

Sustainable investing brings specific tax risks

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Governments are developing their tax strategies towards this emerging asset class, yet investing in sustainable assets already brings some specific tax risks.



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Investments in renewable energy, carbon and sustainability have grown rapidly in the last few years. The main drivers behind this growth are regulatory and other policy initiatives, introduction of tax incentives, expansion of carbon markets, energy security concerns and an increased interest in preventing climate change. Even with the credit crisis, investments in this area have shown significant growth in 2008 and, although the credit crisis will impact growth in 2009, further growth is anticipated.

However, this is still a relatively new asset class and governments worldwide are developing their tax strategies and introducing new taxes or incentives in response to the challenges posed by this sector. It is, therefore, essential that ownership structures are as flexible as possible, particularly given the long-term nature of many of the investments, and that investors keep up to date with global tax developments – a few of which are highlighted below.

An important issue for renewable energy and sustainability assets such as water infrastructure is the tax status in the country where the assets are located. Depending on whether the assets are considered movable or immovable, income from these assets may be taxable in the local jurisdiction, even where the assets are held by a foreign entity. Investing from a tax treaty jurisdiction does not always solve this issue as taxation of income from immovable property is generally reserved to the state where the property is located. However, there are a wide variety of debt financing and leasing structures which may reduce taxation in the local jurisdiction. In certain jurisdictions there are also various 'green' tax incentives or tax holidays which may reduce local taxation.

Where, as a result of the above, the holder of the renewable assets does not have sufficient tax capacity, 'green' tax incentives may not be beneficial to the holder of the assets. In these circumstances, the holder of these assets could explore ways of transferring these 'green' tax credits to, for instance, the leverage financier in order to reduce finance costs.

Investing in the carbon markets

Cap-and-trade schemes and project-based credit mechanisms form the two key building blocks of the carbon markets.

A project-based credit is an emission reduction below a hypothetical business-as-usual baseline. The two project-based credit mechanisms under the Kyoto Protocol are the Clean Development Mechanism (CDM) and Joint Implementation (JI). The CDM is an arrangement allowing countries with greenhouse gas reduction commitments to invest in projects that reduce emissions in developing countries that have no commitments such as China, India and Mexico. The CDM may result in Certified Emission Rights (CER) which can be traded. The JI is a similar sort of arrangement for investments in countries with binding greenhouse emission targets. The JI may result in Emission Reduction Units (ERU) which can be traded.

Investors investing in CDM and JI projects should be aware of the tax issues. Although these are generally long-term investments, offshore funds investing in CDM and JI projects should carefully consider the permanent establishment risks in countries such as China. Failure to do so can lead to unexpected tax costs.

Although the payment of CERs and ERUs generally do not trigger any local withholding tax, certain countries, such as China, claim part of the profits from the cross-border sale of these credits and certain jurisdictions are considering a direct withholding tax on carbon credits. Furthermore, the management of these projects may trigger withholding tax on the project management fees. Where licences and patents are used, licence fees and royalties may result in withholding taxes. VAT, and other indirect taxes, should be carefully considered to avoid irrecoverable VAT for the fund.

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