E/C.18/2013/CRP.6

Distr.: General
14 October 2013

Original: English

Committee of Experts on International Cooperation in Tax Matters
Ninth session
Geneva, 21-25 October 2013

NOTE ON TAX TREATY ISSUES ARISING FROM THE GRANTING AND TRADING OF EMISSIONS PERMITS AND EMISSIONS CREDITS UNDER THE UN MODEL TAX CONVENTION

Summary

At its seventh annual session the Committee noted in its report[1] that

Tax treaty issues arising from the granting and trading of emissions permits and emissions credits under the UN Model Tax Convention

1. Introduction

1. The *United Nations Framework Convention on Climate Change*[3] (UNFCCC) which

as a means for giving flexibility to countries to meet their emissions reduction targets by getting emissions credits from elsewhere.

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[7]. Japan and Russia have stated that they will not sign up to a second commitment period and Canada withdrew from the Kyoto Protocol before the end of the first commitment period. It was agreed at COP 18 in Doha that the second commitment period will cover a period of eight year (2013 to 2020).

4. A broader approach forward was agreed in Durban at COP 17 as the Durban Platform for Enhanced Action (DPEA). The DPEA aims for a new global agreement on climate change that will be negotiated by 2015 and enter into force in 2020. The DPEA marks a step forward as it will cover all UNFCCC Parties, not just the industrialized countries. The process for negotiating the details of this agreement are being progressed under a subsidiary body to the Convention known as the Ad-hoc Working Group on the Durban Platform for Enhanced Action (ADP). It is currently unclear what the new agreement would include but it may have traded elements like the ones covered under the Kyoto Protocol

5. Under a cap-and-trade system, as foreseen under the Kyoto Protocol, an authority sets a limit on the amount of specific pollutants that may be emitted. The allowed emissions are allocated or sold to enterprises in the form of emissions permits which represent the right to emit a specific volume of a specified pollutant. Enterprises that are over their allowed emissions may buy permits from those which have lowered their emissions below their targets. Any country, even if it has not ratified the Kyoto Protocol or is not an Annex I (or Annex B) country, may implement a cap-and-trade system. Cap-and-trade systems can take various forms: mechanisms such as the EU Emissions Trading System (ETS) are clearly linked to the Kyoto Protocol but other mechanisms may be organised independently from that Protocol. Currently, domestic cap-and-trade systems are being implemented or discussed in the European Union, certain provinces in Canada, certain states in the United States[8], certain cities in China, in Australia, Japan, Kazakhstan, New Zealand, South Korea and Switzerland, amongst others. The basic frame of cap-and-trade systems would generally be similar enough to allow the tax treaty analysis made in Section 3 (with respect to the mechanisms organised by the Kyoto Protocol) to serve as a basis for the tax treaty analysis of all these systems.

---

7. Parties that have agreed to the second phase of the Kyoto Protocol include: EU countries, Australia, Belarus, Croatia, Iceland, Kazakhstan, Liechtenstein, Malta, Monaco, New Zealand, Norway, Switzerland and Ukraine.

8. While the United States never ratified the Kyoto Protocol, many of its states are developing cap-and-trade systems and are initiating a process linking their emissions trading system with other systems within or outside the United States in order to improve the liquidity of the market. For instance, five states in the west of the US started the Western Climate Initiative (WCI) to evaluate and implement ways to reduce their emissions of greenhouse gases. By July 2008, the initiative expanded to two more US states and four Canadian provinces. Amongst others, the WCI was to develop a

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 is foreseen.

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

8. The Clean Development Mechanism (CDM) has been provided to encourage the participation of Non-Annex I countries that are a Party to the Kyoto Protocol[11] in the emission reduction process. Those countries that do not have emissions targets to meet may engage in projects which reduce greenhouse gas emissions and which give rise to Certified Emissions

Supply-side energy efficiency improvements;
Fuel switching projects;
Reduction of industrial and manufacturing emissions (e.g. CO_2 from cement, SF_6 gas from various industrial processes, etc.);
Methane capture and re-use from coal mines, landfills and industrial wastewater;
Afforestation/reforestation.
Carbon capture and storage (CCS).

The CDM can only be effective if it produces credits which represent actual emissions reductions achieved by a project. In this respect, it has appeared that some projects (e.g. large hydro-power projects or coal power projects) would anyway have been undertaken in Non-Annex I countries without the extra-financial support provided by the sale of credits and that some project developers artificially increase the reduction of emissions resulting from a project to get more credits. In both cases, the CDM allows an industrialised country to emit more than its emissions targets without an actual equivalent emissions reduction in a Non-Annex I country. These shortcomings undermine the effectiveness of the CDM.

12. Although Non-Annex I countries in which CDM projects may be carried out include four OECD member countries (Chile, Israel, S. Korea and Mexico), they are for the most part non-OECD economies. Most projects undertaken to date are situated in China, India, Brazil, Mexico, Malaysia, Philippines, Chile and South Korea (in decreasing order). The EU advocates creating a new generation of market-based mechanisms in more advanced developing countries, as a first step towards cap-and-trade systems, and will focus the CDM on Least Developed Countries (LDCs). It should be noted that the use of CERs from new CDM projects to satisfy obligations under the EU ETS is prohibited beyond 2013, unless they are from LDCs or can be swapped for CERs from LDCs.[13] This will exclude CERs from new CDM projects in China, India and Brazil from the EU ETS.

Share of CERs from projects registered and undergoing registration and validation by region as of June 2012[14]

Region	Total	Small scale projects	Large scale projects	Non industrial gas projects	Projects undergoing validation
				3%	5%
				10%	10%
			[illegible]		

Alternatively, the project may be operated by an existing company, a government agency, a

Emission Reduction Purchase Agreement (ERPA) Developer Structure

19. Under the ERPA developer structure, the Annex I entity is also involved in the development and implementation of the CDM project. Unlike the PDA structure, however, the ERPA developer structure does not assign rights to CERs generated by the project to the Annex I entity. The host country entity retains the initial rights to receive CERs generated by the project, and agrees to sell the CERs to the Annex I entity.

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 issued at the moment of the purchase agreement, the agreement involves a forward transaction with a fixed price, a simple index price or an indexed price with a floor and ceiling. The delivery risks which exist before the issuance of the CERs will reduce the price paid for the future CERs. In order to take into consideration the costs paid and the services provided by the Annex I entity in developing the project, the price per CER may be reduced or the Annex I entity may not be required to pay for the first CERs generated by the project up to an agreed volume.

ERPA Offtake Structure

Deleted:

21. Under an ERPA offtake arrangement, a host country project developer exercises responsibility for the design, development and implementation of a CDM project, retains the initial rights to receive CERs generated by the project and agrees to sell the CERs to an Annex I entity which has no involvement in the project other than purchasing the CERs. This structure suits host country entities able to take the CDM project through the whole process. Use of the ERPA offtake structure may help host country project developers to realize the highest price per CER, given that the Annex I country buyer has invested little in the development and implementation of the project.

22. The CDM was originally seen as an instrument with a bilateral character where an entity from an industrialised country invests in a project in a developing country. In practice, however, Annex I country entities seem rather reluctant to invest in CDM projects and have shown a preference to just buy CERs. Thus, there also exist unilateral CDM projects where the project development is exclusively planned and financed within a Non-Annex I country and the project developer in the host country does not sign any ERPA but sells the issued CERs on the open market after carrying out the project,.

C. The Joint Implementation (JI) mechanism defined in Article 6 of the Kyoto Protocol

23. Project participants from Annex I countries may jointly implement an emissions-reducing project in the territory of another Annex I country. To be approved, a JI project must prove that it provides a reduction of greenhouse gas emissions additional to the reductions that would have otherwise occurred. Project participants earn emission reduction units (ERUs) from the emission-reduction or emission-removal project in an Annex I country. Each ERU is equivalent to one tonne of CO_2 and can be counted towards meeting Kyoto Protocol emissions targets.

Where such systems cap absolute emissions, there would be mutual recognition of allowances issued by those systems and the EU ETS (see also Par 7).

29. National and regional emissions trading programmes are typically designed to take into account the CDM and JI.

3. Tax treaty issues related to emissions permits/credits[16]

Metal ore, roasting or sintering installations
Installations for the production of pig iron or steel
Mineral industry
Installations for the production of cement clinker in rotary kilns with a production capacity exceeding 500 tonnes per day
Installations for the manufacture of glass including glass fibre
Installations for the manufacture of ceramic products by firing, in particular roofing tiles, bricks, refractory bricks, tiles, stoneware or porcelain

Other activities
Industrial plants for the production of pulp from timber or other fibrous materials or for the production of paper and board

Air transport.
As from 2013, the scope of the ETS will be extended to other sectors and to greenhouse gases other than carbon dioxide. CO_2 emissions from the production of petrochemicals, ammonia and aluminium will also be included, as well as N_2O emissions from nitric, adipic and glyocalic acid production and perfluorocarbon emissions from the aluminium sector.

32. Emissions permits may be granted for free, sold at a predetermined price or sold at auction.

Under the Australian cap-and-trade

the polluting activities of an enterprise.[22] Under Article 7, business profits are taxable on a residence basis unless the profits are attributable to a permanent establishment (PE) situated in the other Contracting State. According to paragraph 6 of Article 7, where the profits of an

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)

from the grant of emissions permits relating to these activities, are also covered by Article 6[26]. The Commentary on Article 6 of the UN Model does not expressly comment on this issue. Paragraph 8 of that Commentary only mentions that the general rule set forth in paragraph 1 of the Article shall apply regardless of the form in which immovable property is used. Would Article 6 not cover the income from the working of mineral deposits and other natural resources, such business would be carried on through a PE and the income derived from such business, including income derived from the grant of emissions permits, would be attributable are also cov4111.8]Tn.96IB

53

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.

59. 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 certified by the designated operational entity. For a CDM project, the crediting period may be either a 7-year period, renewable twice, or a single 10-year period. The crediting period starts after the date of registration of the relevant CDM project activity.

60 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), emissions credits are not issued in respect of the construction or installation activities themselves but, rather, in respect of the emissions reductions that are achieved once a completed installation or facility is operational. The emission credits are not granted to the enterprise which carries out the construction or installation of the project but to the project manager that invests in and develops the project and that will carry out the activities that result in the reduction or removal of greenhouse gas emissions. In general, income from the grant of emissions credits should therefore not be attributable to a

64. 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 (e.g. an installation) once it is operational. The foreign enterprise provides services to the project with respect to the administrative, technical, environmental and risk aspects of the project.

65. Those services may, however, be performed in the host country through a fixed place of business (e.g. an office at the disposal of the employees of the foreign enterprise at the

system, such activities would not be “auxiliary” or “ancillary” to the operation of aircraft in international traffic even if such enterprise would use the credit received by reason of these projects towards fulfilling part of its emissions obligations relating to the operation of aircraft in international.

it does not appear that the CDM or JI mechanism permit the issuance of emissions 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

reduction measures, an entity may engage in transactions involving the (forward) sale of credits that it expects to be awarded for the emission reductions.

79. Once emission permits/credits have been introduced through a primary market, the efficient functioning of carbon markets depends on the ability to freely trade these permits/credits. This trading occurs in the secondary, or resale, markets. With regard to secondary markets, straightforward purchases and sales of actual emission permits/credits for immediate delivery are likely to be the most prevalent types of transactions. However, some market participants may seek to implement long-term emission reduction strategies or otherwise undertake trades to manage their risk profiles. Secondary trading of permits/credits could occur through two broad channels. First, it could occur on one or more regulated, multilateral exchanges, which are particularly well-suited to standardized transactions. Second, trading could occur directly between two counterparties, potentially intermediated by one or more third parties (over-the-counter (OTC) trading) when participants need more tailored

diversity in practice that has arisen in the absence of authoritative guidance and decided to address the topic in coordination with the FASB (the Financial Accounting Standards Board). In December 2012, as part of its response to the Agenda consultation 2011, the IASB reactivated this project as an IASB-only research project. The project is expected to result in the publication of a Discussion Paper considering the financial reporting consequences of government developed schemes designed to encourage reductions in the production of greenhouse gases, which will include:

- an inventory of trading schemes;
- an analysis of common economic characteristics of those schemes;
- an initial assessment of the potential reporting solutions.

82. The accounting policy selected for the emissions permits/credits might have consequences for the tax treatment of the permits/credits. Each jurisdiction has different requirements relating to the tax treatment of permits/credits. In this respect, the tax treatment may be different from the accounting treatment but it may also simply follow the accounting treatment whatever it may be.

83. It is desirable that countries adopt a similar characterization for emissions permits/credits under their domestic law. The characterization of emissions permits/credits as well as the tax treatment of costs relating to the acquisition of emissions permits/credits (e.g. when the permits/credits are surrendered) could be discussed with other issues (e. g. the tax treatment of penalties in lieu of emission certificates) in the framework of future work on domestic tax measures relating to climate changes.

84. With respect to tax treaties issues, the characterization of emissions permits/credits as “commodities”, "rights", “market titles”, "commercial papers" or “intangible assets” would generally not affect the allocation of the taxing rights of income from the trade of permits/credits.

85. 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 Transport), the income or costs derived from the alienation of these permits/credits should be treated as either business profits/losses dealt with under Article 7 (Business Profits) or capital gains/losses dealt with under Article 13 (Capital Gains), depending on how the income is treated under a Contracting State’s domestic law. In this regard, it should be mentioned that the domestic tax laws of many countries contain no express provision with respect to the treatment of emissions permits/credits. Trading of emission permits/credits can generate income as well as costs or losses. Unless expressly mentioned, the allocation of the costs/losses should mirror the allocation of the taxing rights on the potential income or gains.

86. The possible application of Article 9 (Associated Enterprises), Article 12 (Royalties) or 21 (Other Income) of the UN Model to profits from the trading of permits/credits is also discussed below.

1. Article 7 (Business Profits)

87

All such income falls under Article 7 unless it is specifically dealt with in other provisions of the Model (see paragraph 21 of the Commentary on Article 7 of the UN Model, quoting paragraph 59 of the Commentary on paragraph 7 of Article 7 of the 2008 OECD Model).

88. In most cases, many countries would likely consider income derived from the alienation of emissions permits/credits to be business profits and not gains derived from the alienation of property dealt with under Article 13. This would be the case, for instance, where a country treats emissions permits/credits as commodities and includes income derived from the alienation of such commodities in the operating business income of the selling enterprise. This would also be the case where a country treats emissions permits/credits as financial or intangible assets but includes income derived from the alienation of such assets in the operating business income of the selling enterprise because that enterprise is included within the scope of an emissions trading programme (i.e. is required to surrender emissions permits/credits to cover its emissions). This would also be the case where a country treats income from the alienation of emissions permits/credits that are part of a financial trading portfolio of a bank or other financial intermediary as operating business income.

89. To the extent income from the alienation of emissions permits/credits 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 PE in the other Contracting State.

90. The income derived by an enterprise of a Contracting State from the alienation of an emissions permit directly granted to the enterprise in connection with polluting activities carried out by it through a PE situated in the other Contracting State would generally be attributable, in whole or in part, to that PE. In these cases, the profits derived from the sale of these permits by the enterprise are attributable to the PE even if the PE has not been involved in the sale. Whether income derived by an enterprise of a Contracting State from the alienation

E

102. 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.[37] 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.

103. 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. If a jurisdiction would consider that emissions permits/credits are bound to agriculture or forestry activities having given rise to their distributions and therefore remain taxable in the country where these activities ar

deemed to arise in connection with such transfer, provided that such taxation is in accordance with Article 7.

The taxes on capital gains vary from country to country. In some countries, especially

Gains from the alienation of immovable property referred to in Article 6 (paragraph 1 of Article 13)

115. 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 definition of “immovable property”[43], either on the basis of a State’s domestic law Con134(ccessory) propto9(in)-4mm

118. If, however, the domestic law of a State considers an emissions permit/credit as "immovable property" where it is granted in respect of the ownership of immovable property, it could be argued that the capital gains resulting from the sale of such a permit/credit on the secondary market are covered by paragraph 1 of Article 13 and are taxable in the Contracting State in which the immovable property in respect of which the permit/credit was initially granted is situated. At present, however, no country appears to have endorsed such a characterization under its domestic law. This issue might therefore be purely theoretical. Where a State characterised an emissions permit/credit as immovable property under its domestic law – and, accordingly, under Article 6 – this could result in disagreements as to the proper treaty treatment of the gain from the sale of the permit/credit (see section D, "Timing mismatches and disagreements as to the treaty treatment", below).

119. Such characterization could be regarded as inconsistent with a cap-and-trade system which typically treats emissions permits/credits as fungible instruments. Moreover, the linking of cap-and-trade systems internationally is intended to increase the size of the market and facilitate trading of these commodities, in order to provide cost savings, greater liquidity, reduced price volatility and reduced carbon leakage. This system should not be rendered more complex by requiring the tracing of the relevant "immovable" permits/credits through all their subsequent alienations and the application of a tax regime different from the one otherwise eall(

ltd(t)5.3(y)-6.2n o( )5.9(t)5.3(h)-.3(e)7.8(ce)7.8(a)1.9rbda(t)5.3. Fopr theolf-2.1( )5.9cdert,( )5.9(co)5.5unute thwsol (co)5.

mi-6.2(s(i-6.2onm)6.4sa p)6.4(e-2.8(rm))5.5((t-6.2(/t-6.2/cred)6.4(t(s a85.7(t)6.6("a85.7(i).4mrm))5.5os)-5.3v)6.6xabp)6.2

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.

122

of one system will remain different than the market price of the instruments of the other system until the prices converge after a certain period of trading across the different systems. If governments limit the quantity of permits/credits from another system that can be used to demonstrate compliance in its own system, the price convergence may not be complete.[47] In the absence of price convergence, a specific instrument may have different market prices in different domestic or regional systems. Where such instrument is transferred by an enterprise to an associated enterprise at a certain price, the profits of one associated enterprise may be adjusted by reference to the price and the conditions which would have been obtained between independent enterprises in comparable circumstances (e.g. the intermediary price might be considered as the arm's length price at which independent enterprises would have traded).

133. Where, under an Emission Reduction Purchase Agreement (ERPA), an associated enterprise purchases credits that have not yet been issued at the moment of the purchase, the price of such transaction (fixed price, index price or indexed price with a floor and ceiling) must take into consideration the delivery risks which exist before the issuance of the credits. Under such agreement, the purchasing enterprise may also benefit from a reduced price in order to compensate costs paid or services provided to the selling enterprise in order to develop the CDM project. The OECD Transfer Pricing Guidelines and the United Nations Practical Manual on Transfer Pricing for Developing Countries would provide general guidance to resolve these issues, which are not specific to the transfer of emissions credits/permits.

D. Timing mismatches and disagreements as to the treaty treatment

1. Timing mismatches

134. Timing mismatches may arise, for example, where the State of source (e.g. PE State or State where forestry or agricultural activities are carried on) would recognise income at the time an emissions permit/credit was granted whilst the State of residence would recognise income upon the alienation or use of the permit/credit (or vice versa). Such timing mismatches, however, are rather common and should not result in double taxation as long as the relevant treaty does not limit the obligation of the State of reco0 1. Uni0 (e)2(6nt)-5.9(d)-4.6( ).2(v5.5(0 1. Uni)n)-..2(e

permit/credit is effectively connected with, or forms part of the business property of, a PE in the other State). No difficulties will consequently arise if one Contracting State applies one Article and the other State applies the other Article.

136. Difficulties may, however, arise in some other cases where the State of source and the State of residence apply different treaty provisions to the income derived from the alienation (or grant) of a permit/credit.

Deleted: 21

Disputes as to whether the State of source has taxed an item of income in accordance with the treaty provisions

137. Disputes may arise in the following cases:

Deleted: 22

- one State considers that gains from trading emissions permits/credits are covered by paragraph 1 of Article 13 (because the emissions permits/credits constitute "property accessory to immovable property") and the other State disagrees; or
- one State considers that income or gains from trading emissions permits/credits are covered by Article 8 or paragraph 3 of Article 13 whilst the other State considers that they constitute profits or gains attributable to a PE situated in that other State.

138. 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).

Deleted: 23

Conflicts of qualification

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

Deleted: 24

- 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 domestic law, that profits or gains realized by an NGO or a Government upon the alienation of emissions credits are business income dealt with under Article 7 or gains dealt with under paragraph 2 of Article 13 whilst, under the domestic law of the other State, the income realised upon such alienation is not business income but a gain to which paragraph 6 of Article 13 is applicable; or
- one State, in accordance with its domestic law, treats the income realised by an NGO or a Government upon the issuance of emissions credits as other income to which paragraph 3 of Article 21 is applicable whilst the other State, in accordance with its domestic law, does not recognise income upon the issuance of emission credits but treats the income realised upon their alienation as a gain to which paragraph 6 of Article 13 is applicable.

Deleted: first sale

140. Paragraphs 32.1 through 32.7 of the Commentary on Articles 23 A and 23 B of the OECD Model contain guidance on how relief from double taxation is to be provided under the OECD Model in cases of conflicts of qualification. Where the OECD Model permits the source State to tax an item of income, as the item of income is characterised under the domestic law of the source State, the residence State is obliged under Article 23A or 23B 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. In these situations, the OECD Commentary considers that the State of source has taxed the item of income "in accordance with the provisions of this Convention".

141. The Commentary on Article 23 of the UN Model contains no such guidance. During the seventh meeting of the Committee of Experts on international cooperation in tax matters, there was no consensus with respect to the opportunity for the UN Model to endorse the OECD Commentary on conflicts of qualification. Due to lack of time, it was decided not to cover this issue in the 2011 version of the UN Model but to include it in the catalogue of items for future discussion and work. If the State of residence were to disagree with the guidance found in the OECD Commentary on how relief from double taxation is to be provided in a case where there is a conflict of qualification, the case would need to be resolved under Article 25 (Mutual Agreement Procedure) or the affected taxpayer would have to pursue judicial or administrative remedies in the State of residence.

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

Granting of emissions permits

142. 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 I countries are therefore not expected to implement national emissions trading programmes and to grant emissions permits pursuant to such programmes. After 2020, however, some countries in transition could become Annex I countries to which the Kyoto Protocol's cap-and-trade system would apply (see also Par 130).

143. At present, an enterprise carried on by a resident of a Non-Annex I country could, however, exercise activities in an Annex I country that are covered by an emissions trading programme (i.e. that would require the enterprise to surrender emissions permit granted by a

.502ec .502ece tondc( )5.9(u0 g -th)-5orliy to c omptly i-th bptig(.50h9ui)5 [(.5is)-4.9( )5.9ui5.8(d)-5(e)-2.8or tatp.7(to)-4
u(ch)589(a c)-6.1raeinceme that sa coesidentisstriosrio is antdsor (is)-41(is)-41(un)16(tds)-4.2( )]TJ -18.1387 -1.1451 T
pe a PEm or t enterprihe the ni .5(e)-2.8(x Icso)-5(n(try)5(;( )]TJ/TT112 1 Tf -150
dheAE coun65.6(t64.4(r)32(y;g)6.4(r).9( )]TJ/TT112 1 Tf -150015 -1.1451 TD 0 Tc
niexitryi mis,(howe)-89(v)-.5(e,o)-15( )5.9ovey unithm3071(t( )5.9(w)-5.2(o1.5(u)5
trd im96(m96ovettbleA5.6(ep()5.8)(25)-4(o)5e8(p)6(e(m)s)5.8(1.5)5.8(n)25.8(1.0)(t)62

144. An enterprise that is engaged in the operation of aircraft in international transport and which has its place of effective management in a Non-Annex I country (or is a resident of a Non-Annex I country) may be granted emissions permits by an Annex I country with respect to aircraft emissions in that Annex I country.[48] Any income considered to be derived from such granting of permits would be taxable exclusively in the Non-Annex I country in which the enterprise's place of effective management was situated.

145

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.

159. 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.

Deleted: 44

160. Profits or gains from subsequent sales by an 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 the "overall net profits" from the operation of ships in international traffic.

Deleted: 45

****