITs desiring to undertake retrofitting projects, Congress still should clarify that Retrofitting Grants are qualifying REIT assets. Absence of such clarification would limit the usefulness of provisions designed to encourage energy efficiency to a significant segment of the commercial real estate industry well suited to deploy these new technologies.

NAREIT again thanks the Chairman, the Ranking Member and the Committee for the opportunity to submit these comments on this important issue.

[2] Alternatively, similarly to the treatment of Energy Grants in the 2009 stimulus legislation, language could be included that treats Retrofitting Grants as exempt from gross income.

○