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This *Tax Information Bulletin (TIB)* is also available on the internet in PDF. Our website is at **www.ird.govt.nz**

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REGULAR CONTRIBUTORS TO THE TIB

Office of the Chief Tax Counsel

The Office of the Chief Tax Counsel (OCTC) produces a number of statements and rulings; such as interpretation statements, binding pulic rulings and determinations, aimed at explaining how tax law affects taxpayers and their agents. The OCTC also contributes to the "Questions we've been asked" section and "This month's opportunity to comment" section where taxpayers and their agents can comment on proposed statements and rulings.

Legal and Technical Services

Legal and Technical Services contribute the standard practice statements which describe how the Commissioner of Inland Revenue will exercise a statutory discretion or deal with practical operational issues arising out of the administration of the Inland Revenue Acts. They also produce determinations on standard costs and amortisation or depreciation rates for fixed life property used to produce income, as well as other statements on operational practice related to topical tax matters.

Legal and Technical Services also contribute to "This month's opportunity to comment" section.

Policy Advice Division

The Policy Advice Division advises the government on all aspects of tax policy and on social policy measures that interact with the tax system. They contribute information about new legislation and the Orders in Council.

Litigation Management

Litigation Management manages all disputed tax litigation and associated challenges to Inland Revenue's investigative and assessment process including declaratory judgment and judicial review litigation. They contribute the legal decisions and case notes on recent tax decisions made by the Taxation Review Authority and the courts.

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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents. Because we are keen to produce items that accurately and fairly reflect taxation legislation and are useful in practical situations, your input into the process, as a user of that legislation, is highly valued.

A list of the items we are currently inviting submissions on can be found at **www.ird.govt.nz**. On the homepage, click on "Public consultation" in the right-hand navigation. Here you will find drafts we are currently consulting on as well as a list of expired items. You can email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

Public Consultation
Office of the Chief Tax Counsel
Inland Revenue
PO Box 2198
Wellington

You can also subscribe to receive regular email updates when we publish new draft items for comment.

Below is a selection of items we are working on as at the time of publication. If you would like a copy of an item please contact us as soon as possible to ensure you views are taken into account. You can get a copy of the draft from **www.ird.govt.nz/public-consultation/** or call the Team Manager, Technical Services Unit on 04 890 6143.

Ref	Draft type	Description/background information	Comment deadline
XPB0035	Payments made by parents or guardians of students to state schools – GST treatment	This item is a re-issue of an expired public ruling that was issued in 2003 and expired in 2006. The draft ruling addresses the GST treatment of payments made by the parents or guardians of pupils who are New Zealand citizens or New Zealand residents and who are enrolled at state schools (including schools integrated with the state system of education under the Private Schools Conditional Integration Act 1975) to the Boards of Trustees of such schools.	19 December 2008
ED108	Eligible relocation expenditure determination	This draft determination sets out the list of eligible relocation expenses for 2002/03 and subsequent years.	31 March 2009

IN SUMMARY

Binding rulings

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Public ruling BR PUB 08/03: Projects to Reduce Emissions Programme – income tax treatment

Public ruling BR PUB 08/04: Projects to Reduce Emissions Programme – GST treatment

These items address the income tax and GST treatment of agreements entered into between the Crown and participants under the Projects to Reduce Emissions programme. Under such an agreement the participant agrees to implement and operate a project in order to reduce greenhouse gas emissions in return for the transfer of emission units. Emission units received may be sold by participants.

Standard practice statement

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SPS 08/03: Income Tax Act 2007 – penalties and interest arising from unintended legislative changes

SPS 08/03 sets out the treatment of shortfall penalties and use of money interest when a tax position is taken under the Income Tax Act 2007 and a confirmed unintentional legislative change gives rise to a tax shortfall.

BINDING RULINGS

This section of the *TIB* contains binding rulings that the Commissioner of Inland Revenue has issued recently.

The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates their tax liability based on it.

For full details of how binding rulings work, see our information booklet *Adjudication & Rulings: A guide to binding rulings (IR 715)* or the article on page 1 of *Tax Information Bulletin*, Vol 6, No 12 (May 1995) or Vol 7, No 2 (August 1995).

You can download these publications free from our website at **www.ird.govt.nz**

PUBLIC RULING BR PUB 08/03: 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 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.

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

Taxation law

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 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 five 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 **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**

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 by 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
    - 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 **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 CO2-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 two things to the Crown.
    - 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 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.

Single 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: T*asman 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 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
- 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.

PUBLIC RULING BR PUB 08/04: 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.

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

Taxation law

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

- 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 five 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
    - 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 **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 CO2-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. The 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
    - 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).

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
    - 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.

STANDARD PRACTICE STATEMENTS

These statements describe how the Commissioner will, in practice, exercise a discretion or deal with practical issues arising out of the administration of the Inland Revenue Acts.

SPS 08/03: INCOME TAX ACT 2007 – PENALTIES AND INTEREST ARISING FROM UNINTENDED LEGISLATIVE CHANGES

Introduction

1. This Standard Practice Statement (SPS) sets out the treatment of shortfall penalties and use of money interest when a tax position is taken under the Income Tax Act 2007 (ITA 2007) and a confirmed unintentional legislative change gives rise to a tax shortfall.

Application

2. This SPS applies from the 2008/2009 and subsequent income years in relation to unintended legislative changes arising in the ITA 2007.

3. SPS 05/02 "Income Tax Act 2004 – Penalties and interest arising from unintended legislative changes" continues to apply for the 2005/2006 to 2007/2008 income years for unintended legislative changes arising in the ITA 2004.

Background

4. The ITA 2007 was enacted on 1 November 2007 and represents the final stage of a program to progressively rewrite New Zealand's income tax legislation to make it clear and easy to understand. The ITA 2007 applies from the 2008/2009 income year.

5. The ITA 2007 rewrites Parts F to Y of the Income Tax Act 2004 (ITA 2004) as well as making consequential amendments to Parts A to E. No change is intended from the pre-existing law except as specifically listed in Schedule 51 of the ITA 2007 as an identified change in legislation.

6. The ITA 2004 rewrote Parts C to E of the Income Tax Act 1994 (ITA 1994). When reporting back on the Bill that would become the ITA 2004, the Finance and Expenditure Committee (FEC) noted that unintended legislative changes may still arise due to the difference in language from the ITA 1994. The FEC recommended the appointment of an independent committee to review submissions regarding any differences between the Acts and recommend appropriate action to the Government. The Rewrite Advisory Panel (the Panel), which advised on the rewrite of the ITA 1994, took on this role and will carry on this role in regards to the ITA 2007. Details of the Panel and the unintended legislative change process are contained in the Panel statement RAP 001 "*Process for resolving potential unintended legislative changes in the Income Tax Act 2004*". This statement is able to be viewed on the Panel's website at **www.rewriteadvisory.govt.nz**

7. The FEC received submissions expressing concern about shortfall penalties and use of money interest (interest) arising from unintended legislative changes made during the rewrite process. Transitional provisions enacted in the 2004 Act carried over the interpretation of the 1994 Act when the meaning arising under the 2004 Act was unclear or gave rise to an absurdity. Inland Revenue's advice to the FEC was that taxpayers who incurred tax shortfalls as a result of an unintended legislative change would still be required to meet their tax obligations but should not be subject to penalties and any interest where reasonable care had been taken. Similar transitional provisions have been included in the ITA 2007 and the same will apply.

8. Accordingly this SPS sets out Inland Revenue's practice regarding the imposition of penalties and interest when an unintended legislative change results in a tax shortfall for a taxpayer. Unintended legislative changes will generally be reversed by amending legislation. Although the Government will take account of the advice of the Panel, ultimately the final decision is that of the Government. The Government may decide that the unintended legislative change should be retained. The outcome of all unintended legislative change submissions can be followed on the log on the rewrite advisory panel website, at the address above.

LEGISLATION

Income Tax Act 2007

ZA 3 Transitional provisions

When reference to this Act includes earlier Act

(1) A reference in an enactment or document to this Act, or to a provision of it, is to be interpreted as a reference to the Income Tax Act 2004, or the Income Tax Act 1994, or the Income Tax Act 1976, or to the corresponding provision of the earlier Act, to the extent necessary to reflect sensibly the intent of the enactment or document.

When reference to earlier Act includes this Act

(2) A reference in an enactment or document to the Income Tax Act 2004, or the Income Tax Act 1994, or the Income Tax Act 1976, or to a provision of that earlier Act, is to be interpreted as a reference to this Act, or to the corresponding provision in this Act, to the extent necessary to reflect sensibly the intent of the enactment or document.

Intention of new law

(3) The provisions of this Act, including any amendments made by this Act to the Tax Administration Act 1994, are the provisions of the Income Tax Act 2004 in rewritten form, and are intended to have the same effect as the corresponding provisions of the Income Tax Act 2004. Subsection (5) overrides this subsection.

Using old law as interpretation guide

(4) Unless a limit in subsection (5) applies, in circumstances where the meaning of a taxation law that comes into force at the commencement of this Act (the new law) is unclear or gives rise to absurdity—

(a) the wording of a taxation law that is repealed by section ZA 1 and that corresponds to the new law (the old law) must be used to determine the correct meaning of the new law; and

(b) it can be assumed that a corresponding old law provision exists for each new law provision.

Limits to subsections (3) and (4)

(5) Subsections (3) and (4) do not apply in the case of—

(a) a new law listed in schedule 51 (Identified changes in legislation); or

(b) a new law that is amended after the commencement of this Act, with effect from the date on which the amendment comes into force.

Tax Administration Act 1994

183D. Remission consistent with collection of highest net revenue over time—

(1) The Commissioner may remit—

(a) A late filing penalty; and

(aa) A non-electronic filing penalty; and

(b) A late payment penalty; and

(bb) A shortfall penalty imposed by section 141AA; and

(bc) A civil penalty imposed under section 215 or 216 of the KiwiSaver Act 2006; and

(bd) a penalty for not paying employer monthly schedule amount imposed by section 141ED; and

(c) Interest under Part VII—

payable by a taxpayer if the Commissioner is satisfied that the remission is consistent with the Commissioner's duty to collect over time the highest net revenue that is practicable within the law.

(2) In the application of this section, the Commissioner must have regard to the importance of the late payment penalty, the late filing penalty, and interest under Part 7 in promoting compliance, especially voluntary compliance, by all taxpayers with the Inland Revenue Acts.

(3) The Commissioner must not consider a taxpayer's financial position when applying this section.

DISCUSSION

Transitional Provisions

9. The transitional provisions are contained in Part Z of the ITA 2007. The basic premise as reinforced in section ZA 3(3) is that the ITA 2007 is the ITA 2004 in rewritten form. Apart from the identified legislative changes contained in schedule 51 of the ITA 2007 and subsequent amendments, the provisions in the ITA 2007 are intended to have the same effect as the corresponding provisions in the ITA 2004. The intent is to preserve case law and Inland Revenue practice and policy statements made under the ITA 2004 so they can be applied to interpret the ITA 2007.

10. The ITA 2007 has full effect from the 2008/2009 income year and from this time must be used instead of the ITA 2004. In general taxpayers must consider and apply the ITA 2007 on its own terms.

11. However, in situations where the meaning of a provision of the ITA 2007 is unclear or gives rise to an absurdity, the wording of the former provision under the ITA 2004 is to be used to determine the correct meaning of the new law (section ZA 3(4)). In general terms the Commissioner's statements in respect of the ITA 2004 may be relied upon – however this will not always be the case, for example, where the legislation has changed or there is a change in case law.

12. If it is considered that the wording in the ITA 2007 gives rise to a change in meaning from the ITA 2004, a submission can be made to the Panel identifying the potential unintended legislative change (refer Panel statement RAP 001).

13. Section ZA 3(5) excludes from the transitional provisions intended changes as listed in Schedule 51 (Identified changes in legislation) and it also excludes any amendments made to the ITA 2007 after the commencement of the new Act from the application date of the amendment. Therefore if an amendment is retrospective back to the commencement date of the ITA 2007 then the transitional provisions will not apply from that commencement date. In these situations the normal rules of statutory interpretation will apply.

14. If the meaning of the words in the ITA 2007 are clear, then the tax position that a taxpayer takes in their return should be based on the meaning of the words in that Act. This is the case even if the tax liability is greater than was thought to be the case under the ITA 2004. If, on the other hand, it is reasonably believed that the words are unclear or lead to an absurd result, reference should be made to the ITA 2004 to ascertain the meaning of the ITA 2007.

15. In taking a tax position under the ITA 2007, if there is any material doubt about the meaning of the law, a taxpayer is entitled to assume that a provision that has not been amended since the introduction of the Act and not included in Schedule 51 has the same effect as the corresponding provision in the ITA 2004.

Shortfall Penalties

16. If a tax shortfall subsequently arises due to an unintended legislative change from the corresponding provision in the ITA 2004 then it is reasonable that the taxpayer will not have to pay interest on the tax shortfall or be liable to a shortfall penalty.

17. To avoid a shortfall penalty, a taxpayer will still have to take reasonable care in taking a tax position whether or not they are applying a Commissioner's published statement. In addition, in relation to income tax the taxpayer will need to have taken an acceptable tax position. An acceptable tax position is a tax position that meets the standard of being about as likely as not to be correct. This means that the position taken by the taxpayer should have around or close to a 50% chance or more of being upheld in court.

18. In the event that a taxpayer is liable for a shortfall penalty for not taking reasonable care or for taking an unacceptable tax position, the level of the shortfall penalty is 20% of the tax shortfall. This will be reduced by 100% if the taxpayer makes a voluntary disclosure before being notified of a pending tax audit or investigation or by 40% if the disclosure is made after being notified of a pending tax audit or investigation but before the audit or investigation starts.

Interest

19. Interest is automatically calculated when the taxpayer's account is assessed with the correct amount of tax. A taxpayer who incurs a tax shortfall as a result of an unintended legislative change will receive a statement showing interest charged. This cannot be prevented.

20. However section 183D of the Tax Administration Act 1994 (TAA) allows the Commissioner to remit interest if the Commissioner is satisfied that remission is consistent with the Commissioner's duty to collect the highest net revenue that is practicable within the law. In applying section 183D the Commissioner must have regard to the importance of interest in promoting compliance, especially voluntary compliance, by all taxpayers.

21. The Commissioner considers that enforcing the payment of interest in situations where taxpayers incur a tax shortfall as a result of an unintended legislative change would be to the detriment of encouraging voluntary compliance among taxpayers.

22. A taxpayer seeking a remission of interest under section 183D of the TAA is required by section 183H of the TAA to make an application in writing requesting the remission.

STANDARD PRACTICE

Tax Shortfall due to an unintended legislative change

23. If a taxpayer incurs a tax shortfall as a result of an unintended legislative change in the ITA 2007, no shortfall penalty will be charged and the taxpayer will be entitled to apply in writing to the Commissioner for a remission of interest.
24. The taxpayer will still need to have taken reasonable care and an acceptable tax position.
25. To obtain a remission of the interest charged, a taxpayer will need to write to the Commissioner requesting remission as this is a legislative requirement.
26. The taxpayer will still be required to pay the shortfall of tax by the due date that is set for it.
27. The Commissioner has identified two scenarios when a shortfall incurred by a taxpayer is a result of an unintended legislative change to the ITA 2007:

Scenario 1

In taking a tax position in their tax return, a taxpayer applies the ITA 2007 as the law is clear. An unintended legislative change from the ITA 2004 is later identified and confirmed by the Panel. On advice by the Panel, the Government amends the ITA 2007 retrospectively to be consistent with the ITA 2004. As a result of the amendment, a tax shortfall arises. It is established that the taxpayer has taken reasonable care and an acceptable tax position.

Comment

In this situation, the taxpayer had taken an interpretation based on the words in the ITA 2007. The tax shortfall that subsequently arose is solely due to the unintended legislative change and the Government's decision to amend the ITA 2004 retrospectively. In this instance no shortfall penalty will be imposed and the taxpayer will be entitled to a remission of interest upon written application to the Commissioner.

Scenario 2

In taking a tax position in their tax return a taxpayer is required to have regard to the wording of the corresponding provisions of the ITA 2004 as the law in the ITA 2007 is unclear or leads to an absurd result. An unintended legislative change in the ITA 2007 is later identified and confirmed by the Panel. The Government decides not to amend the ITA 2007. As a result, a tax shortfall arises. It is established that the taxpayer has taken reasonable care and an acceptable tax position.

Comment

In this scenario the law in the ITA 2007 is not clear or leads to an absurdity. As required under section ZA 3(4), the taxpayer has used the law in the ITA 2004 to interpret the meaning of the law in the ITA 2007. However, it is later established by the Panel that the meaning of the law in the ITA 2007 is different from that of the corresponding provision in the ITA 2004. The Government decides to retain the new meaning. Thus the tax shortfall that the taxpayer consequently incurs does not arise due to any fault of the taxpayer. No shortfall penalty will be imposed and the taxpayer will be entitled to a remission of interest upon written application to the Commissioner.

Tax Shortfall not due to an unintended legislative change

28. Outside the 2 scenarios above and this SPS, a taxpayer's liability to shortfall penalties and interest will be considered on a case by case basis according to normal principles. This will include the situations where an unintended legislative change is confirmed by the Panel but the tax shortfall incurred by the taxpayer did not arise due to the unintended legislative change. Rather, the tax shortfall arose as a result of an incorrect interpretation by the taxpayer.
29. There will also be instances where an unintended legislative change is not confirmed by the Panel. In this case, it will be clear that a tax shortfall incurred by the taxpayer did not arise due to an unintended legislative change but is the result of an incorrect interpretation by the taxpayer.
30. These cases are no different to any other case when a tax shortfall arises. Whether a taxpayer incurs a shortfall penalty will be decided on the facts of each case, and whether the taxpayer took reasonable care and an acceptable tax position.
31. Interest charged on the shortfall will be payable along with the outstanding tax. Generally, no remission of interest will be allowed. However the taxpayer will still have the right to apply in writing to the Commissioner for a remission of interest and each case will be considered on its merits in accordance with the relevant Standard Practice Statement (currently SPS 05/10 "*Remission of penalties and interest*").
32. By way of contrast to the two scenarios covered above, below are four scenarios that are outside the SPS. The first two are when there is a confirmed unintended legislative change but the tax shortfall that arises is not a result of the unintended legislative change. The following two are when a potential unintended legislative change is not confirmed:

Unintended legislative change confirmed by the Panel.

Scenario 3

A taxpayer takes a tax position under the ITA 2007 as the law is clear. The tax position taken by the taxpayer is not correct and a tax shortfall arises. An unintended legislative change is later identified and confirmed by the Panel. However, the Government decides not to amend the ITA 2007. It is established that the taxpayer has taken reasonable care and has an acceptable tax position.

Comment

The taxpayer has interpreted the ITA 2007 in taking their tax position. An unintended legislative change has been confirmed but the law in the ITA 2007 is not changed. The tax position that the taxpayer has taken is an incorrect interpretation of the ITA 2007 and the tax shortfall is not due to the unintended legislative change. There will be no shortfall penalty charged but interest will be payable. This scenario highlights the need to have particular regard to the wording of the ITA 2007. An acceptable tax position based on the ITA 2004 will not necessarily give rise to an acceptable tax position under the ITA 2007.

Scenario 4

A taxpayer interprets the law in the ITA 2004 in taking a tax position in their return as the corresponding provision in the ITA 2007 is unclear or leads to an absurd result. An unintended legislative change in the ITA 2007 is later identified and confirmed by the Panel. The Government decides to amend the ITA 2007 retrospectively to be consistent with the ITA 2004. Nevertheless, a tax shortfall arises as a result of an incorrect interpretation of the ITA 2004. It is established that the taxpayer has taken reasonable care and has an acceptable tax position.

Comment

As directed by section ZA 3(4) the taxpayer has used the ITA 2004 to ascertain the meaning of the corresponding provision in the ITA 2007 as it is unclear or leads to an absurd result. The ITA 2007 is amended to have the same effect as the ITA 2004 but the taxpayer still has a tax shortfall that is the result of an incorrect interpretation of the provision in the ITA 2004, not the unintended legislative change. There will be no shortfall penalty but interest will be payable.

Potential unintended legislative change not confirmed by the Panel

Scenario 5

A taxpayer applies the law in the ITA 2007 in taking a tax position in their return as the law is clear. A potential unintended legislative change is identified but is not confirmed by the Panel. The tax position taken by the taxpayer is not correct and a tax shortfall arises. It is established that the taxpayer has taken reasonable care and has an acceptable tax position.

Comment

This case is similar to scenario 3 but the Panel has decided that there is no unintended legislative change in the ITA 2007. The taxpayer has a tax shortfall from taking an incorrect interpretation of the ITA 2007. There will be no shortfall penalty but interest will be payable. As with scenario 3, this scenario highlights the need to have regard to the wording of the ITA 2007 when taking a tax position, even when it is thought that there has been an unintended legislative change.

Scenario 6

A taxpayer interprets the law in the ITA 2004 in taking a tax position in their return as the corresponding provision in the ITA 2007 is unclear or leads to an absurd result. A potential unintended legislative change is later identified but not confirmed by the Panel. A tax shortfall arises as a result of an incorrect interpretation of the unchanged ITA 2004. It is established that the taxpayer has taken reasonable care and an acceptable tax position.

Comment

This case is similar to scenario 4 but the Panel has decided that there is no unintended legislative change in the ITA 2007. The taxpayer has incurred a tax shortfall from taking an incorrect interpretation of the law. There will be no shortfall penalty but interest will be payable.

33. Please note that all six scenarios have been based on the assumption that the taxpayer has taken reasonable care and has an acceptable tax position when taking their tax position. In cases where a taxpayer has not taken reasonable care or has an unacceptable tax position, a shortfall penalty will be imposed.

34. The following matrix summarises the Commissioner's practice when a tax shortfall arises. This matrix assumes reasonable care and an acceptable tax position.

Scenario	Unintended change confirmed?	Unintended change reversed retrospectively?	Shortfall penalties?	Remission of Interest?
1 – Relies on new law	Yes	Yes	No	Yes
2 – New law unclear and relies on old law	Yes	No	No	Yes
3 – Relies on new law	Yes	No	No	No
4 – New law unclear and relies on old law	Yes	Yes	No	No
5 – Relies on new law	No	N/A	No	No
6 – New law unclear and relies on old law	No	N/A	No	No

Overpayments by a taxpayer

35. If a taxpayer has an overpayment due to any of the scenarios outlined in the table above the normal rules, as they pertain to the Commissioner paying the taxpayer interest, will apply.

Savings – existing documents and publications

36. All references to the ITA 2004 in existing documents and publications such as standard practice statements and booklets should be read as references to the ITA 2007 and all policies and practices contained within these documents should be applied to the corresponding provisions in the ITA 2007.

This Standard Practice Statement is signed on 14 November 2008

Robert Wells
LTS Manager, Technical Standards

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