



## **TAX TREATY ISSUES RELATED TO THE TRADING OF EMISSIONS PERMITS**

### **DISCUSSION DRAFT**

**31 May 2011 to 30 October 2011**



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### *Public discussion draft*

The effort to limit emissions related to global warming has led to an increased use and interest in emissions trading programmes as a mechanism to achieve reductions in emissions of carbon dioxide and other greenhouse gases in an economically efficient manner. These emissions trading programmes present both domestic and international tax issues, including tax treaty issues.

The Committee on Fiscal Affairs, through its Working Party 1 on Tax Conventions and Related Questions, has examined the tax treaty issues related to the trading of emissions permits. This public discussion draft includes the preliminary conclusions reached by the Working Party on these issues.

The Committee intends to ask the Working Party to revisit these conclusions in light of the comments from all interested parties. It therefore invites comments on this discussion draft **before 30 October 2011**. These comments will be examined at the February 2012 meeting of the Working Party.

Comments on this discussion draft should be sent electronically (in Word format) to:

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Unless otherwise requested at the time of submission, comments submitted to the OECD in response to this invitation will be posted on the OECD website.

This document is a discussion draft released for the purpose of inviting comments from interested parties. It does not necessarily reflect the final views of the OECD and its member countries.

## TAX TREATY ISSUES RELATED TO THE TRADING OF EMISSIONS PERMITS

### Background to the trading of emissions permits

1. The effort to limit emissions related to global warming has led to an increased use and interest in emissions trading programmes<sup>1</sup> as a mechanism to achieve reductions in emissions of carbon dioxide and other greenhouse gases in an economically efficient manner. Through such programmes, a government authority or international body sets a cap or limit on the total amount of emissions of a specific pollutant. This total amount of emissions is then allocated among producers of the pollutant in the form of fungible permits,<sup>2</sup> each of which represents the “right” to emit a specific quantity of the pollutant.<sup>3</sup> These permits are transferrable (*i.e.* tradable), so producers who emit less of the pollutant than the amount allowed by the permits they hold may sell the “extra” permits to other producers or to intermediaries. Total emissions – and thus the total amount of permits – cannot exceed the cap, which is typically lowered over time to achieve a national or regional emissions reduction target. At the end of each compliance period, producers must surrender permits to cover their emissions during the period or face penalties.

2. Emissions trading programmes have now been adopted internationally as part of the global strategy for addressing greenhouse gas emissions. Under the *United Nations Framework Convention on Climate Change*,<sup>4</sup> which entered into force in 1994, governments agreed to launch national strategies addressing that problem. The Kyoto Protocol to that Convention,<sup>5</sup> which entered into force in 2005, set binding targets for a number of industrialized countries and the European community for reducing greenhouse gas emissions. The Kyoto Protocol also offers these countries additional means of meeting their targets through three market-based mechanisms. First, “emissions trading”, which is set out in Article 17 of the Protocol, allows countries that have excess emission units to sell excess units to countries that are over their targets (the trading of these units is known as the “carbon market” as carbon dioxide is the principal greenhouse gas). Second, the “Clean Development Mechanism” (CDM), defined in Article 12 of the Protocol, allows a country with an emission-reduction or emission-limitation commitment under the Protocol to implement an emission-reduction project in developing countries. Such projects can earn for the project developers saleable certified emission reduction (CER) credits which can be counted towards meeting the targets set under the Protocol. Third, the mechanism known as “Joint Implementation” (JI), defined in Article 6 of the Protocol, allows a country with an emission reduction or limitation commitment to earn emission reduction units (ERUs) from an emission-reduction or emission removal project in another country with such commitments, which can be counted towards meeting its Kyoto target.

3. Emissions trading programmes present both domestic and international tax issues. This note focuses exclusively on tax treaty issues that could potentially arise when emissions permits are bought and sold across borders; it does not address such issues that could arise from the trading of CER or ERU credits.

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1. Emissions trading programmes are often also referred to as “cap and trade” programmes.

2. Emissions permits may also be referred to as “allowances” or “credits”.

3. For example, in the European Union Emissions Trading System (EU ETS), each EU Allowance Unit represents one metric tonne of CO<sub>2</sub>.

4. Available at: [http://unfccc.int/essential\\_background/convention/background/items/2853.php](http://unfccc.int/essential_background/convention/background/items/2853.php).

5. Available at: <http://unfccc.int/resource/docs/convkp/kpeng.pdf>.

## The tax treaty issues

4. The typical tax treaty issue that would be associated with the trading of emissions permits is the treatment of the income from the alienation of such permits by a resident of a Contracting State. As explained below, any income or gain for the alienation of property, which would include emissions permits, is covered by either Article 7 (Business Profits), Article 8 (Shipping, Inland Waterways Transport and Air Transport) or Article 13 (Capital Gains) of the OECD Model Tax Convention. Whilst one could theoretically query whether income could be derived from leasing or licensing emissions permits,<sup>6</sup> which would raise issues under Articles 6 (Income from Immovable Property) and 12 (Royalties), emissions permits are designed as commodities to be consumed through their use as opposed to property or rights that could be leased or licensed.

### *Article 7 (Business Profits)*

5. Emissions permits are not expressly dealt with by the OECD Model. The treatment of the income derived from the alienation of these permits as either business profits or capital gains under the OECD Model will depend, to some extent, on how the emissions permits will be treated under a Contracting State's domestic tax law and, consequently, how income derived from their trading is characterised under that State's law.

6. In this regard, it should be emphasised that the domestic tax laws of most countries make no express provision with respect to emissions permits. As recognised in the Copenhagen Economics report, "The general and important point is that often no clear and explicit tax rules have been adopted while case law also remains limited within the EU." The Directive establishing the EU ETS<sup>7</sup> and the related Commission Regulation do not provide any guidance on the direct tax<sup>8</sup> treatment of emissions permits. However, certain countries (for example, New Zealand<sup>9</sup>) have provided specific guidance on the tax treatment of emissions permits.

7. Many countries would likely consider income derived from the alienation of emissions permits to be "business profits" in most circumstances. "Business profits" is a term which is not defined in the OECD Model but which is generally considered to include all types of income derived from the conduct of a business that are not specifically dealt with in other provisions of the Model (see paragraph 71 of the Commentary on Article 7).

8. Under Article 7 of the OECD Model, business profits of an enterprise of a Contracting State are taxable only in that State, unless such business profits are attributable to a permanent establishment of the enterprise in the other Contracting State. Accordingly, to the extent income from emissions permits is

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6. As noted above, no transactions or activities in which an emissions permit would be licensed, leased or give rise to income that would be characterised as Article 12 royalties have yet been identified.

7. Directive 2008/87/EC of the European Parliament and of the Council of 13 October 2003. The Directive and its amending documents are available on the website of the European Commission at: [http://ec.europa.eu/clima/documentation/ets/index\\_en.htm](http://ec.europa.eu/clima/documentation/ets/index_en.htm).

8. The European Commission has provided guidance on the application of VAT to emissions permits. See [http://ec.europa.eu/clima/policies/ets/docs/vat\\_guidelines.pdf](http://ec.europa.eu/clima/policies/ets/docs/vat_guidelines.pdf).

9. See, for example, the description of the Climate Change Response (Emissions Trading) Amendment Act 2008 on the New Zealand Inland Revenue website (available at: <http://www.ird.govt.nz/technical-tax/legislation/2008/2008-85/leg-2008-85-climate-change.html>). See also Public Ruling BR Pub 08/03 (available at: <http://www.ird.govt.nz/technical-tax/public-rulings/2008/public-ruling-2008-0803.html>).

considered to be business profits covered by Article 7, it would be taxable solely on a residence basis, unless such income was attributable to a permanent establishment in the other Contracting State.

### ***Article 13 (Capital Gains)***

9. Depending on the circumstances, the domestic tax law of a jurisdiction may consider the alienation of emissions permits to give rise to a capital gain, rather than business profits. This could be the case, for example, where a jurisdiction considers that the alienation did not occur in the course of carrying on a business or where the jurisdiction classifies emissions permits as capital assets, rather than as ordinary business assets. In these situations, the result would normally be identical to the one under Article 7:<sup>10</sup> the capital gain would be taxable on a residence basis, except to the extent that the emissions permit forms part of the business property of a permanent establishment that an enterprise of a Contracting State has in the other Contracting State. Under paragraph 2 of Article 13, gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State may be taxed in that other State.

10. As explained in paragraph 4 of the Commentary on Article 13, there is no need to determine whether the taxing rights, in such cases, arise from Article 7 or Article 13 as any difference of views on this issue will not have practical consequences.<sup>11</sup>

### ***Could certain emissions permits be considered “immovable property”?***

11. Under paragraph 1 of Article 13 “gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that State”. If certain emissions permits were to fall within the OECD Model’s definition of “immovable property”,<sup>12</sup> either on the basis of a State’s domestic law definition of immovable property or on the basis of the interpretation of the phrase “property accessory to immovable property”, the State in which these emissions permits would be situated would therefore be granted the right to tax gains derived by non-residents from the alienation of these permits even if these permits did not form part of the business

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10. Unless, as is discussed below, the emissions permits were characterised as “immovable property” or as “movable property pertaining to the operation of ships or aircraft or boats engaged in inland waterways transport”.

11. Paragraph 4 of the Commentary on Article 13 makes the following general remarks on the relationship between Article 7 and Article 13:

It is normal to give the right to tax capital gains on a property of a given kind to the State which under the Convention is entitled to tax both the property and the income derived therefrom. The right to tax a gain from the alienation of a business asset must be given to the same State without regard to the question whether such gain is a capital gain or a business profit. Accordingly, no distinction between capital gains and commercial profits is made nor is it necessary to have special provisions as to whether the Article on capital gains or Article 7 on the taxation of business profits should apply. It is however left to the domestic law of the taxing State to decide whether a tax on capital gains or on ordinary income must be levied. The Convention does not prejudge this question.

12. Paragraph 2 of Article 6 of the OECD Model provides:

The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

property of a permanent establishment situated in that State. This could arguably be the case, for example, if in a particular jurisdiction emissions permits were legally “bound” to a specific location, such as a factory or a mine or other natural resource deposit.

12. In such a case, the State of residence would, under Article 23 A or 23 B, be required to provide relief of double taxation with respect to such tax even though, under its own domestic law, the permit would not have constituted immovable property. A potential problem could arise, however, if the State of source took the position that the treaty definition of “immovable property” applied to emissions permits (and allowed it to tax) but the State of residence disagreed. For instance, two States might disagree on the interpretation of the phrase “property accessory to immovable property”. Such a dispute on the interpretation of paragraph 2 of Article 6 would result in one of the two States not taxing “in accordance with the provisions of the Convention”.<sup>13</sup> Such a dispute could be resolved under the mutual agreement procedure provided for in paragraph 1 of Article 25, using, if necessary, the arbitration provision of paragraph 5 of that Article.

13. It would appear, however, that a legal connection between a permit and a specific location would make it substantially more difficult to trade the permit. The application of such a domestic law rule in a multi-jurisdiction regime such as the EU ETS would require some form of tracing in order to source income from the sale of the permit and would introduce a distinction between permits “located” in the relevant jurisdiction and all other permits. As a result, permits would no longer be fungible. This would increase the cost of trading and likely negatively affect the efficiency and liquidity of the market. More fundamentally, the obstacles to trading that would be introduced by treating permits as immovable property rather than a fungible commodity-like instrument would be inconsistent with the economic theory underlying emissions trading, which states that where trade in an externality is possible and there are no transactions costs, bargaining will lead to an economically efficient outcome (in this case, achievement of emissions reductions at the least overall cost to society).

14. The examination of the tax treatment of emissions permits in various jurisdictions has not identified any jurisdictions which would consider an emissions permit “immovable property”. For that reason, this analysis of the treaty consequences of emissions permits falling within the treaty definition of “immovable property” might be more theoretical than practical but is included for the sake of completeness. This issue should continue to be monitored as domestic law continues to evolve, keeping in mind the lack of guidance with respect to the tax treatment of emissions permits in a large number of jurisdictions.

#### ***Application of Article 8 and of paragraph 3 of Article 13***

15. Paragraph 1 of Article 8 (Shipping, Inland Waterways Transport and Air Transport) provides that “profits from the operation of ships and aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated”. Paragraph 2 of the Article provides a similar rule applicable to profits from the operation of boats engaged in inland waterways transport.<sup>14</sup> Paragraph 3 of Article 13<sup>15</sup> extends that rule to gains derived from the alienation of these ships, aircraft and boats and “movable property pertaining to the[ir] operation”.

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13. Either the interpretation of the State of source would be right and the other State would have to provide relief from double taxation or that other State’s interpretation would be right and the State of source would not have the right to tax.

14. “Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.”

16. These rules constitute an exception to Article 7. A non-resident enterprise engaged in these transportation activities will therefore be taxable on such profits and gains only in the State of its place of effective management<sup>16</sup> regardless of whether or not such profits and gains might otherwise be attributable to a permanent establishment situated in another State.

17. It is certainly possible that enterprises engaged in these transportation activities will trade emissions permits required for the operation of their ships, aircraft or boats.<sup>17</sup> If it were determined that emissions permits required or related to such operation qualified as “movable property pertaining to the operation of ships, aircraft and boats” for the purposes of paragraph 3 of Article 13, then gains from the alienation of such permits would be taxable only in the Contracting State where the place of effective management of the enterprise is located. A similar result (*i.e.* taxation in the State where the place of effective management of the enterprise is located) would be obtained to the extent that the trading of emissions permits by an enterprise is directly connected or ancillary to its operation of ships or aircraft in international traffic or boats in inland waterways transport.<sup>18</sup>

18. A potential difficulty could arise, however, if one State considered that income or gains from trading emissions permits were covered by Article 8 or paragraph 3 of Article 13 whilst the other State considered that they constituted profits or gains attributable to a permanent establishment situated therein. Such rare cases could be resolved under the mutual agreement procedure, using arbitration if necessary.

#### **Article 12 (Royalties)**

19. Some treaties include a definition of royalties that cover “payments ... received ... for the use of, or the right to use ... industrial, commercial or scientific equipment”. It has apparently been argued that because the operation of certain industrial and commercial equipment could result in greenhouse gas emissions requiring a permit, the seller of such an emissions permit would receive a payment “for the right to use” the relevant industrial and commercial equipment and the payment might therefore be classified as royalties.

20. Such an interpretation of the phrase “payments ... received ... for the use of, or the right to use ... industrial, commercial or scientific equipment” seems highly inconsistent with any conventional interpretation of treaties that include the leasing of industrial, commercial or scientific equipment in the definition of royalties. The payment from a purchaser of an emissions permit to the seller is not a payment for the use of, or the right to use, any equipment. The property at issue in a sale of an emissions permit is the permit itself.

21. Paragraph 8.2 of the Commentary on Article 12 of the OECD Model makes clear that Article 12 does not cover transactions in which the full ownership of property is transferred:

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15. “Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.”

16. As mentioned in paragraph 2 of the Commentary on Article 8, some States prefer to refer to the State of residence of the enterprise.

17. The aviation sector will be covered by the EU ETS as of 2012. See MEMO/08/796 (available at: [http://ec.europa.eu/clima/documentation/ets/docs/memo08\\_796\\_revised.pdf](http://ec.europa.eu/clima/documentation/ets/docs/memo08_796_revised.pdf)).

18. See paragraphs 4 to 14 of the Commentary on Article 8.

Where a payment is in consideration for the transfer of the full ownership of an element of property referred to in the definition, the payment is not in consideration “for the use of, or the right to use” that property and cannot therefore represent a royalty.

22. As discussed above, no transactions or activities have been identified in which an emissions permit would give rise to income that would be characterised as Article 12 royalties. This issue should, of course, continue to be monitored in light of the lack of guidance with respect to the tax treatment of emissions permits in a large number of jurisdictions.

### ***Article 21 (Other Income)***

23. Income or gains derived from the trading (*i.e.* the alienation) of any property would be covered either by Articles 7, 8 or 13. In view of the residual character of paragraph 5 of Article 13, which covers “gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4”, Article 21 should never apply to profits from trading permits or from trading any property. Whilst Article 21 might potentially apply with respect to income (other than trading income) arising in connection with certain derivative transactions used, for example, to hedge risks associated with the obligation to surrender emissions permits at the end of a compliance period, such transactions are not restricted to emissions permits and do not strictly constitute the “trading” of these permits.

### ***Possible disagreements as to the proper treaty treatment***

24. As explained above, to the extent that the rules in Articles 7 and 13 produce identical results (exclusive taxation in the State of residence unless the emissions permit is effectively connected with a permanent establishment in the other State), no difficulties will arise if one of the Contracting States applies one of these Articles but the other State applies another one.

25. Potential difficulties could arise in rare cases, however, if one State considered that income or gains from trading emissions permits were covered by paragraph 1 of Article 13 (because the emissions permits constituted “immovable property”) and the other State disagreed, or if one State considered that such income or gains were covered by Article 8 or paragraph 3 of Article 13 whilst the other State considered that they constituted profits or gains attributable to a permanent establishment situated therein.

26. As already explained, States might have such disagreements because of differences of views as to the relevant facts or the interpretation of the relevant treaty provisions. Such rare cases would then need to be resolved under the mutual agreement procedure, using arbitration if necessary.

27. These disagreements, however, must be distinguished from what the Commentary on Articles 23 A and 23 B refers to as “conflicts of qualification”. Inconsistencies in the domestic law meaning of “immovable property” in two Contracting States could indeed lead to a conflict of qualification. Paragraphs 32.1 through 32.7 of the Commentary on Articles 23 A and 23 B contain guidance on how relief from double taxation is to be provided under the OECD Model in cases of conflicts of qualification. In synthesis, the analysis under these paragraphs starts with the character of an item of income under the domestic law of the source State. Where the OECD Model permits the source State to tax income so characterised (*i.e.* source State taxation is “in accordance with the provisions of this Convention”), the residence State is obliged under Article 23 to relieve any double taxation of such income even if the residence State characterises the income differently under its domestic law and would thus apply a different article of the Model to the income.

28. As already mentioned, however, it would seem highly unlikely that emissions permits would constitute immovable property for treaty purposes, which is the only potential conflict of qualification that has so far been suggested in relation to emissions permits.