The Role Of The Tax System In The Green Transition

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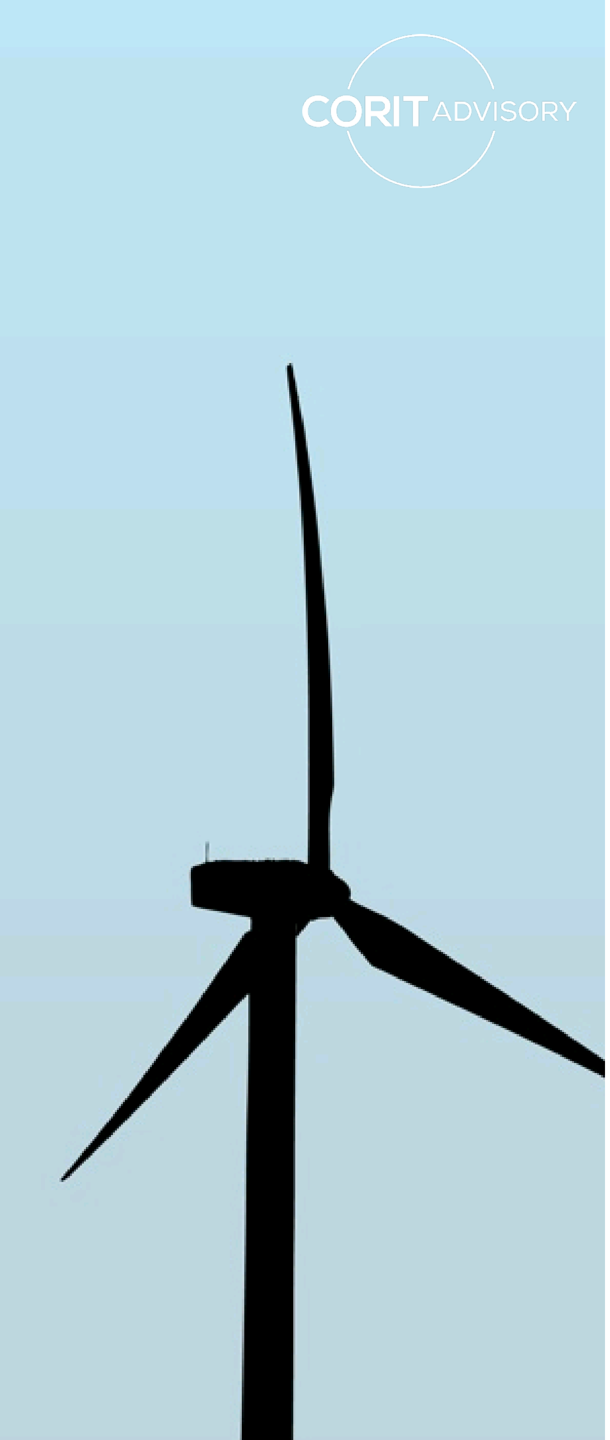
SETTING THE SCENE

- Theme: The role of the tax system in the green transition to combat climate change
- Backdrop: Market failure - insufficient pricing signal on carbon emissions
- Policy options
  - Cap and Trade Systems (financial markets)
    - Eg. The EU Emission Trading Scheme (ETS) – same effect as a tax
  - Actual tax measures
    - Discouragement: Carbon taxes
    - Encouragement: Tax incentives
- Purpose: Illustrate the potential importance of the tax dimension with three current examples from actual business models
  - Voluntary Carbon Off-set credits
  - Carbon Capture and Storage (CCS)
  - Transfer pricing discussions on renewable energy projects
- Each showcasing important lessons…..



VOLUNTARY CARBON CREDITS AND OFF-SETS

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VOLUNTARY CARBON CREDITS

- Carbon credits represents a right emit to one metric tonne of carbon dioxide (either based on permit or offsetting activity)

- Carbon markets involving carbon credits are introduced as a financial incentive to change behavior towards reducing GHG emissions
  - Credits are generated from a host of activities within biological (reforestation) or geological carbon sequestration (land use and biomass to soil) or direct air capture

- Two sub-groups of carbon markets and credits
  - Compliance Carbon Markets (CCM) – Cap and Trade – Allowances and Certified Emission Reduction (CER) credits (JI/CDM)
  - Voluntary Carbon Markets (VCM)
    - Neither legally mandated nor enforced
    - Voluntary Emissions Reductions (VER) => "Credits" (Lingo challenges)
      - *Avoidance credits* (emissions are credited by reductions elsewhere – low value)
      - *Carbon removal credits* (requires actual reduction of emissions – more impact – more valuable)
    - Quality assurance is critical: *Additional, permanent, measurable and verifiable (EU legislation in progress)*

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VOLUNTARY CARBON CREDITS

- The tax dimension: Generally, no specific tax legislation and very limited case law – no uniformity

- Understanding the business cycle and tax challenges
  - Overall characterization of offset/removal credits
    - Intangible asset, inventory, allowance, financial instrument, transferable securities etc.
  - Cross border transactions- Tax treaty issues?
  - Treatment of issuer upon project development and credit issuance?
  - Treatment of buyer
    - Deductibility/depreciation?
    - Surrender/retirement?
  - Transfer pricing
    - No special rules – awareness of industry complexities (e.g., trading as a service)

  - All questions and no answers!!!

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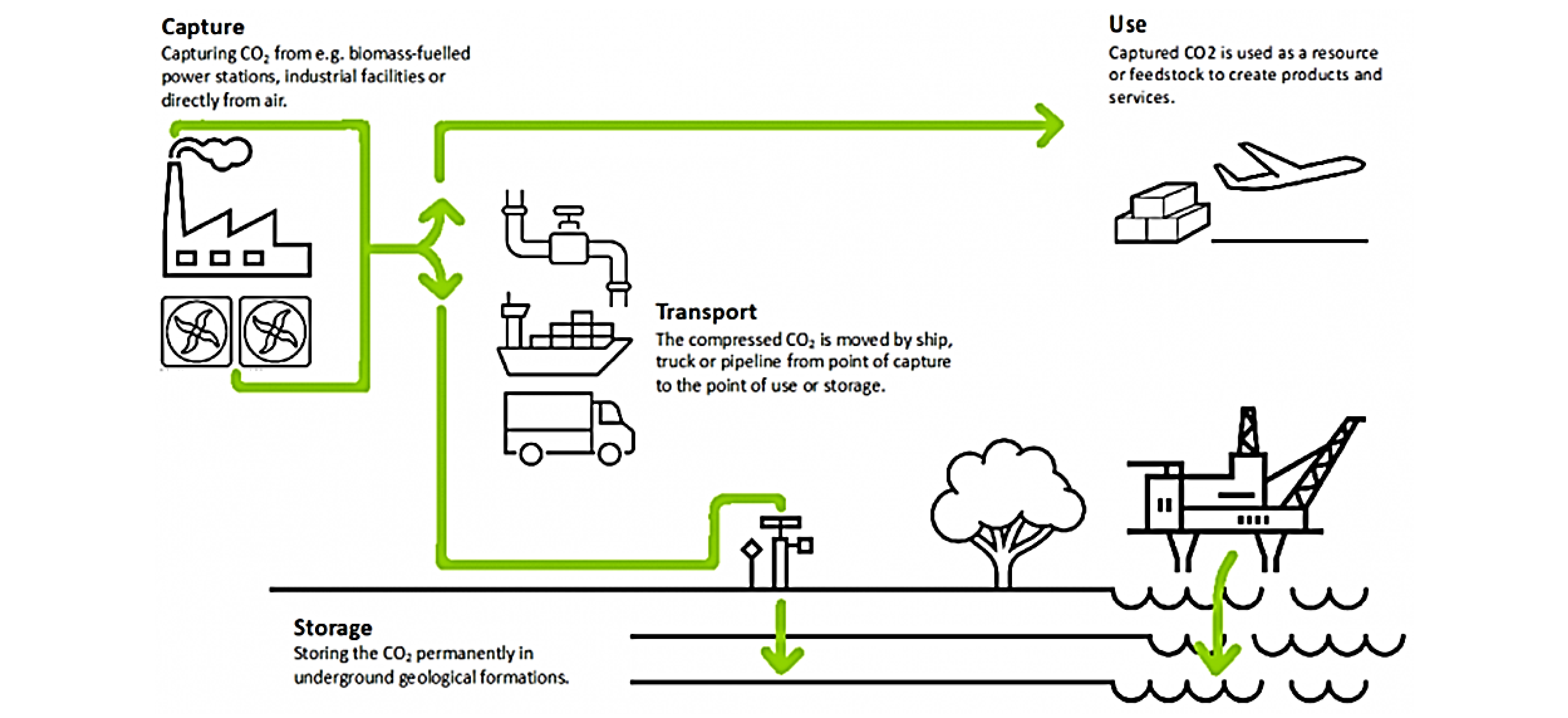
LESSONS

Lesson 1

- Absence of targeted tax legislation and uncoordinated taxation may disturb the market and influence the behavior of the operators on the VCM or even create mismatch opportunities or loopholes……

CARBON CAPTURE AND STORAGE (CCS)

CARBON CAPTURE AND STORAGE



THE ROLE OF THE TAX SYSTEM

- Moving up the political and business agenda – decided to be part of a realistic solution

- EU: Net Zero Industry Act (Regulation on establishing a framework of measures for strengthening Europe's net-zero technology manufacturing ecosystem – 13 June 2024)
  - Union objectives (50 M/tonnes/year by 2030)
  - CO_2 transportation infrastructure
  - Mandatory contributions for oil and gas producers

- The tax dimension
  - Not yet directly addressed. Tax position derived from general tax law
  - EU: The primary incentive seems to be that captured CO_2 is not considered to be emitted for the purposes of the EU's ETS (explicitly mentioned in the EU's Emission Trading Directive since 2015)
  - US: Targeted tax credit for Carbon Sequestration (Internal Revenue Code Section 45Q) "to incentivize investment in carbon capture and storage (CCS) projects."

THE ROLE OF THE TAX SYSTEM

Understanding the business cycle and tax challenges

- Construction phase
  - Deduction for construction and installation phase?
  - Special considerations for oil and gas producers – Uplifted tax deductions (hydrocarbon tax regimes)
  - Depreciation/classification of facility

- Capture – payments from emitters

- Transportation element
  - Pipelines, waterborne transport (by ship), or via rail or road networks
  - Tax imposed on the use of pipelines?
  - Does a pipeline constitute a permanent establishment, property, or something else entirely different
  - Transport via rail and road networks - Shipping and tonnage tax?

- Storage
  - Payment for this service from other greenhouse gas emitters
    - Resource rent taxation? Is subsoil a common good?
    - The 2013 review of the Danish Hydrocarbon Tax Act: *"This suggests that in the long term, income from CO_2 storage should be included under the hydrocarbon taxation."*

- All questions and no answers!!!

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LESSONS

Lesson 2

- Tax treatment may be critical to launch the CCS industry - importance of deduction of massive investment costs while understanding value creation and avoiding multiple layers of taxation in business lifecycle……

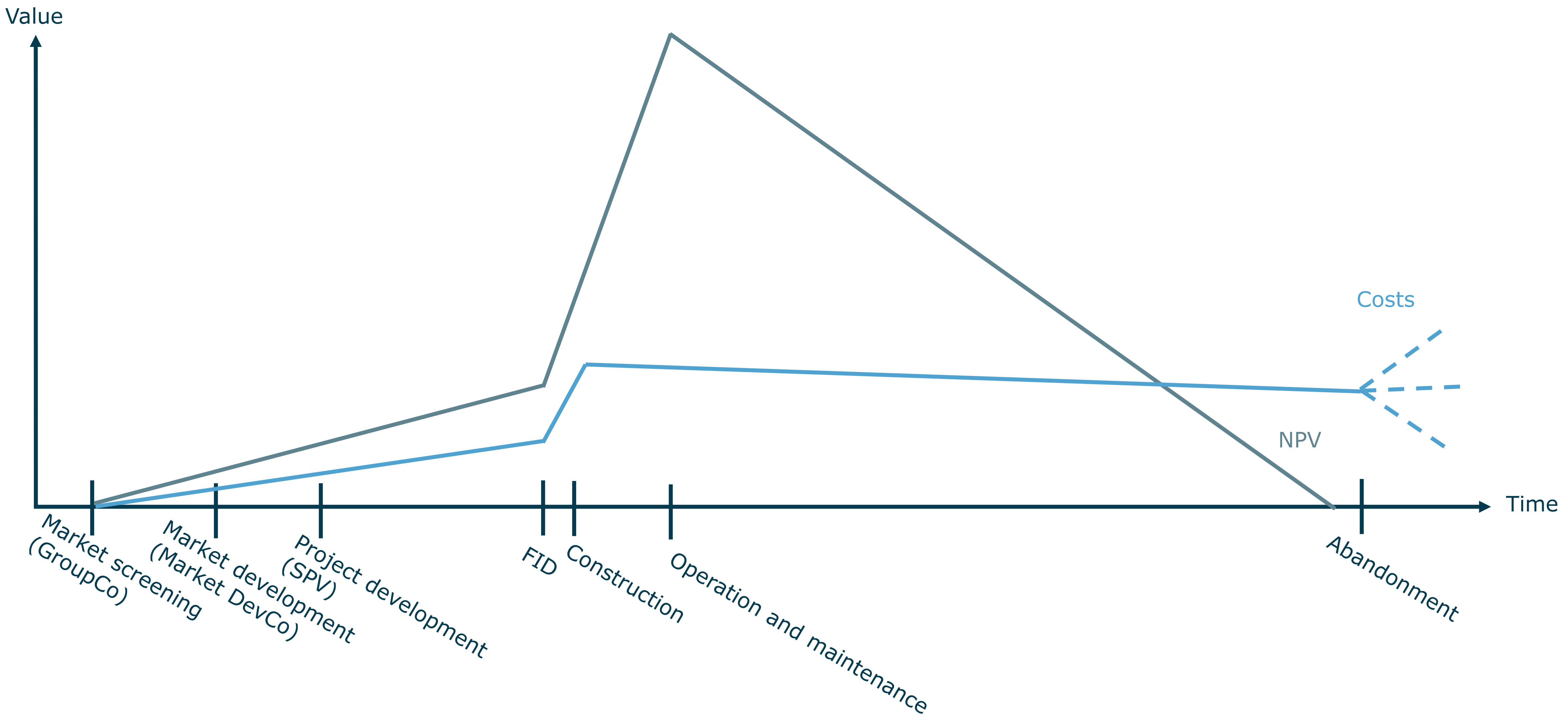
TRANSFER PRICING CHALLENGES TO THE RENEWABLE ENERGY SECTOR

TRANSFER PRICING IN RENEWABLE ENERGY PROJECTS

The issue

- Both the industry and tax authorities are testing new waters regarding the transfer pricing treatment of renewable energy projects
  - We're witnessing increased appetite for revenue and scrutiny from tax authorities, who challenge many of the structures which have been put in place within the sector
- Much uncertainty still prevails in this regards, as many questions remain unanswered
  - Widespread fear of taxation outcomes in the sector
- No best practice has yet formed…
- Renewable energy projects are complex and share many similarities with other project-based industries, such as the oil and gas industry, but also important differences

BUSINESS MODEL IN A NUTSHELL



TRANSFER PRICING IN RENEWABLE ENERGY PROJECTS

- Important starting point: application of ordinary transfer pricing rules under each phase of the business lifecycle to understand value creation
  - Avoid being "blinded by head lights"
  - It should be ensured that the income allocation does not result in 100% of the profit to be allocated to either SPVs or the parent company

- Is there a transaction? Actual or deemed?
  - For example, intra-group services, financing arrangements, guarantees, transfer of assets, use of IP, etc.?

- A FAR-analysis should be performed
  - Typical FAR-analysis may prove insufficient
    - Complex
    - Potentially understatement of tangible assets?
    - Impact of market specifics, such as state aid, the use of natural resources, or if the activity can only be carried on in a particular market
    - Shortcoming of Significant People Functions as allocation key when the activity doesn't require any significant people ("personallosen Betriebsstätten", Bundesfinanzhof, Case No I B 44/21)

- Use of or transfer of IP (hard to value or valuable)?
  - Preliminary investigations?
  - Knowhow?
  - Performance guarantees?
  - Rights to a project?
  - Licenses
  - Intra-group (administrative) services?
  - Permissions?
  - Goodwill?
  - Subsidy contracts (CfD, etc.)?

- Tax authorities take the position that services provided constitute a transfer of IP that should be compensated at a level commensurate to the potential, expected lifetime income from the projects

- Therefore: Ensure remuneration for preliminary investigations, performance guarantees, administrative intra group services

LESSONS

Lesson 3

- Grotesque and business undermining tax outcomes may arise due to:
  - Complexity
  - Lack of understanding of business model and value creation
  - Not paying for actual services, use of rights etc.
  - Absence of sanity checks of outcomes

Thank you!

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