

## **Carbon Credits – Unravelling Regulatory, Taxation & Accounting Issues**

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### **Carbon Credits are Merits**

Global warming issues have been given a serious thought in the recent times and while it has become quintessential to reduce the emission levels, an entirely new industry has emerged having great potential and opportunities for the investors. What was introduced by John Dales, economist from Canada, as tradable rights to control pollution, in 1968, is seemingly lucrative venture and is in vogue for some time now; with carbon credits, green projects, carbon footprints, sustainability reports being off-springs of the initiatives. Industries are projecting to be taking initiatives to fulfill their social responsibility and are also making profits in the offing. It is like being an emblem of being a meritorious entity showing responsible behavior towards the environment.

The initiatives gained momentum with the developed nations (Annex 1 countries) ratifying to the Kyoto Protocol committing themselves to reducing the carbon emission levels by at least 5% below the 1990 baseline emission levels by the commitment period of 2008-2010. The prescribed targets under the protocol were not made applicable to the developing or least developed nations. It was like penalizing the developed countries for polluting the environment while spoiling the developing or less developed countries as they were allowed to continue to pollute. The Protocol provided for various mechanisms to mitigate the climatic changes which include, Clean Development Mechanism (CDM), Joint Implementation ((JI), International Emission Trading (IET). These mechanisms have been discussed in detail in my another article on Carbon Trade Market here <http://www.india-financing.com/staffpublications.htm>

Certified Emission Reductions or carbon credits, earned through the reductions in emission of greenhouse gases can either be self generated or can be traded in the international carbon credit market. Typically carbon credits are purchased either through CER purchase agreements, trading on the stock exchanges or even by bidding for tenders floated by several governments. Looking at the huge demand for carbon credits in the developed nations, the developing nations have geared up for tapping the market

India too is quite bullish on the carbon trade markets. It is estimated that one third of the total CDM projects registered with UNFCCC are from India and India claims 31% of the total world carbon credit trade. As per a CRISIL research report issued in May, 2010, carbon credits generated out from emission reduction projects undertaken in India, will triple over next three years and the numbers are expected to increase from 72 million in November 2009 to 246 million by December 2012.

Though several CDM projects are being undertaken in India, but there remains a lot of ambiguity with regard to legal, regulatory, accounting and taxation issues. For instance several countries are treating carbon credits as services for taxation, in some countries for accounting purposes,

carbon credits are treated as government grants, accounting for R& D expenses incurred on undertaking the CDM project etc. In India too, Bangalore Chamber of Commerce and Industry has mentioned that carbon credits should be treated as ‘services’ and taxed accordingly. The rationale behind this opinion is that either CERs are exported to developed countries or are traded like securities on the stock exchanges, hence attracting service tax, however the recent DVAT notification has clarified the matter. Some of the relevant issues are discussed below:

### **Carbon Credit (CER) traded as commodity**

The Forward Markets Commission has granted trading permission to carbon credits and is included in the list of commodities granted trading permission in the ‘others’ category. The Multi Commodity Exchange of India (MCX) entered into an alliance with Chicago Climate Exchange in 2005 to introduce carbon trading in India, providing further liquidity and greater expanse to the market. However Indian commodity exchange does not allow direct participation of foreign institutions in India, restricting the trade in which largely buyers are overseas buyers

Forward Contracts (Regulation) Amendment Bill of 2006 if passed would be beneficial for the markets as it would introduce option based trading in carbon credits and also determine the regulations for trading.

### **Are Certified Emission Reduction (CERs) carbon credits “goods”?**

The recent notification issued by the Government of the National Capital Territory of Delhi, notifying the legal position with regard to the taxability of CER has raised several questions as to whether carbon credits are to be treated as “goods” and whether it is exigible to tax and that they cannot be considered as *actionable claims or securities*.

The Notification explains that in substance CERs are tradable commodity. They have a market value, having a ready market, with willing buyers and sellers and are freely transferable as other marketable commodities. Thus carbon credits should be considered to be goods under the sales tax laws and any person/ company/ undertaking/ entity engaged in the activity of sale or purchase of carbon credits is a “dealer” in terms of the definition of dealer as contained in Section 2(1) of the DVAT Act, 2004.

The notification further explains that under section 2(1)(m) of the DVAT Act, 2004, “goods” has been defined as –

*“goods” means every kind of moveable property (other than newspapers, actionable claims, stocks, shares and securities) and includes -*

- (i) livestock, all material, commodities, grass or things attached to or forming part of the earth which are agreed to be served before sale or under a contract of sale; and*
- (ii) property in goods (whether as goods or in some other form) involved in the execution of a works contract, lease or hire-purchase or those to be used in the fitting out, improvement or repair of movable property”.*

It is further pertinent to mention Entry No.3 of IIIrd Schedule, under which CERs are to be treated as *goods*. Entry No.3 of IIIrd Schedule reads as follows -

Entry No. 3 of IIIrd Schedule

“01-04-2005

*All intangible goods like copyright, patent, rep license, goodwill etc.”*

To draw conclusion, reliance was placed on several judgments of the Hon’ble Supreme Court in the matter of *H. Anraj v. Government of Tamil Nadu*, [1986] 1 SCC 414, *Vikas Sales Corporation & Another vs Commissioner of Commercial Taxes & Another* JT 1996 (5) SC 482, *Yash Overseas Vs. Commissioner of Sales Tax and Others* (Civil Appeal No.2155 of 2000), *M/s. Sunrise Associates vs. Govt. of NCT of Delhi & Ors.* (Judgment dated 28.4.2006) and so on. The Notification No. 256/CDVAT/2009/43 dated 13.01.2010 issued by the Government of the National Capital Territory of Delhi, concluded that Certified Emission Rights (Carbon Credits) are taxable under DVAT Act, 2004 and the rate applicable is 4% as the said item is covered under Entry No.3 of IIIrd Schedule appended to the DVAT Act, 2004.

In the landmark case of *Vikas sales (ibid)*, the question for consideration before the Hon’ble Supreme Court was whether the transfer of an Import License called R.E.P. License/Exam Scrip by the holder thereof to another person constitutes a sale of goods within the meaning of and for the purposes of the Sales Tax enactments of Tamil Nadu, Karnataka and Kerala and whether it was exigible to tax or not.

Replenishment License or REP licenses were issued by the Central Government to registered exporters facilitating import of essential inputs required for the manufacture of the products exported. These licenses were made freely transferable and lawful holder of the licence could either import the goods permitted thereunder or sell it to another in turn. Thus several registered exporters started trading in these licenses and made profits out of the same. The tax authorities thus claimed that transfer of such licenses was subject to sales tax as these qualified to be goods as per the sales tax act. Several notable points were made which are relevant in case of carbon credits as well, which are as follows:

- As REP license did not require any endorsement or permission from the licensing authority, and were governed by the ordinary law, REP licenses could be transferred by the transferor by way of a formal letter to the transferee and **conferred upon the transferee choate right that was exercisable immediately, these licenses had intrinsic value of their own which was independent of the value of the goods which could be imported.**
- REP licenses could not be contended to be actionable claims, as actionable claims are claims to any debt or beneficial interest in the moveable property whether existent, accruing, conditional or contingent and these licenses conferred right to purchase material and were not claims to any debt
- Lastly, these licenses were bought and sold freely in the market, i.e they had a ready market for trade

Further, in case of *Tata Consultancy Services vs. State of Andhra Pradesh* it was, inter alia, held and was reiterated in case of *BSNL vs UOI* [2006] 152 Taxman 135/ 282 ITR 273/ 145 STC 1, that anything that had the following attributes would be regarded as goods (a) its utility; (b)

capable of being bought and sold and (c) capable of being transmitted, transferred, delivered, stored and possessed. Therefore CER by virtue of fulfilling the above mentioned attributes qualifies to be considered as “goods.”

There are several questions with regard to trade of CERs that are yet to be addressed; like most of these carbon credits are sold to overseas buyers, whether the transfer of the credits to offshore units would tantamount to exports or not, whether CERs would be considered to be goods residing in India as they are issued by offshore entity and so on.

### **Taxation Issues**

Income from sale of CERs should be accounted for under the head Business & Profession and in case of sale of Intangible, it would be taxable under the head Capital Gains though most companies in India are recording earnings from carbon credit trading as Income from Other Sources

Trading in CER is carried out either in spot market or in futures. Service tax will be applicable on account of dealing in CERs on the exchange platform and in case of contracts resulting in delivery VAT will be applicable.

Typically carbon credits in India are sold to overseas buyers, hence there would be no VAT applicable on these goods. Thus sale of CERs to overseas buyers should qualify as exports, however there is no explicit mention made in this regard by the concerned authorities

### **Accounting issues – Exposure Draft on Guidance Note on accounting for carbon credits by ICAI**

Generation and trading in carbon credits has gained a lot of momentum but there remains a lot of ambiguity for the accounting treatment to be rendered. Questions on accounting for expenditure on the CDM projects, accounting for self-generated CERs, accounting for sale consideration and so on. The answers are to be sought in the existing accounting standards as there are no separate accounting standards for accounting, measurement and disclosures of carbon credits.

Some of the countries suggest recognition of carbon credits as government grant, however this approach would be inappropriate as government grants are received by an organization on concessional or nominal rates or free of cost, wherein government would grant or allocate some concessional benefit to an entity. In case of CERs, it is not any benefit that is provided by government or any affiliated authority, it is an incentive provided to entities for doing good to the environment

To resolve the accounting issues, International Accounting Standards Board (IASB) had issued an interpretation **IFRIC 3** on Emission Rights but had later withdrawn the same, continuing to debate on the appropriate treatment for CERs. The Accounting Standard Board of the Institute of Chartered Accountants of India (ICAI) has also issued an Exposure Draft of the Guidance Note on Accounting for Self-generated Certified Emission Reductions in 2009 enumerating the accounting principles for CERs generated by an entity. The exposure draft provides for

accounting principles relating to recognition, measurement and disclosures of CERs generated under the Clean Development Mechanism

Clean Development Mechanism being the relevant mechanism adopted in India for reduction in carbon emissions, it is pertinent to mention that in a CDM mechanism, a developed nation may invest in a project in developing nation, which would result in emission reduction. The emission reductions once certified by the CDM Executive Board, under the protocol are called certified Emission reductions (CERs) or carbon credits and are used to meet nation's commitments under the Protocol.

While undertaking a CDM project an entity has to go through a lot of research and development, documentation and approvals process. Accounting treatment for CERs taking in consideration the exposure draft issued by ICAI should be done in the following manner:

1. **Expenses in the research and development phase:** While undertaking the project for reduction in carbon emission, any cost incurred on development should be accounted for as enumerated in AS 26 for intangible assets. Cost incurred on receiving the CER is measured with certainty at the time of incurring those expenses whereas revenue recognition will happen only at the time of sale of CERs. So there is a mismatch of in accounting for expenses and revenue
2. **CERs held with the CDM Executive Board** – The exposure draft on guidance note on accounting for carbon credits states that when the CERs are in the approval stage, these should be accounted for as per the provisions of AS 29 as Contingent Assets and once approved should be recorded in the books as an intangible asset. There is an anomaly in the drafting as Para 30 of AS 29 says that an enterprise should not recognize a contingent asset. However, once the CER are approved by the Board, these should be recorded as intangible assets under AS 26 as they meet the criteria of 'Intangible Assets' as defined in the Standard, which includes 1) identifiability, 2) control over resources and 3) expectation of future economic benefits flowing to the enterprise.
3. **CERs held for sale** – In case an enterprise possess CER which are to be traded in the ordinary course of business, i.e, the enterprise holds the asset as 'available for sale' then, these should be accounted for as Inventory under provisions of AS 2. Para 8 of the AS 26 states that if any item under this standard does not meet the definition of intangible assets, then the expenditure to acquire it or generate it is internally recognized as an expense when it is incurred

The intent of the entity would determine whether these credits should be recorded as intangible assets or as inventory. There are further questions on CERs that at what cost should CERs be recorded in the books, as huge amount of expenditure is incurred in terms of initializing the project, emission of reduction, approval and acceptance of CERs etc.

The exposure draft of the guidance note clearly indicates that in case intangible asset is generated, expenses are to be capitalized as per AS 26, whereas in case CERs treated as inventory, costs relating to consultant fees, levies imposed by UNFCCC for approving of CERs are to be inventorised and are to be recorded as lower or cost or net realizable value as per the standard. This means that the cost towards certification is the cost of inventory. What

is worthy of taking note here is that, the cost that is inventorised is only a small and insignificant portion of the expenditure incurred, whereas the other incidental cost taken to the profit & loss account would be far more significant, thus deflating by profits. Any other tangible or intangible asset generated in the process is to be recorded as per the existing accounting standard governing them, i.e AS 10 and AS 26 respectively.

Despite several unresolved issues carbon credits have emerged as a sought commodity for trade and will continue to interest the country for sometime to come.