Distr.: General
20 October 2011

Original: English

Committee of Experts on International Cooperation in Tax Matters
Seventh session
Geneva, 24-28 October 2011
Item 5 (j) of the provisional agenda
Tax cooperation and its relevance to major environmental issues, particularly climate change

Tax Cooperation and Climate Change[1]

Summary

At the last meeting of the Committee, a scoping paper was presented on a broad survey of areas where greater international tax cooperation might enhance the effectiveness of domestic responses to climate change (E/C.18/2010/CRP.12). After this presentation, the Committee requested that the Secretariat research further in the area of international tax cooperation on climate change, specifically the tax treaty issues related to emissions trading profits, and generally on environmental taxation as a policy response to climate change.

This paper was prepared to provide a foundation for further discussion and analysis of :
(1) potential classification of the income from emissions permit trading in the UN Model Convention; and
(2) capacity building options in enhancing international cooperation on broader environmental taxation policies to address climate change.

Throughout each section, the Secretariat suggests areas of guidance the Committee may wish to explore further.

[1] This paper was prepared by the Secretariat. It is a preliminary analysis and should not be taken as being the concluded views of the Secretariat. It should not be taken as necessarily reflecting views of UNDESA, the United Nations or the UN Tax Committee. The valuable assistance of the Special Unit on South-South Cooperation of the UN Development Programme in providing the able research assistance of Ms. Erika Siu as part of the South-South Sharing of Successful Tax Practices (S4TP) project is gratefully acknowledged.

1. Tax Treatment of the Emissions Permit Trade

1.1 Introduction

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

1.2 Emissions permitting schemes in the context of international agreement

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

1.3 Emissions permit trading

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[2] See UNFCCC, "Kyoto Protocol", http://unfccc.int/kyoto_protocol/items/2830.php.
[3] See Article 12 of the Kyoto Protocol.
[4] See Article 6 of the Kyoto Protocol.
[5] See Article 17 of the Kyoto Protocol. "[A] new commodity was created in the form of emission reductions or 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." UNFCCC, "Emissions Trading", http://unfccc.int/kyoto_protocol/mechanisms/emissions_trading/items/2731.php.

3. A growing number of countries[6] have developed emissions trading schemes that allocate emissions allowances to permit holders with the intent of accelerating national emission reductions. Under these schemes, permit holders who can upgrade their facilities or alter their practices to decrease greenhouse gas emissions at the lowest cost have the incentive to sell unused emissions permits to other polluters with higher abatement costs. Additionally, traders buy and sell unused emissions permits and derivatives based on these permits on secondary markets. It is for this reason that emissions trading schemes have been found to lead to higher efficiency than other "command and control" regulatory approaches in climate change mitigation. That is, because the permits are tradable commodities, there is a price signal that includes the societal, or external, cost of carbon emissions.

4. Emission permit trading or the "carbon market" has grown exponentially over the past decade. The World Bank has reported that transactions through the carbon market totaled 11 billion USD in 2005, growing to 64 billion in 2007, to 144 billion in 2009.[7] Domestically, this trading income is subject to direct tax, resulting in multiple forms of tax treatment depending on the classification of the permit. There are also international tax implications for cross-border trading of emissions permits. Depending on how this income is treated under double tax agreements (DTAs), there is potential for unintended instances of double taxation or double non-taxation.

5. In order to evaluate potential classifications of emissions trading permits under the applicable Articles, it is important to understand the nature of these permits, i.e. which emissions are covered by emissions trading schemes, and how the permits are issued, transacted, and documented. Because the European Union Emissions Trading System (EU ETS) is the leading global ETS, operating in 30 countries and representing almost 85% of total value of emissions allowances in 2010,[8] a brief description of EU ETS coverage, issuance, and documentation is sufficiently representative to guide the analysis.

(a) *Coverage*: The EU ETS covers "CO_2 emissions from installations such as power stations, combustion plants, oil refineries and iron and steel works, as well as factories making cement, glass, lime, bricks, ceramics, pulp, paper and board", and also includes

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[6] Twenty-seven EU member states have joined the European Union Emissions Trading System as well as Iceland, Liechtenstein, and Norway. For more information, see http://ec.europa.eu/clima/policies/ets/index_en.htm. The New Zealand Emissions Trading Scheme also began operations in 2008. For more information, see http://www.climatechange.govt.nz/emissions-trading-scheme/about/basics.html and for the first report of the Scheme, see http://www.climatechange.govt.nz/emissions-trading-scheme/building/reports/ets-report/. Australia has also recently proposed comprehensive climate legislation that includes an emissions trading scheme. See *Australia reveals carbon price, proposes A$10bn clean energy support*, 12 July 2011, ENVT'L FINANCE, *available at* http://www.environmental-finance.com/news/view/1848. The legislation is expected to be adopted by the end of 2011. See *Legislation passes House of Representatives*, 12 Oct. 2011, http://www.cleanenergyfuture.gov.au/legislation-passes-house-of-representatives/.

[7] World Bank, State and Trends of the Carbon Market 2010, *available at* http://siteresources.worldbank.org/INTCARBONFINANCE/Resources/State_and_Trends_of_the_Carbon_Market_2010_low_res.pdf.

[8] See World Bank, State and Trends of the Carbon Market 2011, Carbon Market Evolution, Tbl.1, *available at* http://siteresources.worldbank.org/INTCARBONFINANCE/Resources/State_and_Trends_Updated_June_2011.pdf.

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

(b) *Issuance*: An emissions permit "gives the holder the right to emit one tonne of CO_2 or the equivalent amount of another greenhouse gas".[11] In order to meeting their binding commitments of emission reductions under the Kyoto Protocol, each of the 30 participating countries submitted National Allocation Plans for the first and second trading periods, (2005-2007) and (2008-2012), which allocated available emissions to covered installations.[12] In 2013, however, emissions will be allocated at the EU level and will be auctioned to covered installations.[13]

(c) *Compliance Cycle*: Covered entities must follow an approved monitoring plan and survey and report their annual emissions, which must be verified by the 31st of March each year by an accredited verification body. Once verified, operators must surrender the equivalent number of allowances by the 30th of April or face heavy penalties.[14]

(d) *Documentation*: Currently, a central electronic registry, which keeps track of each allowance and transfers of ownership, serves as the hub for all national registries. Beginning in 2012, however, a centralized EU ETS Registry will replace the 30 national registries. This electronic system records:

(1) the allowances of each member state;
(2) the account holder (either a person or company, which may or may not be linked to a covered "installation");
(3) transfers of ownership;
(4) verified emissions; and
(5) reconciliation of emissions -- but not the price paid for the allowances.[15]

Emissions permit trading, which may take place on various global exchanges, or the "carbon market", are only recorded within the registry system when there is a transfer in ownership of allowances. As a result, the registry system has been analogized to a "a

[9] See "Emissions Trading System (EU ETS)", http://ec.europa.eu/clima/policies/ets/index_en.htm.
[10] Directive 2008/101/EC: Amending Directive 2003/87/EC so as to include aviation activities in the scheme for greenhouse gas emission allowance trading within the Community (19 Nov 2008).
[11] EU Commission Climate Action, Questions and Answers on the Revised EU ETS, http://ec.europa.eu/clima/faq/ets/index_en.htm.
[12] See "Allocation 2005-2012", http://ec.europa.eu/clima/policies/ets/allocation_en.htm.
[13] EU Commission Climate Action, Member States agree to auction 120 million phase 3 allowances in 2012, 13 July 2012, *available at* http://ec.europa.eu/clima/news/articles/news_2011071301_en.htm.
[14] EU Commission Climate Action, Monitoring, Reporting, and Verification of Greenhouse Gases under EU ETS, http://ec.europa.eu/clima/policies/ets/monitoring_monitoring_en.htm; http://ec.europa.eu/clima/policies/ets/index_en.htm.
[15] "The system is purely electronic, so allowances are not printed on paper but exist only in an online registry account. Each company with a commitment and any person interested in buying or selling allowances needs an account." MEMO/06/452, Brussels, 29 Nov 2006, "Questions and Answers on Emissions Trading and National Allocation Plans from 2008 to 2012", *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/06/452&format=HTML&aged=0&language=EN&guiLanguage=en.

banking system which keeps track of the ownership of money in accounts but does not track the deals made in the goods and services markets which were the cause of the money changing hands."[16] Account and transaction details are searchable on the European Commission website.[17]

1.4 Overview of considerations

6. In light of the unique nature of emissions permits and the global scale of their issuance and trade, the Committee may wish to give guidance (including ultimately) in the UN Model Convention on the Article(s) to which the income from emissions permit trading applies and in what circumstances. Options include the following:

- Article 7: Business Profits
- Article 8: Shipping, Inland Waterways Transport and Air Transport
- Article 13: Capital Gains
- Article 6: Immovable Property
- Article 12: Royalties
- Article 21: Other Income

1.5 OECD and UN Model Convention differences

7. On 31 May 2011, the OECD issued a public discussion draft: *Tax Treaty Issues Related the Trading of Emissions Permits*(the OECD Paper), requesting comments by 30 October, and it will consider this issue further at the February 2012 meeting of the OECD Working Party on Tax Conventions and Related Questions. Preliminarily, the discussion paper concludes that regardless of the treatment under OECD Model Convention Article 7 as "Business Profits," or Article 13 as "Capital Gains" (which were considered the likely treatments by countries under existing tax treaties), taxation of income from emissions permit trading ends up being subject to residence country taxation. This follow up paper takes many of these points into consideration in its analysis.

8. However, because the UN Model differs from the OECD Model and because there are other Articles that can potentially apply to the taxation of permit trading income (whether or not they currently do in respect of countries having emissions trading schemes) and also because the UN Model in key areas preserves more source State taxing rights, there are cases where the distributive rules of tax treaties may lead to source State taxation, as noted below in Table 1. The Secretariat considers that this is an area where the Tax Committee can take a leadership role, working constructively with the OECD, but with a distinctive voice. This could be done by, for example, a Tax and Environment Subcommittee, which could have a broad mandate to consider possibilities for considering and clarifying tax and environment issues at the international level. We therefore do not think it is necessary to wait until the 2012 annual session, when the OECD

[16] See id.

[17] See "Community Transaction Log", Search categories are located in the left margin, http://ec.europa.eu/environment/ets/welcome.do.

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

TABLE 1
POTENTIAL TAX TREATMENT OF EMISSIONS TRADING INCOME

Article	***UN Model Convention***	***OECD Model Convention***	***Different Treatment?****
7: Business Profits	Residence based unless attributable to permanent establishment (PE) or fixed base (FB) or a "limited force of attraction rule" applies	Residence based unless attributable to PE	Potentially Yes[18]
13: Capital Gains	Residence based unless gains related to PE or FB or alienation of immovable property	Residence based unless gains related to PE or alienation of immovable property	Potentially Yes[19]
6: Immovable Property	*Situs* of immovable property; definition based on domestic law	*Situs* of immovable property; definition based on domestic law	No[20]
8: Shipping, Inland Waterways Transport and Air Transport	Taxed in State of effective management unless the shipping activities are more than casual[21]	Taxed in State of effective management	Potentially Yes[22]
12: Royalties	Residence based unless effectively connected with PE or FB; source State may tax up to an agreed %	Residence based unless effectively connected with PE	Potentially Yes[23]
21: Other Income	Residence based unless effectively connected with PE or FB; source State may tax	Residence based unless effectively connected with PE	Potentially Yes[24]

[18] Article 5 of the UN Model has broader permanent establishment rules as well as a "limited force of attraction" rule in Article 7, which the OECD Model does not have.
[19] This difference is due to the broader permanent establishment rules in UN Model Article 5. Some countries also consider that the fixed base concept sets a lower threshold than the permanent establishment threshold.
[20] Although the UN and OECD Models may not differ, the domestic law of the treaty partners may differ resulting in different tax treatment and possible double taxation or double non-taxation.
[21] Article 8 of the UN Model provides an alternative that adds the second clause: "unless the shipping activities are more than casual." See Article 8(2), alternative B. The percentage of taxable income would equal the allocable profits reduced by an agreed percentage.
[22] This difference is due to the second alternative given in the UN Model that adds: "unless the shipping activities are more than casual."
[23] This difference is due to the broader permanent establishment rules in UN Model Article 5 and also the possibility of source State taxation in UN Model Article 12.
[24] This difference is due to the broader permanent establishment rules in UN Model Article 5 and also the possibility of source State taxation in UN Model Article 21.

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

1.6 Article 7: Business Profits

9. Countries will often consider emissions trading income as Article 7 "Business Profits" under applicable DTAs, which are taxed on a net-basis in the State of residence unless the taxpayer has a permanent establishment in the source State. In this case, the result is fundamentally the same under both Models. There are nuances, however, such as the different permanent establishment rules under the different Models and the "limited force of attraction rule" under the UN Model, which makes source country taxation more likely under the UN Model rather than the OECD Model in general. As the limited force of attraction provision is relatively rare in practice, and as it only extends to "business activities "carried on in a state" of a "same or similar kind" as those effected through a permanent establishment, the coverage of emissions trading income under Article 7 of the UN Model, as implemented, is generally unlikely to be greater than under the OECD Model. Nonetheless, these differences are explained below.

1.6.1 Different permanent establishment rules

10. Article 5 of the UN Model allows for a more expansive definition of a permanent establishment than Article 5 of the OECD Model and as a result, greater taxing rights are potentially retained by the source country.

(a) First, the UN Model adopts a 6-month duration test (in contrast to 12 months in the OECD Model) for building, construction, or installation sites and includes any associated supervisory activities as well as assembly sites (Article 5(3)(a)).[25]

(b) The UN Model also recognizes services provided for at least 6 months in any 12-month period as creating a permanent establishment (Article 5(3)(b)) while the OECD Model omits this provision entirely, treating services in the same manner as goods.[26]

(c) Additionally, the UN Model omits "delivery" as an exception to the permanent establishment rule while the OECD Model does not (Article 4(a)-(b)). This means that if goods are stocked in a country for delivery, the host country has taxing rights to the income derived from the delivery of those goods (which may be in many instances be in practice insignificant).

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[25] This 6-month threshold will be changed to 183 days when the UN Model is updated. See UN Committee of Experts on Int'l Cooperation in Tax Matters, Report on the Fifth Session (19-23 Oct. 2009) Para. 18, *available at* http://www.un.org/ga/search/view_doc.asp?symbol=E/2009/45(SUPP)&Lang=E.

[26] See Paras. 42.11, 42.15-18, and 42.23 of the Commentary on Article 5, MODEL TAX CONVENTION ON INCOME AND CAPITAL (2010).

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

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

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

1.6.2 The UN Model's limited force of attraction rule

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

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

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

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

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

[27] "Gas phase pollutants are also generated during welding operations . . . . Known gaseous pollutants (including "greenhouse" gases) include carbon dioxide (CO2), carbon monoxide (CO), nitrogen oxides (NOx), and ozone (O3)." See U.S. ENVT'L PROTECTION AGENCY, WELDING EMISSIONS FACTORS (AP-42), *available at* http://www.epa.gov/ttn/chief/ap42/ch12/final/c12s19.pdf.

> *SteelBuilders, Inc. obtains. Construction is completed in 6 months after which SteelBuilders, Inc. leaves Country A and returns to residence country B. SteelBuilders, Inc. then sells the permit. Which country should have the right to tax the profit from the emissions permit trade?*
>
> *Under the UN Model, a permanent establishment exists because the construction site is active for 6 months and also because SteelBuilders, Inc. provides supervisory services for 6-months within a 12-month period. All profits connected with the services, including the emissions permit trading profits are taxable by the host country.*
>
> *Now assume while SteelBuilders, Inc. is selling its permit (and is deemed to have a permanent establishment through it construction supervisory services), it also invests in other emissions trading permits on the secondary market and makes a profit. The source country would also have the right to tax these profits as well due to the limited force of attraction rule; the business activity of investing in emissions permits is the same or similar to the buying and selling of a permit through the permanent establishment.*
>
> Case 2: *Rubber Co., headquartered in Country B, has a rubber processing plant in Country A that emits GHGs for which it is required to obtain a permit from Country A. Rubber Co. has a permanent establishment in Country A and profits derived from its rubber processing are taxable by Country A. Assume Rubber Co. sells unneeded emissions permits and also invests in other emissions trading permits on the secondary market and makes a profit. The source country would also have the right to tax these profits as well due to the limited force of attraction rule; the business activity of investing in emissions permits is the same or similar to the buying and selling of a permit through the permanent establishment.*

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

16. In sum, under the UN Model, there are two possible scenarios for source State taxation rights over emissions permit trading profits resulting from an Article 7: Business Profits classification:

> *Either:*
>
> (1) the first activity constituting a permanent establishment must require an emissions permit from host country which is then sold

[28] Currently, no emissions trading scheme covers automobile transport. The New Zealand Emissions Trading Scheme does, however, cover the suppliers of transport fuel. See *infra* note 42.

Or:
(1) the first activity constituting a permanent establishment must require an emissions permit from host country which is then sold; and
(2) the other "attracted activities" of secondary investing in emissions permits must take place in the host country.

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

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

1.6.4 Other articles take precedence over business profits

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

1.7 Article 13: Capital Gains

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

(1) the gain is derived from the alienation of **immovable property** located in the source State (in which case Article 6 is relevant as discussed below); or
(2) the gain is derived from the alienation of movable property, which is a part of the taxpayer's **PE or fixed base**[29] located in the source State; or
(3) the gain is derived from the alienation of **ships or aircraft** operated in international traffic , boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircrafts, or boats and the source State is the place of effective management of such enterprise (in which case Article 8 is relevant as discussed below); or

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

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

1.7.1 The Meaning of "Property"

20. Because Article 13(6) of the UN Model and 13(5) of the OECD Model are "residual" clauses, that is, they apply to "gains from the alienation of *any property*" not referred to in the previous clauses, it is necessary to first clarify the meaning of "property". Although neither Model explicitly defines the term, the commentary on Article 13(2) in the OECD Model, which has been cited in a way that suggests adoption by the UN Model, defines "movable property" as "all property other than immovable property . . . . [and] includes also incorporeal property such as goodwill, licenses etc." Furthermore, the Article 6 definition of immovable property includes "property accessory to immovable property", such as "rights" related to the immovable property.[31] Thus, "property" can include both the tangible and intangible.

21. In this context, the emissions permit can be considered "property" because even though the permit, in theory, constitutes a government-issued intangible right or license to pollute, it is still a considered a fungible commodity by the UNFCCC: "[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."[32] Even so, there may be differences in the domestic laws of the treaty partners which may result in double taxation or double non-taxation.

1.7.2 Domestic law differences

20. Article 13 allows domestic law to determine how the gains are taxed. Under either treatment, the taxation result would essentially be the same, except for the fact that Article 7: Business Profits are calculated on a net basis and domestic law determines how capital gains are taxed. Thus, if not clarified under DTAs, there may be a conflict between treaty partners as to whether an item of income should be taxed under Article 7: Business Profits (which is computed on a net basis) or Article 13: Capital Gains.

21. Additionally, under Article13(2) if the capital gain is derived from the alienation of *movable* property and the property can be regarded as the business property of the PE or FB, the gain may be taxed in the source State. Because the OECD Commentary on Article 13 (the UN Model has been cited in a way to suggest adoption of this commentary) states that "'movable property' means all property other than immovable property," Article 6 is relevant in

[30] This provision is found only in the UN Model.
[31] The definition is limited because although Art. 6(2) provides a base definition, it states that the term "shall have the meaning which it has under the law of the Contracting State in which the property in question is situated." See *infra*, § 1.8.
[32] UNFCCC, "Emissions Trading", http://unfccc.int/kyoto_protocol/mechanisms/emissions_trading/items/2731.php.

determining the meanings of both immovable and movable property. As will be explored below, domestic law -- when referenced in DTAs -- plays a significant role in these meanings and can create unintended instances of double taxation and non-double taxation.

22. Further, as paragraph (4) of Article 13 has a special provision dealing with transfers of shares in companies, etc. that derive most of their value from immovable property situated in a Contracting State (and the OECD Model has since introduced a similar provision) the categorisation of permits as "immovable property" would have significant impacts on the operation of a double tax treaty. The differences between Article 13(4) in the UN and OECD Models is subtle but may lead to different outcomes. The Committee has been separately addressing issues related to Article 13(4) but may wish to consider them in this context as well.

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

1.8 Article 6: Immovable Property

23. Article 6 of both the UN and OECD Models provides that income derived from immovable property may be taxed in the State where the property is located. Under both the OECD and UN Models, Article 6(2) contains certain items that are defined as "immovable property" such as "property accessory to immovable property, livestock and equipment used in agriculture and forestry . . . rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources," *as well as* items considered as such under the law of the country in which the property in question is situated.

24. Although emissions permits are fungible commodities, they represent a government-issued allocation of greenhouse emissions to a polluting installation. A State might take the view that because an emissions permit originates from immovable property such as an industrial plant of a particular size (whether or not a *particular* plant), and the emissions permit gives the emitter a "right to pollute," income from the alienation of this right can be considered as immovable property. In this case, the source State, which is the *situs* of the property, would have the right to tax the income of emissions permit trading. However, the alternative argument is that because these permits may be traded by account holders who may or may not be linked to an emitting installation, or the covered installation may be an inherently "movable" object, such as a ship or airplane, the "immovable" characterization may not always fit.

1.8.1 The variety of "immovable property" meanings

24. In practice, however, it appears that many items not normally considered as "immovable" under normal linguistic usages are as a consequence treated as immovable property under

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

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

TABLE 2

EXAMPLES OF "IMMOVABLE PROPERTY" DEFINITIONS UNDER DOMESTIC LAWS

Country	***Law***	***Included in "Immovable Property" definition***
Botswana	VAT Act (2006)	any estate, right, interest, or servitude on or over any land, and things attached to land or permanently fastened to anything attached to land
Cyprus	Companies Law (2004)	land; buildings and other erections, structures, or fixtures affixed to any land or to any building or other erection or structure; trees, vines, and any other thing whatsoever planted or growing upon any land and any produce thereof before severance; springs, wells, water and water rights whether held together with, or independently of, any land; privileges, liberties, easements and any other rights and advantages whatsoever appertaining or reputed to appertain to any land or to any building or other erection or structure; an undivided share in any property hereinbefore set out.
Denmark	Corporate Income Tax Law (1994, 2000)	piece of land with or without buildings, including fixtures, plants and trees; a permanent building on a piece of leased; a right over immovable property and an option to buy can also constitute immovable property for purposes of capital gains

[33] See OECD, *Tax Treaty Issues Related to the Trading of Emissions Permits Discussion Draft* (31 May 2011 - 30 October 2011) at para.14.

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

TABLE 3

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

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

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

[35] In certain recents DTAs, Turkey follows the UN/OECD Model with the phrase: "ships, boats, and aircraft shall not be regarded as 'immovable property'". See, e.g., SOUTH AFRICA-TURKEY INCOME TAX TREATY (2005); IRAN-TURKEY INCOME TAX TREATY (2002).

[36] See Paras. 5-12 of the Commentary on Article 6, MODEL TAX CONVENTION ON INCOME AND CAPITAL (2010).

[37] Australia often includes the following provision in its DTAs:

> in the case of Australia, has the meaning which it has under the laws of Australia, and shall also include:
>
> > (i) a lease of land and any other interest in or over land, whether improved or not; and
> > (ii) a right to receive variable or fixed payments either as consideration for or in respect of the exploitation of, or the right to explore for or exploit, mineral deposits, oil or gas wells, quarries or other places of extraction or exploitation of natural resources.

See, e.g., AUSTRALIA-FRANCE INCOME TAX TREATY (2006); AUSTRALIA-SOUTH AFRICA INCOME TAX TREATY (1999).

[38] Finland includes this phrase under Article 6(4) in certain recent DTAs:

> Where the ownership of shares or other corporate rights in a company entitles the owner of such shares or corporate rights to the enjoyment of immovable property held by the company, the

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

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

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

1.8.3 Can emissions permits be traced through the carbon market?

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

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

See, e.g., FINLAND-INDIA INCOME TAX TREATY (2010); FINLAND-MOLDOVA INCOME TAX TREATY (2008); FINLAND-SLOVENIA INCOME TAX TREATY (2003).

[39] Despite its Reservation in the OECD Model, Mexico largely follows the UN/OECD Model Article 6. See, e.g., MEXICO-RUSSIA INCOME TAX TREATY (2004); BRAZIL-MEXICO INCOME TAX TREATY (2003); BARBADOS-MEXICO INCOME TAX TREATY (2008).

[40] New Zealand specifically includes income from agriculture, forestry, and fishing in its definition of immoveable property under more recent treaties. See, e.g., MEXICO-NEW ZEALAND INCOME TAX TREATY (2006); NEW ZEALAND-UNITED ARAB EMIRATES INCOME TAX TREATY (2003); NEW ZEALAND-TAIWAN INCOME TAX TREATY (1996).

[41] Spain also largely follows the UN/OECD Model Article 6 despite its Reservation in the OECD Model.

[42] See New Zealand Climate Change (Liquid Fossil Fuels) Regulations 2008 (SR 2008/356), *available at* http://www.legislation.govt.nz/regulation/public/2008/0356/latest/DLM1635601.html.

[43] See Directive 2008/101/EC, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32008L0101:EN:NOT.

[44] 'Income' includes income from "exploitation, alienation, exchange as well as rental or leasing." *See, e.g.*, FRANCE - TAJIKISTAN INCOME TAX TREATY, Article 11(1) (1985); *see also* Cmt. at Paras. 6 on Article 6, MODEL TAX CONVENTION ON INCOME AND CAPITAL (2010).

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

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

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

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

1.8.4 Arguments against reference back to domestic law

30. It might be argued that domestic law should not determine the treatment of the permit for the following reasons:

(a) if such a classification was regarded as so divergent from the intended operation of Article 6 as to be inconsistent with the necessary good faith application of treaties under the Vienna Convention on the Law of Treaties[46] or customary international law reflecting it; or

[45] See OECD, *Tax Treaty Issues Related to the Trading of Emissions Permits Discussion Draft* (31 May 2011 - 30 October 2011) at para.13.
[46] See Arts. 26, 31(1).

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

31. While in the case of (i) it is not a step lightly to be undertaken to treat the recourse to domestic law contemplated by the Article as a departure from good faith application of the treaty, the second argument is perhaps a more pertinent one in most cases. Even there, it might be difficult to show an accepted international meaning of where property is situated, where it is potentially "immovable property" under a treaty yet "movable" under normal linguistic usages. There is at least an argument that in cases where domestic law treats an item as immovable, and the treaty allows this domestic treaty to govern the treaty treatment, the "*situs*" rules in that domestic law should be followed unless they are so contrary to reality as to raise issues of good faith application of the treaty (such as deeming a house situated in another country as situated in your country).

1.8.5 What happens when the domestic laws of the two countries differ?

32. When the domestic law meanings of "immovable property" differ (and the domestic law has been referenced in the DTA), there is a so-called "conflict of qualification." Under Article 23, where income may be taxed by the source State "in accordance with the provisions of the Convention," the residence State must relieve any double taxation either through an exemption or credit. Thus, if the State where the property is located considers the permit income to be under the meaning of "immovable property," that State may tax the income and the residence State must relieve the double taxation where it considers the trading income as a form of income that is residence based. Under Article 23, this relief may come in the form of an exemption or credit against taxes due in the residence country. Because Article 23 is the same under both the UN and OECD models, the taxation result would be fundamentally the same, although the issues of conflicts of qualification have not yet been fully considered by the Committee.

- *Recommendation: The Committee may wish to consider issues of conflict of qualification in this context or as part of a broader consideration from the perspective of the UN Model.*

1.9 Article 8: Shipping, Inland Waterways Transport and Air Transport

33. There are two alternative versions of Article 8 in the UN Model; the first follows the OECD Model and the second alternative differs in its first and second provisions. Alternative A will be discussed first and then the difference in Alternative B will be presented, following a discussion of the possible classification of emissions trading profits under Article 8.

34. Under Article 8 (alternative A in the UN Model and Article 8 of the OECD Model), profits from the operation of ships or air craft in international traffic, or boats in inland water ways transport are taxable in the State of effective management. If effective management is aboard a ship or boat, the place of effective management shall be deemed to be in the home

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

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

1.9.1 ETS coverage of aircraft and ships operating in international traffic

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

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

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

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

1.10 Article 12: Royalties

38. Similar to the OECD Model, Article 12(1) of the UN Model allows for residence State taxation of income from royalties. However, the UN Model Article 12(2) also allows for source State taxation not exceeding an agreed percentage when the owner of the royalties resides in the other contracting State. If the owner of the royalties carries on business through a PE or FB in the source State of the royalties and the right or property from which the royalties are paid is effectively connected with the PE, FB, or business activities similar to those effectively connected with the PE or FB, however, Article 7 or 14 applies to that income.

39. Because Article 12(3) in the UN Model defines royalties to include "payments . . . received . . . for the use of, or the right to use . . . industrial, commercial, or scientific equipment", there is a view that income from emissions permit trades could potentially be classified as royalties under the UN Model Convention. Operation of certain industrial and commercial equipment results in greenhouse gas emissions, which requires a permit. A permit holder, regardless of how the permit is used, either as a trading or polluting instrument, has the right to emit a certain amount of CO_2 within a stated period. As stated in para.5(c), under the EU ETS, permit holders must surrender enough emissions permits to cover all of their annual emissions. Thus, under this view, the permit seller sells the right to emit greenhouse gases (for one year) resulting from the use of industrial, commercial, or scientific equipment and this income might on this basis be classified as royalties.

40. The contrary view is that the payment made in a transfer of a permit is not for the right to use particular equipment, etc., but for the right to emit a certain level of CO_2 within a certain time period. That is, if the right to pollute is seen as a distinct entitlement from the right to use equipment that is the source of the pollution, the classification of income from emissions trading as a royalty does not stand. However, if the use of equipment which emits CO_2 can be linked (as it is linked in many real cases), the royalties argument is valid. Furthermore, as mentioned in previous sections, there may not be a "one-size-fits-all" Article that encompasses all income from emissions trading; particular treatments may vary based on the originating activity of the permit. The Committee may wish to give guidance on this issue because there are differences between the OECD and UN Model Conventions and there are many instances where DTAs provide for source State taxation of royalties income, as detailed in the following sections.

1.10.1 OECD Model Convention differences

41. Under the UN Model Convention, such royalties may be taxed by the source State up to a certain percentage as agreed in negotiations. The OECD Model, however, does not contain the "industrial, commercial or scientific equipment" clause; thus permit trading income would not likely be considered royalties under the OECD Model even if the argument noted above applies.

42. The OECD Model also does not provide for source country taxation of royalties, though many OECD countries have "Reservations" on the Model in that respect and follow an approach more aligned with the UN Model approach. These reservations are illustrated in Table 4 below.

TABLE 4

EXAMPLES OF "ROYALTIES" RESERVATIONS IN THE OECD MODEL[49]

Countries	***Reservation***
Australia, Chile, Italy, Korea, Mexico, New Zealand, Poland, Portugal, Slovak Republic	reserves the right to tax royalties at source
Canada, Chile, Hungary, Korea, Poland, Slovak Republic	reserves the right to add the words "for the use of, or the right to use, industrial, commercial or scientific equipment"
Canada, Czech Republic	reserves the right to tax at a rate of 10 per cent at source

- *Recommendation: The Committee may wish to consider whether and in which instances income from emissions trading would fall under Article 12 or at least note differing interpretations and possible bases for further clarification during negotiations or in Competent Authority discussions.*

1.11 Article 21: Other Income

43. In Article 21, the OECD Model provides that income not dealt with in the foregoing Articles and not effectively connected to a permanent establishment is taxable only by the residence State (either on a gross or net basis). The UN Model, Article 21, however, includes a third provision which allows "other income" not dealt with under other Articles and not effectively connected to a permanent establishment or fixed base and arising in the source State to be taxed in the source State of that income. Thus, there is a potential different treatment of other income depending upon which Model provision is used in DTAs. To analyze whether income from emissions trading could be classified as "other income", examples are explored below.

1.11.1 Examples of "other income"

44. The text and commentary of Article 21 does not provide a list of items defined as "other income". Instead, the article serves as a sweeper provision that includes "income from sources not expressly mentioned".[50] In certain countries, "other income" has been determined to include income from estates and trusts, prizes and awards, foundation grants, gambling winnings, alimony payments, individual retirement account distributions, annuity payments, child support payments, certain life insurance income, social security payments, some swap income, penalty charges, certain currency exchange gains and losses, proceeds of disposition of income in trusts, damage awards that do not relate to items covered in the treaty, "golden handshake" awards, and

[49] See Paras. 32-50 of the Commentary on Article 12, MODEL TAX CONVENTION ON INCOME AND CAPITAL (2010).
[50] See Para. 1 of the Commentary on Article 21, MODEL TAX CONVENTION ON INCOME AND CAPITAL (2010).

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

1.11.2 Classification of the Emissions Permit as "property"

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

46. In this context, the emissions permit can be considered "property" because even though the permit, in theory, constitutes a government-issued intangible right or license to pollute within a stated time period, it is still a considered a fungible commodity by the UNFCCC: "[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."[54] Even so, there may be differences in the domestic laws of the treaty partners which may result in double taxation or double non-taxation. The main scope for greater international cooperation in this area would clarify if the "Other Income" Article might be the applicable Article or at least noting the different views and their bases to allow discussion during negotiation or during Competent Authority discussions.

1.11.3 The source of income from emissions permit trading

47. A related question for taxation of emissions trading income -- in the absence of a permanent establishment or fixed base -- concerns the source or "arising" rule for emissions permit trading income.

- Should the source of the emissions trading income be determined by
    - the issuing country
    - the place of exchange, or
    - domestic law definition(s)?

[51] See David A. Ward et al., *The Other Income Article of Income Tax Treaties*, IBFD Bulletin Aug./Sept. 1990, at 15 (footnotes omitted).
[52] See United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006.
[53] See *supra* § 1.7.
[54] UNFCCC, "Emissions Trading", http://unfccc.int/kyoto_protocol/mechanisms/emissions_trading/items/2731.php.

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

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

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

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

1.11.4 Wide acceptance of both Models' Article 21

49. Both Models find wide acceptance in international practice, so this is a significant area of difference. Australia, Canada, Chile, Mexico, New Zealand, Portugal and the Slovak Republic have reservations in the OECD Model Convention maintaining the right to tax "other income" arising from sources in their own country.[55] In practice, it is not just an OECD-member or non-OECD-member issue as both OECD members and non-members tend to have a mixed treaty network drawing upon both Models.

1.11.5 Differing interpretations of the treaty

50. Even if two countries have entered into a treaty based on the UN Model, they may consider permit trading income as covered under different articles, which creates the potential for instances of double-taxation and double non-taxation. The issues are not fully explored under the current UN Commentary, but *prima facie*, if the differences relate to the application of different domestic rules as allowed by the treaty (a conflict of qualification as discussed above), the residence State would need to give an exemption or credit in relation to taxes in the source State. Where the difference is over the interpretation of the treaty (i.e. as to which Article applies or how it applies), however, the matter may have to be resolved under the Mutual Agreement Procedure because the residence country need only give a credit or an exemption

[55] See Para. 13 of the Commentary on Article 21, MODEL TAX CONVENTION ON INCOME AND CAPITAL (2010).

where the other country has taxed in accordance with the treaty. While there is a risk of double taxation, which can hopefully be avoided, the source State cannot be expected to yield its position in the MAP *merely* because of that possibility.

1.12 General principles for consideration

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

1.12.1 Source principle

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

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

1.12.2 Base erosion principle

54. The base erosion principle favors source State taxation and accounts for payments made that reduce the revenues of a country and attempts to ameliorate this reduction with the grant of the taxation right over the income to the recipient. For example, under Article 19, remuneration for services rendered to a State is taxable only by that State. The argument is that the payments are direct outflows from the government and thus, base eroding; the right to tax (in addition to the services rendered) can be viewed as a balancing inflow. The base erosion principle is also evident where deductible payments are taxable only by the residence of the paying taxpayer, for example, as in Article 16: Directors' Fees and Remuneration of Top-level Managerial Officials.

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[56] This analysis follows that of Brian J. Arnold, *The Taxation of Income from Services under Tax Treaties: Cleaning Up the Mess -- Expanded Version*, IBFD, Vol. 65, No.2, § 3 (published on-line 22 Dec. 2010).
[57] See id at § 3.1.3.
[58] See id.
[59] See *supra*, § 1.2.

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

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

1.12.3 Threshold principle

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

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

1.12.4 Enforcement principle

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

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

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

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

1.12.5 Consistency principle

61. The consistency principle broadly implies that like economic activities should incur similar tax treatment. Where there are marked differences in characteristics of the economic activities, however, divergence from the norm may be justified. In considering potential Articles for classification of emissions trading income, it may be helpful to analyse both Models' taxation rules for other financial instruments.

(a) **Stock transactions**: Article 13(6) of the UN Model Convention treats the sale of shares in a corporation (not over an agreed percentage of ownership and of companies comprised of 50% or less of immovable property) as taxable by the residence country of the alienator. In these cases, the place of issuance (presumably corporate headquarters) and the country of exchange bears no relevance to international income taxation rights.

(b) **Derivative financial instrument transactions**: Although not mentioned in either the OECD or the UN Model Convention, according to the International Fiscal Association, "it is generally accepted among reporting countries[62] that source-basis taxation of [derivative financial instruments] will not apply in the absence of a tangible 'presence' in the source country, at least in the absence of a permanent establishment."[63] This view (which, it should be noted, derives from reports relating to countries that generally have a more "residence based" rather than "source-based" approach to allocation of taxing rights) reflects the mobility of derivatives as well as the weaker claim of the source country on the income from derivatives contracts than dividends or interest, which is directly related to capital.[64]

Furthermore, the Technical Explanation to the 2006 US Model Tax Convention states that income from derivative contracts falls within Article 21 as "Other Income" if not derived by persons engaged in a trade or business dealing in such instruments and not being used to hedge against risks arising in a trade or business.[65] The US Model Convention follows the OECD Model Article 21 and considers "other income" as taxable by the residence State only.

- *Recommendation: The Committee may wish to consider the Article(s) to which income from derivative financial contracts applies -- particularly derivatives contracts based on emissions permits -- and in what circumstances or to at least note differing*

[62] See Charles T. Plambeck et al., *Tax Aspects of Derivative Financial Transactions*, 80b CAHIERS DE DROIT FISCAL INTERNATIONAL 685 (1995). Reporting countries were Australia, Austria, Belgium, Brazil, Canada, China, Denmark, Finland, France, Germany, Indonesia, Israel, Italy, Japan, Rep. of Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Peru, Portugal, Spain, Sri Lanka, Sweden, Switzerland, the U.S. and the U.K.
[63] See *id*.
[64] *Id.*
65 See United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006.

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

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

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

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

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

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

1.13 Summary of recommendations

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

[66] See Para. 9 of the Commentary on Article 10, MODEL TAX CONVENTION ON INCOME AND CAPITAL (2010).
[67] *See id.* at Para. 6.

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

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

- *Recommendation: The Committee may wish to consider* ***issues of conflict of qualification*** *in this context or more broadly from the perspective of the UN Model.*

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

- *Recommendation: The Committee may wish to consider whether and in which instances income from emissions trading would fall under* ***Article 12: Royalties*** *or at least note differing interpretations and possible bases for further clarification during negotiations or in Competent Authority discussions.*

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

- *Recommendation: The Committee may wish to consider the Article(s) to which income from* ***derivative financial contracts -- particularly derivatives based on emissions permits --*** *applies and in what circumstances or to at least note differing interpretations and possible bases for further clarification during negotiations or in Competent Authority discussions.*

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

2. Environmental Taxation Policies to Address Climate Change

2.1 Capacity Building Options for Consideration by the Committee

1. This section of the note briefly provides options for consideration by the Committee on areas of international cooperation on broader environmental taxation policies to address climate change. The Committee may wish to propose capacity building efforts for developing countries based on a review of developing country demand in this area. Possible areas of capacity building in this area may include:

(a) Information/ experience sharing on successful tax policies that address environmental concerns, including climate change.

(b) Information/ experience sharing on domestic taxation aimed at projects developed under the Clean Development Mechanism.