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Into the Woods: The Tax Uncertainty of Carbon Contracts

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As woodland landowners look for income diversification opportunities, they may explore the potential of carbon sequestration as a revenue stream, particularly the potential income from woodland carbon programs. The federal income tax implications of this type of income are still not fully addressed in current tax law. This is not to mention that some states are analyzing tax law creation or changes to offset potential decreases in tax revenue generation due to possible decreased logging activity for standing timber enrolled in carbon programs. While the IRS has offered some guidance on underground carbon sequestration, it has yet to provide specific direction regarding income earned from carbon storage in standing, above-ground timber.

One thing that is almost always certain in the U.S. tax system is this: income is taxable unless specifically excluded by law. That includes income from carbon programs. Regardless of whether the payment is made for leasing rights, selling credits, or participating in carbon offset programs, receiving compensation for carbon sequestration is likely to be considered a taxable event. However, how that income is taxed and potential deductions to income depend heavily on how the income is characterized under the Internal Revenue Code.

In the U.S., income is generally characterized as either ordinary income or capital gains. Ordinary income is taxed at progressive rates and may also be subject to self-employment tax if it arises from an active trade or business. Capital gains, by contrast, are typically subject to more favorable long-term tax rates. While there are exceptions that exist, we typically think of selling timber as a capital gains event. Consequently, the way payments for woodland carbon programs are classified has significant implications for woodland landowners, especially those who may not be operating as a formal business but are nevertheless participating in carbon markets.

In August 2023, the IRS released Private Letter Ruling (PLR) 202334007, which provided some helpful, albeit limited, guidance. In that case, a Real Estate Investment Trust (REIT) was receiving payments for underground carbon sequestration services, and the IRS ruled that these payments could be treated as rents from real property, qualifying income under Section 856 of the tax code. This is a very brief and naïve interpretation of a PLR, and one should seek qualified tax counsel to fully understand the implications of how this ruling may or may not relate to a given situation. While this PLR was a step toward guiding how carbon sequestration income should be characterized, it did not address open-air sequestration on forested land. The ruling focused exclusively on subsurface injection of carbon and surface use for exploration but did not extend to the open-air sequestration performed by trees through photosynthesis.

This omission leaves woodland owners and their advisors in a gray area. A key unanswered question is whether carbon sequestration income from standing timber might also be characterized as rental income, which is generally treated as ordinary income, not subject to self-employment tax. If the income were treated instead as compensation for services or business activity, it could be subject to both ordinary income tax and self-employment tax. On the other hand, if structured carefully, the transaction might be positioned to receive capital gain treatment, particularly if tied to the use or disposition of a capital asset. However, without direct IRS guidance, these possibilities remain speculative.

Much of the tax treatment will likely come down to the specific terms of the contract between the woodland owner and the carbon project developer. These contracts vary widely; some involve leasing land rights, others involve selling carbon credits tied to the sequestration capacity of a forest, and others might include performance-based payments or revenue-sharing models. Each variation may influence how the income is classified and reported.

Beyond income characterization, several other tax-related uncertainties remain unresolved from the perspective of the authors of this article:

Basis adjustments: It is unclear how, if at all, the basis of the timber or land might be affected by carbon sequestration payments. Could the basis be recovered, such as depletion in extractive industries (i.e., oil and gas)?

Wildfire or disaster payments: If a fire or disease damages the timber stand, how would any associated insurance proceeds or contract payouts be taxed?

Responsibility for forest management: Who bears the cost (and reaps the benefits of deductions) for maintaining the timber stand under the carbon contract? Could certain expenses be capitalized or deducted?

Duration and permanence obligations: Many carbon contracts require the landowner to defer timber harvest for decades. The long-term nature of these commitments could have implications for installment sale treatment, long-term capital gains, or even constructive receipt rules.

In summary, while carbon markets offer a promising financial opportunity for woodland owners, the federal tax landscape remains murky, especially when it comes to open-air sequestration from standing forests. Until the IRS or Congress provides more definitive guidance, landowners should proceed carefully and work closely with qualified tax advisors and legal counsel to evaluate contract structures, reporting strategies, and risk exposure. This is a relatively new frontier and will likely evolve alongside the carbon markets themselves.

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