Tax Treaty Issues related to the Trading of Emissions Permits
Public discussion draft
Response by IFA Grupo Mexicano, A.C.

Attention: Mr. Jeffrey Owens

Dear Sir,

Below are the comments prepared by IFA Mexican branch (IFA Grupo Mexicano, A.C.) in connection with the abovementioned public discussion draft. For such purposes, we have divided this document into the following sections:

Background to the trading of emissions permits

Paragraph 3. The scope of the draft is limited to the trading of emissions permits, under the first mechanism established by Article 17 of the Kyoto Protocol, which is limited to developed countries as set forth in Annex I. The Clean Development Mechanism ("CDM") and the Joint Implementation ("JI") established in Articles 12 and 6, respectively, are excluded from the draft.

Developing countries participating in the CDM are excluded from the discussion. Some of the countries established in Annex II of the Kyoto Protocol, such as Mexico, are also members of the OECD. Furthermore, many developing countries which are not members of the OECD follow the OCDE Model Tax Convention on Income and on Capital ("MTCIC") for executing and interpreting their tax treaties. Therefore, including these mechanisms will also provide guidelines to such countries.

In addition, the CDM and JI mechanisms apply specifically in situations involving residents of more than one country, inasmuch as they are meant to apply in cases where a resident of one country participates with a resident of another country. This fact increases the scenarios whereby double taxation issues may arise.

Finally, the conclusions reached in the draft may also be applicable to the trading of certified emission reduction ("CER") and emission reduction units ("ERUs") under the CDM and JI; for this reason, extending the scope of the draft should not give rise to additional burdens.

Pursuant to the foregoing, we suggest expanding the scope of the draft to include the three mechanisms established by the Kyoto Protocol, as well as the tax treaty issues related with the trading of CER and ERUs.

Tax treaty issues

Paragraph 4. The draft focuses on the trading of emissions permits as the typical tax treaty issue. We agree with this comment, and also with excluding the leasing or licensing of emissions permits as an activity which may give rise to income from these goods. However, the issuance *per se* of emissions permits may give rise to tax treaty issues if the respective permit was granted by a different Contracting State. In

practice, this might not occur in the case of emissions permits, but may definitely arise in the case of CDM and JI mechanisms.
Therefore, it would be advisable to analyze other tax treaty issues related with emissions permits, CERs and ERUs.

Paragraph 5. According to the draft, the treatment of income derived from the sale of emissions permits would depend, to some extent, on how emissions permits will be treated under a Contracting State's domestic tax law and, consequently, how income derived from their trading is characterized under that State's law.

Resorting to the local laws of the Contracting States to determine the tax treatment applicable to emissions permits might result in a double taxation issue, in those cases where said States adopted different criteria relative to such permits.

If any double taxation problem should arise, the trading of emissions permits would be hindered, which would clearly be contrary to the intention of the Kyoto Protocol, which is to seek to establish efficient mechanisms, from the economic standpoint, that help reduce emissions of greenhouse gases.

To unify and standardize the criteria regarding the tax treatment applicable to the international trading of emissions permits, we believe it is essential to establish a general definition of such concept.

In our opinion, the most efficient way to incorporate such definition would be through the Comments to the MTCIC, which have been adopted by several States as guidance for the interpretation and application of the provisions contained in bilateral tax treaties.

Paragraph 7. We believe that the treatment applicable to the profits obtained by a trader of emissions permits could be that established in article 7 of the MTCIC, whereas the profits obtained by a resident of a Contracting State that obtained revenues from the incidental sale of emissions permits should be included within the scope of article 13 of the MTCIC.

However, we agree that this discussion is irrelevant, because any difference of opinion on this issue will not have any practical consequences.

Paragraphs 9 and 11. In terms of paragraph 24 of the Comments to article 13 of the MTCIC, the term "movable property" means all property other than immovable property, which is dealt with in paragraph 1 of such article (including incorporeal property).

Applying the above to this specific case, we believe that the emissions permits should be considered as movable property for the following reasons: i) they are fungible goods; ii) they are not attached to the ground, but can be transferred from one place to another; iii) they are not property accessory to immovable property; iv) they do not confer rights over real property; and v) they do not fulfill any of the other assumptions referred to in article 6 of the MTCIC.

In our view, the revenues derived from the trading of emissions permits should be treated in accordance with article 13, paragraph 5 of the MTCIC and should therefore, only be taxed in the State in which the vendor resides, except in those cases where such revenues can be attributable to a permanent establishment in the other Contracting State.

In order to avoid the adoption of different criteria in this regard by the Contracting States, we believe it would be advisable to establish that the emissions permits are movable property, within the general definition proposed above.

This would establish a general rule to help standardize the treatments adopted by the Contracting States, thus avoiding any discussion about whether the revenues obtained from the sale of emissions permits should be treated in accordance with other articles of the MTCIC.

Paragraph 19. We believe that the payment received by the vendor of emissions permits should not be treated as a royalty under any circumstances.

This is because, as discussed in the draft, the aforementioned payment derives from a transfer of title, not from granting the temporary use or enjoyment of industrial, commercial or scientific equipment, and does not involve the transfer of know-how.

Position relative to the treatment of the trading of emissions permits

The draft analyzes how income from the trading of emissions permits may fall within the scope of Article 7 (Business Profits), Article 13 (Capital Gains), Article 8 (Shipping, Inland Waterways Transport and Air Transport) in connection with paragraphs 1 and 3 of Article 13, Article 12 (Royalties), and Article 21 (Other Income).

Even though the draft concludes that income from trading activities should only be taxed in the State in which the vendor resides (either based on Article 7 or Article 13, paragraph 5), it does not commit to a final position in this regard. In this sense, the draft allows contracting States to determine how income from these activities should be taxed. Moreover, the draft in paragraphs 12, 18 and 26 recognizes situations in which a potential double taxation should be addressed under a mutual agreement procedure.

Based on the foregoing, we suggest that a position must be defined, to be included in the Comments on the Articles of the MTCIC, for purposes of standardizing the tax treatment of income from the trading of emissions permits.

Conclusions

In our opinion, the draft should attempt to define a general position regarding the tax treatment applicable to the trading of emissions permits, because allowing each individual State to adopt their own specific treatment increases the likelihood of generating a double taxation issue.

To achieve this, we believe it would be useful to establish a general definition of what should be understood as "emissions permits", to the effect that they are movable property, and subsequently include such definition in the Comments on the Articles of the MTCIC.

In our view, the revenues obtained from the sale of emissions permits should be treated in accordance with that set forth in articles 7 or 13 of the MTCIC, and should therefore be taxed only in the country of residence of the vendor, except in those cases where there is a permanent establishment in the country in which the source of the revenue is located.

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Should you have any question or comment in connection with the foregoing, please do not hesitate to contact us.

Sincerely,

IFA Grupo Mexicano