



Submission – Carbon Pollution Reduction Scheme Green Paper

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1. CORE INCOME TAX ISSUES

1.1 Special regime for the CPRS

The Institute supports the development of discrete provisions of the income tax law to govern the tax treatment of permits which should provide increased certainty, reduced complexity and equitable outcomes.

We also consider, in the 'general' case, that the provisions should allow a deduction for expenditure incurred on the purchase of a permit and include any proceeds from the sale of a permit in assessable income.

Submission point 1.1 – Special regime for CPRS

The Institute supports the development of discrete provisions of the income tax law to govern the tax treatment of permits which should provide increased certainty, reduced complexity and equitable outcomes.

However, we have identified a number of issues that need further attention which are discussed below.

1.2 Tax treatment of free permits

1.2.1 *Revenue treatment is inappropriate*

The Green Paper proposes that the tax characterisation of emissions permits should be of a revenue nature, including the treatment of free permits. We disagree with this proposition, so far as it relates to the taxation of free permits and cash grants.

Free emissions permits will be provided as effective compensation for long-term reduction in the value of underlying assets for Strongly Affected Industries (**SAI**) and, potentially, to Emissions-intensive trade-exposed (**EITE**) industries. They will compensate businesses for a decline in the goodwill of their businesses, *prima facie*, treated as an asset of a capital nature for tax purposes.

Revenue treatment of such enduring compensation for loss of capital value will result in upfront tax cash flow costs for business. Also, to the extent that the free permits or cash grants are provided as compensation for long-term declines in the value of goodwill which is of a capital nature and which potentially will result in capital losses on eventual sale of the business, there will be a tax distortion built-in. So the revenue taxation of free permits and cash grants creates:

- (a) a timing disadvantage at the front end of tax payments
- (b) a permanent disadvantage if the compensation component is of a revenue nature and the eventual decline in asset value, potentially with economic losses being suffered, is of a capital nature.

The Treasury's proposal will result in trapped capital losses in adversely affected businesses, which will be unable to be used for tax purposes, while the compensation will have been taxed in earlier years. That would be highly inequitable and economically inappropriate. Such outcomes would result in a major asymmetric treatment of those businesses. The value of the compensation will be taxable, the tax revenue will see a claw back of that compensation through its inclusion in assessable income, and the business and its shareholders will be inadequately compensated.

Two other proposals are considered in the Green Paper discussion:

- recognising the free permit for tax purposes at the time it becomes available for use, or

- an outright exemption of free permits from the tax system;

neither of which is preferred in the Green Paper. The Green Paper does not consider various other potential mechanisms, notably:

- treating free permits and cash grants as capital amounts reducing the tax basis of assets, or
- appropriate spreading mechanisms.

1.2.2 Various existing tax treatments of compensation

There is the view that revenue characterisation is claimed to be consistent with the treatment of compensation generally. However, this analysis is incomplete. There are numerous instances in the tax legislation where compensation for loss of value attributable to capital assets is treated as not being taxable as an ordinary revenue gain. These include:

- (a) Subdivision 20-A of the Income Tax Assessment Act 1997 (ITAA97) has the effect that a recoupment of loss or outgoing or expenditure which is tax deductible is itself assessable. Conversely, section 20-20 does not render assessable a recoupment of an insurance or indemnity receipt in relation to a loss which is not deductible. So the matching principle is preserved.
- (b) Various exemptions which are provided for particular industry restructure situations are exempt under section 53-10 of ITAA97. These are similar to those in respect of the CPRS, and illustrate how the Government provides various compensation payments to particular taxpayers in the course of industry restructures.
- (c) For purposes of the capital gains tax rules, there are precedents where compensation for a loss or outgoing not being a taxable gain in itself, but is instead aligned to the relevant asset in respect of which a loss arises. For example, subdivision 124-B deals with compensation provided to enable the replacement of an asset.

Also, where an asset is not replaced, various rules allow certain capital receipts or payments to adjust the cost base of the relevant asset. For example, section 104-125 (CGT event F4) where lessors receive capital payments for changing leases and the payments reduce the cost base of the relevant capital asset.

- (d) An additional mechanism for dealing with unique gains of a non-operating nature appears in the commercial debt forgiveness rules in Division 245 of Schedule 2C of the ITAA36. Certain gains on debt forgiveness are applied in a statutory sequence to reduce the cost base of specified assets (see section 245-96 for a map of these rules). This sequence is expressed quite simply and, while the precise sequence is not appropriate in relation to free permits of cash compensation, the concept could easily be adjusted, as discussed below.
- (e) Even where there is not an express statutory citation, the practice is to apply compensation to reduce or adjust the cost base of the relevant capital asset. ATO ruling TR95/35 "Income Tax: Capital Gains: Treatment of Compensation Receipts", which discusses the tax treatment of receipts for compensation of actual disposal of an asset, contains the following proposition:

"Compensation for permanent damage to, or permanent reduction, the underlying asset

6. If an amount of compensation is received by a taxpayer wholly in respect of permanent damage suffered to a post-CGT underlying asset of the taxpayer or for a permanent reduction in the value of a post-CGT underlying asset of the taxpayer, and there is no disposal of that underlying asset at the time of the receipt, we consider that the amount represents a recoupment of all or part of the total acquisition costs of the asset.

7. Accordingly, the total acquisition costs of the post-CGT asset should be reduced in terms of sub-section 160ZH(11) by the amount of the compensation. No capital gain or loss arises in respect of that asset until the taxpayer actually disposes of the underlying asset. If, in the case of a post-CGT underlying asset, the compensation amount exceeds the total unindexed acquisition costs (including a deemed cost base) of the underlying asset, there are no CGT consequences in respect of the excess compensation amount.”

This ruling was issued under the Capital Gains Tax law prior to ITAA97 and continues to represent good policy analysis by the ATO which is not clearly articulated in the legislation.

- (f) We observe also that the common practice of the federal, state and local governments, when compensating businesses for capital assets or to encourage investment in capital assets, has been to provide loans to the businesses to fund the construction or compensate for the capital assets involved. Such loans are made precisely to ensure that there is not an amount which might be taxable as ordinary cash compensation, which would distort the underlying economics of the policy intent of the relevant government.

1.2.3 Appropriate tax treatment should not cause hoarding of permits

Treasury states its desire to encourage a free flow of permits into the trading market, and appears to have some concerns about taxpayers hoarding their free permits. However, we do not believe it is equitable for taxpayers receiving free permits, who by definition will be the most exposed and most disadvantaged business taxpayers, to have substantial cash-flow disadvantages in relation to their compensation payments. In any event, it is simple to require the free permits to be the first used by any taxpayer, as recommended below.

1.2.4 Recommended treatment of free permits

It is quite inappropriate for the value of free permits or cash compensation to be included in the taxpayer's assessable income in the year the permits or compensation proceeds are received.

- (a) The simplest mechanism, in relation to free permits or free cash intended to be provided as compensation, is for the free permits and cash grants to be expressly exempted from taxation.
- (b) If this simplest mechanism is not adopted then the tax system needs to deal equitably with the taxpayer to avoid the double tax disadvantage of:
- timing disadvantages plus
 - permanent tax disadvantages.

This would require free permits and cash compensation to reduce the cost base of the taxpayer's relevant capital assets in the following sequence:

- first, capital losses carried forward and capital losses in the year of receipt,
- then, business goodwill and capital assets not eligible for capital allowances,
- then, assets eligible for capital allowances under Division 40 of ITAA97
- then, deductible expenditure.

If, contrary to our submissions, free permits were to be taxable, then they should not be taxable until the year in which the free permits are used to acquit the permit obligations of the relevant company – thus reducing the timing mismatch. However, this taxation would retain the inequitable permanent mismatch arising from the risk of 'stranded' capital losses (occurring in relation to capital losses arising on closure or disposal of the relevant facilities) after the permits had become taxable.

To remedy this inequitable stranding of losses, the tax law should allow carry-back of tax losses, including capital losses, as contained in the joint Institute and Ernst & Young paper "Australia's

Proposed Emissions Trading Scheme – The Tax Policy Dimension” (the **Joint Institute/E&Y Paper**). This is discussed in further detail below.

- (c) To overcome the concern that if free permits were tax exempt taxpayers might hoard the free permits and use their purchased permits first, we submit that it would be simple to introduce a “free permits first use” rule into the tax rules for usage and tax treatment of permits.

Free permits and purchased permits will be subject to registration requirements on the part of the permit issuance authority, which will allow appropriate system integrity. A “free permits first use” rule could deal with any tendency of taxpayers to arbitrage their position by first surrendering their purchase to permits. As a result the supply of permits into the system would not be inappropriately distorted.

- (d) If the design of the CPRS might see free permits awarded both as compensation for impending capital losses and also as a form of operational subsidy for certain participants, the mixed characterisation of free permits could be followed in the tax outcomes.

For example, if a particular business was to receive compensation to fund say 10 years’ of purchase of permits, and that value was to amount an anticipated 70% of the total compensation payment, with the remaining 30% attributable to a decline in the goodwill of the business, then the tax treatment might follow the calculation mechanism for the cash grant, so that 70% of the cash award would be treated as being taxable and subject to spreading and 30% of the cash grant would be treated as being of a capital nature, dealt with in the manner discussed above.

Submission point 1.2 – Tax treatment of free permits

It is quite inappropriate for the value of free permits or cash compensation to be included in the taxpayer’s assessable income in the year the permits or compensation proceeds are received.

The Institute considers that the simplest mechanism for free permits and cash grants intended to be provided as compensation would be to expressly exempt them from taxation.

If this is not adopted, free permits and cash compensation should reduce the cost base of the taxpayer’s relevant capital assets in the following sequence - capital losses carried forward and current year capital losses, business goodwill and capital assets not eligible for capital allowances, assets eligible for capital allowances under Division 40 of ITAA97 and lastly, deductible expenditure.

We submit that it would be simple to introduce a “free permits first use” rule into the tax rules for usage and tax treatment of permits if free permits were tax exempt (to address concerns with hoarding free permits).

The (potentially) mixed characterisation of free permits could be followed in the tax outcomes.

1.3 Tax treatment of cash grants

The treatment of cash compensation payments should be analogous to that of free permits provided as compensation.

- (a) Treasury needs to ensure that the introduction of the emissions trading system does not result in capital loss traps. One solution includes allowing carry back of tax losses, including capital losses, as contained in the Joint Institute/E&Y Paper.

- (b) The simpler mechanism, in relation to cash intended to be provided as compensation, is for the cash grants to be:
 - (i) expressly exempted from taxation or
 - (ii) used to reduce the cost base of the taxpayer's relevant capital assets namely business goodwill, assets eligible for capital allowances and other assets.

Submission point 1.3 – Tax treatment of cash grants

The Institute recommends that cash grants intended to be provided as compensation should be expressly exempted from taxation or, if this is not adopted, used to reduce the cost base of the taxpayer's assets in accordance with Submission point 1.2.

1.4 Tax loss carry-back

An additional requirement, to produce equity for affected businesses, would be to enable tax loss carry-backs to arise in relation to the losses to be suffered by those businesses on eventual termination of their activities.

For example, assume a coal fired power station receives a cash grant or free permits sufficient to enable it to continue in operation for say five years. After five years the coal fired power station is, due to the state of the emissions market and the energy market, no longer viable, and is no longer saleable except at a major capital loss. If the coal fired power station is no longer operational, then prima facie the loss will be largely of a capital nature, and the loss suffered by the investors in the coal fired power station will be largely of a capital nature.

In the circumstances it would be appropriate, from an equity perspective, to enable that business to have a loss carry-back mechanism to:

- (a) enable that loss to be carried back for say five years, in order to reduce any inappropriate advanced-taxation of its compensation payments; and
- (b) to ensure that the loss, if deemed to be of a capital nature, could be applied against the taxation of free permits or other compensation arising from the CPRS and related regulation.

This was recommended in the Joint Institute/E&Y Paper. Recommendation 6(c) stated:

The treatment of tax losses needs consideration against the background of the likely profitability of emissions-intensive industries, to identify the risks and barriers to those industries making significant investments in emissions reduction technologies. The Government should consider whether special measures to reduce the barriers so far as they relate to the treatment of company tax losses, including tax loss carry-backs, tax-loss conversions into cash grants or other benefits, or tax loss consortium relief for joint venture companies in the relevant industries.

We note that the Henry Review of Australia's Future Tax System has made reference to the fact that various countries provide for loss carry-backs (at page 254).

Submission point 1.4 – Tax loss carry-back

We submit that, unless the Henry Review provides for an economy-wide loss carry-back mechanism for existing companies, it is imperative that the tax policy in respect of the Green Paper should include a tax loss carry-back mechanism which will be applicable to the parties which are affected by the constraints on free permits and thus have an adverse impact on their business values arising from this policy.

1.5 Annual calculation of permits used

1.5.1 Principles which should apply

We agree with the position in Chapter 11 of the Green Paper that expenditure on the acquisition of permits should be tax deductible.

We understand the rationale of Treasury that taxpayers should not be entitled to deductions in respect of the permits attributable to income of later years, and as a result some spreading mechanism is required.

However, the proposed rolling balance mechanism in the simple state as expressed in Chapter 11 will not accord with appropriate tax policy. Specifically:

- (a) Taxpayers, to be taxed equitably on their income of a year, must be entitled to a tax deduction in relation to permits acquired and which will be used to acquit the emissions generated in a year.

The design of the CPRS proposed in the Green Paper calls for emissions to be generated in a year ending 30 June, for those emissions to be included in an emissions annual return to be lodged potentially by October under the National Greenhouse Emissions Reporting System (NGERS) and for the relevant permits or corresponding price cap cash payments to be paid potentially up to 6 weeks after that date, in other words, potentially by middle December in a year.
- (b) The fact that emissions permits may not be acquitted for some time after the end of the June 30 year of emissions does not prevent them from having been incurred from a tax perspective. In particular:
 - i) The amount of emissions generated in a year ending 30 June will be clearly determinable in a very short time period after that date.
 - ii) The cost of emissions permits required to acquit those emissions and which are held at the taxpayer's balance date, will be known.
 - iii) The cost of emissions permits required to acquit those emissions, and which are not held by the taxpayer at its relevant balance date, will be capable of estimation quite simply as follows:
 - to the extent that the taxpayer will have forward purchases, derivatives or other financial instruments to secure their permits and those transactions will have been undertaken prior to 30 June, there will be the requisite certainty;
 - to the extent that the taxpayer plans to acquire permits after June 30 and before the acquittal date, the taxpayer will be able to estimate those purchases of permits. The taxpayer's estimates will be able to draw on:
 - market prices of permits of that vintage at 30 June and
 - the taxpayer's anticipated amounts to be paid subsequently as estimated at 30 June and will be recorded in the relevant business financial statements.
- (c) Under the circumstances, we think it imperative, in order to produce a correct reflex of the taxpayer's taxable income in a year, that a deduction be allowed for the cost of the permits required to acquit the emissions estimated by the taxpayer in the relevant income year.

Treasury will be aware that estimation of expenditure occurs throughout the tax system, without any danger to the integrity of the system. For example:

- i) creditors are estimated at June 30 on account of purchases made which have not yet been fully invoiced
 - ii) royalties payable are estimated even though the amounts are not due until a later period (the *Commonwealth Aluminium Case* provides an extended discussion of these issues, in circumstances where even the taxpayer was disputing the amount of the royalty)
 - iii) accruals are made for expenditure such as light, power, water and other utilities even where invoices are not received until well after a balance date.
- (d) We observe also that the participants which will be required to acquit their emissions are expected to number only about 1,000 participants, and we suggest therefore that the quality of compliance processes, and thus the tax system integrity attributable to, these large emitters is likely to be very high.

1.5.2 Taxation of free permits should not be undone in the rolling balance or annual calculation method

As mentioned above, we consider that free permits should not be taxable, or alternatively should have a particular tax treatment aligned to the capital gains tax basis of the relevant assets. It is important that the annual computation of permit usage and deductions should not interfere with these tax outcomes.

1.5.3 Recommendations regarding annual calculation of permits used

- (a) It is a core taxation principle that there should be matching of a taxpayer's expenditure against the revenue which will flow from the year's emissions.

The rolling balance method as currently proposed in Chapter 11 does not achieve this outcome. If the rolling balance method is to be used as the underlying calculation mechanism then it needs to be augmented by:

- i) 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 after year end in relation to emissions identified as occurring before the taxpayer's year end
 - ii) The rolling balance mechanism should allocate a nil value to free permits. In this way the rolling balance mechanism will not undo the tax outcomes of free permits as recommended by us above
- (b) The value of permits on hand at the taxpayer's balance date (reduced by the value of free permits anticipated to be acquitted in relation to the year's emissions) should be, at the election of the taxpayer, the cost of the permits or the market value of the permits.

This choice is desirable, at least for the first 3 years of the CPRS, given the possible significant volatility in pricing of permits. In due course we suggest that the permits could be valued at cost only.

The tax legislation should recognise that larger taxpayers, with larger numbers of permits, might adopt various accounting proxies for calculating the cost of their permits, including average cost, or separate identification of parcels. We observe that, in relation to the calculation of trading stock generally, there are various mechanisms used to simplify compliance by taxpayers.

- (c) Additionally, the taxpayer should be entitled to a deduction in relation to permits not on hand at balance date, but which represent a loss or outgoing incurred in generating that year's assessable income ('the permit gap'). This deduction should be calculated as follows:
- (i) the amount of the permits is to be determined by a reference to the calculations of emissions produced by the taxpayer for purposes of their emissions return or (if a taxpayer has a balance date other than 30 June) the estimate produced for purposes of their financial statements, reduced by the number of permits already held at balance date;
 - (ii) the price attributable to those emissions permits is to be at the taxpayer's choice:
 - the market value of emissions permits at the taxpayer's balance date or
 - the value estimated in the financial statements of the taxpayer in respect of those permits. Appropriate integrity in respect of the use of financial statements could be provided by requiring the taxpayer to provide records of this calculation or by restricting this financial statements method to taxpayers whose financial statements are audited.

Submission point 1.5 – Annual calculation of permits used

The rolling balance method as currently proposed in Chapter 11 does not achieve a matching of revenue and expenditure.

If the rolling balance method is to be used as the underlying calculation mechanism then it needs to 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 after year end in relation to emissions identified as occurring before the taxpayer's year end. Further, the rolling balance mechanism should allocate a nil value to free permits.

The value of permits on hand at the taxpayer's balance date should be, at the election of the taxpayer, the cost of the permits or their market value.

The taxpayer should be entitled to a deduction in relation to permits not on hand at balance date, but which represent a loss or outgoing incurred in generating that year's assessable income ('the permit gap').

1.6 Business criteria for inclusion in the proposed CPRS income tax regime

The discrete CPRS income tax regime should be applicable to all taxpayers that are carrying on a business including taxpayers which may not be obliged to acquire permits such as taxpayer's which voluntarily abate their emissions under a carbon neutral strategy. In particular, the proposed provisions should not require a nexus between the incurrence of the purchase price of permits under the CPRS and the production of assessable income.

Submission point 1.6 – Business criteria

A "taxable purpose" for the purposes of the proposed CPRS income tax regime should include the purpose of emissions abatement by a business, in the absence of a clear nexus with the derivation of assessable income.

2. INTERACTION WITH OTHER INCOME TAX ISSUES

2.1 Taxation of financial arrangements stages 3 & 4 (TOFA)

The introduction of the CPRS is expected to spawn a multibillion-dollar financial market for trade in emissions permits, other environmental instruments and associated derivative products. The Green Paper indicates that a key objective of the CPRS is the development of a primary carbon market and the establishment of secondary markets that will deepen as firms take advantage of the carbon market to manage their scheme obligations and carbon risks.

Indeed trading in derivatives has already occurred with AGL becoming the first Australian company to enter into a forward sale of emissions permits to Westpac Banking Corporation (for 10,000 tonnes of carbon) earlier this year, notwithstanding that the CPRS has not yet been legislated and is not expected to be introduced until 2010. Furthermore, if the European experience is any indication, Australia can expect to see significant development of forward and futures markets in the lead up to, and once the CPRS is in place.

In light of the substantial carbon market that is expected to develop, the tax implications under proposed stages 3 and 4 of the TOFA regime, as set out in Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2007, should be considered. This Bill proposed to introduce a new Division 230 into the ITAA97, which would set out new rules for the taxation of financial arrangements. The Bill lapsed in late 2007 with the calling of the federal election but is expected to be reintroduced. At a recent conference, the Assistant Treasurer, Chris Bowen, announced that he had agreed to a soft start date of 1 July 2009 and a hard start date of 1 July 2010 for the proposed Division 230.

In its current form, proposed Division 230, subject to certain exceptions set out in the provisions, should capture gains and losses from the trade of carbon derivative instruments on forward and other derivative markets that are expected to emerge. We consider that this is an appropriate outcome. To the extent that new derivatives and instruments are developed that do not fall within Division 230 (at this stage, it cannot be determined if any such derivatives or instruments will arise), we consider that they should be specifically scoped into Division 230.

In relation to the actual emissions permits under the CPRS, we note that, in some circumstances, the permits may constitute financial arrangements that fall within the ambit of Division 230. If the Government proceeds with a discrete set of rules for the tax treatment of emissions permits (such as those proposed in chapter 11 of the Green Paper), our recommendation is that the default position be that such permits be excluded from Division 230.

We understand that the preference of some taxpayers may be to have all or some gains on losses on permits recognised under Division 230. This may be where different permits are held for different purposes, eg., some for trading and others for the purposes of surrender to satisfy obligations under the CPRS. Consideration may need to be given to allow such taxpayers to elect for such treatment. We recommend that further consultation on this issue be undertaken but reiterate that such treatment should not be automatically extended to all taxpayers.

Submission point 2.1 – TOFA stages 3 & 4

The tax implications under proposed stages 3 and 4 of the TOFA regime should be considered.

In its current form, proposed Division 230, subject to certain exceptions set out in the provisions, should capture gains and losses from the trade of carbon derivative instruments on forward and other derivative markets that are expected to emerge. To the extent that new derivatives instruments arise which are not within TOFA, we consider that they should be specifically scoped into Division 230

The Institute recommends that the default position should be that the direct trading of actual permits is excluded from Division 230. Further consultation is required to ascertain whether some taxpayers might be allowed to elect to have all or some gains on losses on permits recognised under Division 230.

2.2 Reporting under the AETS

2.2.1 Interaction with the National Greenhouse and Energy Reporting System

Under the Carbon Pollution Reduction Scheme (“CPRS”), liable entities would be required to monitor and report their annual emissions, surrender permits etc. To reduce compliance costs, it is the Government’s preference to adopt an operational control approach that is similar to the National Greenhouse and Energy Reporting System (“NGERS”). We understand that under the NGERS, obligations to report emissions would be imposed as follows:

- Entities with operational control over covered facilities or activities would be liable for emissions obligations arising from those facilities or activities under the scheme;
- Where multiple entities exercise a degree of operational control over a covered facility or activity, a single responsible entity would be required to register and meet scheme obligations;
- For corporations, obligations would be placed on the controlling corporation of a company group where either the controlling corporation or a member of the group has operational control over a covered facility or activity. For these purposes, a controlling corporation is a constitutional corporation that does not have a holding company in Australia (foreign corporations may also be controlling corporations); and
- Unincorporated entities would also be liable under the scheme if they have operational control over a covered facility or activity. There appears to be no guidance however, on how liability will be determined for unincorporated entities that are severally liable (as opposed to jointly and severally liable) for reporting emissions. We consider that guidance should be provided so as to clarify reporting requirements in such an instance.

The following issues may arise as a result of the allocation of reporting responsibility on the basis of operational control:

1. Based on the definition of a controlling corporation and its company group (which includes subsidiaries, as defined under the Corporations Act to be entities that are controlled or in which more than 50% of the share capital is held by another entity), it appears that such a group would not satisfy the definition of a consolidated group (which requires 100% ownership of subsidiaries). The information collated by a controlling corporation of a company group in relation to annual emissions of the corporate group and the resulting number of permits required to be surrendered, will therefore need to be modified for the purposes of determining the tax position of a consolidated group, such that a tax deduction is claimed only in respect of the number of permits required to be surrendered to cover the emissions of the tax consolidated group;

We therefore recommend that the application of the tax law regarding determining the tax deductibility of permits purchased and surrendered by tax consolidated groups should be clarified in any draft tax legislation. To reflect the substance of ownership of permits we recommend that the reporting requirements under the NGERS be amended to ensure that a company group only includes entities in which the controlling corporation holds a 100% direct / indirect interest.

2. Where there has been a change in the controlling corporation during the year we understand that the National Greenhouse and Energy Reporting Act 2007 (NGER Act) provides that emissions are to be determined for each controlling corporation on a pro-rata basis (section 13(2) of the NGER Act).

An issue will arise where the controlling entity at the beginning of the reporting period (being 1 July) ceases to exist part way through the reporting period. As the entity should only be able to determine whether the emissions attributed to it during the period that it is a controlling corporation exceeds the emissions cap, by the reporting date of 31 October or earlier, it will only be able to surrender permits after the year in which it ceases to exist. Accordingly, the tax deduction that the entity would ordinarily be entitled to on the surrender of the permits would not be available to the entity. The proposed tax legislation should provide guidance that in such circumstances a tax deduction would be available to the entity in the year that it ceases to exist.

3. Where entities exercise operational control over a covered facility or activity, such as an independent operation and maintenance company, such entities would be required to register and meet scheme obligations. This may result in such entities which do not wholly own the facility potentially having to firstly measure the emissions of the facility and then purchase and surrender permits to cover the emissions. In the absence of any arrangements to recharge a portion of the costs to the entities that own the facility, the imposition of the obligations under the CPRS would unfairly disadvantage the entity exercising operational control over the facility.
4. Similarly, where an entity exercising operational control over a covered facility or activity such as an independent operation and maintenance company, receives free permits, it would be assessed in respect of these permits in the year of receipt under the proposed tax treatment outlined in the Green Paper. Unless there is an arrangement in place with the actual users of the facility to recharge the tax cost of the permits, the imposition of the obligations under the CPRS would unfairly disadvantage the entity exercising operational control over the facility. We recommend that the tax legislation relating to the free permits allow for the assessable income arising from the receipt of the free permits to be attributed to the entity that uses the facility rather than to the entity exercising operational control.

2.2.2 Tax consolidation

We recommend that clarification is provided regarding the treatment of permits where an entity is joining or leaving a tax consolidated group.

Under the tax cost setting rules, permits would need to be classified as either reset or retained cost base assets. On the basis that we understand that permits are to be taxed under a 'rolling balance' method, which is effectively the same as the tax treatment of trading stock, we consider that permits should be treated similarly to trading stock on entry into, and exit from, a consolidated group. That is, a method which treats the permits as reset cost base assets but which freezes the cost of the asset so as to achieve a tax neutral outcome such as that outlined in sections 701-25 and 701-35 of the ITAA977. We note that such treatment would be consistent with the key principle of maintaining tax neutrality in relation to the treatment of permits as outlined in the Green Paper.

Specific guidance would also be required to determine the terminating value for permits for the purposes of the tax cost setting rules. Presumably, where those rules treat the permits similarly to trading stock, the terminating value of the permits will be determined along the lines of section 705-30 which applies to trading stock.

2.2.3 Entities with substituted accounting periods

We understand that the reporting framework under the NGERS is based on a compliance year of 1 July to the following 30 June. The emissions data is required to be submitted to the scheme regulator by 31 October following the previous 30 June year end, with the final date for surrender of permits relating to emissions over the cap set by the scheme regulator for the previous 30 June financial year, by 15 December.

The timing of allowable deductions and assessable income relating to the purchase and sale of permits outlined in the Green Paper is also based on a compliance year of 1 July to the following 30 June. As we understand, the cost of a permit is deductible when a permit is acquired, the proceeds received from selling the permit will be assessable income and the difference in the value of permits held at the beginning and end of an income year will be reflected in taxable income.

The practical application of the reporting framework will mean that liable entities with a 30 June year end will not surrender permits in respect of emissions for a particular year until the following income year. Consequently, the tax deduction which should eventuate under the rolling balance method will only be available in the income year in which the permits are surrendered and not the year in which the permits are purchased.

We consider that this places June-balancing entities at a disadvantage as there will be a timing mismatch between the year that the economic cost of the permits is borne and the year that the tax deduction is actually allowed.

In contrast, liable entities with substituted accounting periods appear to be at a comparative advantage under the proposed reporting timeline. This is because, from the first year of the scheme (being the year ending 30 June 2011) and onwards, a liable entity with a 31 December year end will be able to determine its emissions in respect of the first six months of its current income year (being 1 January to 30 June 2011), as well as the second six months of its previous income year (being 1 July to 31 December 2010), as the reporting date will be 31 October 2011 and the surrender of permits will take place on 15 December of that income year. Therefore the liable entity will be in a position to claim a tax deduction in respect of permits surrendered during the year ending 31 December 2011 in respect of emissions attributed to the reporting year ending 30 June 2011.

It seems that it would be unfair to place a category of taxpayer at an advantage due to reporting timelines and therefore we recommend that consideration be given to better aligning the timing of emissions reporting in relation to permits to the financial year end of taxpayers. We consider that ultimately there should be no difference between the tax outcomes for entities based on their income year.

2.2.4 Pay As You Go Instalments

We consider that specific clarification be provided as to whether permits constitute ordinary or statutory income as this will impact the determination of a taxpayer's Pay As You Go ("PAYG") instalment income (which is broadly based on a taxpayer's ordinary income and excludes statutory income).

Our understanding is that an entity that trades permits is likely to account for them along similar lines as inventory whereby revenue is recorded on the sale of the permits and the outgoing in acquiring the permit is recognised in cost of sales. Recognising the proceeds on the sale of a permit as sales revenue for accounting purposes could potentially give scope to recognising the income as ordinary income of the entity for tax purposes. The result being that the income from the sale of the permits would be included in the determination of PAYG instalment income.

In our view, it would not be appropriate to include the revenue from the sale of permits in the calculation of PAYG instalment income as the purchase/receipt and disposal of permits is likely to fluctuate on a year by year basis, particularly in the initial years of the CPRS. This would therefore affect PAYG instalment income calculations.

In contrast, where an entity holds a permit for its own use, and later sells that permit outside the course of its ordinary business, the sale is likely to be accounted for as a net gain/loss in the entity's profit and loss statement and this would not be considered to be ordinary income for tax purposes. In this situation there would be no impact on the calculation of PAYG instalment income. We consider this treatment to be appropriate.

We also understand that the Green Paper proposes to treat free permits as assessable on receipt. Presumably, as the receipt of a free permit will be assessable under a statutory provision, it will not be ordinary income and will therefore be excluded from the calculation of PAYG instalment income.

In order to:

- eliminate the inconsistencies between taxpayers that receive free permits and who purchase permits (for own use or for trading purposes) when calculating PAYG instalment income;
- reduce the administrative burden on taxpayers; and
- avoid fluctuations in PAYG instalment income from year to year,

we consider that both free and purchased permits be specifically carved out of the calculation of PAYG instalment income.

Submission points 2.2 – Reporting under the AETS

Interaction of the proposed AETS with the National Greenhouse and Energy Reporting Act 2007 needs consideration including issues that may arise as a result of the allocation of reporting responsibility on the basis of operational control.

The Institute recommends that clarification is provided regarding the treatment of permits where an entity is joining or leaving a tax consolidated group.

Taxpayers with a substituted accounting period may be at an advantage due to reporting timelines as currently proposed in the Green Paper. Therefore we recommend that consideration be given to better aligning the timing of emissions reporting in relation to permits to the financial year end of taxpayers as we consider that ultimately there should be no difference between the tax outcomes for entities based on their income year.

The Institute also submits that both free and purchased permits should be specifically carved out of the calculation of PAYG instalment income.

2.3 International tax

The Institute supports the Government's preferred approach that the emissions trading scheme should be designed so that it can link with international markets and schemes, with a preference for open trade within an effective global emissions constraint (preferred position 6.1).

Chapter 6 of the Green Paper on "Linking the scheme to international markets" proposes that Australian emissions permits would not be convertible to Kyoto/international units for sale in and transfer to international markets in the early years of the scheme. This is to deliver a smooth transition to the CPRS and to minimise

implementation risks. However, we note that some capacity is proposed in the Green Paper to use credits from international activities for Australian purposes (e.g. certified emissions reduction units) at an earlier stage.

The planned eventual linkage to international markets raises a number of international tax issues that will need to be considered as part of the legislative design process. We would recommend that further consultation be undertaken to determine the precise detail of the Australian involvement in international trading. Notwithstanding this, we highlight in this section some of the pertinent tax issues.

2.3.1 Income tax issues

As explained in the Joint Institute/E&Y Paper some of the income tax issues to consider include:

- whether a permit purchased from a foreign resident should be afforded the same tax treatment as one purchased from an Australian offset provider
- the source and nature of the income derived from the sale of permits (since non-residents of Australia are generally only subject to tax on Australian sourced income);
- the capital-revenue distinction having regard to the exemption for non residents for most capital gains and
- ensuring that the Australian interpretation of Australia's Double Tax Agreements (DTAs) with treaty partners facilitates international carbon credit markets.

The Institute considers that payments made by resident taxpayers to non-residents for 'international' emissions permits or offset credits, should be afforded the same domestic tax treatment as if the counter-parties were located in Australia. The converse would also apply – in regard to the sale of emissions permits or offset credits by Australian market participants.

2.3.2 Absence of international 'norms'

No standard international tax practice or understanding in relation to cross-border issues has been developed although with schemes in place and/or emerging, this is an area that is the subject of much attention.

As an example, domestic treatment of the acquisition and sale of permits can vary across jurisdictions. Income derived from the alienation of the permits could result in a capital gain or ordinary income and may depend for instance on whether the permit is for compliance purposes, trading or held outside the scope of a trade or business. Furthermore, tax rates in different countries vary. The effect of any relevant DTA is another aspect that needs to be taken into account¹.

We note that perhaps there may be some scope for harmonisation of different countries' tax treatments in a multilateral initiative in due course, although that will require consideration of many different commercial situations with different tax outcomes.

2.3.3 Double Tax Agreements

The application of Australia's Double Tax Agreements (DTAs) to cross-border carbon credit trading will need to be examined, including:

- confirmation that Australia's DTAs adequately accommodate emissions trading;
- determination of how the distributive rules in Australia's DTAs apply to different types of activities relating to the emissions trading system;

¹ In a paper presented to the International Fiscal Association Conference in Kyoto in October 2007, Krister Andersson, Head of the Tax Policy Department of the Confederation of Swedish Enterprise, noted that "Different tax rates and classification of the emission allowances across countries will result in additional costs for reducing emissions in order to achieve a common objective. By taxing emissions at the national level, the risk of double taxation is furthermore obvious. However, even perfect implementation of tax treaties, would result in allocative distortions and additional costs for emission reductions due to the different tax rates ... It is therefore of utmost importance that classification of emission allowances and their possible taxation is as uniform as possible."

- that as a general rule, residence based taxation will apply – for instance confirmation that if there is no Australian permanent establishment (Article 7), the acquisition or sale of permits by the treaty non-resident will not fall within the Australian tax net;
- the tax treatment of cross-border inward investments; and
- clarity in characterising inward investments into Australia by foreign investors seeking to create emission permits under the various schemes.

2.3.4 Transfer pricing

The administration and interpretation of transfer pricing rules may need attention in order to meet revenue concerns about inappropriate pricing amongst associated international entities not acting at arm's length.

Submission point 2.3 – International tax issues

The Institute supports the Government's preferred position 6.1 that the emissions trading scheme should be designed so that it can link with international markets and schemes, with a preference for open trade within an effective global emissions constraint. This will require the consideration of the domestic tax treatment (once this firms up as a result of this current consultation) and its interaction with international issues and 'norms' as they evolve, including the impact of DTAs and transfer pricing issues.

2.4 Other matters

2.4.1 Same business test

There is potential to argue that trading in permits constitutes a new business or new transaction which may be relevant to an entity in determining whether it satisfies the same business test for the purposes of utilising tax losses. Such an analysis may be detrimental to certain entities under the same business test, and it is foreseeable that this would impact their decision of whether, and the extent to which, they trade in permits. This outcome goes against the aim of tax neutrality of the proposed tax regime and in our view specific guidance should be provided to give taxpayers comfort that trading in permits will not be a factor for consideration under the same business test.

2.4.2 Thin capitalisation

There will be thin capitalisation consequences for reporting entities to the extent that the permits and liabilities in respect of carbon emissions are recognised under the CPRS regime as assets and liabilities on the balance sheet. This has a clear impact for thin capitalisation purposes where entities determine their thin capitalisation position under the safe harbour debt test. We recommend that transitional measures be 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.

2.4.3 Public trading trusts

Where, to provide liquidity in the market, 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. Such uncertainty may affect an entity's decision to trade in permits. Therefore, to avoid triggering the public trading trust rules, we recommend that trading in permits be specifically included in the definition of an 'eligible investment business' in section 102M of the ITAA36.

Submission point 2.4 – Other matters

- Specific guidance should be provided to give taxpayers comfort that trading in permits will not be a factor for consideration under the same business test.
- Transitional measures should be drafted to include assets and liabilities relating to permits gradually for thin capitalisation purposes.
- Trading in permits should be specifically included in the definition of an 'eligible investment business'.

3. OTHER TAXES

3.1 GST

The Green Paper advocates that transactions under the proposed CPRS scheme should be taxed in accordance with the existing GST laws.

3.1.1 Underlying policy basis

We understand that the aim of the CPRS scheme is that permits will be priced in the market at the lowest marginal cost of abatement – that is, polluters will either have to reduce emissions or buy permits. For so long as the cost of a permit is less than the cost of abatement, individual polluters will purchase permits. Hence, the price of a permit will increase until it reaches the lowest marginal cost of abatement.

This feature of the CPRS is, we understand it, critical to the success of the scheme because it ensures that abatement is undertaken at the lowest cost to the economy.

Importantly, the cost of abatement, to a polluter will be exclusive of GST because one presumes that all polluters will be entitled to input tax credits for the cost of abatement.

If the cost of a permit were to be increased to include GST:

- there is a cash flow and compliance cost that distorts the efficiency of the market; and
- if any part of the market were not entitled to an input tax credit (e.g., because it involved a mere investment activity), the market would be distorted because some of the population would suffer a different cost of purchase to others.

We also assume that it is not intended that expenditure on permits (of itself) contribute to the consumption tax base. While the cost of a permit to a polluter will increase its costs of production and hence the price charged to consumers for its goods and services, the tax base (private final consumption expenditure) is not intended to include the price paid by business or consumers for the permit – just as the resources consumed in abatement are not intended to be taxable without input tax relief.

Accordingly, we conclude that the policy imperative is to ensure that payments made to purchase permits should not be subject to non-recoverable GST and that the cash flow and compliance costs of the trade in permits should not be such as to disturb the efficiency of the market. This leads, in our view, to the conclusion that the supply of permits should not give rise to a GST liability for the supplier.

3.1.2 Rationale for adoption of existing GST rules

The recommendation that permits be taxed in accordance with the existing GST rules is in contrast to the recommendations in respect to income tax where specific provisions are to be enacted. However, the reasons given for enacting specific provisions for income tax (i.e. uncertain treatment and high levels of complexity) also exists in respect of GST.

In fact, the reason for a special regime for GST that relieves the price of permits from GST has a greater justification because GST would impact both directly on the price of permits and indirectly through the cash flow and compliance costs involved in accounting for GST and claiming any input tax relief available.

The income tax rationale is based on a neutrality in the income tax effect of the abatement system (largely the capital revenue distinction). The GST arrangements, however, affect the cost of abatement and permits directly.

We deal with some of the specific issues that might give rise to GST costs directly or indirectly through compliance and cash flow costs. We consider that these costs, whether direct or indirect, not only involve inefficiencies in the market for permits but impose additional inefficiencies and cost in the CPRS system itself.

3.1.3 Taxable vs non-taxable supplies

Under the existing rules, the supply of a permit for consideration will give rise to GST if

- the supplier makes the supply in the course or furtherance of an enterprise;
- the supply is connected with Australia;
- the supplier is registered;
- the supply is not GST-free or input taxed.

3.1.3.1 The enterprise question

One of the key reasons for a special regime for income tax is the difficulty and non-neutrality of the capital revenue distinction. However, this distinction, in a GST context manifests itself in the enterprise / non-enterprise distinction. Where an entity acquires a permit for investment purposes or as a hedge, it is possible that the activity is not a part of an existing enterprise and does not fall within the GST purview. Consequently, if the purchase of the permit were subject to GST, the cost to that entity would be higher than (say) a “polluter”. This differential sets up non-neutralities in the market and damages the market efficiency. Equally, the investor can sell the permit without paying GST, but the price that would be offered by a polluter would be less than the GST inclusive price paid in a market populated by “polluters”.

3.1.3.2 Non-residents and non-Australian permits

GST will not be payable on a supply if:

- the permit originates from a scheme outside of Australia and is “connected” to that jurisdiction
- a supplier is not registered

- the supply is not connected with Australia (eg, a non-resident that does not trade in Australia)
- the supply is GST-free (because it is made to a non-resident who is not in Australia).

There are a variety of issues surrounding transactions involving non-residents which create complexity. These include:

- determining which supplies to non-residents are GST-free;
- determining which supplies by non-residents are connected with Australia;
- requiring non-residents to register for GST solely by virtue of selling permits.

Application of the GST-free rules becomes even more problematic if a particular emission unit is characterised as ‘real property’, for example sequestration credits. In this case, the GST-free rules would not apply and GST would need to be charged irrespective of whether the purchaser was a resident or non-resident.

The purchase and sale of permits to and by non-residents and the international trade in non-NZ permits was the reason New Zealand selected a zero-rate (the NZ equivalent of GST-free treatment) for all permits. In this regard New Zealand Government has stated:

‘The Government proposes to zero-rate supplies of emission units. This addresses the issues arising from participation in international markets, as all supplies are zero-rated, whether to purchasers inside or outside New Zealand. The claiming of input tax credits is also straightforward, as all input tax credits can be claimed when supplies are zero-rated.

While the emission units issued by the government will be NZUs, emission obligations under the Climate Change Response Act 2002 may be also be satisfied using certain Kyoto units or approved overseas units. As New Zealand businesses will potentially be trading in all of these different types of units (and potentially, other Kyoto units which may be determined not to be eligible for surrender) it is recommended that the zero-rating treatment be extended to all of these classes of units.

Any actual supply of services in exchange for emission units, such as the supply of the service of carbon capture in forests, will also be zero-rated. ...,

Zero-rating the supply of emission units has the lowest compliance costs of any of the alternatives considered, as it will be relatively straightforward for businesses to implement and does not require any attribution of GST input tax.”

Further, even if a permit is taxed on supply to a non-resident and the non-resident is able to register to claim input tax relief in Australia, our experience is that the non-resident will not do so, having the consequence that:

- the price that the non-resident will pay is less (leaving the Australian supplier liable for GST on its own “production”); and
- a non-neutrality in the market because the price for all purchasers is not the same.

3.1.4 Input tax relief

If a taxable supply, such as the supply of a permit, was made to an entity that was not carrying on an enterprise, no input tax credit will be claimable. This will be an embedded cost even if the entity on sold the permit to an entity carrying on an enterprise.

Similarly, the GST incurred on a permit will not be recoverable by a GST-registered entity to the extent that it relates to making input taxed supplies. This raises complex GST recovery issues and is discussed further below.

3.1.5 Input taxed supplies

There are also issues in respect to whether certain transactions could constitute financial supplies under the current law. If one or more of the potential transactions constitute a financial supply, then it could result in denial of input tax credits to parties involved in the CPRS. It would result in complexity regarding the input tax recovery methodology used to determine the extent of input tax credit entitlements in respect of both the permits and associated costs.

As an example, while the actual sale of a permit might constitute a taxable supply, a transaction involving the forward sale of a permit could constitute a financial supply. While selling a vintage 2014 permit might be a taxable supply, entering into a forward sale agreement for a permit for that year might constitute a financial supply. There would be significantly different GST consequences as a result of entering into a different type of transaction, even if it still gives the same economic result.

There is also some uncertainty as to which financial-type instruments relating to permits will be financial supplies. This is actually a live issue, as currently there is uncertainty as to the GST treatment of certain transactions relating to existing voluntary schemes.

3.1.6 The “entity” question

We understand that permits are likely to be issued and acquitted by entities other than those that might be relevant for GST and other taxation law obligations. For example, we understand that the focus on CPRS is the operator of the facility and not, necessarily, the legal owner. The income tax and GST responsibilities and risk in economic terms may often fall on different entities (e.g. head entities in consolidated groups or legal owners of plants).

The result may be that the purpose of acquisition of permits of entities may not, from a tax purpose perspective, be equated to the purpose of the entity that is the focus of the CPRS. This mismatch will lead to the likelihood from a GST perspective that not all permits purchased will be acquired for a “creditable purpose” depending on the corporate structure and division of ownership and operation.

Again, these complications, where corporate structures (and hence financial holdings) may interfere with the CPRS focus on operators leaves the likelihood that GST will become a cost in purchase and sale of permits affecting the efficiency of the market and producing non-neutral outcomes.

3.1.7 Derivatives

It is apparent that the majority of value traded in relation to permits will take the form of “derivatives”. There is a concern that this trading might be treated as a financial supply and limit input tax relief for costs incurred by traders. This could apply to companies involved in the “pollution” sector as well as financial intermediaries that create and trade the products.

The CPRS will require management of risk and financial exposures for both abatement costs as well as financial risk. This trading, if input taxed will involve additional GST costs (for non-creditable inputs) as well as GST compliance costs. The treatment of financial services in a value added tax is recognised as a source of bias and inefficiency. All countries have sought to limit these inefficiencies. For example, Australia chose the reduced input tax credit regime, New Zealand a B2B zero-rate and Singapore an arbitrary input tax credit regime.

We do not consider that Australia's trading environment that supports the CPRS ought suffer the GST inefficiencies of financial services merely because the trading may fall within the legislative definition. The mischief at which financial services exemption is directed is not, necessarily, present in CPRS trading. If a GST costs of trading in permits were to arise in the same way as exists for financial services, the deadweight costs to the economy (and hence the efficiency of the market) are self evident.

3.1.8 Conclusions

The ultimate success of the Australian emissions trading scheme will be dependent upon developing a highly liquid market with low price volatility, through strong international linkages to provide access to lowest cost abatement globally.

To achieve these hallmarks, it is critical that the GST treatment does not create barriers to cross-border trades by imposing GST price disincentives and compliance complexities for foreign firms. Rather, the GST treatment should promote trades both inbound and outbound within the global market.

Furthermore, removal of GST cash flow impacts and potential embedded GST in the price of emission units will be integral to establishing an efficient, undistorted market that is GST-neutral and attractive to both local and foreign participants.

In light of the policy objectives of the CPRS, our key recommendations are:

- 1 Adopt a stand-alone GST-free (or non-supply) model for core trades and dealings in permits and similar emissions rights. In particular, a specific provision should be inserted into the GST Act to achieve this. This GST-free (or non-supply) provision should cover 2-way supplies / barter transactions, eg 'earned' sequestration permits.
- 2 Consider extending the non-taxable treatment to all financial-type transactions that relate to permits which would otherwise be financial supplies. The aim is to ensure that:
 - the trading instruments that support the CPRS are not subject to GST; and
 - business costs in trading in the market that supports the scheme do not give rise to non-recoverable GST costs.
- 3 Amend GST Act definitions to confirm that all types of emissions permits/units/credits are "a thing other than goods or real property" for GST purposes, i.e. a chose in action being a personal property right.
- 4 Adopt appropriately broad legislative drafting to ensure that all foreign permits/units/credits are treated in the same way as local permits.
- 5 Adopt appropriately broad legislative drafting to ensure 'voluntary' market permits/units/credits are treated in the same way as permits.
- 6 Amend the GST registration rules to confirm that non-residents will not be required to register for Australian GST by reason only of their making supplies of permits connected with Australia.

However, provide a mechanism to enable GST registration on an optional basis to claim credits (i.e. similar to the rules introduced for non-resident tour operators selling rights for use in Australia).

- 7 Amend the Division 81 Determination to include penalties imposed under the CPRS.

Submission points 3.1 - GST

The Institute recommends adoption of a stand-alone GST-free (or non-supply) model for core trades and dealings in permits and similar emissions rights. In particular, a specific provision should be inserted into the GST Act to achieve this.

Extending the non-taxable treatment to all financial-type transactions that relate to permits which would otherwise be financial supplies should be considered.

The GST Act definitions should be amended to confirm that all types of emissions permits/units/credits are “a thing other than goods or real property” for GST purposes.

Appropriately broad legislative drafting should be adopted to ensure that all foreign permits/units/credits are treated in the same way as local permits and to ensure ‘voluntary’ market permits/units/credits are treated in the same way as permits.

The Institute recommends amendment of the GST registration rules to confirm that non-residents will not be required to register for Australian GST by reason only of their making supplies of permits connected with Australia, with an optional GST registration to claim credits.

The Institute also considers that the Division 81 Determination be amended to include penalties imposed under the CPRS.

3.2 Stamp duty

Due to tax reform the duty base is slowly being narrowed to land and land interests, a process which will only be completed when NSW and Queensland abolish business asset and statutory license conveyance duties on 1 January 2011. Accordingly, by January 2011, non-land property such as carbon permits should not come within the duty net in any Australian State or Territory. We do, however, recommend that the State and Territory governments confirm by specific exemption that dealings in such permits are not liable to duty particularly as there may be overlap during the implementation of the scheme in 2010, where trading occurs before January 2011.

A separate issue, which has not been resolved, is ensuring tax neutrality in respect of carbon sequestration/abatement activities. As rights relating to carbon sinks such as tree plantations may be land interests, dealings in such rights could incur duty post January 2011. This additional tax burden for land related abatement activities could affect the neutrality between the various choices available in respect of abatement. For example, R&D activities should not produce a duty burden. We would recommend that the State and Territory governments clarify their position in respect of duty on interests in land based carbon sinks and, if necessary, implement exemptions to ensure no tax based distortions arise in respect of the abatement choices available.

Submission point 3.2 – Stamp Duty

The Institute recommends that the State and Territory Governments confirm by specific exemption that dealings in permits are not liable to duty particularly as there may be overlap during the implementation of the scheme in 2010, where trading occurs before January 2011.

We submit that State and Territory Governments should clarify their position in respect of duty on interests in land based carbon sinks and, if necessary, implement exemptions to ensure no tax based distortions arise in respect of the abatement choices available.

3.3 Fuel tax credit regime

The Green Paper does not comment on the existing Fuel Tax Credit (FTC) regime or its future once the CPRS is introduced. Whilst the Green Paper touches on proposed reductions in the fuel tax payable by consumers to offset the initial price impact on fuel associated with the introduction of the CPRS, no detail is given on how these cuts will impact the FTC regime.

The Government should consult with industry (e.g. the motor vehicle industry, fuel refiners and distributors, etc) and professional bodies to determine the interaction between the CPRS and the FTC. The Government should consider appropriate transitional measures to ensure that affected industries are not adversely impacted.

Submission point 3.3 – Fuel credit tax regime

The Government should consult with industry and professional bodies to determine the interaction between the CPRS and the Fuel Tax Credit regime, including transitional rules.

3.4 Petroleum resource rent tax (PRRT)

The Green Paper does not refer to the interaction of the proposed CPRS and PRRT which is covered by the Petroleum Resource Rent Tax Assessment Act 1987 as amended.

PRRT is a significant obligation imposed on participants in certain petroleum projects in offshore Federal waters. Given the industry specific aspects, we recommend that consultation be held with industry and professional bodies to ensure that the impacts of the CPRS are understood and any required modifications to the PRRT system are identified early in order to achieve the Green Paper's neutrality objectives.

Similar issues may also arise under State mining and petroleum royalties which allow certain costs to be taken into account in calculating the royalty amount payable.

Submission point 3.4 – Petroleum resource rent tax

The Institute recommends that consultation be held with industry and professional bodies to ensure that the impacts of the CPRS are understood and any required modifications to the PRRT system are identified early in order to achieve the Green Paper's neutrality objectives.

Similar issues may also arise under State mining and petroleum royalties that will require investigation.

4. OTHER ISSUES

4.1 Incentives

A challenge associated with putting a price on carbon is that some industries and sections of the community in Australia will be "hurt" more than others while the economy transits to less emissions-intensive technology. The auctioning of permits under the CPRS will create revenue for the Government, which can be used to ease the burden of the CPRS. The big question, however, is how this revenue and other sources of Government assistance should be allocated to change behaviours around climate change.

A key component of driving such behavioural change is the role of incentives, and in particular, the use of tax incentives and grants as part of Government policy, to assist in the response to the challenge of climate change.

The Green Paper proposes to address the problem of potential "carbon leakage" by providing a share of free permits to the most EITE industries (refer to page 27 and Chapter 9). We again refer to sections 1.2 and 1.3 of this submission for our recommendations in relation to the tax treatment of free permits as well as cash grants.

The Green Paper also acknowledges the "tension" that exists between participants in EITE industries and the rest of the economy. As stated in the Green Paper (refer to page 295 at section 9.1.2):

“The design of the EITE industry assistance policy will have an impact on non-assisted industries and households for two principal reasons:

- First, to the extent that carbon pollution permits are freely allocated to EITE industries, the number of permits that are auctioned will be lower, reducing scheme revenue and the Government's capacity to assist other industries and households.
- Second, assisting EITE industries may increase the emissions reduction effort required of the rest of the economy to reach emissions reduction targets. The size of this impact will depend on the way EITE assistance is provided to industries and on the extent of international linking that is allowed.”

Notwithstanding this latter suggestion made by the Green Paper, it is submitted that the size of the impact will also be greatly influenced by the way that assistance and incentives are provided to participants in non-assisted, non-EITE industries. The Green Paper is silent in this regard.

It is therefore further submitted that consideration must be given to the appropriateness of additional incentives through the tax system to all businesses, beyond those referred to in the Green Paper. This is necessary to not only assist and encourage the adoption of less emissions-intensive products and processes across the entire economy, but to ensure that an unfair burden is not initially placed on participants in non-EITE industries, and to ensure that necessary new investment is not discouraged. If so, there may be a risk that "reverse" carbon leakage (ie from participants in non-EITE industries) may occur.

To this end, we note Treasury's acknowledgement of the issues and concerns regarding the question of climate change tax incentives in consultation meetings on 26 and 27 August 2008. We also note Treasury's preference for consideration around such tax incentives to be undertaken as part of the Henry Review of Australia's Future Tax System.

However, we strongly stress the importance played by, and the integral nature of, appropriate climate change tax incentives to the introduction of the CPRS in its entirety, and not just to the tax implications of the CPRS when considered in isolation. It is on this basis that the following comments and recommendations are made.

Specific incentives

As stated in the Joint Institute/E&Y Paper, it is acknowledged that:

“Development of any incentives based on tax deductions requires careful attention and design to provide the relevant certainty for business and to head off any risk that uncertain or inappropriate eligibility conditions will result in revenue outcomes different from those forecast.” (refer to page 32)

While this may be the case, there is also an opportunity for the Government to consider and introduce appropriate tax-based measures, as part of its development and implementation of policy complementary to the aims of the policy underlying the introduction of the CPRS.

4.1.1 Research & Development (R&D)

For example, the Government has an opportunity to introduce R&D measures that will support the massive private investment that the Government acknowledges is required to facilitate the achievement of carbon pollution reduction targets.

Regard should therefore be had by the Government, either as a complementary measure introduced to support the CPRS, or as part of the broader Review of the National Innovation System, to enhance the level of support to available R&D funding programs in Australia.

It is noted that the recommendations outlined below are also common to submissions made by the Institute to the Review of the National Innovation System. It is also noted that while the due date for the Report on the Review of the National Innovation System was extended (with the Report being released on 9 September), it is still the Government's intention to release an Innovation White Paper before Christmas, that will presumably address these (in addition to other) relevant considerations associated with R&D and carbon pollution reduction.

The Institute therefore reiterates the following recommendations as made in the Joint Institute/E&Y Paper in respect of R&D:

1. Increase the deduction on eligible "green" technology R&D expenditure to 200%.
2. Amend or remove R&D thresholds for R&D Tax Offsets for companies developing green technologies.
3. Allow companies accelerated rates of depreciation for assets used in green technology R&D, in order to recognise and provide support for costs associated with the commercialisation of new technologies, and the incorporation of new technologies into existing operations.
4. Recognise that targeted use of funding grants in certain circumstances (eg through the Climate Change Action Fund and provision of partnership funding (refer to page 26 and section 12.1 of the Green Paper)) is a supplementary, and not a primary, incentive, due to the discretionary nature of such grants.

4.1.2 Capital Allowances

A further strategic element in encouraging the adoption of less emissions-intensive products and processes will be to ensure that Australian businesses invest in appropriate capital expenditure to reduce their emissions. Such expenditure may take one of three forms:

- Expenditure on refitting existing equipment;
- Capital expenditure on new equipment, independently of the R&D process; and
- Capital expenditure on infrastructure, such as that required by emissions capture and storage.

The Garnaut Report in June 2008 suggested that an alternative tax concession – in the form of accelerated depreciation of assets – may be an alternative to tax concessions for increased R&D activities.

It is submitted, however, that consideration should be given to the possible introduction of a "green accelerated capital allowance regime" as a complementary measure to the introduction of additional R&D concessions. As stated in the Joint Institute/E&Y Paper (refer to page 34), this would:

... properly recognise the shorter economic life of certain emission-reduction capital equipment, and ... encourage investment in emission reductions capital expenditure.

As noted above, it will be important to ensure that capital allowance tax incentives are not misused and do not lead to unintended revenue outcomes. Subject to Government carbon pollution reduction policy, such incentives may be limited to particular industries or restricted to particular expenditure (refer below).

Further, such incentives may take the form of changes to existing capital allowance provisions, or give rise to the introduction of specific provisions within Division 40, as seen with the introduction of the carbon sink forest provisions. However, notwithstanding the form in which such incentives may be introduced, it is submitted that further consideration be given to the possible substance of such incentives, in particular the recommendations made below (which were also made in the Joint Institute/E&Y Paper in respect of capital allowances).

In addition to the above, the Garnaut Report also suggested that Australia has the opportunity to play a leadership role in both the funding and co-ordinating of major global efforts to develop and deploy carbon capture and storage technologies. Having regard to likely future developments in the carbon pollution reduction realm since the release of Draft Taxation Ruling TR 2008/D2, recently finalised as TR 2008/6, the Government as a matter of policy should also consider broadening the scope of tax relief for geosequestration expenditure.

In summary then, the Institute considers that the Government should consider:

1. Increasing depreciation rates applicable to emissions-reduction capital expenditure in general, either through a detailed analysis or possibly through the use of a "flat loading rate" of 20% (for example) over and above write-off rates otherwise available.
2. In particular, in relation to "add-on", or refitting, capital expenditure (where such expenditure is not immediately deductible as, say, repairs and maintenance), reduce the effective lives of such capital expenditure, or introduce further specific loading rates, to recognise the general proposition that the economic life of such expenditure may be expected to be less than the cost of new equipment.
3. Introducing a targeted investment allowance, such as an Emission Reduction Investment Allowance, at a rate of 20% (for example) of the cost of capital expenditure on "green" plant & equipment, subject to certain parameters (which could include restrictions in application to capital

expenditure that is installed ready for use within 5 years of the introduction of the CPRS, and is designed to reduce the energy utilisation of existing equipment).

4. Amending the concept of "taxable purpose" for various provisions in the income tax legislation to include the purpose of emissions abatement by a business, in the absence of a clear nexus with the derivation of assessable income, particularly in the context of expenditure on geo-sequestration initiatives.

4.1.3 Conclusion

It is apparent that consideration needs to be given to the level and degree of incentives provided through the tax system as part of the Government's "whole of response" to carbon pollution reduction and the introduction of the CPRS.

As the Joint Institute/E&Y Paper identifies (at pages 34 and 36):

... Australia's capital allowances and incentives will need to be internationally competitive. Otherwise, capital expenditure on new facilities will be attracted to countries with lower costs or greater incentives. These incentives will be important for Australia's competitiveness and will be particularly relevant in the initial transitional phase, to take Australian business through the initial wave of expenditure to deal with emission abatement and the structural changes flowing from them.

Submission points 4.1 - Incentives

Consideration should be given to appropriate climate change tax incentives as part of the design and implementation of the CPRS. At the very least the Government must ensure that there is an integrated, cohesive, systematic approach to the consideration of appropriate tax incentives between Treasury (as part of the CPRS process), the Henry Review of Australia's Future Tax System, and the Review of the National Innovation System.

The Institute submits that R&D measures that will support the massive private investment required to meet carbon pollution reduction targets should be considered, including increasing the deduction on eligible "green" technology R&D expenditure to 200% and either amending or removing R&D thresholds for R&D Tax Offsets for companies developing green technologies.

Other incentives could take the form of changes to existing capital allowance provisions, or give rise to the introduction of specific provisions such as increasing depreciation rates applicable to emissions-reduction capital expenditure (including "add-on", or refitting, capital expenditure) in general, either through a detailed analysis or possibly through the use of a "flat loading rate" over and above write-off rates otherwise available. Other initiatives could include introducing a targeted investment allowance and amending the concept of "taxable purpose" for various provisions in the income tax legislation to include the purpose of emissions abatement by a business.

4.2 Penalties for non-compliance

The Green Paper proposes that a penalty imposed under the CPRS legislation, including one imposed on a liable party for failing to surrender sufficient eligible compliance permits, will not be deductible. The paper indicates that this is consistent with the current income tax treatment which does not allow a deduction for penalties imposed under a law (refer section 26-5 of ITAA97).

The Green Paper also canvases penalty mechanisms for non-compliance in Chapter 3 (Box 3.8 and following) and Chapter 5 (point 5.5.2).

In determining the nature and level of any penalties for non-compliance, care needs to be taken to properly consider the tax implications so that the after-tax position of the relevant party is fully understood and unintended behaviours and consequences do not arise. A non-deductible penalty could be interpreted as a type of carbon tax. Indeed, the discussion in Box 3.8 canvases whether penalties for non-compliance without make good provisions will perform a price cap function, which is a characteristic often attributed to a carbon tax system, whereby entities simply pay the monetary penalty which could become a default maximum price for permits.

The paper also canvases the use of make good provisions whereby the non-compliant entity is compelled to proffer permits for surrender in a subsequent period to make up for the short fall. Presumably, the acquisition of additional permits as necessary in order to satisfy this requirement would not be seen as a penalty for income tax purposes and would be deductible in accordance with the discrete income regime proposed for permit transaction. The tax provisions should be made very clear on this point to avoid uncertainty.

Submission point 4.2 – Penalties for non-compliance

In determining the nature and level of any penalties for non-compliance, care needs to be taken to properly consider the tax implications so that the after-tax position of the relevant party is fully understood and unintended behaviours and consequences do not arise.

In particular, the cost of acquiring additional permits in a subsequent period, in accordance with a make good requirement, to remedy any short fall of permits at each acquittal date should not be treated as a non-deductible penalty for tax purposes.