TAX TREATY ISSUES RELATED TO EMISSIONS PERMITS/CREDITS

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BETTER POLICIES FOR BETTER LIVES

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Glossary of some technical terms used in this report	
Annex I countries:	Industrialised countries identified in Annex I to the UNFCCC that have ratified the Kyoto Protocol to that Convention *[see paragraph 2 and footnote 5]*
Non-Annex I countries:	*[see paragraph 6 and footnote 6]*
AAU:	Assigned Amount Units *[see paragraph 4]*
EU AUs:	European Union Allowance Units *[see paragraph 11]*
CDM:	Clean Development Mechanism *[see paragraph 6]*
CERs:	Certified Emission Reduction credits *[see paragraph 6]*
JI:	Joint Implementation *[see paragraph 7]*
ERUs:	Emission Reduction Units *[see paragraph 7]*
UNFCCC:	*United Nations Framework Convention on Climate Change*, which entered into force in 1994 *[see paragraph 2]*

1. Background to emissions permits, CERs and ERUs

1. 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. 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, each of which represents the "right" to emit a specific quantity of the pollutant.[1] Emissions 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 by various countries as part of the global strategy for addressing greenhouse gas emissions. Under the United Nations Framework Convention on

1. For example, in the European Union Emissions Trading System (EU ETS), each EU Allowance Unit represents one metric tonne of CO_2.

Climate Change[2] (UNFCCC), which entered into force in 1994, a number of governments agreed to formulate and implement national (and, where appropriate, regional) programmes containing measures to mitigate climate change which is attributable to these emissions. The UNFCCC did not, however, set mandatory limits on emissions (or provide for enforcement mechanisms). The Kyoto Protocol[3] to that Convention, which entered into force in 2005, set binding targets for 37 industrialized countries and the European Union for the limitation or reduction of greenhouse gas emissions (referred to hereinafter as "Kyoto targets").[4] These countries are often referred to as "Annex I countries".[5]

3. Under the UNFCCC, countries are expected to meet their emissions reductions targets primarily through domestic means. The Kyoto Protocol offers Annex I countries three additional flexible market-based mechanisms to meet their emissions targets.

4. The first of these market-based mechanisms is international emissions trading, which is provided for in Article 17 of the Kyoto Protocol. The agreed emissions targets of Annex I countries are expressed as "assigned amounts", which are in turn divided into "assigned amount units" (AAUs), with each AAU representing an allowance to emit one metric tonne of CO_2. International emissions trading permits a country that has reduced its emissions to a level below its Kyoto target to sell its "excess" AAUs to other countries with emissions that exceed their Kyoto targets.

5. Emissions trading programmes such as the European Union Emissions Trading System (EU ETS) complement the country-to-country trading provided for in the Kyoto Protocol by permitting private party trading of emissions permits. Under such programmes – which are generally co-ordinated with the national emissions targets provided within the framework of the Kyoto Protocol – a national or international authority allocates emissions permits to individual companies based on established criteria, with a view to meeting national and/or regional Kyoto targets at the lowest overall economic cost.

6. The second market-based mechanism provided in the Kyoto Protocol is the Clean Development Mechanism (CDM) defined in Article 12 of the Protocol. The CDM is a project-based mechanism under which authorised emission-reduction or emissions removal projects in non-Annex I countries[6] generate certified emission reduction credits (CERs). CERs may be traded and used by Annex I countries to meet a part of their Kyoto targets. Potential CDM projects are subject to a detailed validation and registration procedure. CERs are issued to project participants by the CDM Executive Board once a "designated

2. Available at: http://unfccc.int/essential_background/convention/background/items/2853.php.

3. Available at: http://unfccc.int/resource/docs/convkp/kpeng.pdf.

4. See http://unfccc.int/essential_background/kyoto_protocol/items/6034.php. For the status of ratification of the Kyoto Protocol, see http://unfccc.int/kyoto_protocol/status_of_ratification/items/2613.php.

5. "Annex I countries" are countries identified in Annex I to the UNFCCC which have ratified the Kyoto Protocol. These countries are: Australia, Austria, Belarus, Belgium, Bulgaria, Canada, Croatia, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Monaco, the Netherlands, New Zealand, Norway, Poland, Portugal, Romania, the Russian Federation, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, Ukraine and the United Kingdom. Belarus, Malta and Turkey are Annex I countries but do not have emissions targets under the Kyoto Protocol. See http://unfccc.int/kyoto_protocol/items/3145.php.

   The 23 developed countries included in Annex II to the UNFCCC are countries which have undertaken to provide financial resources to developing countries to support action on climate change and to meet the costs of the adaptation to its adverse effects. The Annex II countries are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States. The European Union is also included in Annex II.

6. The non-Annex I country must have ratified the Kyoto Protocol and have established a "designated national authority" (DNA), a body responsible for the authorisation and approval of CDM projects.

operational entity" has verified and certified that the CDM project has resulted in real, additional, measurable and verifiable reductions in greenhouse gas emissions.

7. The third of the market-based mechanisms provided in the Kyoto Protocol is Joint Implementation (JI), which is defined in Article 6 of the Protocol. Like the CDM, JI is a project-based mechanism, under which emission reduction units (ERUs) may be generated by "eligible parties" from approved emission-reduction or emissions removal projects in another country. Unlike the CDM, however, both countries involved have emission-reduction or limitation commitments under the Kyoto Protocol (i.e. both countries involved are Annex I countries). A JI project must lead to real, measurable and verifiable emissions reductions in addition to those that would have occurred in the host country without the project. Where such emissions reductions occur, and following verification by an Article 6 "accredited independent entity", the host country issues ERUs to the JI project participants by "converting"[7] AAUs. Like CERs, ERUs may be traded and used by Annex I countries to meet their Kyoto targets.

8. The international framework set up by the Kyoto Protocol provides only basic requirements for CDM and JI projects. As a result, these projects may be structured in many different ways, with a corresponding diversity in the project participants and the functions performed, risks assumed and other contributions made by these participants. Issues such as the structure of a CDM or JI project and the entitlement to and legal ownership of CERs and ERUs generated by these projects will therefore be determined on the basis of the host country's domestic legal framework for CDM and JI projects and the terms of the contractual arrangements between the project participants.[8]

9. National and regional emissions trading programmes are typically designed to take into account the CDM and JI. For example, companies may generally use CERs generated by CDM projects and ERUs generated by JI projects to satisfy their obligations under the EU ETS, subject to certain limitations. The New Zealand Emissions Trading Scheme (NZ ETS) also permits the use of CERs and ERUs.

10. Emissions trading programmes present a number of domestic and international tax issues. This report focuses on the potential tax treaty issues that could arise in connection with a national or regional authority's issuance of emissions permits, the purchase or sale of such permits across borders, and the issuance and trading of CERs and ERUs. In the following paragraphs, emissions permits, CERs and ERUs are sometimes dealt with separately; in other cases, they are referred to collectively as "emissions permits/credits"; also, the "issuance" of emissions permits/credits refers to the issuance of these permits/credits to the person or persons who are first legally entitled to obtain them from the issuing authority.

2. Tax treaty issues related to emissions permits/credits

A. The issuance of emissions permits

11. Under a national or international emissions trading programme, emissions permits are generally issued for free or sold at auction. For example, under the EU ETS, most EU Allowance Units (EU AUs)

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7. "Converting" AAUs means that the host country that issues ERUs must reduce its own AAUs by a corresponding amount. For example, assume that Country A (a JI project host country) has been assigned 100 AAUs. If Country A issues 10 ERUs to JI project participants, it must then reduce its number of AAUs to 90. Conversion ensures that the JI mechanism does not increase the overall amount of credits in the system.

8 . See, for example, Paul Curnow and Glenn Hodes (editors), *Implementing CDM Projects: Guidebook to Host Country Legal Issues* (August 2009) (available at: http://www.bakermckenzie.com/files/Uploads/Documents/Supporting%20Your%20Business/Featured%20Services/bk_implementingcdmprojects_sep09.pdf).

were allocated for free in the first (2005 to 2007) and second (2008 to 2012) compliance periods; only very limited quantities of EU AUs were auctioned. From the start of the third compliance period in 2013, however, about half of EU AUs are expected to be auctioned.

12. If a permit is issued for consideration equal to its fair market value – as would typically be the case when a permit is sold at auction – no income would arise at the time of the acquisition of the permit. The treaty issues related to any profit (or loss) that would subsequently accrue with respect to the permit are discussed below under the section on "The trading of emissions permits/credits".

13. The treaty issues would be similar in the case of a permit issued free of charge or for less than fair market value as long as States would only recognise income at the time of the alienation of that permit, which seems to be the most practical option.

14. A State, however, could conceivably seek to recognise income related to such a permit at the time the permit is issued for free or for less than fair market value. It appears, however, that in those States in which emissions permits are currently issued for free or for less than fair market value, such an approach has not been adopted or would only be applied in limited circumstances. Also, since the vast majority of emissions permits are issued to resident enterprises with respect to their local activities, tax treaty issues that would arise in the case of a State that would apply that approach to the issuance of emissions permits should be rather exceptional.

15. These tax treaty issues would be similar to those that would arise if a State would seek to recognise income at the time of the issuance of CERs and ERUs. These issues would relate to the possible application of Articles 6, 7, 8 and 21 to income recognised at that time. Since the issuance of CERs and ERUs is more likely to trigger cross-border issues, these tax treaty issues are examined in the following section.

B. The issuance of CERs and ERUs

16. National and international emissions trading programmes typically issue emissions permits based on the historic emissions of a company, site or installation during a specific reference period. In contrast, CERs and ERUs are issued with reference to the verified reductions in greenhouse gas emissions that result from projects initiated specifically to achieve such reductions.

17. Under domestic tax law, the treatment of CERs and ERUs issued with respect to CDM and JI projects could differ in the same way as the treatment of emissions permits issued free of charge. A State could conceivably seek to recognise income at the time the CERs or ERUs are issued to project participants in CDM or JI projects (in doing so, however, it would probably take account of the costs, which may be significant, incurred in the application and certification process). That State could alternatively consider that the value of the CERs and ERUs should be applied in reduction of the deductible or depreciable costs of the project that generated them, or it could simply decide that any profit or gain should only be recognised at the time of the transfer or alienation of the CERs or ERUs (which would seem the most practical option).

18. Where the CERs or ERUs related to a CDM or JI project carried on in a given State are issued to a resident of that State, differences in how the issuance of CERs and ERUs is treated under domestic law would not appear to create treaty difficulties. Where, however, the CERs or ERUs are issued to a non-resident project participant, treaty issues could arise.

19. Whether the project participants to whom CERs and ERUs are issued with respect to a CDM or JI project carried on in a given State have a permanent establishment to which these CERS or ERUs are attributable is a matter that does not relate specifically to the treatment of CERs or ERUs and is therefore

not addressed in this report. It should be noted, however, that many countries in which CDM and JI projects may be carried out are not OECD member countries[9] and tax treaties concluded by these countries may include a permanent establishment definition that differs from Article 5 of the OECD Model. Common variations based on the provisions of the UN Model include:

- a lower time threshold for construction sites (see subparagraph 3(a) of Article 5 of the UN Model);
- provisions deeming a permanent establishment to exist when services are provided for the same or connected projects during a certain period (see subparagraph 3(b) of Article 5 of the UN Model);
- the delivery of goods or merchandise belonging to the enterprise is not included in the preparatory and auxiliary exceptions of paragraph 4 of Article 5 (see subparagraphs 4(a) and (b) of Article 5 of the UN Model);
- a permanent establishment is deemed to exist where a dependent agent habitually maintains a stock of goods or merchandise from which it regularly delivers goods and merchandise on behalf of an enterprise of the other Contracting State (see subparagraph 5(b) of Article 5 of the UN Model); and
- an insurance enterprise of a Contracting State is deemed to have a permanent establishment in the other Contracting State where it collects premiums in that other State or insures risks situated therein through a dependent agent (see paragraph 6 of Article 5 of the UN Model).

20. These differences would appear to have limited practical significance in the context of the CDM or JI mechanisms. Whilst CDM or JI projects will often involve construction or installation activities (e.g. the construction of wind turbines and other installations used to exploit sources of renewable energy), CERs and ERUs are not issued in respect of the construction or installation activities themselves (i.e. to the persons who carry out the construction or installation activities) but, rather, in respect of the measured and verified emissions reductions that are achieved once a completed installation or facility is operational (e.g. to participants in the project for the carrying on of activities that directly result in the reduction or removal of CO_2 emissions). In theory, CERs or ERUs might be issued in respect of the mere performance of services performed in the host State;[10] it is not clear, however, when, if ever, CERs or ERUs could be issued in respect of the delivery of goods or merchandise, the collection of insurance premiums or the insurance of risks.

21. Where a foreign enterprise is legally entitled to the issuance of CERs or ERUs with respect to activities carried on by that enterprise through a permanent establishment (as defined in the relevant treaty) in the State where the CDM or JI project takes place, it will be necessary to determine to which part of the enterprise the CERs and ERUs will be considered to have been issued. Whilst this will require an analysis of all relevant facts, it would seem that in most cases the CERs and ERUs will be attributed to that permanent establishment because the CERs and ERUs will be directly related to the emission reductions in the host State resulting from the activities carried out through the permanent establishment (any differences of views as to which part of the enterprise should be considered to have been issued the CERs and ERUs will be addressed under the rules of the applicable treaty). The treatment of CERs and ERUs issued to the permanent establishment will be governed by the domestic law of the host State.

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9. Although non-Annex I countries (*i.e.* countries in which CDM projects may be carried out) include four OECD member countries (Chile, Israel, Korea and Mexico), they are for the most part non-OECD economies (NOEs). Annex I countries (*i.e.* countries in which JI projects may be carried out) also include a number of NOEs: Belarus, Bulgaria, Croatia, Latvia, Liechtenstein, Lithuania, Monaco, Romania, the Russian Federation and Ukraine.

10. A project participant's contribution to a CDM or JI project could constitute the mere provision of services (*e.g.* architectural, engineering or design services related to a project, facility or installation). In that case, the Article 5 analysis as applied with respect to that project participant would consider solely the activities in the host State.

22. In such a situation, there could be a timing mismatch in the recognition of income with respect to CERs and ERUS issued to the permanent establishment of a foreign enterprise. Consider, for example, a case in which the permanent establishment State would recognise income at the time of issuance whilst the home office State (i.e. the State of residence of the foreign enterprise) would recognise income upon the alienation (or vice versa). Timing mismatches, however, are fairly common in the case of the taxation of permanent establishments and should not result in double taxation as long as the relevant treaty does not limit the obligation of the home office State to relieve double taxation. Also, for practical reasons, it seems likely that most States will decide not to recognise income at the time of the issuance but will prefer to wait until alienation.

23. An additional question may arise with respect to CERs and ERUs issued to the permanent establishment of a foreign enterprise where the permanent establishment State and the home office State characterise differently the income realised upon issuance or, in the case of a timing mismatch, where the character of the income realised upon issuance (in one of the two States) is different from the character of the gain realised upon alienation (in the other State). Differences in the characterisation of income are discussed below (see below the section on "Possible disagreements as to the proper treaty treatment").

24. As noted above, current international rules provide only basic requirements for CDM and JI projects. In particular, these rules do not require that particular legal structures be used to carry out CDM and JI projects. CERs and ERUs are issued to "project participants", legal entities[11] which have been properly authorised by their State of residence (which must be a party to the Kyoto Protocol), with respect to the verified emissions reductions from CDM and JI projects which have been properly authorised by the project host State. How CERs or ERUs generated by a particular project are assigned to the different project participants is determined by the domestic law of the host State and the contractual arrangements between the project participants. For example, depending on the facts and circumstances and host State domestic law, these contractual arrangements could give rise to a distinct enterprise in the form of a partnership carried on by the project participants.[12] In this scenario, if the partnership were treated as a fiscally transparent entity under the host State's tax law and the CERs or ERUs generated by the project were attributed to a permanent establishment of that partnership, each project participant that is a partner of that partnership would be considered to have a permanent establishment for purposes of the taxation of its share of the business profits derived by the partnership.

25. In contrast, where the contractual arrangements between the project participants do not give rise to a distinct enterprise – for example, where each project participant carries on separate activities in relation to the project without any joint business activities or sharing of profits – one would need to examine the situation of each project participant in order to determine whether it derives business profits from the project and, if that is the case, whether it has a permanent establishment in the host State to which CERs or ERUs generated by the project should be attributed. For certain project participants, the income that a State may consider to arise when CERs or ERUs are issued may not constitute business profits for purposes of Article 7. This could be the case, for example, of a project participant such as a non-profit organisation or an entity that is not considered to be "carrying on business" for purposes of Article 7. In such cases, Article 21 would apply to any income that a State could consider to arise in the hands of that project participant upon the issuance of CERs or ERUs, subject to the possible application of Article 6

11. The definitions provided in relevant guidance suggest that a "project participant" must be a legal entity. See, for example, the "Glossary of CDM Terms" (available at http://cdm.unfccc.int/Reference/Guidclarif/glos_CDM.pdf) and the "Glossary of Joint Implementation Terms" (available at http://ji.unfccc.int/Ref/Documents/Glossary_JI_terms.pdf).

12. Where a CDM or JI project constitutes a distinct enterprise, the CERs or ERUs generated by the project represent business profits of that enterprise.

(Income from Immovable Property) or Article 8 (Shipping, Inland Waterways Transport and Air Transport), which is discussed below.

26. Since the provisions of Articles 6 and 8 have priority over those of Articles 7 and 21,[13] these provisions would apply to any income recognised in the hands of a non-resident project participant at the time of the issuance of CERS and ERUs to the extent that such income could be considered to be "income from immovable property (including income from agriculture or forestry)" (Article 6) or "profits from the operation of ships or aircraft in international traffic" or "profits from the operation of boats engaged in inland waterways transport" (Article 8). The possible application of these two Articles is further discussed in the next section dealing with the more likely scenario of income that is recognised at the time of the alienation of emissions permits/credits.

27. As noted above, the assignment of the CERs and ERUs generated by CDM and JI projects will be determined by the contractual arrangements between the project participants (subject to the constraints, if any, imposed by the domestic law of the host State). As a consequence, Article 9 (Associated Enterprises) may apply with respect to any profits which accrue from the assignment of CERs and ERUs pursuant to such arrangements where project participants are "associated enterprises" within the meaning of Article 9 and these contractual arrangements differ from those which would be made between independent enterprises. Such transfer pricing issues are not unique to CDM and JI projects – they would arise in the context of any contractual arrangement pursuant to which associated enterprises jointly contribute to, and allocate the value derived from, economic activity – and they are accordingly not addressed in this report.[14]

C. The trading of emissions permits/credits

28. The typical tax treaty issue that would be associated with the trading of emissions permits/credits is the treatment of the income from the alienation of such permits/credits by a resident of a Contracting State.[15] As explained below, any income or gain from the alienation of property, which would include emissions permits/credits, 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. In addition, in the case of agriculture and forestry enterprises, such income may fall within the scope of Article 6 (Income from Immovable Property). Whilst one could theoretically query whether income could be derived from leasing or licensing emissions permits/credits,[16] which would raise issues under Article 6 and Article 12 (Royalties), emissions permits/credits are designed as commodities to be consumed through their use as opposed to property or rights that could be leased or licensed.

1. Article 7 (Business Profits)

29. Emissions permits/credits 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 what a Contracting State's domestic law considers to be business activities.

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13. See paragraph 4 of Article 7 and the reference to income "not dealt with in the foregoing Articles of this Convention" in paragraph 1 of Article 21.

14. Article 9 issues that may arise upon the trading of emissions permits/credits are also not addressed in this report.

15. Participants in the markets for emissions permits/credits include traders, dealers and other market makers. Whilst traders and dealers are not specifically addressed, the discussion in this report of the tax treaty treatment of income from the trading of emissions permits/credits applies to all taxpayers.

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

30. In this regard, it should be emphasised that the domestic tax laws of most countries make no express provision with respect to emissions permits. For example, as recognised in an October 2010 study conducted for the European Commission[17] (the "Copenhagen Economics report"), "[t]he 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[18] and the related Commission Regulation do not provide any guidance on the direct tax treatment of emissions permits. Certain countries, such as New Zealand,[19] have provided specific guidance on the tax treatment of emissions permits.

31. 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).

32. 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 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.

2. Article 13 (Capital Gains)

33. Depending on the circumstances, a country's domestic law may consider that the alienation of emissions permits/credits gives rise to a capital gain rather than business profits. This could be the case, for example, where a jurisdiction considers that the alienator is not an enterprise, where the alienation does 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 result under Article 7:[20] 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.

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17. Available at: http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/ets-report.pdf.

18. Directive 2003/87/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/dgs/clima/acquis/index_en.htm.

19. 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).

20. Unless, as 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", or income from the alienation of emissions permits was considered "income from agriculture or forestry".

34. 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.[21]

3. Article 6 (Income from immovable property)

35. 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/credits were to fall within the OECD Model's definition of "immovable property",[22] 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 considered 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 property of a permanent establishment situated in that State. This could arguably be the case, for example, if in a particular jurisdiction emissions permits/credits were legally "bound" to a specific location, such as a factory or a mine or other natural resource deposit.

36. 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".[23] 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.

37. It would appear, however, that a legal connection between a permit/credit and a specific location could make it substantially more difficult to trade the permit in a multi-jurisdiction regime (such as the EU

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21. 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.

22. 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.

23. 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.

ETS). The application of such a domestic law rule in a multi-jurisdiction context would require some form of tracing in order to source income from the sale of the permit/credit and would introduce a distinction between permits/credits "located" in the relevant jurisdiction and all other permits/credits. Assume, for example, that a CDM or JI project is undertaken in a State and that CERs or ERUs are issued for that project. In most cases, Article 7 and Article 13 will allow that State to tax the first alienation of the CERs and ERUs, either because the enterprise that undertook the project and obtained the CERs or ERUs is a resident of that country or because the project constitutes a permanent establishment to which the CERs or ERUs are attributable. As soon, however, as the CERs and ERUs are sold to a resident of another country with no link to the State in which the project is carried on, it would be difficult for that State to exercise any taxing right on any profit from a subsequent alienation, which it would be entitled to do if the CERs or ERUs qualified as immovable property under that State's domestic law. This would be especially true in the case of multiple trades involving traders in different countries.

38. If the State nevertheless insisted in exercising taxing rights upon those subsequent alienations, it would be required to "trace" the relevant CERs and ERUs through all their subsequent alienations. Whilst such tracing is certainly possible, it would increase the transactions costs associated with trading. In addition, where permits/credits may be used (i.e. surrendered) in more than one jurisdiction, linking specific permits/credits to immovable property in a particular jurisdiction would mean that permits/credits would no longer be fungible. Permits/credits "located" in the relevant jurisdiction – and thus, upon alienation, subject to that jurisdiction's domestic tax regime for immovable property under Article 6 – would generally not be substantially equivalent to other permits/credits, given the likelihood of materially different tax consequences upon their alienation. Such different tax treatment would be expected to affect the value of the permits/credits linked to specific immovable property and would likely negatively affect the efficiency and liquidity of the market. More fundamentally, the obstacles to trading that would be introduced by treating permits/credits 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).

39. 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.

40. The analysis of the potential application of Article 6 to profits or gains from the alienation of emissions permits/credits is not limited, however, to the question of whether these permits/credits can constitute "immovable property" as defined in paragraph 2 of the Article. Another issue is the scope of the reference to "income from agriculture and forestry" in paragraph 1 of Article 6, which reads as follows:

> Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

41. The phrase "including income from agriculture or forestry" can be read as broadening the scope of paragraph 1 of Article 6, so that it covers not only income derived from immovable property as defined in paragraph 2 but also any income from activities that constitute agriculture or forestry.

42. 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.

43. In the case of enterprises engaged in agriculture and forestry, therefore, one could consider that Article 6 applies to income derived from the trading of emissions permits/credits linked to their agricultural or forestry activities, whether those permits/credits have been acquired by such enterprises directly from an issuing authority or through market trading. This view would be based not on the treaty characterisation of the permits/credits as immovable property but rather on the treaty characterisation of the activities of the enterprise and on the link between the permits and those activities (as is the case for enterprises engaged in international shipping and air transport – see paragraphs 45-48 below). Under this view, the income that an enterprise engaged in agriculture or forestry might derive from the trading of emissions permits/credits might be covered by paragraph 1 of Article 6 if an adequate link were found to exist between those permits/credits and the agriculture or forestry activities of the enterprise. Article 6 would not, however, apply to profits or gains from the subsequent resale of these permits/credits by other enterprises as the necessary link would no longer exist.

44. This issue would be of particular relevance with respect to income from the alienation of CERs and ERUs by the participants in afforestation and reforestation projects.[24] 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 or ERUs generated by such projects would be considered to fall within the scope of Article 6 (i.e. could be considered "income from agriculture or forestry").

4. Article 8 (Shipping, Inland Waterways Transport and Air Transport) and paragraph 3 of Article 13

45. Paragraph 1 of Article 8 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". Under paragraph 2 of the Article a similar rule is provided for profits from the operation of boats engaged in inland waterways transport.[25] Paragraph 3 of Article 13[26] extends that rule to gains derived from the alienation of such ships, aircraft and boats and "movable property pertaining to the[ir] operation".

46. These rules constitute an exception to Article 7. A non-resident enterprise engaged in these transportation activities will therefore be taxable on the profits and gains derived therefrom only in the State of its place of effective management,[27] regardless of whether or not such profits and gains might otherwise be attributable to a permanent establishment situated in another State.

24. Both the CDM and JI mechanism provide for LULUCF (land use, land-use change and forestry) projects. Note, however, that the EU ETS does not allow the use of certain LULUCF credits. See *Questions and Answers on the revised EU Emissions Trading System* (available at: http://ec.europa.eu/clima/policies/ets/faq_en.htm).

25. "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."

26. "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."

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

47. It is certainly possible that enterprises engaged in these transportation activities will trade emissions permits/credits required for the operation of their ships, aircraft or boats.[28] If it were determined that emissions permits/credits required for or related to such operations 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/credits would be taxable only in the Contracting State where the place of effective management of the enterprise was located. A similar result (i.e. exclusive taxation in the State where the place of effective management of the enterprise was located) would be obtained to the extent that the trading of emissions permits/credits by an enterprise was directly connected or ancillary to its operation of ships or aircraft in international traffic or boats in inland waterways transport.[29]

48. 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 were not. Such rare cases involving a disagreement on the facts or the interpretation of the treaty could be resolved under the mutual agreement procedure, using arbitration if necessary.

5. Article 12 (Royalties)

49. Some treaties include a definition of royalties that covers "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.

50. 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.

51. 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:

> 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.

52. 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.

6. Article 21 (Other Income)

53. Income or gains derived from the trading (i.e. the alienation) of any property would be covered either by Articles 7, 8 or 13 (or Article 6 in the case of an enterprise engaged in agriculture or forestry). In view of the residual character of paragraph 5 of Article 13, which covers "gains from the alienation of any

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28. The aviation sector will be covered by the EU ETS as of 2012. Information on the inclusion of the aviation sector in the EU ETS is available on the website of the European Commission at: http://ec.europa.eu/clima/policies/transport/aviation/index_en.htm.

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

property, other than that referred to in paragraphs 1, 2, 3 and 4", Article 21 should never apply to profits from trading permits/credits or from trading any property even though it could apply to income recognised at the time of the issuance of emissions permits/credits (as explained in paragraph 25 above). 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/credits at the end of a compliance period, such transactions are not restricted to emissions permits/credits and do not strictly constitute the "trading" of these permits/credits.

7. Possible disagreements as to the proper treaty treatment

54. 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.

55. 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.

56. 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.

57. 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.

58. As already mentioned, however, it would seem highly unlikely that emissions permits/credits 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/credits.

3. Proposed changes to the Commentary

59. It is proposed to clarify the tax treaty treatment of income from the issuance and trading of emissions permits/credits by adding the following paragraphs to the Commentary on the OECD Model Tax Convention:

Add the following paragraph 75.1 to the Commentary on Article 7:

75.1 Emissions trading programmes have been implemented in a number of countries as part of an international strategy for addressing global warming. Under such programmes, emissions permits may be required in order to perform certain economic activities that

generate greenhouse gases and credits issued with respect to emission-reduction or emissions removal projects in other countries may be recognised. Given the multinational character of certain emissions trading programmes (such as the European Union Emissions Trading System), these programmes present specific issues under the Model Tax Convention, most notably the treatment of income from the issuance and trading of emissions permits and credits. These issues are examined in the Committee's report "Tax treaty issues related to emissions permits/credits". As explained in that report, income derived from the issuance or trading of emissions permits and credits is generally covered by Article 7 and Article 13. Under certain circumstances, however, such income may be covered by Articles 6, 8 or 21 (see paragraph 2.1 of the Commentary on Article 6 and paragraph 14.1 of the Commentary on Article 8).

Add the following paragraph 2.1 to the Commentary on Article 6:

2.1 The phrase "including income from agriculture or forestry" in paragraph 1 extends the scope of Article 6 to include not only income derived from immovable property as defined in paragraph 2 but also income from activities that constitute agriculture or forestry. Income from agriculture and forestry includes not only the income that an enterprise engaged in agriculture or forestry derives from selling its agricultural and forestry production but also income that is an integral part of the carrying on of agriculture or forestry activities – for instance, income derived from the acquisition or trading of emissions permits (the nature of these permits is explained in paragraph 75.1 of the Commentary on Article 7) where such acquisition or trading is an integral part of the carrying on of agriculture or forestry activities, e.g. where the permits are acquired for the purpose of carrying on these activities or where permits acquired for that purpose are subsequently traded when it is realised that they will not be needed.

Add the following paragraph 14.1 to the Commentary on Article 8:

14.1 Enterprises engaged in the operation of ships or aircraft in international traffic may be required to acquire and use emissions permits and credits for that purpose (the nature of these permits and credits is explained in paragraph 75.1 of the Commentary on Article 7). Paragraph 1 applies to income derived by such enterprises with respect to such permits and credits where such income is an integral part of carrying on the business of operating ships or aircraft in international traffic, e.g. where permits are acquired for the purpose of operating ships or aircraft or where permits acquired for that purpose are subsequently traded when it is realised that they will not be needed.

Replace paragraph 16.1 of the Commentary on Article 8 by the following:

16.1 Paragraphs 4 to ***14.1***~~14~~ above provide guidance with respect to the profits that may be considered to be derived from the operation of ships or aircraft in international traffic. The principles and examples included in these paragraphs are applicable, with the necessary adaptations, for purposes of determining which profits may be considered to be derived from the operation of boats engaged in inland waterways transport.

Replace paragraph 24 of the Commentary on Article 13 by the following:

24. Paragraph 2 deals with movable property forming part of the business property of a permanent establishment of an enterprise. The term "movable property" means all property other than immovable property which is dealt with in paragraph 1. It includes also incorporeal

property, such as goodwill, licences, ***emissions permits*** etc. Gains from the alienation of such assets may be taxed in the State in which the permanent establishment is situated, which corresponds to the rules for business profits (Article 7).