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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 that:[1]

> "It was also decided to create a working group with a mandate to examine tax treaty issues related to climate change mechanisms, drawing upon the work already done by the Secretariat and in the context of the Organization for Economic Cooperation and Development. The working group, coordinated by Claudine
> Devillet with the participation of Anita Kapur and Marcos Valadão, would report to the annual session in 2012."

An Theeuwes was later invited to join the Working Group. This note was prepared by the Working Group in response to its Mandate.

[1] Report of the seventh annual session, E/2011/45, at paragraph 120.

NOTE ON 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*[2] (UNFCCC), which entered into force in 1994, is an international environmental treaty with the goal of achieving the "stabilisation of greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system". Today 194 states and the EU have signed up to the Convention. Under the UNFCCC, governments agreed to formulate and implement national (and, where appropriate, regional) programmes containing measures to mitigate climate change which is attributable to greenhouse gases. The UNFCCC's ultimate objective is to avoid "dangerous" human-induced climate change but it does not as such set mandatory limits on emissions or provide for enforcement mechanisms. The "supreme body" of the Convention is the Conference of Parties (COP), which meets annually to review the implementation of the Convention and negotiate new agreements.

2. So far, the Kyoto Protocol[3] to the UNFCCC has been the only legally binding instrument that committed several industrialized countries[4] to reduce emissions (by 5 % against 1990 levels over the period 2008 to 2012).[5] These targets cover emissions of the six main greenhouse gases, namely:

- Carbon dioxide (CO_2);
- Methane (CH_4);
- Nitrous oxide (N_2O);
- Hydrofluorocarbons (HFCs);
- Perfluorocarbons (PFCs); and
- Sulphur hexafluoride (SF_6).

The Kyoto Protocol established market-based mechanisms to help countries achieve their targets by allowing trading between Annex I countries through a "cap-and-trade system" and by setting in place the Clean Development Mechanism (CDM) and Joint Implementation (JI) as a means for giving flexibility to countries to meet their emissions reduction targets by getting emissions credits from elsewhere.

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2 Available at: http://unfccc.int/essential_background/convention/background/items/2853.php.

3 Available at: http://unfccc.int/resource/docs/convkp/kpeng.pdf.

4. The 40 industrialized countries which have ratified the current Kyoto Protocol (up to 2012) are generally referred to as "Annex I countries" (countries listed in Annex I to the UNFCC). These countries are : Australia, Austria, Belarus, Belgium, Bulgaria, Canada, Croatia, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Monaco, the Netherlands, New Zealand, Norway, Poland, Portugal, Romania, the Russian Federation, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, Ukraine and the United Kingdom.

   Belarus, Malta and Turkey are Annex I countries but do not have emissions targets under the Kyoto Protocol's Annex B (hereafter referred to as "Annex B countries"). Croatia, Liechtenstein, Monaco and Slovenia are listed in Annex B but not Annex I. In practice, Annex I and Annex B are used almost interchangeably. However, strictly speaking, it is the Annex I countries which can invest in Joint Implementation (JI) / Clean Development Mechanism (CDM) projects as well as host JI projects. This is true despite the fact that it is the Annex B countries which have the emission reduction targets.

5. See http://unfccc.int/essential_background/kyoto_protocol/items/6034.php.

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[6]. 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. The second commitment period will cover either a five or eight year period (2013-2017 or 2013-2020), which is still to be determined.

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[7], 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.

2. Market-based mechanisms under the Kyoto Protocol[8]

A. Emissions trading defined in Article 17 of the Kyoto Protocol

6. Through emissions trading programmes, a governmental authority or an international body sets a limit on the total amount of emissions of a specific pollutant within a specific period of time and a specific country or region in line with the target established for such country or region. This total amount of emissions is then allocated among producers of the pollutant in the form of fungible permits, each of which representing the "right" to emit a specific quantity of the pollutant. The targets for limiting or reducing greenhouse gas emissions are expressed as levels of allowed emissions, or

6. 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.

7. 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 multi-sector market-based cap and trade program to reduce greenhouse gas emissions. Key administrative aspects of this regional cap-and-trade program are being implemented in 2012 and large emitters must comply with the cap by 2013.

8. See: http://unfccc.int/kyoto_protocol/mechanisms/items/1673.php.

"assigned amounts", over the compliance period. The allowed emissions are divided into "assigned amount units" (AAUs) under the Kyoto Protocol. Other trading systems may use other denominations for their certificates.

7. Emissions permits are tradable. Producers who emit less of the pollutant than the amount allowed by the permits they hold may thus keep the spare allowances to cover their future needs or sell the "extra" permits to other producers or to intermediaries. At the end of each compliance period, each producer must surrender permits covering its effective amount of emissions during that period or face penalties. The specific limit of the total amount of emissions within the country or region – and thus the total amount of permits allowed – is normally lowered over time to achieve the national or regional Kyoto target. The trading of AAUs ensures that emissions are cut in the country or in the sector where it costs least to do so.

The European Union Emissions Trading System (EU ETS) enables participating installations like factories and power plants in 30 countries (the 27 EU Member States plus Iceland, Liechtenstein and Norway) to receive emissions allowances which they can sell to or buy from one another as needed. Each EU Allowance Unit (EAU) represents one metric tonne of CO_2. While auctioning of carbon allowances was limited during the first and second trading period, it will be the main allocation method as of 2013. Sectors and sub-sectors found to be exposed to a significant risk of carbon leakage[9] will receive allowances for free based on ambitious benchmarks, but for non-exposed industries such allocations will be phased out.

Under the EU ETS, National Allocation Plans (NAPs) set out the total quantity of greenhouse gas emissions allowances that EU Member States grant to their enterprises in the first (2005-2007) and the second (2008-2012) trading periods. Before the start of the first and the second trading periods, each EU Member State had to decide how many allowances to allocate in total for a trading period and how many each installation covered by the EU ETS would receive. For the third trading period, which begins in 2013, there will no longer be any NAPs. Instead, the allocation will be determined directly at the EU level.

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 was recently announced.

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[10] 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 Reductions (CERs) that may be sold. CERs generated by CDM projects may indeed be purchased by Annex B countries to satisfy their emissions targets under the Kyoto Protocol (each credit equivalent to one tonne of CO2).

9. "Carbon leakage" refers to a phenomenon where there is an increase in CO2 emissions in one country as a result of emissions reductions in a second country with a stricter climate change policy (i.e. an emissions trading programme), typically because polluting activities are relocated to the first country from the second.

10. Currently, 191 States and the European Union are Parties to the Kyoto Protocol to the UNFCCC. For the status of ratification of the Kyoto Protocol, see http://unfccc.int/kyoto_protocol/status_of_ratification/items/2613.php.

9. The CDM allows Annex I countries and authorized private or public entities[11] of such countries to participate in the implementation of emission-reduction projects in Non-Annex I countries. The CERs earned by an enterprise of an Annex B country participating in such projects can be counted towards meeting its emissions target. The CERs can also be sold to enterprises of Annex B countries that are over their targets. Projects hosted in Non-Annex I countries may be developed with investment or support from enterprises, entities and Governments of Annex I countries, as long as the project helps the host country meet its own goals for sustainable development and does not divert Overseas Development Aid away from the country. A CDM project must provide emission reductions that are additional to the emissions reductions that would otherwise have occurred.

10. CDM projects must qualify through a rigorous and public registration and issuance process. CERs are issued to project participants by the CDM Executive Board once a "designated operational entity" has verified and certified that the CDM project has resulted in real, additional, measurable and verifiable reductions in greenhouse gas emissions. Operational since the beginning of 2006, the mechanism was expected to produce CERs amounting to more than 2.9 billion tonnes of CO_2 equivalent in the first commitment period of the Kyoto Protocol (2008–2012). The mechanism stimulates sustainable development and emission reductions, while giving industrialized countries flexibility in how they meet their emission reduction limitation targets. With the confirmation of the second commitment period for the Kyoto Protocol at COP 17, the CDM will continue until 2017 or 2020 (which is to be determined by COP18).

11. Typical CDM projects include:

- Renewable energy projects such as wind power, hydropower and biomass;
- End-use energy efficiency improvements;
- 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.

At COP17, Carbon Capture and Storage (CCS) was also recognised under the CDM.

12. Although Non-Annex I countries in which CDM projects may be carried out include four OECD member countries (Chile, Israel, South 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 also been 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[12]. This will exclude CERs from new CDM projects in China, India and Brazil from the EU ETS.

13. A CDM project is often operated through a Special Purpose Vehicle such as a joint venture company or a limited partnership set up specifically to undertake the project. Alternatively, the project may be operated by an existing company, a government agency, a charity, an NGO or a community organisation. A project may also encompass several different entities under a contractual arrangement.

[11]. A country that authorizes private and/or public entities to participate in CDM projects shall remain responsible for the fulfilment of its obligations under the Kyoto Protocol. Private and/or public entities may only transfer and acquire CERs if the authorizing country is eligible to do so at that time.

[12] See http://ec.europa.eu/clima/policies/ets/linking/faq_en.htm

14. The CERs are in most cases granted to and subsequently sold by project developers based in host countries. Project developers operate the CDM project and own the assets which may be developed into a CDM project (e.g. farms, chemical factories, steel plants, cement plants, land, alternative energy infrastructures). They are the primary owners of any CERs issued.

15. A key issue in the design and development of a CDM project is whether the project will be wholly owned by a host country entity or whether an Annex I country entity (an "Annex I entity") will invest directly in the project and therefore itself own all or part of the project assets. Equity capital for the project may either be:

- only foreign direct investment;
- only domestic investment;
- partly foreign and partly domestic investment (e.g. in the case of joint ventures or special purpose vehicles)13.

16. Where the Annex I entity has made no direct investment in the CDM project and has therefore no ownership of project assets, it may nevertheless be involved in the CDM project. Such involvement may be organized following different structures giving rise to different risks and obligations for the Annex I entity and having influence on the assignment of the CERs. Three main structures exist:

Project Development Agreement (PDA)

17. Under such a structure, the Annex I entity is involved in the project at an early stage, accepting full responsibility for the design and development of the CDM project, from initiating the project idea through to registration and ultimate issuance of CERs. Under a PDA, the host country entity, which owns the project assets, generally plays little or no part in the development and implementation of the CDM project, particularly as regards the project registration process and the ongoing monitoring and verification of the reductions of emissions. This may be particularly beneficial where the host country is new to the CDM mechanism.

18. Where an Annex I entity takes on the full risk associated with the development of a CDM project under a PDA, it will generally also take all or most of the CERs generated by the project. Consequently, the agreement between the project participants would be expected to assign to the Annex I entity all or most of the rights with respect to the CERs generated by the project, based on the contributions of the Annex I entity to the project (i.e. the provision by the Annex I entity of its expertise and services in developing the project).

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.

[13] Foreign ownership of CDM projects may be regulated under the host country's domestic law. It may provide, for instance, that CDM projects must be majority owned or controlled by a host country party. In such a case, an Annex I entity could, for example, form a partnership with a host country entity in which the host country entity held at least a 51% interest in the partnership. The CDM project would be owned by the partnership and the CERs generated by the project would be shared by the host country and Annex I partners in accordance with the terms of the partnership agreement.

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 indexed 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

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.

24. The sale of ERUs provides an additional revenue stream for the project developers. It can reduce perceived risks of investing in climate-friendly projects and thus provide project developers with a tool for leveraging new private and public investment in these projects. JI also enables the transfer of efficient technologies and best available practices to the host countries, thereby contributing to long term climate change mitigation as well as to sustainable development, typically including reductions of local pollution. JI helps investing countries to meet their emission targets under the Kyoto Protocol in a cost effective way by making cheaper investments abroad.

25. JI is currently still a small part of the global carbon market. The number of JI projects under development is, however, increasing. Most projects undertaken to date are situated in Ukraine, Czech Republic, Russia, Germany, Bulgaria, Poland, France, Romania, Lithuania, Estonia and Hungary (in decreasing order). JI project structures are similar to the project structures mentioned above with respect to CDM projects.

D. LULUCF activities

26. The human-induced activities agreed under Article 3.3 of the Kyoto Protocol (afforestation, reforestation and deforestation since 1990) and the activities which countries may elect to use under

Article 3.4 (forest management, cropland management, grazing land management, revegetation), which are referred to as LULUCF (Land Use, Land-Use Change and Forestry) activities, may give rise to removable units (RMUs). An Annex I country may issue RMUs where LULUCF activities on its territory result in a net removal of greenhouse gases. These emissions credits are deemed valid only when the removals have been verified under the Kyoto Protocol's review procedures and they cannot be carried over to future commitment periods.

Under the New Zealand Emissions Trading Scheme (NZ ETS), owners of forests first established after 1989 who opt into the NZ ETS receive sequestered carbon credits as the forests grow and face full liability for emissions at harvest.

27. The CDM allows for the implementation of LULUCF project activities limited to afforestation and reforestation. Under JI, an Annex I country may implement projects that increase removals by sinks in another Annex I country. These projects may give rise to temporary or long-term emissions credits.

E. Interactions between national and regional emissions trading programmes and the CDM and JI

28. A means to reduce emissions more cost-effectively is to develop the global carbon market by linking national and regional emissions trading systems. The increased liquidity and reduced price volatility that this would entail would improve the functioning of markets for emissions permits.

The original EU Directive establishing the EU ETS allowed for linking the EU ETS with the emissions trading programmes of other industrialised countries that have ratified the Kyoto Protocol. New rules allow for linking with any country and group of countries which have established a compatible mandatory cap-and-trade system. 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.

For example, companies may use CERs generated by CDM projects and ERUs generated by JI projects to satisfy their obligations under the EU ETS, subject to certain limitations. CERs may be exchanged one-for-one with EAUs subject to various criteria. CERs generally trade at a discount to EAUs in the secondary market owing to the additional project and regulatory risks. This has given rise to a great deal of interest and activity from European buyers.

The NZ ETS also permits the use of CERs and ERUs for compliance or trading purposes.

3. Tax treaty issues related to emissions permits/credits[14]

[14]. This section takes, in particular, the following papers into account:
OECD Discussion draft on Tax treaty issues related to the trading of emissions permits and the public comments made on that draft, see http://www.oecd.org/document/27/0,3746,en_2649_33747_49036507_1_1_1_1,00.html;
OECD working document CTPA/CFA/WP1/NOE2(2012)6/CONF, which is not yet public;
E/C. 18/2010/CRP.12 and E/C. 18/2011/CRP.9 on Tax Cooperation on Climate Change prepared by the Secretariat of the UN Committee of Experts, see http://www.un.org/esa/ffd/tax/sixthsession/CRP12_Draft.pdf and http://www.un.org/esa/ffd/tax/seventhsession/CRP9.pdf;
Implementing CDM projects, Guidebook to Host Country Legal Issues, by Paul Curnow and Glen Hodes, see http://cotedivoire.acp-cd4cdm.org/media/161996/cdm_hostcountrylegalissues.pdf; and
Tax Treatment of ETS Allowances, Options for improving transparency and efficiency (October 2010), see http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/ets-report.pdf.

30. Emissions trading programmes present a number of domestic and international tax issues. This note focuses on the potential tax treaty issues that could arise in connection with a national or regional authority's grant of emissions permits, the trading of such permits across borders, and the issuance and trading of CERs, ERUs and RMUs. The tax treaty issues are discussed in relation with bilateral treaties with provisions similar to the Articles of the UN Model Double Taxation Convention between Developed and Developing Countries (the UN Model). The issues are discussed with a view to ensuring, as far as possible, a consistent approach with respect to the treatment of emissions trading under the UN Model to prevent possible disputes.

A. The granting of emissions permits

31. In general, national and regional emissions trading programmes issue emissions permits based on the historic emissions of activities carried on at a specific site or through a specific installation during a specific period of time. Under these programmes, a country or region ensures that no activity which results in specified types of emissions is undertaken within its territory unless its operator holds emission permits.

Under the EU ETS, "emissions" means the release of greenhouse gases into the atmosphere from sources in an "installation", which is defined as a stationary technical unit where one or more listed activities are carried out as well as any other directly associated activities which have a technical connection with the activities carried out on that site and which could have an effect on emissions and pollution. An "operator" is any person who operates or controls an installation or, where this is provided for in the national legislation of an EU Member State, to whom decisive economic power over the technical functioning of the installation has been delegated. The EU ETS covers the following activities:

Energy activities
Combustion installations with a rated thermal input exceeding 20 MW
Mineral oil refineries
Coke ovens

Production and processing of ferrous metals
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 EU ETS, most EAUs were allocated for free in the first (2005-2007) and second (2008-2012) compliance periods; only very limited quantities of EAUs were auctioned. From the start of the third compliance period in 2013, however, about half of EAUs are expected to be auctioned.

33. If a permit is granted for consideration equal to its fair market value – as would typically be the case when a permit is sold at auction – no income would arise at the time of the acquisition of the permit. If a permit is granted free of charge or for less than its fair market value, some States could, under their domestic law, consider that income would arise at the time the permit was granted. For practical reasons, however, it seems likely that most States will decide not to recognise income at the time of the granting of the permits but will prefer to wait until the alienation or use of the permits.

Of the 27 EU Member States, only few countries consider the grant of an EAU to give rise to taxable income, in the amount of the market price of the EAU at the time of the grant (i.e. the market price at the time of the grant is used as the purchase cost which is deducted from taxable income when the EAU is surrendered or sold)[15].

34. Emissions permits may be granted by an Annex 1 country or region to any enterprise, whether carried on by a resident of that country or region or a resident of any other country (where such enterprise exercises activities within the relevant territory that release greenhouse gases). An emissions permit may therefore be granted to a resident of a Non-Annex I country with respect to the activities it exercises in an Annex I country.

35. Theoretically, the following articles of the UN Model could cover the income that may be considered to arise under the domestic law of a State at the time a permit is granted free of charge or for less than its fair market value.

1. Article 7 (Business Profits)[16]

36. Business profits normally include the value of benefits obtained, whether in the form of money or assets, that are directly related to the business of an enterprise. This includes benefits obtained as free allowances in relation to the polluting activities of an enterprise. 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 enterprise include categories of income which are dealt with separately in other articles of the Convention, these other articles have, however, priority over Article 7.

37. Where a foreign enterprise operates an installation at which one or more polluting activities are carried out, such installation is, in general, a fixed place of business through which the business of the enterprise is wholly or partly carried on. Consequently, the installation is generally a PE and the profits arising at the time of the grant of an emissions permit would be attributable to that PE and taxable in the State where the PE is situated (costs incurred to obtain the emissions permits, such as in the application process, shall be allowed as deductible expenses incurred for the purposes of the PE).

38. Emissions permits are normally not granted in respect of the construction, assembly or installation of facilities or infrastructure that could have polluting effects. They are granted in respect of the polluting activities exercised through such facilities or infrastructure once they are operational.

12. See paragraph 1.3. of Tax Treatment of ETS Allowances, Options for improving transparency and efficiency (October 2010).

16. The UN Model does not include “delivery” as an exception to the PE rule (if goods are stocked in a country for delivery, the host country has the right to tax the income derived from the delivery) and also provides that a dependent agent may create a PE if he maintains a stock of goods for delivery on behalf of an enterprise. The UN Model additionally provides that a PE is deemed to exist if an insurance agent collects premiums or insures risks in the host country. These provisions are not applicable to activities generating greenhouse gases covered by emissions trading programmes.

If the construction, assembly or installation activity would, however, itself require emission permits (i.e. with respect to emissions produced by the construction, assembly or installation activity), such permits would generally be granted to the project manager and not to the contractor that carries out this activity. Emissions permits would therefore not normally be effectively connected with a construction PE (i.e. a PE envisaged under subparagraph 3(a) of Article 5). If, however, a contractor was required by contract to secure all emissions permits relating to the construction on its own account, the granting of such permits could result in profits attributable to a PE of that contractor if the contractor fulfilled the conditions of subparagraph 3(a) of Article 5 (site, project or activities lasting more than six months).

39. A bilateral treaty that follows the UN Model will contain a provision deeming a PE to exist when services are provided for the same or connected projects during a certain period of time (subparagraph 3(b) of Article 5). It seems, however, difficult to imagine that emissions permits could be issued in respect of the mere performance of services. Emissions permits are indeed granted to an enterprise which operates an installation where polluting activities are carried out and which has emissions targets with respect to those activities. Emission permits are normally not granted to a service provider which furnishes services to the operator of such an installation.

40. The provision of transport services by road or railways could, however, be included within the scope of an emissions trading programme. For instance, the NZ ETS covers fuel transport. Where a foreign enterprise performs such transport services under the conditions provided for in subparagraph 3(b) of Article 5, income from the granting of emission permits with respect to such transport may be taxed in the State where the services are performed in the absence of a fixed place of business.

41. The UN Model also gives the host country the right to tax profits from business activities taking place in the host country that are not attributable through a PE that a foreign enterprise has in the host country, provided those activities are "of the same or similar kind" as those exercised through the PE (paragraph 1 of Article 7, item (*c*)). Emissions permits are normally issued in respect of polluting activities exercised through an installation, and it would be very unusual for such activities to be carried out through a fixed place of business that would not constitute a PE. If, however, activities technically similar to those carried out through a PE situated in the host country are also carried out in that country without giving rise to a PE, any income from the granting of emissions permits with respect to those activities would also be taxable in the host country under the limited force of attraction principle of paragraph 1 of Article 7.

2. Article 8 (Shipping, Inland Waterways Transport and Air Transport)

42. Paragraph 1 of Article 8 provides that "profits from the operation of ships and aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated". Under paragraph 2, a similar rule is provided for profits from the operation of boats engaged in inland waterways transport. These rules constitute an exception to Article 7. A foreign enterprise engaged in these transportation activities will therefore be taxable on any profits that could be recognized as a result of the granting of emission permits for free only in the State of its place of effective management,[17] regardless of whether or not such profits might be attributable to a PE situated in another State.

Since 1 January 2012, emissions from all domestic and international flights that arrive at or depart from an EU airport are covered by the EU ETS. In addition to the 27 EU Member

17. As mentioned in paragraph 5 of the Commentary on Article 8 of the UN Model, some countries prefer to refer to the State of residence of the enterprise.

States, the EU ETS for aviation covers three EEA-EFTA States (Iceland, Liechtenstein and Norway)[18].

43. A bilateral treaty that follows the UN Model could contain a provision similar to paragraph 2 of Article 8 (Alternative B) of the UN Model. Profits from shipping activities are then taxable in the State where they arise if operations in that State are "more than casual" (i.e. "a scheduled or planned visit of a ship to a particular country to pick up freight or passengers" even if the visit is irregular or isolated).

44. There is currently no international regulation of greenhouse gas emissions from ships. Despite many years of efforts, in particular in the International Maritime Organization and the United Nations Framework Convention on Climate Change, it has not yet been possible to agree on an effective global approach to regulating these emissions[19]. If and when the 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)

45. Income arising at the time a permit is granted for free could also fall under Article 6 as income from "immovable property". This could be the case if a State grants permits to the owner of "immovable property", such as a mine or other natural resource deposits giving rise to the release of toxic chemicals or a waste disposal facility, and the permit is bound to that property. In such a case, the income from the granting of permits may also be taxed in the State where the immovable property is situated even if such property would not constitute a PE through which an enterprise carries on its business.

A member of the Working Group considers, however, that permits are never bound to immovable property as such but to activities exercised through immovable property. Therefore income from granting of permits would not be taxed in the State where the immovable property is situated without having activities that constitute a PE.

Disposal facility operators are mandatory participants in the NZ ETS and are required to surrender New Zealand Units (NZUs) for their emissions by 31 May 2014. For purposes of the NZ ETS, "disposal facility" means any facility, including a landfill, that operates (at least in part) as a business to dispose of waste. The operator is the person in control of a disposal facility. Many factors could be relevant in deciding who has control of a disposal facility, including who holds the resource consent for the disposal facility, who oversees the day-to-day management of the facility, who determines gate fees, etc. The NZUs appear, however, to be issued with respect to business activities carried on through a landfill and not with respect to the mere ownership of the location where the activities are carried on.

46. Article 6 would also apply to income arising from the granting of a permit in relation to agriculture or forestry activities, which is expressly covered under paragraph 1 of Article 6.

[18]. See: http://ec.europa.eu/clima/policies/transport/aviation/index_en.htm.

[19]. The European Commission launched however a public consultation on possible measures to reduce greenhouse gas emissions from ships on 19 January 2012.

Under the NZ ETS, voluntary reporting for the agriculture sector began on 1 January 2011, with mandatory reporting required from 1 January 2012. From this time agricultural processors will be required to report on the emissions associated with the agricultural produce they process. Obligations to surrender units for agricultural emissions are scheduled to start in 2015.

47. Even if income from mining activities is not expressly mentioned in paragraph 1 of Article 6, some countries could argue that income from the working of mineral deposits or other natural resources or from landfill activities is also income derived from the direct use of immovable property. These countries may take the position that such income, including income from the grant of emissions permits relating to these activities, would fall under Article 6[20].

In order to avoid future disputes, it would be helpful for the UN Model to address the issue of whether and to what extent profits from mining activities (as opposed to income from mining rights) and profits from landfill and LULUCF activities are covered by Article 6.

4. Article 12 (Royalties)

48. Under paragraph 3 of Article 12, the definition of royalties covers "payments … received as a consideration … for the use of, or the right to use, industrial, commercial or scientific equipment". Those terms do not cover payments received by the operator of equipment with respect to the use he is making of such equipment but cover payments made by the operator of equipment to the lessor in consideration for the concession of the use or the right to use the equipment. The income from the grant of permits relating to the operation of industrial, commercial or scientific equipment would consequently not be classified as royalties.

5. Article 14 (Independent Personal Services)

49. It seems difficult to imagine that emission permits could be issued in respect of the mere performance of independent personal services. As already mentioned, emissions permits are normally granted to an enterprise which carries on polluting activities through an installation and which has an obligation to limit the emissions resulting from such activities. Emissions permits are normally not granted to a service provider with respect to the furnishing of independent personal services to the enterprise operating the installation. The permits are granted to the operator with respect to the polluting activities it carries on at the installation through any equipment, personnel or otherwise.

6. Article *21 (Other Income)*

50. Income arising at the time a permit is granted for free would be covered either by Article 6, 7 or 8. Article 21 would normally not apply with respect to such income.

[20]. See "At Sixes and Sevens: The relationship between the taxation of business profits and income from immovable property under tax treaties", by Brian Arnold in January 2006 Bulletin for International Taxation.

51. The term "profits" used in Article 7 has a broad meaning and includes all income derived in the carrying on of an enterprise[21]. Except where an item of business income is treated separately in another Article of the UN Model, Article 7 is applicable to any income obtained in the carrying on of a business. Because emissions permits are, in general, granted in connection with the carrying on of business activities which give rise to greenhouse gas emissions, profits resulting from their grant would, except where Article 6 or 8 is applicable, typically be considered business income dealt with under Article 7.

A member of the Working Group considers that paragraph 51 does not consider properly the taxing rights of the source country where the activities that originates emissions permits are performed (specially regarding art. 21, paragraph 3 of the UN Model Convention "arising in the other Contracting State").

In this respect, one should note that, where a foreign enterprise carries on pollutant activities in another State, these activities are generally carried on through a PE situated in that State (see paragraph 36 to 39 above). Consequently, the profits arising from the granting of emissions permits are attributable to such PE and taxable in the PE State. Article 7 will thus generally give the taxing rights to the country where the pollutant activities are performed and there is no reason to use Article 21(3) to achieve that result. Moreover, insofar as emissions permits are granted to an enterprise, these permits obviously relate to pollutant business activities carried on by that enterprise. Article 21 cannot apply to the income from the granting of emissions permits dealt with under Article 7.

52. Article 21 could, however, apply where the emissions of greenhouse gases with respect to which the permits are granted do not result from the carrying on of a business. This could, theoretically, be the case, for instance, if a taxable entity were the primary owner of a permit granted in respect of the emissions resulting from its activities and such activities did not constitute the carrying on of a business. In these situations, where the treaty follows the UN Model, the income arising at the time a permit is granted would be taxable only in the State of residence, unless the permit arose in the other Contracting State, which would arguably be the case if the permit were granted with respect to activities exercised in that other State.

B. The granting of emissions credits

53. Emissions credits (CERs, ERUs or RMUs) are issued to project participants with reference to the verified reductions in greenhouse gas emissions that result from a specific project aimed at achieving such reductions. Depending on the type of project, a project participant may be a resident of a Non-Annex I country or of an Annex I country. CERs are, generally, granted to project developers which operate farms, forestry, chemical factories, steel plants, cement plants, wind farms, solar farms, hydropower facilities, etc in Non-Annex I countries.

54. Under domestic tax law, the treatment of emissions credits granted with respect to CDM and JI projects may be similar to the treatment of emissions permits granted free of charge. A country could seek to recognise income at the time the credits are granted. It could alternatively consider that the value of the credits should reduce the deductible or depreciable costs of the investment project that generated them. It could also decide that profits or gain should only be recognized at the time of the alienation or use of the credits.

Countries are encouraged to clarify the domestic tax treatment of granting and transferring tradable emission credits as well as the tax treatment of non-resident project participants in CDM, JI and other

[21]. See paragraph 21 of the Commentary on Article 7 of the UN Model which quotes paragraph 59 of the Commentary on Article 7 of the 2008 OECD Model Tax Convention.

relevant projects. In general, clear tax treatment of such activities – either as part of the emission certificate regulations or as part of the tax legislation – encourages the efficiency of the market and investment in emission reducing activities. Further action for the UN Committee could include gathering best practices in this respect.

55. Theoretically, the following articles of the UN Model could cover the income considered to arise, under a State's domestic tax law, at the time an emissions credit is granted.

1. Article 7 (Business Profits)

- *A CDM or JI project is wholly or partly owned by a host country enterprise.*

56. In such case, the income derived by the host country enterprise from the granting of the emissions credits is exclusively taxable in the host country as business profits relating to the business carried on in the host country by an enterprise of that country. Whether an Annex I entity is also granted emissions credits in respect of the project, or the host country enterprise agrees to subsequently transfer to another party all or part of the emissions credits 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.*

57. 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.

58 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 construction PE dealt with under subparagraph 3(a) of Article 5.

59. Where a CDM or JI project gives rise to a PE in the host country and the project generates emissions credits, it will be necessary to determine to which part of the enterprise the emissions credits will be considered to have been granted. Whilst this will depend on the facts and circumstances, in most cases the emissions credits will be attributable to the PE because they will be directly related to the emissions reductions in the host country resulting from the activities carried out by the foreign enterprise through the PE.

- *A CDM or JI project is operated through a Project Development Agreement (PDA)*

60. Under a PDA, a foreign enterprise takes on the full risk, until the issuance of the emissions credits, associated with the design and development of a project that employs assets owned by a host country enterprise. In consideration for such assumption of risk and the provision by the foreign enterprise of expertise and services in developing and implementing the project, the host country entity may agree under the PDA to assign to the foreign enterprise the right to all or a large portion of the emissions credits generated by the project.

61. 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.

62. 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 premises of the project owner) or under the conditions described in subparagraph 3(b) of Article 5 (i.e. services furnished in the host country through employees or other personnel for a period or periods aggregating more than 183 days within a 12-month period). In such cases, all or part of the income derived by the enterprise in respect of those services may appropriately be considered as income attributable to a PE through which the enterprise has carried on its business.

2. Article 8 (Shipping, Inland Waterways Transport and Air Transport)

63. Project activities reducing emissions resulting from the reduced consumption of bunker fuels (i.e. fuels sold to any air or marine vessel engaged in international transport) are not eligible under the CDM or JI mechanism[22]. This means that aviation and shipping activities are not eligible under the CDM or JI mechanism. This ruling is based on the fact that aviation and marine bunker fuels are not covered by the Kyoto Protocol (Article 2.2 of the Kyoto Protocol).

64. An enterprise engaged in the operation of ships or aircraft in international transport, or in the operation of boats in inland waterways transport, may, however, participate in CDM and/or JI projects in order to obtain emissions credits to cover emissions that relate to the operation of such ships, aircraft or boats. Profits from the granting of such credits are unlikely to be covered by Article 8 because, in most cases, they would not appear to constitute profits from "auxiliary activities which could properly be brought under the provision" or profits "directly connected" or "ancillary to such operation" [23]. Such profits would therefore be taxable in accordance with Article 7.

This might need further elaboration. Since the meaning of "ancillary" in relation to international traffic will be discussed under a separate topic during the 8th Session of the Committee, this issue could be linked to that discussion.

Paragraph 4.2 of the OECD Commentary on Article 8 states that "Activities that the enterprise does not need to carry on for the purposes of its own operation of ships or aircraft in international traffic but which make a minor contribution relative to such operation and are so closely related to such operation that they should not be regarded as a separate business or source of income of the enterprise should be considered to be ancillary to the operation of ships and aircraft in international traffic."

[22]. CDM Executive Board decision (Paragraph 58 of the CDM EB 25).

[23]. See paragraph 10 of the Commentary on Article 8 of the UN Model, quoting paragraphs 5 to 14 of the Commentary on Article 8 as it read in the 2003 version of the OECD Model, for a discussion of additional activities more or less closely connected with the direct operation of ships and aircraft.

In this respect, paragraph 12 of the OECD Commentary considers that Article 8 does not apply to a shipbuilding yard operated in one country by a shipping enterprise having its place of effective management in another country. In line with this example, one should consider that Article 8 does not apply to a CDM or JI project operated by a shipping or air transport enterprise in another country. Consequently, the emissions credits granted in consideration for the operation of such CDM or JI project would not be derived from the operation of ships or aircraft in international traffic.

A member of the Working Group considers that paragraph 64 does not consider properly the taxing rights of the source country where the activities that originates CERs are performed. In this respect, one should note that the application of Article 7 would, however, in most cases allocate the taxing rights to the State where the CDM project is operated (either because the participant in the project is a shipping or air transport enterprise of that State or because the participant is a foreign enterprise for which the CDM project constitutes a PE). If Article 8 would apply, the CERs granted to foreign shipping or air transport enterprises would only be taxable in the State in which their place of effective management is situated.

3. Article 6 (Income from Immovable Property)

65. Income arising at the time a permit is granted for free could also fall under Article 6 as income from "immovable property". This could be the case if a State grants credits to the owner of "immovable property", such as a wind mill, and the credits are bound to that property. In such case, the income from the granting of permits may be taxed in the State where the immovable property is situated even if such property would not constitute a fixed place of business for an enterprise.

A member of the Working Group considers, however, that permits are never bound to immovable property as such but to activities exercised through immovable property. Therefore income from granting of permits would not be taxed in the State where the immovable property is situated without having activities that constitute a PE.

66. The income from the granting of emissions credits may fall under Article 6 as income from immovable property (as defined in paragraph 1 of Article 6) if the credits are granted in consideration for the reduction of emissions achieved in connection with agriculture or forestry activities (including LULUCF activities).

4. Article 12 (Royalties)

67. Under paragraph 3 of Article 12, the definition of royalties covers "payments … received as a consideration … for the use of, or the right to use, industrial, commercial or scientific equipment". Those terms do not cover payments received by the operator of equipment in consideration for the use he is making of such equipment, but cover payments made by the operator of equipment to the lessor in consideration for the concession of the use or the right to use the equipment. The income from the grant of credits with respect to the operation of industrial, commercial or scientific equipment should consequently not be classified as royalties.

5. Article 14 (Independent Personal Services)

68. In theory, where an individual[24] takes on the full risk, under a PDA, associated with the design and development of a project, the PDA could assign to the individual the right to all or a large portion of the emissions credits generated by the project. Note, however, that it does not appear that an individual may be a "project participant" in a CDM or JI project[25] (i.e. 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 provided for in Article 14 (e.g. if the individual is present in the host country for a period or periods aggregating at least 183 days in any twelve-month period and all or part of the income is derived from activities performed in the host country).

6. Article 21 (Other Income)

69. In most cases, income arising at the time emissions credits are granted would be covered either by Article 6, 7 or 14. In such cases, Article 21 would not apply with respect to such income. The term "profits" used in Article 7 has a broad meaning including all income derived in the carrying on of an enterprise[26]. Except where an item of income is treated separately in a specific article of a treaty, Article 7 is applicable to any income obtained by an enterprise in the carrying on of any business, including the benefits obtained in the form of emissions credits relating to its business (e.g. as a project developer or as a participant in a project under a Project Development Agreement).

70. Article 7 would not, however, apply if the benefits in the form of emissions credits are not obtained in the course of the carrying on of a business. This would, for instance, be the case where the project developer or an entity participating in a project under a PDA is an NGO, a Government, a foundation, a charity or a public entity and the activities of such an entity did not constitute the carrying on of a business for treaty purposes. In such a case, the benefits arising in the host country with respect to the project developed therein by a non-resident entity might be taxed by the host country under paragraph 3 of Article 21, although one would assume that most NGOs, governments or charities would not be subject to tax.

A member of the Working Group considers that paragraph 69 does not consider properly the taxing rights of the source country where the activities that originates CERs are performed (specially regarding art. 21, paragraph 3 of the UN Model Convention "arising in the other Contracting State").

One should, however, mention that, where an enterprise of a Contracting State is participating in a CDM project in the other Contracting State, this project constitute in most cases a PE in accordance with Article 5 (see paragraphs 57 to 62 above) and Article 7 allocates the taxing rights to the country

[24]. Some countries consider that the scope of Article 14 is not restricted to individuals and may cover companies in respect of the furnishing of the activities of employees or other personnel. Such countries might therefore consider that the granting of emissions permits in the framework of a PDA may be taxed under the conditions provided for in Article 14.

[25] Relevant guidance suggests that a "project participant" must be a legal entity. See, for example, the definitions of "project participant" in the "Glossary of CDM Terms" (available at: http://cdm.unfccc.int/Reference/Guidclarif/glos_CDM.pdf) and the "Glossary of Joint Implementation Terms" (available at: http://ji.unfccc.int/Ref/Documents/Glossary_JI_terms.pdf). A person cannot be issued CERs or ERUs in connection with a CDM or JI project unless he or she is a "project participant".

[26]. See paragraph 21 of the Commentary on Article 7 of the UN Model.

where the CDM project is operated. There is thus no reason to use Article 21(3) to achieve that result. Moreover, there exists no good reason for deciding that the CERs are not profits derived from business carried on by the enterprise participating in a CDM project.

C. The trading of emissions permits/credits

71. The tax treaty issue associated with the trading of emissions permits/credits is the treatment of the income from the alienation of such permits/credits by a resident of a Contracting State.

72. Under a carbon market, a mechanism is needed to introduce emissions permits/credits into the marketplace. This entry point is the primary market. With respect to emissions permits, entry can occur by the government distributing permits directly to market participants, either free of charge or at a predetermined price, by the government auctioning permits to the highest bidder or by some combination of these two methods. With respect to emissions credits, their creation may involve a number of transactions among participants in the project before credits are issued by the relevant authority (i.e. before reductions in emissions have been achieved and/or verified). For example, to finance particular emission reduction measures, an entity may engage in transactions involving the (forward) sale of credits that it expects to be awarded for the emission reductions.

73. 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 transactions.

74. Regulated entities that face a compliance obligation under a national or regional emissions trading programme will likely be active participants in secondary markets. Other entities that have no compliance obligation may, however, also trade on their own account in the secondary carbon markets, with the goal of either making profits from their trades, and/or of using those trades as a means of offsetting other financial exposure (e.g. hedgers). The last category of market participants could include a variety of businesses whose financial position is indirectly tied to carbon prices (e.g. firms that produce emission reducing technologies that themselves have no compliance obligations but bear risk associated with carbon price changes).

75. An internationally agreed characterization of the traded permits/credits would provide more certainty as to what is being traded and as to how they should be treated for accounting and tax purposes. There exists, however, no such internationally recognised characterization.

> The legal character of EAUs is not defined under the EU ETS. Based on the subsidiarity principle, legal character must be determined according to the national legal system of each EU Member State. The legal character of EAUs has been defined differently amongst Member States[27]. A majority of EU Member States treats EAUs as a commodity[28] (some allow for

[27]. European Environmental Agency, Application of the Emissions Trading Directive by EU Member States (2008), EEA Technical Report No 13/2008.

Tax Treatment of ETS Allowances, Options for improving transparency and efficiency/October 2010 http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/ets-report.pdf.

immediate deduction of the purchase price for tax purposes and others only allow deduction when an EAU is actually used for compliance purposes). A minority of EU Member States treats allowances as intangible assets and allows depreciation over their expected lifetime.

It seems desirable that countries adopt a similar characterization for emissions permits/credits. Such characterization is, however, a matter of domestic law. It seems therefore difficult to issue any recommendation in this respect in the framework of the present work which is dealing exclusively with bilateral tax treaties issues.

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. This characterisation could have consequences with respect to the tax treatment of income from these permits/credits under domestic law (e. g. the costs relating to their acquisition or their depreciation).

In December 2007, the Accounting Standard Board of the IFRS Foundation activated work on the Emissions Trading Schemes project. The IASB noted the considerable 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).

At its September 2010 meeting, the IASB and FASB discussed the issues of recognition of allowances as assets, and the existence and recognition of liabilities when allowances are allocated. They tentatively decided that purchased and allocated allowances should be recognized as assets.

The project is in the early stages of completion. There are many issues in the project that are yet to be discussed. Discussions on the project were, however, deferred in November 2010. It seems that they have not yet been reopened.

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.

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.

76. 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.

[28]. This corresponds to the view expressed under the UN Framework Convention on Climate Change: “[A] new commodity was created in the form of emission reductions or removals. Since carbon dioxide is the principal greenhouse gas, people speak simply of trading in carbon. Carbon is now tracked and traded like any other commodity.” http://unfccc.int/kyoto_protocol/mechanisms/emissions_trading/items/2731.php.

77. 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)

78. "Business profits" is a term which is not defined in the UN Model but which is generally considered to include all types of income derived from the conduct of a business. 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).

79. 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.

80. 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.

81. The income derived by an enterprise of a Contracting State from the sale 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 sale of an emissions permit acquired on a secondary market is attributable to a PE will depend on the facts and circumstances.

What about the situation where the home office oversees the compliance obligations of a PE within the scope of an emissions trading programme? Could the profits from the sale of emissions permits acquired by the home office be attributed to the PE where there is no PE involvement in the acquisition or sale of the permits? Could we attribute to a PE the profits realised on the sale of permits simply because these permits have been acquired by the home office to cover a possible shortfall of permits needed for the PE operation?

Where the purchase price of the emissions permits is deductible as expenses incurred exclusively for the benefit of the PE, it would, however, seem normal to attribute to the PE the profits derived from the sale of these permits by the enterprise. Actual administrative expenses relating to the purchase and the sale of these permits by the home office would be deductible as incurred for the purposes of the business of the PE.

82. Where an enterprise of a Contracting State has been granted emissions permits in connection with the emissions of a PE in another Contracting State and transfers those permits from that PE to another part of the enterprise (e.g. in connection with the compliance obligations of a third-country PE), the fair market value of the permit at the time of the transfer might be taken into consideration in order to determine the profits attributable to that PE (depending on whether or not such an internal transfer would be recognised). Where, subsequently, the emissions permit is used or is sold, the value of the credit at the time of the transfer will also be taken into consideration in order to determine the profits resulting from the use or sale of the permit that are attributable to the part of the enterprise to which the permit was transferred. Where a potential income has been subject to tax at grant, the taxable value at grant should constitute the starting value of the permits for determining the taxable profit (or loss) resulting from the transfer.

83. The income derived by a foreign enterprise from the sale of emissions credits granted to it with respect to a project that it owns (in whole or in part) may be taxed in the host country where the project constitutes a PE. Such income may also be taxed in the host country where the foreign enterprise has performed services in the host country under a Project Development Agreement (PDA) through a fixed place of business and the profits from the sale are attributable to that PE. Similarly, where the foreign enterprise has performed services in the host country under a PDA and satisfies the conditions of subparagraph 3(b) of Article 5 (i.e. the foreign enterprise has a services PE), the profits derived from the sale of these credits may be taxed in the host country where they are attributable to that PE.

84. The income derived by a foreign enterprise from the sale of emissions credits it has acquired under an ERPA Developer Structure at a reduced price or free of charge in consideration for the services provided in developing the project may be taxed in the host country where the services provided under such structure were performed in the host country through a fixed place of business or under the conditions provided for under subparagraph 3(b) of Article 5, to the extent that such income is attributable to such performance. The income relating to the services performed under ERPA Developer Structure would be:

- the foreign price specified for the credits in the purchase agreement where part of the credits are transferred free of charge ; or
- the difference between the fair market value of the credits at the time of the transfer to the purchaser and the reduced price agreed upon by the parties.

85. Where a foreign enterprise has undertaken a CDM or JI project to obtain credits to cover emissions from polluting activities carried out in its country of residence or through a PE situated within a third country, the economic ownership of the credits would typically be transferred to the part of the enterprise that was supposed to use those credits.[29] In such a case, the fair market value of the credits at the time of the transfer is taken into consideration in order to determine the profits attributable to the CDM/JI project PE. When, subsequently, the emissions credits are used or sold, the value of the credits at the time of the transfer will also be taken into consideration in order to determine the profits resulting from the use or sale that are attributable to the part of the enterprise to which the credits were transferred.

86. A foreign enterprise that has undertaken a CDM/JI project may sell the credits that it expects to be awarded in connection with the project before their issuance (a forward sale). The income derived from that sale is attributable to the CDM/JI project PE (actual administrative expenses relating to the sale of these credits incurred by different parts of the enterprise would be deductible as incurred for the purposes of the business of the PE).

[29]. Once CERs have been registered into the Pending Account of the CDM Registry, the project participants may request the transfer of CERs to accounts held by them in the National Registry of the Annex I country that provided the letter of approval to participate in the CDM project activity (or their temporary holding account in the CDM Registry).

87. The profits (or losses) from the sale of emissions credits that a selling enterprise has acquired on the secondary market are not attributable to the CDM/JI project that generated the credits. After sale by their primary owner, the credits are indeed no longer connected to a business that the selling enterprise would carry on through the CDM/JI project. Should the market price of the credits increase after the first sale, the profit or gain arising from any subsequent sales would therefore not be profits attributable to the CDM/JI project. Such profits would be taxable (or losses would be deductible) only in the State of residence of the selling enterprise, unless they were attributable to a PE situated in another State[30].

A member of the Working Group considers that paragraph 87 does not consider properly the taxing rights of the source country where the activities that originates CERs are performed.

88. A bilateral treaty that follows the UN Model will contain a "limited force of attraction" rule. Under such a rule, the other Contracting State (the PE State) may also tax profits attributable to (i) sales of goods or merchandise in that State of the same or similar kind as those sold through the PE and (ii) other business activities carried on in that State of the same or similar kind as those effected through the PE. The question may therefore arise whether the profits derived from the sale of emissions permits/credits in the other Contracting State that are not attributable to a PE may be taxed in that State on the basis of the "limited force of attraction" rule.

89. The "limited force of attraction" covers the "same or similar" activities as those carried on through the PE. The activities carried on through a CDM/JI project PE are activities resulting in a reduction of greenhouse gas emissions which gives rise to the grant of credits if the necessary conditions are fulfilled. These activities generally do not include the trading, as such, of emissions credits for the enterprise. This means that the "limited force of attraction" rule would not apply if an enterprise operating a CDM/JI project PE in a Contracting State directly sold, in that State, emissions credits purchased on the secondary market or issued with respect to a CDM/JI project carried on in another State. Such a sale would indeed not be identical or similar to a possible sale through the CDM/JI project PE of credits granted in respect of the activities carried on through the CDM/JI project.

90. The activities carried on through a PE which is required to hold emissions permits (i.e. to participate in an emissions trading programme) are generally industrial activities giving rise to polluting emissions. These activities generally do not include the trading of emissions permits for the enterprise as a whole (as opposed to the trading of emissions permits in connection with the PE's own compliance obligations). The direct sale by the enterprise, in the PE State, of emissions permits granted to or acquired by the enterprise in connection with polluting activities carried on through other parts of the enterprise would therefore not be similar to the sale through the PE of "excess" emissions permits relating to the emissions produced through the PE.

91. The "limited force of attraction" rule would only apply if the functions of the PE encompassed the management and trading of emissions permits/credits for different parts of the enterprise. In such a case, the profits attributable to the management and trading functions exercised by the PE could be taxed in the PE State, as well as profits relating to trading functions performed directly by the enterprise in the PE State without the involvement of the PE.

The "limited force of attraction" rule is only found in a limited number of treaties. Its operation

[30]. This would be the case even where the primary owner of the credits repurchased (and re-sold) the same credits. This is consistent with the characterisation of the credits under the Kyoto Protocol as fungible commodities.

depends upon the existence of a similar rule in domestic law so that, even if it would be included in a treaty, it may not be operative in practice. The Commentary on Article 7 of the UN Model does not address the operation of the rule in any great detail. There is, consequently, no certainty as to exactly which transactions the rule could apply. The application of the "limited force of attraction" rule to income derived in connection with emissions permits/credits could therefore be clarified in the UN Commentary.

2. Article 6 (Income from immovable property)

92. 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. 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.

93. 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.

3. Article 8 (Shipping, Inland Waterways Transport and Air Transport)

94. Paragraph 1 of Article 8 (alternative A) of the UN Model provides that "profits from the operation of ships and aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated". Paragraph 2 of Article 8 provides a similar rule for profits from the operation of boats engaged in inland waterways transport. An enterprise of a Contracting State engaged in these transportation activities will be taxable on the business profits derived therefrom only in the State of its place of effective management[31], regardless of whether or not such profits might be attributable to a PE situated in another State.

95. As already mentioned, the aviation sector is covered by the EU ETS as of 2012. Enterprises engaged in international air transport could, therefore, trade emissions permits/credits acquired to cover the emissions resulting from their operations. Income derived by the enterprise operating the aircraft from the alienation of emissions permits issued to the enterprise, or of emissions credits purchased on the secondary market, could be considered as operating business profits directly connected to the operation of aircraft. If the aircraft were operated in international traffic, such business profits would therefore be taxable pursuant to Article 8 only in the State of the enterprise's place of effective management.

96. An enterprise engaged in the operation of aircraft in international traffic could participate in CDM/JI projects in order to obtain emissions credits to cover emissions produced by the operation of

31. As mentioned in paragraph 5 of the Commentary on Article 8 of the UN Model, some countries prefer to refer to the State of residence of the enterprise.

such aircraft. Profits from the issuance of such credits are unlikely to be covered by Article 8. In most cases, the CDM/JI project activities would not be considered "auxiliary activities which could properly be brought under the provision"[32] nor would such activities be considered "directly connected" or "ancillary to such operation"[33]. Profits from the first sale of such credits by the enterprise would therefore generally be taxable in accordance with Article 7[34].

97. A bilateral treaty that follows the UN Model could contain a provision similar to paragraph 2 of Article 8 (alternative B) of the UN Model. Under such a provision, profits from shipping activities are taxable in the State where they arise if operations in that State are "more than casual". As already mentioned, there is currently no international regulation of greenhouse gas emissions from ships. If and when the operation of ships is covered by emissions trading schemes in the future, however, income derived from the alienation of emissions permits/credits could be considered as operating business profits directly connected to the operation of ships if it were derived by a shipping enterprise and the emissions permits/credits were acquired in connection with the emissions from such operations. In such a case, the profits to be taxed in the State of source would be determined on the basis of an appropriate allocation of "overall net profits" from the operation of ships in international traffic, including profits derived from emissions permits/credits trading relating to such operation. Profits from the first sale of credits issued with respect to a CDM/JI project in which the shipping enterprise participated would not, however, be included in the "overall net profits". A CDM/JI project would not be considered an activity auxiliary to the operation of ships in international traffic, and profits from such activity should be taxable in accordance with Article 7.

> [Paragraph 14 of the Commentary on Article 8 (alternative B) of the UN Model could provide that it might be specified in the course of bilateral negotiations that profits connected with the sale of emissions permits/credits relating to the operation of ships in international traffic should be included in the overall net profits from shipping operations, part of which is allocated to the State of source.
>
> Some States could, however, prefer to specify in the course of bilateral negotiations that profits connected with the sale of emissions permits relating to the operation of ships in international traffic are excluded from the overall net profits. In such a case, it could be specified that the profits from the sale of emissions permits would be allocated to the State that issued the emissions permits in connection with the operation of ships in that State. However, this may only be appropriate in a case where the shipping enterprise continues to hold the permits from the date they are issued and only sells the "excess" permits it does not have to surrender at the end of the compliance period. Because emissions permits are fungible commodities, the shipping enterprise could well sell in year 1 all of the emissions permits issued by State X (in which it undertakes "more than casual" operations) and buy back in year 5, at a different price, the amount of emissions permits/credits required to cover its emissions in State X. In such a case, the exclusion of permits from the "overall net profits" would lead to the taxation of profits in State X (in year 1) where the overall trading mechanism may have resulted in a loss. Taking into account the fungible nature of emissions permits, it seems,

[32]. Paragraph 10 of the Commentary on Article 8 of the UN Model, quoting paragraph 4 of the Commentary on Article 8 as it read in the 2003 version of the OECD Model.

[33]. Paragraph 4 of the Commentary on Article 8 of the OECD Model as it reads in the 2010 version of the OECD Model.

[34]. Where a foreign enterprise has undertaken a CDM/JI project and obtains credits to cover emissions resulting from its international transport activities outside the host country, the issued credits would typically be transferred from the CDM/JI project PE to part of the enterprise that would use the credits. In such case, the fair market value of the credits at the time of the transfer is taken into consideration in order to determine the profits attributable to the CDM/JI project PE and taxable in accordance with Article 7. Where, subsequently, the emissions credits are used or are sold, the value of the credits at the time of the transfer will also be taken into consideration in order to determine the profits from their use or sale that are attributable to the operation of aircraft in international traffic and taxable in accordance with Article 8.

therefore not accurate to exclude the profits from the trading of permits from the "overall net profits" and to allocate the profits to the State having issued them.]

Paragraphs 96 and 97 might need further elaboration. Since the meaning of "ancillary" in relation to international traffic will be discussed under a separate topic during the 8th Session of the Committee, this issue could be linked to that discussion.

A member of the Working Group considers that paragraphs 96 and 97 do not consider properly the taxing rights of the source country where the activities that originates CERs are performed. In this respect, one should note that the application of Article 7 would, however, in most cases allocate the taxing rights to the State where the CDM project is operated (either because the participant in the project is a shipping or air transport enterprise of that State or because the participant is a foreign enterprise for which the CDM project constitutes a PE). If Article 8 would apply, the CERs granted to foreign shipping or air transport enterprises would only be taxable in the State in which their place of effective management is situated (or would be included in the overall net profit of the shipping enterprise, part of which would be allocated to the State where the CDM project is operated and would be taxable at a limited rate).

The considerations relating to paragraph 14 of the Commentary on Article 8 (alternative B) of the UN Model does not seem really useful. They deal with possible variations of an alternative that is not frequently used and these variations would only be relevant if shipping were to be covered by emissions trading schemes in the future. They could be deleted for the sake of simplicity.

4. Article 13 (Capital Gains)

98. Article 13 does not specify how to compute a capital gain; this is left to the applicable domestic law. A capital gain is, however, typically the amount by which an asset's selling price exceeds its initial purchase price. Domestic law will similarly determine when a capital gain is considered to be realized. A capital gain will generally be realized when an investment is sold at a profit; depending on the applicable domestic law, a capital gain may also be considered to be realized upon certain other dispositions or transfers of appreciated property. In accordance with paragraph 4 of the Commentary on Article 13 of the UN Model (which quotes paragraph 12 of the OECD Commentary on Article 13), as a rule capital gains are determined by deducting the cost (the purchase price and all expenses incidental to the purchase and expenditures for improvement) from the selling price. Special problems may arise when the basis for the taxation of capital gains is not similar in both Contracting States. This issue is discussed in paragraph 4 of the Commentary on Article 13 of the UN Model (see in particular quoted paragraphs 13 to 15 of the OECD Commentary on Article 13).

- *Gains from the alienation of movable property forming part of the business property of a PE (paragraph 2 of Article 13)*

99. Depending on the circumstances, a country's domestic law may treat the income derived by an enterprise from the alienation of emissions permits/credits as a gain from the alienation of property specifically dealt with under Article 13. This could be the case, for instance, where, under its domestic law, a country treats emissions permits/credits as intangible assets or financial assets, the alienation of which does not give rise to operating business income for the enterprise but to capital gain from the alienation of property.

100. In accordance with paragraph 6 of the Commentary on Article 13 of the UN Model (quoting paragraph 24 of the OECD Commentary on Article 13), "movable property" means "all property other than immovable property" and includes "incorporeal property, such as goodwill, licences, etc.". In this respect, emissions permits/credits may constitute movable property dealt with under paragraph 2 of Article 13.

101. Under Article 13, a capital gain from the alienation of emissions permits/credits would be taxable on a residence basis, except to the extent that the emissions permits/credits form part of the business property of a PE that an enterprise of a Contracting State has in the other Contracting State. In such a case, gains from the alienation of emissions permits/credits may be taxed in the other Contracting State. As explained in paragraph 4 of the Commentary on Article 13 of the UN Model, there is no need to determine whether the taxing rights, in such cases, arise under Article 7 or Article 13 because the treaty treatment is similar under both articles and any difference of views on this issue will have no practical consequences.[35]

102. In accordance with paragraph 4 of the Commentary on Article 13 of the UN Model (quoting paragraph 10 of the OECD Commentary on Article 13), where a State assimilates the transfer of an emissions permit/credit from a PE situated on its territory to a PE or the head office situated in the other Contracting State, the PE State may tax gains 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 with respect to capital gains from the alienation of assets of an enterprise, capital gains are taxed as ordinary income. In other countries, capital gains are subjected to special taxes which, on the contrary, may provide for special rates, may provide for specific exemptions and do not take into account the other income or losses of the taxpayer. Paragraph 3 of the Commentary on Article 13 of the UN Model (quoting paragraph 3 of the OECD Commentary on Article 13) notes that "[i]t is left to the domestic law of each Contracting State to decide whether capital gains should be taxed and, if they are taxable, how they are taxed". This issue, not dealt with under the treaty, is not specific to tradable permits/credits. It should be discussed in the course of the negotiations in order to have a better understanding of the tax regimes of both States.

- *Gains from the alienation of ships, aircraft, boats and movable property pertaining to their operation (paragraph 3 of Article 13)*

103. Paragraph 3 of Article 13 provides, for gains derived from the alienation of "movable property pertaining to the operation" of ships and aircraft in international traffic, or of boats in inland waterways transport, the same rule as the rule applicable under paragraph 1 of Article 8 (alternative A) to the profits derived from the operation of such ships, aircraft and boats. The term "pertaining to" has an extended meaning (e.g. "belonging to", "having connection with, dependence on or relation to") which covers the situation where emissions permits/credits were acquired by the enterprise in order to fulfil obligations under an emissions trading programme relating to such operations. In such cases, the permits/credits would qualify as "movable property pertaining to the operation of such ships, aircraft and boats" for the purposes of paragraph 3 of Article 13 and the gains from their alienation by the

35. Paragraph 4 of the Commentary on Article 13 of the UN Model quotes paragraph 4 of the OECD Commentary on Article 13, which describes as follows the relationship between Article 7 and Article 13:

"It is normal to give the right to tax capital gains on a property of a given kind to the State which under the Convention is entitled to tax both the property and the income derived therefrom. The right to tax a gain from the alienation of a business asset must be given to the same State without regard to the question whether such gain is a capital gain or a business profit. Accordingly, no distinction between capital gains and commercial profits is made nor is it necessary to have special provisions as to whether the Article on capital gains or Article 7 on the taxation of business profits should apply. It is however left to the domestic law of the taxing State to decide whether a tax on capital gains or on ordinary income must be levied. The Convention does not prejudge this question."

operating enterprise would be taxable only in the Contracting State where the place of effective management of the enterprise is situated.

The view expressed in paragraph 103 is however questionable.

Following that view, paragraph 3 of Article 13 would apply to gains from the sale of emissions permits that are not used to cover the emissions due to the operation of ships or aircraft. They were acquired for that purpose but they were never used for that purpose. The question arises therefore if sold emissions permits may effectively be considered as pertaining to the operation of ships or aircraft.

104. Where an enterprise engaged in the operation of ships or aircraft in international transport, or in the operation of boats in inland waterways transport, has participated in a CDM/JI project, gains from the first sale by that enterprise of emissions credits generated by the project would generally not be considered as gains from movable property pertaining to such operations. The CDM/JI project giving rise to the issuance of those credits would indeed not be considered as an activity auxiliary or ancillary to such operations. These gains would therefore generally be taxable under paragraph 2 of Article 13 (to the extent that such gains were considered to fall within the scope of Article 13).

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

105. 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",[36] either on the basis of a State's domestic law definition of immovable property or on the basis of the interpretation of the terms "property accessory to immovable property", the State in which these emissions permits/credits would be considered to be situated would have the right to tax gains derived by non-residents from the alienation of these permits, even if these permits did not form part of the business property of a PE situated in that State. Consider, for instance, the case of a permit or credit granted to the owner of immovable property as an attribute of the immovable property, such as a factory, a mine or other natural resource deposit giving rise to covered emissions, or a wind turbine giving rise to reductions of greenhouse gas emissions[37]: It could be argued that the permit/credit is immovable property because it was granted with respect to immovable property, not with respect to activities carried on through immovable property, and that it is consequently accessory to immovable property.

106. If that were the case, paragraph 1 of Article 13 could apply to income derived from the sale of emissions permits/credits by the primary owner of such permits/credits which it has received as the owner of the immovable property to which the permits/credits are bound or as the developer under a Project Development Agreement (PDA) where the permits/credits generated by the project are bound

36. Paragraph 2 of Article 6 of the UN Model provides:

"The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property."

37. This could also be the case if a permit is bound to ships, boats or aircraft regarded as immovable property under the domestic law of the State where they are registered and such ships, boats or aircraft are not excluded from the definition of "immovable property" under paragraph 2 of Article 6 of a treaty concluded by that State.

to immovable property. In practice, however, emissions permits/credits are generally not bound to immovable property but are granted with respect to activities carried on through immovable property.

107. If emissions permits/credits were to fall within the definition of "immovable property" on the basis of the interpretation of the terms "property accessory to immovable property", it could, however, be argued that paragraph 1 of Article 13 would not apply to profits or gains from the subsequent resale of these permits/credits by other persons. Once the permits/credits have been sold by the primary holder, it would be difficult to consider that those permits/credits could still be "property accessory to immovable property". The sale of a permit or a credit by the primary holder could indeed reasonably be considered to cut the link between the permit/credit item and the immovable property in relation to which it was granted so that it could no more be considered as accessory to that property (i.e. an item having a secondary, supplementary or subordinate function in relation to the immovable property).

For the sake of certainty, the Commentary on Article 6 of the UN Model could clarify that emissions permits/credits should generally not be considered as property accessory to immovable property.

108. 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).

The Commentary on Article 6 and/or paragraph 1 of Article 13 of the UN Model could clarify this issue and might, for example, recommend that countries do not characterize emissions permits/credits as "immovable property". Such characterization could be regarded as inconsistent with the cap-and-trade system under the Kyoto Protocol, which treats emissions permits/credits as fungible commodities. 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, lessened market power 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 generally applicable. Immovable property characterization would likely affect the efficiency and liquidity of the carbon market.

It could also be argued that such domestic law characterisation would not be in accordance with Article 6 because it would be so remote from the intended scope of Article 6 that it would violate Article 26 of the Vienna Convention on the Law of Treaties, under which the parties to a treaty must perform the treaty in good faith. Others might, of course, argue that it is within the scope for flexibility of domestic law granted by the treaty and is therefore in accordance with the treaty. These issues could therefore usefully be discussed by the Committee.

A member of the Working Group considers, however, that this issue is a purely domestic law issue that comes under the discretionary powers of the Contracting States and should not be discussed in the UN Commentary. Further, that member considers that the cap-and –trade system under the Kyoto Protocol is not the only system currently operating as non Annex I countries can have their own

systems.

109. As noted above, 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. Paragraph 1 of Article 13, which refers to gains "from the alienation of immovable property", does not cover the alienation of movable property connected with agriculture or forestry activities unless such movable property falls under the definition of paragraph 2 of Article 6 (i.e. equipment used in agriculture and forestry, property accessory to immovable property or property characterized as immovable property under the domestic law of the State in which the property is situated).[38]

- *Gains from the alienation of shares in a company or of an interest in a partnership, trust or estate, the property of which consists, directly or indirectly, principally of immovable property (paragraph 4 of Article 13)*

110. Except where a company, partnership, trust or estate is engaged in the business of management of immovable properties, paragraph 4 of Article 13 does not apply to a company, partnership, trust or estate, the property of which consists, directly or indirectly, principally of immovable property used by such an entity in its business activities. Where emissions permits/credits are considered as immovable property under the domestic law of the State in which the immovable property to which such permits/credit are bound is situated, those permits/credits should be considered as used by that entity in its business activities if they are connected with the coverage of emissions resulting from its business activities. Where an 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.

111. This provision does not seem to have specific implications in relation to emissions permits/credits.

- *Gains from the alienation of property other than property referred to in paragraphs 1, 2, 3, 4 and 5 (paragraph 6 of Article 13)*

112. Article 13 may apply where the alienation of emissions permits/credits does not occur in the course of the carrying on of a business of an enterprise. This could be the case, for instance, where CERs are alienated by an NGO, a charity, a Government or a public entity that is the project developer and the primary owner of the CERs generated by the CDM project and the host country considers that the activities of an NGO, charity, Government or public entity do not constitute the conduct of a business. In these situations, the capital gain would be taxable on a residence basis according to paragraph 6 of Article 13, unless paragraph 1 of that Article would be applicable.

4. Article 12 (Royalties)

113. Treaties following the UN Model include a definition of royalties that covers "payments … received … for the use of, or the right to use … industrial, commercial or scientific equipment". An emissions trading programme may require the operator of equipment that produces greenhouse gas

37. Where agriculture or forestry activities give rise to a PE under Article 5, movable property connected with such agriculture or forestry activities may be considered part of the business property of that PE. In such a case, paragraph 2 of Article 13 would permit the PE State to tax gains from the alienation of such movable property.

emissions to surrender emissions permits in connection with the emissions generated by the equipment during the relevant compliance period. The view has therefore been expressed that where such person sells these permits, he is selling the right to emit the greenhouse gases that result from the use of the equipment he is operating. Following that view, the income from such sale might be considered as resulting indirectly from the use of the equipment and might therefore be considered as royalties.

114. Where the operator of industrial, commercial or scientific equipment is selling an emissions permit obtained in relation with the operation of such equipment, he is actually selling a fungible permit. Consequently, the operator of the equipment does not transfer any right with respect to the use of such equipment but is selling the right to emit greenhouse gazes from any possible installation an enterprise might operate. The income from the sale of permits relating to the operation of industrial, commercial or scientific equipment should consequently not be considered as received for the use or the right to use such equipment and should not be classified as royalties.

For the sake of certainty, the UN Commentary on Article 12 could clarify that payments from the sale of permits relating to the operation of industrial, commercial or scientific equipment are not payments received as a consideration for the use of or the right to use such equipment.

115. The question may arise whether income from the leasing of emissions permits/credits would fall under Article 12. Leasing permits/credits would not, however, make sense under the cap-and-trade systems contemplated by the Kyoto Protocol. Under these systems, a permit/credit is used when it is surrendered at the end of a compliance period in order to cover effective greenhouse gas emissions during the period. As a permit/credit is consumed through this first use, it is not a property or right that could typically be leased.

A member of the Working Group considers, however, that income arising from leasing of emissions permits/credits may be classified as royalties where the owner of equipment who has obtained an emissions permit for the operation of the equipment leases the equipment along with the emissions permit.

It seems, however, that in such case the owner of the equipment would lease the equipment but would sale the emissions permit that the user might surrender by reason of the use he is making of the equipment. Also, in such case, it seems that a permit would not be leased.

5. Article 21 (Other Income)

116. Income or gains derived from the alienation of any property would be covered either by Article 6 (in the case of an enterprise engaged in agriculture or forestry), Article 7, Article 8 or Article 13.

117. As paragraph 6 of Article 13 covers “gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3, 4 and 5”, all gains from the alienation of any type of property are dealt with under Article 13. Article 21 should, therefore, not apply to gains from the trading of emissions permits/credits.

6. Article 9 (Associated Enterprises)

118. Transfer pricing issues may arise with respect to the transfer of emissions permits/credits within a group. A company may indeed transfer emissions permits/credits granted to it or purchased by it to an associated company (e. g. a company which emits less of the pollutant emissions than the amount allowed by the permits they hold may sell the "extra" permits to an associated company which is over its emissions targets). The arm's length principle found in paragraph 1 of Article 9 is applicable to the transfer of these permits/credits. Profits may be adjusted by reference to the price and the conditions which would have been obtained between independent enterprises in comparable transactions and comparable circumstances based on the characterization of tradable permits/credits under the domestic law of the Contracting State making the adjustment.

D. Timing mismatches and disagreements as to the treaty treatment

1. Timing mismatches

119. 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 residence to relieve double taxation. Under Article 23 A and 23 B, the State of residence must provide relief of double taxation with respect to an item of income taxed by the State of source in accordance with the provisions of the treaty even where the State of source taxes that item of income in an earlier or later year (see paragraph 14 of the Commentary on Article 23 of the UN Model, quoting paragraph 32.8 of the OECD Commentary on Articles 23 A and 23 B).

2. Disagreements as to the treaty treatment

120. As explained above, the rules in Articles 7 and 13 result in identical treaty treatment of income (profits or capital gains) from the alienation (or from the grant) of emissions permits/credits (i.e. exclusive taxation in the State of residence unless the emissions 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.

121. 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.

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

122. Disputes may arise in the following cases:

- 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.

123. 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).

- *Conflicts of qualification*

124. A "conflict of qualification" arises where, due to differences in the domestic law characterisation of an item of income in the 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:

- 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 first sale 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.

125. 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 that 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".

126. 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.

The elimination of possible double taxation resulting from differences of characterization in the domestic law of the State of source and the State of residence should as far as possible be sought. If any double taxation would arise, the trading of emissions permits would be hindered and would not be as efficient as expected under the Kyoto Protocol. Therefore, the application of paragraphs 32.1 through 32.7 of the OECD Commentary under Articles 23A and 23B of the UN Model should be discussed as soon as possible in order to reach a consensus in this respect.

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

Granting of emissions permits

127. 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).

128. 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 national or international authority to comply with its obligations under that programme). In such a case, income that is considered to arise when an emissions permit is granted or issued to the enterprise would be taxable in the State of residence of the enterprise. Such income would also be taxable in the Annex I country that issued the permit where:

- the permit relates to a PE of the enterprise in the Annex I country;
- the permit relates to agriculture or forestry activities carried on by the enterprise in the Annex I country; or
- the permit is bound to or considered immovable property under the law of the Annex I country.

It is, however, very unlikely that a permit would be bound to or considered immovable property under the law of the Annex I country and such scenario should be discouraged.

129. 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.[39] 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.

130. Non-Annex I countries may establish emission targets for themselves and organise emissions trading systems even if they have no emissions targets under the Kyoto Protocol. Countries such as Brazil, China, India, Kazakhstan, Mexico and South Korea are exploring the possibilities of introducing domestic emissions trading systems[40]. In order to accumulate knowledge and experience concerning cost-efficient emissions reductions and trading, developing countries could also provide economic incentives for enterprises that commit themselves to achieve reduction targets (as determined by those countries) and organise a "voluntary market" of verified allowances relating to the emissions reductions achieved in the country[41]. The income from the grant of an emissions permit

[39]. As noted above, emissions from ships and boats are not currently covered by emissions trading programmes.

[40]. The introduction of emissions trading systems in these countries is not foreseen in the near future. See Domestic Emission Trading Systems in Developing Countries – State of Play and Future Prospects Wolfgang Sterk and Florian Mersmann http://www.jiko-bmu.de/files/basisinformationen/application/pdf/pp-ets-developing-countries.pdf.

[41]. Trading volumes in a voluntary market are smaller than in a compliance market. Carbon offsets sold in a voluntary market also tend to be cheaper than those sold in a compliance market because demand is created only by voluntary commitment to reduce emissions (i.e. there is a lower demand). Quality standards for voluntary markets are not widely

under such a system would generally be taxable exclusively in the organising country on a residence basis under Article 7 or will be taxable in that country on a source basis where the permit is granted with respect to the PE of a foreign enterprise.

Issuance of emissions credits

131. CERs are issued exclusively in respect of CDM projects in non-Annex I countries. If a Non-Annex I country in which a CDM project was carried on treats the issuance of the CERs relating to that project as a taxable event, that country would generally have the right to tax the income arising from such issuance under a tax treaty. The Non-Annex I country would have the right to tax the income where:

- the income was derived by a resident CDM project participant (income arising in the Non-Annex I country and derived by a resident of that country) ;
- the income was derived by a foreign enterprise through a PE situated in the Non-Annex I country (a CDM project will require such an extended presence in the Non-Annex I country that it would normally give rise to a PE; income attributable to that PE would be taxable in the Non-Annex I country in accordance with Article 7);
- the income was derived by a non-resident through a forestry or agriculture project in the Non-Annex I country or from an emissions credit bound to or considered immovable property under the law of the Annex I country (taxable in the Non-Annex I country in accordance with Article 6); or
- the income was derived by a non-resident project participant which was a foreign Government, NGO or public entity (taxable in the Non-Annex I country in accordance with paragraph 3 of Article 21 where the income is not considered as business income of an enterprise)[42].

It is, however, very unlikely that a CER would be bound to or considered immovable property under the law of the Non-Annex I country and such scenario should be discouraged.

132. Profits from the granting of CERs to an enterprise engaged in the operation of ships or aircraft in international transport, or in the operation of boats in inland waterways transport, would generally not be considered as profits from "auxiliary activities" which could properly be brought under the provisions of Article 8 nor as profits "directly connected" with or "ancillary to" such transport operations. Such profits would therefore be taxable under Article 7.

133. ERUs are issued in respect of JI projects developed by Annex I countries in another Annex I country. Non-Annex I countries are, therefore, not concerned with the issuance of ERUs at this stage.

First sale of emissions permits

134. The profits or gains from the first sale of an emissions permit will generally be taxable exclusively on a residence basis in an Annex I country under Article 7 or Article 13, except where the profits or gains are attributable to a PE situated in another Annex I country or are income from agriculture or forestry activities exercised in another Annex I country.

135. Profits or gains from the first sale of an emissions permit by an enterprise engaged in the operation of ships or aircraft in international transport, or in the operation of boats in inland waterways

established and the carbon offsets traded in such markets are not equivalent to the permits/credits traded in compliance markets.

[42]. It would, however, be rather unusual that the NGO, Government or public entity would be taxable under domestic law if it does not carry on a business.

transport, would be taxable exclusively in the State of the enterprise's place of effective management (or in the State of residence of the enterprise). The place of effective management could be situated in a Non-Annex I country or in an Annex I country. A bilateral treaty that follows the UN Model could contain a provision similar to paragraph 2 of Article 8 (alternative B) of the UN Model. When the operation of ships is covered by emissions trading schemes, the income derived from the first sale of emissions permits could be considered as operating business profits directly connected to the operation of ships (and not as capital gains from property). In such a case, the profits to be taxed in the State of source (under paragraph 2 of Article 8 (alternative B)) would be determined on the basis of an appropriate allocation of "overall net profits" from the operation of ships in international traffic, including profits derived from the first sale of any emissions permits relating to such operation.

136. The first sale of emissions permits can generate losses as well as profits/gains. The country having the right to tax profits/gains resulting from a first sale will therefore also be the country where the deduction of losses resulting from a first sale will be considered.

First sale of emissions credits

137. CERs are issued in respect of CDM projects in non-Annex I countries. The income derived from the first sale of CERs will generally be taxable in the Non-Annex I country where the CDM project giving rise to the CERs is situated. That Non-Annex I country would have the right to tax that income in accordance with Articles 6, 7 or 13 where:

- the income was derived by resident CDM project participant (income arising in the Non-Annex I country and derived by a resident of that country) ;
- the income was derived by a foreign enterprise through a PE situated in the Non-Annex I country (a CDM project will require such an extended presence in the Non-Annex I country that it would normally give rise to a PE; income from the first sale of the CERs would normally be attributable to that PE); or
- the income was derived by a non-resident through a forestry or agriculture project in the Non-Annex I country (taxable in the Non-Annex I country in accordance with Article 6).

138. Profits or gains from the first sale of CERs 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 generally not be considered as profits from activities auxiliary to such operation or gains from movable property pertaining to such operation. Such profits or gains would therefore be taxable under Article 7 or Article 13.

139. Gains from the first sale by a Government, NGO or public entity of CERs issued to it with respect to a CDM project, would, however, be exclusively taxable in the State of residence of such entity in accordance with paragraph 6 of Article 13 if, under the domestic law of the Non-Annex I country issuing the CERs, such entity cannot be considered as an enterprise carrying on business activities through the CDM project.

140. ERUs are issued in respect of JI projects developed by Annex I countries in other Annex I countries. Non-Annex I countries are, therefore, not concerned with first sales of ERUs.

141. The first sale of emissions permits can generate losses as well as profits/gains. The country having the right to tax profits/gains resulting from a first sale will therefore also be the country where the deduction of losses resulting from a first sale will be considered.

Subsequent sales of emissions permits/credits

142. Profits or gains from subsequent sales of emissions permits/credits will generally be taxable in the country of residence of the seller under Article 7 or Article 13, except where the profits or gains are attributable to a PE situated in another State.

143. In most cases, subsequent sales would be made by residents of Annex I countries selling their "excess" permits/credits (i.e. permits/credits in excess of those needed to satisfy compliance obligations). The profits from those sales would be exclusively taxable in the State of residence, unless the permits/credits were:

- effectively connected with a PE in another Annex I country to the extend that the profits from the subsequent sale would be attributable to that PE; or
- 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.

144. 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.

145. 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.

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