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WRITTEN TESTIMONY OF
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BEFORE

THE UNITED STATES SENATE COMMITTEE ON FINANCE

HEARING ON CLIMATE CHANGE LEGISLATION: TAX CONSIDERATIONS

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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]

<u>Tax Considerations and Treatment Under Current Regulations</u>

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.