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First IRS Guidance Under Subpart F on U.S. Tax Treatment of Gain From the Sale of Surplus CO₂ Emissions Allowances

In PLR 200825009 (March 7, 2008), publicly released on June 20, 2008, the Internal Revenue Service (“IRS”) provided its first guidance concerning the treatment of gain from the sale of surplus CO₂ emissions allowances under the Internal Revenue Code’s (the “Code”) Subpart F rules. The sale of the surplus CO₂ emissions allowances occurred under the European Union Emissions Trading Scheme (“ETS”). The IRS determined that the gain was not “Subpart F” income and therefore was eligible for deferral of U.S. tax, although the IRS stated that it continues to study the matter.

The Subpart F provisions apply to foreign corporations that are majority-owned by U.S. corporations or individuals, which are referred to as “controlled foreign corporations” or “CFCs.” Certain passive income earned by a CFC is treated as earned by its U.S. owner in the same year that the CFC earns the income. This income is referred to as “Subpart F income.” However, income that is not characterized as “Subpart F income” is not taxed to the CFC’s U.S. owner until the CFC repatriates that income to the U.S., usually by means of a dividend.

The IRS guidance was in the form of a private letter ruling, which is addressed only to the taxpayer that requested the ruling. Although other taxpayers may not rely on the ruling, such a ruling indicates the IRS position and views at the time the ruling was issued. In this instance, the matter is one of first impression and is important to U.S. multinational corporations that engage in business activities in the European Union and other countries that have similar arrangements.

The ruling determined that the gain from the sale of the surplus CO₂ emissions allowances was not “Subpart F income” because the IRS treated the CO₂ emissions allowances as property that does not give rise to income within the meaning of section 954(c)(1)(B)(iii) of the Code. The IRS further determined that the CO₂ emissions allowances were used in the CFCs’ trade or business and therefore met the business assets sale exception for intangible property as defined under section 936(h) of the Code. The IRS further explained that, without the CO₂ allowances, the CFC could not operate in its industry, and the allowances permit the owner to engage lawfully in a business activity without penalty. As the emissions allowances are independent of the services of any individual, the IRS reasoned that the allowances are intangible property as that term is defined in section 936(h) of the Code.

The taxpayer had also argued that the allowances should be treated as commodities. The IRS did not adopt this treatment, although it did state that it is currently studying the question. There is an exception for active business gains or losses from the sale of commodities, so had the IRS adopted that approach the result would have presumably been the same, *i.e.*, no “Subpart F income.” The IRS further stated that its treatment of the allowances as intangible property was solely for purposes of the ruling. This statement indicates that the IRS is not clear how it will ultimately treat gain from the sale of such emissions allowances.

The IRS previously issued guidance regarding the U.S. federal income tax treatment of the sale of emissions allowances. That guidance, provided in Revenue Procedure 92-91 in connection with sulfur dioxide (SO₂) emissions allowances under the Clean Air Act of 1990, provides that the costs of acquiring emissions allowances must be capitalized, *i.e.*, added to the basis instead of being deducted in the year in which the cost is incurred. Moreover, Rev. Proc. 91-92 does not permit an emission allowance to be depreciated because it has no useful life over which it could be depreciated. Upon sale, any resulting gain or loss is included in the taxpayer’s gross income. The gain is capital gain income unless the seller

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holds the allowance primarily for sale to customers in the ordinary course of a trade or business, in which case the gain or loss is ordinary.

The ruling is the first IRS guidance concerning emissions allowances in 17 years. The fact that the IRS is studying the issue is important as the issue is considered by Congress and other governmental agencies, most notably the U.S. Commodity Futures Trading Commission.



If you have any questions regarding this alert, or the services we provide, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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