Internal Revenue Bulletin: 1992-46
October 29, 1992

REVENUE PROCEDURE NO. 92-91 (Rev. Proc. 92-91)

Tax Guidance Under the Air Emission Allowance Program Under Title VI of the Clean Air Act Amendments of 1990.

Code Secs. 162, 167, 1012, 1031 and 1033

Air Emission Allowance Program: Penalties: Depreciation: Basis: Exchanges: Involuntary conversion.--The IRS has provided guidance on certain federal income tax consequences of the air emission allowance program established pursuant to Title IV of the Clean Air Act, with respect to utilities, non-utilities that elect to participate in the program, and other persons who acquire, hold, or transfer sulfur dioxide emission allowances.

SECTION 1. PURPOSE

This revenue procedure provides guidance in a question and answer format on certain federal income tax consequences of the air emission allowance program (the "program") established pursuant to Title IV of the Clean Air Act Amendments of 1990, Pub. L. No. 101-549, 104 Stat. 2584 (1990), 42 U.S.C. section 7651 et seq. (the "Act"), with respect to utilities, non-utilities that elect to participate in the program, and other persons that acquire, hold, or transfer sulfur dioxide emission allowances.

SECTION 2. BACKGROUND

The purpose of the Act is to reduce the impact of acid rain through a program of annual allocations of sulfur dioxide emission allowances ("allowances") to certain fossil-fuel-powered combustion devices ("units"), such as boilers, owned by electricity generating companies ("utilities"). The program will be administered by the Environmental Protection Agency (the "EPA") with enforcement beginning in 1995. The Act also provides that other facilities emitting sulfur dioxide ("non-utility facilities") may elect to participate in the program by "opting in" under section 410 of the Act, 42 U.S.C. section 7651i. Persons other than utilities or non-utility facilities may also acquire, hold, and transfer allowances pursuant to section 403(b) of the Act, 42 U.S.C. section 7651b(b).

As provided under the Act, the EPA allocates the allowances to certain units that were operational on November 15, 1990 (the date of the enactment of the Act), and to certain units that become operational after the enactment date but before January 1, 1996. The allocation is based, in part, on the 1985--1987 operating levels of each unit covered by the Act. In general, an allowance permits the unit to which it is allocated to emit without penalty one ton of sulfur dioxide. The EPA maintains an allowance account for each covered utility unit, for each non-utility facility that opts into the program, and for any other person that so requests. Only those allowances that are recorded by the EPA in a unit's allowance account as of the allowance transfer deadline for a given year may be applied against the unit's sulfur dioxide emissions during that year.
Except as otherwise provided by the Act, an allowance may be (1) applied against sulfur dioxide emissions occurring in the year to which it has been allocated by the EPA, (2) transferred, (3) sold or exchanged, or (4) held for and applied against sulfur dioxide emissions occurring in a future year. An allowance, however, may not be applied against sulfur dioxide emissions occurring in a year prior to the year to which it has been allocated by the EPA.

Under the Act, the owner or operator of the unit, through the unit's designated representative, must account to the EPA for the total tons of sulfur dioxide emitted by that unit during a calendar year. The designated representative has until the allowance transfer deadline, which occurs at the end of a specified period of time after the close of that calendar year (the "make-up" period), to acquire and record with the EPA allowances sufficient to equal the emissions during that calendar year.

The Act prohibits the operation of any unit in a manner which causes that unit to exceed its sulfur dioxide emission limitation. A unit's emission limitation equals the number of allowances in the unit's allowance account that may be applied against sulfur dioxide emissions of that unit during that calendar year. Each ton of sulfur dioxide emitted by the unit in excess of its emission limitation is a separate violation of the Act. Under section 411 of the Act, 42 U.S.C. section 7651j, the owner (or operator) must pay a $2000 penalty to the EPA for each excess ton emitted. In addition, pursuant to that section, the EPA will reduce a subsequent year's allocation of allowances for the unit by the number of allowances equal to the excess tons emitted. Moreover, emission of excess tons may subject the owner (or operator) of the unit to both civil and criminal penalties under the general enforcement provisions of the Clean Air Act. Section 416 of the Act, 42 U.S.C. section 7651o, directs the EPA to withhold from issuance a small percentage of allowances allocated under the Act to each unit for a particular year. The purposes of this withholding include ensuring that certain power producers (such as the independent power producers and certain utilities that were not operational before November 15, 1990) that are not allocated any specific allowances under the Act can obtain sufficient allowances to apply against their emissions, and stimulating the market for allowances. These withheld allowances will be deposited in two reserves, one for direct sales and one for auction sales. The proceeds from any sale (direct or auction) will be distributed on a pro-rata basis to the designated representative of the units from which the allowances were withheld. Unsold current-year allowances in the direct sale reserve will be transferred periodically to the auction reserve for sale at the next auction. Unsold allowances remaining in the auction reserve will be returned periodically on a pro-rata basis to the designated representative of units from which the allowances were withheld.

Rev. Rul. 92-16, 1992-12 I.R.B. 5, holds that the allocation of emission allowances by the EPA to a utility does not cause a utility to realize gross income under section 61 of the Internal Revenue Code. Accordingly, a utility's basis in those emission allowances under section 1012 is not measured by reference to the fair market value of the allowances.

To help the Service provide additional guidance on the federal income tax consequences of the emission allowance program, Announcement 92-50, 1992-13 I.R.B. 32, requested public comments on certain tax issues arising from that program that were identified for study. The comments submitted have been carefully considered and the following guidance is provided. Although questions 1-7 below are directed to utilities, the federal income tax consequences for non-utility facilities that opt into the program under section 410 of the Act are similar to those for utilities. Therefore, the answers to questions 1-7 generally apply to non-utilities as well as utilities.

SECTION 3. QUESTIONS AND ANSWERS

Q-1: How are the costs of acquiring or holding an emission allowance treated for federal income tax purposes?
A-1: The costs incurred to acquire or hold an emission allowance must be capitalized because the allowance has a useful life substantially beyond the taxable year to which it is allocated. These costs, including any amounts paid to acquire or hold an allowance (such as the purchase price and any properly allocable legal, accounting, and engineering fees), constitute the holder's tax basis in an emission allowance under section 1012 of the Code.

Q-2: Can emission allowances be depreciated under section 167 of the Code?
A-2: An emission allowance is not subject to depreciation under section 167 of the Code. Although an emission allowance confers on its holder the right to emit one ton of sulfur dioxide during a particular calendar year, the emission allowance does not expire in that year if it is not applied against sulfur dioxide emissions, but carries over, without limitation, to subsequent years. Thus, an emission allowance has no ascertainable useful life over which it could be depreciated. Further, it is not subject to gradual exhaustion, wear or tear, or obsolescence over some determinable life within the meaning of section 1.167(a)-1 of the Income Tax Regulations, and its useful life is not limited as required by section 1.167(a)-3. Therefore, a unit-of-production method of depreciation is not appropriate.
Q-3: How and when will a utility recover its basis in an emission allowance if that allowance is applied against sulfur dioxide emissions occurring in a particular year?
A-3: A utility will generally be permitted to recover its basis in an emission allowance that is applied against sulfur dioxide emissions occurring in a particular year by deducting the amount of its tax basis in that emission allowance in the year that the sulfur dioxide was emitted. Despite this general rule, however, capitalization will be required in certain instances. See, e.g., sections 263 and 263A of the Code which provide for the capitalization of otherwise deductible expenses in certain instances. If the utility acquires an emission allowance after the end of a calendar year during the "make-up" period provided by the EPA regulations and applies that allowance against the preceding year's emissions, the recovery of its basis in the emission allowance will be determined under the principles of section 461 of the Code.

Q-4: How and when will a utility recover its basis in an emission allowance if the utility sells or exchanges an emission allowance?
A-4: Generally, a utility will recover its basis under section 1001 of the Code on the sale or exchange of an emission allowance. Therefore, a utility will realize capital gain or loss on the sale or exchange of an emission allowance to the extent of the difference between the amount realized and the utility's adjusted basis in that allowance. If, however, the utility is holding an emission allowance primarily for sale to customers in the ordinary course of a trade or business of dealing in allowances, any gain or loss realized from the sale or exchange will be ordinary. The utility will recognize gain or loss in the year of the sale or exchange, unless a nonrecognition provision of the Code (such as section 1031) applies.

Q-5: Is an exchange of emission allowances an exchange of like-kind property that qualifies for nonrecognition treatment under section 1031 of the Code?
A-5: Emission allowances, regardless of the year to which the allowances are allocated by the EPA, will be treated as like-kind property for purposes of section 1031 of the Code. Therefore, an exchange of emission allowances that would otherwise result in a taxable event and the recognition of gain or loss under section 1001 is an exchange of like-kind property that qualifies for nonrecognition treatment under section 1031, provided that the requirements of that section are otherwise satisfied.

Q-6: Is the withholding and sale by the EPA of allowances allocated to the units under section 416 of the Act treated as an involuntary conversion of the withheld allowances for purposes of section 1033 of the Code?
A-6: The withholding and sale by the EPA of allowances allocated to the units under section 416 of the Act will be treated as an involuntary conversion of the withheld allowances for purposes of section 1033 of the Code. In addition, the purchase of other allowances for the purpose of replacing the withheld allowances will be treated as the purchase of property similar or related in service or use to the withheld allowances. Thus, the nonrecognition treatment of section 1033 may be elected with respect to these withheld allowances, provided that the requirements of that section are otherwise satisfied.

Q-7: Is the $2000 per ton "penalty" paid to the EPA under section 411 of the Act for emissions in excess of a unit's emission limitation deductible under section 162(a) of the Code?
A-7: The purpose of the $2000 per ton penalty imposed by section 411 of the Act is punitive as indicated by the legislative history accompanying the Act. See H.R. Rep. No. 490 (Part 2), 101st Cong., 2nd Sess. 5 (1990). Thus, this exaction is a penalty within the meaning of section 162(f) of the Code and section 1.162-21 of the regulations, and is not deductible under section 162(a). However, the reduction of future emission allowances under section 411 of the Act as a result of excess emissions is not a penalty within the meaning of section 162(f) and will not preclude any deduction of the basis of those allowances in the year of the reduction.

Q-8: What are the federal income tax consequences of participation in the emission allowance program by a person that is an investor or trader?
A-8: The federal income tax consequences for questions and answers 1, 2, 4, and 5 are the same as for a utility. Questions 3, 6, and 7 do not apply.

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective November 16, 1992.

DRAFTING INFORMATION

The principal author of this revenue procedure is Kathryn K. Nunzio of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mrs. Nunzio on (202) 622-4950 (not a toll-free call).
