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Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA
(via email: taxtreaties@oecd.org)

Dear Committee on Fiscal Affairs

Comments on Revised Public Discussion Draft:
Tax Treaty Issues Related to Emissions Permits/Credits

This letter is in response to the invitation of the OECD Committee on Fiscal Affairs to provide comments on the revised public discussion draft Tax Treaty Issues Related to Emissions Permits/Credits, released on 19 October 2012. The comments presented here are mainly from an Australian perspective. The issue of the treatment of emissions permits across borders is of particular interest to Australia given the recent agreement to link the Australian Carbon Pricing Mechanism (Australia's emissions trading scheme, which commenced operation in 2012) and the European Union Emissions Trading System, with partial linking to commence in 2015 and full linking proposed from 2018.

As noted in the discussion draft (at paragraph 29), the domestic tax laws of most countries do not have provisions specific to emissions permits but the Australian Government has taken the somewhat usual step of establishing a detailed domestic tax regime with respect to transactions involving permits that are held on the Australian Registry (the new Division 420 of the Income Tax Assessment Act 1997). All Australian-issued permits (both carbon emissions units and offset units) are held on the electronic Registry on issue and the mechanism also allows for international permits to be held on the Registry (where the transfer of such units to the Australian Registry is a prerequisite to those units being available to meet compliance obligations under the Australian scheme).

Like the EU ETS, a major feature of the Australian scheme is the making of free allocations, discussed in Part 2:A of the discussion draft. In contrast to many other countries (see paragraph 14), the Australian domestic tax rules treat the receipt of free allocations as income in the year that the permits are issued to the recipient (based on the market value of the permits at the time of issue), rather than deferring recognition until alienation. This treatment applies to all free allocations, including permits issued under the offsets regime for land-based activities (the Carbon Farming Initiative) and permits issued as part of the coal-fired electricity generation assistance scheme. In the case of recipients of emissions-intensive trade-exposed industry assistance, there is a limited deferral rule that allows for the recognition of income to be deferred until after the compliance year with respect to which the permits have been issued. In effect, the

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value of the permits is only recognised as income if they are carried forward beyond the compliance year (that is, banked rather than surrendered). This is referred to as the "no disadvantage rule" in the Australian Government documentation. This treatment of free allocations could lead to a timing mismatch and potential double taxation where the States of residence and source do not tax at the same time. Although this may be seen as an issue for domestic law, it may be considered relevant to highlight that any credit mechanism should contemplate timing issues such as these and thereby not prevent relief from any potential double taxation. (An analogous issue has been raised with respect to employee stock option plans in the 2004 report of the Committee of Fiscal Affairs on the Cross-Border Income Tax Issues arising from Employee Stock Option Plans.)

With respect to trading of emissions permits (Part 2:C), Australia's specific domestic tax provisions in relation to emissions permits also apply to trading activities, whether such transactions are undertaken by compliance entities or traders/dealers. Any profit or gain in relation to permits is treated as on revenue account (not a capital gain) and would generally be considered "business profits". The Australian provisions allow for such income/profits to be recognised on a realisation basis or, by election, on a mark-to-market annual accruals basis. This treatment could exacerbate the timing mismatch issue given that the overall gain on a freely-allocation permit could be recognised for Australian purposes in three stages: the initial value on allocation; any accrued (but unrealised) gains under the mark-to-market option; and then the balance of any additional gain on alienation. It may be appropriate to also considered the treatment of expenses incurred to purchase emissions permits in the context of the discussion of business profits. The domestic tax rules may follow the financial accounting treatment, although as yet not entirely settled, which should provide for a deduction against profits on an accruals basis in line with the emissions liability. An alternative approach for tax purposes, and the one adopted by the Australian tax rules, provides for a deduction in the year of surrender, which is generally the following year. In any case, such expenses should be taken into account in determining the business profits from permit transactions.

As a final comment, due to the scope of activities that may qualify for offset generation under Australia's Carbon Farming Initiative, the income derived by the receipt of permits for no consideration under this scheme could, in some cases, be considered "income from agriculture or forestry" so as to thereby fall within the scope of Article 6 (see paragraphs 42 and 43 of the discussion draft in relation to CERs and ERUs). As noted above, such income is considered to be derived in the year of the receipt of such permits under Australia's domestic tax rules and not on alienation.

Thank you for the opportunity to comment on this discussion paper. I would be pleased to offer more detailed comments in relation to the Australian domestic tax approach if such would be of assistance to the Committee.

Sincerely,

Celeste M Black