

Tax Brief

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Tax Issues Arising from the CPRS

On Tuesday 10 March, the Government released exposure draft legislation for its proposed Carbon Pollution Reduction Scheme ('CPRS'). The legislative package of six draft Bills contains a number of tax measures relevant for Australian businesses, as well as the rules for establishing and running the CPRS trading regime itself. This Tax Brief sets out the main tax issues that businesses will need to grasp arising from a measure that many are saying will be the biggest structural adjustment to the Australian economy since the GST.

1. Background

The process which led to this legislation has been long and difficult, and involved many agencies. Major milestones so far include:

- the establishment of a National Emissions Trading Taskforce by the State and Territory governments in 2004 and the release of its discussion paper and final report (August 2006 and December 2007);
- the establishment in December 2006 by Prime Minister John Howard of the Prime Ministerial Task Group on emissions trading and the release of its report (June 2007);
- the appointment by the Labor Government of Professor Ross Garnaut to examine a CPRS and the release of his interim report (February 2008);
- the issue of the *Carbon Pollution Reduction Scheme – Green Paper* by the Department of Climate Change (July 2008);
- Professor Garnaut's final report (October 2008); and
- the White Paper, *Carbon Pollution Reduction Scheme: Australia's Low Pollution Future* published by the Department of Climate Change (December 2008).

Throughout that process, while there has been much controversy surrounding several issues – for example, the handling of trade-exposed industries, the range of greenhouse gases to be included, the number of free permits to be issued, special rules for coal-fired electricity generators and the speed and extent of the carbon reduction targets – many of the major design elements of the scheme have remained the same:

- the scheme would be based around tradable permits (now called emissions units), rather than the imposition of a "carbon tax";

- few Australian businesses would need to hold emissions units – a recent estimate was about 1,000 businesses;
- initially, permits would be tradable domestically though this might eventually extend to international trading; and
- it was expected that there would be an extensive secondary market in units and in derivatives over units.

Even assuming there will not be major changes to the package during its passage through Parliament, implementing the CPRS will still take some time. The key stages of the Government's proposed timetable for implementing the CPRS are:

- May-June 2009: official Bills to be introduced into Parliament and enacted;
- early 2010: first auction of CPRS permits;
- 1 July 2010: the first year of the CPRS starts;
- 31 October 2011: businesses file reports on emissions during the 2010-11 year;
- 15 December 2011: businesses surrender permits for emissions during the 2010-11 year.

2. Key Design Elements of the CPRS

The basic design of the proposed CPRS set out in the package of exposure draft legislation largely follows the pattern that was developed through the *Green Paper* and *White Paper* process. Key elements of the regime are set out below.

- The scheme will cover the six greenhouse gases recognised under the Kyoto Protocol at levels exceeding the equivalent of 25,000 tonnes of carbon dioxide (CO₂) per annum.
- The scheme applies to businesses which are operating in five key industry sectors: industrial processes, stationary energy, transport, waste and fugitive emissions. The scheme will also apply to firms that are direct emitters, importers, producers or suppliers of certain fuels and synthetic greenhouse gases. (Special rules attempt to manage the potential double-counting of emissions where, say, a supplier and its customer are both within the scheme.) Forestry businesses can opt into the CPRS under certain conditions. Doing so will entitle them to receive free emissions units that they can then on-sell (and expose them to the need to buy units if forests are felled). The destruction of greenhouse gases will also entitle firms to receive free emissions units.
- Emissions units specific to a year (the "vintage") will be issued by the regulator – the Australian Climate Change Regulatory Authority – up to the annual limit for that year (a number which has yet to be determined) with their ownership and currency recorded in digital form on an Australian registry. Some emissions units will be issued free to certain industries; the remainder will be sold at monthly auctions, starting early in 2010. For the first 5 years of the scheme, the price of units will be capped, with the price set at \$40 per ton for 2010-11, and rising

annually thereafter. Further details of the auction process are yet to be finalised.

- The scheme will operate on a financial year basis, starting on 1 July 2010. Affected businesses are required to report their emissions for a year by 31 October after the end of the year and to surrender by 15 December an eligible emissions unit of the appropriate “vintage” for every tonne of CO₂ equivalent gas reported. (It seems that businesses will be able to surrender units earlier than 15 December which may be useful for tax purposes.)
- Firms which do not buy and surrender sufficient emissions units will suffer an administrative penalty – that is, they will have to pay a sum calculated by reference to the average price of units auctioned during the year, increased by 10%. In addition, in the next year, the firm will have to buy and surrender a number of units equal to the shortfall that arose in the previous year.
- The CPRS will have a cross-border dimension from the outset. In addition to emissions units issued by the Australian regulator, Australian businesses will be able to buy, trade and surrender so-called “Kyoto units” – that is, units issued by the relevant authorities in other countries that meet certain aspects of the Kyoto process. Also, there will be no restriction on the ownership of Australian-issued units – that is, non-residents can bid for them at auction.
- There will also be a secondary market in emissions units and Kyoto units. Unused units may be traded to other businesses, and units that are not surrendered can be ‘banked’ for use in later years. It will also be possible to ‘borrow’ up to 5% of the units needed for a year – that is, to acquire units with a future vintage for use in the current year.

3. Income Tax Issues

3.1 Issues for firms acquiring units for use

The proposed tax treatment of emissions units is set out in one of the exposure draft bills which proposes amendments to the income tax and GST legislation. (Hopefully this will save Australia from the UK experience where the tax implications of their scheme are still being debated.) The proposed income tax treatment for emissions units resembles a modified version of trading stock tax accounting.

The cost of acquiring an emissions unit or Kyoto unit (even if on an overseas register), either at auction or on the secondary market, will be deductible. However, if the proceeds of selling the unit would not be taxable in Australia, the cost of the unit is not deductible. This qualification appears to be directed at situations where Australia’s jurisdiction to tax is limited by a double tax agreement – for example, the sale of an emissions unit by a non-resident enterprise, resident in a treaty country, with no permanent establishment in Australia.

The receipt of units issued free to some firms will have no tax consequences – they are not to be treated as a taxable bounty or subsidy – unless they remain on hand at the end of a year, in which case they will be treated as acquired at their market value at the time of issue. (This position

differs in form from that proposed in the *Green Paper* where the value of a free permit would have been included in assessable income in the year of receipt and a special deduction provided for the surrender of a free permit.)

The value of units remaining on hand at the end of a year will be added back to assessable income. A special rule mandates that emissions units are sold or surrendered on a first-in-first-out basis. Taxpayers holding unused units at the end of the first year of operation of the scheme can choose to value their closing units either at cost or market value. This decision remains in effect indefinitely, although it can be changed once in the period until the end of the 2016 income year.

Under this mechanism, the surrender of a unit will have the effect of triggering the deduction for the cost of the unit. We mentioned above that businesses will be able to surrender units early, and this will permit businesses to trigger the deduction for the cost of acquiring units in the year of acquisition, rather than the succeeding year when the reporting and reconciliation is done.

The sale of unused units into the secondary market will generate assessable income. The same treatment will apply if a firm surrenders a unit outside the ordinary course of its operations. Income from the sale of units is treated as sourced in Australia which will be relevant for non-residents.

Transactions between associates involving units will generally be deemed to occur at market value.

There are some other aspects of the CPRS which will raise tax questions, but for which there are no specific provisions. The treatment of the shortfall penalty payable under the CPRS where a firm has failed to buy and surrender an emissions unit is not set out. However, it is likely that any administrative penalty imposed under the CPRS would not be deductible under current law.

There are some special rules for cross-border transactions involving emissions units:

- the transfer pricing rules are invoked for international transactions between associated enterprises; and
- further, special rules operate where a firm buys (or is issued) a Kyoto unit (or some other kind of offshore unit in the future) that is registered on a foreign register and then transfers the unit to its Australian register so that it can be surrendered in Australia to meet its obligations under the CPRS. In such a case, the taxpayer is treated as having sold the unit to itself for its market value at that time, presumably triggering a revenue gain or capital gain at the time of transfer, unless an exemption (such as the branch profits exemption) applies. Thereafter, the usual rules apply – the cost of the unit is deductible and proceeds of sale assessable as statutory income; and
- similar “deemed sale” rules are provided for Australian issued units that are transferred to an offshore registry, although at present, the legislation does not permit Australian permits to be transferred to an offshore registry.

The draft legislation states that these rules deal exhaustively with the tax obligations arising from transactions involving emissions units, with a few exceptions. Thus, no capital gain or loss will result from transactions with an emissions unit (except for the rules just described on the cross-border movements of units). Further, the new rules for taxing financial arrangements (“TOFA”) will not apply to transactions in emissions units.

3.2 Issues for firms trading in units and derivatives over units

More interesting tax questions will arise where firms try to hedge their cost for future years. It is expected that there will be a lively market in derivatives written over emissions units – for example, affected firms may wish to buy options to acquire emissions units they expect to need in future years; banks may offer to forward sell emissions units for future years. These transactions may be designed to result either in the delivery of units in the future or in cash payments to allow units to be purchased.

It was noted above that the proposed rules are intended to deal exhaustively with the tax obligations arising from transactions involving emissions units, but they do not extend to transactions with derivatives over emissions units. The provision which removes the operation of the TOFA rules is limited to transactions with the units themselves; the explanatory material which accompanied the draft bill says that the TOFA rules may apply to derivatives over emissions units. The demarcation between transactions within the proposed CPRS tax rules and those within the TOFA rules will likely turn on whether the transaction is intended to result in the delivery of a unit or a payment of cash.

The new TOFA regime can potentially treat cash-settled derivatives, including those over emissions units, in various ways:

- under the default rules, gains or losses will be recognised either on an accrual or realisation basis depending on whether relevant amounts are “sufficiently certain;”
- a fair value basis will apply if the appropriate timing election is made. This may be attractive to banks and others trading in emissions units. The fair value election would only apply to derivatives that are recorded at fair value through profit and loss for financial accounting purposes.
- a hedging regime may allow timing matching between the derivative and the underlying emissions unit. This may be attractive to firms acquiring derivatives for use in their business. (Character matching will occur automatically as both the hedge and Australian units will be on revenue account.)

4. GST

Emissions units will be defined, for the avoidance of doubt, to be a form of personal property for GST purposes and expressly excluded from being “real property” or even “directly connected with real property.” The legislation proposes no amendments to the GST law other than these definitional propositions which means that the ordinary rules of the GST regime will apply to transactions involving emissions units.

This means, for example:

- the sale of units in a secondary market would be treated as a taxable supply, with registered sellers liable to GST on the sale and registered buyers typically entitled to an input tax credit;
- no GST would apply where units are issued free as the supply is treated for GST purposes as not made for consideration, and so no input credit would arise on receiving the units;
- no GST consequence will arise from the surrender of units as they will be treated for GST purposes as surrendered for no consideration.

The consideration for supplies and acquisitions of units between related entities will be adjusted to the arm's length price if the buyer would not be entitled to a full input tax credit.

We assume that the shortfall penalty will be added to the Treasurer's list of non-creditable government fees and charges so that no input credit will arise where a firm is liable for a shortfall penalty imposed for failing to surrender sufficient units.

More interesting GST issues will arise from the cross-border elements of the proposed system. Emissions units are taken to be personal property, not real property, but they are not taken to be goods; they remain a form of intangible personal property. This means that the "import" of a Kyoto unit by a resident GST-registered firm – that is, the purchase by a registered firm of a Kyoto unit from a non-resident seller – will not trigger importation GST unless the reverse charge rules apply. The reverse charge regime on the buyer of the "imported" Kyoto unit would not apply if the unit will be used for making taxable supplies in Australia – either the re-sale of the unit or the sale of taxable commodities to which the Kyoto unit was an input. At present, the Government will not permit the "export" of an Australian unit, and so it seems unlikely that sales to a non-resident of Australian-issued units for registration on offshore registries could occur. If this transaction is subsequently allowed, it would most likely be GST-free as an export.

Non-resident firms required to register in Australia will be liable to Australian GST if the sale of an emissions unit occurs in Australia – typically, the contract is entered into in Australia – or if the supply occurs through a permanent establishment the non-resident maintains in Australia.

Transactions with derivatives over emissions units also raise potential GST issues. The supply of a derivative over an emissions unit may be a financial supply for GST purposes or a taxable supply, depending on whether the underlying unit is to be supplied or the derivative is instead to be settled in cash (in line with the TOFA distinction noted above). This may have an impact on the supplier's ability to recover input tax credits on its operations, which may be alleviated by the reduced input tax credit rules.

5. Next steps

The government is seeking submissions on the package of exposure draft legislation by 14 April.

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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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