**Internal Revenue Service**

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February 15, 2017

**Legend:**

Taxpayer =

Subsidiary =

Agency =

Organization A =

Organization B =

Date 1 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Year 7 =

State A =

State B =

State C =

Foreign Country =

A =

B =

C =

D =

E =

F =

G =

H =

I =

J =

K =

L =

Dear :

This letter is in reply to a letter dated November 25, 2013, and supplemental correspondence, in which Taxpayer requests rulings in connection with its status as a real estate investment trust ("REIT") under Section 856 of the Internal Revenue Code.

Taxpayer has requested the following rulings:

(1) Taxpayer will accrue income with respect to the issuance of the Credits (as defined below) and properly recognize such income upon the earliest of the following events to take place: the Credits are earned, the Credits are received, or the Credits are due; and

(2) Pursuant to the authority of Section 856(c)(5)(J), income from the issuance of the Credits will be considered as qualifying income under Sections 856(c)(2) and (c)(3).

**Facts:**

Taxpayer is a domestic corporation that elected to be treated as a REIT beginning with its taxable year ended Date 1. Taxpayer's annual accounting period is the calendar year, and its method of accounting is the accrual method. Taxpayer is publicly traded.

Taxpayer currently owns and manages over A acres of commercial forestland throughout the United States, including forestland in State A and State B. During the tax years Year 1 through Year 2, Taxpayer realized approximately B dollars, or C percent, of its gross income as qualifying income, primarily from timber sales and rental revenue with respect to its forestlands.

Taxpayer also owns Subsidiary, a Foreign Country corporation. Subsidiary was formed in Year 3 and has been a qualified REIT subsidiary ("QRS") under Section 856(i)(2) since Taxpayer's election of REIT status. Through Subsidiary, Taxpayer owns and manages forestlands and grasslands in Foreign Country. Taxpayer currently owns or leases approximately D acres of forestland and grassland in Foreign Country.

Taxpayer and Subsidiary plan to participate in two carbon sequestration projects, one in the United States and one in Foreign Country, involving the development and implementation of forestland management parameters on certain portions of Taxpayer's existing landholdings. Third party providers will analyze Taxpayer's forestlands, develop forestland management parameters complying with the applicable carbon sequestration standards, and market and sell the resulting carbon sequestration credits on behalf of Taxpayer. Collectively, the U.S. Credits (as defined below) and the Foreign Credits (as defined below) are referred to as the "Credits."

The U.S. Project

The U.S. project will cover E acres of Taxpayer's landholdings in State A and State B, and will entitle Taxpayer to State C carbon offset credits ("U.S. Credits") under a program administered by Agency and monitored by a third-party developer. Taxpayer expects to sell U.S. Credits to third parties who wish to offset their carbon emissions.

The area of land encompassed by the U.S. project will be described in detail using either land surveys or latitude and longitude coordinates, as well as detailed maps showing topography and location relative to nearby towns and roads. The U.S. project will involve the design and implementation of forestland management parameters that will include the following criteria (the "U.S. land use restrictions"):

(1) Taxpayer must maintain a specified composition of tree species;
(2) Taxpayer must either (i) adhere to sustainable harvesting practices certified by an independent third party or governmental agency, or (ii) adhere to specified silvicultural practices and canopy retention averaging at least 40 percent as measured over any 20 acres within the project area;
(3) Taxpayer must maintain or progress toward maintaining no more than 40 percent of the project area with forestland aged less than 20 years; and
(4) Taxpayer must maintain specific quantities of sequestered carbon in dead wood within the project area.

Taxpayer expects that the Agency will issue approximately F U.S. Credits between Year 4 and Year 5 as a result of the U.S. project, which will be sold to third parties at a price between G and H per U.S. Credit. Taxpayer expects the U.S. Credits to be sold as soon as practicable upon receipt and does not intend to hold U.S. Credits for purposes of speculating on future appreciation.

Taxpayer will commit to the U.S. land use restrictions for a minimum of 100 years following the issuance of the U.S. Credits. These restrictions will be imposed on the parcels of land that Taxpayer specifically identifies. Taxpayer will not have the right to substitute forest land that is not the subject of the U.S. project, and third parties will monitor Taxpayer's compliance with the U.S. land use restrictions.

Taxpayer may intentionally decide to forego the U.S. land use restrictions. To do so, Taxpayer would be required to pay to the Agency 100 percent of the U.S. Credits previously issued to Taxpayer plus a penalty that begins at 40 percent of the U.S. Credits issued and decreases until it reaches 0 percent in year 50 of the U.S. project. To make the required payment, Taxpayer would either have to obtain the U.S. Credits in the open market or, if Taxpayer had generated U.S. Credits from another carbon sequestration project, Taxpayer could use those U.S. Credits. Additionally, the U.S. project requires that certain credits be held in a buffer account to offset unintentional carbon loss, such as carbon loss due to a forest fire.

Taxpayer is allowed, but not required by the U.S. project agreements, to record conservation easements on the land that is part of the U.S. project. Under the local law of both State A and State B, Taxpayer could record conservation easements reflecting the applicable forestland management parameters in the land records of the U.S. project area. Either the easement holder or a third party with a right of enforcement could bring an action to enforce any such recorded easement.

A recorded conservation easement would reduce the amount of buffer credits required by the Agency, and any conservation easement would identify the Agency as the beneficiary and specify the Agency's right to enforce all obligations under the easement. However, Taxpayer would be required to find a third party to hold the easement on behalf of the Agency. Due to the cost involved in finding third parties to

hold such easements and the process involved to record the conservation easements, Taxpayer has represented that it is does not currently intend to pursue recording of conservation easements with respect to the U.S. project.

The Foreign Country Project

The second project is a forest management project covering approximately I acres of recently planted forestland in Foreign Country that will entitle Taxpayer to certain carbon credits ("Foreign Credits") under a program administered by Organization A, a third-party provider of carbon reduction standards. Taxpayer expects to sell the Foreign Credits to third parties who wish to offset their carbon emissions.

Planning for the Foreign Country project began in Year 6, at which time Taxpayer commenced planting several types of trees over approximately I acres in Foreign Country. The Foreign Country project describes the subject land by specific latitude and longitude coordinates. Under the terms of the Foreign Country project, Taxpayer commits to the following forestland management parameters (the "Foreign Country land use restrictions," and, collectively with the U.S. land use restrictions, the "land use restrictions"):

(1) Establishment of pine and eucalyptus plantations on non-forested land;
(2) Periodic pruning of pine and eucalyptus plantations to certain specifications;
(3) Periodic thinning of pine and eucalyptus plantations to certain specifications;
(4) Periodic clear-cut harvesting of pine and eucalyptus plantations at specified intervals;
(5) Site preparation and replanting of trees following each clear-cut harvest; and
(6) Formation of permanent sampling plots in year 4 after planting and maintenance of a continuous forest inventory to monitor tree growth, forest health, and fire risks.

Taxpayer submitted the Foreign Country project to Organization A at the beginning of Year 7. As part of the application process, Taxpayer submitted a validation report prepared by Organization B regarding the carbon sequestration potential of the Foreign Country project. The Foreign Country project is currently in a monitoring and audit period that will result in the preparation of a monitoring report and a verification report. Those reports will be submitted to Organization A along with a verification deed, whereby Organization B will represent to Organization A that the Foreign Country project continues to comply with the applicable Organization A rules and program requirements and that Organization B has independently verified the amount of sequestered carbon. Taxpayer has previously submitted a registration deed of representation to Organization A, and Taxpayer will also submit to Organization A an issuance deed. Taxpayer represents in these deeds, among other things, that all project documents are true and accurate.

Following the submission of the project documents, Organization A will determine the number of allocable Foreign Credits and will begin to deposit the Foreign Credits into Taxpayer's account. Taxpayer expects Organization A to issue over J Credits with respect to the Foreign Country project with the vast majority of those Foreign Credits being issued in the first K years following approval. A third party will sell the Foreign Credits on Taxpayer's behalf. Taxpayer expects to receive between L dollars and K dollars per Foreign Credit. Taxpayer expects the Foreign Credits to be sold as soon as practicable after receipt and does not intend to hold Foreign Credits for purposes of speculating on future appreciation.

Taxpayer will commit to the Foreign Country land use restrictions for a minimum of 100 years. The Foreign Country project will impose these restrictions on the parcels of land that Taxpayer will specifically identify. Taxpayer will not have the right to substitute forest land that is not the subject of the Foreign Country project. Third parties will monitor Taxpayer's compliance.

Taxpayer does not have the ability to forego entirely the Foreign Country land use restrictions. Rather, a portion of the Foreign Credits attributable to the Foreign Country project will be held in a buffer account as potential replacement credits for any future loss of sequestered carbon based on the "non-permanence risk rating" of the Foreign Country project. The non-permanence risk rating is prepared by Organization B using a list of risk factors designed to evaluate the potential for losses in carbon with respect to the Foreign Country project. The risk factors Organization B evaluates include the management and financial viability of the project, the longevity of the project, and political and natural risks associated with the project. The higher the non-permanence risk rating, the more credits required in the buffer account. Buffer credits are not issued a serial number and cannot be sold. Organization A can release buffer credits from the buffer account over time as an incentive for continued verification of the project's carbon sequestration potential. Once released, buffer credits are issued as Foreign Credits into Taxpayer's designated account. In the event Taxpayer sells any portion of the Foreign Country project, the purchaser will be required to execute a deed of accession in respect of the registration deed under which the purchaser will agree to be bound by the terms of the registration deed.

Taxpayer has consulted with local Foreign Country counsel and has been advised that only a limited set of enumerated items are able to be recorded in Foreign Country land records. A conservation easement such as what would be recordable in the U.S. is not an item that could be recorded in Foreign Country land records. However, Foreign Country counsel has advised Taxpayer that a properly executed agreement imposing restrictions on land would be enforceable in Foreign Country as a matter of contract. Taxpayer intends to execute the Foreign County project documents in a manner that could be enforced under the laws of Foreign Country.

**Law and Analysis:**

Section 61(a) provides that except as otherwise provided by law, gross income means all income from whatever source derived. Under Section 61, Congress intends to tax all gains or undeniable accessions to wealth, clearly realized, over which taxpayers have complete dominion. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 477 (1955).

Section 856(c)(2) provides that for a corporation to qualify as a REIT, at least 95 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from sources that include dividends, interest, rents from real property, and gain from the sale or other disposition of stock, securities, and real property (other than property in which the corporation is a dealer), abatements and refunds of taxes on real property, income and gain derived from foreclosure property, commitment fees, and gain from certain sales or other dispositions of real estate assets.

Section 856(c)(3) provides that for a corporation to qualify as a REIT, at least 75 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from rents from real property, interest on obligations secured by real property, gain from the sale or other disposition of real property (other than property in which the corporation is a dealer), dividends from REIT stock and gain from the sale of REIT stock, abatements and refunds of taxes on real property, income and gain derived from foreclosure property, commitment fees to make loans secured by mortgages on real property or to purchase or lease real property, gain from certain sales or other dispositions of real estate assets, and qualified temporary investment income.

Section 856(d)(1) provides that rents from real property include (subject to exclusions provided in Section 856(d)(2)): (A) rents from interests in real property; (B) charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated; and (C) rent attributable to personal property leased under, or in connection with, a lease of real property, but only if the rent attributable to the personal property for the taxable year does not exceed 15 percent of the total rent for the tax year attributable to both the real and personal property leased under, or in connection with, the lease.

Section 856(c)(5)(J) provides that to the extent necessary to carry out the purposes of Part II of Subchapter M of the Code, the Secretary is authorized to determine, solely for purposes of such part, (i) whether any item of income or gain that does not otherwise qualify under Sections 856(c)(2) or (c)(3) may be considered as not constituting gross income for purposes of Sections 856(c)(2) or (c)(3), or (ii) whether any item of income or gain that otherwise constitutes gross income not qualifying under Sections 856(c)(2) or (c)(3) may be considered as gross income that qualifies under Sections 856(c)(2) or (c)(3).

Section 1.856-4(a)(1) provides that the term "rents from real property" means, generally, the gross amounts received for the use of, or the right to use, real property of the real estate investment trust.

Section 1.451-1(a) provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Generally, all events that fix the right to receive income occur upon the earliest of the following events to take place: the payment is received, the payment is due, or the income is earned by performance. See Schlude v. Commissioner, 372 U.S. 128 (1963); Rev. Rul. 2003-10, 2003-1 C.B. 288.

The legislative history underlying the tax treatment of REITs indicates that a central concern behind the gross income restrictions is that a REIT's gross income should largely be composed of passive income. For example, H.R. Rep. No. 2020, 86thCong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-23 states, "[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business."

Taxpayer will earn the Credits as a result of agreeing to certain restrictions on the use of its land. The land use restrictions require Taxpayer to abstain from certain uses of its land in both the U.S. and Foreign Country. Additionally, the Foreign Country land use restrictions require Taxpayer to affirmatively perform certain actions, such as planting trees, on its land. The restrictions in the U.S. project are restrictions that could otherwise be recorded as an easement under local law. The restrictions in the Foreign Country project, although not recordable as an easement under the local law of Foreign Country, are enforceable under the local law of Foreign Country. Taxpayer is agreeing to the restrictions in each project for a period of 100 years. Taxpayer will incur significant penalties if Taxpayer does not abide by the restrictions to which it has agreed. For these reasons, the Credits are akin to receiving payment for granting an easement for a term of years with respect to the Taxpayer's real property. Cf. Wineberg v. Commissioner, 326 F.2d 157, 169-70 (9th Cir. 1963) (holding amount received for granting 10-year right to use a road was rent rather than sale of an interest in land), aff'g T.C. Memo. 1961-336; Nay v. Commissioner, 19 T.C. 114, 119 (1952) (concluding amount received for granting a "right of way" for a term not to exceed three years is ordinary income because such a "limited easement" does not constitute sale of real property). Under these circumstances, treating the Credits as qualifying income does not interfere with or impede the objectives of Congress in enacting Sections 856(c)(2) and (c)(3).

With respect to the issuance of the Credits, Taxpayer will include the fair market value of the Credits in its gross income in accordance with Section 1.451-1(a). Taxpayer's basis in a Credit will be equal to its fair market value when accrued as income. Cf. Philadelphia Park Amusement Co. v. United States, 126 F.Supp. 184, 188-189 (1954).

**Conclusions:**

As discussed above, we hereby rule as follows:

(1) Taxpayer will accrue income with respect to the issuance of the Credits and properly recognize such income upon the earliest of the following events to take place: the Credits are earned, the Credits are received, or the Credits are due.

(2) Pursuant to the authority of Section 856(c)(5)(J), income from the issuance of the Credits will be considered as qualifying income under Sections 856(c)(2) and (c)(3).

This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed with regard to whether Taxpayer otherwise qualifies as a REIT under subchapter M of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Robert A. Martin
Senior Technician Reviewer, Branch 1
Office of Associate Chief Counsel
(Financial Institutions & Products)