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**MITIGATING CLIMATE CHANGE THROUGH THE INCOME TAX  
LEGISLATION: A brief analysis of section 12K of the Income Tax Act No 58 of 1962  
and its implications for South African CDM projects**

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## **ABSTRACT**

The importance of taxation laws in moulding our corporate environmental behaviour cannot be over-emphasized. This introduction of new environmentally related taxes and incentives in South Africa is a promising start towards a more environmentally friendly economy in the future. The present dissertation is dedicated to this attempt of making South Africa a more environmentally sustainable economy through the development of new CDM projects. This dissertation examines the introduction of section 12K in the Income Tax Act 58 of 1962 and how this novel incentive interacts with our current income tax legislation. This dissertation highlights some issues surrounding the section 12K exemption which may detract from its true potential and proposes ways to resolve these issues in order to make this incentive more attractive to the CDM project developers.

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Yashaswini Garrod

Cape Town, January 2011

University of Cape Town

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# 1 INTRODUCTION

## 1.1 BACKGROUND

The past few decades have witnessed the issue of climate change metamorphose into a genuine cause of concern for the international community. So much so, that today climate change is the focal point of the most heated debates in the world. Unfortunately, despite the size of its small population and economy, South Africa ranks among the top polluters in the world.<sup>1</sup> As these national emissions are not going unnoticed, there is an ever increasing pressure on the South African government to take active steps to reduce its national emissions.

Currently, there is no consensus in the international community on the best means of achieving emission reduction. The two options that have been long debated are: carbon taxes and cap-and-trade.

### CARBON TAXES vs CAP-AND-TRADE

The starting point is to understand the distinction between carbon tax and cap-and-trade. In simple terms, carbon tax is the tax/price placed by the national government on the carbon emissions generated by the consumption of fossil fuels<sup>2</sup> so the polluter pays for its actions, whereas, the cap-and-trade system places a limit on the total national emission of the country and any emissions above this limit must be acquired through emissions reduction in another jurisdiction.

The proponents of the cap-and-trade model argue that it is a better option for climate mitigation<sup>3</sup> as it places a limit on the national emissions unlike carbon tax which merely

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1 'Global Warming: Each Country's Share of CO<sub>2</sub> Emissions'. Available at: [http://www.ucsusa.org/global\\_warming/science\\_and\\_impact/science/each-countrys-share-of-co2.html](http://www.ucsusa.org/global_warming/science_and_impact/science/each-countrys-share-of-co2.html) [Accessed on 6 October 2010].

2 'Carbon Tax Centre: What's a Carbon Tax'. Available at: <http://www.carbontax.org/introduction/> [Accessed 15 July 2010].

3 The Intergovernmental Panel on Climate Change (IPCC) defines the term 'mitigation' as "Technological change and substitution that reduce resource inputs and emissions per unit of output. Although several social, economic and technological policies would produce an emission reduction, with respect to climate change, mitigation means implementing policies to reduce GHG emissions and enhance sinks". Available at <http://www.ipcc.ch/pdf/assessment-report/ar4/wg3/ar4-wg3-annex1.pdf> [Accessed 5 February 2010].



puts a price on the pollution leaving a choice for the polluter to emit more and pay the price.<sup>4</sup> On the other hand, those who support carbon taxes argue the potential benefits of “double dividend” which arises when the government reduces the taxing of “good” such as employment income (taxation of labour) that it wants to encourage, and impose taxes on the “bad” such as pollution, which the government wants to discourage.<sup>5</sup> The double dividend is achieved as the government not only raises revenue but it also assists the environment. The proponents of carbon tax argue that if implemented in the right fashion carbon taxes can render desirable results for the nation.<sup>6</sup>

The supporters of the cap-and-trade model argue that it offers the state a competitive advantage which is hindered by the domestic tax system which may not be the same as other countries.<sup>7</sup> Whereas proponents of the carbon tax argue that it is relatively easy to calculate and monitor compared with the cap-and-trade system.<sup>8</sup>

There are most certainly pros and cons in both the aforementioned options, which may be the reason behind the new emerging hybrid approach.<sup>9</sup> This view acknowledges that both carbon tax and carbon trade carry their own advantages and disadvantages and by combining the best of both we can achieve an ideal model. Although South Africa currently has certain carbon taxes such as the fuel levy and the latest ad valorem CO<sub>2</sub> emission tax on the new passenger vehicles,<sup>10</sup> it is not exclusively relying on these carbon

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4 Climate Change: Why emission trading is more effective than carbon tax'. Available at <http://www.ieta.org/ieta/www/pages/getfile.php?docID=3259> [Accessed 3 May 2009].

5 William K. Jaeger 'Environmental taxation and the double dividend' (2003) The Internet Encyclopedia of Ecological Economics at page 3. Available at [www.ecoeco.org/pdf/envtaxanddblediv.pdf](http://www.ecoeco.org/pdf/envtaxanddblediv.pdf) [Accessed 5 June 2010].

6 Tuladhar, Sugandha D and Peter J Wilcoxon 'An Econometric Look at the Double Dividend Hypothesis (1998) National Tax Association Proceedings'. Available at: <http://wilcoxon.maxwell.insightworks.com/papers/NTApaper6-pub.pdf> [Accessed 21 July 2010].

7 Graham Terry 'Carbon Tax or Cap-and-trade' Greenhouse Gas Emissions, South African Environmental Taxes, Sustainability South Africa. Available at <http://www.sustainabilitysa.org/CarbonTrading/Carbontaxorcapanandtrade.aspx> [Accessed 21 July 2010].

8 Ibid.

9 PricewaterhouseCoopers 'Carbon Taxes vs Carbon Trading – Pros, cons and the case for a hybrid approach' March 2009. Available at <http://www.ukmediacentre.pwc.com/Media-Library/A-hybrid-carbon-tax-and-trading-scheme-597.aspx> [Accessed 17 July 2009]

10 National Treasury Press Release CO<sub>2</sub> Vehicle Emissions Tax, August 2010. Available at [http://www.treasury.gov.za/comm\\_media/press/2010/2010082601.pdf](http://www.treasury.gov.za/comm_media/press/2010/2010082601.pdf) [Accessed 4 October 2010].

taxes to achieve its emission reduction goals. It will suffice to say that in South Africa the last word on the best way to achieve emission reduction has not yet been spoken.

This debate between carbon tax versus the cap-and-trade model as a means to national emissions reduction is a healthy indicator of the global consensus on climate change mitigation issues.

Although the roots of this global consensus can be traced back to the United Nations Framework Convention on Climate Change (UNFCCC) which opened for signature in 1992 at the Earth Summit in Rio de Janeiro;<sup>11</sup> it was the Kyoto Protocol to the UNFCCC 1997<sup>12</sup> that converted these historical promises into binding obligations internationally. South Africa ratified the Kyoto Protocol on 31 July 2002<sup>13</sup> and like other parties to the Protocol, South Africa is obliged to abide by it.

### KYOTO PROTOCOL

The Kyoto Protocol is undoubtedly the most important international climate change treaty of our time. It is not only the first agreement that **obliges** all member states<sup>14</sup> to take active steps in mitigating the climate change crises by reducing their national greenhouse gas (GHG) emissions<sup>15</sup> but also acknowledges the UNFCCC principle of “*common but differentiated responsibilities*”.<sup>16</sup>

In simple words, the principle of “*common but differentiated responsibilities*” states that equal treatment of all parties to the Protocol would result in undue hardship for those developing states that lack the capabilities to meet their environmental obligations to the same extent as developed states.

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11 United Nations Framework Convention on Climate Change (1992). Available at <http://unfccc.int/resource/docs/convkp/conveng.pdf> [Accessed 12 July 2010].

12 Kyoto Protocol to the United Nations Framework Convention on Climate Change (1998). Available at <http://unfccc.int/resource/docs/convkp/kpeng.pdf> [Accessed 11 May 2010].

13 'International Conventions and Protocols On Climate Change' The Department of Environmental Affairs of Republic of South Africa. Available at [http://www.environment.gov.za/Documents/Documents/2003May26/climate\\_change\\_conventions\\_26052\\_003.html](http://www.environment.gov.za/Documents/Documents/2003May26/climate_change_conventions_26052_003.html) [Accessed 21 July 2010].

14 The terms “member states” and “parties to the protocol” are used interchangeably in the present dissertation and refer to those sovereign states that have ratified the Kyoto Protocol.

15 Kyoto Protocol (Note 12) at Art 3.

16 UNFCCC (Note 11) at Art 3(1).

It was the recognition of this UNFCCC principle that resulted in the historically bigger emitters<sup>17</sup> (hereinafter referred to as the Annex I countries) having more onerous obligations under the Kyoto Protocol than the developing member states.<sup>18</sup> The Annex I parties are obliged to limit their GHG emissions in terms of the Kyoto Protocol<sup>19</sup> by not exceeding their permissible GHG emissions during the first commitment period (2008-2012).<sup>20</sup> These permissible emissions are called the “assigned amount” under the Kyoto Protocol.

The Kyoto Protocol also provides some useful mechanisms for the parties to assist them to achieve their commitments of emission reductions. For example, Article 2 of the Protocol requires the Annex I Parties to implement some form of national policy aimed at fostering the goals of the Protocol.<sup>21</sup> The other means of achieving emission reduction can be found under Article 6, 12 and 17 of the Kyoto Protocol. These three articles provide for three important “market-based” mechanisms (also known as the Kyoto flexible mechanisms) which may be used by the parties to achieve their commitment targets.

Two of these mechanisms are project based mechanisms<sup>22</sup> that encourage parties to work across their national borders towards the common climate goal. The aim of such cross-border interaction is to stimulate the transfer of energy efficient technology from Annex II<sup>23</sup> countries to Annex I Economies in Transition (EIT) and Non Annex parties,<sup>24</sup> while simultaneously allowing all the parties to achieve their international environmental and economic goals. In other words, these market-mechanisms offer the desired means to strike a balance between the need for economic and environmental development.

17 Parties in Annex I to the Protocol with emission reduction commitments stipulated in Annex B to the Kyoto Protocol.

18 These developing economies with no emission reduction targets in terms of the Kyoto Protocol are referred to as the Non Annex I states.

19 'Negotiating the transfer and acquisition of project-based carbon credits under the Kyoto Protocol' (UNIDO) Vienna, 2007 at page 8. Available at [http://www.unido.org/fileadmin/user\\_media/Publications/Pub\\_free/Negotiating\\_transfer\\_and\\_acquisition\\_of\\_project\\_based\\_carbon\\_credits\\_under\\_Kyoto\\_protocol.pdf](http://www.unido.org/fileadmin/user_media/Publications/Pub_free/Negotiating_transfer_and_acquisition_of_project_based_carbon_credits_under_Kyoto_protocol.pdf) [Accessed 10 January 2009].

20 Kyoto Protocol (Note 12) at Art 3.

21 Kyoto Protocol (Note 12) at Art 2.

22 These mechanisms allow the Annex I parties to engage in a specific emission reduction projects / a business activity that aims to reduce emission levels in other countries.

23 Annex II to the UNFCCC. These are countries listed in Annex I to the UNFCCC but not Economies in Transition.

24 UNIDO (Note 19) at page 9.

The first market-based mechanism is a project based mechanism that finds its origin in Article 6 of the Kyoto Protocol. It allows an Annex I party to invest in an emission reduction project in another Annex I party (economies in transition 'EIT') resulting in emission reduction in the latter Party. As this mechanism is only available to Annex I countries and South Africa is not an Annex I country, this mechanism will not be further discussed in this dissertation.

The second market-based mechanism is known as the “clean development mechanism” (CDM). This project based mechanism finds its origin in Article 12 of the Kyoto Protocol which gave rise to the introduction of section 12K in the Income Tax Act 58 of 1962 which is the subject matter of the present study. This market based mechanism allows an Annex I party to invest in an emission reduction project in a Non Annex Party (host party) resulting in emission reduction in the latter. The consequence of such emission reduction is the generation of certified emission reduction units (CER) by the host party, that can be ultimately used by an Annex I party to discharge its Kyoto obligation. As these projects are carried out in Non Annex parties, such as South Africa who do not as yet have any emission reduction commitments, the CDM projects offer a convenient mechanism for achieving the Annex I emission reduction commitments while simultaneously assisting in the sustainable economic development of the Non Annex countries.<sup>25</sup>

The third market-based mechanism is not a project-based mechanism and it finds its origin in Article 17 of the Kyoto Protocol. It allows the Annex I parties to participate in emissions trading with other Annex I parties. This mechanism provides these parties the freedom to transfer or acquire any Kyoto units<sup>26</sup> to assist them to meet their commitments.<sup>27</sup> The participation in emissions trading is limited to those parties that are included in Annex I with commitments stipulated in Annex B to the Protocol. Although this mechanism is not directly available to the Non Annex countries such as South Africa, CERs are readily traded on such carbon markets<sup>28</sup> and their tax treatment in the host country plays an

<sup>25</sup> Refer to Annexure 1 for a summary of various stages in the life of a CDM project.

<sup>26</sup> The term Kyoto units refers to CERs and ERUs acquired in terms of one of the flexible mechanisms under the Kyoto Protocol.

<sup>27</sup> Seventh Conference of the Parties (COP) Marrakesh (2001) Decision 18/CP.7 at page 52-59. Available at <http://unfccc.int/resource/docs/cop7/13a02.pdf> [Accessed 10 August 2009].

<sup>28</sup> “Carbon market” is a generic term used to refer to all existing emissions trading schemes. An example of

important part in the investor's choice between various Non Annex jurisdictions. It is therefore crucial to investigate the South African tax treatment of CERs generated by the CDM projects within the Republic.

## **1.2 SOUTH AFRICAN TAX TREATMENT OF CERs**

The year 2008 marked the beginning of the first emission reduction commitment period under the Kyoto Protocol. Although South Africa has registered more than 15 CDM projects in this period, this is a relatively small number of projects compared to other developing economies like India and China. Acknowledging that the lack of clarity on the income tax implications of certified emission reduction units may have been the reason for the slow development of CDM projects in South Africa, the then South African Minister of Finance announced the National Treasury's intention to introduce certain tax incentives for the disposal of primary certified emission reduction (pCERs) generated by the CDM projects.<sup>29</sup> The two options that were initially mentioned during the 2009 National Budget Speech were: either to exempt the income from disposal of pCERs, or to subject the receipt and accrual from the disposal of pCER to capital gains tax instead of the normal income tax.

This announcement was shortly followed by the Draft Taxation Laws Amendment Bill issued on 1 June 2009, where the National Treasury proposed the introduction of a new section 12K in the Income Tax Act No 58 of 1962 ("the Act") exempting any income derived from the sale of pCERs for the purposes of normal tax. Section 12K which was finally promulgated on 30 September 2009 by the Taxation Laws Amendment Act 17 of 2009<sup>30</sup> ("TLAA"), provides an exemption from the normal tax on disposal of CERs in the hands of the primary holder. In other words, the exemption is only available on the disposal of pCERs and not on the disposal of secondary certified emission reduction units ("sCERs").<sup>31</sup> So far as the disposal of sCER is concerned, it is to be treated as normal

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a carbon market is the European Union Emission Trading Scheme (EUETS) which is one of the biggest carbon markets in the world today. Available at <http://www.ecx.eu/What-is-the-EU-ETS> [Accessed 10 July 2010].

29 Budget 2009/10 Tax Proposal, South African Revenue Service (SARS) Available at <http://www.treasury.gov.za/documents/national%20budget/2009/guides/Budget%20Proposals%202009.pdf> [Accessed 1 September 2009].

30 Taxation Laws Amendment Act 17 of 2009.

31 Refer to Annexure 2 for the distinction between pCERs and sCERs.

trading stock.<sup>32</sup>

The new section 12K of the Act is a retrospective piece of legislation, which is deemed to have come into operation on 11 February 2009 and applicable to receipts and accrual from disposal of pCERs on or after that date. The application of section 12K is restricted to a “qualifying CDM project”, consequently it only exempts income in respect of pCERs derived from the projects registered on or before 31 December 2012 and disposed on or after 11 February 2009. Furthermore, the exemption is only available for the projects located within the Republic of South Africa.

### **1.3 INTRODUCTION OF SEPARATE SECTION 12K EXEMPTION**

Today, with the introduction of the section 12K exemption, South Africa has become one of the few countries in the world with special provisions for the taxation of CERs.<sup>33</sup> Despite the fact that all the other exemptions in the Act are incorporated in section 10, the legislature drafted a separate section 12K to avoid any unforeseen implications following from the inclusion of this novel concept into the Act.<sup>34</sup> Whether the legislature achieved this goal through introduction of a separate section is questionable, as section 12K certainly carries some issues that require some consideration.

### **1.4 OBJECTIVES AND APPROACH**

This dissertation will discuss the interaction of section 12K with three specific areas of the Act. The aim of the present dissertation is to highlight the issues surrounding the section 12K interaction with section 11(a), the general deduction formula; section 12K interaction with section 22, the trading stock provisions and section 12K interaction with Part VII, the secondary tax on companies' provisions. As the issues highlighted in the present dissertation can potentially defeat the underlying purpose behind the introduction of this novel provision, it is relevant to address these issues in the current climate.

The present dissertation aims to offer a good understanding of some of the preliminary

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<sup>32</sup> Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009 at page 29.

<sup>33</sup> Anuschka Bakker 'Tax and the Environment: A world of possibilities' 2009 IBFD.

<sup>34</sup> According to the information provided by the drafter of the Taxation Laws Amendment Bill, 2009 to the writer of the present dissertation.

issues surrounding the taxation of pCERs in South Africa and hopes to serve as a starting point in the domestic attempts to make section 12K a genuinely attractive incentive for the CDM investors.

This dissertation begins with a brief discussion of the legal nature of pCERs which may impact a taxpayer's rights associated with CERs and provides some existing international views on the topic. However, as the main focus of the present dissertation is the interaction of section 12K with section 11(a), section 22 and Part VII of the Act, the dissertation will discuss each of the aforementioned areas respectively. This dissertation refers to relevant legislative and common law rules to the extent it is useful in the context. This dissertation sought to highlight specific issues with the help of hypothetical examples to make the issues more accessible to the reader.

Furthermore, as the National Treasury never debated the pros and cons of the two initially proposed incentives (exemption and capital gains tax), the present dissertation will also undertake a brief discussion of some of the issues that would have arisen had the National Treasury opted to subject the receipt and accrual from the disposal of pCERs to capital gains tax (CGT). However, as this is not the main focus of the present dissertation the discussion does not aim to offer an in-depth analysis of the topic.

Acknowledging the novelty of the present topic, there may be number of issues that are not addressed in the present dissertation and which may form the basis of future research.

Please note that, unless indicated otherwise, any references to the sections or schedules in the present dissertation refer to the sections and schedules of the Income Tax Act No 58 of 1962 ("the Act") and any reference to Amendment Act refers to the Taxation Laws Amendment Act No 17 of 2009.

## 2 NATURE OF CERTIFIED EMISSION REDUCTION UNITS

### 2.1 INTRODUCTION

As mentioned previously, emissions trading became a global phenomenon with the introduction of the Kyoto Protocol. Despite the recent global economic turmoil, emissions' trading remains a multi-billion dollar industry worldwide. This is enabling the participants to trade in emissions in a traditional fashion on recognised climate exchanges such as the Chicago climate exchange (CCX), the European Climate Exchange (ECX) and the European Energy Exchange (EEX). This multi-billion dollar trade raises one vital question: what exactly is being traded?

What is the legal nature of emission reduction units or CERs?

As the legal nature of any right or property is a pre-requisite to an understanding of the holder's ability to deal<sup>35</sup> in those rights/property and its income tax implications; it will be prudent to briefly discuss the nature of these CER units prior to proceeding with the discussion of the section 12K exemption.

It what follows, the present chapter will briefly analyse some of the international views on the legal nature of CERs and the merits of these views.

### 2.2 INTERNATIONAL POSITION ON THE LEGAL NATURE OF CERs

Currently there is a lack of clarity in the international community as to the legal nature of the emission reductions. Some argue that emissions reductions/carbon credits are comparable to currency<sup>36</sup> whereas others regard these credits akin to commodity.<sup>37</sup> Some sovereign states regard these emission reductions as intangible rights while others regard them as financial instruments.<sup>38</sup> There are also those who support the treatment of emission

<sup>35</sup> The holder's ability to create, cede or dispose of a CER.

<sup>36</sup> Jillian Button 'Carbon: Commodity or Currency? The case for an international market based currency model' (2008) 32 *HELR*. Available at [http://www.law.harvard.edu/students/orgs/elr/vol32\\_2/Button%20Final%20Final.pdf](http://www.law.harvard.edu/students/orgs/elr/vol32_2/Button%20Final%20Final.pdf) [Accessed 21 September 2009].

<sup>37</sup> Martijn Wilder 'et al' 'Carbon Contracts, Structuring Transactions: Practical Experiences' (2005). Available at <http://www.bakernet.com/NR/rdonlyres/1298A282-673A-4E4E-9D2B-C3552030E375/40202/CarbonContracts.pdf> [Accessed 11 July 2009].

<sup>38</sup> Kenneth Markowitz and Jessica Davies 'Property Rights Conveyed by Emission Allowances: An



reductions as ordinary “property rights”.<sup>39</sup>

These aforementioned conflicting views corroborate the argument that the legal nature of emission reduction credits is a complex area in need of further investigation. Although each view contains its own merit, there are corresponding weaknesses in each argument.

### **2.3 ANALYSIS OF THE LEGAL NATURE OF CERs**

Unlike some European jurisdictions, South Africa has not as yet adopted an official stance on the legal nature of CERs. This lack of debate in the South African legal community on the classification of CERs also explains the dearth of literature on this issue within the Republic.

In the absence of such debate and due to the lack of literature in South Africa: this chapter will briefly analyse the traditional understanding of some of the aforementioned international classifications of CERs and whether these classifications can be harmonised with our basic understanding of CERs.

#### **2.3.1 THE DEFINITION OF “CERTIFIED EMISSION REDUCTION” UNIT**

Certified Emission Reduction unit was defined in the UNFCCC Report of the Conference of the Parties Serving to the Kyoto Protocol held at Montreal in 2005 as follows:

“A “certified emission reduction” or “CER” is a unit issued pursuant to Article 12 and requirements there under, as well as the relevant provisions in these modalities and procedures, and is equal to one metric tonne of carbon dioxide equivalent, calculated using global warming potentials defined by decision 2/CP.3 or as subsequently revised in accordance with Article 5.”<sup>40</sup>

Basically a CER unit represents one tonne of CO<sub>2</sub> equivalent of emissions that was prevented from being released into the earth’s atmosphere. In what follows, the discussion

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Analysis' Climate Regulation Series, AKIN GUMP STRAUSS HAUER & FELD LLP at page 3.

39 M.J. Mace 'Legal Nature of Emission Reductions and EU Allowances' (2005) 2 (2) Journal for European Environmental and Planning Law at page 12 Available at <http://www.field.org.uk/files/Legal%20Nature%20JEEPL%20Article.pdf> [Accessed 16 June 2009].

40 Conference of the Parties Serving as the Meeting of the Parties to the Kyoto Protocol at Montreal FCCC/KP/CMP/2005/8/Add.1 Decision 3/CMP.1, Annex para 1(b) <http://cdm.unfccc.int/Reference/COPMOP/08a01.pdf> [Accessed 29 May 2009].

will focus on whether this definition of CERs can be harmonised with some common international classifications of CERs.

### 2.3.2 CERs AND CURRENCY

One view on the legal nature of CERs suggests that these units are akin to currency.<sup>41</sup> However, prior to proceeding with the comparison of CERs with “currency” we need to understand what is understood by the term “currency”?

According to the Blacks Law dictionary “currency” is:

“An item (such as a coin, government note or banknote) that circulated as a medium of exchange”.<sup>42</sup>

According to the above definition, the fundamental characteristic of currency is that it is a *medium of exchange*. If CERs were akin to currency, CERs will be capable of being described as a medium of exchange. In other words, in order to determine whether CERs are akin to currency we need to determine whether CERs can be used as a medium of exchange in the present day world.

It is respectfully submitted that CERs are not akin to currency as understood in the traditional sense. This is because where currency is a recognised medium of exchange, CERs are a recognised medium of discharging only the Kyoto obligations.

The example below illustrates the problem in describing CERs as currency in its traditional sense:

- **Currency as a medium of exchange** – Currency/Money is the accepted medium of exchange in the modern day world. It provides us with a commonly acceptable standard which is readily exchangeable for goods and services. For example – If Mr A needs a can of baked beans he can go to the supermarket with *money* (acceptable currency) and exchange his money for a can of beans on the shelf. However, Mr A cannot offer the supermarket a sack of oranges in exchange for a can of beans that

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<sup>41</sup> Button (Note 36).

<sup>42</sup> Bryan A. Garner, *Black's Law Dictionary* 9<sup>th</sup> edition 2009.

he wants (ancient barter system).

- **CERs are a means to discharge the Kyoto obligations** – The ultimate use of a CER is to discharge the emission reduction obligations created under the Kyoto Protocol. These CER units are not readily exchangeable for goods and services. For example – If Mr A needs a can of baked beans he cannot go to the supermarket with CERs and exchange them for a can of baked beans on the shelf or purchase gas from a gas station with his carbon card.

As CERs are not an acceptable medium of exchange at present in any sovereign jurisdiction, it is submitted that CERs are not akin to “currency” as traditionally understood.

Although CERs may have elements of “currency” such as the manner in which they come into existence and how they may lose their recognition,<sup>43</sup> CERs at present lack the most fundamental characteristic of any currency, which is: recognised medium of exchange. It is conceivable that in future, the domestic and international laws of sovereign states may bestow the status of currency on CERs. For example, the suggestion of introducing “carbon ration cards” in the United Kingdom requiring individuals to use their carbon card when they purchase petroleum, energy or air tickets debiting their carbon account.<sup>44</sup> It may be difficult at that stage to distinguish between currency and carbon credits, however it will be sometime before this or similar concepts become a reality and until such time we could dismiss this comparison and proceed with the analysis of other more commonly used classification of CERs.

### 2.3.3 CERs AND COMMODITY

A more common classification of CERs is to describe them as a “commodity”, capable of being traded on the commodities market. To determine the validity of this argument, one is required to have a basic understanding of the term “commodity”.

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<sup>43</sup> Button (Note 36) at 577.

<sup>44</sup> The Daily Mail electronic news. Available at: <http://www.dailymail.co.uk/news/article-1021983/Every-adult-Britain-forced-carry-carbon-ration-cards-say-MPs.html> [Accessed on 8 December 2010].

According to the Blacks Law dictionary a “commodity is:

“An article of trade or commerce. The term embraces only tangible goods, such as products or merchandise, as distinguished from services.”<sup>45</sup>

In light of the above definition a “commodity” has two main requirements: firstly, it must be an item of “trade or commerce” and secondly it must be “tangible”.

It is trite that CERs have a monetary value and are capable of being purchased and sold in the market, therefore it is submitted that CERs satisfy the first requirement of commodity. However, the second requirement that only tangible goods can be classified as a commodity poses a hurdle for CERs.

This is due to the fact that unlike coal or petrol which are tangible commodities, CERs only come into existence with the abatement of greenhouse gas emissions (GHG). Although GHG are tangible because they are capable of being measured in the earth's atmosphere, their abatement is not tangible, for it reflects the absence of something that was never produced. It is for this reason CERs are considered notional units (representing the pollution avoided).

However, this hurdle could be circumvented if instead of representing abatement of one tonne of CO<sub>2</sub> equivalent of GHG, a CER represented one tonne of oxygen, nitrogen or carbon dioxide (all these gases are tangible as they have a mass and substance and form the earth's atmosphere).

The argument is that, at present CERs represent the notional amount of GHG or dangerous gases that were never emitted into the earth's atmosphere. While it represents the amount of pollution never emitted in the earth's atmosphere, it also represents the preservation/generation of one of the essential gases in the atmosphere.

To put it differently, the emission reduction units could potentially represent both: the harm

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<sup>45</sup> Bryan A. Garner (Note 42).

that is avoided by abatement of ghg as well as the preservation of tangible gases in the atmosphere by refraining from emitting certain ghg in the atmosphere. If one accepts that a CER represents the preservation of tangible gases in the atmosphere, it will satisfy the second requirement of “commodity”.

To explain by means of an example:

If a CER represents preservation of oxygen in the earth's atmosphere, each CERs unit will represents preservation of a calculated amount of oxygen in the atmosphere. As oxygen is a tangible gas capable of being measured, stored and traded in the commodities market, a CER unit representing it will also satisfy the two requirements of “commodity”. This may be one way we can regard CERs as commodity.

This argument may be further strengthened if one looks at the objectives as set out in Article 2 of the UNFCCC which states:

The ultimate objective of this Convention and any related legal instruments that the Conference of the Parties may adopt is to achieve, in accordance with the relevant provisions of the Convention, stabilization of greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system. Such a level should be achieved within a time frame sufficient to allow ecosystems to adapt naturally to climate change, to ensure that food production is not threatened and to enable economic development to proceed in a sustainable manner.<sup>46</sup>

The aforementioned objective states that, in order to mitigate climate change, the emission of GHG resulting in rapid climate change need to be reduced. Each time we emit GHG that results in the destruction/imbalance of these atmospheric gases, we consume part of the earth's healthy atmosphere and accelerate the climate change process. In order to stop further damage to the atmosphere, the Kyoto Protocol imposed limits on the consumption of this finite resource (earth's atmosphere which can be destroyed by emission of dangerous greenhouse gases).

In instances where the nations with prescribed limits exceed their emissions, they are

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<sup>46</sup> UNFCCC (Note 11) Art 2.

obliged to purchase an equivalent part of the atmosphere. As CERs represent the amount of GHG that were prevented from being released into the earth's atmosphere, they simultaneously represent that portion of the atmosphere that has either not yet been consumed or has been created by certain activities such as afforestation and reforestation. This portion of the atmosphere comprises of tangible gases which are capable of being measured and may be represented by CERs.

If one accepts the above, one could accept that CERs are a new kind of commodity. The above discussion illustrates that although at first glance it may appear unlikely that CER could fall within the ambit of commodity definition, this classification is not completely without merit.

This takes the discussion to the analysis of the next common classification of CERs as a type of financial instruments.<sup>47</sup> In what follows the dissertation will briefly analyse the accounting definition of financial Instruments as defined in the International Financial Reporting Standards (IFRS) and whether CERs can rightly be described as financial instruments.

#### **2.3.4 CERs AND FINANCIAL INSTRUMENT**

According to the IFRS definition, a “financial instrument” is:

“[A]ny contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity”.<sup>48</sup>

According to the IFRS definition, a financial instrument is a contract giving rise to an asset in the hands of one and a liability in the hands of another. The IFRS definition of an asset includes a contractual right and the definition of liability includes a contractual obligation.

In what follows, the present dissertation will argue that CERs do not fall within the above

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<sup>47</sup> CER units fall under the umbrella term “carbon credit” which is defined as a type of financial instrument in the CO2 Capture Project Glossary Available at <http://www.co2captureproject.org/glossary.html> [Accessed 1 September 2010].

<sup>48</sup> International Accounting Standard 32 Financial Instruments: Presentation. Available at [http://ec.europa.eu/internal\\_market/accounting/docs/consolidated/ias32\\_en.pdf](http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias32_en.pdf) [Accessed 1 June 2010].

definition of financial instrument for the reasons given below.

The definition of financial instruments provides that there must be a *contract*. As discussed in the previous chapter, in order for a party to generate CER there must be national compliance with the Kyoto Protocol. In other words, only entities from those sovereign states that are signatory to the Kyoto Protocol (international treaty/contract) and who have ratified this treaty can participate in the CDM projects that generate CER. As CERs are a result of an international contract the present dissertation concedes that CERs satisfy this first requirement of being regarded as a financial instrument. However, in order to be classified as a financial instrument it is imperative that CERs satisfy all three requirements of the aforementioned definition of financial instrument.

According to the definition of financial instrument, the contract must give rise to an asset in the hands of one party and a liability of another.

The definition of asset is a substantially wide definition and easily encapsulates any right or item with a monetary value. It is trite that CERs have a monetary value and are readily traded in international markets in a similar fashion to derivatives and forwards. So provided the Kyoto Protocol remains in effect, a CER can easily qualify as an asset in the hands of the holder. In light of the above it is submitted that CERs satisfy the second requirement of the definition of financial instruments.

The last requirement of a financial instrument is connected with the second requirement i.e the asset in the hands of one party must constitute a corresponding liability in the hands of another.

This is the most difficult requirement to satisfy when dealing with CERs. This is due to the fact that, although CER constitutes asset in the hands of the holder, this unit may not necessarily give rise to a corresponding liability of another party. This submission is based on the interpretation of the Kyoto Protocol as recognised in the Marrakesh Declaration. The Marrakesh Declaration expressly states that the Kyoto Protocol does not create “any

right, title or entitlement”.<sup>49</sup> In the absence of any such right, title or entitlement a CDM project owner who holds CER or who anticipates the generation of CER does not have any enforceable right in the circumstances where CER becomes valueless because of some unforeseen circumstance.

To explain the above submission with the aid of an example –

A CDM project owner generates 1000 CERs in year 1 and in the same year the Kyoto Protocol expires. The expiration of the Kyoto Protocol results in relieving the states from their obligation to reduce the emission reduction targets that in result plummets the value of CERs to nil. In such circumstances, the project owner or the holder of CER cannot enforce his claim for the loss in the value of CER held by it against the United Nations or any other entity. This is because the Kyoto Protocol never bestowed any right, title or entitlement with the introduction of CDM, JI and ET. It is this absence of right, title or entitlement that results in the failure to satisfy the last but a fundamental requirement of financial instruments (i.e the corresponding liability).

In light of the aforementioned argument it is submitted that CERs could not be classified as financial instruments or at the very least may not have the potential to be classified as financial instruments. Although the asset and liability created by the international contract (Kyoto Protocol) largely depends on the national compliance with the treaty, even if all such requirements are satisfied a CER will not easily fall within the definition of a financial instrument.

As a financial instrument can also be regarded as property in the hands of one person, the last view to be discussed in the present chapter is whether CERs are a form of property right?

### **2.3.5 CER AND PROPERTY RIGHTS**

There is some support for the argument that CER are a form of property right. This view is

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<sup>49</sup> The Marrakesh Accords - Work Program on Mechanisms DECISIONS 7/CP.4 AND 14/CP.4 Available at [http://unfccc.int/cop7/documents/accords\\_draft.pdf](http://unfccc.int/cop7/documents/accords_draft.pdf) [Accessed 1 October 2010].



based on the premise that there are certain property rights attached with CERs such as: the right of the holder of CERs to dispose off CERs to a willing buyer in the same fashion as disposal of any other private property owned by such person or the right to retain CERs for consumption.

Traditionally property rights give the owner, the right to possess, sell, consume or dispose of the subject matter of the right. The property rights also provide a right of recourse to the owner against any person who unlawfully deprives that owner of his property. However, whether CERs carry all the attributes of *property* (own emphasis) as traditionally understood is unclear. Although one may argue that CERs carry the usual property rights as a matter of common law; it is unclear whether the South African courts of law will be willing to confirm these rights. The biggest risk in confirming full property rights to CERs may open the floodgates of claims arising from all kinds of instances of CER deprivation. Such instances could include anything from a claim arising as a failure to renew the emissions trading scheme in the post Kyoto regime to instances where specific CERs are suspended / cancelled while in the holder's account. This will further raise the issue of who should be liable to compensate the CER owner in instances where such owner is deprived of the ability to trade in them as a result of state's failure to meet its Kyoto obligations.

Furthermore, treating emission reductions as "property rights" would also be in conflict with the principle that natural resources such as the earth's atmosphere are the responsibility and property of the state, which are available for the reasonable use and enjoyment of all citizens.<sup>50</sup> Whether the primary CERs will qualify as ordinary property rights is an area which requires further research and guidance from the legislature. However, in light of the above discussion of the basic characteristics of property rights, it is submitted that CERs cannot be easily equated to ordinary property rights.

### **2.3.6 CERs AND INTANGIBLE RIGHTS**

If CERs could be classified as property right, they will fall within the category of intangible property rights due to their incorporeal nature (for example copyright, trademark or patent). However CERs as intangible right will give rise to another question which will

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<sup>50</sup> Wilder 'et al' (Note 37) at page 301.

need to be addressed should the legislature decides to classify CERs as intangible rights. The question is one of source of CERs. As CERs only come into existence on certification of emission reduction, which might often be done in a country other than the one where the CDM project is located, one will have to determine the source of such CER. The landmark South African judgment on the topic of source was provided by the Appeal Court in the case of *CIR v Lever Brothers & Unilever Ltd* 14 SATC 1 where Watermeyer CJ said the following:

“[T]he source of receipts, received as income, is not the quarter whence they come, but **the originating cause of their being received as income**, and that the originating cause is the work which the taxpayer does to earn them, the quid pro quo which he gives in return for which he receives them.”

In light of the above, the source of CERs will be deemed to be the place where the CDM project is located, being the originating cause of the emission reduction that gives rise to the certification process. Although resolution of the source of CERs may at times be more complex than as stated above, the wealth of case law on the topic in South Africa will provide sufficient guidance to CDM project owners. However, the bigger issue will be overcoming the hurdle of classifying CERs as a property right in the first place for the reasons discussed under paragraph 2.3.5 above.

## 2.4 CONCLUSION

In light of the above discussion, it is clear that the legal nature of CERs is a vexed question and not capable of a straightforward answer. It may be that this ongoing uncertainty can only be resolved by the domestic laws of each sovereign state.<sup>51</sup> However, until such time the CER owners will have to accept the uncertainty surrounding these novel units.

Although the legal nature of CERs is a topic of increasing interest, it does not restrict the South African legislature from taking a stance for the purposes of the income tax legislation. The South African Income Tax legislation could deem CERs to be anything the legislature considers appropriate. However, this does not diminish the relevance of this discussion for a better understanding of CERs.

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<sup>51</sup> Markowitz and Davies (Note 38) at page 3.

### **3 DEDUCTIBILITY OF EXPENSES INCURRED BY SOUTH AFRICAN CDM PROJECTS**

#### **3.1 INTRODUCTION**

The original intention behind the introduction of the exemption in section 12K was to provide an incentive that would encourage the development of new CDM projects in South Africa. However, one of the direct consequence of providing an incentive in the form of an income tax exemption is non deductibility of expenses in terms of section 11(a) of the Act.

The general deduction formula, as discussed below, allows for the deduction of any expenditure and losses actually incurred in the production of income from carrying on any trade, provided they are not of a capital nature. This non-deductibility of expenses is further endorsed by section 23(f) of the Act which provides that, a deduction shall not be allowed where an expenditure was incurred in respect of an amount that does not constitute “income”.<sup>52</sup> The term “income” is defined in section 1 of the Act as any amount remaining after excluding any exempt amounts.<sup>53</sup>

In summary, any amount which is incurred in the production of an exempt income will not form part of taxpayer's income and therefore will not be deductible in terms of the general deduction formula. In the present chapter, the focus of the discussion will be: whether the exemption in section 12K restricts the ability of South African CDM projects to claim a deduction for expenditure incurred in terms of section 11(a)? If yes, how this may diminish the incentive that was initially contemplated by the National Treasury with the introduction of section 12K?

#### **3.2 THE GENERAL DEDUCTION FORMULA**

Unless a deduction for an expenditure is specifically provided for in Part I of the Act, it may be deductible under the general deduction formula. The general deduction formula of section 11(a) provides that, in order for an expense or loss to be deductible it must satisfy

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<sup>52</sup> Income Tax Act 58 of 1962 s 23(f).

<sup>53</sup> Income Tax Act 58 of 1962 s 1.

all the requirements of section 11(a) as read with section 23(g) of the Act.

Section 11(a) of the Act reads as follows:

“For the purposes of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived -

- (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;”<sup>54</sup>

The general deduction formula above lists five requirements, that must be satisfied prior to claiming a deduction thereunder. These five requirements are as follows:

1. The deduction must be claimed for income derived from carrying on a trade,
2. The deduction claimed for expense or loss must be actually incurred,
3. The expense or loss sought to be deducted must have been incurred during the year of assessment,
4. The expense or loss must be incurred in the production of income and
5. The expense or loss must not be of a capital nature.

Over the years, all these requirements have been scrutinized and ruled upon by South African courts of law, creating invaluable precedent which will act as a guide for all South African CDM projects. In what follows, each of these requirements will be discussed respectively with specific consideration for CDM projects and their ability to satisfy these requirements.

### **3.2.1 CDM PROJECTS AND THE 'CARRYING ON A TRADE' REQUIREMENT**

The term “trade” is defined widely in section 1 of the Act and includes every 'profession, trade, business, employment, calling, occupation, or venture including letting of any property'.<sup>55</sup> Although CDM projects are likely to fall within the ambit of business, in case of uncertainty guidance can be sought from the common law.

The term “carrying on a trade” has been interpreted by South African courts of law on various occasions. The courts have accepted that an endeavour to earn income may be

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<sup>54</sup> Income Tax Act 58 of 1962 s 11(a).

<sup>55</sup> Income Tax Act 58 of 1962 s 1.

sufficient to satisfy the requirement of carrying on a trade.<sup>56</sup> This would mean that South African CDM projects will be able to satisfy the trade requirement if the primary activity of the CDM project is an income generating activity, irrespective of the fact that the motivation for the development of the CDM project was generation of exempt CERs. In other words, a CDM project that aims to generate normal income as well as exempt income can satisfy the requirement of “carrying on a trade”.

However, one must bear in mind that an endeavour to earn income is just one of the various indicators in the determination of the trade requirement, there is nothing that restricts a CDM projects from using one or more of the other indicators to satisfy this first requirement.

The next requirement of section 11(a) is that the expenditure or losses must be “actually incurred”. The question for any South African CDM project here will be: when can a CDM project claim to have actually incurred the expense that it seek to deduct?

### **3.2.2 CDM PROJECTS AND EXPENDITURE 'ACTUALLY INCURRED'**

The term “actually incurred” has been subject of much judicial consideration in South Africa and the common view is that, an amount is actually incurred when there is “an absolute and unconditional liability to pay at the end of the year”.<sup>57</sup> An unconditional liability to pay does not exclusively refer to an outstanding liability to pay but also where the liability to pay an amount is discharged in the same year or the amount was actually paid.<sup>58</sup> The court in *Port Elizabeth Electric Tramways Co Ltd v Commissioner for Inland Revenue* [1935] 8 SATC 13 (C) (*Port Elizabeth* case) emphasized that although it is not a pre-requisite that the amount claimed as a deduction is actually paid, it is essential for the deductibility of any amount that there be a liability to pay it.<sup>59</sup> In the recent Supreme Court of Appeal judgment of *Ackermans v Commissioner for South African Revenue Service* [2010] JOL 26200 SCA (*Ackermans* case) the court interpreted the term “actually

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<sup>56</sup> *The Commissioner for South African Revenue Service v Megs Investments (Pty) Ltd and Another* 2004 SCA at paragraph 8. Available at: [http://www.justice.gov.za/sca/judgments/sca\\_2004/2003\\_034.pdf](http://www.justice.gov.za/sca/judgments/sca_2004/2003_034.pdf) [Accessed 20 October 2010].

<sup>57</sup> *Nasionale Pers Bpk v Kommissaris Van Binnelandse Inkomste* 1986 (3) SA 549 (A);  
*Edgars Stores v Commissioner for Inland Revenue* 1988 (3) SA 876 (A).

<sup>58</sup> *Caltex Oil (SA) Ltd v Secretary for Inland Revenue* 1975 (1) SA 665 (A).

<sup>59</sup> *Port Elizabeth* case at page 15.

incurred” quite narrowly and said the following:

“The fact that Ackermans rid itself of liabilities by accepting a lesser purchase price than it would have received had it retained the liabilities, does not mean in fact or in law that it incurred expenditure to the extent that the purchase price was reduced by the liabilities. At the effective date no expenditure was actually incurred by Ackermans.”<sup>60</sup>

The court in the above case ruled that in order for an expense to be incurred there must be an actual liability to pay an amount. In the *Ackermans* case Ackermans (the seller) opted to accept lower price for its business in return for the transfer of liabilities to the purchaser, no expense was actually incurred by it in terms of the general deduction formula in section 11(a) of the Act.

In light of the above, it is not sufficient for a CDM project to foresee a monitoring fee in the future in order for it to deduct such fee; it is a pre-requisite that the liability to pay such fee must already exist during the tax year when it is sought to be deducted or the monitoring fee must have actually been paid. An unconditional liability is exactly what it read; it is not dependent on or subject to the happening of another event.

In order to satisfy this second requirement of the general deduction formula, a CDM project will have to show that it incurred an unconditional liability to pay the expenditure that is sought to deduct. The question, whether a CDM project satisfies this requirement will depend on the specific facts of each case.

### **3.2.3 'IN THE YEAR OF ASSESSMENT'**

The third requirement of the general deduction formula is that an expense which is actually incurred must be incurred during the year of assessment. The Cape Provincial Division in *Concentra (Pty) Ltd v Commissioner for Inland Revenue* [1942] 12 SATC 95 emphasized this legislative requirement in the quote below:

“The basis of the income tax law is the assessment of the yearly income: the amounts earned and the expenses incurred. If a taxpayer because of shortage of funds could postpone the payment of

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<sup>60</sup> *Ackermans* case at para 11.

liabilities incurred and by so doing take them out of the year of assessment for income tax purposes the entire system of taxation would be affected.”<sup>61</sup>

The aforementioned extract is a restatement of the general principle that tax is an annual event and any deviation from this general principle will be unacceptable. This principle was also emphasized by the Appellate Division in *Sub-Nigel v Commissioner for Inland Revenue* [1948] 15 SATC 381 (A) (*Sub-Nigel* case) where the court noted that “as the taxpayer is assessed for income tax for a period of one year, no expenditure incurred in a year previous to the particular tax year can be deducted”.<sup>62</sup>

As CDM projects involves various stages, usually the expenses will be spread over several years of assessment. In order to successfully claim a deduction, it is crucial that a CDM project claims the deduction for expenses incurred in that particular year of assessment. In other words, the South African Revenue Service (“SARS”) will not allow a deduction in year 3 for an expense that was incurred by a CDM project in year 1 and was never taken into account during the tax calculation for that year of assessment. In instances where a CDM project fails to bring an expense into account in the year when it was incurred, the deduction will be lost for good.

This takes the discussion to the fourth requirement of section 11(a) of the Act, that is that, the expenditure which is sought to be deducted, must have been incurred in the production of income. As CDM projects generate CER which are exempt in terms of section 12K of the Act, one must consider when a CDM project will be able to satisfy this next requirement of the general deduction formula?

#### **3.2.4 IS THE GENERATION OF PRIMARY CER 'IN THE PRODUCTION OF INCOME'?**

The general deduction formula in section 11(a) requires that prior to deducting any expenditure or losses, actually incurred by a CDM project, a taxpayer must show that such expenditure or losses were actually incurred in the production of income. In order to determine how this requirement can be satisfied by CDM projects, one needs to understand

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<sup>61</sup> *Concentra* case at page 98.

<sup>62</sup> *Sub-Nigel* case at page 390.

what is meant by the term “in production of income”.

While dealing with the issue of whether the expenditure was incurred in the production of income or not the court in the *Sub Nigel* case said the following:

“...Court is not concerned whether a particular item of expenditure produced any part of the income: what it is concerned with is whether that item of expenditure was incurred for the purpose of earning income.”<sup>63</sup>

The above dictum suggests that it is not necessary that the expense sought to be deducted must have generated actual income, however, it is required that such amount was expended for the **purpose** of producing income. The emphasis on the term 'purpose of expenditure' was later expanded by the Cape Provincial Division in the *locus classicus* test devised by AJP Watermeyer in the *Port Elizabeth* case. This two-legged test is aimed at determining whether an expense was incurred in the production of income or not.

The first leg asks the question: whether the act that created the expenditure was performed in the production of income? This is a subjective test and the question that one need to ask is whether the expense was incurred for the purpose of producing income. The response to this question is often affirmative as most business expenses are incurred with some purpose of producing income. As this is a subjective test, whether CDM projects satisfy this requirement will be depend on the specific circumstances of each case.

The second leg asks the question: whether the expenditure is closely linked to the act of producing income?<sup>64</sup> This is an objective test and one that often poses a hurdle for the taxpayers. Although seemingly straightforward, the closeness of link is not easy to prove; especially without understanding when will an expense be regarded as sufficiently close to the expenditure in order to be considered as having been incurred for the purposes of producing income. To quote AJP Watermeyer's dictum in *Port Elizabeth* case:

“[A]ll expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such

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<sup>63</sup> *Sub-Nigel* case at page 394.

<sup>64</sup> *Port Elizabeth* case at page 16.



operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.”<sup>65</sup>

In light of the above dictum, the question that the taxpayer needs to answer is: whether the expense incurred was such that it could be regarded as the cost of performing the business? If the answer is affirmative, the expense was incurred in the production of income; if the answer is negative, then it was not incurred in the production of income. However, the use of the term “income” in section 11(a) refers to the amount remaining after excluding exempt income. In other words, an expense was not incurred in the production of income if it was expended in the production of exempt income.

As the generation of primary CERs is a crucial part of any CDM project, this requirement may pose a hurdle for the deductibility of CDM expenses considering the exemption in section 12K. This exclusion from the deductibility of expenses is echoed in section 23(f) of the Act, which disallows the deduction of expenses incurred in the production of exempt income. However, as the generation of pCERs and generation of income might occur simultaneously the deductibility of expenditure may become a more complex issue for CDM project participants.

In such situations, the South African courts have ruled that where expenditure is incurred in the production of income as well as exempt amounts (as in the case of CDM projects), a reasonable apportionment of expenditure can be sought, in other words, apportionment of the total expenditure between “income” and exempt income on a pro rata basis.<sup>66</sup> However, the problem with apportionment of CDM expenses can be illustrated with the use of example A below:

**Example A**

Widget Co is a widget manufacturer who wishes to implement new technology in the manufacturing of its widgets. This new technology would reduce Widget Co's current carbon emissions and energy consumption by 50%. Widget Co establishes a new company named New Widget Co which will acquire all the latest equipment

<sup>65</sup> *Port Elizabeth* case at page 18.

<sup>66</sup> *Commissioner for Inland Revenue v Nemojim Pty Ltd* 45 SATC 241 (A).

and would be responsible for this new undertaking. New Widget Co wishes to be registered as a CDM project as the income from CERs is crucial for the financial sustainability of the New Widget Co.

The New Widget Co CDM project involves various expenses which include drafting project plan, registering of the CDM project, on-going monitoring to ensure emission reduction is accurately documented, verification of emission reduction and certification costs requesting the issuance of CERs. The expenses also include the acquisition costs of a new plant and machinery and on-going costs of maintaining the new plant to ensure optimum emission reduction.

At the end of the year New Widget Co seek to deduct expenses incurred in the production of income from the CDM project. New Widget Co needs to apportion expenses incurred in the production of income (widget) from expenses incurred in the production of exempt CERs. However, determining what expense was incurred in the production of widgets is not a simple task bearing in mind that New Widget Co would not have generated any CERs unless it generated widgets (taxable income). In other words, generation of CERs is merely a by product of the widget manufacturing business. As emission reduction cannot be measured until such time the business performs its ordinary function which emits the GHG and measures the emission reduction achieved through the use of CDM technology.

In order to achieve a reasonable apportionment in example A above, one needs to divide the expenses between those incurred in the production of widgets and those incurred in the production of exempt pCERs. The problem in the above case arises as the same expense has generated income as well as exempt income. Whilst dealing with the deductibility of certain expenses incurred by the taxpayer in the *Commissioner for Inland Revenue v Standard Bank of SA Limited* 47 SATC 179 the court emphasized the principle that what is vital for the determination of deductibility of expenses in terms of the general deduction formula is the *purpose* (own emphasis) for which the expense was incurred. Although an insignificant amount of the expense was actually incurred by the Bank in the production of exempt income, the Appeal court ruled that it was not Bank's purpose to earn exempt

income in incurring the expense that it sought to deduct. The court in the *Standard Bank* case did not apportion the expenses between deductible and non-deductible as it ruled that the purpose was 'in production of the bank's income'. However, the apportionment in the case of pCERs will be further complicated by the fact that generation of income is also pre-requisite for the generation of exempt income as illustrated in example A above. In other words, *but for* the generation of income (production of widgets) there would not have been any exempt income (CER units). This is one of the biggest hurdles in the apportionment of CDM expenses.

Acknowledging that the apportionment of such expenses could be a hairsplitting task, especially determining the ratio of expenditure incurred for the generation of exempt pCERs and that incurred for the generation of income, the National Treasury initially indicated that it will accept non-apportionment of CDM project expenditure. However, the National Treasury simultaneously stated that any expenditure directly incurred in the certification process would not be deductible.<sup>67</sup>

Unfortunately when section 12K was finally legislated in the Amendment Act it made no reference to this non-apportionment of CDM project expenditure and therefore it is not clear whether SARS will accept non-apportionment of CDM project expenditure.

One solution in such situation is for the taxpayers to apply for a binding tax ruling from the South African Revenue Service (SARS) which can be relied on during assessment. However, binding tax rulings can be lengthy and costly exercise creating additional burden for the CDM projects and detracting from the incentive contemplated by the introduction of tax exemption in section 12K.

Another hurdle that a taxpayer might encounter in proving that the expense was incurred predominantly in the production of income is posed by the CDM requirement of investment additionality. The investment additionality requires the participants to prove (prior to registration of CDM project) that the project would not have been viable *but for*

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<sup>67</sup> "Certification is a formal written confirmation by an independent auditor that emissions reductions which are set out in the verification report were actually achieved". Available at: <http://www.cdmrulebook.org/133> [Accessed 21 October 2010].

the income generated by CERs.<sup>68</sup> For those CDM projects that make use of the investment additionality to satisfy the additionality requirement of the project, the case for apportionment of expenses is even stronger. In other words, if a taxpayer argues that the expense was incurred with the intention to generate exempt income from the inception (in the absence of exempt income the project would not have been viable), it could be difficult to argue that the entire expense or major part of it was incurred in the production of income.

It is not clear how the taxpayers would apportion the CDM project expenditure should SARS insist on such apportionment. One option may be to pro-rata the CDM project expenses between income as defined in section 1 and exempt income as generated from CERs. Although this may not be a fair option, it is one of the ways to apportion the expenses.

At this stage it is safe to conclude that the exemption in section 12K may pose some issues for the South African CDM projects that want to deduct significant expenses incurred in the production of income.

### **3.2.5 'NOT OF A CAPITAL NATURE'**

Although the capital and revenue debate is not the main focus of the present discussion, it is important to briefly state the position with regards to deductibility of expenses in terms of the general deduction formula in section 11(a) of the Act. Section 11(a) of the Act specifically provides that expenditure and losses will only be deductible if they are not of a capital nature. South African courts of law have noted that there is no single infallible test that could be applied to all cases in determining when an expenditure is capital or revenue in nature.<sup>69</sup> It is for this reason each case dealing with the capital and revenue issue should be decided in light of its own unique facts. If an amount is established to be capital in nature, it is governed by the Eighth Schedule of the Act.

The Eighth Schedule to the Act provides guidance on when the disposal of a capital asset

<sup>68</sup> Au Yong, H.W. 'Technical Paper – Investment Additionality in the CDM' Ecometrica Press. Available at: [http://d3u3pjcknor731.cloudfront.net/assets/media/pdf/investment\\_additionality\\_technical.pdf](http://d3u3pjcknor731.cloudfront.net/assets/media/pdf/investment_additionality_technical.pdf) [Accessed 21 October 2010].

<sup>69</sup> *SIR v Cadac Engineering Works (Pty) Ltd* 1965 (2) SA 511 (A).

gives rise to capital gain or capital loss. As the discussion on the Eighth Schedule is comprehensively dealt with under chapter 6 of the present dissertation, for the purposes of the present discussion it will suffice to say that if normal tax exempt pCERs were capital in nature, they will be disregarded for capital gains or loss purposes in terms of paragraph 64 of the Eighth Schedule.<sup>70</sup>

### **3.3 CONCLUSION**

In light of the above discussion, it is submitted that despite the noble intentions behind the introduction of section 12K exemption, this incentive carries the baggage of potential non-deductibility of expenditure.

It is possible that the South African CDM projects might have to battle with SARS when attempting to claim a deduction for expenses that could easily be attributed to the production of exempt pCERs. As most CDM projects will have expenses which are incurred with dual intention to earn income as well as exempt income, it may not always be easy to convince SARS that a particular expense was incurred solely with the intention to produce income (and not exempt income). In such circumstances it is possible that SARS would require the CDM projects to apportion their expenses to indicate what was incurred in the generation of pCERs and what was incurred in the production of ordinary income.

The issue is further complicated by the fact that apportionment of expenses between income and exempt income is not a straightforward exercise while dealing with a CDM project, CERs cannot be generated without producing the regular business product. To put it differently, the generation of exempt CERs is inherently linked to the generation of ordinary CDM income. This close link between exempt income (pCERs) with the generation of income makes apportionment an extremely difficult task for CDM projects. Although, the National Treasury had initially indicated that only expenses directly related to the certification process will be disallowed, section 12K in its final form makes no such provision.

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<sup>70</sup> Income Tax Act 58 of 1962, Eighth Schedule para 64.

Another possibility, albeit a remote one, is that the revenue might disallow the deductibility of all expenditure should the taxpayer fail to reasonably apportion the expenses. This inability to deduct the expenditure could potentially act as a major disincentive for any prospective CDM projects in South Africa.

As the purpose behind the introduction of section 12K exemption was to provide an incentive for the development of new CDM projects in South Africa, the non-deductibility of expenditure could defeat this purpose. It is therefore crucial that the National Treasury provides some guidance on the issue of deductibility and apportionment. In the meantime the taxpayers could apply for an advance tax ruling from SARS on this issue. Although binding rulings could be time consuming and expensive exercise, it appears to be the only option available to taxpayers providing some certainty for the tax treatment of CDM expenditure.

Despite being a major cause of concern for current and prospective CDM projects in South Africa, non-deductibility of expenditure is not the only concern raised by the new section 12K. Another issue for CDM projects in South Africa arises from the definition of “trading stock” as defined in section 1 of the Act. The following chapter will look at how this definition impacts the CDM projects in South Africa and its interaction with section 12K.

## **4 CERTIFIED EMISSION REDUCTION UNITS AS TRADING STOCK**

### **4.1 INTRODUCTION**

The preceding chapter highlighted the lingering uncertainty surrounding the deductibility of certain CDM project expenditure. Although this uncertainty can be a potential disincentive for CDM projects in South Africa; it is certainly not the only cause of concern for investors.

As mentioned previously, the introduction of section 12K exemption has made South Africa one of the few countries in the world which offers special tax treatment of pCERs.<sup>71</sup> Although during the 2009 Budget Proposal, the National Treasury had indicated that only the disposal of sCERs will be subject to trading stock provisions; whether the final section 12K exemption actually restricts the application of section 22 provisions to the disposal of pCERs is questionable.

As pCERs are often generated for the purposes of sale, there is a potential that these units might fall within the ambit of “trading stock” as defined in section 1 of the Act. Such inclusion within the definition of “trading stock” could give rise to various undesirable consequences for CDM projects in South Africa. The aim of the present chapter is to look at some of these consequences that follow the inclusion of pCERs within the “trading stock” definition and examine whether section 12K exemption will be able to circumvent these consequences.

### **4.2 THE DEFINITION OF 'TRADING STOCK'**

The “trading stock” definition in section 1 of the Act read as follows:

“trading stock includes -

(a) anything -

(i) produced, manufactured, constructed, assembled, purchased or in any other manner

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<sup>71</sup> Bakker (Note 33).

acquired by a taxpayer for the purposes of manufacture, sale or exchange by him or on his behalf, or

(ii) the proceeds from disposal of which forms or will form part of his gross income, otherwise than in terms of paragraph (j) or (m) of the definition of “gross income”, or as a recovery or recoupment contemplated in section 8 (4) which is included in gross income in terms of paragraph (n) of that definition; or

(b) any consumable stores and spare parts acquired by him to be used or consumed in the course of his trade,

but does not include a foreign currency option contract and a forward exchange contract as defined in section 24I (1)<sup>72</sup>

The paragraph (a) in the above definition comprises of two parts. The first part provides that, trading stock includes anything that is acquired with the purpose of manufacture, sale or exchange; and the second part provides that, trading stock includes anything the proceeds from the disposal of which form part of the taxpayer's gross income. As the two parts are independent of each other, inclusion of pCERs in either part would trigger the application of the trading stock provisions.

In order to determine whether pCERs fall within the ambit of the first part of the above definition, the taxpayer must analyse the purpose of acquisition/generation of pCERs. It is trite that pCERs in South Africa are not generated for the purposes of manufacture, leaving two remaining possibilities: that is that pCERs in South Africa are either generated for sale or for exchange.

In instances where a CDM project generates pCERs for the purposes of sale, pCERs will fall within the ambit of paragraph (a)(i) of the above “trading stock” definition. However, where the intention behind the generation of pCERs was to distribute them among the shareholders, such distribution would constitute dividends, as defined, and giving rise to secondary tax on companies (“STC”) which will be discussed in more detail in the next chapter.

As the definition of gross income includes all amounts whether exempt income or otherwise, it is submitted that, the proceeds from disposal of pCER will fall within the ambit of gross income irrespective of the amount being exempt in terms of section 12K. Consequently, instances where pCERs are sold by a CDM project, they will also satisfy the

<sup>72</sup> Income Tax Act 58 of 1962 s 1.



second part of the trading stock definition in paragraph (a)(ii) which reads: “the proceeds from disposal of which form part of taxpayer's gross income”.<sup>73</sup> In what follows, this chapter will focus on various implications of this inclusion of pCERs into the trading stock definition and its implications for the South African CDM projects.

### **4.3 APPLICATION OF TRADING STOCK PROVISIONS TO PRIMARY CER UNITS**

As pCERs in South Africa (when generated for the purposes of sale) fall within the ambit of trading stock definition, their income tax treatment will be governed by section 22 of the Act. The present dissertation will discuss a few issues arising from the application of section 22 provisions to the disposal of pCERs by South African CDM projects. However, prior to proceeding with this analysis, it is worth acknowledging that section 22 is irrelevant when a taxpayer is buying and selling an item of trading stock in the same year. This point was highlighted by the Supreme Court of Appeal in *Ernst Bester Trust v Commissioner for South African Revenue Service* 2008 (5) SA 279 (SCA) (*Ernst case*).<sup>74</sup>

#### **4.3.1 SECTION 22(1) OF THE INCOME TAX ACT 58 OF 1962**

Section 22(1) of the Income Tax Act reads as follows:

“The amount which shall, in the determination of the taxable income derived by any person during any year of assessment from carrying on any trade (other than farming), be taken into account in respect of the value of any trading stock held and not disposed of by him at the end of such year of assessment, shall be -

- (a) in the case of trading stock other than trading stock contemplated in paragraph (b), the cost price to such person of such trading stock, less such amount as the Commissioner may think just and held by any company in any other company, has been diminished by reason of damage, deterioration, change of fashion, decrease in the market value or for any other reason satisfactory to the Commissioner; and
- (b) in the case of any trading stock which consist of any instrument, interest rate agreement or option contract in respect of which a company has made an election which has taken effect as contemplated in section 24J (9), the market value of such trading stock as contemplated in such section.”<sup>75</sup>

Section 22(1) as quoted above requires the taxpayer to include the value of the trading stock held and not disposed of by him in the determination of his taxable income. This would mean that CDM projects will be required to include the value of pCERs held and

<sup>73</sup> Income Tax Act 58 of 1962 s 1.

<sup>74</sup> *Ernst case* at paragraph 23.

<sup>75</sup> Income Tax Act 58 of 1962 s 22(1).

not disposed of, during a year of assessment, in the determination of their taxable income. Although, the term “value” is fairly wide referring to different kinds of trading stock that must be valued in different ways; the legislature provides guidance to enable the taxpayers determine the correct form of valuation for pCERs.

Section 22(1)(a) and (b) of the Act provides how a taxpayer is expected to determine the value of two different categories of trading stock. These two categories of trading stock are:

1. Firstly, trading stock as contemplated in terms of section 22(1)(b) which includes any instrument, interest rate agreement or option contract in respect of which the company has made an election which has taken effect as contemplated in section 24J(9).
2. Secondly, any trading stock that does not fall within the ambit of section 22(1)(b) of the Act.

In order to determine whether a CDM project should use the cost price of pCERs or the market value in determination of its taxable income, one must first determine whether pCERs will fall within the ambit of section 22(1)(a) or (b). As section 22(1)(a) is only applicable if the item is not specifically covered by section 22(1)(b) of the Act, it will be prudent to determine whether pCERs fall within the ambit of trading stock as contemplated under section 22(1)(b) of the Act.

Section 22(1)(b) of the Act provides guidance for the valuation of trading stock that comprises of the following:

- Instrument,
- Interest rate agreement or
- Option contract for which the company has made an election

If pCERs fall within the description of any of the aforementioned items, the CDM project

will include the market value of the stock held and not disposed of in determination of its taxable income. Paragraph 4.3.2 below will briefly look at the nature of these three items and whether pCERs can be compared to any of them. The aim of the following discussion is to determine whether the valuation of pCER should be governed by section 22(1)(a) or section 22(1)(b).

#### **4.3.2 INSTRUMENT, INTEREST-RATE AGREEMENT OR OPTION CONTRACT**

As mentioned above, section 22(1)(b) lists three items of trading stock that should be valued at market value when including into the closing stock. First on this list is “instrument”. The term “instrument” is defined in section 24J of the Act as any form of interest bearing arrangement.

An 'interest bearing-arrangement' has an underlying asset (i.e a loan or an asset being financed), which is quite different from pCER that do not have any tangible underlying asset (pCERs are notional units). Interest-bearing arrangements offer recurring benefit, whereas, pCER generates once off income on disposal. Unlike pCERs which owe their existence to an international treaty; interest-bearing arrangements arise as a result of a commercial undertaking between two parties. Furthermore, all instruments are a form of property right and can be defended against anyone who attempts to encroach upon them. However, pCERs lack some of the fundamental rights associated with ownership distinguishing them from normal instruments. For example – if one's property is expropriated, the law of property would dictate that such person be entitled to compensation, however in the case of pCER there is no such right granted by the Kyoto Protocol<sup>76</sup> in instance pCERs are lost due to the failure of the state to comply with the Protocol. It is therefore submitted that pCERs do not fall within the definition of instrument as defined under section 24J.

Next in line under section 22(1)(b) is an “interest-rate agreement”. An “interest-rate agreement” is defined under section 24K as a swap agreement between two parties, whereby both parties agree to pay certain amount to the other based on some notional amount. The concept of a swap-agreement is incomparable to the generation of pCERs, as

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<sup>76</sup> The Marrakesh Accords [Note 49].

pCERs cannot come into existence with mere agreement between parties. To generate pCERs the CDM project must prove actual emission reductions. Also, an interest-rate agreement cannot come into existence in the absence of two parties which is again quite different from pCERs that can be generated unilaterally by a Non Annex country.

This takes the discussion to the last remaining possibility, that is CERs falling within the ambit of an “option contract” as defined in section 24L. An option contract is an agreement between two parties and the underlying right emerges from this agreement. As emphasized previously, pCERs do not emerge from agreements between individual parties and though it is possible to have an option to purchase pCERs, pCER themselves cannot be described as an option contract. It is therefore submitted that, pCERs are *sui generis* units incomparable to items contemplated by section 22(1)(b) of the Act.

As, pCERs do not fall within the ambit of any of the items listed in section 22(1)(b), it follows that the valuation of pCERs will be dealt in the manner provided under section 22(1)(a).

### **4.3.3 THE VALUATION OF PRIMARY CERs**

In terms of section 22(1)(a), the value of trading stock to be included in the closing stock is the cost price to such person of such trading stock, less any amount the Commissioner may think just and reasonable by which the value of the trading stock has diminished as a result of reasons listed thereunder or for any reason satisfactory to the Commissioner.<sup>77</sup> In short, it is the cost price of pCERs that forms the basis of valuation for the purposes of section 22(1).

Section 22(3)(a)(i) and (b) of the Act in turn provides guidance on how this cost price should be determined and it states that the cost price of trading stock is as follows:

“Section 22(3)(a)(i) the cost incurred by such person, whether in the current or any previous year of assessment in acquiring such trading stock, plus, subject to the provisions of paragraph (b), any further costs incurred by him up to and including the said date in getting such trading stock into its then existing condition and location, but excluding any exchange difference as defined in section 24I(1) relating to the acquisition of such trading stock

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<sup>77</sup> Income Tax Act 58 of 1962 s 22(1)(a).

Section 22(3)(b) the further costs which in terms of paragraph (a)(i) are required to be included in the cost price of any trading stock shall be such costs as in terms of any generally accepted accounting practice approved by the Commissioner should be included in the valuation of such trading stock.”<sup>78</sup>

The valuation of CERs is one area where the distinction between primary CER and secondary CER becomes relevant. This is because secondary CERs are usually acquired for a fixed monetary amount, so there is a clear cost price which can be included into the closing stock; unlike primary CERs, which are generated by the CDM project during its day to day business activities and therefore requires an apportionment of expenses between the production of pCERs and those incurred in the production of other income generating activities of the project. As section 22(3) of the Act simply states that the cost price of trading stock is the: the cost incurred by such person in acquiring such trading stock and the costs of getting it into its current position, it is sufficient for the determination of the value of sCERs but not for the valuation of pCERs.

One problem in determining the cost price of pCERs is that, it is contrary to logic to allocate costs to something that was actually never produced (the emission that was never emitted). To determine the cost price of emissions that were never produced, one must determine the expenditure that is incurred to not produce the emissions in day to day working of the business (which otherwise would have been produced). This task is further complicated by the fact that often these expenses are the same expenses that generate ordinary trading stock of the business.

An allocation of expenses to pCERs will also have other tax implications for CDM projects such as: disallowance of deductibility of expenses that were allocated as the cost of pCERs, against income from the sale of ordinary trading stock. Such outcome could make the CDM projects more reluctant to determine the costs of producing CERs.

Although CDM projects could argue that pCERs are merely the by product of clean technology with no special costs attached to their production, the South African Revenue Service could reject the above argument. The Revenue might argue that any business that incurs significant costs in registering a CDM project does so with the intent to derive

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<sup>78</sup> Income Tax Act 58 of 1962 s 22(3).

benefit from the generation of pCERs.

Both the aforementioned arguments are on the opposite ends of the spectrum. The problem is establishing a middle ground where the costs can be fairly allocated between those incurred in the generation of pCERs and ordinary trading stock of the business.

Although, there are certainly expenses which are more closely attached to the generation of pCERs such as: monitoring costs of emission reduction or the certification costs of pCERs; there is uncertainty whether SARS will accept this as the cost-price for section 22(1)(a) purposes. In such prevailing uncertainty, it may be a point of departure for the taxpayers to use these costs as the basis of valuing pCERs until further guidance from the National Treasury.

Unfortunately, this is only the beginning of hurdles posed by the trading stock provisions for CDM project participants in South Africa. So far as section 12K exemption goes, it cannot avoid the inclusion of pCERs held and not disposed of during the same year from these trading stock consequences. Even if a CDM project successfully crossed this first hurdle of determining the cost price of pCERs, the CDM project participants will find themselves in a more undesirable situation of having to include this value of pCERs into their closing stock in terms of section 22 of the Act.

#### **4.3.4 INCLUSION OF PRIMARY CER INTO CLOSING STOCK**

The court in *Commissioner for Inland Revenue v George Forest Timber Company Ltd* 1 SATC 20 (*George Forest* case) highlighted that the trading stock will always be revenue in nature and by implication generally deductible in terms of section 11(a) of the Act.<sup>79</sup> This deduction is crucial from a cash flow point of view, as it provides a nil result on the taxable income of the taxpayer. However, the same does not hold true for all trading stock. For example: If a specific trading stock produces exempt income, the expense incurred to acquire such trading stock will not be deductible in terms of section 11(a) of the Act. The inclusion of pCERs into the closing stock will furnish the same result.

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<sup>79</sup> *George Forest* case at page 24.

In other words, although the project participants will have to include the cost price of pCERs into their closing stock, a corresponding deduction for such expense will not be available under the general deduction formula. Although this argument was placed before the National Treasury<sup>80</sup> supporting the case for exclusion of pCERs from the trading stock definition in section 1; the National Treasury refused this proposal for the reason discussed below.

The National Treasury's reasoning for not excluding pCERs from the definition of trading stock was that: section 22 only defers the deduction of allowable expenses, and as pCERs are exempt under section 12K they will not be deductible under section 11(a).<sup>81</sup> In other words, if there is no allowable deduction, it cannot be deferred. This gives rise to the question: whether the non-deductibility of an expenditure in terms of section 11(a) restricts the inclusion of pCERs into closing stock in terms of section 22 of the Act?

In terms of section 22(1) the value of any trading stock held and not disposed of during a year of assessment must be included into the closing stock of the taxpayer. The National Treasury's reasoning does not take cognizance of the fact that the cost price of pCERs as determined under section 22(3) is not subject to/or dependent on such amount being deductible in terms of section 11(a) of the Act. It is this amount, irrespective of whether it is deductible or not, that has to be included into closing stock in terms of section 22(1) of the Act.

To put it differently, as the inclusion of the cost price of the trading stock in terms of section 22(3) is not influenced by its deductibility under section 11(a), the cost of pCERs will still have to be added back into the income of CDM project as closing stock irrespective of the deductibility of expense incurred in their production. This inflates the taxable income of the CDM project with corresponding deduction only being allowed under section 22(2) in the year when pCERs are disposed.

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<sup>80</sup> Standing Committee on Finance: Report-Back Hearings (5 August 2009) Taxation Laws Amendment Bills, 2009, Preliminary Response Document at para 2.3.1. Available at <http://www.treasury.gov.za/legislation/bills/2009/TLAB%20Response%20Doc-25%20August%202009.pdf> [Accessed 3 February 2010].

<sup>81</sup> Ibid.

This could potentially create a cash flow problem for CDM project, that will be required to pay tax in respect of an amount that is not only non-deductible in terms of section 11(a) of the Act but the income from which was intended to be tax exempt in terms of section 12K. Unfortunately, the exemption in section 12K is incapable of circumventing this issue, hence the submission from various interest groups to the National Treasury requesting exclusion of pCERs from the “trading stock” definition.

As mentioned previously, the inclusion of pCERs within the trading stock definition creates various complications for CDM projects in South Africa. One tax issue that South African CDM projects are likely to encounter is: when the project decides to distribute pCERs to its shareholders. The next section will look at the issues arising from such *in specie* distribution of pCERs and whether section 12K will be able to overcome these issues?

#### **4.4 'IN SPECIE' DISTRIBUTION OF PRIMARY CER**

As mentioned previously, the sale of pCERs is just one of the ways for a CDM project to dispose pCERs. The example below, will present another form of disposal which may give rise to some new income tax issues for CDM projects within the Republic.

##### **Example 1**

ZA Co is a company incorporated in South Africa. ZA Co's business comprises of widget production in Cape Town. ZA Co wishes to implement a new form of green technology that will assist it to reduce its emission levels from 1 000 000 tonne per annum to 500 000 tonne per annum. ZA Co would like to register its new plant as a CDM project which will not only be advantageous from a corporate image point of view but will also create a new revenue stream from the sale of CERs. However, ZA Co does not have the financial means or access to the technology.

UK Co is a company incorporated in United Kingdom. UK Co is a successful fertilizer manufacturer with emission reduction targets in its home country. UK Co has access to the latest emission reduction technology and it decides to make an investment in a CDM project in order to hedge against any future need for CERs.



UK Co approaches ZA Co with the offer to invest equity in ZA Co's new plant and provide the requisite technology that would reduce their emissions by half. SA Co agrees to make UK Co a partner in this new venture.

ZA Co forms a new subsidiary called SA Co (incorporated in South Africa) which will run the new plant. SA Co and UK Co enter into an agreement which states that UK Co would invest R50,000,000 in SA Co in return for 10% shareholding in SA Co.

In year 1 SA Co generates 50 000 pCERs. SA Co sold these pCERs to a multilateral fund. The profits from the disposal were re-invested by SA Co in its plant. In year two SA Co generated another 50 000 pCERs which it carried forward to the next year as it could not find a buyer. In year 3, SA Co generated another 50,000 CER and at the end of the year 3, SA Co decided to declare dividends to its shareholders. SA Co distributed 98,000 pCERs to UK Co and R1000 000 in cash to its other shareholders.

The distribution of pCERs by SA Co to UK Co did not amount to reduction of SA Co's share capital or share premium.

The discussion under paragraph 4.2 illustrated that, despite the National Treasury's initial comment that only sCERs will be subject to trading stock provisions and that pCERs will be exempt in terms of section 12K, pCERs when generated for the purposes of sale will fall within section 1 definition of "trading stock" which triggers the trading stock provisions in the Act.

In the above example 1, pCERs will be regarded as trading stock for SA Co's intention was to generate pCERs in order to sell them for a monetary amount. It was only when SA Co failed to find a buyer in year 2 that SA Co decided to declare a dividend and distribute the accumulated pCERs in year 2 and 3 to UK Co.

In such instances, one needs to be wary of all the trading stock provisions that may impact the distribution of pCERs. One such provision is section 22(8) of the Act.

Section 22(8) is a recoupment provision dealing with the income tax implications for taxpayers under specific situations. One such situation is covered by section 22(8)(b) which provides that, when a taxpayer distributes its trading stock *in specie* to any of its shareholder, the cost price of which was taken into account by the taxpayer to determine his taxable income for any year of assessment, the taxpayer will recoup an amount which is equal to the market value of such stock on the date of distribution.<sup>82</sup>

#### **4.4.1 THE RECOUPMENT OF PRIMARY CERs IN TERMS OF SECTION 22(8)**

Prior to proceeding with the discussion on the implications of section 22(8) recoupment, for the parties in example 1 above, it is important to be bear in mind that this recoupment only arises for such trading stock: the cost price of which was taken into account by the taxpayer to determine his taxable income for any year of assessment. The recoupment is an amount equal to the market value of such stock on distribution by the company.

Although section 22(8) recoupment of the full market value inflates the taxable income, the taxpayer can generally claim a deduction for the cost price of the trading stock either in terms of section 11(a) (if the stock was acquired in the current year) or in terms of section 22(2) (where the stock was acquired in a previous year). However, there may be circumstances where section 22(8) can lead to a recoupment of the market value with no corresponding deduction under section 11(a) or section 22(2) of the Act. This will be the case where the income from the trading stock is exempt in terms of the Act.

To illustrate the problem with the use of example 1 above: SA Co did not sell 50,000 pCERs generated by it in year 2. As a result of this non-disposal of pCERs in year 2, the value/cost price of these pCERs had to be included by SA Co in its closing stock in the end of year 2. This inclusion of the cost price of closing stock in year 2 had no corresponding deduction for SA Co in that year because section 23(f) disallows a deduction of expenses incurred in the production of exempt income. The cost price of this closing stock will also

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<sup>82</sup> Income Tax Act 58 of 1962 s 22(8)(b).

be taken into consideration in determination of SA Co's taxable income in year 2. Although SA Co will be able to deduct the cost price of the 50,000 pCERs generated in year 2 as its opening stock in year three, SA Co's distribution of 98,000 pCERs to UK Co in the end of year 3 will give rise to section 22(8) recoupment in year 3. The result being that, SA Co will be deemed to have recouped the market value of 50,000 pCERs from year 2 which were taken into account in determination of SA Co's taxable income in year 2 at the time of distribution by SA Co to UK Co in year 3. In summary, SA Co will have to include the market value of 50,000 pCERs in its income in year 3 resulting in an increased taxable income in that year.

This inclusion of pCERs into taxable income also conflicts with the legislature's intention to exempt the income from disposal of such units in terms of section 12K. This raises the question: whether section 12K exemption is sufficiently wide to circumvent section 22(8) recoupment? This question requires an analysis of section 12K exemption and its application on section 22(8) recoupment provision.

#### **4.4.2 THE CONFLICT BETWEEN SECTION 22(8) AND SECTION 12K**

As mentioned previously, the intention behind the introduction of section 12K exemption was to provide an incentive for the development of new CDM projects in South Africa. The above discussion illustrated that there may be circumstances where CDM projects will have to include the value of pCERs into their income. In particular, section 22(8) recoupment arising on the distribution of pCERs by a CDM project to its shareholders. As it could not have been the legislature's intention to punish the CDM project should they decide to distribute their pCERs among their shareholders, the question arises, whether section 12K exemption protects the taxpayer against section 22(8) recoupment?

The relevant part of section 12K of the Income Tax Act reads as follows:

“For the purposes of this section ...(2) There must be exempt from normal tax any **amount received by or accrued to or in favour of any person in respect of the disposal by that person of any certified emission reduction** derived by that person in the furtherance of a qualifying CDM project

carried on by that person.”<sup>83</sup>

The above extract highlights four key requirements that must be present in order for any receipt and accrual to fall within the ambit of this exemption. These requirements are as follows:

1. An “amount” which was either;
2. “received” or “accrued” in favour of a person;
3. “in respect of”;
4. the “disposal by that person of any CERs”

It is only if the distribution in example 1 satisfies these four requirements that it can enjoy the incentive provided by section 12K. It is therefore prudent to briefly discuss these requirements respectively and determine whether they are satisfied by the transaction in example 1.

#### **4.4.2.1 'ANY AMOUNT'**

The first requirement of section 12K exemption is that there must be an “amount”. The term “amount” has been judicially considered by the South African courts of law on various occasions. In *WH Lategan v Commissioner for Inland Revenue* (1925) 2 SATC 16 (*Lategan case*) while dealing with the interpretation of the term “amount” in relation to the “gross income” definition Watermeyer J said:

“[T]he word “amount” had to be given a wider meaning and must include not only money but the value of every form of property earned by the taxpayer whether corporeal or incorporeal which had a money value.”<sup>84</sup>

The above interpretation was later approved by the Appellate Division in *Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd* (1990) 52 SATC 9 (*People's Stores case*) where Hefer JA confirmed that an amount not only refers to money but to anything that has a monetary value.<sup>85</sup>

<sup>83</sup> Income Tax Act 58 of 1962, s 12K(2).

<sup>84</sup> *Lategan case* page 19.

<sup>85</sup> *People's Stores case* page 21.

If “any amount” includes not only money but any item with monetary value, it is submitted that pCERs (which are readily traded on international climate exchanges) will satisfy the “amount” requirement under the section 12K exemption. Although the above cases dealt with the interpretation of “amount” in the context of gross income, there is no reason why this interpretation will not be equally applicable in the context of section 12K exemption.

However, in order to successfully enjoy section 12K exemption, the parties in example 1 must also satisfy the three remaining requirements. To this end, paragraph 4.4.2.2 will look at the next requirement that an amount must be “received or accrued” by a taxpayer.

#### **4.4.2.2 'RECEIVED' OR 'ACCRUED'**

The term “received or accrued” has been judicially considered by the South African courts of law on various occasions. The meaning of the word “receipt by” was first analysed by the Cape Provincial Division in *Geldenhuis v Commissioner for Inland Revenue* (1947) 14 SATC 419 (*Geldenhuis* case) where the court held that the term should be interpreted to mean “received by the taxpayer for his own benefit”.<sup>86</sup> In other words, the amount can only be said to have been received by the taxpayer, if it is received by such taxpayer for its own benefit. This interpretation negates the possibility of an agent being taxed on an amount which he receives on behalf of his principal. Furthermore, there may be instances where a taxpayer may receive/possess an amount on his own behalf yet not satisfy the receipt requirement. One such scenario was highlighted by the court in *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A) (*Genn* case) where the Court said that the money borrowed will not satisfy the requirement of receipt if there is a simultaneous obligation to repay.<sup>87</sup>

In summary, in order for a taxpayer to 'receive' an amount, it is not sufficient that the taxpayer is in possession of that amount; such amount must also be received by the taxpayer for his own benefit without an obligation to repay it. Although the meaning of “receipt” is quite narrow, the ambit of term “accrued” is reasonably wide. Similar to

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<sup>86</sup> *Geldenhuis* case at page 265.

<sup>87</sup> *Genn* case at 299B-G.

'receipt' the meaning of the word “accrue” has also been subject of much judicial scrutiny over the years.

*Lategan* case is one of the early cases dealing with the interpretation of the word “accrued to”. The court in *Lategan* case held that the words “accrued to in favour of any person” merely meant to “which he has become entitled to”.<sup>88</sup> The *Lategan* principle that “accrual” occurs when a person gains the entitlement/right to the amount has been reaffirmed by the courts in later decisions.

The Appellate Division in *Mooi v Secretary for Inland Revenue* (1972) 34 SATC 1 (*Mooi* case) extended the *Lategan* principle of “accrual” from “entitled to something” to mean “unconditional entitlement”.<sup>89</sup> The court held that, a right which is contingent on the happening of future events cannot be said to have accrued to the taxpayer until such contingent future requirement is satisfied. This interpretation has since been accepted by the South African courts of law as the correct interpretation of the term “accrual”. The court in *People's Stores* case analysed the principles surrounding the interpretation of the word “accrual” and endorsed the *Lategan* principle.<sup>90</sup>

Applying the above interpretation to the facts in example 1, where SA Co neither received an amount from UK Co nor was entitled to any amount in respect of pCERs distributed by it, leads to the conclusion that the second requirement of section 12K is not satisfied by the facts in example 1. This second requirement in 12K exemption will limit the ambit of this novel exemption to only such instances where pCERs are sold by a CDM project in return for an amount. Unfortunately, as illustrated above, section 12K exemption is not sufficiently wide to exempt recoupments such as those contemplated by section 22(8) of the Act.

#### 4.5 CONCLUSION

The present chapter highlighted some of the issues surrounding the inclusion of primary CERs into the trading stock definition. Issues such as the determination of the cost price of

<sup>88</sup> *Lategan* case at page 20.

<sup>89</sup> *Mooi* case at 683G-H.

<sup>90</sup> *People's Stores* case at 367D.

pCERs are not only time consuming but also create a disincentive for the taxpayers by requiring them to include such cost into their closing stock. The above discussion also illustrated the flaw in the National Treasury's reasoning, by demonstrating that section 22 of the Act is not influenced by the deductibility of an expense in terms of section 11(a) of the Act. It is this independent operation of section 22 that results in a CDM project being taxed on pCER irrespective of the fact that they are not deductible. The discussion also exposes the narrow ambit of section 12K which does not extend the exemption to circumstances where a CDM project decides to distribute its pCER resulting in section 22(8) recoupment.

Although the National Treasury initially indicated (reassuringly) that it does not intend to tax the revenue from the disposal of primary CERs, which would also mean that they do not intend to tax unsold CERs as closing stock; the legislation as it reads currently is of little comfort to CDM projects in South Africa. It appears that despite the National Treasury's reassurance that only sCERs will be subject to trading stock provisions, pCERs in South Africa are under the risk of falling within the trading stock definition in section 1 of the Act.

It is unlikely that the legislature could have intended these results when opting to provide an exemption for the producer of primary CERs. Fortunately, these issues can be easily circumvented by specifically excluding pCERs from the definition of "trading stock" as defined in section 1 of the Act. Although an exclusion of pCERs from the trading stock definition will avoid the aforementioned consequences, it does not resolve all the issues surrounding pCERs. In the absence of a specific exclusion from the dividend definition or specific exemption in terms of section 12K, the distribution of pCERs will also give rise to secondary tax on companies. The next chapter is dedicated to expose some of these STC and dividend tax issues surrounding pCERs and section 12K.

## 5 SECTION 12K EXEMPTION AND THE SECONDARY TAX ON COMPANIES

### 5.1 INTRODUCTION

As noted in the preceding chapter, the sale of pCERs is one of the two commonly known ways of disposal of pCERs. The distribution of pCER by a CDM project to its shareholders is another. However, this latter form of disposal by means of distribution to shareholders, may give rise to some secondary tax on companies (“STC”) issues. It is to this end, the present chapter, with the help of a hypothetical example 2 below, will look at the circumstances in which the distribution of pCERs by a CDM project to its shareholders gives rise to STC; and what are its implications for South African CDM projects. The discussion will also look at whether section 12K exemption is extended to CDM project owners in such circumstances?

The present discussion will entail a brief analysis of the “dividend” definition and its application to the facts as set out in example 2 below. The present chapter will also discuss some other provisions dealing with the tax treatment of dividends in Part VII of the Act, as well as, the proposed dividends withholding tax that is set to replace the existing STC.

#### HYPOTHETICAL EXAMPLE 2

In order to expose the issues underlying the distribution of pCERs and its implications for the South African CDM projects, the present discussion will use the set of facts given below. Recurring reference will be made to these facts throughout the current chapter.

#### **Example 2**

ZA Co is a company incorporated in South Africa. ZA Co's business comprises of widget production in Cape Town. ZA Co wishes to implement a new form of green technology that will assist ZA Co to reduce its emission levels. However, ZA Co does not have the financial means or access to the requisite technology.

UK Co is a company incorporated in the United Kingdom. UK Co is a successful fertilizer manufacturer with emission reduction targets that it must meet in order to



be compliant with the its national laws as well as their international obligation under the Kyoto Protocol. UK Co decides to acquire some CERs to discharge its emission reduction obligation.

UK Co approaches ZA Co with the offer to invest equity in ZA Co's new plant (which they intend to register as a CDM project) and provide the requisite technology that would reduce their emissions by half. ZA Co agrees to make UK Co their partner in this new venture.

ZA Co forms a new subsidiary called SA Co (incorporated in South Africa) which will run the new plant. SA Co and UK Co enter into an agreement which states that UK Co would invest R 50,000,000 in SA Co in return for 15% shareholding in SA Co. The agreement further states that UK Co will receive 98% all such CERs generated by SA Co instead of cash dividends. UK Co will also have partial ownership of company's assets which is not influenced by its claim for pCERs generated by the CDM project.

SA Co agrees to the aforementioned investment agreement. In year 1 SA Co generated 50 000 pCERs and in year two SA Co generated another 50 000 pCERs. At the end of year 2, SA Co transferred 98,000 pCERs to UK Co's pending account. This distribution of pCERs did not amount to reduction of SA Co's share capital. SA Co declares dividends out of its sale of widgets to its other investors.

The first question that is raised by the aforementioned facts is: whether the distribution of pCERs by SA Co to UK Co amounts to a “dividend” as defined in section 1 of the Income Tax Act? In order to answer this first question one needs to look at the dividend definition as set out in section 1 of the Act.

## **5.2 INTERPRETATION OF THE 'DIVIDEND' DEFINITION**

The introduction to the “dividend” definition in section 1 provides as follows:

“dividend” means any amount distributed by a company (not being an institution to which section 10(1)(d) applies) to its shareholders, and in this definition the expression “amount distributed”

includes ...”<sup>91</sup>

The introduction above highlights four key components, which must be present, for a distribution to be regarded as “dividend”. These are: amount, distributed, company and shareholder. Prior to proceeding further with the analysis of the dividend definition one needs to determine whether the facts in example 2 above will successfully satisfy these four components.

### **5.2.1 THE DEFINITION OF 'COMPANY'**

Section 1 of the Act defines “company” as including:

“any association, corporation or company (other than a close corporation) incorporated or deemed to be incorporated by or under any law in force or previously in force in the Republic or in any part thereof, or any body corporate formed or established or deemed to be formed or established by or under any such law; or ...”<sup>92</sup>

As the facts in example 2 provide that SA Co is incorporated under the company laws of South Africa, this requirement does not necessitate much analysis. However, prior to proceeding to the next requirement, it should be acknowledged that this is a factual question which will generally be determined on a case by case basis. The next requirement under consideration is: whether UK Co satisfies the requirement of a “shareholder” as defined in section 1 of the Act?

### **5.2.2 THE DEFINITION OF 'SHAREHOLDER'**

Section 1 of the Act defines “shareholder” as:

“ (a) in relation to any company referred to in paragraph (a), (b) or (d) of the definition of “company” in this section, means the registered shareholder in respect of any share, except that where some person other than the registered shareholder is entitled, whether by virtue of any provision in the memorandum and articles of association of the company or under the terms of any agreement or contract, or otherwise, to all or part of the benefit of the right of participation in the profits, income or capital attaching to the share so registered, that other person shall, to the extent that such other person is entitled to such benefit, also be deemed to be a shareholder; or...”<sup>93</sup>

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91 Income Tax Act 58 of 1962 s 1 “dividend” definition.

92 Income Tax Act 58 of 1962 s 1 “dividend” definition .

93 Income Tax Act 58 of 1962 s 1.

In light of the above, shareholder will not only include registered shareholders of a CDM project but also any foreign investor who may have a contract with such South African CDM projects giving it the right to pCERs attaching to a portion of the shares in the CDM project. The facts in example 2 provide that UK Co is a shareholder in SA Co and therefore it is unnecessary to discuss this requirement in any further. The discussion will therefore proceed to the analysis of the next requirement of the dividend definition: “amount”.

### **5.2.3 THE 'AMOUNT' REQUIREMENT**

As mentioned previously under paragraph 4.4.2.1, pCERs will satisfy the requirement of “amount” as interpreted by the South African courts of law. Although the discussion in preceding chapter dealt with the interpretation of “amount” in a different context, the *Comprehensive Guide to Secondary Tax on Companies* (Issue 2) issued by the South African Revenue Service in 2007 (STC Guide), confirms that such interpretation will be acceptable in the context of dividends.<sup>94</sup> It is therefore submitted that the primary CERs in example 2 will satisfy the requirement of “amount”.

This takes the discussion to the last of the four requirements highlighted above, which is: “distributed” to the shareholders. The question under consideration is: whether the transfer of pCERs by SA Co to UK Co's account in example 2 above amounts to a distribution of dividend?

### **5.2.4 INTERPRETATION OF THE TERM 'DISTRIBUTED'**

The term “distribute” is defined in the 6<sup>th</sup> edition of the *Oxford Advanced Learner's Dictionary* as an “act of giving things to a large number of people; to share something between a number of people”.<sup>95</sup> The term is also defined by online *Free Dictionary* by Farlex as “apportionment, allotment or the act of dispersing”.<sup>96</sup>

Both these aforementioned definitions point to the same meaning, which is: the act of giving or allocation of something by one person to others. This is the same meaning that

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<sup>94</sup> STC Guide at page 12.

<sup>95</sup> A S Hornby & S Wehmeier *Oxford Advanced Learner's Dictionary* (2000) 6 ed.

<sup>96</sup> Farlex *The Free Dictionary* Available at: <http://www.thefreedictionary.com/distribution> [Accessed 11 February 2010].

the South African judiciary has attributed to the word “distributed” in the context of dividends. In *Commissioner for Inland Revenue v Legal & General Assurance Society Ltd* 25 SATC 303 (*General Assurance Society* case) Steyn CJ while dealing with the meaning of “distributed” said the following:

“In my view, effect can be given to this apparent intention of the legislature by ascribing to “distribute”, in the relevant context, the wider meaning of apportion, appropriate, allocate or apply towards”.<sup>97</sup>

In light of the above, it is submitted that the transfer or allocation of pCERs by SA Co to UK Co in example 2 will satisfy the fourth and last requirement in the dividend definition introduction. However, satisfaction of these requirements does not answer a critical question: what is understood by the term “dividend”?

#### **5.2.5 UNDERSTANDING THE MEANING OF 'DIVIDEND'**

While dealing with the meaning of the term “dividend” in *Henry v Great Northern Railway Co* (1857) 27 LJ Ch 1 18 Knight-Bruce LJ referred to dividends as a 'share in profits'. If dividends are a share in profit, what is understood by the term 'profit'? The term “profit” in the tax legislation can be found in section 64B, which defines “profit” as including any amount that is deemed in terms of the definition of dividend in section 1 to be a profit available for distribution. In other words, if something falls within the definition of dividend as set out in section 1 of the Act, it can be regarded as profit. The third proviso to the dividend definition also states that “profits” include realised and unrealised profits of a company, whether or not those unrealised profits have been recognised in the financial records of the company.<sup>98</sup> To answer the initial question, a distribution of profits by a company to its shareholders would amount to dividend.

However, this may not hold true for all distributions of profits by the company to its shareholders. There are certain distributions which are specifically excluded from the dividend definition, while others specifically included in the definition. In instances where a distribution does not fall within the ambit of dividend as contemplated in Part VII of the

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<sup>97</sup> *General Assurance Society Ltd* at page 315.

<sup>98</sup> Income Tax Act 58 of 1962 s 1 “dividend” definition.

Act, it could still give rise to capital gains tax if it falls within the ambit of paragraph 74 and 75 of the Eighth Schedule. This will be the case where the distribution by the company to the shareholder amounts to a capital distribution. Paragraph 74 defines the term capital distribution by the company and paragraph 75 provides what is understood by the term distribution *in specie* by a company to its shareholders. If the distribution in example 2 was a capital distribution as contemplated by paragraph 74 and 75 of the Eighth Schedule, it would have given rise to capital gains tax implications instead of STC. However, if the distribution in example 2 falls within the ambit of a specific inclusion to the dividend definition, it could not be simultaneously excluded therefrom, resulting in the application of Part VII provisions.

In what follows, the discussion will illustrate how the distribution in example 2 falls within the ambit of a specific inclusion to the dividend definition, giving rise to STC implications in terms of Part VII of the Act unless exempt thereunder.

### 5.3 SPECIFIC INCLUSIONS TO THE “DIVIDEND” DEFINITION

The dividend definition provides four specific instances when the transfer of an amount will give rise to a dividend as contemplated in the Income Tax Act. However, as submitted above, it is the specific inclusion in paragraph (b) that brings the distribution in example 2 within the ambit of the dividend definition.

#### Paragraph (b) going-concern dividend

This inclusion was aimed to cover any distribution made by a company during the normal course of its life.<sup>99</sup> The inclusion reads as follows:

“Amount distributed includes – in relation to a company that is not being wound up, liquidated or de-registered or where the corporate existence of that company is not finally terminated, **any profits distributed**, including an amount equal to the nominal value, at the time of issue thereof, of any capitalisation shares awarded to shareholders and the nominal value of any bonus debentures or securities awarded to shareholders”.<sup>100</sup>

This is a widely phrased inclusion incorporating any distributions made by a company

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<sup>99</sup> Keith Huxham & Phillip Haupt *Notes On South African Income Tax* 28ed (2009) at page 341.

<sup>100</sup> Income Tax Act 58 of 1962 s 1 “dividend” definition paragraph (b).

during the ordinary course of its life. The distribution could be capital or revenue, realised or unrealized,<sup>101</sup> cash or in kind. It is due to this wide ambit that any distribution of profits by a going-concern to its shareholders falls within the ambit of this inclusion. In example 2 above, the distribution of pCERs by SA Co to UK Co was during the ordinary course of SA Co's life. The pCERs were generated by SA Co for distribution to UK Co, which makes them capital in nature, however, as paragraph (b) is not influenced by the nature of the amount distributed, it is submitted that the inclusion in paragraph (b) will be applicable to the parties in example 2. This distribution of pCERs in example 2 is a distribution in kind also known as dividend *in specie*.

An implication of specific inclusion is that, such distribution cannot be simultaneously excluded from the dividend definition and therefore a discussion of specific exclusion will not be necessary. As the distribution of pCERs by SA Co to UK Co would amount to dividends and dividends trigger the provisions of Part VII of the Income Tax Act, in what follows, the discussion will examine some of the relevant provisions of Part VII and its implications for the parties in example 2.

#### **5.4 SECONDARY TAX ON COMPANIES**

The Part VII of the Act provides for secondary tax on companies. Section 64B(2) of the Act provides that STC must be levied on the net amount of any dividends declared by any company which is a resident. The term “declared” is defined in section 64B as the approval of the payment, or distribution by the directors of the company or some other person who is so authorised by the memorandum or articles of association of the company or the liquidator where the company is being liquidated.

The STC which is levied on the dividends declared by companies, is calculated at the rate of 10% of the net amount as determined in terms of section 64B (3) of the Act. However, STC liability does not arise on any distributions which is exempt in terms of section 64B(5) of the Act. It is therefore crucial to determine whether the distribution of pCERs in example 2 falls within the ambit of any exemptions provided under section 64B (5) of the Act. If the distribution in example 2 falls within the ambit of these exemptions, it will not

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<sup>101</sup> K Jordaan 'et al' *Silke: South African Income Tax* (2008) at page 427 paragraph 17.4.2.

be subject to STC.

#### **5.4.1 EXEMPTION FROM SECONDARY TAX ON COMPANIES**

Any dividends declared by companies the entire receipts and accrual of which would be exempt from tax are also exempt from STC in terms of section 64B (5)(a) of the Act.<sup>102</sup> This is a logical exemption as it would be inconsistent to impose STC on a company that is otherwise exempt from tax on any form of income it receives. However, as section 12K exemption only extends to normal tax on any receipts and accrual from disposal of pCERs in SA Co's account, and not all the income generated by SA Co during the course of its ordinary business, this exemption will not be available to SA Co in example 2.

Any liquidation and de-registration distribution of profits derived prior to 31 March 1993 or capital profits of asset acquired prior to 1 October 2001 is also exempt from STC in terms of section 64B(5)(c) of the Act. However, as the distribution of pCERs by SA Co to UK Co was neither during liquidation nor de-registration, this exemption is inapplicable to the distribution of pCERs by SA Co and UK Co in example 2 above.

The exemption in section 64B(5)(e) deals with dividends declared by gold mining companies, it is therefore not applicable to SA Co and UK Co.

The next available exemption from STC can be found under section 64B(5)(f) of the Act, which deals with inter-group dividends. As SA Co and UK Co are not part of the same group of companies (and could not be for these purposes as UK Co is not a resident) this exemption will be inapplicable to parties in example 2. The same applies to the next STC exemption in section 64B(5)(i) which deals with qualifying companies that enjoyed a tax holiday status. This exemption is inapplicable to SA Co, as SA Co does not fall within the ambit of a qualifying company as contemplated in terms of section 37H.

This takes the discussion to the last remaining STC exemption in section 64B(5)(j) of the Act. This exemption is applicable to any dividends declared by collective investments scheme. As SA Co does not qualify as a collective investment scheme, this exemption will

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<sup>102</sup> *STC Guide* at page 86.

be inapplicable to SA Co in example 2 above.

As the distribution of pCERs by SA Co to UK Co in example 2 above, neither falls within any STC exemptions nor under the section 12K exemption,<sup>103</sup> it is submitted that the distribution of pCERs in example 1 will give rise to the STC liability for SA Co.

#### **5.4.2 STC IMPLICATIONS FOR SA CO AND UK CO**

The first implication for the parties in example 2 will be that, SA Co will be required to pay STC on the net amount of dividends declared by it to its shareholders, which will include, the distribution of pCERs to UK Co. The STC on the distribution of pCERs by SA Co to UK Co will be calculated on the market value of such pCERs on the date of distribution. In the context of section 12K incentive and the purpose behind its introduction in South Africa, this STC liability on the distribution of pCERs by CDM project to its shareholders may not be a great incentive for the development of new CDM projects in South Africa. Especially when one considers that SA Co would have been exempt from normal tax on any receipts or accruals from the sale of pCERs, there is no prudent reason why the distribution of the same pCERs by the CDM project to its shareholders should give rise to STC liability.

Such result might lead one to think that the sale of pCERs is far more attractive option for businesses than to distribute such pCERs as dividend *in specie*. However, one must be weary of making such assumptions as, despite the fact that the receipts and accrual from the disposal of pCERs are exempt in the hands of the company, any distribution of such receipts and accrual to shareholders will still be subject to STC in terms of section 64B. In other words, the company will pay STC if it either distributes the tax exempt pCERs among its shareholders or if it distributes the income from the disposal of such pCERs among its shareholders.

Unfortunately, the National Treasury deliberately opted not to exempt the distribution of profits from the disposal of pCERs for STC purposes. In its response to the comments on the Draft Taxation Laws Amendment Bill 2009, the National Treasury clarified this

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<sup>103</sup> As discussed under the preceding chapter, the distribution of pCERs will not satisfy the “receipt and accrual” requirement under section 12K exemption.



intention and stated the following:

“[T]he distribution derived from CERs will not additionally be exempt from other taxes (e.g. STC)”<sup>104</sup>

To the extent that the exemption for distribution *in specie* is concerned, there appears to have been some misinterpretation on the part of the National Treasury. In response to the comments on section 12K of Draft Taxation Laws Amendment Bill 2009, the National Treasury responded that “*in specie*’ distributions will be exempt from normal tax as the law currently reads”.<sup>105</sup> However, as illustrated in the preceding and the current chapter, *in specie* distribution of pCERs not only has the potential to give rise to recoupment in the hands of SA Co in terms of section 22(8) but also STC in terms of section 64B of the Act. Unfortunately, section 12K as it reads currently is unable to avoid these implications. It is important to bear in mind that these STC implications will only impact SA Co being the company declaring the dividends. As UK Co is the recipient of South African dividends, the amount received by it will be tax exempt in its hands in terms of section 10(1)(k)(i) of the Act.

However, as it is only a matter of time when STC will be replaced by the new dividends tax in South Africa, the question arises: whether the distribution of pCERs under the new dividends tax as set out in the Taxation Laws Amendment Act, 2009 will bear different results for SA Co and UK Co in example 2 above. To answer this question, the next section will briefly look at the proposed dividends tax and its application for parties in example 2.

## 5.5 NEW DIVIDENDS TAX

As the new dividends tax which is set to replace the secondary tax on companies is already incorporated in Part VIII of Chapter II of the Income Tax Act, it is only a matter of time when this new dividends tax will govern all matters previously dealt by STC. The new dividends tax will come into effect on a date to be determined by the South African Minister of Finance by notice in the Government Gazette. Part VIII as set out in the Taxation Laws Amendment Act No 17 of 2009 (“Amendment Act”) contains eleven new sections from section 64D to 64N. In what follows, this dissertation will briefly look at

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<sup>104</sup> Standing Committee on Finance (Note 97).

<sup>105</sup> Standing Committee on Finance [Note 97].

some of these new provisions and their tax implications for the parties in example 2.

The point of departure in the present discussion will be the new dividend definition as provided in section 1 of the Amendment Act which is a significant improvement to the current dividend definition in Act 58 of 1962. The new definition is visibly concise yet encapsulates the crux of the current dividend definition.

According to the new definition, “dividend” means any amount transferred by the company for the benefit of any shareholder of such company, by virtue of shares held by such shareholder in that company.<sup>106</sup> As discussed previously, pCERs do satisfy the requirement of “amount”. As pCERs in example 2 were transferred by SA Co to UK Co by virtue of UK Co's shareholding in SA Co and as this distribution does not fall within any exclusions provided in the above definition, leads to the conclusion that the transfer of pCERs by SA Co to UK Co in example 2 will still fall within the ambit of the new dividend definition.

As this definition merely provides whether a distribution will fall within the ambit of Part VIII as substituted by the Amendment Act, in order to determine the implications of the dividends tax on parties in example 2 one needs to analyse some other provisions of Part VIII.

Section 64D of Part VIII states that an amount will be regarded as “dividend” if it falls within the ambit of the dividend definition as set out in section 1 of the Amendment Act provided: it is either paid by a company that is South African resident, or a non-resident company which paid it in respect of the shares that are listed. The primary CERs in example 2 not only fall within the ambit of the “dividend” definition in section 1 of the Amendment Act, but also within section 64D “dividend” definition as they were paid by SA Co which is a South African resident company.

Unlike section 64B(2) of Part VII which provides that STC is to be levied on the declaration of dividends, section 64E of Part VIII provides that the dividends tax will be levied on the payment of dividends by a company. Such dividends are to be calculated at

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<sup>106</sup> Taxation Laws Amendment Act 17 of 2009 s 1 “dividend” definition.

the rate of 10 per cent of any amount paid by a company.

Section 64E of the Amendment Act also provides for situations when a dividend is paid *in specie*. The amount which is subject to the dividends tax is: in the case of a listed company, is deemed to be equal to the market value of the asset on the date of approval of distribution and where the company is not a listed company such amount is deemed to be the market value of the asset on the date of distribution as defined in paragraph 74 of the Eighth Schedule.

The dividends tax also includes a new concept of “beneficial owner”. Section 64E of the Amendment Act defines beneficial owner as “the person entitled to the benefit of the dividend attaching to the share”. This is an important concept in proposed dividends tax as it looks beyond the registered shareholder to determine the person who actually benefits from the share. It is this ultimate beneficiary who is looked at to determine the dividends tax liability of the recipient. Section 64F of the Amendment Act lists certain instances when the payment of dividend to beneficial owner is exempt from the dividends tax. However, for the purposes of the present discussion it will suffice to say that the distribution in example 2 does not fall within any of these exemptions. Furthermore, as the dividends tax is incurred by the shareholders unlike STC which is incurred by the company, the tax burden in example 2 will be for the shareholder that is: UK Co.

Section 64G of the Amendment Act creates an obligation on the companies paying the dividends to withhold the dividends tax at the rate of 10 per cent of the amount of that dividend. This would mean that SA Co in example 2, will have this withholding obligation, unless certain exceptional circumstances exist which warrant SA Co not to withhold the dividends tax on payments made to the shareholder. These exceptions are listed in section 64G(2), however, the distribution in example 2 does not fall within the ambit of any of these exceptions.

In light of the above, it is submitted that the distribution of pCERs by SA Co to UK Co would certainly amount to dividend as contemplated by the new dividend definition. It will also be subject to dividends tax as it will be paid by a South African resident company. SA Co will be obliged to withhold the dividends tax from the amount of dividends declared,

which in the case of pCERs will be the market value of the units on the day they accrue to UK Co. However, it will be borne by UK Co who is the shareholder and not by SA Co (the company giving the dividend). The exemption in section 12K of the Act makes no provision to exempt such distribution of pCERs from dividends tax that will replace the current STC. As there is neither receipt nor an accrual in return for the pCERs, section 12K exemption will have no application on the distribution of pCERs by SA Co to UK Co. In instances where SA Co opt to sell the pCERs, any amount received or accrued will be exempt from normal tax in the hands of SA Co in terms of section 12K exemption. However, section 12K exemption will not be applicable to any *in specie* distribution of such receipts and accrual to the shareholders. Such distribution will still give rise to dividends tax in the hands of shareholders.

With the use of a hypothetical example 2, the present chapter highlighted some of the STC and dividends tax implications arising from the distribution of pCERs by a South African CDM project. Unfortunately, the tax consequences do not differ under the future dividends tax and section 12K remains equally inapplicable to the distribution of pCERs in future as it is in the present. However, as it is possible to overcome these issues with minor alterations to the Act, the present dissertation will propose amendments which will assist in making the exemption in section 12K a more attractive incentive for the CDM projects.

## **5.6 PROPOSAL AND CONCLUSION**

The aim of the present chapter was to determine whether section 12K exemption will be available to those CDM projects that distribute primary CERs to their shareholders. With the help of the hypothetical example 2, the present chapter highlighted the circumstances when the distribution of primary CERs by a CDM project to its shareholders will fall within the ambit of “dividend” as defined in section 1 of the Act. The discussion also illustrated that such distribution of pCERs will trigger STC for South African CDM project which is not exempt under section 12K (that exempts any receipts and accrual from the disposal of primary CERs).

Unfortunately, the situation will remain the same under the proposed dividends tax which is expected to replace STC in the near future. The exemption in section 12K will remain

equally inapplicable under the dividends tax as it is currently under STC provisions. However, this absurd outcome can be avoided by introducing minor amendments to the Income Tax Act.

These amendments are necessary to extend the scope of the exemption in section 12K in a manner that provides a genuine incentive for the growth of foreign investments in South African CDM projects. One of the options is to amend the dividend definition in section 1 to include a new exclusion that provides that: *in specie* distribution of pCERs by the company to its shareholders will not fall within the ambit of the dividend definition. Another option may be to include a provision in section 12K which exempts the distribution of pCERs by any South African CDM project to its shareholder. Both options aim to rectify the same absurdity that is: rise of STC liability when they distribute pCERs to their shareholders. The aforementioned proposals will be equally applicable to the dividends tax in the future when it replaces STC.

Although it may be more desirable for investors to have an exemption on the distribution of profits from the disposal of pCERs for STC or dividends tax purposes; it is clear that at this point in time, South African legislature has no such intention to provide such exemption. However, in order to ensure that section 12K is a worthy incentive, it is crucial that the legislature rectifies some of the issues outlined in the present chapter.

As the normal tax exemption on the disposal of pCERs by South African CDM project was one of the two incentives initially considered by the National Treasury. It is curious why the National Treasury opted exemption over capital gains tax. It leads one wondering, what would have been the implications for South African CDM projects had the National Treasury opted the capital gains tax (CGT) route? To this end, the following chapter will briefly discuss some of the preliminary issues arising from the treatment of pCERs as capital asset and the implications of subjecting the receipt and accrual from disposal of pCERs to capital gains tax (CGT)?

## **6 CERs AND CAPITAL GAINS TAX**

### **6.1 INTRODUCTION**

During the 2009 Budget speech, the then Minister of Finance Mr Trevor Manuel disclosed the National Treasury's intention to opt between two potential incentives to encourage the development of new CDM projects in South Africa. The options were either:

1. Exempt the receipt and accrual from the disposal of pCERs for normal tax purposes; or
2. Subject the receipts and accrual from the disposal of pCERs to capital gains tax.

The preceding chapters discussed the former option which was incorporated into the Income Tax Act as section 12K. The present chapter will look at the latter option that failed to convince the South African National Treasury of its potential to encourage the development of new CDM projects in South Africa.

The present chapter is divided into two main parts. The first part will briefly discuss the traditional approach to determining when something falls within the ambit of capital and revenue; and the second part will look at some of the issues that would have arisen if the receipts and accrual from disposal of pCERs were subjected to capital gains tax in accordance with the Eighth Schedule.

## PART I

The “gross income” definition as set out in section 1 of the Act provides, that a receipt or accrual will fall within the ambit of gross income to the extent that it is not of a capital nature. This raises the obvious question: what did the legislature envisage by the term capital?

Unfortunately, the legislature opted to remain silent on this topic which necessitated the common law to step in and resolve the issues surrounding the capital and revenue debate. During the past decades, the South African courts of law have devised various tests to assist taxpayers and SARS in the determination of when an amount forms part of capital and when it is revenue in nature. In what follows, this dissertation will briefly look at some of these common law tests.

### 6.2 CAPITAL versus REVENUE

As no amount is inherently capital or revenue in nature, the question is usually determined in light of the specific facts of each case. The Appellate Division in *Commissioner for Inland Revenue v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A) (*Pick 'n Pay* case) acknowledged that a universal test was not prudent and noted that: there is “no single infallible test of invariable application”.<sup>107</sup>

Although there is a reservoir of case law surrounding the capital and revenue debate in South Africa, it is the dissenting judgment of Corbett JA in Appellate Division decision of *Elandsheuwel Farming (Edms) Bpk v Sekretaris Van Binnelandse Inkomste* 1978 (1) SA 101 (A) (*Elandsheuwel* case) that eloquently sums up all the relevant principles as follows:

“Where a taxpayer sells property, the question as to whether the profits derived from the sale are taxable in his hands by reason of the proceeds constituting gross income or are not subject to tax because the proceeds constitute receipts or accruals of a capital nature, turns on the further enquiry as to whether the sale amounted to the realization of a capital asset or whether it was the sale of an asset in the course of carrying on a business or in pursuance of a profit-making scheme. Where a single transaction is involved it is usually more appropriate to limit the enquiry to the simple alternatives of a capital realization or a profit-making scheme. In its normal and most

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<sup>107</sup> *Pick 'n Pay* case at para 4.

straightforward form, the latter connotes the acquisition of an asset for the purpose of reselling it at a profit. This profit is then the result of the productive turn-over of the capital represented by the asset and consequently falls into the category of income. The asset constitutes in effect the taxpayer's stock-in-trade or floating capital. In contrast to this the sale of an asset acquired with a view to holding it, either in a non-productive state or in order to derive income from the productive use thereof, and in fact so held, constitutes a realization of fixed capital and the proceeds an accrual of a capital nature. In the determination of the question into which of these two classes a particular transaction falls, the intention of the taxpayer, both at the time of acquiring the asset and at the time of its sale, is of great, and sometimes decisive, importance. Other significant factors include, inter alia, the actual activities of the taxpayer in relation to the asset in question, the manner of its realization, the taxpayer's other business operations (if any) and, in the case of a company, its objects as laid down in its memorandum of association. The foregoing principles are trite and require no supportive citation of authority. They have been stated and restated, in various forms, by this court on numerous occasions.<sup>108</sup>

As can be seen from the above extract, the traditional approach to determining whether pCERs were disposed to realise a capital asset or in pursuance of a profit making scheme will depend on the intention of the CDM project. The intention of a taxpayer can be determined from surrounding factors that indicate towards the presence of a particular intention. For example, the memorandum of association of a company operating as a CDM project might reflect either an intention to create a new source of revenue from the disposal of pCERs or an intention to retain pCERs as investment for difficult times.<sup>109</sup> Where the intention is to generate additional stream of revenue, the receipts and accrual will fall within the ambit of revenue, however, where the intention is to retain the pCERs for difficult times the receipts on disposal may qualify as capital in nature being subject to capital gains tax.

Unfortunately, the real life tax cases are never this straightforward. Intention is a subjective concept that must be proved based on the objective facts surrounding each disposal of an asset. This task is further complicated by the possibility of change in the intention post acquisition or pre-sale of the asset. To put it differently, as the intention of a taxpayer with regards to an asset can change after s/he acquires that asset or before s/he sells an asset such change will impact the nature of the receipt or accrual on disposal. This was

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<sup>108</sup> *Elandsheuwel* case page 118A.

<sup>109</sup> ITC 1355 (1981) 44 SATC 132 (C).



acknowledged by the court in *CIR v Richmond Estates (Pty) Ltd* 1956 (1) SA 602 (A) where the taxpayer originally acquired properties for trading purposes but had a change in intention after acquisition and decided to retain the properties as investment, which he later on sold at profit. The possibility of such change in intention was also acknowledged by the court in *Natal Estates Ltd v Secretary for Inland Revenue* 1975 (4) SA 177 (A).

In light of the aforementioned common law rule that no amount is inherently capital or revenue in nature, the question arises: how the National Treasury was intending to subject the disposal of pCERs to capital gains tax? The answer is simple; there is nothing that restricts the legislature from deeming pCERs as capital assets. There is a visible advantage in deeming pCERs as capital assets as it circumvents all the problems associated with determining the nature of pCERs on a case by case basis. However, subjecting pCERs to capital gains tax will not be without challenges. The discussion in part II below will look at some of the issues in subjecting the receipts and accrual from disposal of pCERs to capital gains tax.

## PART II

### 6.3 PRIMARY CER AND CAPITAL GAINS TAX REQUIREMENTS

The Eighth Schedule to the Act governs the taxation of capital assets disposed by South African residents and non-residents on or after 1 October 2001. Had the National Treasury opted to deem pCERs as capital assets, any disposal of these units would also have been governed by the Eighth Schedule to the Act. The following discussion will briefly examine the four fundamental requirements of capital gains tax: asset, disposal, base cost and proceeds. The aim of the present discussion is to highlight some of the issues that CDM projects might encounter in satisfying all four requirements for determination of CGT liability.

As CGT liability varies for South African residents and non residents any reference to the disposal of pCERs in the remainder of this chapter refers to the disposal of pCERs by South African resident CDM projects.

#### 6.3.1 DO pCERs SATISFY THE “ASSET” REQUIREMENT?

This is the first pre-requisite of capital gains tax as set out in the Eighth Schedule to the Income Tax Act. If there is no asset there cannot be any capital gain or loss. It is therefore important to examine whether pCERs will fall within the ambit of “asset” as contemplated by the legislature in the Eighth Schedule of the Income Tax Act.

Paragraph 1 of the Eighth Schedule defines the term “asset” widely including:

- “(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and
- (b) a right or interest of whatever nature to or in such property.”<sup>110</sup>

The definition of “asset” in paragraph 1 clearly states that an asset includes any type of property and any interest in such property, while specifically excluding any “currency”

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<sup>110</sup> Income Tax Act 58 of 1962, Eighth Schedule para 1 “asset” definition.

from the definition of “asset”. As highlighted in Chapter 2 *Nature of Certified Emission Reduction Units*, pCERs do not fall within the ambit of “currency” (as traditionally understood) therefore the specific exclusion in the “asset” definition will not apply to pCER. However, describing pCERs as a form of property or a right in a property is also problematic (see discussion in chapter 2).

If the legislature in future decides to subject the proceeds from the disposal of pCERs to capital gains tax, this uncertainty regarding the legal nature of pCERs may have to be resolved. Although, it is possible that the National Treasury might either specifically include pCERs into the definition of asset in paragraph 1 of the Eighth Schedule or simply deem pCERs as capital assets for the purposes of the Eighth Schedule. In the absence of either of the above, there will be ongoing battle between the taxpayer's on one hand who may challenge that pCERs are unable to qualify as property rights and SARS on the other hand who might try to subject the proceeds from the disposal of pCERs to capital gains tax. Once the legislature deems pCERs as a capital asset this issue will not pose any hurdle for either the taxpayers or the revenue.

However, it is trite that a presence of an asset on its own is not sufficient to trigger capital gains tax. Such asset must be disposed of by the taxpayer to trigger capital gain or loss in terms of the Eighth Schedule. In the next section, the present dissertation will briefly examine what is contemplated by the term “disposal” and when pCERs will be regarded as being disposed by a CDM project?

### **6.3.2 THE “DISPOSAL” REQUIREMENT**

As capital gain or loss is triggered by some form of disposal or deemed disposal of the asset, it is critical to look at the instances which give rise to disposal of pCERs by a CDM project. This requires an understanding of what exactly is contemplated by the term “disposal” as defined in paragraph 11 of the Eighth Schedule.

Paragraph 11 includes various instances that give rise to disposal for CGT purposes and includes:

“any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset”.<sup>111</sup>

The present dissertation will briefly discuss three of the aforementioned events that commonly give rise to disposal of pCERs by a CDM project.

The first event that is listed in paragraph 11 is: disposal by means of “sale” of an asset. This is without a doubt one of the most common forms of disposal giving rise to capital gain or loss in general. As many CDM projects generate pCERs for the purposes of adding a new stream of revenue, this event will often give rise to capital gain or loss in the hands of such CDM projects. In the event of such disposal, CDM project must account for the capital gain or loss arising from the sale of its pCERs.

The second disposal event is where the project distributes pCERs to its shareholders. This transfer of pCERs is common where the Annex I party makes a financial or technological investment in a Non Annex party with an expectation to receive pCER in return. Such distribution of pCERs by a South African CDM project will trigger capital gain tax in the hands of the project and it will be required to bring such gain or loss into account.

The third and the last form of disposal event to be discussed hereunder is: disposal as a result of expiration of an asset. In terms of the Kyoto Protocol, a long term CER expires at the end of its crediting period<sup>112</sup> and it will fall within the ambit of a disposal as provided in paragraph 11 of the Eighth Schedule. A pCER ceases to exist after its expiration date unless it is renewed (if it is a renewable CER). In such instances expiration of the pCERs, if it was still within the CDM registry, will be viewed as a disposal event that will trigger capital gain or loss in the hands of the South African CDM project that held it at the time of expiration.

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<sup>111</sup> Income Tax Act 58 of 1962, Eighth Schedule para 11.

<sup>112</sup> Modalities and Procedures for Afforestation and Reforestation Project Activities under the Clean Development Mechanism in the First Commitment Period of the Kyoto Protocol, decision 5/CMP.1, Annex paragraph 46. Available at: [http://www.ciesin.columbia.edu/repository/entri/docs/cop/Kyoto\\_COP001\\_005.pdf](http://www.ciesin.columbia.edu/repository/entri/docs/cop/Kyoto_COP001_005.pdf) [Accessed 6 July 2010].

As mentioned above, all disposal events will trigger capital gain or loss in the hands of the person who disposed such asset. It is the responsibility of that person to account for any capital gain or loss arising from such disposal event at the time of the disposal.<sup>113</sup> However, as the timing of disposal could vary for different events, paragraph 13 of the Eighth Schedule provides timing rules for different disposal events.

To illustrate how the time of disposal may vary from one event to another, one can look at the three aforementioned disposal events. The time of disposal for these aforementioned events will be as follows:

1. The time of disposal where the CDM project sells the pCERs to an Annex I party will be the time when the sale agreement is concluded (provided the contract was unconditional),<sup>114</sup>
2. The time of disposal where the CDM project distributes the pCER to its shareholder will be the date of such distribution,<sup>115</sup> and,
3. The time of disposal as a result of expiration of the pCER will be the date of extinction of such pCERs, or the date when pCER cease to exist because they are transferred into the cancellation account.<sup>116</sup>

These different timings of disposal also determine when the CDM project becomes responsible to account for the capital gain or loss incurred from such disposal event. However, in order to account for the capital gain or loss incurred as a result of disposal, the taxpayer needs to determine the “base cost” of the asset disposed. The next section will briefly discuss what is understood by the term “base cost” and how CDM projects will determine the base cost of pCER generated and disposed by them during a particular year of assessment?

### **6.3.3 DETERMINING THE “BASE COST” OF PRIMARY CERs**

The base cost of an asset is essentially the cost that a person may deduct from the proceeds received or accrued from the disposal of an asset. As CGT was introduced in the South

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<sup>113</sup> South African Revenue Service *Comprehensive Guide to Capital Gains Tax 2* (2007) at page 100.

<sup>114</sup> Ibid.

<sup>115</sup> Income Tax Act 58 of 1962, Eighth Schedule para 75.

<sup>116</sup> (Note 110) at page 101.

African tax legislation on 1 October 2001, the rules regarding the determination of base cost of asset on or after 1 October 2001 are different from those rules that are used to determine the base cost of an asset acquired before 1 October 2001. However, as the first Kyoto Protocol commitment period began in January 2008, the relevant rules for the determination of base cost of pCERs will be those for assets acquired post 1 October 2001.

In overly simple terms, the base cost of an asset acquired on or after October 2001 includes the acquisition cost plus specific costs incurred to improve such asset.<sup>117</sup> This is the most difficult requirements to satisfy when it comes to the disposal of primary CERs. As discussed in the paragraph 4.3.3 of Chapter 4 *Certified Emission Reduction Units As Trading Stock*. The problem with the determination of the cost price of pCERs is that, pCERs would not be generated in the absence of the ordinary business activities of the CDM project. As pCERs would not be generated in the absence of other revenue producing activities of the business, it is difficult to pin point what portion of the expense was incurred in producing pCERs (capital asset) and what portion was incurred in the operation of ordinary business activities (production of revenue by the CDM project).

Although there are certain costs which are more closely associated with the generation of pCERs<sup>118</sup> than other revenue producing activities of a CDM project; it is not clear whether these costs can be regarded as the base cost of pCERs. The determination of the base cost of pCERs will most certainly create a conflict between the taxpayer and SARS. This is because the taxpayer might attempt to inflate their base cost to reduce the CGT liability, while SARS will try to restrict this base cost to a minimum. However, as section 82 of the Act places the onus on the taxpayer to prove the base cost of an asset, SARS may not have too much to be concerned about. In instances where the taxpayer fails to prove the base cost of pCERs, the revenue could potentially tax the full proceeds from the disposal of pCERs.<sup>119</sup> Although this may be correct from a legal point of view, such tax treatment will most certainly not be viewed as an incentive by CDM projects in South Africa.

As pCER do not fall within the scope of traditional asset definition, one should refrain

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<sup>117</sup> Huxham & Haupt (Note 103) page 778.

<sup>118</sup> Certification costs of pCERs and monitoring costs of CDM project, see Chapter 4.

<sup>119</sup> (Note 114).

from the temptation of imposing traditional rules of determining the base cost on them. If in the future the National Treasury decides to subject the receipt and accrual from the disposal of pCERs to CGT, it may be more prudent for the National Treasury to devise a new formula for the determination of the base cost of pCERs. Such new formula should be designed with consideration of the specific nature and issues surrounding pCERs and CDM projects. As this will be a time consuming and costly exercise, the National Treasury will have to carefully consider all the potential benefits of such incentive against the costs. However, for the purposes of the present dissertation, it will suffice to say that a novel problem requires a novel solution and attempting to determine the base cost of pCERs with traditional means may only render unsatisfactory results.

The next paragraph will briefly discuss the last of the four essential requirements for the determination of CGT: “proceeds”.

#### **6.3.4 “PROCEEDS” FROM THE DISPOSAL OF PRIMARY CER**

Paragraph 35 of the Eighth Schedule provides that “proceeds” are the amount received or accrued or treated as having received or accrued in favour of a person in respect of that disposal.<sup>120</sup> In other words, the amount received or accrued or treated as having received or accrued in favour of the CDM project on disposal of pCER is: the proceeds from disposal of such pCERs. The meaning of the term “amount”, “received” or “accrued” were discussed under Chapter 4 paragraph 4.4.2.1 and 4.4.2.2, therefore any reference to these terms holds the same meaning as discussed thereunder.

Paragraph 35 also provides what is specifically included in “proceeds” from the disposal of an asset and what should be reduced from such proceeds. In the case of straightforward disposal of pCERs by means of sale, any amount received or accrued to the CDM project from the disposal of pCERs is the “proceeds” from such disposal. However, there may be circumstances where a CDM project may not receive or accrue any amount on disposal of pCER, for example, when a CDM project makes an *in specie* distribution of pCERs. How must such project account for the disposal when there is no receipt or accrual of “proceeds”? Fortunately, the Eighth Schedule caters for such instances and the answer lies

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<sup>120</sup> Income Tax Act 58 of 1962, Eighth Schedule para 35.

in paragraph 75 of the Eighth Schedule. Paragraph 75 provides that the proceeds from *in specie* disposal are the market value of the asset disposed at the time of the disposal.

The aforementioned example is an overly simple illustration of receipt and accrual of proceeds from the disposal of pCERs. As pCER disposal agreements will often be significantly more complex than the example used above, the determination of “proceeds” may not always be a simple task. On successful determination of this last requirement of capital gains tax, the taxpayer will be able to deduct the base cost from such proceeds and the remaining amount will determine whether the taxpayer made a capital gain or a capital loss. However, this will not be possible in the absence of any one of the four requirements mentioned in the present chapter.

#### **6.4 CONCLUSION**

The present chapter sought to highlight some of issues surrounding the capital gains tax treatment of receipts and accrual from the disposal of pCERs. If the National Treasury opt to subject the receipts and accrual from the disposal of pCER to capital gains tax, it will have to deem pCERs as capital assets for the purposes of the tax legislation. Once the legislature deems pCERs as capital assets, every disposal of pCERs by CDM project will require such project to determine the base cost of the pCERs disposed. If the CDM project fails to satisfy SARS as to the correct amount of base cost, it is possible that the revenue service may subject the entire proceeds to capital gains tax in terms of the Eighth Schedule to the Act. The question as to how easy CDM projects will find the task of satisfying all four requirements of capital gains tax cannot be answered at this point in time. However, one thing that is clear is that subjecting pCERs to capital gains tax like section 12K exemption will have its own issues. As an incentive not only has to be financially attractive but also administratively manageable for CDM projects in South Africa, it may be that the National Treasury made the correct decision in opting for section 12K exemption as an incentive instead of going the CGT route.



## 7 CONCLUDING REMARKS

This dissertation sought to examine some of the issues surrounding the new exemption in section 12K and whether these issues will defeat the purpose behind the introduction of this novel provision. To this end, the present dissertation highlighted some of the issues that may detract from section 12K incentive.

The implications of section 12K exemption on the deductibility of CDM expenses were discussed in chapter 3. The discussion highlighted that an incentive in the form of an exemption inevitably carries the burden of non-deductibility of expenses. As an apportionment of CDM expenses between those incurred in the production of income and those incurred in the production of exempt pCERs can be a hair-splitting exercise, there is an inherent risk that CDM projects might not be able to deduct expenses they incurred in the production of income. This lingering uncertainty regarding which expenses will be deemed to have been incurred in the production of exempt pCERs and which ones in the production of income could act as a disincentive for CDM projects. However, with the help of the National Treasury's guidance, this issue can be easily resolved.

The discussion in chapter 4 focused on the issues surrounding the inclusion of pCERs into the “trading stock” definition in section 1 of the Act. An application of the trading stock provisions on pCERs will not only create a burden for CDM projects, to determine the cost price of these units, but also a potential risk of having to include this cost price in the income of the CDM projects as closing stock creating potential cash flow issues. The discussion also highlighted that there may be circumstances where the CDM project may be deemed to have recouped the value of pCERs generated and disposed to the shareholders. All these issues are potential disincentives that the CDM project will have to weigh against the advantages of incentive offered in section 12K. Unfortunately, section 12K as it reads currently is unable to avoid these trading stock implications. However, the National Treasury can easily circumvent these undesirable consequences by specifically excluding pCERs from the trading stock definition.

It appears that in the case of pCERs that are distributed as dividends, the law will impose

STC. Although the National Treasury expressly stated that *in specie* distribution of pCERs by the CDM project will not give rise to STC in the hands of the CDM projects, there is no basis for this view. As the Act currently read, any *in specie* distribution of pCERs by a CDM projects to its shareholders will trigger STC in the hands of such CDM project. Furthermore, the analysis of dividends tax also leads to the same conclusion and any distribution of pCERs by a CDM project in the future will reap the same results. The exemption in section 12K as it reads currently will not be able to circumvent such result which potentially detracts from this incentive.

All the issues highlighted above make the exemption in section 12K a questionable incentive. As capital gains tax option for receipts and accrual form the disposal of pCERs was never publicly debated in South Africa, one cannot be certain that section 12K is better or worse of the two incentives. It is to this end, chapter 6 looked at what issues would have arisen if the disposal of pCERs was subject to the capital gains tax in terms of the Eighth Schedule to the Act.

The discussion highlighted that one of the major obstacles in the determination of CGT on the disposal of pCERs will be the determination of the base cost of these units. Although, the National Treasury could devise a formula to assist the taxpayers in the determination of the base cost of pCERs, it may not be a simple task due to the unique nature and circumstances in which pCERs are generated. The discussion in chapter 6 was merely a glimpse of the alternatives to section 12K. It is a topic which is worth exploring as it might hold the key to development of new CDM projects in South Africa. Until such time, the CDM projects and the National Treasury will have to work together to resolve some of these preliminary issues and assist in making South Africa an environmentally sustainable economy.

## CLEAN DEVELOPMENT MECHANISM PROJECT CYCLE

Although the issuance of certified emission reduction unit (CER) sounds reasonably uncomplicated, CDM project is without a doubt one of the most complex of the three Kyoto Protocol mechanisms. This is due to the fact that there are several phases in any CDM project cycle and each phase of the project cycle contains its own unique requirements with different role players and all these requirements must be fulfilled prior to the issuance of any CERs.

Provided all the eligibility requirements<sup>121</sup> to host a CDM project are met, the different phases of a CDM project are briefly summed below:<sup>122</sup>

### 1) Phase 1 – Project Design Document

The project participants are required to complete the Project Design Document (PDD). This is one of the most important documents in the CDM project cycle. As there are different PDD's for different types of CDM projects, the project participants have to select the appropriate PDD for their CDM project. To list some examples of the information required by this document:

- Information detailing the project activity – This would provide technical information on the specific CDM project.
- The applicable baseline methodology.<sup>123</sup>
- The demonstration of additionality requirement.<sup>124</sup>
- The environmental impacts of the project.

121 'Negotiating the transfer and acquisition of project-based carbon credits under the Kyoto Protocol' (UNIDO) Vienna, 2007 at page 8. Available at [http://www.unido.org/fileadmin/user\\_media/Publications/Pub\\_free/Negotiating\\_transfer\\_and\\_acquisition\\_of\\_project\\_based\\_carbon\\_credits\\_under\\_Kyoto\\_protocol.pdf](http://www.unido.org/fileadmin/user_media/Publications/Pub_free/Negotiating_transfer_and_acquisition_of_project_based_carbon_credits_under_Kyoto_protocol.pdf) [Accessed 10 January 2009] page 25

122 The information provided in this dissertation on the different phases of a CDM project is a brief synopsis of a more complex and technical area of study. For an authoritative resource dealing with this CDM project, see [www.CDMrulebook.com](http://www.CDMrulebook.com) [Accessed 9 March 2009].

123 [Note 121] page 27.

124 Ibid.

## **2) Phase 2 – Validation and Registration**

The validation phase involves the evaluation of the aforementioned PDD and the CDM project by the Designated Operating Entity (DOE). If all the validation requirements are fulfilled the DOE would submit the validation report to the CDM Executive Board.<sup>125</sup> If all additional requirements are satisfied, the CDM Executive Board would accept the CDM project activity resulting in registration of a CDM project.

## **3) Phase 3 – Monitoring Phase**

This is the process where actual emissions of the project are monitored to determine the emission reduction from a particular project.<sup>126</sup> The project participants are required to perform this function however it is objectively verified by independent parties in the next phase.

## **4) Phase 4 – Verification and Certification**

The verification phase requires the DOE to verify the legitimacy of the emission reduction from the CDM project.<sup>127</sup> Once the DOE is satisfied that emission reduction are legitimate, the DOE will create a certification report requesting the issuance of CERs from the Executive Board of CDM.<sup>128</sup>

## **5) Phase 5 – Issuance of CER**

The CDM Registry Administrator would issue CER equivalent to the GHG reduction achieved by a particular CDM project.<sup>129</sup> These CER are issued in the pending account of the Executive Board and from this account the CERs are transferred to the relevant national registries of the project participants.<sup>130</sup>

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125 [Note 121] page 29.

126 Baker & McKenzie CDM Rulebook Clean Development Mechanism Rule, Practice & Procedure. Available at: <http://www.cdmrulebook.org/pageid/115> Accessed on [13 April 2009].

127 Baker & McKenzie CDM Rulebook. Available at <http://www.cdmrulebook.org/pageid/124> Accessed 13 April 2009].

128 Baker & McKenzie CDM Rulebook. Available at <http://www.cdmrulebook.org/pageid/133> [Accessed 13 April 2009].

129 [Note 121] page 32.

130 Baker & McKenzie CDM Rulebook. Available at <http://www.cdmrulebook.org/PageId/352> [Accessed on 13 April 2009].

**PRIMARY CERTIFIED EMISSION REDUCTION UNITS  
VERSUS  
SECONDARY CERTIFIED EMISSION REDUCTION UNITS**

**PRIMARY CERTIFIED EMISSION REDUCTION UNIT**

A CER unit is called primary CER or pCER when it is held by the CDM project owner/participant who generated that CER (the primary owner).

To explain by means of an example:

A wind farm called Breezy wheels is a registered CDM project located in South Africa. The project generates renewable energy. Breezy wheels have two project participants namely SA Co and USA Co. Breezy wheels successfully generated 1000 CERs in 2009 which are held by SA Co and USA Co in their pending account in the CDM registry.<sup>131</sup> These 1000 CERs are primary CERs in the hands of SA Co and USA Co being the primary party with the right to dispose of these 1000 CERs.

In the above example should SA Co or USA Co decide to dispose off their CERs to another entity for ex UK Co, any receipts and accrual on disposal of those CERs will be exempt from normal tax in the hands of SA Co and USA Co. This is because they will be disposing of pCERs and receipts and accrual from disposal of pCERs is exempt from normal tax in terms of section 12K of TLAA. As section 12K exemption is not applicable to receipts and accrual from disposal of sCER it is worth noting when a CER unit will fall within the ambit of sCER.

**SECONDARY CERTIFIED EMISSION REDUCTION UNIT**

A sCER is a CER unit which is disposed by an entity that was not the primary owner of that unit.

To explain by means of the above example:

SA Co and US Co dispose off their 1000 pCERs to UK Co. UK Co decides to on sell these 1000 CERs to Brazil Co for a profit. This disposal by UK Co to another entity will not qualify for section

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<sup>131</sup> United Nations Framework Convention on Climate Change *CDM Registry*. Available at <http://cdm.unfccc.int/Registry/index.html> [Accessed 24 October 2009].

12K exemption because UK Co was not the primary owner of these 1000 CERs. These CERs acquired by Brazil Co are sCER.

As can be seen from above, the distinction between pCER and sCER is not between the nature of the two units but between the status of the two units. This status changes with the change in ownership and fairly justifies the differentiation between the tax treatment of the two units. As pCERs are disposed directly by the CDM project (often before they are generated), there is a risk associated that the investor may not receive the pCERs if the project was unsuccessful, unlike secondary CERs which are already issued and available in the market but at a higher cost because of the lower risk. It is for this reason the decision of whether to acquire pCERs or sCERs has an impact on the financial status as well as the risk resistance of the business.

Although the decision to acquire pCER or sCER is an important decision, equally important is the decision of which business model should be adopted for a CDM project. Currently there are three well known business models available for participation in a CDM project for the generation of CERs. As the different business model will impact the tax implications for different parties, it will be prudent to briefly discuss these business models.

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