

BUDGET 2016: TAXATION OF EMISSIONS TRADING ACTIVITIES CLARIFIED

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In several jurisdictions, regulated emitters are required by law to deliver "emissions allowances" to the government. The quantum of the allowances required to be delivered are typically determined by reference to the amount of a regulated substance released into the environment by an emitter. Allowances can generally be purchased by emitters, earned in relation to emissions reduction activities, or obtained directly from the government.

Many taxpayers have commented on the lack of rules in the *Income Tax Act* (the "**Tax Act**") governing the treatment of expenditures incurred to comply with emissions regulations.

For instance, many questions have been posed regarding how taxpayers should account for free emission allowances granted by a government. (As a general principle, assistance provided by a government to a taxpayer in the course of carrying on its business is required to be included in computing the taxpayer's income.)

In the absence of specific rules governing the tax treatment of transactions relating to emissions allowances, much uncertainty has also arisen in several other areas, particularly in circumstances where (i) there is a mismatch between the incurrence of an expense and the year in which it is deductible, or (ii) an emissions allowance is subsequently sold by a taxpayer to a third party.

Budget 2016 proposes to amend the Tax Act to introduce specific rules to clarify the tax treatment of emissions allowances, and eliminate the prospect of double taxation where a taxpayer subsequently sells an emission allowance that was granted to it by a government for little or no consideration.

Budget 2016 calls for emissions allowances to be treated as inventory for tax purposes. (However, the "lower of cost and market" method for valuing inventory will not apply in respect of emissions allowances on account of the Government's concern over the potential volatility in the value of such allowances.)

Budget 2016 proposes that if a regulated emitter receives a free allowance from a government, the emitter will not be required to include an amount in income upon the receipt of the allowance. Deductions in respect of

accrued emissions obligations will be limited to the extent that the obligation exceeds the cost of any emissions allowances that the taxpayer acquired that can be used to settle the obligation. In particular, each year that a taxpayer claims a deduction in respect of an emissions obligation, the deduction will be limited to the cost of emissions allowances that it has acquired that can be used to settle its emissions obligation plus the fair market value of any emissions allowances that it still needs to obtain to fully satisfy its obligation. Where a deduction is claimed in respect of an emissions obligation that accrues in one year (e.g., 2017), and that will be satisfied in a future year (e.g., 2018), the amount deducted in the initial year will be required to be brought back into income in the subsequent year (i.e. 2018), and the taxpayer will be required to quantify the deductible obligation again each year until the obligation is ultimately satisfied.

Finally, taxpayers that dispose of an emissions allowance, otherwise than in the course of satisfying an emissions obligation, will be required to include in computing their income the amount by which any proceeds of disposition received on the sale of the allowance exceed the taxpayer's cost of the allowance.

The proposals contained in Budget 2016 relating to the taxation of emissions trading activities will apply to emissions allowances acquired in taxation years beginning after 2016. However, taxpayers will be permitted to elect to apply the new rules in respect of emissions allowances acquired in taxation years ending after 2012.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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