

Emission Trading: Accounting and Tax Regime in Belgium

One of the market-based mechanisms established by the Kyoto Protocol is “tradable allowances” or “emission trading rights” (ETRs). Directive 2003/87/EC implemented the principles of the Kyoto Protocol regarding market-based mechanisms, but did not indicate the tax regime applicable to them. Thus, this is to be determined by each Member State. This article focuses on the tax consequences of the tradable allowance mechanism in Belgium. The article explains how the ETRs mechanism works and the tax regime for the operators concerned.

1. Introduction

There is a growing interest in climate change, its consequences and the possible remedies. Undoubtedly, reducing polluting emissions is one of the necessary measures to be considered.¹ Initiatives are being taken at various levels. The United Nations plays a decisive role at the international level as do the European authorities.

The Kyoto Protocol established the “market-based mechanisms”, i.e. “tradable allowances” or “emission trading rights” (ETRs), “joint implementation” (JI) and “clean development mechanism” (CDM). Market-based mechanisms are considered the best means to require economic operators to identify the costs of climate change and to integrate them into their market prices – costs that have been completely ignored until now. Market-based instruments include indirect taxation, targeted subsidies, and tradable emission rights; these market-based instruments are considered to provide a flexible and cost-effective means for reaching the policy objectives.²

Directive 2003/87/EC³ implemented the principles of the Kyoto Protocol regarding market-based mechanisms, but it did not address the question of the tax regime applicable to them. Thus, this question is to be determined according to the tax laws of each Member State. This harmonized instrument then becomes “non-harmonized” because of the tax disparities between the Member States.⁴ Moreover, it appears that this sui generis instrument raises some questions which would probably require that at least some aspects of the accounting and tax regulations be modified.

This article focuses on the tax consequences of the tradable allowance mechanism in Belgium.⁵ Most of the problems raised by ETRs are really similar among the various EU Member States, even if Belgium has some peculiarities. The article first explains how the ETRs

mechanism works and then focuses on the tax regime for the operators concerned. The tax regime is linked to the accounting treatment.

2. The United Nation Framework Convention on Climate Change and the Kyoto Protocol

The United Nation Framework Convention on Climate Change (“UNFCCC”), signed in 1992,⁶ sets the overall framework for intergovernmental efforts to tackle the challenge of climate change.⁷ Accordingly, Art. 2 of the UNFCCC provides that its ultimate objective is to achieve stabilization of greenhouse gas (GHG) concentrations in the atmosphere “at a level that would prevent dangerous anthropogenic interference with the climate system”.

According to Art. 1 of the UNFCCC, “climate change” means “a change of climate which is attributed directly or indirectly to human activity that alters the composition of the global atmosphere and which is in addition to nat-

* © Isabelle Richelle, 2008. HEC Business School, University of Liège; Member of the Brussels Bar; and Avocat, Liedekerke, Wolters, Waelbroeck, Kirkpatrick.

1. For an overview of this problem, see Klein, R., E.L. Schipper and S. Desai, “Integrating Mitigation and Adaptation into Climate and Development Policy: Three Research Questions”, Tyndall Center for Climate Change Research, Working Paper 40 (2003), at www.tyndall.ac.uk/publications/working_papers/wp40.pdf; and Stern Review, “The Economics of Climate Change, 2006”, at www.hm-treasury.gov.uk/independent_reviews/stern_review_economics_climate_change/stern_review_report.cfm.

2. See the Commission’s Green Paper on Market-Based Instruments for Environment and Energy-Related Policy Purposes, COM(2007) 140 final, dated 28 March 2007, at ec.europa.eu/taxation_customs/resources/documents/common/whats_new/com2007_0140en01.pdf, and its Working Document SEC(2007) 338; and Decision No. 1600/2002/EC of the European Parliament and of the Council of 22 July 2002 laying down the Sixth Community Environment Action Programme, OJ L 242/1, 10 September 2002.

3. Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC, OJ L 275/32, 25 October 2003.

4. Richelle, I., “Emission trading: accounting and tax aspects”, in Lang, M. and F. Vanistendael (eds.), *Accounting and Taxation & Assessment of ECJ Case Law*, EATLP International Tax Series, Vol. 5 (2007), at 45.

5. The clean development mechanism and joint implementation are beyond the scope of this article.

6. See unfccc.int/resource/docs/convkp/conveng.pdf. The Convention entered into force on 21 March 1994. See also United Nations Framework Convention on Climate Change Handbook, Intergovernmental Panel on Climate Change, “16 Years of Scientific Assessment in Support of the Climate Convention”, WMO-UNEP (2004).

The UNFCCC was approved by Council Decision 94/69/EC of 15 December 1993, OJ L 33/1, 7 February 1994.

7. Under the UNFCCC, the parties (189 ratifying countries) recognize that the climate system is a shared resource that is affected by human activities generating emission of carbon dioxide and other greenhouse gases. They agree that information on greenhouse gas emissions has to be gathered and shared in order for governments to launch national strategies for adapting to expected impacts and to cooperate in preparing for that adaptation.

ural climate variability observed over comparable time periods”. The term “emissions” means “the release of greenhouse gases and/or their precursors into the atmosphere over a specified area and period of time”, and the term “greenhouse gases” means “those gaseous constituents of the atmosphere, both natural and anthropogenic, that absorb and re-emit infrared radiation”.

The objective of stabilizing GHG emissions was strengthened by the 1997 Kyoto Protocol (ratified by 171 parties):⁸ Annex I parties to the Protocol are committed to individual, legally-binding targets to limit or reduce their GHG emissions below the levels specified for each of them in the Protocol. This means a total cut in GHG emissions of at least 5% from the 1990 levels during the commitment period 2008-2012.

The target for 15 of the EU Member States is to reduce their emission level by 8%.⁹ Under the Kyoto Protocol, it is agreed that these 15 Member States receive a global reduction objective that is to be redistributed among the Member States.

The Protocol covers emissions of six main greenhouse gases, namely, carbon dioxide (CO₂), methane (CH₄), nitrous oxide (N₂O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs) and sulphur hexafluoride (SF₆).

It is worth noting that the Kyoto Protocol (Art. 1(a)) puts a general obligation on each contracting party in Annex I to:

implement and/or further elaborate policies and measures in accordance with its national circumstances, such as (v) progressive reduction or phasing out of market imperfections, fiscal incentives, tax and duty exemptions and subsidies in all greenhouse gas emitting sectors that run counter to the objectives of the Convention [UNFCCC] and application of market instruments.

Besides this general obligation, the Protocol appears to be very innovative by using market-based instruments to reach the objective of reducing GHG emissions.

Industrialized countries can meet their reduction target by trading emission allowances between themselves and/or gaining credits for emission-curbing projects abroad either in countries that have an emission target (JI) or in countries with no such target (CDM).

According to its commitment to reduce GHG emissions in the EU territory, the European Union issued Directive 2003/87/EC establishing a scheme for GHG emission allowance trading within the Community.¹⁰

Emission trading under the Kyoto Protocol concerns the Annex I parties, i.e. the states themselves, but within the EU, emission trading is aimed at certain enterprises. The Kyoto Protocol considers the 2008-2012 period,¹¹ while the EU scheme already applied on an experimental basis for a first period (2005-2007).

3. The EU Emission Trading Scheme

The EU Emission Trading Scheme integrates for the EU territory the obligations resulting from the Kyoto Protocol. In addition, it appears as part of a broader action

plan for the environment, including climate change,¹² taking into account the need to ensure the security of energy supply within the EU and the need to enhance business competitiveness.¹³

The EU Emission Trading Scheme covers the enterprises that produce the most CO₂ emissions within the EU.¹⁴ The “participating” enterprises must be granted by their competent authority, for each installation they own, a permit authorizing them to emit greenhouse gases from all or part of the installation if it is satisfied that the operator is capable of monitoring and reporting emissions.¹⁵ The enterprises concerned are listed in Annex I of Directive 2003/87: they are engaged in energy production activities, production and processing of ferrous metal, mineral industry (cement, glass and ceramic), paper production and chemicals.¹⁶

When authorized to emit greenhouse gases, the participating enterprises receive from the competent authority designated by each Member State a certain amount of emission trading rights (or “quotas” or “allowances”) representing the authorization to emit a certain quantity of greenhouse gases.¹⁷ One allowance represents the right

8. Approved by Council Decision 2002/358/EC of 25 April 2002, *OJ L 130/1*, 15 May 2002.

9. The new Member States have an individual target of 8%, except Poland and Hungary, which have a reduction target of 6%; Malta and Cyprus have no target. Some countries are allowed an increase in their emissions level, i.e. Australia (+8%) and Iceland (+10%); Kyoto Protocol, Art. 3.

10. For Directive 2003/87/EC, see note 3, *supra*. See also the Commission's Green Paper on Market-Based Instruments for Environment and Energy-Related Policy Purposes, *supra* note 2. For an overview of the actions undertaken at the EU level, see the European Climate Change Programme, at ec.europa.eu/environment/climat/pdf/eu_climate_change_progr.pdf.

11. Future negotiations are to be held regarding the post-2012 period.

12. See the Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions, “Limiting Global Climate Change to 2° Celsius: The Way ahead for 2020 and beyond”, COM(2007) 2 final. The objective within the EU (but also in international negotiations) is to reach at least a 20% GHG reduction by 2020.

13. See the Action Plan for the Period 2007-2009 (Council of the European Union, Presidency Conclusions, 8/9 March 2007 (7224/07)), especially Point III, at 10, Nos. 27-39), based on the Commission's Communication, “An Energy Policy for Europe” (COM(2007) 1 of 10 January 2007). See also e.g. the new package of proposals of January 2008 to fight climate change and promote renewable energy, including a proposal to amend the EU ETRs Directive, at europa.eu/rapid/pressReleasesAction.do?reference=IP/08/80&format=HTML&aged=1&language=EN&guiLanguage=en; and Proposal COM(2008) 16 final.

14. As regards possible extension to other gases, see the Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions, “Building a Global Carbon Market – Report pursuant to Article 30 of Directive 2003/87/EC”, COM(2006) 676 final of 13 November 2006. Directive 2003/87/EC should be extended to NO₂; see Proposal COM(2008) 16 final.

15. Directive 2003/87, Art. 4.

16. Directive 2003/87 should be extended in the future; see the Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC so as to include aviation activities in the scheme for greenhouse gas emission allowance trading within the Community, COM(2006) 818 final of 20 December 2006; and Working Paper of the Commission, SEC(2006) 1685 of 20 December 2006, “Summary of the Impact Assessment: Inclusion of the Aviation in the EU Greenhouse Gas Emission Trading Scheme”. On the other hand, the Emission Trading Scheme is excluded as regards passenger cars and light-commercial vehicles; see COM(2007) 19 final of 7 February 2007, “Results of the Review of the Community Strategy to Reduce CO₂: Emissions from passenger cars and light-commercial vehicles”, and SEC(2007) 61. See also Proposal COM(2008) 16 final.

17. Directive 2003/87, Arts. 3(a) and 11.

to emit one tonne of CO₂ equivalent during a specified period.¹⁸

At the end of the year, each participating enterprise has to determine the quantity of its GHG emissions and report it to the competent authority.¹⁹ Each enterprise also has to return, before 30 April of the following year, the number of ETRs corresponding to its actual emissions.²⁰

It is possible for an enterprise that does not have enough allowances to surrender to buy additional ETRs on the market, to use the ETRs received in the meantime for the following year, or to use the excess ETRs from a preceding year which it has not yet surrendered. On the other hand, if the enterprise has too many ETRs, it is allowed to sell all or part of them on the market.

If an enterprise does not surrender the required number of allowances by 30 April of each year to cover its emissions during the preceding year, it must pay a penalty of EUR 40 per missing ETR for the period 2005-2008 and EUR 100 for the period 2009-2012.²¹ Payment of the penalty does not release the operator from the obligation to surrender the allowances due in the following year.²²

Allowances are valid for a specified period. Those received for one year but not used to cover emissions of that year are valid for the following years within the same period. At this time, it is not possible to carry forward excess certificates from one period to the next.²³ The first period covered the years 2005-2007; the second period covers the years 2008-2012 and began on 1 January 2008.²⁴

It is up to the Member States to allocate the ETRs among the participating enterprises. During the first period, at least 95% had to be granted free of charge; for the second period (2008-2012), at least 90% of the certificates must be granted free of charge.²⁵

The competent authority must cancel the allowances which are surrendered in order to cover the GHG emissions during the preceding year as well as the allowances which are no longer valid and have not been surrendered after the period 2008-2012.²⁶ However, in order to avoid increased GHG emissions at the end of a period so as to use the available ETRs, it is possible for the competent authority to issue new allowances to replace any cancelled allowances held by a person, in addition to the allowances granted to that person for a new period.²⁷

Under Directive 2003/87, it is also possible for the participating enterprises to pool the management of their allowances, but this pooling must be expressly authorized by each Member State. The operators must nominate a trustee to whom all the allowances for the installations will be issued and who will be responsible for surrendering the allowances covering the total emissions from the installations in the pool.²⁸ In this case, the trustee will also be responsible for paying any penalty that might be due.²⁹

In Belgium, implementation of Directive 2003/87 is in the competence of both the federal³⁰ and regional authorities which have enacted the required regulations.³¹

4. General Remarks on the EU Emission Trading Scheme

According to Directive 2003/87, any person, whether an individual or a legal person, within the European Union is allowed to buy and sell EU allowances. At present, the system covers about 10,000 industrial plants across the EU,³² and coverage should increase in the future.

As regards the participating operators, allowance trading is at first a matter of compliance with their obligation to reduce their polluting CO₂ emissions. ETRs can also be viewed as a financial investment both for listed operators and for other persons. Moreover, various financial products based on emission trading (funds, derivatives such as forwards, options and swaps, etc.) are proposed by financial institutions. It is not the purpose of this article to examine the tax aspects of these financial products. Rather, this article focuses on the emission trading system itself and its accounting and tax consequences for the operators listed in the Directive from a Belgian perspective.

-
18. Id., Art. 3(a).
 19. Id., Arts. 12.3 and 14.
 20. Id., Art. 12.3.
 21. Id., Art. 16.
 22. Id., Art. 16.4.
 23. Id., Art. 13.2.
 24. Id., Arts. 11.1 and 11.2. Regarding the changes as from 2013, see Proposal COM(2008) 16 final.
 25. Directive 2003/87, Art. 10; see also Proposal COM(2008) 16 final.
 26. Directive 2003/87, Arts. 10 and 11.
 27. Id., Arts. 13.2(2) and 13.3(2).
 28. Id., Art. 28.
 29. Id., Art. 28.4. If the trustee fails to pay the penalties, each operator is responsible for paying the penalty in respect of emissions from its own installation(s) (Art. 28.6).
 30. Law of 11 April 2003 approving the Agreement of cooperation between the federal State, the Flemish Region, the Walloon Region and the Region of Brussels-Capitale concerning the establishment, the execution and the follow-up of a national Plan Climate, as well as the establishment of reports, within the framework of the United Nations Framework Convention on Climate Change and of the Kyoto Protocol, concluded in Brussels on 14 November 2002 (*Moniteur Belge/Belgische Staatsblad*, 15 July 2003).
 31. Order of the of Region Brussels-Capitale establishing a system of exchange of emission trading rights and relating to the flexible mechanisms under the Protocol of Kyoto (*Moniteur Belge/Belgische Staatsblad*, 12 February 2008), and replacing the Decree of the Government of the Region of Brussels-Capitale of 3 June 2004 (*Moniteur Belge/Belgische Staatsblad*, 23 June 2004); Decree of the Walloon Region of 10 November 2004 establishing a system of exchange of emission trading rights, creating a Walloon Fund Kyoto and relating to the flexible mechanisms under the Protocol of Kyoto (*Moniteur Belge/Belgische Staatsblad*, 2 December 2004) as modified by the Decree of 22 June 2006 (*Moniteur Belge/Belgische Staatsblad*, 12 July 2006); Decree of the Flemish Region of 2 April 2004 on the reduction of greenhouse gas emissions in the Flemish Region through the promotion of the rational use of the energy, the use of renewable sources of energy and the application of the mechanisms of flexibility foreseen by the Kyoto Protocol (*Moniteur Belge/Belgische Staatsblad*, 23 June 2004), completed by a Decree of the Flemish Government of 4 February 2005 concerning the exchange of quota of greenhouse gases and modifying the order of the Flemish Government of 6 February 1991 fixing the Flemish regulation concerning the ecological authorization and modifying the order of the Flemish Government of 1 June 1995 fixing the general and sector-based arrangements in hygiene of the environment.
 32. EU IP/08/80 of 28 January 2008.

These operators have to choose between investing in less-polluting machines in order to reduce their actual GHG emissions or buying allowances in order to cover excessive GHG emissions compared to the level allowed to the enterprise. In order to compare the cost of these two choices, the exact price of ETRs, including their tax cost, must be determined.

According to Directive 2003/87, Art. 3(a): “allowance” means “an allowance to emit one tonne of carbon dioxide equivalent during a specified period, which shall be valid only for the purposes of meeting the requirements of this Directive and shall be transferable in accordance with the provisions of this Directive”. The Directive does not provide any precision as to the legal nature of an allowance, the only points of certainty being that it gives a right to emit a certain amount of CO₂ and that, as a rule, it is transferable.

This has been pointed out as a very serious omission which gives rise to numerous practical difficulties and uncertainties not only regarding the accounting and tax treatment but also from a civil, administrative and commercial point of view.³³

Belgium does not have an official position on the legal nature of allowances.³⁴ It may be considered rather strange that one can recognize as a valuable right the ability to pollute a common good – the atmosphere.³⁵ This uncertainty regarding the legal nature of allowances is reflected in the accounting and tax fields.

Directive 2003/87 itself contains no accounting or tax rules. The EU Commission did not issue any comment except regarding VAT.³⁶ Even if accounting rules are harmonized within the EU, disparities appear because some Member States already apply (some) IAS/IFRS to statutory accounts, while others only refer to the Fourth Directive on the annual accounts of certain types of companies (Fourth Directive).³⁷ This leads to “dis-harmonization” of what is and should remain a harmonized instrument. Put another way, why create a harmonized instrument aimed at taking into account the cost of pollution while distorted accounting and tax regulations lead to economic distortions?

5. Corporate Tax Treatment of Participating Enterprises

5.1. The tax treatment depends on the accounting treatment

In Belgium, the corporate income tax is based on the annual accounts, except when specific tax rules apply. As a consequence, the ETRs tax regime is closely connected with the accounting regime.

As mentioned above, no guidance is given regarding the accounting treatment at either the EU level or international level.³⁸ Several methods have been suggested.³⁹ In Belgium, the Belgian Accounting Committee (BAC) published an advice on the accounting treatment of ETRs which focuses on the situation of enterprises operating for compliance purpose,⁴⁰ acquiring ETRs in order

to satisfy their obligation to reduce their polluting emissions. Trading operations do not present these specifics. Of course, an enterprise could hold ETRs both for compliance and trading.

This distinction is important for audits conducted by the tax authorities and for taxpayers having to provide evidence. ETRs are registered in a specific register managed by the competent authority, which makes it possible to individualize the ETRs received free of charge from the competent authority; differentiation is more difficult regarding the ETRs bought on the market or managed within a multinational group of companies. ETRs thus appear as a kind of hybrid instrument whose nature changes according to its use.

As a rule, a BAC advice has no binding effect,⁴¹ but a kind of morally binding effect. However, such doctrine cannot be binding if it does not fully respect the law in force. Since it appears that the existing accounting rules do not fit perfectly with the characteristics of ETRs, a question arises regarding the compatibility of the BAC Advice (CNC 179/1 of August 2005) with the constitutional principle of legality, according to which no tax is due but by virtue of a law. This principle is infringed when not all the fundamental elements of a tax assessment – taxable event, tax base, tax rates – are determined by law. In this respect, it must be noted that the Belgian

33. See e.g. European Environment Agency, “Application of the emissions trading directive by the EU Member States”, *EEA Technical report*, 2/2006, especially at 38; “Legal Framework for Emission Trading in the European Union” (2006), at www.ecologic.de/modules.php?name=News&file=article&sid=865; FIEL Report, “Legal Nature of GHG Emission Reductions: An International Workshop”, London, 25-26 May 2004, at www.field.org.uk/PDF/LNA%20REPORT-%20final.pdf; Delaisse, Ph., V. Sepulchre and R. Winzen, *Kyoto, climat et commerce de CO₂: fondements juridiques, économiques et stratégiques* (Brussels: Kluwer, 2004); Maes, F. (ed.), *L'échange des droits de pollution comme instrument de gestion du climat* (Bruges: Die Keure-La Chartre, 2004); Geldhof, W. and D. Hommez, “Handel in schone en vuile lucht: groenestroomcertificaten en verhandelbare emissierechten vanuit kikvorspectief”, *TBH*, 2004/8, at 823; and Wermaere, M., “Legal Ownership and Nature of Kyoto Units and EU Allowances”, in Freestone, D. and Ch. Streck (eds.), *Legal Aspects of Implementing the Kyoto Protocol Mechanisms* (Oxford University Press, 2005).

34. Pâques, M., “Nature juridique du quota d'émissions de gaz à effet de serre”, in Maes, supra note 33, especially at 43.

35. See the discussion in “Legal Framework for Emission Trading in the European Union”, supra note 33.

36. See europa.eu/environment/climat/pdf/vat_guidelines.pdf.

37. Fourth Council Directive 78/660/EEC of 25 July 1978 based on Art. 54(3)(g) of the Treaty on the annual accounts of certain types of companies, *OJ L* 222/11, 14 August 1978.

38. An IFRIC 3 draft was published in December 2004 (www.iasplus.com/pressrel/2004pr32.pdf); it was later withdrawn (www.iasplus.com/pressrel/0507withdrawifric3.pdf) after publication of an EFRAG opinion, 6 May 2005 (www.iasplus.com/efrag/0505ifric3endorsementadvice.pdf) that led to “vigorous debate” within the IFRIC, which finally considered its proposal not to be completely in line with the principles laid down in the IAS concerned. The IFRIC 3 treated allowances received as intangible assets that are initially recorded at their fair market value. The difference between the price paid (if any) and the fair market value is treated as a government grant (IAS 20). As a counterpart, companies have to recognize a liability for the obligation to surrender allowances to cover polluting emissions. This provision is booked at the market value. See Råty, P., “The relation between accounting and taxation: the example of emission trading rights – accounting aspects”, in *Accounting and Taxation & Assessment of ECJ Case Law*, supra note 4, at 29.

39. See e.g. the IFRIC 3 and the “French method”, Advice No. 2004-C of 23 March 2004 of the French National Council for Accountancy.

40. BAC Advice CNC 179/1 of August 2005.

41. It is only “authorized doctrine”; see BAC Advice CNC 14/1.

accounting rules implement the rules decided upon at the EU level (especially the Fourth Directive).

5.2. Qualification of ETRs

Most of the EU Member States consider ETRs to be intangible assets,⁴² but some treat them as inventory/stock⁴³ or as subsidies. Even if, from a civil law point of view, the qualification as intangible assets seems to be the most adequate, it is questionable whether the qualification may be used for accounting – as does the BAC in its Advice – and taxation.

Indeed, accounting rules within the EU are based on the Fourth Directive. According to Art. 9 of the Directive, intangible assets are defined as:

1. Costs of research and development;
2. Concessions, patents, licences, trade marks and similar rights and assets;
3. Goodwill;
4. Payments on account.⁴⁴

Clearly, this definition does not fit ETRs. However, the BAC justifies the qualification as intangible assets as the best solution in the absence of other possible classifications, considering it best to take into account the main characteristics of ETRs.⁴⁵ But in light of the legality principle, one may doubt that this qualification is satisfactory for purposes of Belgian tax law. The definitions given for other assets, whether tangibles, stock,⁴⁶ “investment – other investments”⁴⁷ or even financial assets,⁴⁸ are not more satisfactory.

The Fourth Directive does not define the term “public grant”. In Belgium, the BAC refers to payments from the competent authority which are directly linked to investments aimed at the activity of the undertaking.⁴⁹ In a very broad concept of public grant, tradable allowances granted free of charge by the competent authority could be regarded as such, but this qualification should apply only to the ETRs acquired free of charge from the competent authority; this does not solve the problem of the qualification of ETRs bought on the market for compliance.

Some of the IAS/IFRS⁵⁰ concepts might actually be considered to be satisfactory,⁵¹ but they cannot be used for taxation in Belgium, where the IAS/IFRS do not apply to statutory accounts.

From a tax perspective, a correct qualification is important in order to respect the legality principle and to give the right tax treatment to gains and losses resulting from the ETRs scheme. As a conclusion, it must be noted that the existing definitions are not satisfactory. For practical reasons, however, the qualification as “intangible assets” is probably the least bad solution.

5.3. The counterpart: provision or liability?

An operating company holds ETRs in order to comply with its obligation to surrender allowances in order to cover its polluting emissions. This obligation must be reflected in the annual statements and must be valued at

the close of the year (in this context, it should be noted that the enterprise must implement adequate procedures to collect and verify information on the level of its polluting emissions).

The obligation to deliver a certain number of ETRs to cover GHG emissions can be qualified as a debt or a provision, depending mainly on the closing date of the year. A debt exists if the obligation is certain as to its existence and amount. In contrast, a provision covers liabilities “the nature of which is clearly defined and which at the date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which they will arise” (Fourth Directive, Art. 20.1).

As regards ETRs, the level of polluting emissions is fixed at year-end, i.e. on 31 December. The operator has until 28 April of the following year to meet its obligation to surrender the required number of ETRs. If the account closing date is 31 December, the liability is to be recorded as a debt: the amount of pollution at year-end is known, as well as the amount and value⁵² of the ETRs to surrender. In other cases, the liability should be recorded partly as a debt and partly as a provision.⁵³

5.4. How to value?

5.4.1. Valuation of ETRs

The most controversial question in Belgium probably pertains to the valuation of ETRs received free of charge from the competent authority. Of course, the ETRs bought on the market are to be booked at the acquisition

42. Austria, Belgium, Cyprus, the Czech Republic, Denmark, Estonia, Finland, Germany, Ireland, Lithuania, Luxembourg, Portugal, Slovenia, Spain and the United Kingdom.

43. The Netherlands and Poland.

44. See Art. 95 of the Royal Decree implementing the Companies Code.

45. BAC Advice CNC 179/1 of August 2005, point IV(2).

46. Referring to “raw materials and consumables, works in progress, finished goods and goods for resale, and payments on account”.

47. This qualification is doubtful at least as regards allowances received free of charge from the competent authority.

48. Defined by the Fourth Directive as “shares in affiliated undertakings, loans to affiliated undertakings, participating interests, loans to undertakings with which the company is linked by virtue of participating interests, investments held as fixed assets, other loans, own shares”. ETRs might, however, be considered to be “other investments” even if it is conceptually difficult to admit that the ETRs held for compliance purposes constitute an “investment” by the operator.

49. BAC Advice” CNC 125-5, at www.cnc.cbn.be/FR/fichiersAvis/FR_125-05.htm.

50. Hereafter “IAS” refers to the IAS as applied within the EU; Commission Regulation (EC) No. 1725/2003 of 29 September 2003 adopting certain international accounting standards in accordance with Regulation (EC) No. 1606/2002 of the European Parliament and of the Council, OJ L 261/1 of 13 October 2003.

51. See IAS 38.8 (EU Regulation of 29 September 2003, OJ L 261/1 of 13 October 2003) establishing a broader concept of “intangible asset”, defined as “identifiable non-monetary asset without any physical substance”; this definition expressly includes “import quotas” (IAS 38.9) and could therefore be applied by analogy to ETRs. As regards “stock”, IAS 2 could be of help as its definition of inventory includes “assets ... in the form of materials or supplies to be consumed in the production process ...”. The right to emit greenhouse gases which is integrated and recognized in ETRs could be considered as linked to materials used in the production process.

52. By reference to the market price.

53. Art. 50 of the Royal Decree implementing the Companies Code.

value, whether they are treated as intangible assets or as financial assets/investments. Operations within a group of companies must be based on transfer pricing rules.

The basic valuation rule provided in the Royal Decree implementing the Companies Code, and thus implementing the principles of the Fourth Directive, is valuation at the acquisition value. This means that, in the case of acquisitions free of charge, the asset should be valued at zero. This was the traditional view endorsed by the tax authorities.

In another context, however, the BAC issued a controversial advice on the accounting treatment of assets acquired (nearly) free of charge,⁵⁴ stating that these assets must be recorded at their fair market value. The BAC actually uses a new argument developed by the Belgian tax authorities, aimed at taxing immediately the value of assets received free of charge by recording them at their fair market value. This very controversial position⁵⁵ has been endorsed by some Belgian courts, including the Supreme Court, in very “sensitive” cases.⁵⁶ The fair market value of ETRs is recommended by the BAC in Advice 179-1.⁵⁷

In this author’s view, there is no legal basis in the Belgian regulations for referring to the fair market value in such cases; see (1). In addition, Belgium’s tax system itself provides a specific rule that can be considered to be an exception to the accounting rule if the latter is understood – which is not the case here – as referring to the fair market value; see (2).

(1) Art. 32 of the Fourth Directive as amended refers to the “purchase price or production cost”. Belgian law uses the terms “*prix d’acquisition/aanschaffingsprijs*”, which seems (to the author) to be broader, including any kind of acquisition whether or not it is for a price as such. This principle is reaffirmed in Art. 35.1(a) as regards intangible and financial fixed assets.

In 2001, the Fourth Directive was amended to provide the Member States with the possibility “to permit or require in respect of all companies or any classes of companies valuation at fair value of financial instruments, including derivatives” (Art. 42(a)). Furthermore, in 2003, Art. 42(2) was modified so that the “Member States may permit or require in respect of all companies or any classes of company the valuation of specified categories of assets other than financial instruments at amounts determined by reference to fair value” (Art. 42(e)).

Thus, valuation at fair market value would be acceptable in the Member States which have explicitly incorporated this rule for their annual statements. This is not the case for Belgium, which has not (yet) amended its accounting law.

(2) Some might be surprised that an enterprise could receive an asset free of charge without incurring any tax on its value at that time. In the author’s view, however, the tax system itself provides for this. Capital gains realized by companies are taxable as well as recognized capital gains,⁵⁸ but booked capital gains are generally expressly

tax exempt.⁵⁹ This structure of the tax system is designed to avoid a tax liability as long as the asset is the property of the company, i.e. as long as it does not have the cash to pay the tax. In the author’s view, the correct situation is reflected by booking at zero, with revaluation of the asset when required in order to give a fair view of statutory accounts. In this context, the fair market value leading to immediate taxation would not be in line with the tax law and the specific aim of the legislature. If there is immediate taxation of the assets received free of charge, the position of the enterprise is less favourable than that of a company having undervalued assets.

Applied to ETRs, while the BAC recommends booking at fair value on a (debatable) legal basis, the acquisition value should be used for tax purposes. Since ETRs are qualified as intangible assets, it would not be permitted under accounting law to revalue them at market value.⁶⁰ Thus, capital gains and losses would be recognized only when realized. The tax authorities do not have an official position on ETRs.

As a conclusion, the taxpayer has the choice to apply fair value, which lacks of a legal basis but is probably endorsed by the Belgian tax authorities, or to book at the acquisition value (zero), thus postponing – as provided by the accounting and tax rules – realization of the gain, which might lead to disputes with the tax authorities.

5.4.2. Valuation of liability

According to the BAC (Advice 14/1), the value of the provision corresponds to the corresponding ETRs held by the operator; as regards emissions exceeding the ETRs held, the valuation must be at the fair market value on the closing date. Thus, for accounting and tax purposes, gains or losses can occur due to the difference in the fair value retained for ETRs and for valuing the provision.

If the enterprise decides to book its ETRs at the acquisition value, i.e. zero, the provision should also be booked at the same value for the amount covered by the ETRs received free of charge. For the excess, the fair value could apply.

A debt is tax deductible if it is certain as to its existence and amount (Art. 49 ITC); a provision is tax exempt if the charge is probable as to its existence but uncertain as

54. BAC Advice 126/17, May 2002.

55. See Cheruy, C. and M. Dhaene, “Fiscale implicaties van de adviezen 126/17 en 126/18 van de Commissie voor Boekhoudkundige Normen, Deel I: Fiscale implicaties van het advies 126/17”, *T.F.R.* (2002), at 169; and Causin, E., “Evaluation et réévaluation des acquisitions à titre gratuit ou onéreux”, *C&FP* (2003), at 177.

56. See e.g. Belgian Supreme Court, 18 May 2001, *FJF* 2001/219 (*Goco* case). In *Goco*, a company received a building free of charge further to the renunciation by another company of its long-term leasing rights. In the *Artwork System* case, the transfer value of shares had incredibly increased in some days so that the tax authorities considered that they were acquired mostly free of charge (Trib. Ghent, 14 November 2002, *Fiscologue*, No. 868/1).

57. Which, however, does not refer to BAC Advice 126/17.

58. Art. 24(1) of the Belgian Income Tax Code (ITC).

59. Art. 44 § 1, 1° ITC.

60. Art. 57 of the Royal Decree implementing the Companies Code.

to its amount (Art. 48 ITC). These conditions should be satisfied for ETRs so that the charges correctly relate to the tax period(s).

5.4.3. Fair value and the notional interest deduction

The notional interest deduction allows companies to reduce their tax base by an amount equal to the fictitious interest cost on the adjusted equity capital.⁶¹ As regards operating companies, their ETRs should have a very limited impact on the amount of adjusted equity capital to be considered since the valuation of the asset and corresponding liability is closely linked, the two counterbalancing each other. A difference might occur if the fair value applied to the liabilities differs from the fair value applied for booking the ETRs received or bought on the market.

5.5. The “net” and “gross” methods

Acquisitions and sales of the ETRs held for trading purposes will lead to realized capital gains or losses recognized in the profit and loss account. As regards operating companies, the BAC recommends two methods, at the election of the enterprise: the “net” method and the “gross method”.

5.5.1. Net method

The net method is based on the idea that the ETRs received free of charge do not increase the property/wealth of the operator because the operator has to surrender them to cover its GHG emissions. It is only at year-end (assuming an account closing date of 31 December) that the operator can determine whether it realizes a profit or a loss, depending on its polluting level and the number of ETRs it holds. The sale by the enterprise of some or all of its tradable allowances generates a profit up to the price obtained. All the book entries relate to the profit and loss account.⁶²

This method is easy to apply, but is not recommended for enterprises that intend to manage their allowances in an effective way: it would not give a true and fair view of the enterprise.

5.5.2. Gross method

With the gross method, the tradable allowances are recorded as assets when they are received; at the end of

the year, a charge (debt or provision) reflects the amount of the enterprise’s emissions which must be covered by the ETRs surrendered to the competent authority. This method is based on the idea that ETRs are immediately tradable by the operators and thus represent a value for them. It also gives a better and fairer view of the enterprise’s real situation. Thus, income and expenditures are shown for the years to which they relate.

On the other side, the operator has to book its debt vis-à-vis the competent authority to surrender the ETRs corresponding to its GHG emissions during the year.

5.5.3. Consequences

The two methods are not equivalent as to their results, as shown in Example 1. Under the net method, a charge can be “anticipated” (when the GHG emissions exceed the ETRs received), while taking profits into account can be postponed (when the ETRs received exceed the GHG emissions). In contrast, from this point of view, the gross method is neutral. The gross method also better reflects the reality of the enterprise, i.e. that it operates for compliance and/or for trading.

From a tax perspective, the net method leads to taxation on the surplus allowances when they are realized. No income is recognized at the time the allowances are acquired free of charge as there is no entry. In contrast, if the allowances are insufficient at year-end, the enterprise will record a liability corresponding to the amount not covered by the ETRs already held. This mismatch between the time of recognition of the profits and charges, of course, affects the tax base of the enterprise.

As regards the gross method, the profits and losses are correctly linked to the tax period concerned. A mismatch can occur if the fair market value retained for the ETRs received differs from that used to value the provision. This does not happen if the acquisition value applies.

.....

61. For further discussion, see Haelterman, Axel and Henk Verstraete, “The ‘Notional Interest Deduction’ in Belgium”, in this issue of the *Bulletin*.

62. A variant of this method, i.e. “net method with accruals”, is not used here because it uses “prepayments and accrued income” accounts inadequately.

Method	Allowances received = GHG emissions		GHG emissions > (by 10%) ETRs received		GHG emissions < (by 10%) ETRs received	
	emission period	“assessment period”	emission period	“assessment period”	emission period	“assessment period”
net method ⁽¹⁾	0	0	0	sale: + 100	– 100	0
gross method	ETRs: + 1,000 charge: – 1,000 balance: 0	0	ETRs: + 1,000 charge: – 900 balance: + 100 ⁽²⁾		ETRs: + 1,000 charge: – 1,100 balance: – 100 ⁽³⁾	

1. The results of the “French gross method” are the same as the results of the net method.
 2. The excess ETRs could be sold on the market.
 3. The operator is required to buy ETRs to comply with its obligation to surrender the ETRs corresponding to its actual GHG emissions.

5.6. Specific tax regime?

As a rule, the capital gains realized on intangible assets are taxable. The capital gains are the difference between the “acquisition value” and the “realization value” (Art. 43 ITC).

In Belgium, no special regime applies in practice to e.g. exempt capital gains or postpone taxing them.⁶³ On the other hand, there is no restriction on the deduction of losses.⁶⁴

5.7. Penalties

If the number of ETRs surrendered to the tax authorities is insufficient, the enterprise must pay a penalty of EUR 40 per missing ETR (period 2005-2007) and EUR 100 per missing ETR (period 2008-2010). The penalty is due for the period in which the allowances must be surrendered, i.e. the year following the polluting emissions. In Belgium, this penalty is not tax deductible, which increases the cost of non-compliance.

6. Conclusion

The example of Belgium illustrates some of the practical difficulties when translating into accounting and taxation the operations relating to ETRs. It is a pity that a unique qualification was not given in the EU Directive, and it is regrettable that the accounting and tax rules of the EU Member States have importance differences.

As for direct taxes, total harmonization is not possible, but approximation of the main rules would be desirable within the framework of the negotiations that led to amending Directive 2003/87/EC. The same exercise would be useful regarding VAT.

63. It is doubtful that the holding period of five years can be satisfied (Art. 47 ITC).

64. Belgian law provides for an unlimited carry-forward of losses (Art. 206 ITC).

BOOK

Taxation of Investment Derivatives

Doctoral Series Volume 13

This dissertation aims to provide a comprehensive overview of the taxation of investment derivatives and the relationship between the derivatives and the accrual and realization methods. Investment derivatives, such as convertible bonds, include an initial investment and a derivative (an option) to buy or sell or to participate in the value movements of some underlying property. The principal focus of this study is on three universal tax issues, namely valuation, timing and the taxation of unrealized gains.

Author: Antti Laukkanen
Price: EUR 125 / USD 160
Pages: 486
Published: December 2007
ISBN: 978-90-8722-022-8

Order two books from the Doctoral Series and receive a 20% discount. Order three or more books and receive a 30% discount. For further information or to order online, visit www.ibfd.org or contact our Customer Service department via info@ibfd.org or +31-20-554 0176.



IBFD, Your Portal to Cross-Border Tax Expertise

030TID/A01/H