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Via email: jeffrey.owens@oecd.org

Dear Mr Owens

Tax treaty issues related to the trading of emissions permits:
CIOT comments on the OECD discussion draft

The CIOT presents its comments on the discussion draft dealing with the trading of emissions permits.

Background

Our comments look at the draft from a mainly European perspective. The European Union (EU) established its emissions trading scheme in Directive 2003/87. We set out brief notes of its operation in the attached Appendix.

The key objective of the scheme is to drive down emissions by placing a cost on emissions that exceed a certain target and thereby meet the EU obligations under the Kyoto Protocol. We take the view that when considering the direct tax treatment of emissions trading, the most important issue is to ensure that tax does not distort the operation of the trading scheme and render it ineffective or not wholly effective. Although we have cited the EU emissions trading scheme, we note that the issue is the same for other countries that operate such schemes.

The discussion draft notes that the OECD model treaty does not contain specific provision dealing with the treatment of emissions trading and that accordingly, in principle, emissions could fall within articles 7 (business profits), 8 (transport), 12 (royalties), 13 (capital gains) or 21 (other income). In our view, it is important that a consistent approach be adopted to prevent possible distortion. We discuss these issues briefly below.

The direct tax treatment of emissions

Article 7 – business profits

It will be clear from the outline of the workings of emissions trading that it can be expected that two types of businesses are likely to be involved in emissions trading:

- Businesses that require allowances to cover the emissions that they make in the course of their business; and
- Businesses that acquire allowances in the expectation that they will later be able to sell them at a profit.

We agree with the comments in the discussion draft that most countries will treat any income from emissions trading as business profits. We also agree that this is the most appropriate treatment of them.

However, it is not only which article applies but how it applies that should be considered. Emissions allowances are in principle assets of a business until they are sold, expire or used to cover emissions of a business. That would suggest that the tax treatment of such allowances, including expenditure by businesses acquiring allowances to cover emissions, should follow the accounting treatment. We understand that the IASB currently has the accounting treatment under discussion.

We think it is important to spell out that expenditure on emissions allowances is a trading item. As a trading item, the costs would be deducted against profits (either on an accruals, or mark to market basis, depending on the accounting treatment). This would additionally make it clear that transfer pricing rules would apply to purchases and sales between related parties.

Possible taxation under other articles

Under EU law, the emissions trading scheme will be extended to air travel with effect from 2012. That means it is appropriate to consider whether or not article 8 (transport) should be applied to income and gains from emissions.

We agree that it is unlikely that any countries would regard emissions trading as falling within article 12 (royalties) although there may be some technical arguments in favour of this, since the allowances traded represent a right of use (to discharge carbon and other emissions into the air). Differences in practices in Contracting States can potentially lead to inconsistencies which can trigger withholding taxes.

We note that while EU emissions allowances are normally issued for a specific period, they can effectively be renewed by replacement with new allowances. Accordingly, they are capable of being held for periods longer than a year and therefore depending on how a country treats gains from long-term assets may potentially be subject to capital gains tax under their tax law and taxed as a capital gain (article 13). On balance, we suspect that incidences of allowances being accumulated will be rare because the nature of the scheme is such that in most cases there will always be a demand for unused allowances.

Voluntary emissions schemes code of taxation

The report issued by Copenhagen Economics, Tax Treatment of ETS Allowances (October 2010) gives its support to a voluntary code to adopt a set of best practice rules for taxation.

Whilst we would support any commentary that tax payers can be given to assist with their tax affairs, this should not be a substitute for legislation. Given the possible areas for tax planning identified in this response we would prefer to see this used as a complement to the OECD tax treaty model.

Conclusion

We conclude that if the OECD issues commentary on emissions trading it should recommend that they be taxed under article 7 and that the tax treatment of allowances should follow the accounting treatment. Commentary should also cover transfer pricing issues.

Yours sincerely

Mark Delaney
Chairman, Environmental Taxes Working Group

The Chartered Institute of Taxation

The Chartered Institute of Taxation (CIOT) is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

The CIOT's comments and recommendations on tax issues are made solely in order to achieve its primary purpose: it is politically neutral in its work. The CIOT will seek to draw on its members' experience in private practice, Government, commerce and industry and academia to argue and explain how public policy objectives (to the extent that these are clearly stated or can be discerned) can most effectively be achieved.

The CIOT's 15,600 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA'.

Appendix 1

Outline of emissions trading in the EU

1 EU Directive 2003/87 established the EU Emissions Trading Scheme (EUETS). The scheme covers a range of manufacturing industries, eg those dealing with the production of metals, chemicals and paper. The scheme was subsequently extended to include aviation emissions but it is important to note that there is current litigation that challenges the validity of the scheme insofar as the scheme applies to air travel. There are therefore uncertainties within the market.

2 We use the EU scheme as an example because it is the scheme most likely to be operated within the UK but our understanding is that other schemes work in the much the same way.

3 There may be circumstances where there are equivalent measures in place to reduce carbon emissions for small installations, in particular taxation, and suggest that consideration is given as to the tax treaty impact of this. We note that within the EUETS, paragraph 11 recommends that States should adopt a procedure enabling States to exclude small installations from the trading scheme.

4 In order to operate legally, affected businesses, established in countries that have signed up to the Kyoto Protocol, may have restrictions placed on the emissions that they are allowed to generate from processes undertaken in that country. If they exceed their allowance they can be subject to a penalty. However, instead of paying a penalty, the business can purchase further allowances either from an auction or from other businesses that have been able to conserve allowances, eg by installing more efficient processes.

5 It will follow that if the market value of allowances is less than the cost of a penalty it will be advantageous to a business that has exceeded its allowances to buy further allowances.

6 The stages in the emissions trading process can be identified as follows:

a The State allocates allowances to businesses. These are set at a level below the emissions generated in the previous year. There is currently no charge for the allocation of allowances but from 2012, the EU will start auctioning some allowances so eventually there will be a cost to acquiring allowances.

b Businesses can buy and sell allowances. Those allowances can be local (ie from the country in which the business is established) or foreign. It is not only businesses that acquire allowances to offset their own emissions that trade in emissions – brokers and speculators can also be involved, although clearly the starting point is allocation to persons who actually generate emissions.

c A business has choices, eg if it thought the price of allowances was likely to fall it could sell its allowances on allocation or thereafter and trust that it can repurchase sufficient allowances in time to surrender them at the appropriate time.

7 If certificates of allowances are not utilised they may expire. While the initial allocation may have been free, such expiry will effectively result in a cost to the business that bought them in the expectation of being able to sell them at a profit or use them in their business.

8 The length of time that a permit can be held may affect its tax treatment, so we note below some points relevant to the EU scheme which we have taken into consideration when reviewing the points made in the discussion paper.

9 Permits are usually initially created for fixed periods, but there is a mechanism under the EUETS for rolling over the allowances. This has the effect that they can theoretically continue indefinitely.

10 Under the EU scheme the permits are issued in phases. Those phases (Directive 2003/87/EC, article 11 as amended by Directive 2009/29) are as follows:

- Phase 1 - 2005 to 2007 inclusive (3 years);
- Phase 2 - 2008 to 2012 inclusive (5 years); and
- Phase 3 - 2013 onwards for 8 year periods.

11 The EU Directive has specific provision for the 'validity' of the permits (article 13). They are only valid for the period for which they are issued. Each calendar year in a phase is called a scheme year. A business emitting carbon and other covered emissions must surrender allowances by 1 April after the end of the scheme year. Allowances surrendered are cancelled (article 12). In order to prevent businesses from wrongly accumulating allowances, there are penalties if sufficient allowances are not surrendered.

12 At the end of each phase, a business may have accumulated unused permits. The EU regulations provide for their cancellation and replacement in the following phase. It is our understanding that unused permits at the end of a period can be 'banked' by effectively exchanging for replacement permits.

13 Within the EU regulations, there are provisions for the transfer of permits and there do not appear to be any express restrictions on their exploitation, eg by licensing them. There are restrictions on the ability of businesses to borrow allowances, for example to cover their emissions and avoid the penalties of having greater emissions than their allowances permit. This could create complications with the ability to exploit permits.