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1. Tax Treatment of the Emissions Permit Trade

1.1 Introduction

1. This section of the note provides options for consideration by the Committee on the taxation of income from emissions permit trading. A brief description of emissions permitting schemes is first explored, followed by an examination of potentially applicable articles to this income. Finally, several general principles of international taxation are applied to potential classifications of emissions trading income. The note concludes with a summary of recommendations for the Committee to consider.

1.2 Emissions permitting schemes in the context of international agreement

2. Linked to the United Nations Framework Convention on Climate Change (UNFCCC), the Kyoto Protocol set binding emissions reduction targets for 37 countries and established three market based mechanisms to stimulate efficient solutions in reducing greenhouse gas (GHG) emissions:[2] (1) the Clean Development Mechanism (CDM), whereby signatory countries can implement emission-reducing projects *in developing countries* and receive certified emission reduction (CER) credits to meet their commitments;[3] (2) Joint Implementation (JI), whereby participating countries can implement emission-reducing projects *in other signatory countries* and receive emission reduction units (ERUs) to meet their commitments;[4] and (3) Emissions Trading whereby countries with excess emissions allowances, that is, more reductions in emissions than their binding targets, may sell these excess allowances or permits as tradable commodities.[5]

1.3 Emissions permit trading

[2] See UNFCCC, “Kyoto Protocol”, http://unfccc.int/kyoto_protocol/items/2830.php.
[3] See Article 12 of the Kyoto Protocol.
[4] See Article 6 of the Kyoto Protocol.
[5] See Article 17 of the Kyoto Protocol. “[A] new commodity was created in the form of emission reductions or

"nitrous oxide emissions from certain processes."[9] Airlines arriving and departing from EU airports will also be covered as of 2012.[10]

banking system which keeps track of the ownership of money in accounts but does not track the deals made in the goods and services markets which were the cause of the

work will most likely be finished, to begin work on addressing the issues for countries following the UN Model. If the OECD conclusions are agreed with, that will, of course give extra international currency to those conclusions.

TABLE 1

POTENTIAL TAX T

** There will be differences in the application of these distributive rules in particular situations, especially where there is a reference back to domestic definitions, but the purpose of this table is to highlight more fundamental differences in the potential operation of applicable Articles under both Models.*

1.6 Article 7: Business Profits

9. Countries will often consider emissions trading income as Article 7 “Business Profits” under applicable DTAs, which are taxed on a net-basis in the State of residence unless the taxpayer has a permanent establishment in the so

(d) This omission of the delivery exception, however, can also affect classification of an agent as a dependent agent (and thus create a permanent establishment) if the agent maintains stock for delivery (Article 5(b)).

(e) Finally, the UN Model provides that if an insurance agent collects premiums in a host country or insures risks in the host country, a permanent establishment is deemed to exist (Article 5(6)).

11. These expansions of the rule potentially allocate more source country taxation rights to the business profits connected to the permanent establishment. The limited force of attraction rule in Article 7, however, broadens the source country taxation rights further beyond the strict permanent establishment criteria to cover some other profits derived in the host country.

1.6.2 The UN Model's limited force of attraction rule

12. Unlike the OECD Model, Article 7 of the UN Model gives source country taxing rights to profits not only attributable to a permanent establishment, but also to sales of goods or other business activities carried on in the host country that are "of the same or similar kind" as through the permanent establishment (Article 7(1)(a)-(b)). This means that as long as the profits are derived from sales of the same or similar goods or from the same or similar business activities as those effected through the permanent establishment, they may be taxed by the source State as well.

13. In practice, however, this "limited force of attraction" rule is rarely adopted in DTAs, minimizing the overall difference in the UN and OECD Model PE rules. Where adopted in DTAs and supported by domestic legislation, it does not necessarily indicate any deep disagreement with the PE concept but may be an attempt to deal with the practical difficulties of tracing back sales to PEs.

1.6.3 How the UN Model's more expansive definition could specifically affect taxation of emissions trading profits

14. In the context of emissions trading profits, only the broader UN Model source taxation rights in relation to items (a) construction sites; and (b) services appear potentially relevant to the permanent establishment determination. Consider the following scenarios:

Case 1: *Construction site in Country A supervised by SteelBuilders, Inc., residents of Country B for A-Co. based in Country A. Project contract requires SteelBuilders, Inc. to secure all permits for construction on its own account. The project duration is 6 months, deforests 100 acres, and creates greenhouse gas GHG emissions from steel welding,*[27] *requiring a permit from Country A, which*

[27] "Gas phase pollutants are also generated during welding operations . . . . Known gaseous pollutants (including "greenhouse" gases) include carbon dioxide (CO2), carbon monoxide (CO), nitrogen oxides (NOx), and ozone (O3)." See U.S. ENVT'L PROTECTION AGENCY, WELDING EMISSIONS FACTORS (AP-42), *available at* http://wwNS

SteelBuilders, Inc. obtains. Construction is completed in 6 months after which SteelBuilders, Inc. leaves Country A and returns to residence country B. SteelBuilders, Inc. then sells the permit. Which country should have the right to tax the profit from the emissions permit trade?

Under the UN Model, a permanent establishment exists because the construction site is active for 6 months and also because SteelBuilders, Inc. provides supervisory services for 6-months within a 12-month period. All profits connected with the services, including the emissions permit trading profits are taxable by the host country.

Now assume while SteelBuilders, Inc. is selling its permit (and is deemed to have a permanent establishment through it construction supervisory services), it also invests in other emissions trading permits on the secondary market and makes a profit. The source country would also have the right to tax these profits as well due to the limited force of attraction rule; the business activity of investing in emissions permits is the same or similar to the buying and selling of a permit through the permanent establishment.

Case 2: *Rubber Co., headquartered in Country B, has a rubber processing plant in Country A that emits GHGs for which it is required to obtain a permit from Country A. Rubber Co. has a permanent establishment in Country A and profits derived from its rubber processing are taxable by Country A. Assume Rubber Co. sells unneeded emissions permits and also invests in other emissions trading permits on the secondary market and makes a profit. The source country would also have the right to tax these profits as well due to the limited force of attraction rule; the business activity of investing in emissions permits is the same or similar to the buying and selling of a permit through the permanent establishment.*

15. Although Case 1 is remotely plausible, more often than not, Case 2 is more likely to occur. It is improbable that a construction activity or other similar service -- standing alone -- would require an emissions permit from regulatory authorities. The provision of services, such as transport, however, could conceivably require a permit from a foreign service provider when cross-border trucking is involved.[28] Thus, Case 1 cannot entirely be discounted and Case 2 remains the more likely scenario.

16. In sum, under the UN Model, there are two possible scenarios for

Or:

(1) the first activity constituting a permanent establishment must require an emissions permit from host country which is then sold; and

(2) the other "attracted activities" of secondary investing in emissions permits must take place in the host country.

17. Unlike the OECD Model, the UN Model creates a greater potential for source country taxation of emissions trading income under Article 7 because of the "limited force of attraction rule" and a more expansive definition of permanent establishment in Article 5. In practice, however, the result will usually be the same under the business profits articles of both the UN and OECD Models because the "limited force of attraction" provision is relatively rare in practice, and as it only extends to "business activities "carried on in a state" of a "same or similar kind" as those effected through a permanent establishment.

- *Recommendation: The Committee may wish to consider whether and in which instances profits from emissions trading would fall under Article 7 or to at least note differing interpretations and possible bases for further clarification during negotiations or in Competent Authority discussions.*

1.6.4 Other articles take precedence over business profits

18. Even if emissions trading profits are generally considered business profits, however, other articles of the Model Conventions may apply instead of Article 7. Under both Models, where there are items of income which are dealt with separately in other Articles, the provisions of those Articles effectively take precedence. Paragraph 6 of Article 7 currently achieves this in the UN Model.

1.7 Article 13: Capital Gains

19. The issue then arises of whether Countries might treat emissions trading income as capital gains under Article 13 which provides that "gains from the alienation of any property" are taxed in the residence State of the alienator *unless*:

(1) the gain is derived from the alienation of **immovable property** located in the source State (in which case Article 6 is relevant as discussed below); or

(2) the gain is derived from the alienation of movable property, which is a part of the taxpayer's **PE or fixed base**[29] located in the source State; or

(3) the gain is derived 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, aircrafts, or boats and the source State is the place of effective management of such enterprise (in which case Article 8 is relevant as discussed below); or

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[29] The OECD Model Convention does not use "fixed base" terminology due to the deletion of Article 14 and only uses "permanent establishment" terminology. See Para. 1.1 of the Commentary on Article 5, MODEL TAX CONVENTION ON INCOME AND CAPITAL (2010).

(4) the gain is derived from the **alienation of shares**/interests of a company/ partnership/ trust/ estate **constituted principally** (more than 50%) **by immovable property** located in the source State; or
(5) the gain is derived from the **alienation of** a bilaterally negotiated percentage of **shares**/ interests of a **company which is a resident** of the source State.[30]

1.7.1 The Meaning of "Property"

20. Because Article 13(6) of the UN Model and 13(5) of the OECD Model are "residual" clauses, that is, they apply to "gains from the alienation of *any property*" not referred to in the previous clauses, it is necessary to first clarify the meaning of "property". Although

treaties. Because the term "immovable property" is only partially defined under the UN and OECD Models, the rest of the definition depends on relevant domestic law concepts when referenced in the DTAs. There are myriad domestic laws classifying "immovable property" and many include intangible rights related to the property, such as rights related to natural resources like fishing or agriculture, as illustrated below in Table 2. There are no doubt many other instances. Further, many countries have made special reservations in the OECD Model Treaty to preserve taxation rights over intangible rights in immovable property, as shown in Table 3. These designations are also indicated in DTAs, as illustrated in the footnotes to Tables 2 and 3. The OECD Paper notes that "[t]he examination of the tax treatment of emissions permits in various jurisdictions has not identified any jurisdictions which would consider an emissions permit "immovable property"[33], but it is by no means certain that this situation will continue.

25. Note that in the Table 2, Turkey and Pakistan include ships, vehicles, and aircraft as "immovable" property in their domestic laws but in recent DTAs, both countries follow the UN and OECD Models and provide that immovable property *does not* include "ships, boats, and aircraft." However, because these countries also reference domestic law meanings of immovable property in recent DTAs and both countries include "vehicles" in their domestic law definitions of immovable property, this diversity of tax treatment could result in unintended instances of double taxation.

TABLE 2

EXAMPLES OF "IMMOVABLE P

		taxation
Mauritius	Trusts Act (2001)	rights and interests in any immovable property
Pakistan	Income Tax Ordinance (2001)	machinery or plant; "plant" includes ships, aircraft and vehicles registered in Pakistan[34]
Turkey	Income Tax Law (GVK)	income from the leasing of real property; income derived from copyrights (royalties), ships or an interest therein; vehicles and machinery, estates in mortmain and the leasing of such rights as patents, trademarks, films, etc., and know-how[35]

TABLE 3

EXAMPLES OF "IMMOVABLE PROPERTY" RESERVATIONS IN THE OECD MODEL[36]

Country	***Reservation***
Australia	reserves the right to include rights relating to all natural resources[37]
Finland	reserves the right to tax income of shareholders in Finnish companies from the direct use, letting, or use in any other form of the right to enjoyment of immovable property situated in Finland and held by the company, where such right is based on the ownership of shares or other corporate rights in the company[38]

[34] Pakistan does not include this definition in certain recent DTAs but instead follows the UN/OECD Model with the phrase: "ships, boats, and aircraft shall not be regarded as 'immovable property'". See, e.g., AUSTRIA-PAKISTAN INCOME TAX TREATY (2005); PAKISTAN-YEMEN INCOME TAX TREATY (2004); PAKISTAN-SYRIA INCOME TAX TREATY (2001).

[35] In certain recents DTAs, Turkey follows the UN/OECD Model with the phrase: "ships, boats, and aircraft shall not be regarded as 'immovable property'". See, e.g., Se , d U

Mexico	reserves the right to treat as immovable property any right that allows the use or enjoyment of immovable property situated in a contracting state where the use or enjoyment relates to time-sharing[39]
New Zealand	reserves the right to include fishing and rights relating to all natural resources[40]
Spain	reserves its right to tax income from any form of use of a right to enjoyment of immovable property situated in Spain when such right derives from the holding of shares or other corporate rights in the company owning the property[41]

1.8.2 Can the "immovable property" classification rule adapt to coverage of transportation sector emissions?

26. Currently, suppliers of transport fuels are covered under the New Zealand Emissions Trading Scheme[42] and as of 2012, the EU Emissions Trading Scheme will cover the aviation sector.[43] Can these emissions permits for traditionally "movable" economic activities be classified as immovable property or would another treatment of these emissions be required, say for example, under Article 8: Shipping, Inland Waterways Transport and Air Transport?

1.8.3 Can emissions permits be traced through the carbon market?

27. Another related issue concerning the classification of trading income as immovable property is one of tracing. Can the underlying "immovable property" trait be traced through the carbon market? There is evidence of some amount of tracing income derived from immovable property from company to shareholders. For example, France considers shareholder income (and this includes income from the sale of shares) derived from their corporation's use of immovable property within the respective country to be covered by Article 6 and has also reserved this right within the OECD Model Convention.[44] Thus, if the shareholder is analogised to the permit

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income from the direct use, letting, or use in any other form of such right to enjoyment may be taxed in the Contracting State in which the immovable property is situated.

See, e.g., Finland-India Income Tax Treaty (2010); Finland-Moldova Income Tax Treaty (2008); Finland-Slovenia Income Tax Treaty (2003).

[39] Despite its Reservation in the OECD Model, Mexico largely follows the UN/OECD Model Article 6. See, e.g., Mexico-Russia Income Tax Treaty (2004); Brazil-Mexico Income Tax Treaty (2003); Barbados-Mexico Income Tax Treaty (2008).

[40] New Zealand specifically includes incom Tceeer2(e,0 TD[-.1-.0Tw(d by A7[(New Z.5(m)3.ws th)-(es ttry, (sp)-475(erighp)-475.6(v

buyer, who invests in the emissions permit just as he or she would in stock, the immovable property trait might be traced through the carbon market, and the income from the trade may be taxed by the source State.

28. Just as shares may be linked to the underlying immovable property without impairing their fungibility, so too, may emissions permits. Linking the emissions permit to an installation would be a simple administrative function of retaining a trait already recorded and maintained by electronic registries. There are some cases, however, where the permit may have never been linked to an installation, such as when a government does not allocate all of its allowances under international agreement and instead, sells them on the market, or where the initial allocation may be to a typically "movable" installation such as an aircraft, or where an investor trades the permits as she would any other commodity with no intent of using it as a license to pollute. These instances would create a distinction in classification of income from emissions trading under DTA's -- where some permits may be treated under Article 6 and others under Article 8 and possibly others under Articles 7 or 13, but it would not create an obstacle to trade as the OECD Paper suggests.[45] Uniform treatment of the income resulting from trade of all emissions permits may be a blunt instrument to ensure efficiency and might ignore the distinct characteristics of each type of permit.

29. Ultimately, however, the answer to the tracing question seems to be that to the extent the permit remains "immovable property" under the domestic law and therefore the treaty; the only real issue is the *situs* one mentioned above, because the tracing issue does not "trump" or override the domestic law status as immovable property. However, the Committee may wish to provide guidance on whether and in what circumstances the emissions permit may be linked to the underlying property.

- Ø *Recommendation: The Committee may wish to consider whether and in which instances income from emissions trading would fall under Article 6 or at least note differing interpretations and possible bases for further clarification during negotiations or in*

(b) if the domestic law was not considered relevant since it was not the domestic law of the country in which the property in question is situated because the internationally traded permit should not be treated as situated in the country that issued the permit.

31. While in the case of (i) it is not a step lightly to be undertaken to treat the recourse to domestic law contemplated by the Article as a departure from good faith application of the treaty, the second argument is perhaps a more pertinent one in most cases. Even there, it might be difficult to show an accepted international mean

harbor, or the resident State of the operator, if no such home harbor. If the profits arise from participation in a pool, joint business, or international operating agency, the profits are taxable in the State of effective management of the enterprise.

35. Alternative B of the UN Model, however, restricts application of the first provision to only aircraft and includes an additional provision, which applies to profits from the operation of ships in international traffic. Article 8(2) (alt B) provides that these profits are taxable in the State of effective management "unless the shipping activities arising from such operation in the other Contracting State are more than casual" in which case the profits may be taxed in that other State, determined by an allocation of the overall profits, which are then reduced by a negotiated percentage. The commentary to the UN Model also provides that "more than casual" refers to "a scheduled or planned visit of a ship to a particular country to pick up freight or passengers."[47]

1.9.1 ETS coverage of aircraft and ships operating in international traffic

36. It is highly plausible that aircraft and ships operating in international traffic could be covered under an emissions trading scheme. As noted in para. 5(a), the EU ETS will cover air transport arriving in and departing from EU airports in 2012. Under this scheme, airlines will be required to operate within the amount of emissions allowances allocated to them.[48] If these airlines sell unused permits, the income from this sale will have both domestic and international tax consequences. The international tax consequence under the UN Model treaty may be that these profits are classified as profits from the operation of ships or aircraft in international traffic and thus, are taxable in the State of effective management. A country may claim that such profits should be treated under Article 13(3). However, the result would be the same under both provisions; the income from the alienation of the permits would be taxable in the State of effective management.

37. Under the UN Model, when shipping activities are "more than casual", the effect of Alternative B of Article 8(2) on the income from emissions trading would be treated similarly as other profits from the operation of ships or aircraft in international traffic. There may, however be an ambiguity in allocation of the overall profits from the alienation of emissions permits depending upon the chosen metric used to allocate profits from the sale. If the profits are allocated to the country that issued the emissions permit, the assignment would be more straightforward. However, some countries might choose to allocate the profits from the sale based on other factors. Therefore, the Committee may wish to give guidance on the allocation metric under Alternative B of Article 8(2) in its overall consideration of the application of Article 8 to the income from emissions trading.

- *Recommendation: The Committee may wish to consider whether and in which instances income from emissions trading would fall under Article 8, and also specifically under Alternative B of Article 8(2) or at least note differing interpretations and possible bases for further clarification during negotiations or in Competent Authority discussions.*

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[47] See Para. 13 of the Commentary on Art. 8.
[48] See *Reducing emissions from the aviation sector,* http://ec.europa.eu/clima/policies/transport/aviation/index_en.htm.

1.10 Article 12: Royalties

gains realized on the repayment of debts denominated in foreign currencies.[51] The Technical Explanation to the US Model Treaty provides that Article 21 can include "income from a variety of financial transactions, where such income does not arise in the course of the conduct of a trade or business".[52]

1.11.2 Classification of the Emissions Permit as "property"

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45. If emissions trading income represents a type of financial instrument not dealt with under other Model Articles, it is at least plausible this income could fall under Article 21. If classified as such, the taxation result may differ depending on which Model is employed. The contrary view, however, is that because income from the alienation of an emissions permit constitutes income from "property", and it is not dealt with under Article 7: Business Profits, or Article 6: Immovable Property; or Article 8: Shipping, Inland Waterways Transport and Air Transport, it is "swept up" by either Article 13(6) of the UN Model, or Article 13(5) of the OECD Model and as a result is taxable only by the residence State.[53] ough Transp9.43riety

- The issuing country may not be the country in which the permit is traded nor the residence of the permit holder. For example, although South Africa may issue an emissions permit to a non-resident polluter, that polluter may sell the emissions permit on an exchange in India. Where should this trading income be regarded as sourced?

- Can the taxation right of the issuing country be traced through the carbon market or should the taxation right depend on the country of exchange or residence of the alienator? A polluter could sell a permit issued by the EU on an EU exchange but the permit could then be sold again by a trader who is a resident of Ghana on an exchange in Brazil. Where should the income from this secondary trade be regarded as sourced?

48. Article 3(2) of both Models allows domestic law to determine the meaning of undefined terms within the DTA (unless the context otherwise requires). Conflicting domestic law meanings, however, create issues of qualification, which are dealt with under Article 23 as discussed above in section 1.8.5. In order to minimize these conflicts, the Committee may wish to provide guidance as to the appropriate sourcing rule for emissions permit trading income.

Ø *Recommendation: The Committee may wish to consider clarification of the operation of Article 21 in relation to emissions trading permits including in relation to the sourcing issues previously noted or at least note differing interpretations and possible bases for further clarification during negotiations or in Competent Authority discussions.*

1.11.4 Wide acceptance of both Models' Article 21

49. Both Models find wide acceptance in international practice, so this is a significant area of difference. Australia, Canada, Chile, Mexico, New Zealand, Portugal and the Slovak Republic have reservations in the OECD Model Convention maintaining the right to tax "other income" arising from sources in their own country.[55]w[(on.8(mincm1.1inc-6)-ii)-6.7sance oin thw[(on.8(mincm-6) thsh to
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where the other country has taxed in accordance with the treaty. While there is a risk of double taxation, which can hopefully be avoided, the source State cannot be expected to yield its position in the MAP *merely* because of that possibility.

1.12 General principles for consideration

51. In addition to examining potential Articles that may be applied to the taxation of income from emissions permit trading, there are several general principles that are relevant in this context. They include: the source principle, the base erosion principle, the threshold principle, the enforcement principle, the consistency principle, and the net-basis taxation principle.[56]

1.12.1 Source principle

52. The source principle upholds the right of the country where an income-generating activity or property is located to levy a tax on that income, even if the activity/property is conducted or held by a non-resident. This principle recognizes the contribution of the source State in enabling and hosting the income producing activity or property and requires a share of the fruits of the investment. The source principle is most notably reflected in Article 6: Immovable Property and is also evident in many of the Articles addressing the taxation of services[57] but the source principle is becoming more evident in DTAs as developing countries enter into new treaty partnerships.[58]

53. Because emissions permits are issued by governments based on actual greenhouse gas emissions in a country and may be part of a country's total allowed emissions under international agreement[59], the source principle would recognize a right to tax the income from alienation of such permits. Further, the enabling of the host country in maintaining emissions permit registries and the facilitation of environmental and financial monitoring activities also requires a share of the income from the permit trade.

1.12.2 Base erosion principle

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55. Depending on the domestic tax treatment of emissions permits, i.e. whether the permit is acquired in connection with a trade or business, or whether the permit was issued by the government freely or by auction, the cost of acquiring these permits may or may not be considered a deductible expense. Thus, the base erosion principle, in economic terms, may not be relevant and the income generated by such trades may not need to be taxed for this reason.

56. In environmental terms, however, the base erosion principle can apply to ameliorate the outflow of emission permits allowed to a country under international agreement. Through the Clean Development Mechanism and Joint Implementation systems under the Kyoto Protocol, offset credits can be earned by implementing emissions lowering projects in other countries. Taxing the income from a trade of a government-issued emissions permit by a non-resident taxpayer brings revenue back into the country which can be used for other investments to compensate for the outflow of the emissions permit.

1.12.3 Threshold principle

57. Threshold requirements under the UN Model are common: the permanent establishment rules under Article 5, along with the 183-day requirement for independent and dependent personal services in Articles 14 and 15 are notable examples. These requirements are established to prevent *de minimis* activities from being taxed in a source State and also serve goals of administrability.

58. In the case of emissions permit trading, a threshold requirement may not be as necessary to ease the administration of taxing the income from the trade. Countries with emissions permitting schemes maintain electronic registries to account for issued permits and thus, can easily tax the transactions.[60] Moreover, because the "source" of the trade income could either be the issuing State, or the State in which the exchange occurs, it is plausible that the trade is sufficiently facilitated by the commercial infrastructure of the source State.

1.12.4 Enforcement principle

59. The enforcement principle requires that only those taxation rights which can realistically be enforced should be allocated under DTAs. This principle does not mean that countries with capacity constraints should not have taxation rights but recognizes that some taxes are inherently difficult to collect, such as taxes on income from services performed outside of the country by non-residents.[61]

60. As noted above in para. 53 above, national registries that account for issued permits and transfers in ownership could plausibly also account for taxes on the income from transactions of the permits. Although there exist technological capacity constraints in many developing

[60] *See* New Zealand Emission Unit Register, *available at* http://www.eur.govt.nz/. Information on the registries within the European Union are available at http://ec.europa.eu/clima/policies/ets/registries_en.htm.
[61] See *supra* note 56 at § 3.1.6.

countries, it is foreseeable that these constraints will be overcome in the future through greater international cooperation.

1.12.5 Consistency principle

61. The consistency principle broadly implies that like economic activities should incur similar tax treatment. Where there are marked differences in characteristics of the economic activities, however, divergence from the norm may be justified. In

interpretations and possible bases for further clarification during negotiations or in Competent Authority discussions.

(c) **Dividends**: According to Article 10 of the UN Model, dividends may be taxed by the residence country of the beneficiary but the source country may also tax these payments up to an agreed percentage. On the other hand, the OECD Model limits source country taxation to 15% and 5% for holders of 25% or more of the company shares, reasoning that "[a] higher rate could hardly be justified since the State of source can already tax the company's income."[66] The OECD Model Commentary also states:

> [T]axation of dividends exclusively in the State of the beneficiary's residence is not feasible as a general rule. It would be more in keeping with the nature of dividends, which are investment income, but it would be unrealistic to suppose that there is any prospect of it being agreed that all taxation of dividends at the source should be relinquished.[67]

62. In comparison to corporate stock, dividends, and income from derivatives contracts, emissions permits are similar because they represent intangible financial rights that are highly mobile. Taxation of emissions permit trading income based on residence reflects that income from these financial instruments is income from a capital investment. Therefore, it is arguable on this approach that taxation based solely on source could impede the free flow of capital. This view of permit trading income would favor residence State tax treatment.

63. Because the permits are issued by governments based on actual greenhouse gas emissions in a country and may be part of a country's total allowed emissions under international agreement, however, the source country may possess a stronger tie to the income from trading. This is more true than in the case of corporate stock or derivatives because corporate stock and derivatives are privately issued financial instruments while emissions permits are regulatory instruments (albeit privately bought and sold) created and issued by the State. Thus, due to its hybrid nature, emissions permit trading income arguably has a stronger tie to the source State than other financial instruments dealt with in the UN and OECD Model Conventions.

- *Recommendation: The Committee may wish to consider these **general principles** in determining the Article(s) to which income from emissions permit trading applies and in what circumstances or to at least note differing interpretations and possible bases for further clarification during negotiations or in Competent Authority discussions.*

1.13 Summary of recommendations

- *Recommendation: The Committee may wish to consider whether and in which instances profits from emissions trading would fall under **Article 7: Business Profits** or at least note differing interpretations and possible bases for further clarification during negotiations or in Competent Authority discussions.*

- Ø *Recommendation: The Committee may wish to consider whether and in which instances income from emissions trading would fall under* ***Article 13: Capital Gains*** *or at least note differing interpretations and possible bases for further clarification during negotiations or in Competent Authority discussions.*

- Ø *Recommendation: The Committee may wish to consider whether and in which instances income from emissions trading would fall under*

2. Environmental Taxation Policies to Address Climate Change