A Discussion on Environmental Preservation Credits

American Bar Association
Section of Taxation
Tax Accounting Committee
January 18, 2019

Moderator
Christian Wood
RSM
Washington, DC

Panelists
Katharine Abdoo
PwC
Washington, DC

The information contained herein is of general nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax advisor. The government panelists did not participate in the preparation of this handout.

Mitigation banking is the preservation, enhancement, restoration or creation of a wetland, stream, or habitat conservation area which offsets, or compensates for, expected adverse impacts to similar nearby ecosystems.¹ In the United States, federal agencies (under section 404 of the Clean Water Act), as well as many state and local governments, require mitigation for the disturbance or destruction of wetland, stream, or endangered species habitat. Once approved by regulatory agencies, a mitigation bank may sell credits to developers whose projects will impact these various ecosystems.

The EPA identifies four components of a mitigation bank as: the bank site, the bank instrument, the Interagency Review Team (IRT), and the service area.² The bank site identifies the acreage of the area preserved, enhanced, restored, or created. The bank instrument is the formal agreement between regulatory agencies and the bank owner, which establishes liability and success of the mitigation bank. The IRT regulates approval and oversight of the mitigation bank. The service area identifies the area in which the bank can sell credits for permitted impacts.³

In order to maximize these programs it is critical that the participants know the federal tax treatment at the outset. The existing guidance generally focuses on other specific aspects (such as "good" assets for a Real Estate Investment Trust) or does not reached consistent outcomes. Both the IRS and the participants in these types of programs will need clear guidance regarding several fundamental income tax questions. With respect to the credits themselves, participants will expect to know (1) how and when any allocations of credits will be taxed; (2) the tax basis of the credits; (3) whether the cost of acquiring a credit should be capitalized or deducted; (4) when and how any capitalized costs are to be recovered; and (5) the character of any gains and losses recognized.

The panel will discuss when taxpayers recognize income, the character of the income, whether the taxpayer is considered a dealer in property related to the credits, when taxpayers may recover the basis, and purchase price allocations. The panel will also discuss other topics addressed in the Climate Change Legislation: Tax Considerations prepared by the Joint Committee on Taxation⁴.

¹ https://en.wikipedia.org/wiki/Mitigation_banking
² https://www.epa.gov/cwa-404/mitigation-banking-factsheet
⁴ https://www.jct.gov/publications.html?func=fileinfo&id=3559
For example, PLR 201123003 reached a conclusion that “[g]enerally, the granting of a transferable right by a government does not cause the realization of income. Rev. Rul. 92-16, 1992-1 C.B. 15 (allocation of air emission rights by the U.S. Environmental Protection Agency does not cause a utility to realize gross income); Rev. Rul. 67-135, 1967-1 C.B. 20 (fair market value of an oil and gas lease obtained from the federal government through a lottery is not includible in income).” However, the IRS revoked this guidance in PLR 201751011 and treated the issuance of the credits as income when granted. The reasoning for changing the timing of income was that the units were akin to receiving payment for granting an easement for a term of years and therefore was similar to rent. The result of the change in reasoning is that a taxable event could occur years before taxpayers generate any income for the use or disposition of a credit.