The Institute of Chartered Accountants in Australia

Ref 007.09

26 March 2009

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

Email: economics.sen@aph.gov.au

Dear Sir/Madam

Inquiry into the exposure drafts of the legislation to implement the Carbon Pollution Reduction Scheme (CPRS) – Taxation amendments

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to make this submission on the exposure draft (ED) of the legislation to implement the Carbon Pollution Reduction Scheme (CPRS) to the Senate Standing Committee on Economics (the Committee).

The Institute is the leading professional accounting organisation in Australia, representing over 48,000 members in public practice, commerce, academia, government and the investment community. The Institute's members are advisers to businesses at all levels, from small and medium sized businesses to the largest global corporations operating in Australia and overseas.

The Institute acknowledges the wide consultation undertaken by the Department of Climate Change (DCC), the Treasury and various other parties in seeking the views of stakeholders including the business community, professional bodies and practitioners. This culminated in the release of the White Paper in December 2008. Given the relatively short timeframes between release of the ED legislation and the due date for lodgement of this submission, it is important for us to acknowledge that with the benefit of further time to consider the implications of the proposed CPRS, additional issues may be identified. The Institute intends to lodge a separate submission by 14 April 2009 with the DCC in respect of the ED legislation.

TAXATION AMENDMENTS

The proposed measures relating to taxation are all contained in Schedule 2 of the exposure draft of the *Carbon Pollution Reduction Scheme (Consequential Amendments) Bill 2009* (the draft Bill) and the accompanying commentary (the Commentary).

The Institute considers there to be a number of areas within the draft Bill that require further clarification and analysis by the Government. Some of those areas were previously raised in the Institute's 10 September 2008 submission in response to the Green Paper (the Green Paper submission) which is attached and references given below where appropriate.

Overall, our comments are guided by the tax policy aims of neutrality, fairness and simplicity.

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1. Proposed application of the GST Law

1.1 Applying the normal rules to CPRS transactions will create uncertainty and complexity for business taxpayers

The Government's White Paper stated that the preferred approach is to tax CPRS transactions under the "normal GST rules". In adopting this policy, the Government has assumed that the normal GST rules will achieve certain desirable outcomes, in particular that imposing GST "generally would not lead to embedded GST for registered entities", that it would avoid complexity, minimise compliance costs and that there will be no GST on exported and imported emissions units.

Having explored the application of the normal GST rules to the CPRS transactions, the Institute is of the view that the assumed GST outcomes will not in fact be realised under the scheme of the existing GST law. Instead, the Institute believes that applying the normal rules to CPRS transactions will create uncertainty and complexity for business taxpayers, particularly in relation to exports, imports and derivatives trading of registered emissions units. Additionally, the application of the current GST law is likely to give rise to significant compliance costs and unrecoverable GST. These outcomes are considered to be detrimental to the broader CPRS policy objectives of encouraging international trade and attracting foreign entities to participate in the CPRS.

Some of the more pressing issues identified by the Institute in respect of the draft Bill are:

- *Risks of GST being charged on exported emissions units to foreign purchasers.* There are likely to be difficulties in entities being able to satisfy the criteria of the GST-free rules in respect of trading in registered emissions units (because there are certain requirements under those rules that involve obtaining information about the purchaser via a register and determining where the permit will be used). Section 3.1.3.2 in the Institute's Green Paper submission contains more detailed information on this issue.

- *Risks of imported emissions units being within the Australian GST net.* Foreign participants with no presence in Australia could be required to register for Australian GST. (Refer to 3.1.3.2 in the Institute's Green Paper submission)

- *Derivative transactions may be input taxed or taxable.* There is uncertainty as to which financial-type supplies of registered emissions units are subject to GST or input taxed, e.g. forward contracts. Refer to sections 3.1.4 and 3.1.5 in the Institute's Green Paper submission.

- *Traditionally 'taxable' businesses will face partial denial of input tax credits.* This will create a layer of complexity for businesses that have not to date had to deal with GST apportionment, as well as unrecoverable GST costs. Refer to section 3.1.7 in the Institute's Green Paper submission.

In light of the above, a GST model which does not impose GST on registered emissions units but allows full recovery of GST on inputs would be preferable in the view of the Institute. Further detail and support for this GST-free approach is set out in section 3.1.8 of the Institute's Green Paper submission.

It is worthwhile pointing out that the European Union (EU) classifies registered emissions units as taxable (referred to as 'standard rated' for VAT purposes). However, central to this approach is the fact that the EU has fundamentally different and less complex rules for the charging and recovery of VAT on cross-border trades (also 90% of registered emissions units must come from within the European Union jurisdiction so relatively few genuinely international trades are made).

By contrast, New Zealand (NZ) has adopted a zero-rated (i.e. GST-free) model as has been recommended by the Institute, recognising the importance of international trade to their market, and that zero-rating provides the lowest compliance costs of any of the alternatives considered. Refer to 3.1.3.2 in the Institute's Green Paper submission.

1.2 Harmonisation with New Zealand

We note the recent joint announcement by the Australian and NZ Climate Change Ministers, Senator Penny Wong and Dr Nick Smith about the importance of "close trans-Tasman collaboration". Senator Wong acknowledged that harmonisation is a priority given the large number of firms operating in both jurisdictions.

One of the priority areas for harmonisation identified by the Ministers to promote "trans-Tasman competitiveness" relates to the rules for the import and export of registered emissions units. The GST rules applying to the import and export of emissions units should therefore be an important aspect of their work in this area. Australia has an opportunity as part of the design of our new CPRS to adopt the same GST-free approach as NZ already has in place. In the Institute's view, doing so would be consistent with the broader objective of harmonising the key design features of the Australian CPRS and the NZ ETS.

2. Income taxation of free permits – Strongly affected industries (coal power generators) should be treated the same as EITE entities

Contrary to the Institute's Green Paper submission (*section 1.2 Tax treatment of free permits*), the Government has proposed that administratively allocated (or free) permits are to be taxable. In that case, the Institute believes that in principle they should not be taxable until the year in which the free emissions permits are used to acquit the permit obligations of the relevant entity – thereby eliminating any potential for a timing mismatch.

In the draft Bill, a free emissions unit issued to an emissions-intensive trade-exposed (EITE) entity is valued at zero if (broadly) the entity holds the unit at the end of the relevant income year if this ends on or before the last day for surrendering units of that particular vintage. This so-called "no-disadvantage rule" is designed to minimise any timing disadvantage that could otherwise arise if the free permit was still held at year end. This treatment is not made available to non-EITE taxpayers in strongly affected industries (SAI) (coal fired generators) so that the year end balance of administratively allocated or free units will be taxable based on market values.

The Institute is still of the view that the proposed approach does not result in an appropriate outcome for non-EITE taxpayers, and that the Government should re-consider the benefits of aligning the income tax treatment of free permits as between EITE and non-EITE taxpayers.

We do not believe it is equitable for SAI receiving free permits, which by definition will together with EITE industries be the most exposed and most disadvantaged business taxpayers, to have substantial cash-flow disadvantages imposed on them.

The Institute therefore recommends that the free emissions units issued to SAI should not be assessable until the year in which they are used to acquit the obligations of the relevant entity or in the vintage year – thus achieving matching and not generating cash flow disadvantages. This would provide SAI entities with the same income tax treatment as EITE entities. It should be recognised that free permits allocated to SAI and EITE entities will ultimately be taxable and the Institute would recommended that in determining the value of free permits to be allocated, the after tax impacts on such entities should be considered.

3. Accounting for registered emissions units is too inflexible

3.1 Rigidity of proposed permit valuation methodology

Tax accounting for registered emissions permits is achieved using the "rolling balance" method whereby taxpayers will be required to bring to account the difference between the value of registered emissions units held at the start of an income year, and the value of the registered emissions units held at the end of the income year.

An integral requirement of the rolling balance method of accounting will be the need to determine the value of the registered emissions units held at the start and end of an income year. The draft Bill proposes that taxpayers can use historical cost to determine the value of the registered emissions units, or they can make an irrevocable choice to use market value in the year they first hold registered emissions units. Only a single change of valuation method before the 2015-16 income year is proposed to be allowed under the draft Bill.

The Institute considers that this methodology is overly restrictive, unduly protective of the revenue and inconsistent with tax neutrality and simplicity principles. The Institute cannot identify any compelling reasons for the proposed approach, especially when it is compared to the existing approach to valuation of trading stock in the income tax law (which is analogous in some respects). Those provisions do not restrict valuation methods in the same manner as is proposed in respect of the registered emissions units.

Finally, given that it is expected that Australia's CPRS will align with and support other international emissions trading schemes, imposing limitations in respect of the valuation of registered emissions units seems potentially problematical.

3.2 "First-in-first-out" method too restrictive

The Institute believes that the proposed approach of prescribing that a "first-in-first-out" (FIFO) rule for all registered emissions units that have the same vintage year if the cost method is used places another unnecessary restriction on taxpayers.

Imposing a restriction in this way will result in extra compliance costs for taxpayers due to the need to track registered emissions units on a unit-by-unit basis in some cases. As with the proposed valuation methods, the Institute considers this proposal is unduly protective of the revenue and is inconsistent with tax neutrality and simplicity principles.

If concerns remain over any perceived tendency to "hoard" free emissions units that are valued at zero at year end, a "free permits first rule" might be considered which would be limited to SAI and EITE entities only. This was raised in the Institute's Green Paper submission (see section *1.2.4 Recommended treatment of free permits*).

3.3 Timing of surrender of permits – matching of deductions to appropriate income year

In the Institute's view, the "rolling balance" method of accounting for the registered emissions units should be augmented by an express rule that the permits on hand at the end of the taxpayer's balance date should be reduced by the permits which will be acquitted/surrendered after year end in relation to emissions identified as occurring before the taxpayer's year end.

This is because in the interests of tax neutrality for commercial decision making purposes, the matching of expenditure to the relevant income year in which emissions occur (and therefore a liability to surrender permits arises) is the Institute's recommended approach. This approach is explored in more detail in the Institute's Green Paper submission section 1.5.3 *Annual calculation of permits used.*

4. Surrender for a purpose other than gaining assessable income

Where an entity ceases to hold a registered emissions unit and that cessation is unrelated to gaining assessable income or in carrying on a business for the purpose of gaining or producing assessable income, there is a requirement under the draft Bill that any amount that the entity has previously deducted (or can deduct) for expenditure incurred in acquiring the unit must be reversed.

The Institute believes it is important for the Government to provide further clarity around this issue to confirm that businesses (including those outside the CPRS) will continue to be entitled to tax deductions for the purchase of emissions units that are surrendered for purposes such as abatement (in respect of being a 'good corporate citizen').
The Commentary clarifies that the 'claw–back' (reversal of previously deducted expenditure) would not apply to a business entity that surrenders units (beyond any potential emissions liability) for promotional or marketing purposes.

Nevertheless, the Institute considers that all taxpayers that are carrying on a business (including taxpayers who may not be obliged to acquire permits such as those who voluntarily abate their emissions under a carbon neutral strategy), should be allowed a tax deduction for the acquisition of emissions permits. Adopting this approach is considered desirable as it will encourage a broader population of business taxpayers to participate in the community's efforts in reducing Australia's carbon emissions. The proposed provisions in this area should not require a nexus between the incurrence of expenditure in acquiring registered emissions permits under the CPRS and the production of assessable income. This approach is outlined in further detail in the Institute's Green Paper submission (*section 1.6 Business criteria for inclusion in the proposed CPRS income tax regime*).

5. Scope of taxation rules limited to Australian registered emissions units

The scope of the taxation rules in proposed Division 420 is limited to CPRS units such that units outside the CPRS are subject to the uncertainty of the "normal tax rules" which are undefined.

The uncertainty of the application of these normal tax rules was the reason why a discrete set of provisions for the tax treatment of emissions units was proposed in the first place. However, there are items that can fall outside these provisions such as Renewable Energy Credits and Kyoto units which have not been registered as Australian emissions units. As such, the taxation treatment is not covered under proposed Division 420.

The Institute would recommend that consideration be given to providing flexibility to allow a broader class of emissions related units that are not registered under the CPRS, for example units registered under the proposed Mandatory Energy Renewable Targets scheme, to be included in proposed Division 420 in order to achieve greater certainty. This may occur, for instance, by way of regulation.

There are also consequences when such units enter or exit the CPRS (see next item).

6. Entry and exit of units into the CPRS system – market value deeming

Market value deeming rules expose participants to "paper" taxable profits when units are exported, imported or converted to emissions units from approved reforestation schemes.

This potential taxation of unrealised gains does not accord with the objective of neutrality of the taxation treatment of permits and serves as a potential disincentive to business behaviour. It is also likely to increase compliance costs and complexity for businesses.

The transactions affected are:

- Incoming and outgoing international transfers of emissions units – The import and export of an international emissions unit will give rise to a deemed sale and re-purchase of the unit at market value which could result in taxation of unrealised gains.

- Permits created from reforestation and destruction of synthetic greenhouse gases - If created permits are on hand at the end of the income year they are issued, they will be included in the rolling balance at the market value at the date of issue (if historical cost is used) or the market value at the end of the year (if the market value method is used).

7. Other

7.1 Other income tax interaction issues requiring development

There are a number of other issues that were raised in the Institute's Green Paper submission that require development so for the sake of completeness, we have listed them here.

- *Same business test* – The Institute considers that specific guidance should be provided to give taxpayers comfort that trading in permits will not trigger a breach of the same business test which would unfairly disadvantage companies in a tax loss position solely as a consequence of the introduction of the CPRS. Further detail is in section 2.4.1 of the Institute's Green Paper submission.

- *Thin capitalisation* - The Institute recommends that transitional measures are drafted which introduce the inclusion of the assets and liabilities relating to permits gradually for thin capitalisation purposes so as to minimise the thin capitalisation impact of reporting for permits for the first time. Further detail is in section 2.4.2 of the Institute's Green Paper submission.

- *Public Trading Trusts* - If a public unit trust trades in permits, there will be uncertainty as to whether such an activity causes it to fall within the scope of the public trading trust rules in Division 6C of the ITAA36. To avoid triggering these rules, the Institute recommends that trading in permits be specifically included in the definition of an 'eligible investment business'. Further detail is in section 2.4.3 of the Institute's Green Paper submission

7.2 State taxes – stamp duty

Although not within the scope of the draft Bill, the Institute understands that the Commonwealth Government has requested clarification from all State and Territory Governments of whether the trading in registered emissions units will give rise to a liability to taxes or duties at a state government level. Clarification of the impact of state-based taxes and duties should be provided as a matter of urgency to allow businesses to appropriately model and cost their participation in the CPRS as accurately as possible.

7.3 Tax incentives should be developed in tandem with CPRS

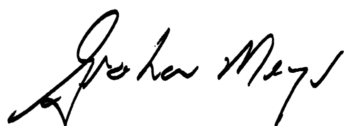
The Institute stresses the importance played by appropriate climate change tax incentives to support low emissions technologies in conjunction with the introduction of the CPRS.

Incentives suggested by the Institute include possible measures increasing the deduction on eligible "green" technology R&D expenditure to 200%, capital allowances inducements such as accelerated depreciation rates and targeted investment allowances (see Green Paper submission *section 4.1 Incentives*).

We also note from previous consultation that consideration around such tax incentives may be undertaken as part of the Henry Review of Australia's Future Tax System which is not due to report until the end of this year, with any recommendations unlikely to eventuate until 2010 (or later).
The Institute submits that tax incentives to support the massive private investment required (for example to assist in the development of Carbon Capture Storage projects) need development and implementation in tandem (contemporaneously) with the implementation of the CPRS.

Should there be any questions regarding this submission, please do not hesitate to contact either Lee White, General Manager, Quality and Leadership on 02 9290 5598 or Yasser El-Ansary, Tax Counsel on 02 9290 5623.

Yours sincerely



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