Paris, 15 January 2013

Object: BIAC response to the OECD Model Tax Convention: Revised Discussion Draft on Tax Treaty Issues Related to Emissions Permits and Credits

Dear Pascal:

This letter is in response to the request by the OECD Committee on Fiscal Affairs for comments on its revised discussion draft, released on 19 October 2012, concerning tax treaty issues related to emissions permits and credits.

General Comments

BIAC appreciates the OECD's continued focus on tax treaty issues related to emissions trading systems and supports the OECD in its effort to promote a clear and coordinated interpretation of tradable emissions permits and credits. As member states are still developing domestic rules on the tax treatment of emissions permits and credits, guidance by the OECD at this time can promote consistent, sensible rules, both domestically and internationally. Such guidance may limit potential tax obstacles to emissions trading systems and should improve the effectiveness of carbon markets. Efficient carbon markets will maximize CO2 reductions while minimizing costs.

BIAC supports the OECD in its confirmation of the treatment of emissions permits and credits as fungible commodities to be consumed through their use and not property or rights that can be leased or licensed. Credits and permits are instruments created distinctly, separately and differently from the underlying property and should be taxed as such, as distinct and separate property. We believe that any gain on the sale of a permit is properly the subject of either Article 7 (Business Profits) or Article 13 (Capital Gains), and thus subject to tax in the state of residence unless attributable to permanent establishment in the other state. Although the Discussion Draft discusses the possible application of Article 6 (Immovable Property), Article 8 (Shipping, Inland Waterways Transport and Air Transport), and Article 12 (Royalties), taxation under any of these articles should be extremely limited if the emissions permits are properly characterized as commodities, as gain (or loss) on the sale of commodities is generally subject to tax under Article 7 or Article 13. BIAC supports the OECD in preferring to treat profits from the alienation of emission permits as either business profits or capital gains, which should allow for a wide application and support the widespread trading needed for an efficient emission trading system. BIAC appreciates that the OECD has proposed to expand its guidance to include emissions credits as well as permits in its interpretations.[1]

[1] See BIAC letter to the OECD, Comments on Discussion Draft – Tax Treaty Issues Related to the Trading of Emissions Permits , dated October 25, 2011.

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Specific Comments

Paragraph 17 of the Discussion Draft provides that "the treatment of CERs[2] and ERUs[3] issued with respect to CDM[4] and JI[5] projects could differ in the same way as the treatment of emissions permits issued free of charge. BIAC believes any gain should be taxed only once, preferably at the moment of transfer, to limit distortions in the market. That is, if the value of the CER or ERU is exceptionally taxed at issuance, subsequent taxation at certification or sale should take this first taxation into account.[6]

Paragraphs 34 through 43 of the Discussion Draft deal with the possible application of Article 6 to emissions permits and credits. BIAC believes that further clarification of the limited circumstances under which emission permits and credits can be taxable under Article 6 will avoid potential market inefficiencies and tax distortions. Again, BIAC believes that starting from the principle that emissions credits are commodities – in this case, created distinctly, separately and differently from the conservation rather than the use of land – may be helpful in guiding policy choices on the appropriate tax treatment of both (1) the income from the project that creates the tradable permit, and (2) the income from subsequent sales or derivative transactions with respect to that permit. This approach is likely to achieve the treatment the OECD appears to be seeking in the Discussion Draft whilst avoiding potential confusion about certain activities are "considered" to be treated as agriculture or forestry.

The OECD's reasoning in paragraph 42 of the Discussion Draft is helpful in this respect, requiring a link between the underlying activities that give rise to income from immovable property and the permits and credits before Article 6 may be applied. If that link exists, then gains from the disposition or surrender of permits and credits could be taxable under Article 6, and costs associated with acquiring the permits or credits should be deductible against taxable income. If, however, the permit or credit were sold, then the link would no longer exist, and income from subsequent sales or surrender of the permits and credits should be analysed under Articles 7 or 13.

Regarding credits, more clarity to the extent of the link would be helpful. If an enterprise is engaged in afforestation or reforestation projects that produce credits, then the credits are available for emissions **reductions**. Paragraph 43 of the Discussion Draft states (without explanation) that "participants in such projects could reasonably be considered to be engaged in forestry with the consequence that the income from their sale of the CERs … would be considered to fall within the scope of Article 6 (i.e., could be considered "income from agriculture or forestry")."

Generally, the application of Article 6 to agriculture and forestry provides for taxation when timber (or fruits and vegetables) have been harvested, and, without a special rule, would no longer be considered immovable property.[7] In the case of emissions credits for afforestation or reforestation, the timber may be planted and left standing. Paragraph 43 "considers" the participants in such projects to be engaged in agriculture or forestry and then "considers" the income from the CREs to be taxable in the country in which the project is located. It is important that the basis for allocating taxing rights is clear to avoid disagreements, BIAC would consider it helpful for the OECD to include such clarification in Paragraph 43.

2 Certified Emission Reduction credits.
3 Emission Reduction Units.
4 Clean Development Mechanism.
5 Joint Implementation.
6 The proper method for achieving this result may be to provide a basis step up in the CER or ERU.
7 Clearly, lumber sold in a hardware store is no longer immovable property.

Additional Suggested Language Changes

Paragraph 58 of the Discussion Draft contains the recommended additions to the Commentary. BIAC has the following suggestions concerning the proposed Draft Commentary. We propose the following edits in order to eliminate ambiguity and improvement the clarity of the Commentary with respect to the tax treatment of emissions permits and credits.

As to proposed paragraph 75.1 to the Commentary on Article 7, BIAC suggests that a footnote be added following "income derived from the issuance" to read as follows:

> *There is no indication that any of the States in which emissions permits are currently issued free or for less than fair market value has adopted such an approach. Further, recognizing income at the time of alienation seems the most practical option.*

A new sentence could be added at after the first sentence of paragraph 2.1 to read as follows:

> *This means, for example, that whilst harvested crops or harvested timber (as opposed to standing crops or timber) would not constitute immovable property under the domestic law of most (if not all) countries, income derived from their sale would be covered by Article 6 in the case of the enterprise engaged in agriculture or forestry that would have harvested them, even though it would not be possible to apply paragraph 1 of Article 13 to timber (or fruits or vegetables) sold by intermediaries.*

An additional sentence should also be added at the end of paragraph 2.1.:

> *The mere acquisition of permits or credits or the mere financing of activities that create credits regarding agricultural or forestry projects should, however, not be sufficient to be "considered a participant in [an agricultural or forestry] project". Therefore gains from such acquisitions or financing should not be taxable under Article 6.*

Thank you again for the opportunity to comment on this important project. We would welcome further consultation on the project, and would be pleased to receive any questions that you may have on our submission.

Sincerely,

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Chair, BIAC Tax Committee

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