

# **Legal Considerations for Carbon Contracts**

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# Legal Considerations for Carbon Contracts

## Carbon Markets

- The increased interest in greenhouse gases and carbon reduction efforts has led to an increased interest in carbon markets. A carbon market is any program involving the purchase and sale of “credits” or “offsets” that signify greenhouse gas sequestration or emission reduction.



# Who Are Some of the Players?

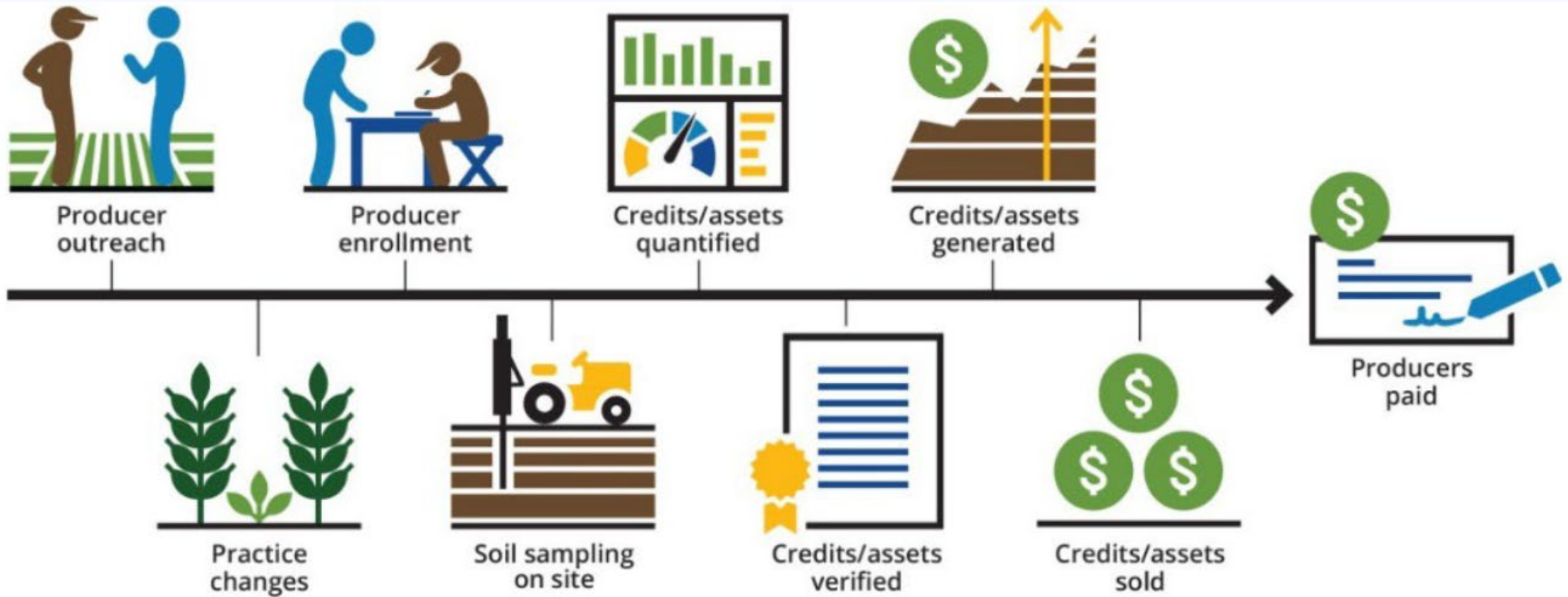
- Private Market Operators (Nori, Indigo, etc.)
- Corporate America (Bayer, Corteva, etc. )
- Environmental Partnerships (Ecosystem Services Market Consortium, etc.)
- Carbon Registries (Climate Action Reserve, etc.)
- Verifiers (SGS, etc.)
- Buyers



# What May Be Ahead?

- **Growing Climate Solutions Act** passed at the end of 2022.
  - Will create a USDA certification program for third-party verifiers and for providers of technical assistance to farmers and ranchers considering or implementing carbon offset protocols.
  - USDA will help connect landowners to private sector actors who can assist the landowners in implementing the protocols and monetizing the climate value of their sustainable practices.
- The Inflation Reduction Act of August 2022 calls for new “climate smart” farm programs under EQIP, CSP, etc.
- 2023 Farm Bill may present opportunities for funding climate smart practices

# Many Different Approaches



\*Ecosystem Services Market Consortium

## Generating Agricultural Carbon Offsets: An Example Process

A *project developer* (e.g., Corteva) incorporates one or more *protocols* (e.g., the Soil Enrichment Protocol) developed by a *carbon registry* (e.g., Climate Action Reserve) in designing a *carbon market program* (in this example, Corteva's Carbon Initiative) to generate carbon offsets. Protocols are specific to individual GHG mitigation practices (e.g., cover cropping, no-till farming), and they standardize the measuring, reporting, and verification (also referred to as MRV) requirements for generating carbon offsets. The project developer enrolls *participants* (e.g., farmers, ranchers), who implement the protocols. Protocols generally require that *third-party verifiers* (e.g., SGS) independently confirm that the requirements of the protocol were met, before offset credits are issued. The project developer may register the carbon offsets with a carbon registry, and may sell the carbon offsets to *purchasers* (e.g., private companies, individuals) on compliance or voluntary carbon markets.

Profits associated with each carbon offset may be reduced by: initial costs associated with enrolling in a carbon market program and implementing new practices; ongoing costs of measuring, reporting, and verifying carbon offset protocols; and transaction costs associated with and registering and selling carbon offsets.

For more information, see

Corteva, "Corteva's Carbon Initiative," <https://granular.ag/carbon>.

Climate Action Reserve, <https://www.climateactionreserve.org>; and Climate Action Reserve, "Soil Enrichment Protocol," <https://www.climateactionreserve.org/how/protocols/soil-enrichment>.

SGS, <https://www.sgs.com>. **Source:** "Agriculture and Forestry Offsets in Carbon Markets: Background and Selected Issues," CRS (November 21, 2021)



# General Considerations

- The soil carbon sequestration/emission reduction “market” is an uncertain, evolving space, particularly in the agriculture sector.
- New standards will likely emerge and additional opportunities will no doubt open up down the road.
- Consider potential missed opportunity costs for early adopters.



# Contractual Rights v. Property Rights

- These agreements are generally creating **contractual rights and** sometimes **a new personal property asset (Credit)**.
- They do not generally convey **real property rights**.



# Producers Must Understand the Program

- Signing an agreement with a private company is a promise to provide something of value to that company in exchange for something of value.
- Lots of models out there. They are not all the same.
- Producers should seek legal counsel before signing and make sure they know what they are selling/giving up.



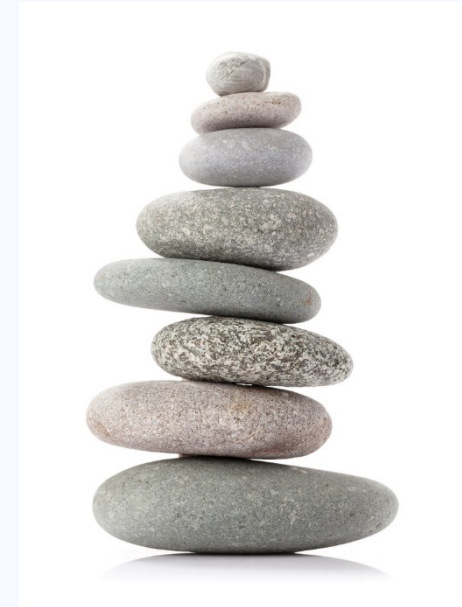
# Additionality

- Most programs only apply to **NEW** programs the producer implements (otherwise credit is not valid).
- Penalizes **early adopters** of conservation practices.
- Means that producers should **select carefully**.
  - Once they've enrolled in one program, they will likely be ineligible for another program, without a “portability” provision.



# Stacking

- Contracts generally **prohibit “stacking”** programs or receiving payments from other programs for the same practice or outcome.
- Some programs advertise, however, that implementing certain practices will result in **multiple benefits**: i.e. water quality and carbon sequestration.
- Some contracts provide additional compensation for “stacked” practices.



# Permanence and Leakage

- High quality carbon credits or offsets require assurance of **permanence** and limited **leakage**.
  - These components will be crucial to full participation within the agricultural sector.
  - Lack of these requirements impacts quality of credits or offsets, but requirements to maintain these standards may be intrusive and burdensome.
- **Permanence** – 100 years or more of storage is standard.
- **Leakage** – Oversight of entire operation may be required.

# Requirements and Restrictions

- Producers must understand the **specific practices** required throughout the duration of the contract.
- How will the contractual commitments impact agricultural production?
- The producer must consider whether they will be restricted from also enrolling land in government conservation programs (current and future) or from selling a conservation easement while the contract is in force.
  - What **future opportunities** might be foreclosed?
    - 2023 Farm Bill Programs?

# Length of the Contract

- Lengths of contracts vary: **1-, 5-, 10-, 15-year** provisions.
  - Some commitments **may run beyond the stated term** (to ensure permanence).
  - Short contracts may still foreclose future options because of **additionality** requirement.
  - Long contracts may cause producers to forfeit more lucrative options arising down the road because of **stacking** prohibition.





# Payments under the Contract

- Payment provisions vary significantly (stated \$ does not equal actual value).
- Producers must understand **what** they are being paid for and **when** the payment(s) will be made.
  - Paid for implementing a practice, sequestering carbon in soil, or for value of credit or offset?
- What **costs** must be incurred to receive payment (i.e. verifier or broker fee)?
- **How** is payment made? Tokens? Currency? Cryptocurrency?



# Verification

- Parties to a carbon contract must pay careful attention to the verification provisions. In particular, it is important to understand who is responsible to engage and pay the verifier and who that verifier must be.
- Of equal importance is understanding clearly what must be measured and verified:
  - Practice implemented
  - Amount of carbon sequestered
  - Overall carbon footprint of operation
  - How is measurement taken?



# Landlords and Tenants

- Brokers have been urging tenants to participate.
  - Generally require landlords to give permission and assign rights to register the project to the tenant.
- Tenants must ensure that their lease is of a sufficient term to cover the term of the agreement.
- Lease language should be adapted to accommodate any carbon agreement.
  - Landlords must review agreement with legal counsel to understand any obligations impacting the land.
  - Consider indemnification agreement from tenant.

# Data Ownership and Disclosure

- Data is the lifeblood of the carbon contract.
- Producers should review the contract provisions regarding **data creation, storage, and ownership** carefully to ensure that their interests (including **privacy**) are protected.
- How much effort must be devoted to data creation and submission?



# Contractual Remedies

- Careful attention should be paid to the remedy provisions of the contract, first the remedies provided to the contracting company if the terms of the contract are breached.
  - What are the penalties for failing to implement required practices (what about impossibility)? [liquidated damages, termination, repayment with interest?]
  - What are the penalties if carbon sequestration does not meet required standards? [again, consider maximums and factors beyond control]
  - What are penalties if it is determined that additionality requirement or stacking prohibitions are violated?

# Contractual Remedies

- Careful attention should also be paid to the remedies provided to the producer in the event of non-payment or other breach.
  - What is the producer's remedy if the payment is not made on time?
  - Does the producer have any right to **terminate** or **modify** the contract?
  - Does the contract require arbitration or mediation to settle disputes?
  - Are there choice of law / venue requirements built into the contract?
  - Are there attorney fee shifting provisions in the contract?

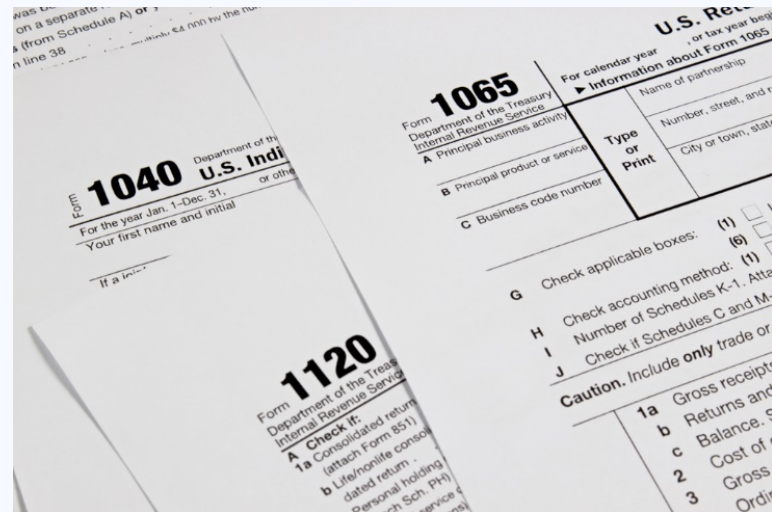
# Privacy and Land Access

- Producers should carefully consider whether the contract allows third-parties to access their land for measurement and verification and what notice must be provided for that access.
- Does the company have the right to make public or sell the data collected?



# What are the tax consequences?

- This will depend upon the interests and obligations that are created and sold.
- In most cases, payments under these agreement will be ordinary income, taxed in the year of receipt, subject to SE tax, as part of the farmer's trade or business.





# Final Thoughts

- Producers should seek trusted technical advisors and legal counsel before signing any carbon contract.
- Consider the risks and any lost opportunity costs.



# What Other Contracts are Farmers Considering?

- Carbon sequestration pipeline easement agreements
- Solar energy leases
- Wind energy agreements



# Carbon Pipeline Update

# Summit Carbon Solutions

- On **August 4, 2021**, Summit Carbon Solutions, LLC, initiated the legal process to build a proposed 710-mile **carbon sequestration pipeline** through 30 Iowa counties.
- **Filed its application for a hazardous liquid pipeline permit on January 28, 2022.**
- The proposed hazardous liquid pipeline would “capture carbon dioxide emissions from ethanol plants that otherwise would be emitted into the atmosphere and transport those emissions through a pipeline to North Dakota where they will be permanently and safely stored in deep underground geologic storage locations.”

# Summit Carbon Solutions

- Proposed **\$4.5 billion project** would have the capacity to capture and permanently store **12 million metric tons of carbon dioxide every year**.
- The proposed pipeline would also cross through four other states—North Dakota, Nebraska, Minnesota, and South Dakota—and would capture and transport the emissions from **more than 30 ethanol plants** for long-term underground sequestration.
- Summit Carbon projects starting construction in 2023, with a **2024 completion date**.

# Summit Carbon Solutions

## CAPTURE

CO<sub>2</sub> is captured before it is released into the atmosphere.



## TRANSPORT

CO<sub>2</sub> is channeled to the sequestration site via pipeline, the safest mode of transportation.



## STORE

CO<sub>2</sub> is safely and permanently stored underground in North Dakota.



# Carbon Sequestration Pipeline - Summit



# OUTREACH BY THE NUMBERS



## 1,750

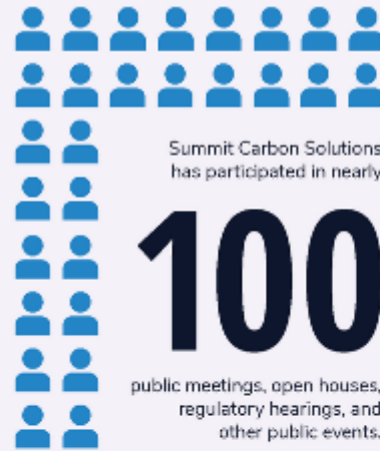
meetings with policymakers, economic development leaders, Native American Tribes, civic organizations, stakeholders and more, were completed by the company across the five-state project footprint.

## 3,000



### PERMITS AND APPROVALS

will be sought and secured by Summit Carbon Solutions for its carbon capture, transportation, and storage project. That is approximately one permit or approval for every 0.67 miles of the project.



Summit Carbon Solutions has participated in nearly

## 100

public meetings, open houses, regulatory hearings, and other public events.

Summit Carbon Solutions has held thousands of meetings with landowners across the Midwest.

As of January 1, 2023, the company has partnered with

## 2,350

LANDOWNERS

— TO SIGN —

## 3,800

EASEMENT AGREEMENTS

accounting for **56%** of the proposed route or **1,165** total miles.

## 2,800

### ROUTE ADJUSTMENTS

completed based on feedback from landowners, policymakers, and other stakeholders, or to avoid identified sensitive areas.



# Timeline for Pipeline Projects (Example – Iowa)

## ✓ Informational Meetings

### ✓ Surveying

- ✓ (Shall not be deemed a trespass and may be aided by injunction. Iowa Code §479B.15)

### ✓ Negotiating Easements

## ✓ File **application for hazardous liquid pipeline permit**

- ✓ 30 days to two years after last informational meeting

## ▪ IUB Hearing

- “public convenience and necessity”

## ▪ Eminent Domain Authority Granted

“shall be vested with the right of eminent domain, to the extent necessary and as prescribed and approved by the Board”

# Summit Carbon Solutions

- Hearing will be held at the Webster County Fairgrounds.
- If IUB grants the permit, **eminent domain rights are automatic.**
- Presently waiting to see **WHEN** the hearing will be scheduled.

# Navigator Heartland Greenway, LLC

- BlackRock and Valero venture: **Heartland Greenway Carbon Capture and Sequestration System**
- Seeking to build carbon sequestration pipeline through Iowa.
- 1,300-mile pipeline
  - Permanently sequestering the carbon in secure, underground sites being actively developed in south-central Illinois.
  - The Heartland Greenway would provide carbon sequestration for biofuel producers and other rural industrial processors.
  - **Last informational meetings have been held.**



# Wolf Carbon Solutions LLC (ADM)

- Chicago-based ADM, partnering with Denver-based Wolf Carbon, proposes capturing carbon from ADM plants in Cedar Rapids and Clinton and sequestering it in Illinois.



## Pipeline Easement Agreements

- Landowners will generally convey permanent and temporary easements to the company.
  - Temporary easements allow access for construction.
  - Permanent easements allow the pipeline to remain forever.
  - Additionally, landowners should be compensated for crop damages and ensured that tile and land will be restored.

## Pipeline Easement Agreements

- Although the terms of the agreements will vary, landowners signing a contract with one of these companies must understand the rights they are granting and the tax impact of the sale.
  - Tile and land restoration
  - Liability and indemnity
- *We advise landowners to seek legal counsel to review the terms of the agreement before signing.*

## Tax Treatment of Perpetual Easement

- Because an easement is a property right, it is an I.R.C. § 1221 capital asset or an I.R.C. § 1231 business asset.
- The granting of a perpetual easement is treated like the sale of land.
- Because the landowner is selling only part of the rights to the property, however, the general rule in Treas. Reg. § 1.61-6(a) requires a basis allocation.
- **Note:** Most pipeline or power line easements are permanent.



# Perpetual Easement

- Two basis allocations may be required when an easement is granted:
  - The basis in the entire property must be allocated between the portion of the property that is affected by the easement and the portion that is not affected by the easement.
  - The basis in the property that is affected by the easement must then be allocated between the rights that are sold (the easement) and the rights that are retained.
    - However, the IRS has taken a more liberal view for easements. If it is impossible to determine a separate basis for the interest that is sold (such as a development right), the entire basis of the affected property can be used to compute any gain [Rev. Rul. 77-414, 1977-2 C.B. 299].

## Example – First Basis Allocation

- A carbon company paid \$10,000 for an easement along the southern boundary of Samantha's farm for the construction and maintenance of a pipeline.
- The easement crossed about 20 acres of Samantha's 600-acre farm.
- Samantha's basis was \$300 per acre.
- Because the easement immediately affected only 20 acres, Samantha can use only \$6,000 (20 acres × \$300 per acre) as basis to compute her gain on the sale of the easement.

## Example - Reporting the Sale

- Samantha, from the must report a \$4,000 (\$10,000 sales price – \$6,000 basis) gain from her sale of the easement as I.R.C. § 1231 gain.
- The gain is reported on Form 4797, Sales of Business Property, Part I.

## Example – Basis Reduction from Sale of Easement

- Assume instead that the basis of Samantha's affected property was \$14,000, instead of \$6,000.
- In this case, because the \$10,000 payment is less than the \$14,000 basis, Samantha would have no reportable gain.
- She cannot report a loss, however, because she has not sold her entire interest in the property.
- She thus reduces her basis by the \$10,000 payment so that on a subsequent sale of part or all of the remaining interest in the affected land, her basis for gain or loss is \$4,000 ( $\$14,000 - \$10,000$ ).

## Term Easements

- As a general rule, regardless of how a payment is characterized, a payment for a temporary easement or a term easement of less than 30 years is treated as a rental payment for tax purposes.
- These typically annual payments are generally reported as **rental income, not subject to self-employment tax** [I.R.C. § 1402(a)], on Schedule E (Form 1040), Supplemental Income and Loss. Payments for temporary construction easements are reported the same way.
- Temporary construction easements are handled this way. Note also that most **solar payments** and **many wind energy payments** are lease payments or annual payments for a term easement.

## Crop Damage Payments

- A farmer who grants an easement or a lease may receive payments for crop damage during the construction or maintenance phase.
- If construction occurs when a crop is not already growing and it cannot be planted, the farmer may receive a payment for loss of income.
- In either case, the payment is reported **as income from a crop sale**. Farmers report this income on Schedule F (Form 1040), Profit or Loss from Farming (on line 8, rather than line 2). Non-materially participating crop share landlords would report this payment on Form 4835, Farm Rental Income and Expenses.

## Crop Damage Example

- Morris raises corn and soybeans on rented farmland. The carbon company paid Morris \$20,000 for the damage to his crop that occurred during installation of a pipeline on his acreage subject to the easement.
- Morris must include the \$20,000 in the amount he reports on line 8 of Schedule F (Form 1040). It will be subject to self-employment tax.

# Involuntary Conversions

- IRC §1033 (a): An involuntary conversion occurs when your property is **destroyed, stolen, condemned, or disposed of under the threat of condemnation** and you receive other property or money in payment, such as insurance or a condemnation award.
  - Rules are similar, but some important differences, as compared to an IRC § 1031 exchange.



# Involuntary Conversions - Condemnation

- To qualify for deferral, the taxpayer must purchase replacement property that is “**similar or related in service or use to the property destroyed**” or the taxpayer must purchase a controlling interest (at least 80%) in a corporation owning such property.
- The property must generally be replaced **within three years after the close of the first taxable year in which any part of the gain is realized**.
  - This three year period applies only to condemnations. General rule is two years.
  - this 3-year replacement period cannot be used if you replace the condemned property by acquiring control of a corporation owning property that is similar or related in service or use (2 year rule applies).

# Involuntary Conversions – Under Threat of Condemnation

**Threat of condemnation.** A threat of condemnation exists if a representative of a government body or a public official authorized to acquire property for public use informs you that the government body or official has decided to acquire your property. You must have reasonable grounds to believe that, if you do not sell voluntarily, your property will be condemned.

The sale of your property to someone other than the condemning authority will also qualify as an involuntary conversion, provided you have reasonable grounds to believe that your property will be condemned. If the buyer of this property knows at the time of purchase that it will be condemned and sells it to the condemning authority, this sale also qualifies as an involuntary conversion.

# Involuntary Conversions - Condemnation

- If companies receive state permission, sale of easement could be considered involuntary conversion and tax could be deferred.

# Discussion

