PROJECTS TO REDUCE EMISSIONS PROGRAMME—GST 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 08/04

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

Taxation Laws

All legislative references are to the Goods and Services Tax Act 1985 unless otherwise stated.

This Ruling applies in respect of sections 4, 8(1), and 9(3)(a) and the definitions of "goods", "services", and "consideration".

The Arrangement to which this Ruling applies

The Arrangement is a project agreement between the Crown and a participant under the Crown's Projects to Reduce Emissions programme.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows.

- For the purposes of section 8, the participant will supply emission reduction services as defined in section 2 (the implementation and operation of a project so as to reduce emissions of greenhouse gases) to the Crown.

- For the purposes of section 8, the consideration for the supply of emission reduction services will be in the form of emission units transferred by the Crown to the participant.

- The value of the supply of emission reduction services determined under section 4 will be:

    - an amount equal to the price emission units transferred under the project agreement would fetch at the time of supply, if they were supplied between arm's length parties; or

- if it is not possible to establish that price, an amount equal to the price similar emission units would fetch at the time of supply if they were supplied between arm's length parties; or

- if it is not possible to establish the price at which the emission units or similar emission units could be sold on the emissions market in New Zealand at the time of supply, the price (at the time of supply) of emission units calculated by The Treasury for the purpose of estimating the Crown's contingent liability under the Kyoto Protocol.

- Under section 9(3)(a) the time of supply of each annual supply under the project agreement will be the earlier of the relevant transfer date (as defined in the project agreement) and the date on which emission units are actually transferred to the participant.

The period or income year for which this Ruling applies

This Ruling will apply from 1 January 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 08/04

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 08/04 ("the Ruling").

All legislative references are to the Goods and Services Tax Act 1985 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 have ratified 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 abilities to reduce greenhouse gas emissions differ. 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 the Projects to Reduce Emissions programme 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 that 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) that 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).

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). 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 of the project agreement. (All references to clauses are to clauses in the project agreement.)

21. Both the Crown and the participant under a project agreement will be registered persons for GST purposes, and any supplies made by the Crown or a participant under a project agreement will be made in the course or furtherance of their taxable activity.

22. 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.

23. 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 that 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).

24. 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).

25. 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).

26. The maximum number of emission units that the Crown is required to transfer will be 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.)

27. The Ministry for the Environment administers the Projects to Reduce Emissions programme, and the Ministry of Economic Development manages the emissions 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.

28. Under clause 5.1 the emission units are to be transferred to the participant on or before the transfer date. "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.

29. 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.

30. 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.)

31. 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).

32. 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.

33. 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).

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 the purpose of 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 8(1) provides:

> Subject to this Act, a tax, to be known as goods and services tax, shall be charged in accordance with the provisions of this Act at the rate of 12.5 percent on the supply (but not including an exempt supply) in New Zealand of goods and services, on or after the 1st day of October 1986, by a registered person in the course or furtherance of a taxable activity carried on by that person, by reference to the value of that supply.

37. Section 5(1) provides:

> For the purposes of this Act, the term **supply** includes all forms of supply.

38. The definition of "goods", "services", and "consideration" in section 2 read:

> **Goods** means all kinds of personal or real property; but does not include choses in action, money or a product that is transmitted by a non-resident to a resident by means of a wire, cable, radio, optical or other electromagnetic system or by means of a similar technical system:
>
> **Services** means anything which is not goods or money:
>
> **Consideration** in relation to the supply of goods and services to any person, includes any payment made or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods and services, whether by that person or by any other person; but does not include any payment made by any person as an unconditional gift to any non-profit body:

39. Section 10(2) states:

> Subject to this section, the value of a supply of goods and services shall be such amount as, with the addition of the tax charged, is equal to the aggregate of,—
>
> (a) To the extent that the consideration for the supply is consideration in money, the amount of the money:
>
> (b) To the extent that the consideration for the supply is not consideration in money, the open market value of that consideration.

40. Section 4 provides:

> **4 Meaning of term open market value**
>
> *Similar supply defined*
>
> (1) For the purposes of this section—
>
> (a) The term **similar supply**, in relation to a supply of goods and services, means any other supply of goods and services that, in respect of the characteristics, quality, quantity, functional components, materials, and reputation of the goods and services first mentioned, is the same as, or closely or substantially resembles, that supply of goods and services:
>
> (b) The open market value of a supply shall include any goods and services tax charged pursuant to section 8(1) of this Act on that supply.

Consideration in money

(2) For the purposes of this Act, the open market value of any supply of goods and services at any date shall be the consideration in money which the supply of those goods and services would generally fetch if supplied in similar circumstances at that date in New Zealand, being a supply freely offered and made between persons who are not associated persons.

Similar supply

(3) Where the open market value of any supply of goods and services cannot be determined under subsection (2) of this section, the open market value shall be the consideration in money which a similar supply would generally fetch if supplied in similar circumstances at that date in New Zealand, being a supply freely offered and made between persons who are not associated persons.

Method approved by Commissioner

(4) Where the open market value of any supply of goods and services cannot be determined pursuant to subsection (2) or subsection (3) of this section, the open market value shall be determined in accordance with a method approved by the Commissioner which provides a sufficiently objective approximation of the consideration in money which could be obtained for that supply of those goods and services.

Non-monetary consideration

(5) For the purposes of this Act the open market value of any consideration, not being consideration in money, for a supply of goods and services shall be ascertained in the same manner, with any necessary modifications, as the open market value of any supply of goods and services is ascertained pursuant to the foregoing provisions of this section.

41. Section 9(3)(a) provides:

Agreements to hire

Notwithstanding anything in subsection (1) or subsection (2) of this section,—

(a) Where goods are supplied under an agreement to hire, or where services are supplied under any agreement or enactment which provides for periodic payments, they shall be deemed to be successively supplied for successive parts of the period of the agreement or the enactment, and each of the successive supplies shall be deemed to take place when a payment becomes due or is received, whichever is the earlier:

Application of the legislation

42. Under section 8(1), GST is chargeable on the supply of goods and services by a registered person in the course or furtherance of a taxable activity carried on by that person by reference to the value of the supply. The participant under a project agreement is a registered person and any supply made under a project agreement will be made in the course or furtherance of the participant's taxable activity.

Is a supply of goods or services made by the participant to the Crown?

43. The participant has two obligations under the project agreement.

- The participant must implement the project in accordance with the specifications in the agreement and the milestone dates specified in the agreement, including completion of the final milestone. A "milestone" is a significant event in the project's implementation and a "milestone date" is the date by which the participant is required to complete a milestone.

- The participant must operate the project so as to ensure that the project results in the minimum emission reductions specified in the project agreement:

44. The term "goods" is defined in section 2(1) as meaning all kinds of personal or real property except choses in action and money. A "chose in action" refers to all property rights that cannot be exercised by taking physical possession and can be enforced only by legal action: *Torkington v Magee* [1907] 2 KB 427; *Simperingham v West Haven Marine Centre Ltd* (1990) 12 NZTC 7111. As the Crown obtains no rights in respect of any plant or equipment constructed under a project to reduce emissions or other property of the participant, a participant does not provide goods to the Crown under a project agreement.

45. The term "services" encompasses anything other than goods or money and means some action that helps or benefits the recipient: *Case S65* (1996) 17 NZTC 7408; *F B Duvall Ltd v CIR* (1997) 18 NZTC 13,470. tThe activities undertaken by participants in the performance of the participant's obligations to the Crown under the project agreement constitute the supply of services (emission reduction services) to the Crown, being activities sought by the Crown in order to assist the Crown to meet its obligations under the Kyoto Protocol and to reduce its potential liability under the Kyoto Protocol.

Consideration

46. For a payment to be "consideration" for GST purposes, there must be a sufficient relationship between the making of the payment and the supply of goods or services. The legal nature of the transaction must be considered in order to determine whether there is the required nexus between the payment and any supply. See *CIR v NZ Refining Co Ltd* (1997) 18 NZTC 13,187; *Chatham Islands Enterprise Trust v CIR* (1999) 19 NZTC 15,075; *Taupo Ika Nui Body Corporate v CIR* (1997) 18 NZTC 13,147; *Trustees & Executors and Agency Co New Zealand Ltd v CIR* (1997) 18 NZTC 13,076.

47. To be entitled to receive emission units, the participant must establish that a specific level of emission reductions has been achieved under the project. The Crown is not obliged to transfer emission units unless emission reductions are achieved and may terminate the agreement if the operation of the project fails to achieve less than 10 percent of the required emission reductions in any year: clause 18.2. Emission reductions will not be achieved unless the project is in continuous operation over the Commitment Period. The number of emission units transferred in each year of the agreement will depend on the emission reductions achieved by the project in each year. The participant is required to provide the information specified in the project agreement in order to enable the Crown to verify that a particular level of emission reductions has been achieved from the project. There is, therefore, a clear link between the transfer of

emission units by the Crown and the supply of emission reduction services by the participant.

48. The consideration for the supply of emission reduction services by the participant to the Crown is, therefore, in the form of emission units transferred by the Crown to the participant. As emission units are consideration (within the statutory definition) for the supply of services by the participant and as any supply made under a project agreement is in the course or furtherance of the participant's taxable activity, it is unnecessary to consider whether the emission units are deemed by section 5(6D) to be consideration for the supply of services in the course or furtherance of a taxable activity carried on by the participant.

Value of the supply

49. The value of a supply is the total of the:

- amount of money, to the extent that the consideration is expressed as an amount of money; and

- open market value of the consideration, to the extent that the consideration is not expressed as an amount of money: section 10(2).

50. The consideration for the emission reduction services is not consideration expressed as an amount of money. A monetary value is not attributed to the emission reduction services (compare with *Case T11* (1997) 18 NZTC 8054). Therefore, it is necessary to establish the open market of the emission units in order to determine the value of the supply of emission reduction services made by the participant to the Crown: section 10(2)(b).

Open market value

51. Section 4 sets out rules for determining the open market value of supplies made between associated persons. The same valuation methods are to be used for valuing consideration that is not expressed as an amount in money: section 4(5).

52. If the open market value of the emission units is not able to be ascertained by applying section 4(2), their open market value is to be determined under section 4(3). If the open market value of the emission units cannot be determined by applying section 4(2) or section 4(3), the method in section 4(4) applies. See *Newman v CIR* (200) 19 NZTC 15,666.

53. Under section 4(2), (3), and (4), the value of the emission units would be determined in the following manner.

- The open market value of the emission units under section 4(2) is the amount of the consideration in money that a supply of the emission units would fetch if they were supplied between arm's length parties in New Zealand.

- The open market value of the emission units under section 4(3) is the amount of the consideration in money that would be received from the sale of similar emission units under a supply between arm's length parties in New Zealand.

- The open market value of the emission units under section 4(4) is to be determined "in accordance with a method approved by the Commissioner which provides a sufficiently objective approximation of the consideration in money which could be obtained" for the emission units.

54. There is no formal, organised market in New Zealand or elsewhere for emission units, so there is no institution like a stock exchange where a high volume of transactions takes place, providing reliable information as to the market value of emission units. The emissions market has been primary, bilateral, non-transparent, and with prices heavily influenced by project-specific factors. If the nature of the market does not change, it may not be possible to apply the methods set out in section 4(2) and (3) in determining the market value of emission units. Both subsections (2) and (3) refer to an arm's length supply in New Zealand. The ability to apply these methods depends on a New Zealand market for emissions unit developing before it is necessary to determine the value of emission units transferred under project agreements. If it is not possible to apply the methods in section 4(2) or section 4(3), the open market value is to be determined in accordance with a method approved by the Commissioner that provides a sufficiently objective approximation of the consideration in money that could be obtained for the supply of those services: section 4(4).

> 55. If it is not possible to determine the open market value of ~~a formal market for~~ emission units by other means ~~is not established~~, it is proposed to value the emission units on the basis of the price used to estimate the Crown's contingent liability under the Kyoto Protocol (that is, the price the Crown would be required to pay for emission units, if New Zealand was required to purchase additional emission units in order to comply with New Zealand's obligations under the Kyoto Protocol). This estimate is made annually for the purpose of completing the Crown's accounts. New Zealand has a commitment under the Kyoto Protocol to reduce its greenhouse gas emissions to 5% below their 1990 level. If this target is not achieved, the Crown must purchase emission units to make up the shortfall. The Crown is required to hold sufficient emission units at the end of the first Commitment Period to offset its emissions during the first Commitment Period of the Kyoto Protocol. The question is whether the method used by The Treasury to estimate the price that the Crown would be required to pay to purchase emission units in order to satisfy its liability under the Kyoto Protocol would provide a sufficiently objective approximation of the consideration in money that could be obtained for emission units.

55. If a formal market for it is not possible to determine the open market value of emission units by other means, it is proposed to value the emission units on the basis of the price used to estimate the Crown's contingent liability under the Kyoto Protocol (that is, the price the Crown would be required to pay for emission units, if New Zealand was required to purchase additional emission units in order to comply with New Zealand's obligations under the Kyoto Protocol). This estimate is made annually for the purpose of completing the Crown's accounts. New Zealand has a commitment under the Kyoto Protocol to reduce its greenhouse gas emissions to 5 percent below their 1990 level. If this target is not achieved, the Crown must purchase emission units to make up the shortfall. The Crown is required to hold sufficient emission units at the end of the first

Commitment Period to offset its emissions during the first Commitment Period of the Kyoto Protocol. The question is whether the method used by The Treasury to estimate the price that the Crown would be required to pay to purchase emission units in order to satisfy its liability under the Kyoto Protocol would provide a sufficiently objective approximation of the consideration in money that could be obtained for emission units.

56. There is considerable volatility in the emissions market and uncertainty as to prices for emission units, but as trade volumes and liquidity in the emissions market increase, the quality of information used to calculate the estimate and, therefore, the accuracy of the estimate, is likely to increase. Therefore, at the time emission units are transferred under project agreements, there may be more certainty as to the value of emission units on the international emissions market.

57. The Treasury's estimate is based on the average price that the Crown could expect to pay for an emission unit. The Crown could purchase emission units for a range of prices, and an average price could be used for calculating the Crown's contingent liability. The price of emission units is influenced by project risk (that is, the possibility that projects may not result in a particular level of emission reductions). Therefore, not all emission units are of the same quality.

58. AAUs or ERUs will be transferred under project agreements. However, the estimate of the Crown's contingent liability is based on the international price for certified emission reduction units (CERs). This is because other types of emission units have not been substantially traded to date, so there is insufficient price information on which to assess international prices for these types of emission units.

59. For these reasons, the price for emission units used to estimate the Crown's contingent liability under the Kyoto Protocol may not necessarily equate to the amount that a participant could obtain for an emission unit received under a project agreement. However, The Treasury's calculation of the price of emission units will be based on the best available information in relation to international prices for emission units using a methodology that has been peer-reviewed by independent consultants. Therefore, the Commissioner accepts that the price for emission units calculated by The Treasury would provide a sufficiently objective approximation of the price that could be obtained for emission units transferred under a project agreement.

60. Therefore, the Commissioner accepts that if the amount at which emission units transferred under the project agreement (or similar emission units) could be sold on the emissions market cannot be ascertained, the open market value of emission units transferred under the project agreement would be the price (at the time of supply) of emission units calculated by The Treasury for the purpose of estimating the Crown's contingent liability under the Kyoto Protocol.

Time of supply

61. Under section 9(1) the time of supply is the earlier of the time when an invoice is issued by the supplier, or the recipient, or the time when any payment is received by the supplier. However, section 9(3) overrides section 9(1). Section 9(3)(a) applies when

services are supplied under any agreement or enactment that provides for periodic payments. In those circumstances, section 9(3)(a) deems services to be supplied successively over successive periods of the agreement and each successive supply is deemed to be made when a payment becomes due or is received, whichever is the earlier.

62. Whether section 9(3)(a) rather than section 9(1) applies, depends on whether the project agreement provides for periodic payments for the supply of emission reduction services. This requires consideration of the meaning of "payment" and what constitutes payment for emission reduction services.

Meaning of "payment"

63. The cases indicate the following.

- The terms "consideration" and "payment" are not synonymous: *Nicholls v CIR* (1999) 19 NZTC 15,233.

- "Payment" is not limited to the transfer of cash: *White v Elmdene Estates Ltd* [1959] 2 All ER 605; *Garforth (Inspector of Taxes) v Naismith Stainless Ltd* [1979] 2 All ER 73; *Case L34* (1989) 11 NZTC 1204; *Lanauze v King*.

- "Payment" includes payment in kind, and includes all methods by which the payer's obligations are satisfied (including accounting entries, the giving of a mortgage, the delivery of a letter of credit issued by a bank, the issue of fully paid up shares, the transfer of property, and the setting off of obligations): *Case L34*; *Case Q10* (1993) 15 NZTC 5061; *Case S99* (1996) 17 NZTC 7622; *Case T61* (1998) 18 NZTC 8461; *Case U13* (2000) 19 NZTC 9293.

- In determining whether payment has been made by the recipient of a supply of goods or services, the issue that needs to be considered is whether the recipient has been unconditionally discharged from liability under the contract in respect of the supply: *Case T61*; *Lanauze v King*.

64. The Crown's obligation under the project agreement is to transfer emission units. The transfer of emission units by the Crown constitutes payment by the Crown for the supply of emission reduction services by the participant. A "payment" need not be in the form of a transfer of cash. The delivery of an asset constitutes payment for GST purposes.

65. As the project agreement requires the Crown to transfer emission units annually, subject to verification of the emission reductions achieved from the project, the emission reduction services are supplied under an agreement that provides for periodic (annual) payments. Therefore, the time of supply in respect of the supply of emission reduction services would be determined under section 9(3)(a) rather than section 9(1).

66. Under section 9(3)(a), the time of supply in respect of each successive supply (that is, each annual supply) is when a payment becomes due or is received, whichever is the earlier.

When is the debt due?

67. A debt would not be due where the amount of the debt has not, or has not yet, been established: *Malissard Frères Savarzeux et Cie v Freightex* [1976] 2 Lloyds Rep 665. A debt is "due" when it becomes payable, when payment is enforceable: *Re European Life Assurance* LR 9 Eq 122; *Potel v IRC* [1971] 2 All ER 504.

68. The participant will not be entitled to the transfer of emission units unless agreement has been reached on the level of emission reductions achieved in the particular year (and, therefore, the number of emission units the Crown must transfer). The participant is entitled to the transfer of the number of emission units calculated in accordance with the formula in clause 5.1 on or before the transfer date: clause 5.1. The transfer date (as defined) is the last day by which the emission units must be transferred. Clause 5.1 provides that the Crown must transfer emission units "on or before the Transfer Date". The Commissioner considers that payment (the transfer of the emission units) would not become due until each transfer date, as the Crown is not obliged to transfer emission units until the transfer date.

When is payment received?

69. A payment is received when the supplier (or the supplier's agent) receives it for the supplier's own benefit: *CIR v Dormer* (1997) 18 NZTC 13,446; *Auckland Institute of Studies Ltd v CIR* (2002) 20 NZTC 17,685. Payment would be received by the participant when emission units are actually transferred to the participant.

When is the supply made?

70. Payment for emission reduction services is due on the "Transfer Date" (as defined in the project agreement). The "Transfer Date" is the latest date on which the Crown is required to transfer the agreed number of emission units. It is possible that payment could be received by the participant between the date when the annual report is accepted or agreement is reached on the emission reductions achieved and the transfer date (which is the fifth business day after the annual report is accepted or agreement is reached on the level of emission reductions achieved). However, when the emission units are transferred on the transfer date, the date when payment becomes due and the date when payment is received by the participant will be the same.

71. Therefore, the time of supply of each successive supply of emission reduction services made under a project agreement is the relevant transfer date (as defined in the project agreement), unless the emission units are transferred before the transfer date, in which case the date on which emission units are actually transferred to the participant will be the time of supply (being the date on which a payment is received by the participant).

Adjustments

72. The actual number of emission units that would be transferred in respect of each year of the term of the project agreement is determined by reference to the level of emission reductions that has been achieved in that year. If it is subsequently determined that the number of emission units that has been transferred to the participant in respect of a particular year exceeds the correct number, the project agreement requires the participant to transfer emission units equal to the difference to the Crown. If the number of emission units transferred to the participant is less than the correct number, the Crown must transfer to the participant the number of emission units equal to the difference.

73. Section 25(2), (4), and (5) provides for adjustments to output tax and input tax where the output tax that has been accounted for is incorrect as a consequence of "the previously agreed consideration for [the] supply of goods and services has been altered, whether due to a discount or otherwise". The output tax adjustment must be made in the period in which it becomes apparent that the output tax is incorrect and an input tax adjustment must be made in the period in which the recipient receives knowledge that the input tax previously charged was incorrect.

74. The total number of emission units and the total level of emission reductions agreed under the project agreement will not change. However, if an adjustment in the number of emission units is made in respect of a particular year, the consideration agreed for the supply (a specific number of emission units calculated by reference to level of emission reductions previously accepted by the Crown) made in that year would be altered. Therefore, section 25 would apply when it is determined that the number of emission units previously transferred was incorrect.

75. Section 25(2)(a) deems output tax not accounted for as a consequence of an alteration in the previously agreed consideration to be tax charged on a taxable supply made in the taxable period in which the adjustment is to be made. Section 25(2)(b) allows a deduction where a supplier has accounted for output tax in excess of the supplier's true liability. As section 25(2) and (4) does not deem a supply to be made; the valuation provisions in section 4 do not apply. Therefore, the value of emission units and emission reduction services is to be determined as at the time of supply, and that value would apply for the purpose of any adjustment required. The adjustments required under section 25 are aimed at reversing the GST position based on the previously agreed consideration. Any adjustments necessary are made in a subsequent taxable period.

76. Therefore, a subsequent adjustment to the number of emission units for the provision of emission reduction services in any particular year will not alter the value of the supply made in that year.

Conclusion

77. Under a project agreement the participant supplies emission reduction services (the implementation and operation of a project so as to result in reductions in greenhouse gases) to the Crown.

78. The consideration for the supply of emission reduction services by the participant is the supply of emission units.

79. The value of the consideration provided by the Crown is:

- an amount equal to the price that emission units transferred under the project agreement would fetch at the time of supply if they were supplied between arm's length parties in New Zealand;

- if is not possible to establish that amount, the price that similar emission units would fetch at the time of supply if they were supplied between arm's length parties in New Zealand; or

- if it is not possible to establish the price at which emission units or similar emission units would fetch at the time of supply if they were supplied between arm's length parties in New Zealand, an amount equal to the price (at the time of supply) of emission units calculated by The Treasury for the purpose of calculating the Crown's contingent liability under the Kyoto Protocol.

80. The time of each annual supply of emission reduction services is the earlier of the relevant transfer date (as defined in the project agreement) or the date on which emission units are actually transferred to the participant.

Legislative amendments

81. The Climate Change Response Act 2002 has been amended to include provisions relating to an emissions trading scheme 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 their emissions; and

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

In conjunction with these amendments, the Goods and Services Tax Act 1985 has been amended to ensure that acquisitions and disposals of emission units can take place across international markets, where buyers and sellers will not be known to each other and where transactions may have multiple counterparties. The proposed amendments preserve the existing GST treatment of supplies made by participants under agreements entered into under the Projects to Reduce Emissions programme.