Tax Article

Carbon Credits

Background

- The burning of fossil fuels is a major source of greenhouse gas emission by the power, cement, steel, textile, fertilizer and many other industries. The major greenhouse gases emitted by these industries are carbon dioxide, methane, nitrous oxide, hydroflourocarbons etc. All these greenhouse gases increases the atmosphere's ability to trap the infrared energy, thereby affecting the climate and endangering not only the human life but also all the creatures in the globe. There are several ways for reducing the emission of greenhouse gases like switching over to wind and solar energy, forest regeneration, installation of energy efficient machinery etc.

- To limit the concentration of greenhouse gases in the atmosphere for addressing the problem of global warming, the United Nations Framework Convention on Climate Change (UNFCCC) was adopted in 1992. Subsequently, to supplement the Convention, an international agreement between several countries known as ‘Kyoto Protocol” was signed on 11.12.1997 in the city of Kyoto, Japan which came into force on 16.02.2005. The agreement sets to limit the maximum amount of emission of greenhouse gases by the countries, provides for reduction in the emission of greenhouse gases in the commitment period and a mechanism for measuring the reduction of greenhouse gases.

- The countries with binding emission reduction targets (which at present are applicable to the developed countries) in order to meet the assigned reduction targets are issued allowances i.e. carbon credits/certified emission reduction (CER). To meet the emission reduction targets, binding countries in turn set limits on the greenhouse gas emissions by their local businesses and entities. An allowance (carbon credit/CER) represents an allowance to emit one metric tonne of carbon dioxide equivalent. In other words, if any industry reduces the emission of carbon dioxide to the extent of one metric tonne, then that industry will be given one CER. CERs are in the form of certificates. Similarly, if the industry reduces the other greenhouse gases in the equivalent terms, necessary credit would be given. Therefore, the carbon credit is nothing but an incentive given to the industrial undertaking for reducing the emission of greenhouse gases including carbon dioxide. To provide incentive to the industries, a mechanism for carbon trading was created.

Carbon Trading

The concern for global warming arising out of emission of harmful gases into the atmosphere, more precisely the emission of carbon dioxide has given rise to the concept of carbon trading. The mechanism provided for trading the CERs provides an opportunity to the holder of such certificate to sell the same to the commercial or the individual customers who are interested in acquiring such credit to be accounted towards fulfillment of its committed target reduction. Therefore, the question which arises for consideration is the accounting treatment, the tax treatment and the treatment in computing book profit u/s 115JB of CERs.

Accounting Treatment of Carbon Credit

The recent times have witnessed a rise in the number of transactions involving carbon trading. With India being an important partner in such transactions, the Accounting Standard Board of Institute of Chartered Accountants of India (ICAI) has formulated Guidance Note on Accounting for Self-generated Certified Emission Reductions (CERs) [GN(A) 31 (Issued 2012)] to provide guidance on the accounting for carbon credits.

- CER comes into existence and meets the definition of asset when the communication of credit of CERs by the UNFCCC is received by the generating entity in a manner to be unconditionally made available to the generating entity. This is because only at this stage, the CER becomes a resource controlled by the generating entity and therefore leads to expected future economic benefits in the form of cash and cash equivalents which would arise on the future sale of CERs. Therefore, CERs should not be recognized before that stage.

- CERs are inventories of the generating entity as they are generated and held for the purpose of sale in the ordinary course of business. Therefore, even though CERs are intangible assets, these should be accounted for as per the requirements of AS-2. Accordingly, CERs should be measured at lower of cost and net realizable value. The cost of inventories of CERs is the cost incurred by the generating entity for certification of CERs. This includes the fees paid by the generating entity to the consultant for the services rendered to obtain the certification of CERs by UNFCCC and the cash payment charged by the UNFCCC towards meeting its administrative costs.

- An entity should present the CERs as part of inventories, in the balance sheet, separately from other categories of inventories such as raw materials, work-in-process, finished goods and others. Since CERs are recognized as inventories, the entity should apply AS-9 to recognize the revenue in respect of sales of CERs.

Tax Treatment of Carbon Credit

➢ An issue which arises for discussion is whether the income on sale of CERs is revenue receipt or capital receipt. The Income Tax Act, as the title denotes, taxes incomes. Section 2(24) of the IT Act defines 'income' in an inclusive manner to include certain receipts specified therein. So, what needs to be examined is whether the amount received by the assessee on sale of CERs is fitting within any of the items mentioned in sec. 2(24), more specifically under clause (vd) – the value of any benefit or perquisite taxable u/s 28(iv) and under clause (vi) – any capital gain chargeable u/s 45.

➢ The various judicial pronouncements wherein it has been held that receipt on account of carbon credit is capital in nature and neither chargeable to tax under the head 'business income' nor liable to tax under the head 'capital gains' is as under:-

  - **My Home Power Ltd. Vs. DCIT 21 ITR (Trib.) 186 (Hyd.) dated 02.11.2012**
    Carbon Credit is in the nature of an "entitlement" received to improve the world atmosphere and environment by reducing carbon, heat and gas emissions. The entitlement earned for carbon credits can, at best, be regarded as a capital receipt and cannot be taxed as a revenue receipt. It is not generated or created by carrying on business but accrues due to "world concern". Due to that, the assessee gets a privilege in the nature of transfer of carbon credits. Thus, the amount received for carbon credits has no element of profit or gain and it cannot be subjected to tax in any manner under any head of income. It is not liable for tax in terms of sections 2(24), 28, 45 and 56 of the Income-tax Act, 1961. The person having carbon credits get benefit by selling the same to a person who needs carbon credits to overcome one's negative point carbon credit. The amount received is not received for producing or selling any produce, by-product or for rendering any service for carrying on business. Carbon credit is entitlement or accretion of capital and hence income earned on sale of these credits is capital receipt & cannot be taxed as revenue receipt.

  - The principles stated above have been accepted and followed by the **Chennai Bench of Tribunal in case of Ambika Cotton Mills Ltd. Vs. DCIT 27 ITR (Trib.) 44 decision dt. 16.04.13 and Sri Velayudhaswamy Spinning Mills P. Ltd. Vs. DCIT 27 ITR (Trib.) 106 decision dt. 12.06.13.**

- The above decisions pronounced by the **Hyderabad Tribunal and Chennai Tribunal has been followed by the Jaipur Tribunal in case of Shree Cement Ltd. Vs. ACIT 100 DTR 33 decision dt. 27.01.14**

➢ After a series of judgments pronounced in the favour of the assessee, a contrary view is taken by the **Cochin Bench of Tribunal in the case of Apollo Tyres Ltd. Vs. ACIT 31 ITR (Trib.) 477 decision dated 07.03.2014** wherein it is held that income on sale of CER/carbon credit cannot be treated as capital receipt. It is to be treated as profits and gains of business or profession and hence liable for taxation. The following findings were given by the Bench:-

- The assessee is engaged in the business of manufacture of tyres and marketing of same. For the purpose of captive consumption, the assessee is generating electric power by using the gas turbine. In the process of generation of the power, the assessee reduced the emission of carbon dioxide in the atmosphere. Therefore, CER/carbon credit was given to the assessee by the UNFCCC. Hence, it is obvious that the CER/carbon credit was obtained by the assessee in the course of its business activity.

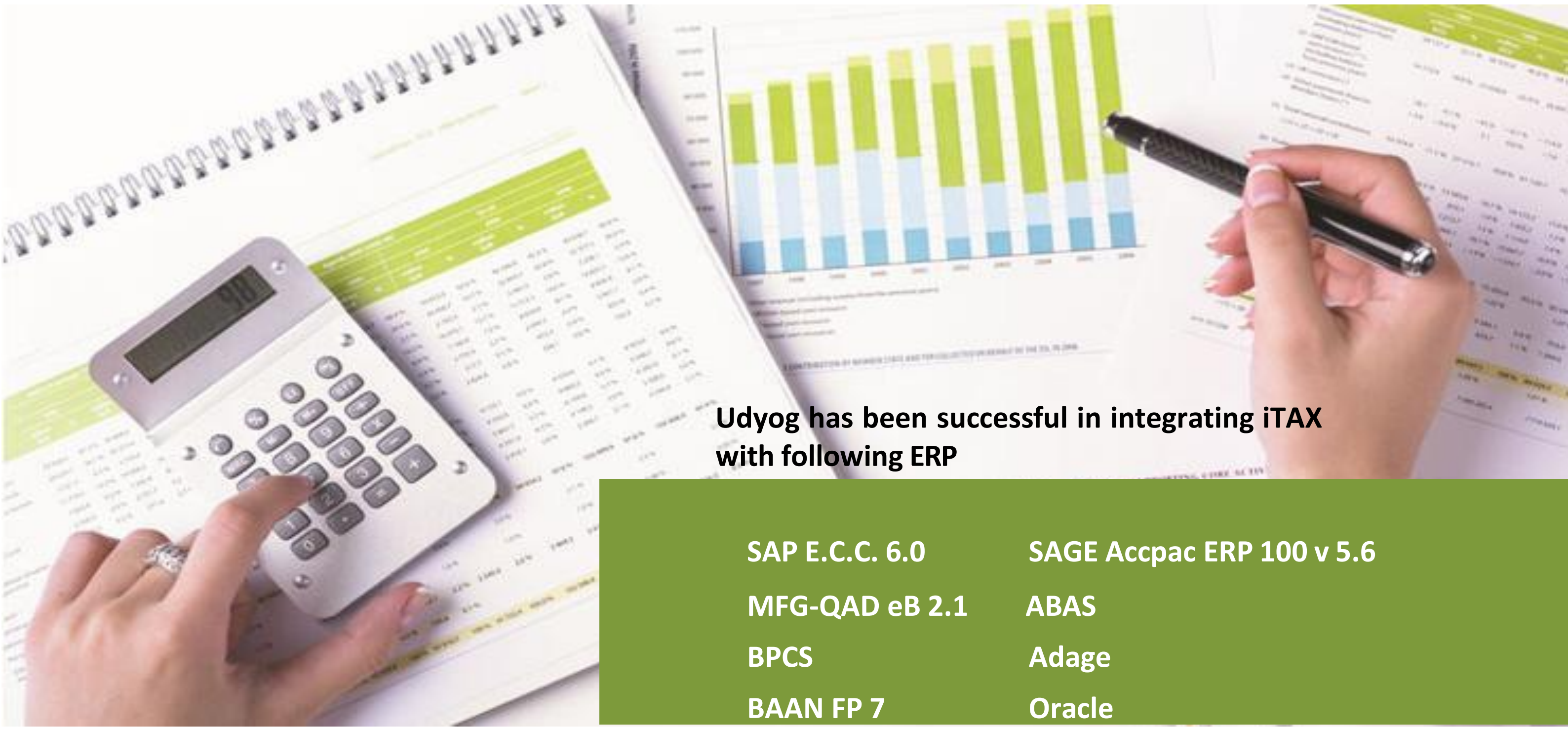
- In view of sec. 28(iv) r.w.s. 2(24)(vd) of the IT Act, it is obvious that the value of any benefit or perquisite arising from business or profession forms part of the profit and gains of the business. Therefore, the income on sale of CER/carbon credit which is admittedly a benefit arising out of the business of the assessee, would fall within the definition of 'income' u/s 2(24)(vd) of the Act. These provisions of IT Act i.e. sec. 2(24)(vd) and section 28(iv) were not brought to the notice of Hyderabad Bench of Tribunal in case of My Home Power Ltd. 21 ITR (Trib.) 186, hence not applicable to the facts of this case. Therefore, income on sale of CER/carbon credit would form part of the chargeable income under the IT Act.

Treatment of Carbon Credit in computing book profit u/s 115JB of the Act

The Jaipur Bench of Tribunal in case of Shree Cement Ltd. Vs. ACIT 100 DTR 33 decision dt. 27.01.14 has held that capital receipt in the form of sales-tax subsidy needs to be excluded in the computation of book profit all the more since they do not have any element of profit embedded in it. Since, carbon credit is also capital receipt which does not have any element of profit embedded in it, receipt on account of carbon credit being purely capital in nature, needs to be excluded in computation of book profit u/s 115JB of the Act.

Conclusion

The Apex Court in case of Vodafone International Holdings B.V. Vs. UOI & Anr. (2012) 341 ITR 1 while deciding an issue on international transaction made a comparative analysis of the provisions of Direct Tax Code (DTC) Bill, 2010 and the IT Act, 1961 and held that treatment of any particular item in a different manner in the 1961 Act and DTC serves as an important guide in determining the taxability of the said item. The proposed Direct Tax Code 2013 vide clause 33(2)(xi) specifically provides that any consideration accrued or received on transfer of carbon credits is business receipt chargeable to tax. However, no such similar provision is present under the current IT Act, 1961. Thus, a view can be taken that the intention of the Parliament is not to tax the CERs, otherwise when the same is included as income in the bill of DTC, there is no other reason as to why the same is not included in sec. 2(24) or sec. 28 of the IT Act, 1961. The Jaipur Bench of Tribunal in case of Shree Cement Ltd. Vs. ACIT 100 DTR 33 decision dt. 27.01.14 has also vide Para 38 of the order has held that since DTC by virtue of the deeming provisions specifically provides for taxability of carbon credit as business receipt and IT Act does not do so, their view gets duly fortified by the principles stated in the above decision of Supreme Court.



Udyog has been successful in integrating iTAX with following ERP

SAP E.C.C. 6.0	SAGE Accpac ERP 100 v 5.6
MFG-QAD eB 2.1	ABAS
BPCS	Adage
BAAN FP 7	Oracle

Updated and written by,

CA P.C. Parwal
pparwal@kalanico.com

CA Sneha Parwal
sparwal@kalanico.com

Consultant to Udyog Software (India) Ltd.
Visit www.udyogsoftware.com
Call us on - 022-67993535
sales@udyogsoftware.com | www.udyogsoftware.com