PROJECTS TO REDUCE EMISSIONS PROGRAMME—INCOME TAX TREATMENT

The Projects to Reduce Emissions programme was established by the New Zealand Government in 2003 in order to assist New Zealand to meet its obligations under the Kyoto Protocol. A total of 41 agreements in the form described in this ruling were entered into under the programme before the Government's climate change policies were reviewed and changed in 2005. This ruling applies only to agreements in the form described in this ruling and entered into under the Projects to Reduce Emissions programme.

PUBLIC RULING - BR Pub 08/03

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Ruling applies in respect of sections BD 3, CB 1, DA 1, EW 3, and EW 32.

The Arrangement to which this Ruling applies

The Arrangement is the provision of emission units under a project agreement between the Crown and a participant under the Crown's Projects to Reduce Emissions programme, and the sale to a third party of emission units received by a participant under such an agreement.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows.

- Emission units derived by a participant under a project agreement are income of the participant under section CB 1.
- Emission units will be derived in each year of the term of a project agreement when the Crown accepts the annual report or if the Crown does not accept the annual report, the dispute as to the amount of emission reductions resulting from the project is resolved.
- If in a subsequent year the participant becomes entitled to receive additional emission units in respect of emission reductions achieved in a prior year, the additional emission units will be derived in the year in which it is determined that the participant is entitled to additional emission units.

- If in a subsequent year it is determined that the participant is required to refund emission units to the Crown (or to pay a cash equivalent), provided a participant continues to carry on the business involving the generation of energy for sale or for use in the supply of goods or services for sale, a deduction is allowed for the emission units refunded or the cash repaid in the year in which the refund is made.

- Amounts derived by a participant from the sale of emission units are income of the participant under section CB 1.

- If the participant continues to carry on the business involving the generation of energy for sale or for use in the supply of goods or services for sale (in connection with which the project agreement was entered into), a deduction is allowable under section DA 1 in the year in which emission units are sold by the participant for an amount equal to the value of emission units at the time of their transfer to the participant.

- A project agreement is a financial arrangement.

- The consideration provided by and payable to the participant under the Arrangement is an amount equal to the value of the emission units transferred to the participant.

The period or income year for which this Ruling applies

This Ruling will apply from 1 April 2008 to 31 December 2013.

This Ruling is signed by me on the 7th day of November 2008.

Martin Smith
Chief Tax Counsel

COMMENTARY ON PUBLIC RULING BR Pub 08/03

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Ruling BR Pub 08/03 ("the Ruling").

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

Background

1. The Kyoto Protocol is an international agreement that was signed in 1997 and came into force on 16 February 2005. The Kyoto Protocol was entered into in pursuit of the ultimate object of the United Nations Framework Convention on Climate Change ("the Convention"), the stabilisation of greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system. The aim of the Kyoto Protocol is to reduce total greenhouse gas emissions to 5 percent below their level in 1990 during the first Commitment Period (2008–12).

2. Only countries that ratify the Kyoto Protocol are bound by it. New Zealand ratified the Kyoto Protocol on 19 December 2002.

3. The Kyoto Protocol recognises that countries have different economic circumstances and that their ability to reduce greenhouse gas emissions differs. Therefore, different countries have different emission reduction targets under the Kyoto Protocol. New Zealand's commitment under the Kyoto Protocol for the first Commitment Period is to reduce New Zealand's greenhouse gas emissions to their 1990 level, or to accept responsibility for the excess emissions. New Zealand has an initial quantity of emission units based on its emission reduction target under the Kyoto Protocol. Additional emission units can be derived:

   - from New Zealand's forest sink credits, which are given in respect of forests planted since 1990 on land that did not previously contain forests (known as "Kyoto forests") in recognition of the ability of growing forests to absorb carbon dioxide;

   - by purchasing emission units on the international market; or

   - by participating in projects recognised under the Kyoto Protocol.

What are emission units?

4. The term "emission units" in relation to Projects to Reduce Emissions is defined by the Ministry for the Environment in the key terms section of its website (http://www.mfe.govt.nz/issues/climate/policies-initiatives/projects/key-terms.html) as follows:

Emission units

Means all of the unit types specified in the Kyoto Protocol, namely, assigned amount units (AAUs), certified emission reduction units (CERs), emission reduction units (ERUs), and removal units (RMUs). For the purposes of the Projects to Reduce Emissions programme and the Model Project Agreement, the Emission Units being offered by the Crown are AAUs (or ERUs if these are requested by the project participant).

5. Assigned amount units (AAUs) are issued out of a country's assigned amount under the Kyoto Protocol (which in New Zealand's case is an amount equal to its 1990 greenhouse gas emissions multiplied by five). Certified emission reduction units (CERs) are issued in relation to Clean Development Mechanism projects (between an Annex I party to the Convention and non-Annex I countries and which are implemented in a non-Annex I country). The purpose of Clean Development Mechanism projects is to assist non-Annex I countries to achieve sustainable development, to contribute to the ultimate objective of the Convention, and to assist Annex I parties to achieve compliance with their commitments to limit and reduce emissions: Article 12 of the Kyoto Protocol. Emission reduction units (ERUs) are derived from a Joint Implementation project under Article 6 of the Kyoto Protocol (which allows the acquisition and transfer of ERUs resulting from projects to reduce emissions undertaken between two Annex I countries). Removal units (RMUs) result from a country's sink activities that result in a net removal of greenhouse gases. The term "sink" is defined by the Ministry for the Environment in the key terms section of its website:

Any natural or man-made system that absorbs and stores greenhouse gases, including carbon dioxide from the atmosphere. To be considered a sink, a system must be absorbing more carbon dioxide than it is releasing, so that the permanent store of carbon is expanding.

6. There is an agreed international standard for the measurement of greenhouse gas emissions, so that the position of each country is calculated in the same manner. One emission unit is equivalent to one tonne of carbon dioxide (or its equivalent in other greenhouse gases) that would otherwise have been emitted into the atmosphere).

7. Emission units are tradable allowances for greenhouse gas emissions. The ultimate users of emission units are national governments, which will be required to retire (that is, set aside) emission units in order to meet their obligations under the Kyoto Protocol. If a country's initial assigned amount, plus any additional sink and project credits earned over the Commitment Period, is less than its total emissions for that period, it must be a net purchaser of units over the Commitment Period, or it will be required to make up any shortfall by purchases at the end of the Commitment Period. Emission units can be used only once to offset emissions equal to the equivalent greenhouse gas value.

Emissions trading

8. Emission units are tradable between nations and, where nations provide for private ownership of emission units, they can also be traded by private entities. The cost of emission units on the international market is expected to reflect the cost of achieving

emission reductions throughout the market. The aim of emissions trading is to lower the overall cost of achieving emission reductions. Because it is likely to be more difficult and expensive for some parties to the Kyoto Protocol to achieve emission reductions than for other parties, some parties may purchase emission units on the international market in order to comply with their obligations under the Kyoto Protocol.

9. The Kyoto Protocol allows governments to devolve responsibility for emissions to private entities. This means private entities would be required to report their emissions and hold a matching number of emission units. To the extent that some states have devolved, or are expected to devolve, national obligations to reduce emissions to individual emitters, private entities may be required to purchase emission units.

10. The New Zealand Government has announced a "cap and trade" emissions trading scheme under which participants in the system are allocated, or purchase, New Zealand units (NZUs), which they can trade with others. NZUs are a type of emission unit and will be the primary domestic unit of trade. It is intended that during the first Commitment Period the New Zealand emissions trading scheme will be linked to the international market for emission units issued under the Kyoto Protocol (Kyoto units), and that, subject to certain restrictions, NZUs will be interchangeable with Kyoto units, so that participants in the New Zealand emissions trading scheme will be able to surrender both NZUs and Kyoto units for New Zealand emissions trading scheme compliance purposes. See *The Framework for a New Zealand Emissions Trading Scheme* (Ministry for the Environment and The Treasury, September 2007).

11. At present, there is no formal or organised market for emissions trading, and trading is being conducted through brokers.

12. Annex I parties to the Convention are required to establish and maintain a national registry system in order to keep track of transfers and acquisitions of emission units, the setting aside of units for the purpose of compliance with Kyoto Protocol commitments (retirement), and the cancellation of units. New Zealand is an Annex I party under the Convention. A New Zealand registry system for emission units will be established under the Climate Change Response Act 2002.

13. Unique serial numbers must be allocated to each AAU when the initial assigned amount is recorded and to each ERU when it is issued: section 15 of the Climate Change Response Act 2002.

14. An international transaction registry will verify the issue of units, transfers and acquisitions between registries, the retirement and cancellation of units, and the carry-over to any subsequent commitment period, and a clean development registry will issue Clean Development Mechanism units: United Nations Framework Convention for Climate Change website (http://unfccc.int/2860.php).

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Projects to Reduce Emissions programme

15. One of the measures the New Zealand Government has adopted to enable New Zealand to meet its commitments under the Kyoto Protocol is the Projects to Reduce Emissions programme. Under this programme, individuals, companies, or organisations were invited to submit proposals for projects that would reduce greenhouse gas emissions in New Zealand, and to tender for emission units. The Crown awarded emission units in respect of projects undertaken under the programme. The use of a competitive tender process was intended to create pressure on participants to bid down to the minimum number of units they required to allow them to proceed with the project.

16. Initially, it was proposed that subject to Budget allocations being made and a decision of the Government to implement the round in each year, the opportunity to make tenders under the programme would be made available annually. Fifteen projects received emission units in the first tender round in 2003 and a further 26 projects received emission units in the second tender round in 2004. No more Projects to Reduce Emission agreements will be entered into as the New Zealand Government has reviewed and changed its climate change policies. Projects entered into include projects for wind farms, hydro-electricity generation, geothermal-electricity generation, and bio-energy and landfill gas projects. (The first tender round took place before the Kyoto Protocol came into force and successful bidders took the risk that it might not come into force.)

17. A tender under the Project to Reduce Emissions programme had to be for a single definable project. To be eligible to receive emission units under the programme, a project had to:

- take place in New Zealand;
- result in measurable emission reductions additional to reductions that would otherwise occur;
- achieve a minimum annual reduction in emissions of 10,000 tonnes of carbon dioxide equivalent in the first Commitment Period of the Kyoto Protocol; and
- be a project that would not have proceeded if emission units had not been awarded in respect of the project.

18. The selection criteria for projects are explained on the Ministry for the Environment's website (http://www.mfe.govt.nz/issues/climate/policies-initiatives/projects/eligibility-selection.html) as follows:

> In the second tender round, eligible projects were ranked and selected on the following basis:
>
> - The ratio of the number of emission units requested by the tenderer divided by the tonnes of CO_2-equivalent emissions expected to be reduced by the project during the first commitment period of the Kyoto Protocol (2008-2012).
> - Risk assessment of the project.

> Subject to the assessed risk of a project, projects offering the most reduction in emissions in exchange for the least number of emission units requested were ranked highest.
>
> Projects were selected in order of their ranking until the 6 million emission units available in the second tender round had been allocated.

19. If a project delivers emission reductions, the Crown's requirement to retire emission units to meet its commitments under the Kyoto Protocol will reduce and these units will become available to the Crown to deliver to the participant instead. To the extent that the project results in greater emission reductions than the emission units to be provided by the Crown, the Crown will have improved its compliance position.

20. Project agreements have been entered into between the Crown acting through the Minister of Finance and the Minister Responsible for Climate Change Issues and a successful bidder under the programme (the participant). Participants under a project agreement are either in the business of supplying energy or in the business of supplying goods or services requiring the large-scale use of energy. Project agreements apply for a term beginning on the date of the agreement and ending on 31 December 2013 (unless they are terminated earlier): clause 3. (All references to clauses are clauses in the project agreement.)

21. Project agreements in relation to projects under the programme contain standard terms and conditions and information specific to the project (such as implementation milestones and verification processes). Examples of milestones include the lodging of applications for resource consents, the granting of resource consents, entry into a contract for the supply of major equipment, starting construction, and milestones in the construction process from site preparation to equipment delivery to completion of the commissioning of equipment and commencement of operation.

22. Under a project agreement the participant agrees to two things.

- The participant agrees to implement the project in accordance with agreed specifications and milestone dates specified in the project agreement and to complete the project by the final milestone date. The participant will achieve completion of the final milestone when:

  > (a) the Participant has carried out all work necessary to complete the final Milestone; and
  >
  > (b) the Crown has accepted, in accordance with clause 7, the Milestone Report in respect of such Milestone or it has been resolved, in accordance with clause 7, that the Participant has carried out all work necessary to complete the final Milestone.

- The participant agrees to operate the project so as to ensure the project results in the specified emission reductions before and during the Commitment Period (1 January 2008 to 31 December 2012). The definition of "emission reductions" in clause 4.4 reads as follows:

  > In this Agreement, "Emission Reductions" means greenhouse gas emission reductions where:
  >
  > (a) the Participant has achieved completion of the final Milestone in accordance with clause 4.1;

(b) the Greenhouse Gas emission reductions have been determined in accordance with the requirements of Schedule 2, including the measurement methodology set out in that Schedule; and

(c) either the Crown has accepted, in accordance with clause 7, the Annual Report in which such Greenhouse Gas emission reductions are reported or, in the case of non-acceptance by the Crown, the Dispute has been resolved in accordance with clause 16 (including resolution of the Greenhouse Gas emission reductions achieved).

23. The project agreement provides for a monitoring process to enable the Crown to establish that the participant has complied with its obligation to implement the project and to establish the emission reductions achieved by the project. The participant must deliver to the Crown two things.

- The participant must deliver to the Crown a milestone report containing the information specified in Schedule 3 of the project agreement within 20 business days of completion of each milestone: clause 7.2(a). If a milestone is not completed by the relevant milestone date, the participant, within 20 business days of that date, must deliver an interim milestone report outlining progress towards completion of the milestone, the reasons for the delay in completion, and the date by which the participant expects to complete the milestone: clause 7.2(c).

- The participant must deliver to the Crown an annual report containing the information specified in Schedule 4 of the project agreement for each year from the first year in which the participant has promised in its tender that it will deliver emission reductions to 2012 (inclusive) by 31 January of the following year: clause 7.2(b).

24. The Crown may request any further information necessary to enable it to verify the information in any report, inspect the project, interview the participant's staff, and arrange for any annual report to be audited by an independent person: clauses 7.3, 7.4, and 7.5. The Crown must notify the participant that it accepts a report or, if it does not accept a report, the Crown must notify the participant specifying the reasons for such non-acceptance: clause 7.3(b). If the Crown fails to notify the participant within the time-frame specified in clause 7.3(b), it is not deemed to have accepted the report: clause 7.3. If the participant disagrees with the Crown's position, the dispute is to be resolved in accordance with the disputes resolution procedure in clause 16: clause 7.3(c).

25. The maximum number of emission units the Crown is required to transfer is specified in the project agreement: clause 5.2. Emission units are to be transferred to the participant annually during the Commitment Period. The number of emission units transferred in respect of each year is to be determined by reference to the reduction of emissions achieved by the project during the relevant year and calculated in accordance with the following formula:

$A = B \times C$

Where:

A is the number of Emission Units to be transferred

B is the Emission Reductions, stated in (tCO_2-e), resulting from the Project during the relevant year of the Commitment Period; and

C is a number not more than one that reflects the ratio of emission units to emission reductions requested by the participant in its tender.

(The term "tCO_2-e" means tonnes of carbon dioxide or, for greenhouse gases other than carbon dioxide specified in Schedule 2 (if any), their equivalent in tonnes of carbon dioxide calculated in accordance with their respective global warming potential conversion rates specified in Schedule 2.)

26. The Ministry for the Environment administers the Projects to Reduce Emissions programme, and the Ministry of Economic Development manages the emission unit registry. If the Ministry for the Environment is satisfied a project has achieved emission reductions (so that the participant is entitled to emission units under a project agreement), the ministry will recommend to the Ministers that a specific number of emission units be transferred to the participant. This transfer will be made through the registry.

27. Under clause 5.1 the emission units are to be transferred to the participant on or before the transfer date. The term "Transfer Date" is defined in the project agreement as follows:

"Transfer Date" means 5 Business Days after:

(a) acceptance by the Crown of a Commitment Period Annual Report in accordance with clause 7.3; or

(b) in the case of non-acceptance by the Crown, resolution of the Dispute (including resolution of the Emission Reductions achieved) in accordance with clause 16.

28. Under clause 5.3 if the participant gives notice by 31 January in any year that the participant wishes the Crown to transfer the emission units resulting from the project during the previous year to a nominated person or persons, the Crown must transfer the emission units to the nominated person or persons unless:

- the Crown is unable to do so for any reason; or

- in the Crown's reasonable opinion, it is impracticable to do so.

29. Either AAUs or ERUs may be transferred under project agreements. The participant may elect to receive ERUs if the project meets the eligibility requirements for a project under Article 6 of the Kyoto Protocol, provided the participant bears any costs the Crown incurs as a result of the participant requiring the transfer of ERUs. (Usually AAUs (being units issued out of New Zealand's assigned amount under the Kyoto Protocol) will be transferred. There may be price differences between different types of units. Therefore, the value of the emission units transferred under a project agreement could differ depending on whether ERUs or AAUs are transferred.)

30. If it is established that the amount of emission units that have been transferred to the participant is incorrect, the participant must refund the excess amount of emission units to the Crown. This could occur when it is ascertained after the transfer of emission units that the level of emission reductions resulting from the project differs from that previously accepted in respect of a particular year. If either the Crown or the participant determines that the amount of emission reductions resulting from the project in any year varies from the amount accepted in respect of that year, they may give written notice to the other party setting out the amount of and the reason for the variation and the revised amount of emission units that should have been transferred to the participant: clause 9.1. If the party receiving the notice does not trigger the disputes resolution provision in the project agreement (clause 16), the notice is deemed to have been accepted and, if the number of emission units transferred to the participant is:

- more than the number specified in the notice, the participant must transfer the number of emission units equal to the difference (clause 9.3(a));

- less than the number specified in the notice, the Crown must transfer to the participant the number of emission units equal to the difference (clause 9.3(b)) (but the total number of emission units that would be transferred over the term of the project agreement will not exceed the maximum specified in the project agreement).

31. The participant may (with the Crown's consent) assign all (but not less than all) its rights under the project agreement: clause 21.1. Such consent must not be unreasonably withheld. A direct or an indirect change in the effective control of the participant is deemed to be an assignment, unless the participant is a listed company or the change in the effective control of the participant is due to a change in the control of any other listed company: clause 21.3.

32. The Crown may terminate the agreement if the:

- participant fails to meet a significant milestone in the project's implementation;

- project fails to result in more than 10 percent of the emissions reductions required under the agreement in any year (except where such failure is the direct result of the participant failing to achieve a milestone within 12 months after the relevant milestone date);

- participant fails to provide any report within 30 business days of the due date;

- participant provides inaccurate, incomplete, or misleading information; or

- participant becomes insolvent (clause 18.2).

33. The agreement may also be terminated by either party if the other party committed a material breach that is incapable of being remedied or the other party has failed to remedy a material breach that is capable of being remedied within 20 business days of notice of the breach: clause 18.3.

34. Clauses 6.1 and 6.2 provide:

6.1 **Lowest price clause:** The parties acknowledge that:

(a) they are independent parties dealing at arm's length with each other in relation to the matters contemplated by this agreement; and

(b) for the purposes of Division 2 of Part EH of the Income Tax Act 1994, neither the consideration provided by the Participant under clause 4 nor the consideration provided by the Crown under clause 5 includes any interest component, and in each case such consideration is the lowest price the parties would have agreed, on the Effective Date, if the obligations imposed on the parties under those respective clauses were required to be paid or discharged in full on the Effective Date.

6.2 **GST:**

(a) On the date on which the Crown transfers Emission Units to the Participant or a Nominated Person or Persons in accordance with clause 5, the Crown shall issue a Tax Invoice to the Participant for that supply of Emission Units. At that time, the Crown shall also issue to the Participant a Buyer-Created Invoice in respect of the supply of services by the Participant under clause 4 that corresponds to the Emission Units being transferred under that Tax Invoice. The amount to be recorded on both the Tax Invoice, and the Buyer-Created Invoice which corresponds to that Tax Invoice, as:

(i) the value of the supply, shall equate with the value of the Emission Units being transferred under that Tax Invoice;

(ii) the tax charged in relation to the supply, shall be the value mentioned in (i) multiplied by the applicable rate of GST as determined under Part II of the Goods and Services Tax Act 1985.

For the avoidance of doubt:

(iii) each such invoice shall also record the GST-inclusive amount in relation to the supply, which amount shall equate with the sum of (i) and (ii);

(iv) the date on which the Tax Invoice is issued is the time of supply of both supplies[the supply of Emission Units by the Crown and the supply by the participant] for] for GST purposes.

(b) For the avoidance of doubt, the parties agree that the GST chargeable in respect of a supply of Emission Units to the Participant, as recorded in a Tax Invoice, and the equivalent amount of GST chargeable in respect of the supply of services by the Participant under clause 4 that corresponds to the Emission Units being transferred under that Tax Invoice (which amount will be recorded in the Buyer-Created Invoice that corresponds to that Tax Invoice) can, be set off against each other.

35. If a formal, organised market for emission units does not develop, it is intended that the value of emission units would be determined on the basis of the information and methodology used by The Treasury for calculating the Crown's contingent liability under the Kyoto Protocol (that is, the price that the Crown would be required to pay to purchase emission units if New Zealand's greenhouse gas emissions over the first Commitment Period exceed the target under the Kyoto Protocol). New Zealand's contingent liability under the Kyoto Protocol was recognised for the first time in the Government's accounts for the period ended 31 May 2005. The Treasury re-estimates

the liability annually using World Bank published reports and having regard to European Union allowance prices and information from Point Carbon (a provider of news, analysis, and consulting services for European and global power, gas, and carbon markets). The methodology used and price calculated by The Treasury is peer reviewed.

Legislation

36. Section BD 3 provides:

Application

(1) Every amount of income must be allocated to an income year under this section.

General rule

(2) An amount of income is allocated to the income year in which the amount is derived, unless a provision in any of Parts C or E to I provides for allocation on another basis.

Interpretation of derive

(3) When the time of derivation of an amount of income is being determined, regard must be had to case law, which—

(a) requires some people to recognise income on an accrual basis; and

(b) requires other people to recognise income on a cash basis; and

(c) more generally, defines the concept of derivation.

Income credited in account

(4) Despite subsection (3), income that has not previously been derived by a person is treated as being derived when it is credited in their account or, in some other way, dealt with in their interest or on their behalf.

(5) Part E (Timing and quantifying rules) contains a number of provisions that—

(a) specifically modify the allocation of income or have the effect of modifying the allocation of income; or

(b) allocate income as part of the process of quantifying it.

Sngle allocation

(6) An amount of income may be allocated only once.

37. Section CB1 provides:

Income

(1) An amount that a person derives from a business is income of the person.

Exclusion

(2) Subsection (1) does not apply to an amount that is of a capital nature.

38. Section DA 1(1) provides:

Nexus with income

(1) A person is allowed a deduction for an amount of expenditure or loss (including an amount of depreciation loss) to the extent to which the expenditure or loss is—

(a) incurred by them in deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income; or

(b) incurred by them in the course of carrying on a business for the purpose of deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income.

39. Section EW 3 provides:

Meaning

(1) Financial arrangement means an arrangement described in any of subsections (2) to (4).

Money received for money provided

(2) A financial arrangement is an arrangement under which a person receives money in consideration for that person, or another person, providing money to any person—

(a) at a future time; or

(b) on the occurrence or non-occurrence of a future event, whether or not the event occurs because notice is given or not given.

Examples of money received for money provided

(3) Without limiting subsection (2), each of the following is a financial arrangement:

(a) a debt, including a debt that arises by law:

(b) a debt instrument:

(c) the deferral of the payment of some or all of the consideration for an absolute assignment of some or all of a person's rights under another financial arrangement or under an excepted financial arrangement:

(d) the deferral of the payment of some or all of the consideration for a legal defeasance releasing a person from some or all of their obligations under another financial arrangement or under an excepted financial arrangement.

Excepted financial arrangement ceasing to be excepted

(4) For sections EW 7 and EW 8,—

(a) an excepted financial arrangement that ceases to be an excepted financial arrangement through the operation of section EW 7 is a financial arrangement:

(b) an excepted financial arrangement that ceases to be an excepted financial arrangement for a party through the operation of section EW 8 is a financial arrangement for the party.

40. Section EW 32 provides;

When this section applies

(1) This section applies when an original party to an agreement for the sale and purchase of property or services, a hire purchase agreement, a specified option, or a finance lease pays or is paid consideration that includes property or services.

Value of property or services

(2) The value of the property or services is determined by applying subsections (3) to (6) in numerical order until a subsection applies.

Lowest price

(3) The value of the property or services is the lowest price the parties would have agreed on for the property or services, on the date the agreement, option, or lease was entered into, if payment had been required in full at the time the first right in the property was transferred or the services provided. Two qualifications are—

(a) this subsection does not apply to an agreement for the sale and purchase of property or services that is part of another financial arrangement:

(b) section EW 34 applies if the consideration is in a foreign currency.

Cash price

(4) The value of the property or services is the cash price of the property or services to which the agreement, option, or lease relates, as determined by section 5 of the Credit Contracts and Consumer Finance Act 2003, if that Act applies to the agreement, option, or lease.

Future or discounted value

(5) The value of the property or services is the future value, or the discounted value, or a combination of both the future and discounted values, of the amounts paid or payable on the date on which the first right in the property is transferred or the services are provided, as determined by the Commissioner under a determination under section 90AC(1)(i) of the Tax Administration Act 1994.

Determined by Commissioner

(6) The value of the property or services is the amount determined by the Commissioner when either party to the arrangement applies to the Commissioner for a specific determination. Both parties must use this amount.

Exclusion

(7) This section does not apply if the agreement, option, or lease has lapsed or does not proceed.

Application of the legislation

Whether emission units are business income

41. An amount derived from a business is income: section CB 1. An amount would be derived from a business if:

    - the amount was derived from a transaction in the ordinary course of the taxpayer's business (that is, the amount arises from a transaction that is of a type normally undertaken in carrying on the taxpayer's business); or

    - although the amount was not derived from the taxpayer's main activity, the amount is derived from a transaction that is an ordinary incident of the taxpayer's business (that is, the transaction was part of the income earning process); or

    - although the transaction is unusual or a one-off transaction, it was entered into by the taxpayer for the purpose of making a profit.

    See *AA Finance Ltd v CIR* (1994) 16 NZTC 11,383; *CIR v Rangatira Ltd* (1995) 17 NZTC 12,182; *Birkdale Service Station Ltd v CIR* (2000) 19 NZTC 15,981; *CIR v Wattie* (1998) 18 NZTC 13,991.

42. Participants are either in the business of supplying energy or in the business of supplying goods or services for which energy is used. To be entitled to the transfer of emission units, a participant must implement and operate the project so as to result in the reduction of greenhouse gas emissions. The participant is required to provide the information specified in the project agreement in order to enable the Crown to verify the amount of emission reductions that has been achieved from the project. The Crown may terminate the agreement if in any year the project fails to achieve more than 10 percent of the emission reductions required in respect of that year: clause 18.2. Emission units are the product of services rendered by the participant (being the undertaking of an activity that results in emission reductions). The consideration provided for emission units is the achievement of emission reductions as defined in clause 4.4.

43. The participant's obligations under a project to reduce emissions are carried out on an ongoing basis over the term of the project agreement. The participant does not sell or give up any capital asset in return for the emission units and the provision of emission reduction services involves participants carrying on their existing business in a different manner. Therefore, the Commissioner considers that the activities of participants under a project agreement constitute an extension of their business. See *Rolls-Royce Ltd v Jeffrey* [1962] 1 All ER 801.

Grant or subsidy for capital asset?

44. Emission units are provided by the Crown under the Projects to Reduce Emission programme to support projects that would not be economic without the award of emission units.

45. A subsidy provided as assistance in relation to the carrying on of a business or for the reimbursement of expenditure of a revenue nature is income under ordinary concepts: *Brisbane Amateur Turf Club v FCT* 118 CLR 300; *Lincolnshire Sugar Co Ltd v Smart* [1937] AC 697; *Reckitt & Colman Pty Ltd v FCT* 74 ATC 4185. However, when a payment is made as a contribution towards the acquisition or reinstatement of a capital asset, the amount will not be income: *Seaham Harbour Dock Co v Crook* 16 TC 333; *Watson v Samson Bros* 38 TC 346.

46. Projects under the Projects to Reduce Emissions programme will usually involve the acquisition or construction of plant or equipment. Emission reductions will be achieved in one of the following methods (or a combination of these methods).

    - The substitution of other sources of energy (such as wind, water, or bio-energy) for fossil fuels.

    - The displacement of greenhouse gases that would otherwise be released into the atmosphere by establishing a plant or system that uses gases resulting from other activities (such as landfill or waste gases) to provide energy.

47. The expenditure relating to the acquisition or construction of such plant or equipment is likely to be expenditure of a capital nature (being expenditure incurred in order to acquire a capital asset for use in producing energy for sale or for use by the participant's business). A participant must put in place plant and equipment in accordance with the agreed specifications by the agreed date in order to achieve emission reductions during the first Commitment Period. However, to be entitled to receive emission units, it is not sufficient that plant or equipment be acquired or constructed. The Crown is not obliged to transfer emission units to the participant unless it is established that the project has achieved a certain level of emission reductions. Therefore, the emission units do not constitute a subsidy for the purpose of acquiring an asset (plant and equipment) of a capital nature. The Crown provides the emission units for services (the achievement of emission reductions).

48. The Commissioner considers that emission units do not constitute and are not a capital receipt. Emission units are not a subsidy for the purpose of acquiring an asset of a capital nature. Emission units are transferred periodically for services (the achievement of emission reductions) provided by the participant.

Section CX 47

49. The Commissioner has also considered section CX 47, which applies to payments in the nature of a grant or subsidy made by a public authority. If section CX 47 applies,

the emission units would be excluded income. The Commissioner considers that section CX 47 does not apply, because emission units are not transferred to participants "in relation to" expenditure incurred by them in implementing or operating projects, as required by section CX 47(1)(d). Emission units would not be transferred to a participant merely because the participant incurs expenditure in implementing and operating a project. The entitlement of participants to the transfer of emission units is directly linked to the achievement of emission reductions and the level of emission reductions achieved determines the number of emission units transferred. The number of emission units transferred has no relationship with the amount of expenditure incurred by participants. Emission units are provided in relation to the achievement of emission reductions.

Convertibility

50. For the emission units to be income, they must be convertible into money: *Tennant v Smith* (1892) AC 150; *FCT v Cooke & Sherden* 80 ATC 4140.

51. There is no prohibition on the transfer of the emission units in the project agreement. The project agreement contemplates that emission units may be sold by the participant. Clause 5.5 limits any liability on the part of the Crown as a consequence of the inability of the participant or the participant's nominee to transfer or trade the emission units. Clause 5.5 provides:

> **Tradeability**: The Crown has no obligation or liability to the participant or any nominated person in respect of the ability or inability to transfer or trade Emission Units following transfer of Emission Units to the Participant or a Nominated Person, except where the Participant is, during the term of this agreement, unable to transfer Emission Units from the Registry to an overseas registry for the sole reason that New Zealand is not in compliance with the inventory and registry eligibility requirements for transferring and acquiring Emission Units of [sic] under Article 17 of the Protocol or established thereunder.

Because emission units can be sold, they are convertible into money, and because an international market exists for emission units, their value is able to be ascertained.

52. Therefore, the Commissioner considers that the emission units are income derived from a business carried on by a participant being transferred to participants for services (the achievement of emission reductions) provided by participants on an ongoing basis as part of their business.

Whether amounts derived from the sale of emission units are income

53. Generally, when a taxpayer receives an asset in satisfaction of a business debt and merely sells the asset, the amount derived from the sale is not income from the business. In *Case D6* 72 ATC 28, a timber and hardware retailer had received land from a customer who was unable to pay their debt. After acquiring the land, the taxpayer subdivided and sold the land. The Board of Review considered that the land was a capital asset (being acquired in discharge of a trade debt rather than for the

purpose of sale for profit) and that the transaction was an isolated one that was unconnected with the company's business. Therefore, the Board of Review considered that the amount derived from the sale of the land was not income from the taxpayer's business.

54. The Commissioner considers that *Case D6* is distinguishable. In *Case D6* an asset was received to satisfy an existing debt and the sale of the asset was not connected with the activity giving rise to the debt or with any other activity related to the business. The taxpayer had no choice but to accept the land in order to recover its debt. In this case, participants will receive periodic transfers of emission units in return for the ongoing provision of services in the course of their business. The business of participants includes the supply of services for emission units. Emission units are a product of services provided by the participant in the course of carrying on a business.

55. The Commissioner considers that on that basis amounts derived from the sale of emission units are income from the participant's business. Therefore, the participant will derive income in the form of the emission units and income from the sale of the emission units. If a deduction is not allowable in respect of the emission units, the participant will be subject to tax both on the value of the emission units and on the proceeds of sale, although the participant receives one gain in the form of money's worth that is converted into cash.

Whether a deduction is allowable in respect of the emission units

56. For expenditure to be deductible under section DA 1(1) there must be a sufficient relationship between the expenditure (and the advantage provided or sought to be provided from the expenditure) and the income-earning process: *CIR v Banks* (1978) 3 NZTC 61,236. The Commissioner accepts that there is a sufficient relationship between any expenditure incurred by a participant in acquiring emission units and assessable income derived from the sale of emission units, because the participant would be unable to derive income from the sale of emission units unless the participant had acquired emission units. However, a deduction under section DA 1 is not allowable when the taxpayer has not incurred expenditure.

What is the expenditure for emission units?

57. Expenditure means something that passes from the person incurring the expenditure in money or in money's worth that has the effect of diminishing the taxpayer's assets: *Oram v Johnson* [1980] 2 All ER 1; *Case S75* (1996) 17 NZTC 7469; *Case T16* (1997) 18 NZTC 8095. In *Oram v Johnson* the court accepted that expenditure could be in the form of money's worth that *diminishes the total assets of a person* and considered that when expenditure is in the form of money's worth, a valuation exercise is necessary to determine the amount of the expenditure incurred by the taxpayer. However, the taxpayer's own services do not constitute expenditure.

58. In this case, services are provided in order to acquire the emission units rather than the giving up of an asset. The only expenditure incurred by a participant is the expenditure incurred in constructing and operating the plant or equipment required to generate energy. No additional cost above the cost of carrying out the project is incurred by a participant in order to obtain the emission units. When shares are acquired in order to acquire the assets of a company, the cost of acquiring the asset is the cost of the shares: *Tasman Forestry Ltd v CIR* (1999) 19 NZTC 15,147; *John v FCT* 89 ATC 4101; *Steinberg v FCT* 75 ATC 4221. A possible argument is that by analogy the cost of the emission units is the expenditure incurred in carrying out the project. However, expenditure incurred in carrying out a project is incurred primarily in order to acquire and operate plant or equipment to produce energy for sale, or for the participant's own use in carrying on a business, rather than in order to acquire emission units. Essentially, the emission units represent an additional return from the project. The Commissioner considers that expenditure incurred in implementing and operating a project cannot be regarded as the cost of the emission units.

59. In any event, expenditure in operating a project is likely to be deductible on the basis that it is incurred in deriving income from the generation and sale of electricity or from another income-earning activity involving the use of the project, and expenditure in constructing a project is likely to be deductible as a "depreciation loss" being depreciation on an asset used in deriving income. A deduction is not allowed twice for the same expenditure: section BD 4(5).

60. Therefore, the Commissioner considers that expenditure is not incurred in acquiring the emission units. However, it may be appropriate to attribute a cost to the emission units.

Can a cost be attributed to the emission units?

61. *Sharkey v Wernher* [1956] AC 58 (HL) concerned a taxpayer who carried on a stud farm (a "taxable activity") and a recreational activity of horse racing and who had transferred horses from the stud farm to the racing activity. The House of Lords held that the horses should be treated as having been transferred from the stud farm activity to the racing activity at their market value. Lord Radcliffe said (at pages 84–86; emphasis added):

> **When a horse is transferred from the stud farm to the owner's personal account, there is a disposition of trading stock.** …
>
> **In a situation where everything is to some extent fictitious, I think that we should prefer the third alternative of entering as a receipt a figure equivalent to the current realizable value of the stock item transferred. In other words, I think that the case of *Watson Brothers v. Hornby* was rightly decided and that its principle is applicable to all those cases in which the income tax system requires that part of a taxpayer's activities should be isolated and treated as a self-contained trade.** The realizable value figure is neither more nor less "real" than the cost figure, and in my opinion it is to be preferred, for two reasons. First, it gives a fairer measure of assessable trading profit as between one taxpayer and another, for it eliminates variations which are due to no other cause than any one taxpayer's decision as to what proportion of his total product he will supply to himself. A formula which achieves this makes for a more equitable distribution of the burden of tax, and is to be preferred on that account. Secondly, it seems to me better economics to credit the trading owner with the current realizable value of any stock which he has chosen to dispose of without commercial disposal than to credit him with an

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amount equivalent to the accumulated expenses in respect of that stock. In that sense, the trader's choice is itself the receipt, in that he appropriates value to himself or his donee direct instead of adopting the alternative method of a commercial sale and subsequent appropriation of the proceeds.

62. The principle in *Sharkey v Wernher* constitutes an exception to the general principle that a person cannot trade with himself or herself. Viscount Simonds and Lord Radcliffe noted that the exception applied in all cases where the legislation requires that part of a taxpayer's activities must be isolated and treated as a self-contained activity. In such cases, it is necessary to attribute a cost to assets brought into or transferred out of the activity in order to determine the true profit arising from that activity.

63. The same principle applies to the reverse situation to that considered in *Sharkey v Wernher*. Therefore, when assets acquired otherwise than in the ordinary course of business (such as when assets are acquired by way of gift) are brought into a business or capital assets are appropriated to a business or income-earning activity, a cost can be attributed to the assets. See the judgment of Viscount Simonds in *Sharkey v Wernher*; *JB Macdonald & Sons Ltd v MNR* [1970] CTC 17; *Case A27* (1974) 1 NZTC 60,245; *Bath and West Counties Property Trust Ltd v Thomas (Inspector of Taxes)* [1977] 1 WLR 1423; *Rank Xerox (NZ) Ltd v CIR* (1983) 6 NZTC 61,501; *Halliwell v CIR* (1991) 13 NZTC 8197; *Rangatira Ltd v CIR* (1996) 17 NZTC 12,727.

64. As emission units are received as business income and it is always intended that they will be sold, it is difficult to argue that their character changes at any point. However, *Tasman Forestry Ltd v CIR* left open the possibility that an analogy could be drawn with *Sharkey v Wernher* in different fact situations. See also the judgment of Viscount Simonds in *Sharkey v Wernher* and *Halliwell v CIR*.

65. The rationale for the principle in *Sharkey v Wernher* and the other cases is that it is necessary to attribute a cost to an asset acquired outside a trading activity and appropriated to the trading activity in order to determine the true profit arising from the trading activity. In the main judgment in *John v FCT* it was said (at page 4111; emphasis added):

> **It must be accepted that in some situations there is a cost involved in the appropriation of bonus shares to trading stock in the same way as there is a cost involved in the appropriation of a gift to trading stock, and that a value must be ascribed on appropriation if the taxpayer's accounts are to reveal a "substantially correct reflex of the taxpayer's true income": see *C. of T. (S.A.)* v. *Executor Trustee and Agency Co. of South Australia Ltd.* (1938) 63 C.L.R. 108 at pp. 154-156.** An obvious example of such a situation is where the original shares were not trading stock but the bonus shares are appropriated to trading stock. It is not here necessary to identify all situations in which it will be necessary to ascribe a value to bonus shares appropriated to trading stock. It is necessary only to consider the circumstances relevant to the present case.

Therefore, this approach is consistent with the principle recognised in case law that accounting principles and commercial practice are relevant in calculating business income, and that the accounting method that should be preferred is that which is "calculated to give a substantially correct reflex of the taxpayer's true income": *Commissioner of Taxes (SA) v Executor Trustee and Agency Co of South Australia Ltd* 48 CLR 26 *(Carden's case)*; *CIR v Farmers Trading Co Ltd* (1982) 5 NZTC 61,200.

66. The above approach is also consistent with the presumption against double taxation in interpreting revenue legislation. Double taxation means a situation where the same person pays tax twice on the same income: *Levin v Commissioner of Taxes* (1912) 31 NZLR 717; *Canadian Eagle Oil Co Ltd v R* [1946] AC 119; *Commissioner of Taxes v Luttrell* 4 ATD 67. In *Carden's case*, Dixon J commented that an interpretation that results in double taxation would be adopted only where it was absolutely clear that that result was intended (at page 44):

> No interpretation of a taxing Act should be adopted which results in the imposition of double taxation unless the intention to do so is clear beyond any doubt.

67. The arrangement involves income derived under two transactions, but only one gain to participants. The second transaction (the sale of emission units) involves the realisation of a non-cash receipt derived in the first transaction (the project agreement). If a cost is not attributed to the emission units, participants would be taxed twice on the same gain (on receipt of the emission units and on the conversion of the emission units into cash).

68. Therefore:

- the participant derives income in the form of emission units;
- a deduction of an amount equal to the market value of the emission units at the time of receipt is allowable in the year of their sale by the participant; and
- the amount derived from the sale of the emission units is income.

Whether a project agreement is a financial arrangement

69. If the project agreement is a financial arrangement, the accrual rules apply to the allocation of income or deductions under the project agreement: sections BD 4(3) and BD 4(4). For a project agreement to be a financial arrangement, it must be:

- an arrangement;
- under which the Crown or the participant receives money or money's worth;
- in consideration for the Crown or the participant providing money or money's worth;
- at a future time or on the occurrence or non-occurrence of a future event.

70. The definition of "arrangement" in section OB 1 includes a contract. Project agreements are arrangements being contracts under which the Crown receives services (emission reduction services) in consideration for the Crown providing emission units.

71. The definition of "money" in section OB 1 includes "money's worth, whether or not convertible into money", but to be "money" for the purpose of the definition of

"financial arrangement", it must be possible to value the benefit: *McElwee v CIR* (1997) 18 NZTC 13,288. Emission units are convertible into money and it will be possible to determine the monetary value of emission units as they are tradable on the international emissions market. The monetary value of emission reduction services can be determined by reference to the value of emission units.

72. Services (an activity that results in emission reductions) provided under project agreements are provided over the term of the agreements. At the end of each year of the Commitment Period, the participant must provide such documentation as the Crown requires to verify that emission reductions up to the required level have been achieved under the project during the year. The verification process determines the number of emission units that are to be transferred to the participant in respect of the year. Payment is to be made on or before five business days after completion of the verification and agreement as to the emission reductions achieved during the year. There will, therefore, be a delay between the emission reduction services being provided and emission units being transferred.

73. The Commissioner considers that a project agreement is a financial arrangement being an arrangement under which the Crown receives money (emission reduction services) in consideration for the Crown providing money (emission units) to the participant at a future time (on acceptance by the Crown of the level of emission reductions achieved in the previous year). Therefore, the accrual rules apply to project agreements.

What is the consideration under a project agreement?

74. The value of the consideration under a project agreement is to be determined under section EW 32, which applies when an original party to an agreement for the sale and purchase of property or services pays or is paid consideration that includes property or services: section EW 32(1). The value of the property or services is to be determined by applying subsections (3) to (6) of section EW 32 in numerical order until a subsection applies. If the lowest price method applies, it is not necessary to consider the other methods of valuation specified in section EW 32.

75. The lowest price method does not apply to an agreement for sale and purchase of property or services that is part of another financial arrangement. A project agreement is both an agreement for the sale and purchase of services (emission reduction services) for which the consideration is property (emission units) and an agreement for the sale and purchase of property (emission units) for which the consideration is services (emission reduction services). There is one arrangement under which the consideration for services is provided in the form of the transfer of property and the consideration for the property is in the form of the provision of services. Therefore, the lowest price method applies.

76. Under section EW 32(3) the value of property or services is the lowest price that the parties would have agreed on the date that the agreement was entered into, if payment would have been required in full at the time the first right in the contracted property was transferred or the services provided. In *Lyttelton Port Company Ltd v CIR* (1996)

17 NZTC 12,556, Hansen J considered that it was not necessary that the parties had actually agreed on the lowest price or that the parties had actually considered the issue. The question was what was the lowest price that the parties would have agreed to, having regard to the surrounding circumstances.

77. Under the Projects to Reduce Emissions programme participants are invited to submit tenders for projects. The tender document must specify the number of emission units requested by the tenderer, and the tenderer must provide information to enable the Crown to determine the reduction in emissions that is likely to result from the project. The consideration provided by each of the parties under a project agreement is determined under a competitive tender system under which applicants compete for the award of emission units and the Crown seeks to achieve the maximum emission reductions for the least number of emission units.

78. Emission reduction services are provided over the term of the arrangement. The reduction of greenhouse gas emissions is achieved by generating energy from non-fossil fuels or by displacing greenhouse gases over the period of the arrangement. The project agreement specifies the maximum number of emission units that the Crown is required to transfer under the agreement. The actual number transferred on each transfer date depends on the amount of emission reductions achieved under the project in the previous year. The formula in clause 5.1 for calculating the number of emission units to be transferred does not take into account any interest element for a delay in the transfer of emission units.

79. The Commissioner considers that the lowest price that the parties would have agreed on the date of the agreement would be determined by reference to the ratio of emission units to emission reductions (as defined in the project agreement) specified in the project agreement. The value of the emission reduction services provided by participants is an amount equal to the value of the emission units transferred to participants. Therefore, the participant will not derive income or expenditure under the accrual rules in respect of the project agreement.

When are emission units derived?

80. The general rule is that income must be allocated to the year in which it is derived unless Part C or Parts E to I provide for allocation on another basis: section BD 3(2). When income is derived is to be determined having regard to case law under which some people are required to recognise income on an accrual basis and others are required to recognise income on a cash basis, and on the concept of derivation generally: section BD 3(3).

81. Generally, income from a business must be recognised on an accruals or earnings basis: *Fincon (Construction) Ltd v CIR* [1970] NZLR 462; *CIR v National Bank of New Zealand Ltd* (1976) 2 NZTC 61,150; *CIR v Farmers Trading Co Ltd*; *Whitworth Park Coal Co Ltd v IR Commrs* [1959] 3 All ER 703. The following principles can be drawn from the case law on recognition of income on an accruals basis.

- For an amount received to be income derived, the amount must be received beneficially and the recipient's entitlement to the payment must not be received subject to any contingencies. It is necessary to consider whether the income-earning process is complete and whether, as a consequence of the provision of goods or services, a debt has been created, or whether the taxpayer is required to take further steps before becoming entitled to payment: *Arthur Murray (NSW) Pty Ltd v FCT* 14 ATD 98; *Hawkes Bay Power Distribution Ltd v CIR* (1998) 18 NZTC 13,685; *FCT v Australian Gas Light Co Ltd* 83 ATC 4800.

- To the extent permitted by the legislation, accounting principles and practice are relevant to (but not determinative of) when income has been derived: *Arthur Murray (NSW) Pty Ltd v FCT*; *Hawkes Bay Power Distribution Ltd v CIR*.

- It is not relevant that the due date for payment has not arrived: *Henderson v FCT* 70 ATC 4016; *Gasparin v FCT* 94 ATC 4280.

- When the taxpayer has an absolute entitlement to amounts received, the possibility that an obligation may arise in the future to refund all or part of the amount does not mean that the amounts are not income derived by the taxpayer: *CIR v Mitsubishi Motors Ltd* (1994) 16 NZTC 11,107; *Bowcock v CIR* (1981) 5 NZTC 61,062.

82. Accounting principles are relevant (although not determinative) in establishing when income is derived. In *Hawkes Bay Power Distribution Ltd v CIR* the High Court noted that accounting principles required income to be recognised when:

    (a) the income earning process is complete;

    (b) the amount of income can be reasonably calculated;

    (c) there is a reasonable expectation that the supplier will be paid for the goods or services provided.

83. The earning process is complete when all events that determine the right to receive income have occurred: *Hawkes Bay Power Distribution Ltd v CIR.* Emission units are earned under a project agreement by achieving a verified amount of emission reductions. Under clause 4.1, the participant must implement the project in accordance with the agreed specifications and the milestone dates specified in the agreement, including achieving completion of the final milestone by the specified date, and must operate the project so as to ensure that the project results in at least the emissions reductions specified in the project agreement during each year before the Commitment Period (and during the first Commitment Period): clauses 4.2 and 4.3. Participants are not entitled to receive a transfer of emission units unless it is verified that emission reductions have been achieved from the project. The participant must provide milestone and annual reports to enable the Crown to verify that the participant has complied with its obligations under the project agreement to implement the project and to operate the project so that it results in emission reductions: clause 7.2. The participant obtains a right to have the emission units transferred once the verification process is completed.

84. The project agreement specifies the method for determining the amount of emission reductions resulting from the project: clause 4.4. The method is tailored to each project. The Crown's acceptance of the annual report in which emission reductions reported (or, if the Crown does not accept the annual report, the resolution of the amount of emission reductions achieved) establishes the amount of emission reductions resulting from the project in a particular year. This determines the number of emission units that the participant is entitled to receive in respect of the particular year. The number of emission units is calculated in accordance with the formula in the project agreement. Therefore, once the verification process has been completed, it is possible to determine the number of emission units to which the participant is entitled.

85. Clause 9 contemplates that it may be determined subsequently that the level of emission reductions resulting from a project and, therefore, the number of emission units that the participant was entitled to, varies from the amount accepted or resolved. However, the possibility that it may later be established that the number of emission units to which the participant is entitled varies from the number previously accepted or resolved, does not mean that the amount of income could not be determined. Income under a project agreement is determined in accordance with the method for determining the amount of emission reductions and the formula for calculating the number of emission units set out in the project agreement.

86. Given that the Crown is the other party to a project agreement and the Crown's credit rating, it can also be reasonably expected that the participant will receive the emission units.

87. Therefore, income under a project agreement will be derived when the participant becomes entitled to receive emission units in each year of the term of the project agreement (that is, once the verification process has been completed and the amount of emission reductions achieved in a particular year has been determined). At that point, the Crown has an obligation to transfer to the participant the number of emission units calculated in accordance with the formula in clause 5.1. The possibility that an obligation may arise in the future to reimburse the Crown if it is subsequently ascertained that the level of emission reductions accepted by the Crown is incorrect, would not mean that the emission units would not be derived.

Additional emission units

88. A participant is not entitled to additional emission units in respect of emission reductions achieved in any previous year, unless the Crown accepts that the participant is entitled to the additional emission units or it is resolved in accordance with the dispute resolution provisions in the project agreement that the participant is entitled to the additional emission units. At the end of the year in which the participant provided emission reduction services, the participant is entitled to receive only the emission units then agreed in respect of that year. At that stage there is no "debt" owing to the participant in respect of additional emission units. See *FCT v Squatting Investment Ltd* 10 ATD 136; *Ritchie v Trustees Executors and Agency Company Ltd* 84 CLR 553; *Bass Billiton Petroleum (Bass Strait) Pty Ltd v FCT* 2002 ATC 5169. A participant becomes

entitled to receive additional emission units, if it is established that emission reductions above the previously accepted level were achieved in a previous year. The Commissioner considers that any additional emission units that a participant becomes entitled to receive will be derived in the year in which it is agreed or resolved that the participant is entitled to receive the additional emission units. At that point, the earning process will be complete and all conditions precedent to the participant's entitlement to payment will be satisfied.

89. Therefore, any additional emission units that a participant becomes entitled to receive would be derived in the year in which it is established that the participant is entitled to receive the additional emission units.

Refund of emission units

90. Participants who have received emission units and are subsequently required to transfer emission units back to the Crown or pay an amount of money to the Crown will incur expenditure. "Expenditure" need not be in the form of money: *Oram v Johnson*. It is possible to value the emission units for the purpose of determining the amount of the expenditure when emission units are refunded.

91. For expenditure to be deductible under section DA 1(1) there must be a sufficient relationship between the expenditure and the income-earning process: *CIR v Banks*. In *FCT v Smith* 81 ATC 4144, the High Court of Australia made the following comments in respect of the equivalent of section DA 1 in the Australian legislation (at page 4117):

> The section does not require that the purpose of the expenditure shall be the gaining of the income of that year, so long as it was made in the given year and is incidental and relevant to the operations or activities regularly carried on for the production of income. What is incidental and relevant in the sense mentioned falls to be determined not by reference to the certainty or likelihood of the outgoing resulting in the generation of income but to its nature and character and generally to its connection with the operations which more directly gain or produce the assessable income.

92. To determine whether expenditure is deductible it is necessary to consider the scope of the business or other income-earning activity and the relationship between the expenditure and the business or income-earning activity. To earn emission units a participant must carry on an activity that results in the reduction of greenhouse gas emissions. This requires the participant to change the way in which they carry on business (for example, by constructing and operating a wind farm or geothermal or bio-fuel projects (rather than using fossil fuels) or by using landfill gas to generate energy for sale or for use in the production of goods or services for sale). The provision of emission reduction services is part of the business carried on by participants. When the participant continues to carry on that business, the obligation to repay emission units arises out of and is closely related to the business carried on by the participant. In such circumstances the Commissioner considers that the repayment of emission units (or their cash equivalent) is incidental and relevant to the business carried on by participants.

93. Therefore, the Commissioner considers that a deduction is allowable in respect of emission units repaid by a participant to the Crown. A deduction would be allowable in the year in which emission units are repaid or an equivalent amount in cash is paid to the Crown.

Conclusion

94. Emission units are income from the participant's business. Emission units are provided to the participant in return for their undertaking an ongoing activity resulting in reductions in greenhouse gas emissions. The activities of participants under a project agreement are part of the business carried on by participants. The emission units are convertible into money, because participants can transfer the emission units and their value can be determined. Emission units are not a capital receipt. Emission units are not excluded income under section CX 47, because they are not transferred to participants in relation to expenditure incurred by the participant under a project agreement.

95. Amounts derived from the sale of emission units are income from the participant's business, which includes the supply of services in return for emission units.

96. It is appropriate to attribute a cost equal to the market value of the emission units at the time of receipt in order to correctly calculate the income of participants. A deduction is allowable for an amount equal to the value of the emission units in the year in which the participant sells emission units received under the project agreement.

97. A project agreement is a financial arrangement. The consideration for services provided by a participant under a project agreement is an amount equal to the value of the emission units transferred by the Crown. As the values of the consideration provided and received by the participant under the project agreement are equal, the participant will not derive income or expenditure under the accrual rules.

98. Income under a project agreement is derived in each year of the term of the project agreement when the verification process has been completed and the amount of emission reductions resulting from the project is determined. Any additional emission units to which a participant becomes entitled in a subsequent year will be derived in the year in which it is determined that the participant is entitled to additional emission units.

99. If it is determined in a subsequent year that the participant is required to refund emission units to the Crown (or to pay a cash equivalent) and the participant continues to carry on a business involving the generation of energy for sale or for use in the production of goods or services for sale, in connection with which the project agreement was entered into, the participant is entitled to a deduction in respect of the emission units refunded (or the cash repaid) in the year in which the refund is made.

Proposed amendments

100. The Climate Change Response Act 2002 has been amended to include emissions trading rules under which:

- businesses in certain sectors will be required to calculate the emissions from their activities and to surrender one emission unit for each tonne of those emissions; and

- the government may allocate "free" emission units to businesses in certain sectors.

Amendments are proposed to the Income Tax Act to provide for the income tax treatment of emissions trading units. Such amendments are not intended to alter the existing income tax treatment of arrangements entered into outside the emissions trading scheme between the Crown and industry.

Period of Ruling

101. Given the terms of section 91C of the Tax Administration Act 1994, it is not possible to issue a ruling in respect of the Income Tax Act 2004 for the period before 1 April 2008. However, the Commissioner is of the view that the same principles and conclusions as set out in this ruling apply in respect of any income derived or expenditure incurred under a project agreement before 1 April 2008.