Income Tax Treatment of Forest Carbon Credit Payments to Landowners

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Tax is *Important to Private Forests*

- Tax is consistently listed as one of the top concerns for private woodland owners.
Selling Carbon Offset
Ranked Top by Woodland Owners

• Income from selling ecosystem services—especially carbon offset—are hot issues

From USDA Forest Service, National Woodland Owner Survey
Private Forests
Key for Carbon Offset

• Domestic forests absorb about 10 percent of US fossil fuel emissions

From New York Times and Land Trust Alliance website
General Tax Principles

• **Income:** capital gains better than ordinary income

• **Loss:** ordinary loss better than capital loss
Tax Rates

- Ordinary Income: 10% - 35%
- Long-term capital gains: 0% - 15%
Tax Status Is Key

• Timber property is taxed either as:
  – an income-producing property (i.e. investment) or
  – a business
Forms of Forestry Carbon Projects

• Individual forest landowners contract with aggregator to create a pool to be sold via the CCX

For example: landowners in the South was reported to receive checks for carbon credits sold, averaging $1,000 per owner

*From the Forestry Source, December 2008*
Requirements of Forestry Carbon Projects

• Enrolled forests are to be maintained by set standards
• Requires third-party verification by authorized verifier
• Acceptable forestry projects include
  – Afforestation (planting trees)
  – managed existing forests
  – long-lived wood products

*From the Forestry Source, December 2008*
Currently there are no clear guidance from the tax law or rules.

Thus reporting of carbon offset income may vary case from case.
1) Ordinary Income

• If forestry carbon offset is an incidental part of timber holding, carbon income may be ordinary income

  – As “other income” by timber investment or business taxpayers
1) Ordinary Income (Cont’d)

- For timber growing business filers, ordinary income is subject to self-employment taxes
  - on Schedule SE
  - about 2.9%-7.65% on net profit
2) Rental/Royalty Income

• If forestry carbon offset is treated like a lease (e.g. a hunting lease), the carbon income could then be rental income
  – Rental income are ordinary income but
  – It is not subject to self-employment tax (while ordinary business income does)
3) Is Carbon Offset a Capital Asset, Inventory or Intangible Asset?

- Capital gains apply to sale of “capital asset” and “business use” asset
  - “Capital asset” include all property, such as:
    - personal (house, car) or investment (stocks, timber) property, with a list of exceptions:
      - inventory or property used in business (such as business truck)
3) Is Carbon Offset a Capital Asset, Inventory or Intangible Asset?

- Typical byproduct from timber is ordinary income
  - Firewood, nuts, maple syrup (Revenue Ruling 56-434)
  - An exception: capital gains is provided for tree stumps from cutover land held as investment (Revenue Ruling 57-9)
Deduction of Establishment Costs

• Costs in developing the property for carbon offset are **capital costs** that may not be written off in whole in the year it was incurred

• You must deduct them over a period of time
Deduction of Operating Expenses

• Ordinary and necessary expenses are **deductible**:
  – Forester’s fee
  – Verification fee
  – Other compliance costs
Tax Resources
by US Forest Service

• National Timber Tax Website:
  www.timbertax.org

• Provide timber tax workshops
Tax Publications
by US Forest Service

- Annual Timber Tax Tips
- Federal Income Tax on Timber: A Key to Your Most Frequently Asked Questions
- 2009 Edition: Estate Planning for Forest Landowners—available now