

Climate Change and International Taxation



Agenda

- Presentation of the panel
- Objective of the seminar
 - The overall objective of the seminar is to provide the participants with an introductory understanding of Climate Change in an international tax policy and tax law context.
 - In addition the objective is to provide the audience with an understanding of the potential risks and issues at stake and accordingly to assess where further knowledge is needed on the topic.

Introduction

The subject and its relevance

- What is climate change?
- Some policy choices:
 - Incentives & penalties
 - Cap and trade system
 - Carbon taxes
- Climate change in the context of international tax law:
 - Global issue
 - Any cross border economic activity may give rise to difficult tax issues.
 - No globally uniform climate legislation – several approaches and variations are observed.

Overview of Climate Change Policy Means and Legal Framework



Policy means & legal framework

Carbon taxes - Cap and trade systems

- A policy consideration in climate change is to create a carbon-price signal.
- Theoretical solutions to pricing carbon.
 - An important instrument is cap-and-trade systems, e.g. introduced by the Kyoto protocol and in the EU as regards greenhouse gases.
 - Another policy approach is to introduce carbon taxes and other environmental taxes.
- The relative merits are widely debated.

Policy means & legal framework

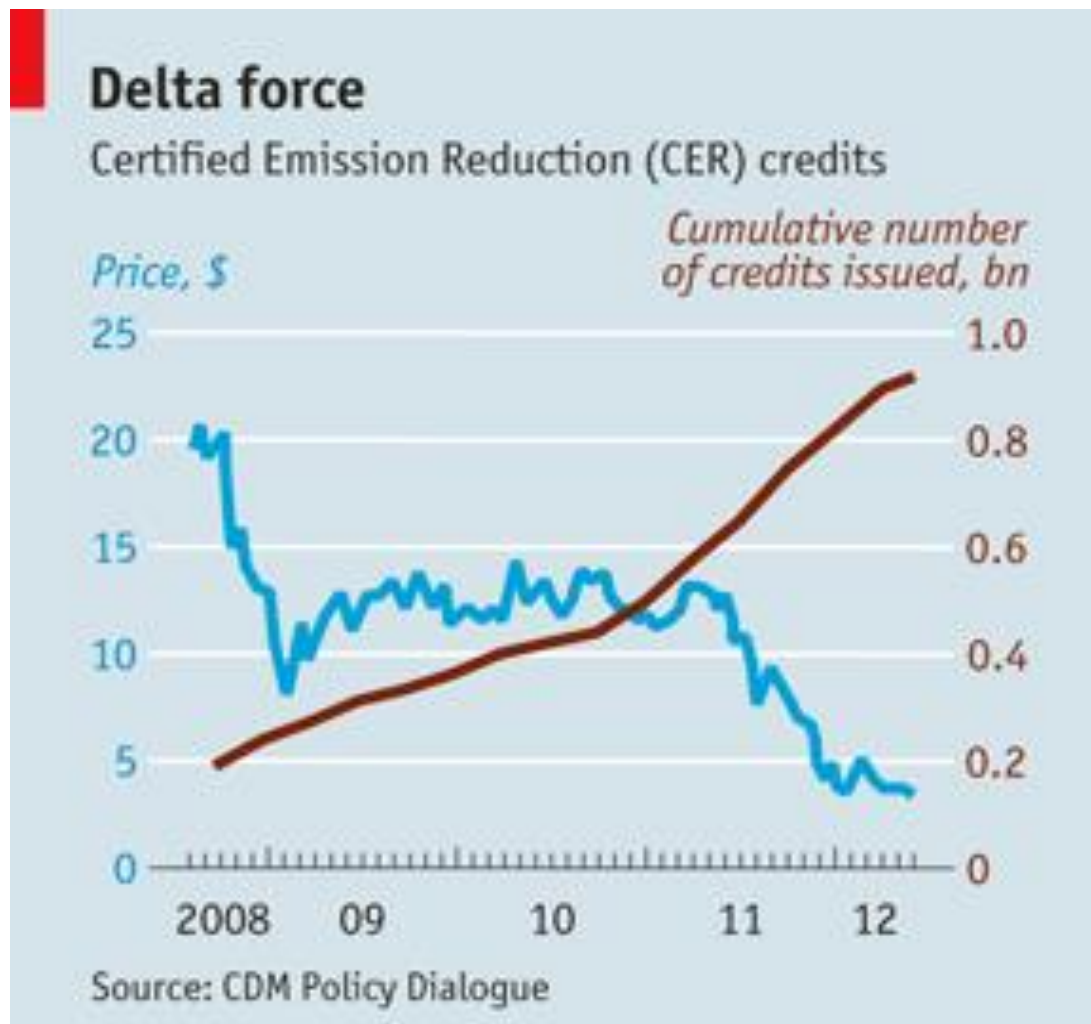
Overview of legislative measures

- Kyoto protocol (1998)
 - First international agreement with binding reductions on greenhouse gasses.
 - Reduction with 5% in average.
 - Went into force 1 January 2008 (2005-2008 being a testperiod).
 - Expired in 2013 - prolonged by a number of countries until 2017 or 2020.
- Joint Implementation (JI)
 - Possible way of reaching reduction targets by carrying out projects in other industrialised countries.
- Clean Development Mechanism (CDM)
 - Similar actions as under the JI scheme - in relation to developing countries.
- The participants obtain credits in the form of CERs (Certified Emission Reductions) or ERUs (Emission Reduction Units) which the domestic Authorities can “trade” with emission allowances to be used in the National emission trading systems (and within the EU).

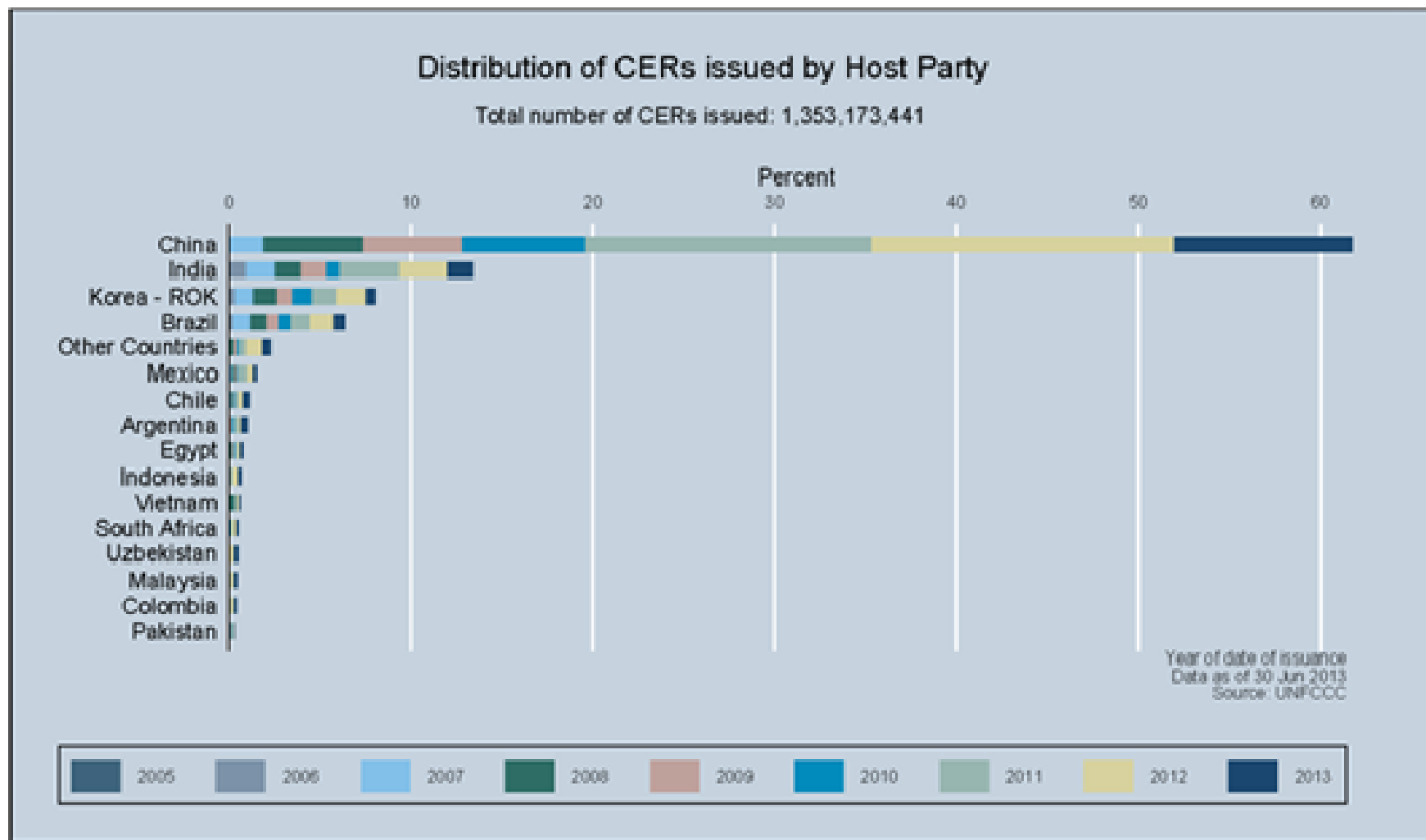
Policy means & legal framework

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Policy means & legal framework IFA 2013



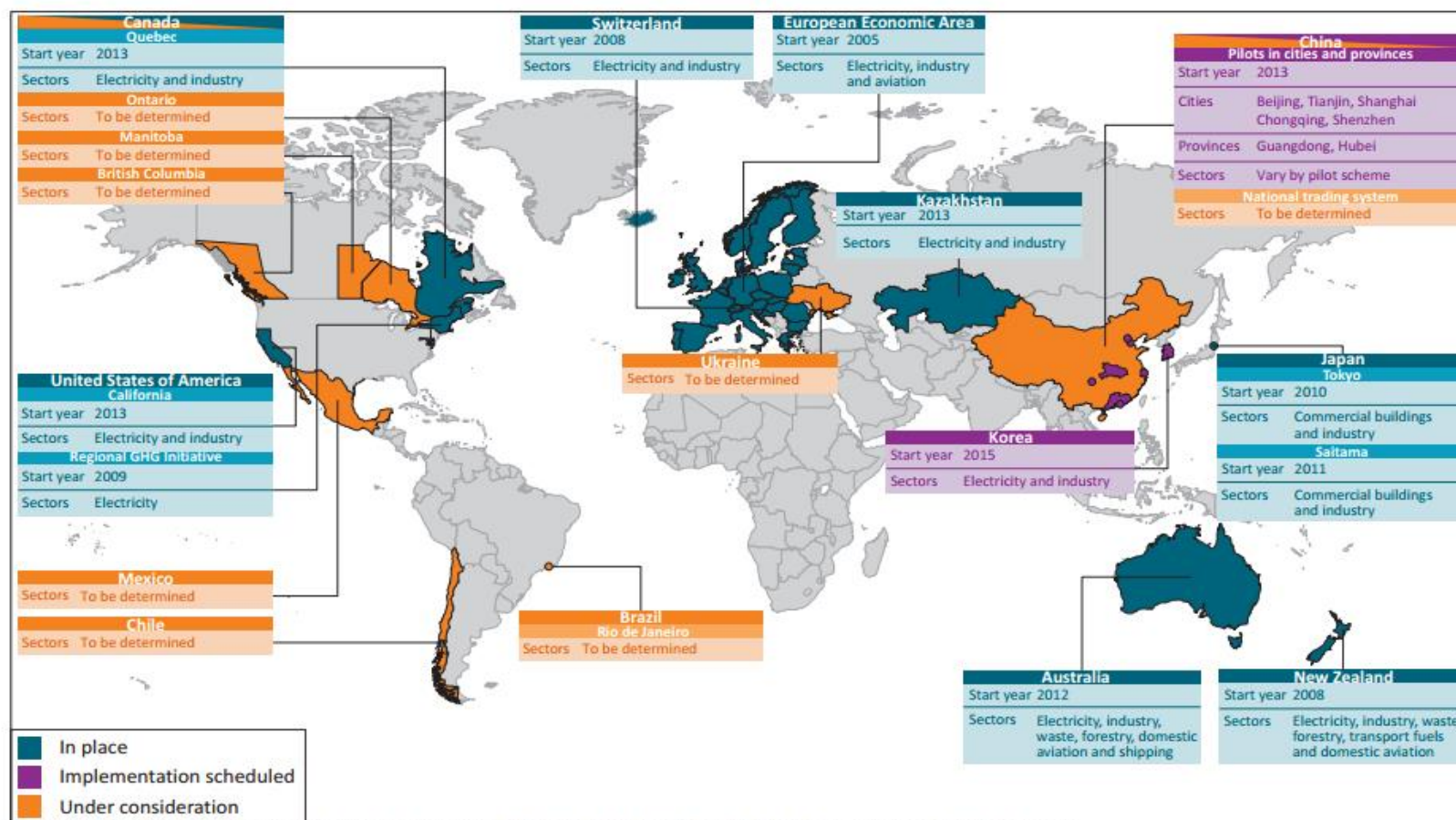
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Overview of legislative measures - continued

- The EU Emission Trading directive
 - The Kyoto protocol has been supplemented with an EU wide Cap and Trade system introduced under the EU Emission Trading directive (directive 2003/87).
 - "Quota companies" are primarily heavy emitters of greenhouse gasses.
- Different domestic legislation - e.g. Australia, New Zealand, California.

Policy means & legal framework

Current and proposed emission trading scheme



This map is without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries, and to the name of any territory, city or area.

Source: International Energy Agency

Policy means & legal framework

Consequences of emission trading schemes

- The rise of a new financial market with new financial instruments.
 - Referred to in Fortune magazine as "The most bizarre, complex and controversial new industry of the 21. century".
- The Kyoto protocol and EU directive are legal innovations implying substantial legal challenges.
- Pricing on emission allowances and credits determined on the basis of demand and supply.

Policy means & legal framework

Tax implications

- Only little focus on tax implications of emission allowances regulation and trading.
 - In order to ensure efficiency of the Cap and Trade system tax issues should not create obstacles.
 - Significant uncertainties still exist regarding the tax treatment of emission rights in different countries and JI and CDM projects.
 - Uncertainty regarding Financial reporting.
 - Risk of double taxation and double non-taxation.
 - Tax planning opportunities.

Policy means & legal framework

Tax incentives to spur clean initiatives

- Two overall approaches are available: technology push and demand pull.
- Types of incentives:
 - Incentives can be designed in a number of different ways and not one specific design seems to be preferred among policymakers around the world.
 - Taxation plays a leading role as an instrument in climate policy and environmental policy.

Tax used increasingly as a green policy tool



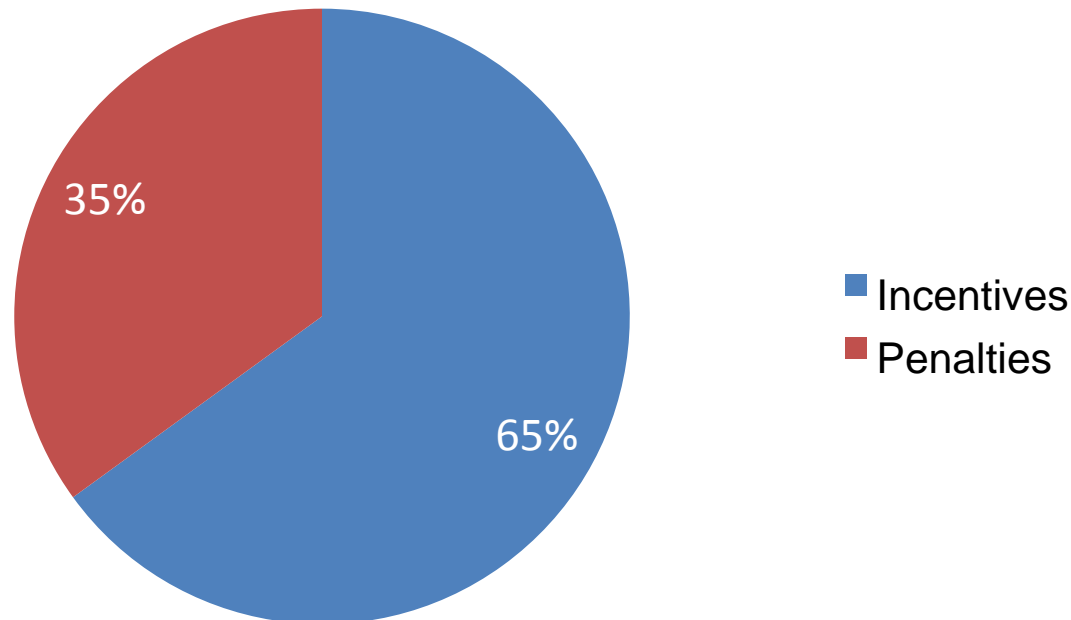
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Policy Choice: Penalties or Incentives

200+ Green Taxes Reviewed



Policy means & legal framework

The Green Tax Index, a research study

OVERALL RANKING	
US	1
Japan	2
UK	3
France	4
South Korea	5
China	6
Ireland	7
Netherlands	8
Belgium	9
India	10
Spain	11
Canada	11
South Africa	13
Singapore	14
Finland	15
Germany	15
Australia	17
Brazil	18
Argentina	19
Mexico	20
Russia	21

TAX INCENTIVES ONLY	
US	1
South Korea	2
China	3
India	4
UK	5
Canada	6
Netherlands	6
Japan	8
Ireland	9
Belgium	10
Singapore	11
Brazil	12
South Africa	12
Argentina	14
Spain	15
France	16
Germany	17
Mexico	18
Australia	19
Russia	20
Finland	21

TAX PENALTIES ONLY	
France	1
Japan	2
UK	3
Finland	4
China	5
Ireland	6
Spain	6
Australia	6
Netherlands	6
South Korea	9
South Africa	9
Belgium	9
Germany	9
US	14
Singapore	15
Canada	16
Russia	17
India	17
Argentina	17
Brazil	19
Mexico	19

Overview on Corporate Tax Treatment of Emission Allowances



Corporate Income Tax Treatment

To assess the CIT treatment of CO2 emission allowances:

- Understand CO2 emission trading system – to identify:
 - Potential taxable moments.
 - Value at stake at the taxable moment.
- To consider:
 - Issues under corporate income tax in country for tradable emission rights.
 - Issues under indirect tax for tradable emission rights (see Section 4).
 - International aspects of emission trade (see Section 5).
 - Impact on business through CO2 pricing – tax treatment will influence CO2 pricing (see Section 6) for some issues.

Corporate Income Tax Treatment

General considerations

- Emission allowances set up to price CO2:
 - Tax treatment influencing CO2 pricing.
 - Need for special tax regime for emission allowances?
- Character of emission allowance:
 - Legal definition – e.g. fungible commodity, financial asset, penalty, (im)movable right, intangible?
 - Relevance for applicable tax – e.g. stock market tax, VAT as good or service, in scope for corporate tax.
 - Accounting definition – available (IFRIC3), need?

Corporate Income Tax treatment

Potential taxable moments

- Moment of grant
 - Special considerations regarding free allowances.
- Moment of acquisition
 - For trade or for use?
- Moment of sale or use
 - Tax and accounting treatment between grant/acquisition and use to be considered.
 - Interaction taxation at use and accounting/tax treatment of CO2 emission obligation.
- Other
 - Depending on emission trading system set up potentially taxable moment during hold in between - e.g. Taxation at end of first accounting year subsequent to grant.
 - How to deal with penalties?

Corporate Income Tax treatment

Value at stake

- Availability of market price
 - Transfer pricing considerations
 - Potential discount
 - Quid free allowances?
- Relevance of system set up
 - Asset or inventory?
 - Moment of taxation
- Consideration of costs
 - Acquisition costs
 - Management costs
- Special consideration
 - CDM related allowances
 - Other offset mechanisms

VAT, GST and Emission Allowances



VAT, GST and Emission Allowances

Theoretical basis for imposing VAT/GST on emission allowances

- Emission Trading Schemes are based upon markets providing the most economic and efficient system of regulation.
- Traditional approach: Emission units are treated like any other business input, i.e. VAT/GST apply treating the B2B supplies of units/permits as taxable supplies.
 - This approach was adopted in the EU – e.g. Netherlands, Germany and the United Kingdom.
- Alternate view: Should be treated as a zero rated supply.
 - This is the position adopted in Australia and New Zealand.
- Derivative products based upon emission units are exempt (input taxed) under both approaches.

VAT, GST and Emission Allowances

Complexity that can arise under application of VAT/GST

Transactions	VAT/GST treatment
Buying or selling a unit/permit	Taxable supply
Allocated free unit/permit	No consideration – no VAT/GST
Import/Export of unit/permit	No VAT/GST (zero rated (GST free))
Government Cash Grant	No supply – no VAT/GST
Surrender of a unit/permit	No consideration – no VAT/GST
Payment of a penalty	No VAT/GST
Financial derivatives in relation to unit/permit	Exempt (input taxed) supply (financial supply)

VAT, GST and Emission Allowances

Missing Trader Intra-Community (MTIC) fraud

- “Carousel fraud” or “missing trader fraud” is not restricted to emissions trading spot markets.
 - The sellers import goods/services VAT free from other EU countries, and then sell the goods/services to domestic buyers, charging them VAT at the applicable standard rate.
 - The sellers in turn collect the VAT then disappear without paying the tax to the Government.

2008/2009 EU VAT fraud

- Suspicious trading activities (2008).
 - Europol reveals that 90% market volume of EUAs traded in some countries could be result of MITC fraud costing governments more than 5 billion euro (December 2009).
 - The Commission proposed listing a number of goods and services to which, for a limited period, the reverse charge mechanism could be applied (2009).

VAT, GST and Emission Allowances

EU Response

- 16 March 2010: Council of the European Union endorsed a short term reverse charge limited to greenhouse gas emission allowances (Council Directive 2010/23/EU2).
 - Member States responded by either zero rating EUAs or introducing a reverse charge mechanism whereby the liability to pay the VAT is shifted to the recipient.
- December 2011: a German court sentenced six people to jail terms of between three years and seven years and 10 months in a trial involving evasion of taxes on carbon permits.
- 22 July 2013: Amendments to Directive 2006/112/EC.

Double Tax Treaty Issues



Double Tax Treaty Issues

OECDs work on related treaty issues

- May 2011 & October 2012: discussion drafts released for public comment.
- February 2013: discussion draft approved by Working Party 1.
- January 2014: the draft will be submitted to the CFA for approval (proposed changes to the Commentary should be included in the 2014 update of the OECD Model Convention).

UNs work on related treaty issues

- October 2012: a draft paper was discussed by the Committee.
- October 2013: a new draft will be discussed and possibly approved by the Committee.

Objective:

- Ensuring a consistent approach with respect to the tax treaty treatment of income from emissions permits/credits under the OECD/UN Model Conventions.

Double Tax Treaty Issues

Possible impact of the treatment under domestic tax law

- Differences in characterising the income.
- Taxation at the time of issuance versus the time of transfer or alienation.
 - Timing mismatches: no double taxation as long as a treaty does not limit the obligation of the State of residence to relieve double taxation.

Tax treaty issue associated with trading of emissions allowances/credits

- The treatment of the income derived from the alienation of allowances/credits:
 - Enterprises participating in an emissions trading programme.
 - NGOs participating in a CDM project.
 - Traders.
 - Dealers in financial assets etc.
- Income covered by Articles 6, 7, 8, 12, 13 or 21???

Double Tax Treaty Issues

Income derived by an enterprise from the alienation of permits/credits, Article 7 and Article 13(2)

- Business profits taxable only in the State of residence of the enterprise, unless attributable to a permanent establishment (PE) in the other State (Article 7).
- Gains taxable only in the State of residence of the alienator, unless the permit/credit forms part of the business property of a PE in the other State (Article 13(2)).
 - Polluting activities carried out by an enterprise in another State?
 - A CDM or JI project carried on by an enterprise in another State?
 - Income derived by an enterprise from the sale of emissions permits/credits acquired on a secondary market?
- Variations based on Article 5 of the UN Model: limited incidences:
 - Lower time threshold for construction sites.
 - Service PE provision.

Double Tax Treaty Issues

Immovable property, Article 6 and Article 13(1)

- Immovable property shall have the meaning which it has under the law of the Contracting State in which the property is situated.
 - Thus, emissions permits/credits as such could be characterised as immovable property under domestic law.
- Income from the alienation of “property accessory to immovable property”.
 - Emissions permits/credits may be legally “bound” to immovable property, such as a factory or a mine giving rise to emissions or a wind turbine giving rise to reductions of emissions.
- Income from agriculture and forestry activities is specifically covered by Art. 6.
 - Art. 6 may apply to income derived from permits by farmers or from credits by participants in afforestation or reforestation.

Double Tax Treaty Issues

International traffic, Article 8(1) and Article 13(3)

- Alienation of permits issued or allowances/credits acquired in relation to operations in international traffic would be “directly connected” to these operations.
- Credits issued in relation to participation in a CDM/JI project are unlikely to be covered by Art.8(1) and 13(3), as such participation would not be “directly connected” or “ancillary” to the enterprise’s operations in international traffic.

Gains from the alienation of other property referred to in the last paragraph of Article 13

- OECD and UN Models
- Some bilateral treaties

Royalties, Article 12

- No right with respect to the use of an industrial, commercial or scientific equipment is transferred.
- Emissions permits/credits cannot be leased because they are used when they are consumed (i.e. surrendered to fulfil emissions obligations).

Double Tax Treaty Issues

Other Income, Article 21

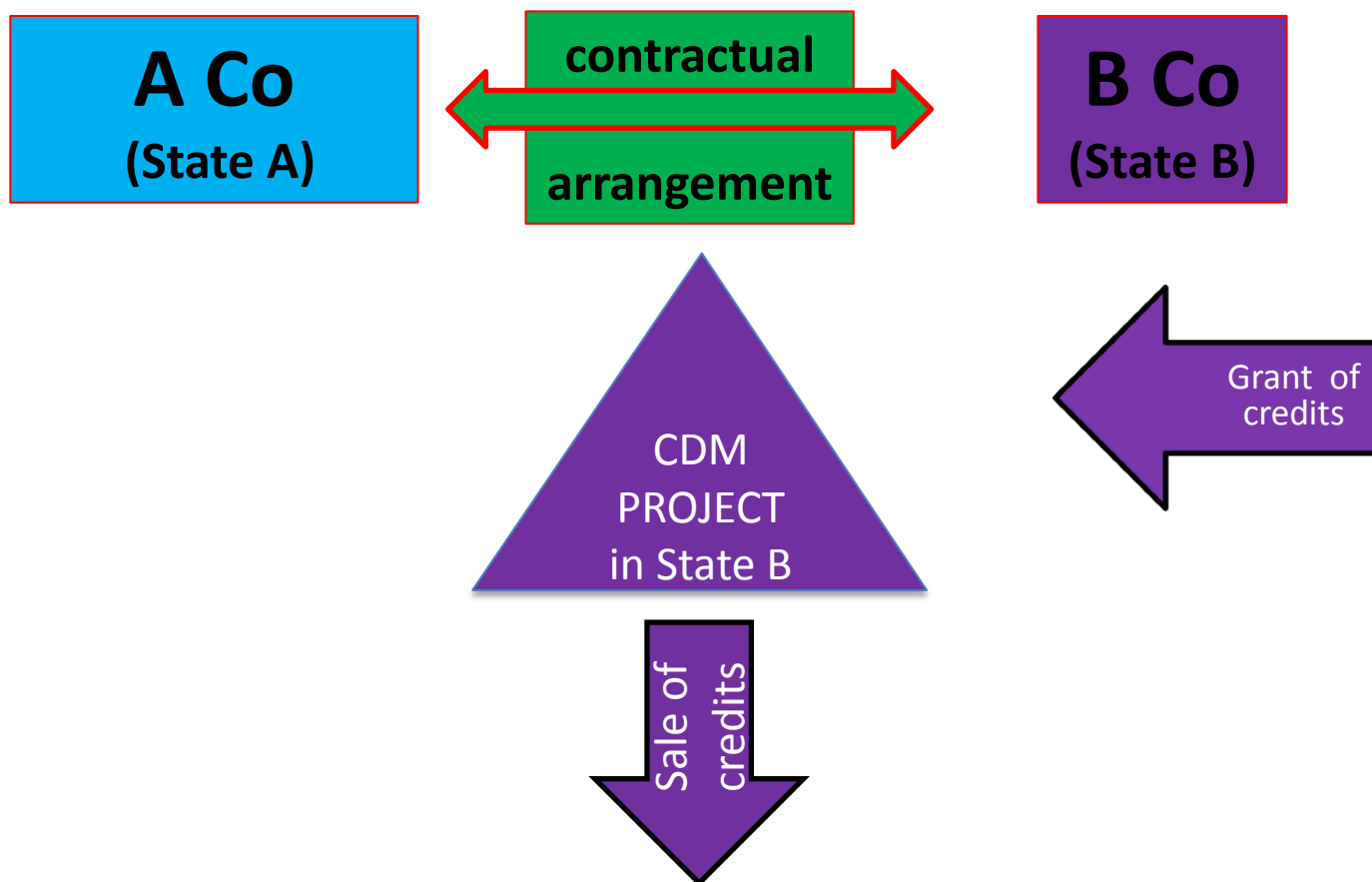
- Due to the residual character of Art. 13(5) of the OECD Model or 13(6) of the UN Model, Art. 21 should never apply to income from the alienation of emissions allowances/credits.
- Art. 21 could apply:
 - to income recognised and taxed at time of grant of allowances/credits when the income is not obtained in the course of carrying on a business.
 - to income (other than trading income) arising in connection with derivative transactions.

Disagreements as to the treaty treatment

- Art. 7 and 13 produce identical results.
- Difficulties may arise where:
 - One State considers the income is covered by Art. 6 or Art. 13 (1) and the other State disagrees; or
 - One State considers the income covered by Art. 8 or 13(3) and the other State considers Art. 7 or 13 (2) applies.

Double Tax Treaty Issues

Example



Border Tax Adjustments



Border Tax Adjustments

“Carbon leakage” is carbon leaking from regulated area

- As result of unilateral or disproportionate pricing of carbon
- Impact on competitiveness

What Leakage

- “leakage” of production – emission costs not being included in the consumer price due to competitiveness pressures.
- “leakage” of emissions – moving more polluting/energy intensive activities to more lightly or unregulated jurisdictions.

Potential ways to address it

- For market systems – free allowances
- Border tax adjustments – on import or export
- Tax rebates under carbon tax

Border Tax Adjustments

Dealing with carbon leakage

Free allowances

- Outbound adjustment – investment over revenue
- Easier for trading system
- Complexity in determination of leakage

Border tax adjustments

- Inbound adjustment – revenue over investment
- Complexity in implementation:
 - Reporting
 - Enforcing
 - Auditing
- Trade agreement concern

Outlook



Outlook

- Challenges
- Tendencies
- Conclusions