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*[3] (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 prevent da -.000dec .0n i0 TD -onlprevent ll iis to as such sits otiip(itstria scn -5Tc 0 z)]TJounew agreem

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.[7] 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. It was agreed at COP 18 in Doha that the second commitment period will cover a period of eight year (2013-2020).

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

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 is foreseen.

B. The Clean Development Mechanism (CDM) defined in Article 12 of the Protocol

8. The Clean Development Mechanism (CDM

Fuel switching projects;
Reduction of industrial and manufacturing emissions (e.g. CO2 from cement, SF6 gas from various industrial processes, etc.);
Methane capture and re-use from coal mines, landfills and industrial wastewater;
Afforestation/reforestation.
Carbon capture and storage (CCS).

The CDM can only be effective if it produces credits which represent actual emissions

charity, an NGO or a community organisation. A project may also encompass several different entities under a contractual arrangement.

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 and alternative energy infrastructure). 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[15]).

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:

<u>Project Development Agreement (PDA)</u>

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

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.

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 (nuclear energy projects, afforestation or reforestation activities, and – from 2013 – projects involving the destruction of industrial gases are excluded). CERs may be exchanged one-for-one with EUAs subject to various criteria. CERs generally trade at a discount to EAUs in the secondary market owing to the additional project and regulatory risks.

without an emission reduction scheme in order to avoid carbon leakage (i.e. an increase in global greenhouse gas emissions when companies shift production or investment outside the EU in order to avoid the costs induced by the EU ETS in the

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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 progr

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

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1. Article 7 (Business Profits)

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

58. 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

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.

63. A “project participant” is defined in the CDM Glossary of Terms (Version 07.0) as a

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78. 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.

79. 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.

80. Regulated entities that face a compliance obligation under a national or regional

purposes and others only allow deduction when an EAU is actually used for compliance purposes). Other EU Member States treat allowances as intangible assets and allows depreciation over their expected lifetime.

In December 2007, the Accounting Standards 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). In December 2012, as part of its response to the Agenda consultation 2011[35] Agenda consultation 2011, the IASB reactivated this project as an IASB-only research project. The project is expected to result in the publication of a Discussion Paper considering the financial reporting consequences of government developed schemes designed to encourage reductions in the production of greenhouse gases, which will include:

- an inventory of trading schemes;
- an analysis of common economic characteristics of those schemes;
- an initial assessment of the potential reporting solutions.

82. 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.

83. It is desirable that countries adopt a similar characterization for emissions permits/credits under their domestic law. 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.

84. With respect to tax treaties issues, th2(s)i2757 ( )T36-6.6(tp Tf r)4.8(es r)4s“costi1(uencet)5.8

Trading of emission permits/credits can generate income as well as costs or losses. Unless expressly mentioned, the allocation of the cost

96. 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).

97. The profits (or losses) from the alienation of emissions credits that an 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 out 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 alienation 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 enterprise using or selling it, unless they were attributable to a PE situated in another State.[37]

98. 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.

99. The “limited force of attraction” covers the “same or similar” activities as those carried out through the PE. The activities carried out 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

105. As already mentioned, the aviation sector is covered by the EU ETS as of 2012. Enterprises engaged in air transport could, therefore, trade emissions permits/credits to cover the emissions resulting from their operations. Income derived by the enterprise operating an 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 the aircraft. To the extend that the aircraft is operated in international traffic, such business profits are therefore taxable pursuant to Article 8 only in the State of the enterprise's place of effective management.

106. 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 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"[40] nor would such activities be considered "directly connected" or "ancillary to such operation"[41]. Profits from the alienation of such credits by the enterprise would therefore generally be taxable in accordance with Article 7.[42]

107. 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 emission permits/credits trading relating to such operation. Profits from the alienation of credits issued with respect to a CDM/JI project in which the shipping enterprise participated would, however, not 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.

4. Article 13 (Capital Gains)

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40. 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.

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

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112. 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 to an alienation, 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)

113. 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 on the secondary market 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 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 113 is however questionable.
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> 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.

114. 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 alienation 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

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).

118. 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 characterized 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).

119. Such characterization could be regarded as inconsistent with a cap-and-trade system which typically treats emissions permits/credits as fungible instruments. 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 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. For the sake of certainty, countries that would consider emissions permits/credits as "immovable property" under specific circumstances should clarify their position during bilateral treaty negotiation.

120. As noted above, paragraph 1 of Article 6 extends 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).[46]

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)

121. 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

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.

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.

122. 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)

123. Article 13 may apply where the alienation of emissions permits/credits does not occur in the course of the carrying out of a business or 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

operator of polluting installations has no obligation to hold permits/credits during the compliance period (a period of one year or several years during which the operator must comply with its emission targets). The obligation to hold an adequate number of permits/credits only exists at the end of the compliance period when permits/credits must be surrendered. 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 that period. As a permit/credit is consumed through this first use, it is not a property or right that could typically be leased.[47]

5. Article 21 (Other Income)

128. 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.

129. 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)

130. 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.

131. Tradable permits/credits are generally fungible instruments which are intended to be actively traded. The trading market determines the price of a permit/credit.The prins price10.7.2775

132. Linkages may exist between domestic or regional cap-and-trade systems or between a cap-and-trade system and a credit system. In such case, the market price of the instruments of one system will remain different than the market price of the instruments of the other system until the prices converge after a certain period of trading across the different systems. If governments limit the quantity of permits/credits from another system that can be used to demonstrate compliance in its own system, the price convergence may not be complete.[48] In the absence of price convergence, a specific instrument may have different market prices in different domestic or regional systems. Where such

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.

136. 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

137. 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.

138. These disputes will generally occur because the Contracting States have different 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

139. 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 alienation 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 realized

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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 characterized 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".

141. 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.

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

Granting of emissions permits

142. 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 Paragraph 145).

143. 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 avoided).

144. 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.[49] 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.

145. 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.[50] 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.[51] The income from the granting of an emissions permit 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

146. 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); it is, however, rather unlikely that a CER would be bound to or considered immovable property under the law of the Non-Annex I country; 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

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

[50]

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).

153. 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 taxabvithe ierpr 7ens ie f1534 ProfitsGom9( )-5.5(t)6.3(h)at9(anri)6.ircdergm9(vern

160. 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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