

Report on the proceedings of the Seminar B

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Seminar B: International tax aspects of trading in emission allowances

The seminar was organized following an unusual format whereby an introductory lecture was followed by the panel discussion and interventions from the floor.

The emphasis of the seminar is on trading of emission allowances and finding solutions to the issue of reducing overall trading costs including taxes. It can be debated whether emission allowances trigger wholly new tax questions. This is in any event a global issue, the Chair argued, and calls for some drastic rethinking on how to tackle the issue. Traditional tax issues are in fact intertwined with new and yet unaddressed issues.

To date, the Chair explained, one hundred and sixty-five countries have ratified the Kyoto Protocol on emission trading. As of the date of the seminar, thirty-five countries and the EU Member States (MS) are required to reduce emissions of green-house gases below specified levels for an overall reduction of at least five percent from 1990 in the commitment period 2008-2012. EU MS have issued emission trading schemes specific to some industries since 2005.

Emission trading schemes pre-existed the Kyoto-related schemes in some jurisdictions such as the US. Some were known as “cap-and-trade” programs, used to allocate a required reduction as cost efficient as possible among participants, leaving the market to “decide” the parties that have to reduce emissions. Sweden was one of the first countries to introduce taxes on emissions. Taxes aim at increasing the cost of creating negative externalities in order to curb them. Price plays a key role in allocating allowances. With price increases parties may find it too expensive to buy emission rights, effectively being forced to reduce emissions. Taxes or tradeable quotas have similar goals, tradeable quotas arguably being the most cost-efficient system to curb emissions, however.

The Chair discussed a series of cases where companies are engaged in transactions with related and unrelated parties, involving emission allowances. It is in particular important to recognize that in case a company is allocated emission allowances and decides not to use them directly but to transfer them to an affiliated company, the transfer may constitute a taxable event. There is also a transfer pricing issue to be addressed in that case. Ultimately it is a decisional process whereby groups should deliberate on where to pollute and produce negative externalities and where to use the emission allowances. Tax rates differentials play an important role in this decisional process, but ultimately if distortions are generated because of the possibility to arbitrage, there might be a negative impact on the viability and effects of the trading schemes. That is the reason why taxation of emission rights should be structured in a tax-neutral way.

Indirect tax issues, alongside with accounting and classification issues do constitute additional aspects that deserve utmost attention.

The Chair argued that a single price constitute the cornerstone for an efficient system for emission rights trading. A global problem calls for a global solution. This proposition calls into

question some of the analyses that are currently conducted in the area of corporate taxation with reference to emission allowances. Possibly introducing a common objective also in the area of taxes would allow the optimum redistribution of resources, not hindering the common objective under emission allowances trading schemes, which is the reduction of greenhouse gases or pollutants in general.

In addition, the 'OECD framework' on emission allowances has proven insufficient in establishing one single price, but at the same time it calls into question what is being done in other areas. There should henceforth be a strive for a balance between economic efficiencies in a larger context and efficient allocation of resources also in the tax arena. Obstacles to establishing this one price of emission allowances are caused not only by direct but also by indirect taxes.

One of the panellist, the representative of the EU, interjected and clarified that work has been conducted in the indirect tax area: one of the questions that should be asked is whether indirect taxes on energy should be abolished altogether, in fact. Here the issue is the overlapping concerns between energy policy and environmental policy. Introducing incentives for greener fuels, such as natural gas, may also imply that countries find themselves locked into a position of being completely or overwhelmingly dependant on only one source of energy. Ultimately there is a trade-off between energy and environmental policy choices. In addition, as to the ideal situation of one instrument across the board with one price in relation to emission trading schemes, this may be applicable and achievable in a situation where there is small number of large emitters such as the manufacturing industry. On the other hand, with a large number of small emitters such as in the case of transport, imposing taxes on negative externalities may be the best solution or at least the most practicable.

It was pointed out that probably the one of the main problems is that not all countries adhere to emission allowances trading schemes. This creates imbalances and distortions. It is not necessarily proven, in fact, that emission trading follows tax arbitrage opportunities.

The Chair pointed out how classifications problems may further constitute an obstacle in determining the correct tax treatment. As one of the panellists commented, the current definition and classification of emission allowances under the Kyoto Protocol does not shed light on the right classification from a tax perspective. If for instance the emission allowances were classified as property rights (the UK and Hungary would probably follow this approach), this would contribute in determining the correct tax treatment and in providing certainty in the application of protective measures applicable to property rights in general. The US, however, treats emission allowances in a dual manner: the Clean Air Act for instance clearly states that emission allowances are not property rights between private parties and the US Government. US courts have already characterized emission allowances as property rights in arrangements between private parties, however. Ultimately, it was argued that, although a uniform classification from a civil law or contract law perspective would help in determining the correct tax treatment, this is not strictly necessary as long as accounting issues are uniformly address. In many countries, in fact, tax rules are linked to accounting rules. The IASB, under the cap-and-trade system, had issued accounting guidance – later withdrawn – on emission allowances. The withdrawn guidance established, under IAS 38, that emission allowances were to be accounted as intangible assets (government grants under IAS 20) and IAS 37 provisions for contingent liabilities and contingent assets would have been used. Currently, guidance is dearly needed as, for instance, in the UK alone at least fifteen different accounting approaches to emission allowances are reported. The IASB together with the FASB are working on the topic to issue joint guidance on the issue and a final position was to be expected by the end of 2007.

Domestic legislation also lacks clarity: the only country having issued guidance being the Netherlands. The panellist argued that a dual accounting treatment would be preferable for emission allowances: according to the hybrid system proposed during a 2004 seminar in the UK, treatment of emission allowances would depend on the usage for the allowance. Companies holding the allowances for compliance purposes would account for the allowances as intangible assets. Companies holding them for trading purposes should account for them as inventory, so no special treatment would be applicable.

Another panellist interjected by saying that, while common accounting (and civil law) standards would help in shaping the correct tax treatment, in his opinion the most appropriate approach is the acquisition cost model, however.

The Brazilian panellist explained how in Brazil, although no specific accounting guidance exists, the company that issues emission allowances for future reduction of emissions must treat them as deferred revenue, which will be allocated to the profit and loss statement insofar the reduction actually takes place. In general emission allowances are considered as current intangible assets, i.e. only for trading purposes, in absence of an imposition onto Brazilian companies to curb emissions.

In Canada the legal character is rather uncertain. Although Canada is a signatory to the Kyoto Protocol, a different system is being implemented, a panellist said, which is actually a plethora of similar systems that do not only address carbon dioxide but also other pollutants, in gas, liquid or solid form. Accounting standards in Canada are followed extensively for tax purposes, but accounting does not necessarily determine taxable income: the fundamental question is to characterize legal- and accounting-wise the emission allowances when are issued, when are bought/transferred, when they expire, when they are 'consumed'.

The Chair concluded that accounting rules do not appear to establish a level-playing field across countries. He then addressed the tax treatment from a direct taxation standpoint.

The domestic tax treatment of emission allowances can follow the following principles: if there are no special provisions dealing with emission allowances, then general tax principles apply; if there is specific legislation, then two possible scenarios arise. In the first one the specific legislation refers to general tax principles, or sometimes to general accounting treatment; alternatively, in the second scenario, the rules substantially deviate from the general tax and accounting treatment. The classification of emission allowances is very important for the application of basic tax rules such as depreciation and amortization rules; profit and loss recognition; etc.. Furthermore, treatment of the profits generated by the trading of emission allowances may vary: in some countries they may be treated as capital gains whereas in other countries they may be treated as ordinary profits. The classification (either inventory or intangible assets) has obviously also an impact on cross border treatment of income generated by the trading in emission allowances, a panellist interjected.

In Brazil the income tax treatment is closely linked to accounting rules. In general if the emission allowances related to past reductions in emission, an item of income generated by the sale-purchase of the allowance would trigger immediate taxation. This item of income would be treated as ordinary profit and not capital gain. In other cases, it is possible to defer taxation, the panellist said.

Initial allocation (which is usually free of charge) of emission allowances may give rise to taxation, a panellist commented. In countries where this is the case, there may also be split

taxation following depreciation rules (this could be the case for instance where emission allowances are seen as public grants). In other cases emission allowances are fully exempt from taxation, or taxation is deferred until realization. In case emission allowances are auctioned, the question is whether acquisition costs can be immediately deductible, or instead depreciated. Timing issues may include the possibility to make provisions for lack of sufficient emission allowances for own use, or problems connected with valuation of the 'stock' of emission allowances and periodical use/release of emission allowances issued and stratified over different periods of time.

The Chair questioned whether there is any relation between taxation of financial instruments and rules thereof and taxation of emission allowances. The Brazilian panellist remarked that, although it is clear that in many countries the taxation of emission allowances is based on taxation of financial instruments rules, it is at times argued that there is risk that this may lead to a 'per se' trading market of emission allowances, distancing the behaviour of parties issuing and trading emission allowances from the ultimate objective of the Protocol, i.e. curbing pollution., but rather triggering speculation and arbitrage typical of a trading economy. In her view, however, this is not the case: although in Brazil emission allowances are not regarded as financial instruments, she advocates for an efficient though regulated trading market. She also said that changes in legislation are envisioned whereby a trading market will be established and income generated by trading in emission allowances will be considered financial income possibly exempt from taxation for non-resident taxpayers, which are not established in privileged tax systems.

The Canadian panellist argued that a significant problem is constituted by the fact that emission allowances are issued in the jurisdiction where pollution occurs through an allocation by the Government to the company that is involved in a polluting activity: how should then this allocation be treated, he questions. Should this be treated as an income event? The difference probably should lie in whether the allowances are destined to own use or are traded instead: in this latter case, income recognition is justifiable in his view. In general terms, in Canada these transactions give rise to ordinary trading income and not capital gains.

The Chair then introduced the issue of indirect taxes and in particular Value Added Tax (VAT). European VAT legislation, a panellist commented, was not amended after the introduction of the Protocol-based system on emission allowances, since it was deemed unnecessary: existing rules can be applied through interpretation, according to the view upheld by the EU. Member States agreed on 'general guidelines' on the application of VAT rules as follows: if emission allowances are exchanged for payment, VAT applies. The supply would be regarded as provision of services, subject to standard VAT rate, i.e. not less than 15%. In any circumstances the supply cannot be regarded as a financial service and exempted from VAT. In cross border situations, the rules on the shifting of place supply apply. As a consequence, there is no export VAT.

In Canada purchase of emission allowances from foreign parties for further sale abroad would not trigger GST. However, the sale to foreign entities of emission allowances issued by the Government for the benefit of Canadian enterprises would trigger application of GST, leading to an anomalous and inefficient situation.

In Brazil, multiple levels of value added taxation or quasi-VAT are normally imposed. However, State, federal and municipal VAT does not apply to emission allowances. Vice-versa, in case of specific 'quasi-VAT' forms of taxation, any type of income is subject, potentially including income generated by emission allowances.

The Chair then introduced the topic of interpretation and application of double tax treaties in relation to emission allowances. The OECD framework failed in establishing the 'one single price' approach, he said. This notwithstanding, a correct application of treaty rules may still help in alleviating the problems arising in cross border situations. One example was discussed where cases of double taxation or double non taxation may arise because of differences in classification of the item of income (current versus capital gain) between the country of source and the country of residence. It was argued that the OECD Model Convention does represent an appropriate start for analyzing possible solutions to through application of the distributive rules. In terms of applying tax treaty rules that are based on the OECD Model Convention, it was discussed that taxes on emission allowances would probably be covered by Art. 2 insofar as falling under the category of taxes on business income or on capital gains. Would current distributive rules cover emission allowances and if not would a new rule be needed or would amendments to the Commentary suffice? Art. 13 might be the appropriate article in case of emission allowances kept for compliance purposes, when an item of income arises in connection with a sale of such allowances, the panellist submitted. Art. 7 would in her view not be applicable as the company would not be acting in the ordinary course of its business when selling the emission allowances. Art. 6 would also not be appropriate and Art. 21 would be irrelevant as the item of income would have been dealt with under foregoing provisions. If the compliance company has generated the emission allowances via Clean Development Mechanism (CDM) projects, the relevant article would instead be Art. 7 for the income arising from the sale, as the company would be acting in the ordinary course of its business, which would also be the case if the company were to be mainly engaged in trading of emission allowances. Art. 7 would also be applicable in relation to trading of financial instruments connected to emission allowances, such as derivatives, Art. 11 being irrelevant as the underlying interest element would be missing. In her view there is no need to amend the Model Convention by introducing a new distributive rule, or even to add clarifications to the Commentary. She argued that this position would also encounter the favour of the OECD because of the residence-based taxation approach that it underscores. The major drawback would be related to the double non-taxation possibly arising in connection with the application of Art. 13, where the country of residence does not tax that item of income because of domestic rules.

The Brazilian panellist argued that Art. 7 should prevail over Art. 13 in light of the fact that also dealing with emission allowances constitutes part of the ordinary business of a company that pollutes and operates in a country that adheres to the Kyoto Protocol or applies a similar system. One issue with Brazil may arise from situations where a Brazilian company is purchasing emission allowances from a foreign corporation. In some circumstances, in fact, the Brazilian authorities would attempt taxing the stream of payment to the non-resident company on the ground of their interpretation of treaty provisions whereby Art. 7 would not cover these payments. In those circumstances, the authorities argue for the application of Art. 21, leaving room for source taxation.

Also another panellist supported that Art. 7 should be the only relevant article. He also agreed that there is no need to introduce additional distributive rules, but he would welcome amendments to the Commentary to Art. 2 and Art. 7.

The Chair finally addressed the issue of potential distortions in cross-border situations and branch issues. At the front end of these issues there is always the question of taxation or non taxation of emission allowances and at the back end there is the issue of whether consumption of the allowances results in a cost, or a write-off. The transfer across the border would trigger a taxable event if the transfer occurs at a value above zero. The transfer would be subject to the arm's length principle and there would be an issue of income recognition particularly if there was no

recognition of income when the allowances had been granted. A panellist argued that probably these cross-border transactions would not be captured by broadly-drafted withholding tax rules, but in some cases this is not quite clear. VAT and GST implications, on the other hand, may present serious obstacles and cause international inefficiencies. There is then the issue of sophisticated trading activities of emission allowances, which may lead to PE issues especially in case of brokerage or intermediation activities within the supply chain of a group.

Some questions were raised from the floor. In particular it was questioned whether the analysis on the consequences in issuing and trading of emission allowances should be conducted in light of the functions performed by the participants resulting in situations where legal and economic ownership are in fact separated or where the allowances are even allocated to a different entity than the one that is actually polluting by carrying out the manufacturing activity.