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3. A second commitment period for the Kyoto Protocol (post 2012) was agreed at COP 17 in Durban by the EU countries and a few other industrialized countries such as Australia and Norway.[6]

"assigned amounts", over the compliance period. The allowed emissions are divided into "assigned amount units" (AAUs) under the Kyoto Protocol. Other trading systems may use other denominations for their certificates.

7. Emissions permits are tradable. Producers who emit less of the pollutant than the amount allowed by the permits they hold may thus keep these allowances to cover their future needs or sell the "extra" permits to other producers or to intermediaries. At the end of each compliance period, each producer must surrender permits covering its effective amount of emissions during that period or face penalties. The specific limit of the total amount of emissions within the country or region – and thus the total amount of permits allowed – is normally lowered over time to achieve the national or regional Kyoto target. The trading of AAUs ensures that emissions are cut in the country or in the sector where it costs least to do so.

> The European Union Emissions Trading System (EU ETS) enables participating installations like factories and power plants in 30 countries (the 27 EU Member States plus Iceland, Liechtenstein and Norway) to receive emissions allowances which they can sell to or buy from one another as needed. Each EU Allowance Unit (EAU) represents one metric tonne of CO_2. While auctioning of carbon allowances was limited during the first and second trading period, it will be the main allocation method as of 2013. Sectors and sub-sectors found to be exposed to a significant risk of carbon leakage[9] will receive allowances for free based on ambitious benchmarks, but for non-exposed industries such allocations will be phased out.
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> Under the EU ETS, National Allocation Plans (NAPs) set out the total quantity of greenhouse gas emissions allowances that EU Member States grant to their enterprises in the first (2005-2007) and the second (2008-2012) trading periods. Before the start of the first and the second trading periods, each EU Member State had to decide how many allowances to allocate in total for a trading period and how many each installation covered by the EU ETS would receive. For the third trading period, which begins in 2013, there will no longer be any NAPs. Instead, the allocation will be determined directly at the EU level.
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> The EU has set out a vision for the development of an international carbon market: the market is expected to develop through bottom-up linking of compatible domestic cap-and-trade systems. At the EU's initiative, it was agreed in December 2011 that a global and more ambitious UN legal framework covering all countries would be implemented from 2020. The link with the Australian market starting 2015 was recently announced.

B. <u>The Clean Development Mechanism (CDM) defined in Article 12 of the Protocol</u>

9. The CDM allows Annex I countries and authorized private or public entities[11] of such countries to participate in the implementation of emission-reduction projects in Non-Annex I countries. The CERs earned by an enterprise of an Annex B country participating in such projects can be counted towards meeting its emissions target. The CERs can also be sold to enterprises of Annex B countries that are over their targets. Projects hosted in Non-Annex I countries may be developed with investment or support from enterprises, entities and Governments of Annex I countries, as long as the project

20. Following such arrangement, the host country entity would act as the primary seller of the CERs and the Annex I entity would pay for all CERs. Because the relevant CERs have not yet been

Article 3.4 (forest management, cropland management, grazing land management, revegetation), which are referred to as LULUCF (Land Use, Land-Use Change and Forestry) activities, may give rise to removable units (RMUs). An Annex I country may issue RMUs where LULUCF activities on its territory result in a net removal of greenhouse gas. These emissions credits are deemed valid only when the removals have been verified under the Kyoto Protocol's review procedures and they cannot be carried over to future commitment periods.

Under the New Zealand Emissions Trading Scheme (NZ ETS), owners of forests first established after 1989 who opt into the NZ ETS receive sequestered carbon credits as the forests grow and face full liability for emissions at harvest.

27. The CDM allows for the implementation of LULUCF project activities limited to afforestation and reforestation. Under JI, an Annex I country may implement projects that increase removals by sinks in another Annex I country. These projects may give rise to temporary or long-term emissions credits.

E. Interactions between national and regional emissions trading programmes and the CDM and JI

28. A means to reduce emissions more cost-effectively is to develop the global carbon market by linking national and regional emissions trading systems. The increased liquidity and reduced price volatility that this would entail would improve the functioning of markets for emissions permits.

The original EU Directive establishing the EU ETS allowed for linking the EU ETS with the

30. Emissions trading programmes present a number of domestic and international tax issues. This note focuses on the potential tax treaty issues that could arise in connection with a national or regional authority's grant of emissions permits, the trading of such permits across borders, and the issuance and trading of CERs, ERUs and RMUs. The tax treaty issues are discussed in relation with bilateral treaties with provisions similar

States, the EU ETS for aviation covers three EEA-EFTA States (Iceland, Liechtenstein and Norway)[18].

43. A bilateral treaty that follows the UN Model could contain a provision similar to paragraph 2 of Article 8 (Alternative B) of the UN Model. Profits from shipping activities are then taxable in the State where they arise if operations in that State are "more than casual" (i.e. "a scheduled or planned visit of a ship to a particular country to pick up freight or passengers" even if the visit is irregular or isolated).

44. There is currently no international regulation of greenhouse gas emissions from ships. Despite many years of efforts, in particular in the International Maritime Organization and the United Nations Framework Convention on Climate Change, it has not yet been possible to agree on an effective global approach to regulating these emissions[19]. If and when the operation of ships is covered by emissions trading schemes, the granting of emission permits with respect to the operation of a ship in international traffic could be included in the business profits of the shipping enterprise as profits directly connected to the operation of such ship. In such a case, the profits taxable in the State of source pursuant to Article 8 (alternative B) will be determined on the basis of an appropriate allocation of overall net profits derived by the enterprise from its overall shipping operations.

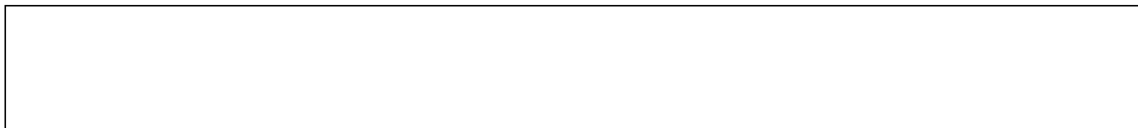
3. Article 6 (Income from Immovable Property)

45. Income arising at the time a permit is granted free could also fall under Article 6 as income from "immovable property". This could be the case if a State grants permits to the owner of "immovable property", such as a mine or other natural resource deposits giving rise to the release of toxic chemicals or a waste disposal facility, and the permit is bound to that property. In such a case, the income from the granting of permits may also be taxed in the State where the immovable property is situated even if such property would not constitute a PE through which an enterprise carries on its business.

Disposal facility operators are mandatory participants in the NZ ETS and are required to surrender New Zealand Units (NZUs) for their emissions by 31 May 2014. For purposes of the NZ ETS, "disposal facility" means any facility, including a landfill, that operates (at least in part) as a business to dispose of waste. The operator is the person in control of a disposal facility. Many factors could be relevant in deciding who has control of a disposal facility, including who holds the resource consent for the

Under the NZ ETS, voluntary reporting for the agriculture sector began on 1 January 2011, with mandatory reporting required from 1 January 2012. From this time agricultural processors will be required to report on the emissions associated with the agricultural produce they process. Obligations to surrender units for agricultural emissions are scheduled to start in 2015.

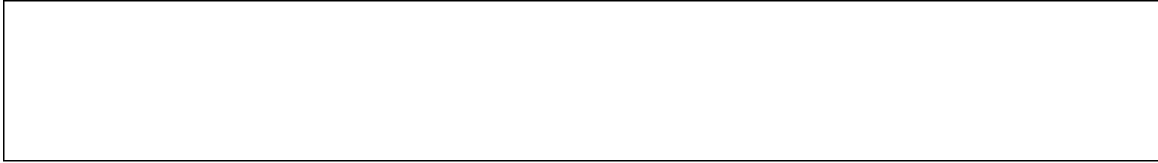
47. Even if income from mining activities is not expressly mentioned in paragraph 1 of Article 6, some countries could argue that income from the working of mineral deposits or other natural resources or from landfill activities is also income derived from the direct use of immovable property. These countries may take the position that such income, including income from the grant of emissions permits relating to these activities, would fall under Article 6.[20]



4. Article 12 (Royalties)

48. Under paragraph 3 of Article 12, the definition of royalties covers "payments … received as a consideration … for the use of, or the right to use, industrial, commercial or scientific equipment". Those terms do not cover payments received by the operator of equipment with respect to the use he is making of such equipment but cover payments made by the operator of equipment to the lessor in

51. The term “profits” used in Article 7 has a broad meaning and includes all income derived in the carrying on of an enterprise.[21] Except where an item of business income is treated separately in another Article of the UN Model, Article 7 is applicable to any income obtained in the carrying on of a business. Because emissions permits are, in general, granted in connection with the carrying on of business activities which give rise to greenhouse ga



55. Theoretically, the following articles of the UN Model could cover the income considered to arise, under a State's domestic tax law, at the time an emissions credit is granted.

1. Article 7 (Business Profits)

- A CDM or JI project is wholly or partly owned by a host country enterprise.

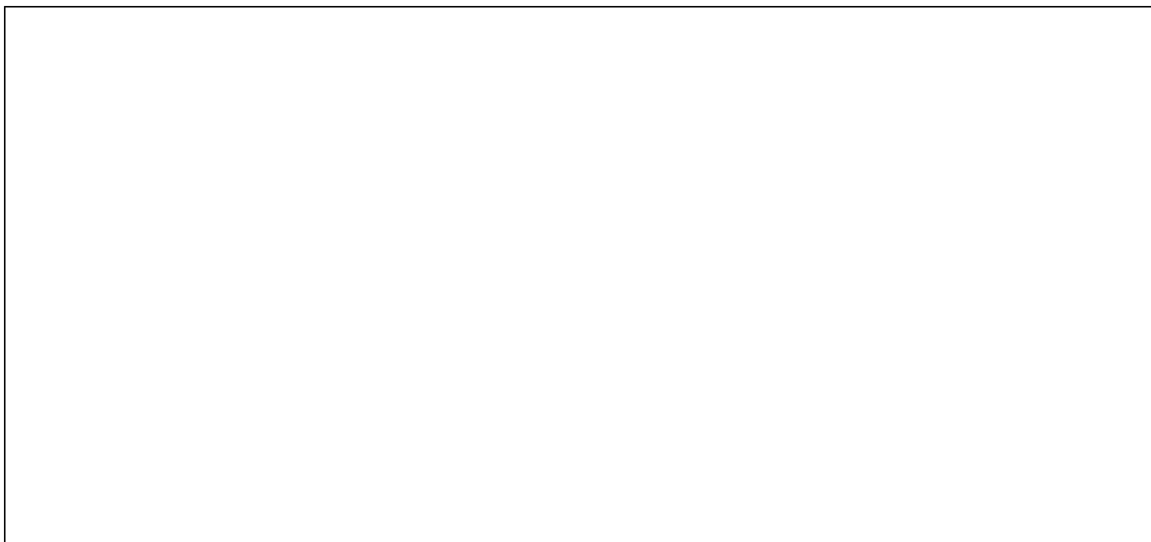
56. In such case, the income derived by the host country enterprise from the granting of the emissions credits is exclusively taxable in the host country as business profits relating to the business carried on in the host country by an enterprise of that country. Whether an Annex I entity is also granted emissions credits in respect of the project, or the host country enterprise agrees to subsequently transfer to another party all or part of the emission credits generated by the project, does not affect this result. Besides such other party should not have a PE in the host country by reason of the sole transfer of the credits.

- A CDM or JI project is wholly or partly owned by a foreign enterprise.

57. Typical CDM or JI projects falling under Article 7 will involve activities exercised through an installation lasting more than six months and thus through a PE (i. e. the installation through which the activities giving rise to the emission reductions and the issuance of emissions credits are exercised). Emissions credits are issued for a crediting period for which reductions of emissions are verified and

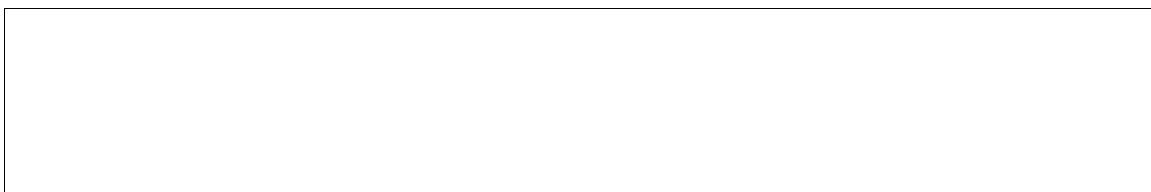
60. Under a PDA, a foreign enterprise takes on the full risk, until the issuance of the emissions credits, associated with the design and development of a project that employs assets owned by a host country enterprise. In consideration for such assumption of risk and the provision by the foreign enterprise of expertise and services in developing and implementing the project, the host country entity may agree under the PDA to assign to the foreign enterprise the right to all or a large portion of the emissions credits generated by the project.

61. In such cases, the location of the activities giving rise to the emissions reductions – and, consequently, the issuance of emission credits – generally does not constitute a PE for the foreign enterprise. The foreign enterprise indeed typically exercises no business activities through that location



3. Article 6 (Income from Immovable Property)

65. Income arising at the time a permit is granted for free could also fall under Article 6 as income from “immovable property”. This could be the case if a State grants credits to the owner of “immovable property”, such as a wind mill, and the credits are bound to that property. In such case, the income from the granting of permits may be taxed in the State where the immovable property is situated even if such property would not constitute a fixed place of business for an enterprise.



66. The income from the granting of emissions credits may fall under Article 6 as income from immovable property (as defined in paragraph 1 of Article 6) if the credits are granted in consideration for the reduction of emissions achieved in connection with agriculture or forestry activities (including LULUCF activities).

4. Article 12 (Royalties)

67. Under paragraph 3 of Article 12, the definition of royalties covers “payments … received as a consideration … for the use of, or the right to use, industrial, commercial or scientific equipment”. Those terms do not cover payments received by the operator of equipment in consideration for the use he is making of such equipment, but cover payments made by the operator of equipment to the lessor in consideration for the concession of the use or the right to use the equipment. The income from the grant of credits with respect to the operation of industrial, commercial or scientific equipment should consequently not be classified as royalties.

5. Article 14 (Independent Personal Services)

68. In theory, where an individual[24] takes on the full risk, under a PDA, associated with the design and development of a project, the PDA could assign to the individual the right to all or a large portion of the emissions credits generated by the project. Note, however, that it does not appear that an individual may be a "project participant" in a CDM or JI project[25] (i.e. it does not appear that the CDM or JI mechanism permit the issuance of emission credits to an individual). The other project participants would make such an assignment of the right to the emissions credits generated by the project in consideration of such assumption of risk and the provision of expertise and services in developing and implementing the project. In such a case, the income from the assignment of the emissions credits may be considered as income derived in respect of independent personal services and may be taxed under the conditions provided for in Article 14 (e.g. if the individual is present in the host country for a period or periods aggregating at least 183 days in any twelve-month period and all or part of the income is derived from activities performed in the host country).

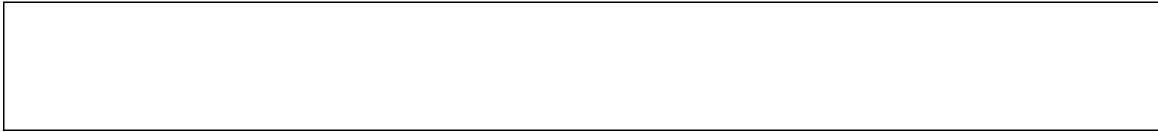
6. Article 21 (Other Income)

69. In most cases, income arising at the time emissions credits are granted would be covered either

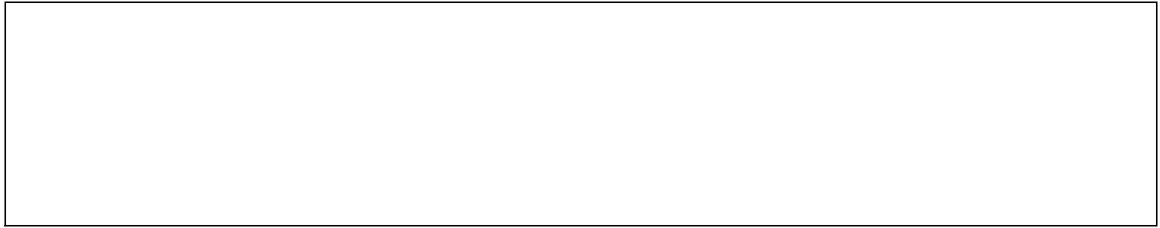
immediate deduction of the purchase price for tax purposes and others only allow deduction when an EAU is actually used for compliance purposes). A minority of EU Member States treats allowances as intangible assets and allows depreciation over their expected lifetime.

76. Emissions permits/credits are not expressly dealt with by the UN Model. Unless the emissions permits/credits fall under Article 6 (Income from Immovable Property) or 8 (Shipping, Inland Waterways Transport and Air Tr

87. The profits (or losses) from the sale of emission credits that a selling enterprise has acquired on the secondary market are not attributable to the CDM/JI project that generated the credits. After sale by their primary owner, the credits are indeed no longer connected to a business that the selling enterprise would carry on through the CDM/JI project. Should the market price of the credits increase after the first sale, the profit or gain arising from any subsequent sales would therefore not be profits attributable to the CDM/JI project. Such profits would be taxable (or losses would be deductible) only in the State of residence of the selling enterprise, unless they were attributable to a PE situated in another State.[30]



88. A bilateral treaty that follows the UN Model will contain a "limited force of attraction" rule.



2. Article 6 (Income from immovable property)

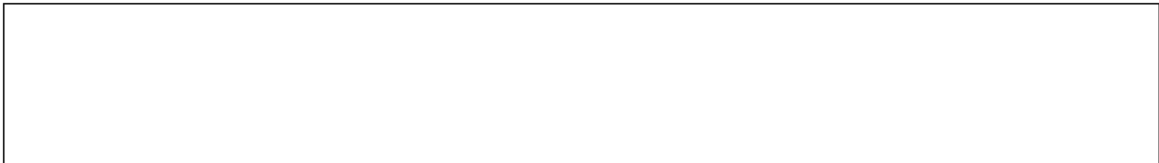
92. Paragraph 1 of Article 6 broadens the scope of Article 6 to cover not only income derived from immovable property (as defined in paragraph 2) but also any income from agriculture or forestry activities. Article 6 is, therefore, applicable to income derived by enterprises from the trading of emissions permits/credits relating to their agriculture or forestry activities. This would be the case where permits/credits have been acquired by such enterprises directly from an issuing authority or through market trading connected with their compliance obligations under an emissions trading programme. This would also be the case with respect to income from the alienation of emissions credits by the participants in afforestation and reforestation CDM/JI projects. Where the participants in these projects are considered to be engaged in forestry, the income they derive from the sale of credits generated by their forestry projects in a given State would be "income from agriculture or forestry" activities in that State and would therefore be covered by Article 6.

93. Article 6 would not apply to profits from the subsequent resale of these permits/credits by persons for whom those profits would not constitute income from their agriculture or forestry activities.

3. Article 8 (Shipping, Inland Watesp

such aircraft. Profits from the issuance of such credits are unlikely to be covered by Article 8. In most cases, the CDM/JI project activities would not be considered "auxiliary activities which could properly be brought under the provision"[32] nor would such activities be considered "directly connected" or "ancillary to such operations"[33]. Profits from the first sale of such credits by the enterprise would

therefore not accurate to exclude the profits from the trading of permits from the "overall net profits" and to allocate the profits to the State having issued them.



4. Article 13 (Capital Gains)

98. Article 13 does not specify how to compute a capital gain; this is left to the applicable domestic law. A capital gain is, however, typically the amount

100. In accordance with paragraph 6 of the Commentary on Article 13 of the UN Model (quoting paragraph 24 of the OECD Commentary on Article 13), "movable property" means "all property other

operating enterprise would be taxable only in the Contracting State where the place of effective management of the enterprise is situated.

109. As noted above, paragraph 1 of Article 6 broadens the scope of Article 6 to cover not only income derived from immovable property (as define in paragraph 2) but also any income from agriculture or forestry activities. Paragraph 1 of Article 13, which refers to gains "from the alienation of immovable property", does not cover the alienation of movable property connected with agriculture or forestry activities unless such movable property falls under the definition of paragraph 2 of Article 6 (i.e. equipment used in agriculture and forestry, property accessory to immovable property or property characterized as immovable property under the domestic law of the State in which the property is situated).[38]

- Gains from the alienation of shares in a company or of an interest in a partnership, trust or estate, the property of which consists, directly or indirectly, principally of immovable property (paragraph 4 of Article 13)

110. Except where a company, partnership, trust or estate is engaged in the business of management of immovable properties, paragraph 4 of Article 13 does not apply to a company, partnership, trust or estate, the property of which consists, directly or indirectly, principally of immovable property used by such an entity in its business activities. Where emissions permits/credits are considered as immovable property under the domestic law of the State in which the immovable property to which such permits/credit are bound is situated, those permits/credits should be considered as used by that entity in its business activities if they are connected with the coverage of emissions resulting from its business activities. Where an emissions credit/permit is considered immovable property under the domestic law of the State in which the immovable property to which that permit/credit is bound is situated and an entity does not have compliance obligations under an emissions trading programme, the use of the permit/credit by the entity should be evaluated on the basis of the facts and circumstances of the specific case.

111. This provision does not seem to have specific implications in relation to emissions permits/credits.

- Gains from the alienation of property other than property referred to in paragraphs 1, 2, 3, 4 and 5 (paragraph 6 of Article 13)

112. Article 13 may apply where the alienation of emissions permits/credits does not occur in the course of the carrying on of a business of an ente

6. Article 9 (Associated Enterprises)

118. Transfer pricing issues may arise with respect to the transfer of emissions permits/credits within a group. A company may indeed transfer emissions permits/credits granted to it or purchased by it to an associated company (e. g. a company which emits less of the pollutant emissions than the amount allowed by the permits they hold may sell the “extra” permits to an associated company which is over its emissions targets). The arm’s length principle found in paragraph 1 of Article 9 is applicable to the transfer of these permits/credits. Profits may be adjusted by reference to the price and the conditions which would have been obtained between independent enterprises in comparable transactions and comparable circumstances based on

123. These disputes will generally occur because the Contracting States have differences of views as to the relevant facts of a case or as to the interpretation of the relevant treaty provisions. Such cases would need to be resolved under Article 25 (Mutual Agreement Procedure).

- Conflicts of qualification

124. A "conflict of qualification" arises where, due to differences in the domestic law characterisation of an item of income in the State of source and the State of residence, the State of source applies (with respect to an item of income) a different treaty provision than the State of residence would have applied. Such conflicts may occur in the following cases:

- one State considers that gains from trading emissions permits/credits are covered by paragraph 1 of Article 13 (because the emissions permits/credits constitute "immovable property" according to the domestic law of that State) and the other State disagrees; or
- one State considers, in accordance with its dome

E. Consequences of cap-and-trade systems for developing countries and countries in transition

Granting of emissions permits

127. As developing countries and countries in transition are Non-Annex I countries, they do not have binding targets for the limitation or reduction of emissions under the Kyoto Protocol. Non-Annex

under such a system would generally be taxable exclusively in the organising country on a residence basis under Article 7 or will be taxable in that country on a source basis where the permit is granted with respect to the PE of a foreign enterprise.

Issuance of emissions credits

131. CERs are issued exclusively in respect of CDM projects in non-Annex I countries. If a Non-Annex I country in which a CDM project was carried out treats the issuance of the CERs relating to that project as a taxable event, that country would generally have the right to tax the income arising from such issuance under a tax treaty. The Non-Annex I country would have the right to tax the income where:

- the income was derived by a resident CDM project participant (income arising in the Non-Annex I country and derived by a resident of that country) ;
- the income was derived by a foreign enterprise through a PE situated in the Non-Annex I country (a CDM project will require such an extended presence in the Non-Annex I country that it would normally give rise to a PE; income attributable to that PE would be taxable in the Non-Annex I country in accordance with Article 7);
- the income was derived by a non-resident through a forestry or agriculture project in the Non-Annex I country or from an emissions credit bound to or considered immovable property under the law of the Annex I country (taxable in the Non-Annex I country in accordance with Article 6); or
- the income was derived by a non-resident project participant which was a foreign Government, NGO or public entity (taxable in the Non-Annex I country in accordance with paragraph 3 of Article 21 where the income is not considered as business income of an enterprise[42]).

132. Profits from the granting of CERs to an enterprise engaged in the operation of ships or aircraft in international transport, or in the operation of boats in inland waterways transport, would generally not be considered as profits from "auxiliary activities" which could properly be brought under the provisions of Article 8 nor as profits "directly connected" with or "ancillary to" such transport operations. Such profits would therefore be taxable under Article 7.

133. ERUs are issued in respect of JI projects developed by Annex I countries in another Annex I country. Non-Annex I countries are, therefore, not concerned with the issuance of ERUs at this stage.

First sale of emissions permits

134. The profits or gains from the first sale of an emissions permit will generally be taxable exclusively on a residence basis in an Annex I country under Article 7 or Article 13, except where the profits or gains are attributable to a PE situated in another Annex I country or are income from agriculture or forestry activities exercised in another Annex I country.

135. Profits or gains from the first sale of an emissions permit by an enterprise engaged in the

143. In most cases, subsequent sales would be made by residents of Annex I countries selling their "excess" permits/credits (i.e. permits/credits in excess of those needed to satisfy compliance obligations). The profits from those sales would be exclusively taxable in the State of residence, unless the permits/credits were:

- effectively connected with a PE in another Annex I country to the extend that the profits from the subsequent sale would be attributable to that PE; or
- effectively connected with agriculture or forestry activities exercised in another Annex I country to the extend that the profits from the subsequent sale would be attributable to these activities.

144. Income from the sales of emissions permits/credits by traders or dealers which acquire permits/credits in the expectation that they will later be able to sell them at a profit will generally be covered by Article 7.

145. Profits or gains from subsequent sales by enterprise engaged in the operation of ships or aircraft in international transport, or in the operation of boats in inland waterways transport, would be taxable exclusively in the State of the enterprise's place of effective management. Where a treaty includes paragraph 2 of Article 8 (alternative B) of the UN Model, the profits derived from the subsequent sales of emissions permits/credits could be considered as operating business profits directly connected to the operation of ships and included in their "overall net profits" from the operation of ships in international traffic.

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