

## Carbon pollution reduction scheme - tax implications

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With the introduction of the Carbon Pollution Reduction Scheme (CPRS), the Government is seeking to “cap and limit” the amount of carbon pollution industry can emit. The Green Paper, released on 16 July 2008, made public the government’s intention to commence the scheme in 2010 with an ultimate goal of reducing Australia’s carbon pollution by 60% below 2000 levels, by 2050.

The Green Paper reveals two primary concerns in crafting the tax treatment of eligible compliance permits, namely:

- to meet emission reduction targets through the tax-neutral treatment of permits; and
- simplicity, efficiency and equity in the tax treatment of permits.

In this article, we analyse the tax implications of the structure of the CPRS, bearing in mind the above concerns.

### **Income tax treatment of permits**

The government has proposed two options regarding the income tax treatment of permits:

- to allow the current income tax law to apply; or
- to develop new specific provisions tailored for permits.

The following table sets out more detail on both of these two approaches.

Application of existing tax law	Introduction of new provisions
<ul style="list-style-type: none"> <li>• This may lead to greater complexity and uncertainty in circumstances where permits:               <ul style="list-style-type: none"> <li>○ are treated differently when held by different types of taxpayers;</li> <li>○ are held by the same taxpayer, but for different purposes</li> </ul> </li> <li>• The uncertainty may result in taxpayers using financial institutions to hold permits which undermines the scheme's objective of simplicity</li> <li>• The complexity may lead taxpayers to seek costly professional advice to ensure compliance eroding the cost-efficiency of the scheme</li> <li>• Any attempt by the ATO to manage the complexity may be a long-term process involving changes to existing law and legal processes</li> </ul>	<ul style="list-style-type: none"> <li>• The introduction of new provisions would:               <ul style="list-style-type: none"> <li>○ allow a deduction for expenses incurred in acquiring a permit; and</li> <li>○ include any sale proceeds as assessable income</li> </ul> </li> <li>• CGT will not apply to transactions relating to permits</li> <li>• Private or domestic expenditure on permits will not be deductible</li> <li>• This approach provides:               <ul style="list-style-type: none"> <li>○ simplicity and consistency for taxpayers; and</li> <li>○ removes potential tax minimisation opportunities producing tax-neutrality</li> </ul> </li> <li>• Satisfies the axioms of simplicity, efficiency and adheres to the goal of meeting emission reduction targets</li> </ul>

At present, the preferred option of the Government is for a new set of discrete provisions in the income tax law to be introduced allowing for deductions when an expense is incurred to purchase a permit and the inclusion of any proceeds from the sale of a permit in assessable income.

### ***Timing issues***

The issue of when costs and proceeds from purchases and sales of permits are to be recognised for tax purposes is also addressed in the Green Paper. The Government suggests a point-of-use approach that will achieve tax-neutrality by delaying the effect of a deduction until the income year the permit is sold or surrendered. This will allow permits that are purchased and sold or surrendered in the same income year to be deducted in that year.

Alternatively, if a permit is banked and used at a later date, the deduction will be deferred until the permit is surrendered or sold. Similarly, proceeds from the sale of permits will only be included in assessable income in the year of sale.

To achieve a point-of-use approach the scheme uses a rolling balance method under which:

1. the cost of a permit is deductible when purchased;
2. the proceeds from selling a permit are assessable in the year of sale;
3. any difference in the value of permits held at the beginning of an income year and the end of the income year are included in taxable income (the rolling balance), with:
  - a. any increase in value being assessable income;
  - b. any decrease in value giving rise to a deduction.

This limits the effect of the rolling balance to the year which the permit is sold or surrendered. However, in determining the value of permits at the end of an income year the CPRS suggests two options with no indication of any preference:

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| <ul style="list-style-type: none"><li>• The value of a permit is equal to the original acquisition price of the permit</li><li>• As this method disregards market value, if the taxpayer does not sell or surrender a permit there will be no income tax consequences for the permit</li><li>• Upon the sale or surrender of a permit the cost of the permit is allowed as a deduction (the deduction comes from the decrease in the rolling balance)</li><li>• This method only requires information on the cost of the permit and the proceeds from its sale</li><li>• This method avoids the taxing of unrealised gains as profits and losses are only recognised when realised.</li></ul> | <ul style="list-style-type: none"><li>• The value of a permit at the end of each income year is equal to the market value of a permit at year end</li><li>• This requires the rolling balance to be adjusted every year even if there has been no sale or surrender of the permit</li><li>• If the taxpayer sells or surrenders a permit in an income year the deduction will equal the opening value of the permit for the year (the opening value is last year's closing market value)</li><li>• This method essentially creates an indifference for the taxpayer as to whether to sell or retain the permit as the increase or decrease in value will be accounted for either way</li></ul> |
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### ***Future-dated permits***

In the Green Paper, it is suggested that future-dated permits may be issued. These permits may be sold prior to their vintage year and include with them a provision preventing the ability to surrender the permit until the vintage year (and thereafter).

Such permits will be treated similarly to banked permits in that if a future-dated permit is held at the end of an income year its year-end market value will be included in the rolling balance. As is the case for other permits, the acquisition price of a future-dated permit will be deductible in the year of purchase and the sale of this type of permit will be included in that year's assessable income.

### ***Penalties for non-compliance***

There are essentially three methods to avoid incurring a penalty under the CPRS:

- acquire and surrender an eligible compliance permit;
- emit less carbon by reducing or altering production processes; and
- sequester greenhouse gases to reduce net emissions.

It is noted in the Green Paper that any penalty imposed under the scheme will not be deductible for income tax purposes. This consistent with the usual position regarding the tax treatment of penalties.

### **Government assistance for liable entities**

The Green Paper aims to provide certain liable entities with free permits or cash grants. As is the case under the current income tax system, the value of any benefit obtained by a liable entity should be included in the entity's assessable income.

To ensure tax neutrality, the treatment of free permits and cash grants must be the same as permits acquired for consideration. The following table outlines how the treatment of such permits can be tax-neutral.

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| <ul style="list-style-type: none"><li>• A free permit will be recognised as assessable income at the time of receipt</li></ul> | <ul style="list-style-type: none"><li>• The grant can be used to acquire permits which will then be subject to the same</li></ul> |
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| <ul style="list-style-type: none"> <li>• Where a free permit is received and surrendered in the same income year the taxpayer will be entitled to claim a deduction equal to the amount included in the assessable income from the permit</li> <li>• Free permits that are banked will be dealt with under the rolling balance method (having the same book value as a purchased permit)</li> <li>• Should free permits be sold, any proceeds will be treated as assessable income</li> </ul> | <p>taxation as other permits</p> <ul style="list-style-type: none"> <li>• In line with the principle of income tax law benefits, the grant will be included in assessable income</li> <li>• The year the grant is received is the same year in which it is to be added to assessable income</li> </ul> |
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## GST

The Government's preferred approach is to treat CPRS transactions under the normal GST rules, as it is expected that all entities that need to be covered by the scheme will be registered for GST. Accordingly, permit transactions involving consideration will be subject to GST, whilst free-permit transactions will not.

The Green Paper sets out the different types of transactions under which the normal rules of GST will apply:

Auctioned permits	✓
Free permits	×
Unconditional government assistance (including cash grants)	×
Surrendered permits	×
Payment of a penalty for non-compliance	×
Imports of eligible compliance permits	×

## Conclusion

Whilst the eagerly awaited draft legislation package - due late 2008 - will clarify many of the finer details required to further assess the CPRS, the Government's approach in devising a tax-neutral, efficient and simple method for the taxation of permits is to be applauded.

The Government is aware that the inappropriate tax treatment of permits may affect the decisions liable entities make in deciding whether to emit or abate. Should the opportunity arise where a business is able to consider non-neutral after-tax costs of permits the goal to meet Australia's emissions reduction targets in a cost-effective way may be undermined.

It remains to be seen whether the Government, Treasury and the ATO together with businesses are able to devise a legislative package without undermining any of the key elements the proposed CPRS seeks to uphold.