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The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Sir or Madam

Inquiry into exposure draft of the legislation to implement the Carbon Pollution Reduction Scheme

The Taxation Institute of Australia (**Taxation Institute**) is pleased to provide its submission to the Senate Standing Committee on Economics in relation to the exposure draft of the legislation to implement the Carbon Pollution Reduction Scheme (CPRS), in particular the *Draft Carbon Pollution Reduction Scheme (Consequential Amendments) Bill 2009* (**Consequential Amendments Bill**). The Taxation Institute has a number of concerns with both the exposure draft bills and aspects of the design of the CPRS. Although the interface with the tax system is not a primary policy driver, it is still crucial that the tax policy complements and supports the CPRS rather than creating unnecessary compliance costs which reduce the scheme's efficiency.

1. Design Concerns

The Taxation Institute believes that there are three key design features that need revision to ensure that compliance costs, and therefore the cost to the community, are minimised. The key concern is the application of GST to permits. The two other concerns are the application of GST to CPRS based derivatives and unrealised gains arising from the holding of Kyoto permits.

1.1 GST Treatment

The decision to treat permits as a taxable supply needs reconsideration as little weight has been given in the Government's *Carbon Pollution Reduction Scheme: Australia's Low Pollution Future White Paper* (**White Paper**) and the Consequential Amendments Bill to the associated compliance cost of the measures combined with the finance cost.

Currently finance trading markets do not apply GST to the items traded (share, options, etc). As a result they will need to incur substantial costs in developing systems that are able to capture the GST in an electronic trading environment where sellers are not aware of the identities of buyers. This makes the use of tax invoices in their current form problematic, in particular in a mature system with foreign entry where the CPRS permits will be GST free supplies when acquired by foreigners. It was these compliance difficulties that convinced the New Zealand Government to exclude permits from the GST net despite having a goods and services tax (GST), which applies to virtually all supplies of goods and services.

The case for GST free treatment equally applies in Australia. We note that although the market in domestic permits is intended to be closed to world trade for the first five years, the Consequential Amendments Bill contemplates the import and export of international emissions units (para 420-35). Therefore, by imposing the associated compliance cost to set up the systems with a chance of abandonment of the prohibition on trading domestic permits in five years times is short sighted. The system needs to be designed with that mature system in place.

Another concern is that the treatment of permits as being taxable will result in a permanent increase in the working capital requirements of companies (of $1.15 billion in 2010) to fund the GST between the time of purchase and the BAS lodgement time (somewhere between 22 and 53 days) when the GST input credit is allowed. Businesses will be forced to recoup the high funding costs by higher prices to consumers.

Although it is assumed in the White Paper that for all businesses this cost will be offset by the cash generated by charging higher prices for affected goods and services not all businesses will be able to increase prices. This assumption does not work for exports (where prices are determined on the world market), except in the minor case of EITE industries, nor in domestic industries where prices cannot be strongly influenced by just the larger players who have CPRS liabilities.

An example is the oil industry where it is proposed that the price adjustment is only going to reflect an average price of carbon for the preceding six months period. The sheer number of permits required to be purchased by the oil companies to meet the expected emissions (over 100 million tonnes) will require purchase of permits close to the time of the emission, potentially at prices greater than the average for the preceding six months. Potentially, the companies may need to purchase credits at the $40 cap, yet the price charged to customers would be substantially lower and would not be recoverable from customers. Given profit margins in the oil industry were about 2.2 cents per litre in 2007 and will be lower in 2008 there is no margin for error. The GST finance cost merely adds to these risks.

Finally, the proposed GST treatment is far from simple as illustrated by the following table.

Circumstance	**GST treatment**
Buying or selling a permit	Taxable supply
Supply of free permit	No GST (no consideration)
Import or Export of permits	No GST (out of scope or GST free)
Government Cash Grant	No GST (no supply)
Surrender of a permit	No GST (no consideration)
Payment of a penalty	No GST
Use of financial derivatives of permits	Input taxed supply (financial supply)

From the above table, it is clear that some transactions are taxable and others are not. There is an overall increase in complexity, administration and tracking costs by not making all transactions GST Free. Distinguishing between the different types of transactions increases the likelihood of processing errors, rework, penalties etc for no added value.

In summary, in light of:

- the compliance and financial cost;
- the imposition of GST in circumstances where there is no intention to raise GST revenue;
- the provision for the export of permits; and
- the fact that an agreement on 19 March 2009 on the terms of reference to explore harmonising the design of the CPRS and the New Zealand Emissions Trading Scheme was reached;

the decision to treat permits as taxable needs to be reviewed.

1.2 GST and Derivatives

The White Paper recommends the input taxation of CPRS based derivatives on the basis of simplicity and consistency. This is reflected in the absence of amending rules in the Consequential Amendments Bill. Given that the CPRS was preferred as the most efficient mechanism for delivering carbon reduction by the creation of deep secondary markets for permits and the associated derivative products, the input taxation of CPRS derivatives operates to undermine that strategy. The input taxation of the derivatives (in the estimated $115 billion per annum secondary market) will give rise to large amounts of trapped GST and businesses will be forced to recoup this trapped GST by higher prices to consumers. There will be a GST windfall to the States and Territories. Further, the input taxation of this newly created class of derivatives seems to run counter to the Government's undertaking of not increasing the scope of the GST.

Again the Taxation Institute believes this issue needs to be legislatively addressed in these measures.

1.3 Unrealised gains on imported Kyoto units

The purchase of Kyoto Units may lead to the payment of tax on unrealised gains. This can arise where the Kyoto price is cheaper than permits on the Australian market. The "gain" on the difference between the price paid overseas and market value of an equivalent permit/unit on the Australian exchange is treated as assessable income in the year the permit is imported and registered on the Australian register. However, the offsetting deduction for the higher Australian price for a permit is not allowed until the permit is actually physically surrendered

Although this is viewed as an issue of taxpayer management (ie it was up to taxpayers to manage the importation of such units such that unrealized gains were minimised) there may be regulatory issues in respect of registers of permits overseas which may force an entity to import such units ahead of any need to utilise them. For example, changes in expiration dates, costs imposed in holding units in foreign registers etc. This again is an issue that needs to be addressed in the Consequential Amendments Bill.

2. Issues with the Consequential Amendments Bill

2.1 Scope of deduction provision too narrow.

The draft Bills propose a new section 420-15 allowing a deduction for expenditure "to the extent the taxpayer incurs it in becoming the holder of a registered emissions unit". This is viewed as too narrow. It should be expanded to include on-going costs incurred after registration, for example expenditure incurred in on-going maintenance and protection of the registered units.

2.2 "Cost" of permit uncertain

It is not clear from the draft bills which expenditure is included in the "cost" of a permit. For example, refer to the existing provisions for Capital Gains Tax, trading stock (as clarified by detailed rulings issued by the Australian Taxation Office and the tax depreciation provisions), which provide detailed guidance. This issue needs to be clarified.

2.3 The FIFO (first in first out basis) methodology

The draft Bills propose that the FIFO (first in first out basis) methodology is required to be used under the cost method when determining the value of units on hand. The prescription of this methodology prior to the determination of the IFRS methodology has the potential to, if the eventual IFRS methodology is divergent, create extra administration costs in working out the timing differences (eg one ledger for tax and another reflecting reality). This may occur as, unlike a stockpile of homogenous goods (eg coal), under the legislative scheme the units when surrendered are clearly identifiable and the transfer needs to be registered. This is also inconsistent with other provisions of the tax legislation which allow specific identification.

An example of where the proposed tax rule would create problems may be if an entity has sought to cover its position by acquiring units before it receives free units (given that you may not necessarily know whether you will receive units or the number you may receive). In this circumstance it is more likely that the free units will be on hand at the end of the ' no disadvantage' period under the first in first out tax rule and therefore a taxpayer will be subject to tax on the market value of such units.

In summary, the FIFO test is inappropriate and should be deleted from the bill.

2.4 Discrete code

The boundaries of this code and the operation of the anti-overlap provisions are currently uncertain. Certainty is crucial as whether expenditure is in or out of the code may give rise to potentially different tax treatments under Division 420 compared with the normal tax rules.

An example is the breadth of the proposed para 420-15 (3) (what you can deduct) as modified by para 420-65. The interaction between paras 420-15(3) and 420-65 seems to provide that the costs incurred in receiving free EITE permits are not deductible under Div 420, but rather may be deductible under the general provisions (refer EM paras 2.29 & 2.91).

To ensure certainty in respect of such outcomes notes need to be added to the legislation to specifically state that deductions may be available for such expenditure under other provisions of the normal tax rules.

2.5 Covered Entities disadvantaged

Further, covered entities may be disadvantaged compared to other entities dealing in permits. This arises as the taxing regime focuses on dealings in permits (to obtain consistency) and ignores the liability accruing under the CPRS to covered entities. Covered entities will have to bear the economic cost and will seek to recover it in their cost of sales. They will be subject to income tax on any such recovery in the current year but the offsetting deduction will be deferred until the following year. Trading entities that are not covered entities will not have to fund this timing disadvantage as their acquisition of permits will not be driven by a CPRS obligation.

This issue needs to be addressed.

3. Requirement to hold a financial services licence.

Under the proposed changes to the Corporations Act and the Australian Securities and Investments Commission Act, there would appear to be a requirement that if an affected entity wishes to directly participate in the auction process that it would need to have a financial services licence. This needs reconsideration as it would severely restrict the level of trading thereby impacting on the ability of the market to provide the lowest economic price.

The Taxation Institute is happy to meet with the Committee to discuss our concerns. If you require any further information or assistance in respect of our submission, please contact Joan Roberts on 03 9611 0178 or the Taxation Institute's Senior Tax Counsel, Dr Michael Dirkis, on 02 8223 0011.

Yours faithfully

Joan Roberts

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President