17 December 2012
Taxand

Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/ CTPA
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Dear Sir/Madam,

Re: Taxand responds to the OECD invitation for public comments on a revised discussion draft on tax treaty issues related to emissions permits/credits.

Further to the publication of the OECD's invitation for public comments on the revised discussion draft on tax treaty issues related to emissions permits/credits - addressing the application of the OECD Model Tax Convention to the cross-border trading of emissions permits - Taxand is honoured to provide combined feedback from around the world.

First of all, we would like to salute the efforts of the OECD Committee of Fiscal Affairs for its continual improvement to the efficiency of the Model Convention, which is an essential tool for coordinating international taxation in the business community.

COMMENTS ON THE OECD DRAFT REPORT ON EMISSIONS PERMITS / CREDITS

The OECD Committee on Fiscal Affairs recently released a discussion draft on tax treaty issues related to the trading of emissions permits and credits (emissions rights).

The main focus of the discussion draft is to clarify the classification for tax treaty purposes of the income generated from the alienation of emissions rights in order to avoid double taxation problems that could arise in case of diverging characterisations in the residence and source states. In principle, income or gains from the alienation of emissions rights could fall under Article 6 (Immovable Property), Article 7 (Business Profits), Article 8 (Shipping, Inland Waterways Transport and Air Transport) or Article 13 (Capital Gains).

The draft concludes with the proposal to add several paragraphs to the Commentary on the OECD Model Tax Convention. The amended Commentary would state that income derived from the issuance or trading of emissions rights would generally be covered by Article 7 or Article 13. Only if the acquisition or trading of emissions rights is an integral part of carrying out a transport business or agriculture or forestry activities, should such income be covered by Articles 8 or 6. Thus the new Commentary would largely restrict the potential characterisation of the income derived of the alienation of emissions rights as income from immovable property or as income derived from transport activities. In this way it should contribute to the reduction of potential double taxation issues arising from dual classification of income.

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However, in our global view, it would be desirable that the previous discussion of these issues in the report were clearer with regards to the characterisation of emissions rights for tax treaty purposes. It is difficult to understand how these rights could be treated as immovable property and -as the draft report itself recognises- the examination of their tax treatment has not identified any jurisdictions which would consider them as such.

Moreover, its characterisation in one jurisdiction as income from immovable property, apart from potentially resulting in double taxation, would also pose several practical problems: the source country would need to establish a tracking system in order to be able to execute its taxation right and each buyer of a permit would need to scrutinise its origin in order to ascertain whether it were subject to such source taxation. For these reasons, it would seem advisable not to leave the door open for the potential characterisation of this income as income from immovable property. In this respect, the explicit mention of “emissions permits” among incorporeal property, and hence movable property, in the new paragraph 24 of the commentary on Article 13 is, though not fully conclusive, of the utmost importance.

Where the gains obtained in connection with emissions rights fall under Article 6 due to their link with agricultural or forestry activities, it could be advisable to specify in the Commentary, similarly to paragraph 42 of the draft, that such characterisation would only apply to the entity carrying out those activities, not to subsequent acquirers or traders of those rights. A similar clarification could also be included in the Commentary to Article 8.

Potential double taxation issues could derive from dual characterisation of this income, if in one country the income is classified under Article 13 (Capital Gains) and in another jurisdiction under Article 7 (Business Profits). It is true that the rules in Articles 7 and 13 produce the same results under the OECD Model Tax Treaty (exclusive taxation in the State of residence unless the emissions rights are effectively connected with a permanent establishment in the other State), but several treaties allow for source taxation under Article 13, which makes it necessary to distinguish between business income and capital gains. In several jurisdictions (USA and Finland, among others), this distinction will depend on how the trading in emissions rights relates to the business of the enterprise. If such trading has a direct link to the ordinary business of the taxpayer, the income derived is usually treated as business profits and should fall under the scope of Article 7. This can be the case if the taxpayer trades in emissions rights to help manage its business emissions or if the taxpayer is a professional trader in emissions rights. On the contrary, the profits obtained in the alienation of emissions rights would usually be classified as capital gains (Article 13) if the taxpayer trades them sporadically for investment purposes and the emissions rights are not otherwise utilisable in the taxpayers’ businesses. The OECD draft could clarify along similar lines when the income derived from trading of emissions rights should be characterised as business profits or as capital gains.

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The proposed new paragraph 75.1 of the commentary to Article 7 would allow for the classification of this type of income under Article 21, but would provide no guidance with regards to when that article could apply. A clarification of this point would be helpful.

Finally, we find it proper that the draft clearly establishes that income from trading in emission rights should not be characterised as royalty income.

Taxand's Take

Taxand supports the commentary draft from OECD, but, in order to reduce the risks of potential double taxation, we would appreciate more clarity on dual classification issues. In particular, further clarification could be provided with regard to the following points:

- Characterisation of income derived from the alienation of emission rights for tax treaty purposes as business profits or capital gains.
- Explicit and full exclusion of the characterisation of emission rights as immovable property.
- Characterisation as income from immovable property (Article 6) due to links with agricultural or forestry activities should only apply to the entity carrying out those activities, not to subsequent acquirers or traders of those rights. A similar clarification could also be included in the commentary with regard to Article 8 (Shipping, Inland Waterways Transport and Air Transport).
- Scope of application of Article 21.

We appreciate this opportunity to provide comments to the OECD Committee of Fiscal Affairs and would be pleased to discuss this further and to participate in any further discussion on these matters.

More information on how to contact me and about Taxand is provided as Appendix I. Taxand is wholly committed to supporting the OECD Committee of Fiscal Affairs and we look forward to contributing to further debate.

Yours faithfully,
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APPENDIX I

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ABOUT TAXAND

Taxand provides high quality, integrated tax advice worldwide. Our tax professionals, nearly 400 tax partners and over 2,000 tax advisors in nearly 50 countries - grasp both the fine points of tax and the broader strategic implications, helping you mitigate risk, manage your tax burden and drive the performance of your business.

We're passionate about tax. We collaborate and share knowledge, capitalising on our collective expertise to provide you with high quality, tailored advice that helps relieve the pressures associated with making complex tax decisions.

We're also independent—ensuring that you adhere both to best practice and to tax law and that we remain free from time-consuming audit-based conflict checks. This enables us to deliver practical advice, responsively.

Taxand has achieved worldwide market recognition. In the International Tax Review's (ITR) World Tax 2013, 43 Taxand locations were commended. 35 countries were voted top in the ITR Transaction Tax Survey 2012 and in the ITR Tax Planning Survey 2012. Taxand has received 48 national awards and 15 regional awards in the ITR European, Americas and Asia Tax Awards since 2009. These include European Private Equity Tax Firm of the Year, European Indirect Tax Firm of the Year, European Tax Policy Firm of the Year, Asia Transfer Pricing Firm of the Year, Asia Tax Policy Firm of the Year, North America Indirect Tax Firm of the Year, and Latin America Tax Disputes Firm of the Year. Full details of awards can be viewed at www.taxand.com/media/factsheet.
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