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The trading of GHG emissions rights has various antecedents in the United States, such as the leaded gasoline trading program, the federal Acid Rain Program, allotments of ozone-depleting substances pursuant to Montreal Protocol obligations, vehicle manufacturer certification trading, California's RECLAIM trading scheme for nitrogen and sulfur emissions, and, more recently, a federal renewable fuels standard,¹ and various state-level alternative energy portfolio standards. There are a number of legal issues common to trading programs that must be considered, some of which may need to be modified or clarified as applied to carbon trading. These issues relate broadly to carbon trading programs whether at the state, regional or federal level; however, much of the experience and commentary on these issues is drawn from the US federal context.

(a) Property rights

Surprisingly, the basic notion of a 'right' to emit GHGs (sometimes disparagingly referred to as a 'right to pollute') and the nature of the emissions being traded remains subject to some uncertainty. Domestic law in each sovereign jurisdiction determines the legal status of the allowances traded and the corresponding property rights granted to the allowance holders. In the US tradition, property rights are 'bundles' of smaller sub-rights, such as the right to use, transfer, or preserve property, and which enjoy conditional protection from government interference.² The concept of trading carbon emissions as 'rights' has set up a tension wherein, on the one hand, a strong conception of property rights could trigger government compensation requirements under the US Constitution's 'taking clause'³ if rights are altered (for instance, if allowances are promised to emitters, but the overall cap on emissions is subsequently lowered), yet, on the other hand, a weak conception of property rights could fail to vest participants with the certainty needed to invest in, transfer and trade in emissions allowances. Thoughtful definition of emissions rights will be necessary to ensure administrative flexibility while minimizing risk and uncertainty in emissions trading. The US experience through the Clean Air Act's (CAA) pioneering Acid Rain Program established the contours of property rights in emissions trading.⁴ Allowances

¹ See Energy Policy Act of 2005, Pub L No 109-58 (8 August 2005); Energy Independence and Security Act of 2007 (EISA), HR 6; Pub L No 110-140 (19 December 2007); see also Beveridge & Diamond, PC, 'New RFS Program Requirements for Renewable Fuel Producer and Importers' (Beveridge and Diamond Client Alert 18 July 2007) <<http://www.bdlaw.com/news-202.html>>, accessed 2 February 2009.

² Eg, Markus W Gehring and Charlotte Streck, 'Emissions Trading: Lessons From SO_x and NO_x Emissions Allowance and Credit Systems Legal Nature, Title, Transfer, and Taxation of Emission Allowances and Credits' (2005) 35 ELR 10219, 10221; *Moore v Regents of the Univ of Cal*, 793 P 2d 479 (Cal 1990) (Mosk J, dissenting) ('[T]he concept of property is often said to refer to a 'bundle of rights' that may be exercised with respect to that object—principally the rights to possess the property, to use the property, to exclude others from the property, and to dispose of the property by sale or gift.');

Travis Allan & Kathy Baylis, 'Who Owns Carbon? Property Rights Issues in a Market for Green House Gasses' (2005) <http://works.bepress.com/cgi/viewcontent.cgi?article=1017&context=kathy_baylis>, accessed 2 February 2009.

³ US Const amend V ('... nor shall private property be taken for public use, without just compensation').

⁴ The Acid Rain Program was established under Title IV of the Clean Air Act Amendments of 1990. The program is administered by the US EPA and applies principally to emissions of sulfur dioxide and nitrogen oxides from large (>25MW) fossil-fuel electric generation units in the continental United States.

under the Acid Rain Program do not constitute legal property rights; instead, they are termed ‘limited authorization[s]’ to emit certain levels of sulfur and nitrogen.⁵ The CAA further states that nothing under the act or US law shall be construed to limit the government’s authority to ‘terminate or limit’ the authorizations.⁶ At the same time, and perhaps paradoxically, acid rain allowances may be ‘received, held, and temporarily or permanently transferred.’ The existing and proposed GHG cap and trade systems in the United States have incorporated similar language.⁷

The policy justification for denying allowances the legal status of property rights is two-fold. First, there is a concern that granting full property rights to emitters would restrict the government’s ability to adjust emissions targets, for example, if the existing allocation program fails to achieve anticipated reductions in atmospheric concentrations of GHGs or if new scientific data shows that more vigorous cuts are needed. As noted, under the Fifth Amendment to the US Constitution, the government may not take private property for public use ‘without just compensation’.⁸ US courts have interpreted this clause to include regulatory takings, requiring the government in some situations to compensate property owners where regulations have significantly impaired the value of property.⁹ A second justification, with particular currency in the environmental community, is the strong philosophical objection to granting participants a ‘right to pollute’.¹⁰ Artfully drafted definitions of emissions rights help protect the government against regulatory takings

Allowances are distributed to facilities according to a 1985–1987 actual emissions baseline. Facilities must hold sufficient allowances in a compliance account to equal annual emissions during a given calendar year. Failure to maintain the required allowances results in a \$2,000/ton penalty, debiting of allowances to cover the deficit from the next allocation, and possible criminal and civil penalties. Clean Air Act Amendments of 1990, Pub L No 101-549, 104 Stat 2399 (1990) (codified at 42 USC §§ 7651–7651o).

⁵ Clean Air Act, 42 USC § 7651b(f).

⁶ Ibid.

⁷ For example, RGGI defines a CO₂ allowance as a ‘limited authorization’ by the regulatory agency to emit up to 1 ton of CO₂. The definition further states that no provisions should be construed to ‘limit the authority of the regulatory agency or a participating state to terminate or limit such authorization’ and adds that the limited authorization ‘does not constitute a property right.’ RGGI Model Rule, XX-1.5(c)(6)–(7) (revised 31 December 2008). Proposals for federal cap and trade legislation have followed this template closely. The Lieberman-Warner bill provided that: ‘An emission allowance shall not be a property right . . . Nothing in this Act or any other provision of law limits the authority of the United States to terminate or limit an emission allowance.’ Lieberman-Warner Climate Security Act of 2007, S 2191 § 1201(c), 110th Cong (2007). Similarly, the American Clean Energy and Security Act of 2009 (also known as the ‘Waxman-Markey bill’) provides that an emissions allowance ‘does not constitute a property right’ and that nothing shall ‘limit or alter’ the authority of the US government to terminate or limit the allowances or credits. American Clean Energy and Security Act of 2009, HR 2454, 111th Cong § 721(c) (2009) [hereafter: ‘Waxman-Markey Bill’].

⁸ US Const amend V.

⁹ Eg, *Penn Coal Co v Mahon*, 260 US 393 (1922) (‘[W]hile property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking.’).

¹⁰ See, eg, *Gehring & Streck* (n 17 above), 10221.

claims, while avoiding any grant of an express ‘right to pollute,’ and at the same time ensuring maximum transferability of allowances in the trading system.

Despite the constrained statutory definition of emissions allowances under the US Clean Air Act, experience under the Acid Rain trading program resulted in de facto property rights protections under the US system of common law interpretation of statutory mandates. In recognition of the value of Acid Rain Program allowances in business transactions and financial accounting, and despite the absence of a defined property right, US courts have ruled that rights to receive these allowances can be litigated in federal courts,¹¹ and that a state-law triggered diminution in value of these allowances constitutes ‘injury in fact’ sufficient to demonstrate standing.¹²

GHG emissions allowances under a federal climate bill are likely to benefit from these de facto property right protections even if cap and trade legislation ultimately incorporates the limited definition of allowances under the CAA Acid Rain Program. However, given some level of inherent uncertainty, participants in GHG trading markets should be aware of the limited nature of the ‘rights’ to allowances and should take care to structure their business transactions to clarify that the counter-parties to any transaction must recognize the right to emit GHGs as a thing of value which can be contracted for, regardless of whether it is technically a property right.

(b) Contracting and transactions

Even in the absence of statutorily defined property rights, parties to allowance trades are likely to be able to protect their rights and enforce trades through properly structured contracts. Under US law, private parties can typically create rights that are enforceable between themselves, even if the rights are not otherwise legally recognized, as long as there is sufficient ‘consideration,’ or in other words, both sides bring something of value to the transaction. US courts place great emphasis on the principle of freedom of contract, and generally prefer to honor the intent of the contracting parties as conveyed through the contract terms. Therefore, the parties to a carbon transaction should strive to ensure that the final contract fully reflects the parties’ intent.

The legal elements of such transactions are addressed elsewhere in this book and are beyond the scope of this chapter. However, in developing a carbon trading contract and structuring the trade in the United States, parties will need to familiarize themselves with the regulatory procedures that apply to the transaction as well as the potential business implications and tax rules (discussed below) governing the trade. All of the emerging carbon trading regimes in the US have proposed to use a system of project validation, emissions verification, and electronic-based registry to manage ‘ownership’ and trading of emissions allowances or credits, similar to the experience of the Acid Rain Program and Europe’s ETS. However, as of this point the precise requirements for US programs, other than RGGI,

¹¹ Ormet Corp v Ohio Power Co, 98 F 3d 799 (4th Cir 1996). In Ormet, the US Court of Appeals for the Fourth Circuit determined that disputes over ownership of emissions allowances under the Acid Rain Program presented a substantial federal question that could be heard by federal courts, notwithstanding the fact that the Clean Air Act did not confer property rights in allowances and did not create a private right of action for claimants of allowances.

¹² Clean Air Markets Group v Pataki, 194 F Supp 2d 147 (NDNY 2002).

can only be guessed at and companies will have to make decisions based on projections of most likely regulatory structure.

(c) Taxation

Tax treatment of carbon trading markets in the United States remains somewhat uncertain, although precedents established by the Internal Revenue Service (IRS) in the US EPA's Acid Rain Program and other pollution trading scenarios may inform the IRS's approach to the use and trade of carbon market instruments. In the United States, taxes may be imposed at the federal, state, and sometimes regional or local level. Accordingly, the full tax implications of an individual market action will vary based on the jurisdiction. In addition, it is possible that sales or excise taxes (as opposed to income tax) could be imposed on carbon market transactions, or that allowances could be taxed as capital property. A full discussion of the tax consequences of market activities is beyond the scope of this chapter, and entities should consult experienced tax specialists; however, the principal tenets of basic federal income and capital gains tax law, as they have applied to allowance trading under the Acid Rain Program, are surveyed below.

Typically under the federal tax system, tax is assessed on net 'ordinary' income, while profits from the sale of property or assets are treated as 'capital gains' (or losses) based on the difference between the sale price and the seller's tax basis.¹³ Basis is simply the cost of, or the money invested in, the property or asset, usually including transaction costs such as broker fees.¹⁴ The tax treatment in a carbon cap and trade market will depend on whether allowances are freely distributed or auctioned, and, if the allowances are freely distributed, whether the IRS decides that it may tax the receipt of these allowances as income.¹⁵

In the Acid Rain Program, the US government distributed allowances without cost to regulated entities, and the IRS subsequently determined that the receipt of these allowances was not taxable as income.¹⁶ Instead, the IRS treated the allowances as intangible capital assets, the value of which could not be depreciated (like, for example, machinery) but could be deducted in the year that the allowance was used by the regulated entity for compliance purposes. The basis of the allowance holder in this scenario is considered to be zero.¹⁷ Under these rules, the sale of allowances by a regulated entity results in capital gain or loss, whereas transactions by allowance traders or investors (as opposed to regulated entities) are typically declared as ordinary income. With a zero tax

¹³ Ethan Yale, 'Taxing Cap-and-Trade Environmental Regulation' (2008) 37 JLS 535, 539.

¹⁴ 26 USC § 1012; Gehring and Streck (n 17 above), 10230.

¹⁵ Yale (n 28 above), 539.

¹⁶ Tax rules applicable to the federal Acid Rain Program are described in Rev Rul 92-16, 1992-12 IRB 5 (23 March 1992) and Rev Proc 92-91, 1992-46 IRB 32 (16 November 1992); see also Announcement 92-50, 1992-13 IRB 32 (30 March 1992).

¹⁷ Larry B Parker & Donald W Kiefer, 'Implementing SO2 Allowance Trading: Implications of Transaction Costs and Taxes' (12 March 1993) CRS Report 93-313 5. <<http://ncseonline.org/nle/crsreports/air/air-11.cfm>> accessed 10 March 2009; Gehring & Streck (n 17 above), 10225.

basis, and thus nothing to offset gains, the full amount realized by the sale of these allowances on the trading market is taxed as a capital gain.¹⁸

Although these rules have been tested in the Acid Rain Program, it is unclear whether the IRS or state taxing authorities will extend this approach to GHG trading. Currently no IRS guidance exists regarding the tax treatment of GHG transactions under emerging sub-national trading programs. Given the differences between these emerging programs and the Acid Rain Program—particularly the auctioning, rather than free distribution, of allowances—participants should exercise caution in relying on the Acid Rain tax rules for GHG allowance trading. The fact that participants in many emerging trading programs will be required to purchase their allowances through an initial auction, for example, should result in the purchaser acquiring some tax basis in the allowances. As a result, gains from the subsequent sale of these allowances on the market would presumably be taxed at the applicable capital gains rate (usually between 10 and 15%) on the excess of the sale proceeds over the seller's basis.¹⁹ If these allowances were used for compliance purposes (ie, retired in the EPA registry), rather than sold on the market, it is likely that the basis of the allowances (whether the company purchased the allowances from the initial auction or in a secondary market trade) would be recognized as an operating expense and allowed a tax deduction for that year.²⁰ Despite the differences in the emerging 'ecosystem' commodity markets, the IRS did apply the Acid Rain Program tax rules to trading of wetland mitigation credits, thus giving some indication of the likelihood of applying the rules to other ecosystem credits, including carbon.²¹

International trading of GHG allowances imposes another layer of tax planning. The IRS recently published its first guidance on emissions trading in over seventeen years.²² The guidance addresses US tax treatment of gains from the sale of CO₂ allowances on the European market by 'controlled foreign corporations,' or foreign corporations that are majority-owned by US corporations or individuals.²³ The IRS characterized the allowances as 'property that does not give rise to income' under Subpart F of the IRC and concluded that the taxpayer was eligible for a deferral of US taxation. Although the guidance stems from a 'Private Letter Ruling' and therefore may not be used as binding precedent, it is an indication that the IRS is beginning to consider the US tax consequences of GHG trading.

¹⁸ Yale (n 28 above), 540.

¹⁹ Ibid. If the seller does not realize a profit on the sale of allowances (i.e., incurs a capital loss), losses can usually be set off against current year capital gains, carried forward five years, or carried back three years. However, losses cannot generally be used to offset regular income, and accordingly, there is a risk that market participants would lose the value of the capital loss if they have no gains to offset. Gehring & Streck (n 17 above), 10225.

²⁰ See Parker & Kiefer (n 32 above), 6.

²¹ IRS Priv Ltr Rul 9612009 (18 December 1995).

²² Daniel R McKeithen and others, 'United States: First IRS Guidance Under Subpart F on US Tax Treatment of Gain From the Sale of Surplus CO₂ Emissions' (25 June 2008) <<http://www.mondaq.com/article.asp?articleid=63262>> accessed 2 February 2009.

²³ IRS Priv Ltr Rul 200825009 (7 March 2008).

While it is unclear at this juncture what tax rules will be applied to carbon allowance trading, it is possible that some components of the tax rules formulated for the Acid Rain Program will persist. At the same time, tax treatment of GHG trading at the state and local level, despite RGGI's entry into force in early 2009, also remains unclear. Entities participating in any of the emerging trading regimes should plan for a variety of tax implications, and should consider the option of approaching the IRS as well as state tax authorities for administrative guidance or private letter rulings.²⁴

²⁴ See also Ernst & Young, Thought Center, Webcasts and Podcasts, 'Emission allowances and renewable energy certificates, Accounting and tax issues' <<http://webcast.ey.com/thoughtcenter/default.aspx?prog=%7B8c1a84e5-68a1-4330-b04f-f1aacceebb43%7D>>, accessed 6 February 2009.