

14 Tax and accounting issues

The tax treatment of permits will not compromise the Scheme's main objectives of meeting Australia's emissions reduction targets on a cost effective basis and contributing to the development of an effective global response to climate change.

Tax arrangements will support the principles of simplicity, efficiency and equity.

This chapter sets out arrangements for the valuation and tax treatment of eligible compliance units, including carbon pollution permits.

The chapter is structured as follows:

- Section 14.1 discusses the tax treatment of permits, taking into account the need for the tax system to be simple, efficient and equitable.
- Section 14.2 considers the desirability of developing discrete legislative provisions for the tax treatment of permits.
- Section 14.3 discusses the tax treatment of administratively allocated permits.
- Section 14.4 discusses the tax treatment of permits surrendered for non-commercial purposes.
- Section 14.5 outlines the tax treatment of permits created from reforestation and destruction of synthetic greenhouse gases.
- Section 14.6 discusses the transfer of eligible Kyoto units into and out of the Australian registry.
- Section 14.7 outlines the tax treatment of penalties and of additional permits issued for immediate surrender as part of the price cap.
- Section 14.8 discusses other tax issues related to the treatment of carbon pollution permits.
- Section 14.9 considers whether normal GST rules should apply to Scheme transactions.
- Section 14.10 discusses appropriate accounting requirements for emissions-related assets and liabilities resulting from the Scheme.

14.1 Objectives of the tax system in relation to the Scheme

The tax design aims to:

- ensure the tax treatment of permits does not compromise the Scheme's main aim of cost-effectively meeting Australia's emissions reduction targets and contributing to the development of an effective global response to climate change
- incorporate the tax axioms of simplicity, efficiency and equity
 - The Government has placed a strong emphasis on simplicity to ensure the implementation of the Scheme by 2010, to reduce compliance costs for taxpayers and government administration costs and to allow effective decision-making. Simplicity in law design ensures affected taxpayers clearly understand their responsibilities and rights, and can easily understand and apply the law to their circumstances. Simplicity ensures consistency in the application of the law. A complex tax treatment makes it harder for emitters choosing between options and deciding whether to use, bank or sell permits. This increases the entity's likelihood of making less optimal choices and increasing the Scheme's economic cost.
 - Efficiency in the tax system refers to the interaction between the tax system and the wider economy, so tax system arrangements do not interfere with investment decisions and the efficient allocation of resources.
 - Equity in the tax system refers to both horizontal and vertical equity. Horizontal equity means that taxpayers in similar economic circumstances are treated similarly. Vertical equity means that taxpayers in different situations are treated differently, with a greater share of the tax burden being borne by those with a greater capacity to pay.

14.1.1 Cost-effectiveness and tax neutrality

Cost-effectiveness means the achievement of environmental goals as efficiently as possible; that is, the permits should go to the user who values them most highly and the lowest cost abatement should be undertaken.

Tax has the potential to change behaviour and distort choices, and can lead to the reallocation of resources. A tax neutral design minimises distortions to decisions about acquiring, surrendering or selling permits. This ensures that permits are used when they are most valued.

Tax can also affect decisions that businesses make about whether to emit or abate. Businesses can use a number of methods to manage their potential exposure to carbon costs, including:

- acquiring and surrendering permits
- emitting less carbon by reducing or altering production processes
- sequestering greenhouse gases to reduce net emissions.

Businesses will consider the after-tax cost of each method. The Scheme's cost may increase if businesses choose actions that receive preferential tax treatment over otherwise cost-effective actions.

If all three methods are tax neutral, the tax treatment should not influence an entity's decision to:

- surrender or trade purchased or administratively allocated permits
- acquire and surrender permits, or to incur capital expenditure to sequester or eliminate an equivalent amount of emissions.

When the tax treatment is free from distortions, businesses can use or trade permits when they are most valuable, improving the Scheme's cost-effectiveness by increasing market flexibility. Tax arrangements that are tax neutral across time will ensure that businesses can use permits when they are most valuable.

Box 14.1: Scheme features integral to the tax treatment of permits

The Carbon Pollution Reduction Scheme's design affects the tax treatment of permits. The Scheme allows permits to be:

- purchased either directly from the Government through auctions or a secondary market to meet obligations from emissions
- issued free of charge to entities in emissions-intensive trade-exposed industries or to coal-fired electricity generators
- created and issued to entities undertaking Kyoto-compliant forestry activities or destruction of synthetic greenhouse gases
- surrendered either to meet Scheme obligations or voluntarily to reduce or remove a carbon footprint when there is no legal requirement to do so
- carried over to the following year if entities surrender too many permits
- surrendered to meet a liability during the emissions year or up to 15 December in the following year
- issued with a future vintage year, whereby, subject to a borrowing allowance, entities cannot surrender the permit before the permit's 'vintage' year (that is, the first year the permit can be surrendered)
- set aside for use in a later compliance period (banked).

It is necessary for the income tax system to recognise permits. Permits are a business input for an emitting entity. Expenditure on permits should be recognised as deductions and hence reduce taxable income. In addition, taxpayers can make gains and losses from buying and selling permits that income tax, which is essentially a tax on the net gains (called taxable income) made by a taxpayer in an income year, should take into account in working out the taxpayer's annual liability.

14.2 Income tax—development of discrete legislative provisions for the treatment of permits

In designing a tax treatment for permits, the Government considered applying the existing law. Applying the existing law leads to neutral outcomes for most permit holders, but its application is complex and uncertain.

Enacting discrete provisions achieves simplicity, efficiency and equity through:

- allowing a deduction for expenditure incurred in purchasing permits for commercial taxpayers
- including in assessable income the proceeds from selling permits
- not applying the capital gains tax provisions of the income tax law to transactions involving permits.

This treats expenditure on permits consistently, and disregards an entity's reasons for holding the permits. It reduces tax minimisation opportunities that could otherwise arise and helps to cost-effectively reduce greenhouse gas emissions.

Green Paper position

The Government's preferred position was to develop discrete provisions of income tax law. Such provisions would generally treat permits purchased by taxpayers who carry on a business or other income-earning activity in the same way as they would be treated under existing legislation, but would increase certainty and reduce complexity.

The provisions would allow a deduction for expenditure incurred in purchasing permits and include in assessable income proceeds from selling permits.

Most stakeholders who commented on the Green Paper agreed with the proposal to develop discrete legislation. For example, the Institute of Chartered Accountants in Australia (Submission 847, p. 1) supports the proposal, as it 'should provide increased certainty, reduced complexity and equitable outcomes'.

The joint submission by the Energy Supply Association of Australia, the National Generators Forum, the Energy Retailers Association of Australia and the Australian Pipeline Industry Association (Energy Supply Association of Australia et al.) (Submission 715, p. 27), welcomed the Green Paper's focus on cost-effectiveness, simplicity and neutrality and endorsed the proposal to create discrete provisions in the income tax law.

Policy position 14.1

Discrete legislative provisions will be developed for the tax treatment of permits.

14.2.1 Rolling balance method

The Scheme includes banking to allow entities to purchase permits for use in different income years.

The ‘rolling balance’ method ensures that entities bring permits to account, for income tax purposes, when they are used. Under the rolling balance method:

- the permit’s cost is deductible
- the proceeds of the permit’s sale are assessable
- any difference in the permit’s value from the start to the end of an income year is reflected in taxable income, with
 - increases in value included in assessable income
 - decreases in value allowed as a deduction.

The effect of the rolling balance method will generally be that any expenditure on permits will only affect taxable income in the year in which the permit is surrendered or sold. Therefore, if a permit is purchased and surrendered in the same income year, the cost of the permit will reduce the taxable income in that year. However, if a permit purchased in an income year is banked, the cost of the permit will not affect the taxable income in that year, where the permits banked are valued at historical cost (which is expected to be the usual valuation method—see the discussion of valuation methods in section 14.2.2).

After a permit held at the start of the income year is surrendered or sold, the rolling balance will be lower than if the permit had not been surrendered. In effect, this gives the taxpayer a deduction for using the permit. The sale price will be included in assessable income.

Green Paper position

The effect of deferring a deduction for the purchase of a permit would be achieved through a rolling balance method, under which the value of permits held at the beginning and end of the income year would be taken into account.

Stakeholders were broadly comfortable with the rolling balance method.

For example, CPA Australia (Submission 800, pp. 18–19) noted that the rolling balance method would mimic most of the features of existing trading stock provisions, which are very familiar to business taxpayers, and that it would ensure consistency across all segments of the business community, including emitters, traders of permits, entities that both emit and trade, and non-liable entities that voluntarily purchase permits for marketing purposes.

Some stakeholders suggested modifying the method, particularly the timing and valuation. This is discussed in sections 14.2.2 and 14.2.3.

Policy position 14.2

The rolling balance method will be used to bring permits to account for income tax purposes, as it provides an effective mechanism for achieving the goals of the Scheme and upholds the principles of simplicity, tax neutrality and cost-effectiveness.

14.2.2 Valuing permits held in the rolling balance

How the law requires permits to be valued is an important consideration in the operation of the rolling balance method. The valuation method can influence the tax outcomes if the price changes over time. The Green Paper outlined two methods that could be used to determine the values of permits under the rolling balance method: historical cost and market value.

Historical cost method

Under the historical cost method, the value of a purchased permit in the rolling balance would be the original purchase cost. This method does not adjust for movements in the market value while the permit is held. If the taxpayer does not sell or surrender a permit in a particular income year, they do not face any income tax consequences for holding that permit in that income year.

If the taxpayer acquires and banks a permit in an income year, the rolling balance increases in line with the permit's cost. If the taxpayer later sells or surrenders the permit, the effect will be to reduce the value of the rolling balance by the value of the permit's original cost. If the taxpayer banks a permit in an income year, the cost of acquiring that permit will also be taken into account in determining the amount of any increase or decrease in the rolling balance for that income year.

Market value method

Under the market value method, the closing value of a permit will be equal to the market value of the permit at the end of the income year. This method adjusts the rolling balance every year to take account of changing market values. If a taxpayer does not acquire, sell or surrender permits in an income year, an increase in the market value of permits held at the start of the year will be included in the taxpayer's assessable income for that year. Similarly, any fall in the value of permits will be a deduction.

If the taxpayer sells or surrenders a permit in an income year, the permit's value is deducted from the previous closing balance, so the new closing balance will be lower than if the permit had not been sold or surrendered. This effectively is a deduction for the permit's opening value for the year. The proceeds from the sale of the permit will also be included in the taxpayer's assessable income.

Green Paper position

The Government did not outline a preferred approach in the Green Paper for valuing permits for the rolling balance, but noted that possible approaches included:

- valuing permits at historical cost
- valuing permits at market value.

Advantages and disadvantages of the two methods

Stakeholders raised advantages and disadvantages for both methods.

Under the historical cost method taxpayers would need to record only the permit's cost and sale proceeds. The Taxation Institute of Australia (Submission 119, p. 4) explained the compliance costs would be implementation costs arising from creating the record-keeping system and would not be substantial. This method might require the taxpayer to keep a record of the cost of each permit until it is surrendered or sold. Such a period might be considerably longer than the period over which records are normally kept for tax purposes.

The historical cost method also avoids taxing unrealised gains, because a gain or loss will only be recognised when it is realised. Gains would be realised at sale; losses would be realised at sale or surrender.

Under the market value method, from a tax perspective, taxpayers should be indifferent to whether they sell or retain permits. This is because net increases in the rolling balance will be included in assessable income (and any net decrease will be allowed as a deduction), irrespective of whether the permits are sold. Also, it is less likely that large amounts will be included in a taxpayer's assessable income upon sale, because the increase in market value of permits in previous income years would have been taxed in those years.

There is the potential for taxpayers to be taxed on unrealised gains under the market value method. For example, this might occur where the value of permits suddenly increases before year end, but goes back to trend levels a few days later. This may result in taxpayers being taxed on gains that they are unlikely ever to realise—although a deduction could be allowed in the subsequent year if prices fall back to trend at the end of that year.

Requiring taxpayers to value assets on a market-value basis might also impose additional compliance costs. This is because new record-keeping systems will be required on implementation, and ongoing costs will be incurred (Taxation Institute of Australia, Submission 119, pp. 4–5).

The Government does not expect compliance costs to be high, as market values should be readily available at low cost with the regular auctions of permits (see chapter 9) and an active secondary market.

Different taxpayers might prefer one valuation method to another. CPA Australia (Submission 800, p. 20) observed that the historical cost method may be attractive to emitters, while financial intermediaries may prefer the market value method. It stated that such preferences resulted from existing systems and business practices. This is consistent with stakeholder views expressed in consultations conducted by the Treasury.

Most submissions favoured a flexible approach to valuing permits, allowing the use of either historical cost or market value. Stakeholders also wanted the ability to change methodologies so that they can adapt to the Scheme and opt for the method most suited to their commercial situation, particularly in the transition to the Scheme.

Many stakeholders sought flexibility but did not comment on when or how often the methodology might be changed (Energy Supply Association of Australia et al., Submission 715, p. 29; Business Council of Australia, Submission 812, p. 9; and the Taxation Institute of Australia, Submission 119, p. 5).

The Corporate Tax Association and PricewaterhouseCoopers (Submission 863, p. 5) sought the flexibility of existing trading stock provisions and a choice on a permit-by-permit basis. Rio Tinto (Submission 768, pp. 22-23), on the other hand, discouraged any requirement to track the cost of individual permits, as it would impose an excessive administration burden.

Some submissions sought flexibility to allow an entity an annual choice to value permits at either historical cost or market value at year end (CPA Australia, Submission 800, p. 21; Minerals Council of Australia, Submission 884, p. 45).

The Corporate Tax Association and PricewaterhouseCoopers (Submission 863, p. 5) stated their disapproval of a once-off election because it would be inflexible and inadequately anticipate future business changes. Similarly, the National Institute of Accountants (Submission 441, pp. 1-2) was opposed to a mandatory market value approach and suggested an annual choice as an alternative.

The Minerals Council of Australia (Submission 884, pp. 47-48) suggested that an annual election (in contrast to a one-off election) should be allowed at least for the initial transitional period until the current uncertainties such as the accounting treatment of permits and international linking are resolved.

Choice of valuation method for transitional period

There is no overriding policy rationale for allowing only one valuation method. A single method could not provide appropriate outcomes for all stakeholders.

Giving taxpayers a choice of valuation method will enable them to choose the method most suited to their commercial situation and to use existing business practices. It will also enable them to respond to changing circumstances while transitioning to the Scheme.

However, giving taxpayers a choice will make the tax legislation more complex and will increase interpretive and administrative complexities for the Australian Taxation Office.

Some stakeholders suggested during consultation meetings that the 'first in, first out' rule would be acceptable if the historical cost method were chosen. Under this rule, for income tax purposes, permits of the same vintage leave the rolling balance in same order as they entered. This would limit possible distortion of choices between using an administratively allocated permit and using a purchased permit.

Allowing a choice on a permit-by-permit basis would introduce a high compliance burden for taxpayers.

The Government agrees that there are advantages in allowing taxpayers to choose their valuation method for all permits. This will enable them to apply their existing business practices to their commercial situation and will reduce their compliance costs. Giving taxpayers a choice of valuation method will therefore meet the simplicity objective of the tax regime.

However, allowing an annual choice would create opportunities for tax arbitrage (that is, the exploitation of differences in the historical cost and market value of permits in order to reduce tax liabilities). It would also increase administrative and compliance costs for the Australian Tax Office.

The Government has decided to give taxpayers limited flexibility, for a transitional period of five years, to elect the valuation method they will use to value permits under the rolling balance method. The first time taxpayers hold permits at the end of an income year they will have to choose whether they will use historical cost or market value to value their permits. They will be able to change valuation methods only once during the transitional period. After the transitional period, each liable entity will be required to make an irrevocable election and will not be able to change the method.

The exposure draft legislation will contain further detail about the operation of the historical cost and market value methods.

This will ensure that taxpayers can adjust to the Scheme and select the method that best suits their existing business practices. It will give them the opportunity to consider changing valuation methods in the period after the first Kyoto Protocol commitment period ends in 2012, should circumstances change.

Policy position 14.3

Taxpayers will make an election to use either historical cost or market value to value all permits held at the end of an income year.

Taxpayers will be able to change valuation methods once during a transitional period of five years from the Scheme's commencement, after which no change will be allowed.

14.2.3 Timing of deductions for permits

Determining when costs and proceeds are to be recognised for income tax purposes is important, because permits can be banked and can change in value over time. The value of the deduction available to the taxpayer also changes.

The rolling balance method is tax neutral because it delays the deduction until the year the permit is surrendered or sold. Consequently, this does not bias a taxpayer's decision to acquire, trade or surrender purchased permits or administratively allocated permits, or to incur capital expenditure to sequester or eliminate an equivalent amount of emissions. It ensures no adverse tax consequences from using or selling a permit. Tax neutrality across time ensures permits are surrendered or traded when they are most valuable.

Where a permit is purchased and surrendered or sold in the same income year, a deduction will be allowed in that year. If a permit is banked, the effect of the deduction will be deferred

until the permit is surrendered or sold. Proceeds from the sale of a permit will be included in assessable income in the year of sale.

Green Paper position

The cost of acquiring a permit would be deductible at the time the permit is acquired.

If the permit is banked, the effect of the deduction would be deferred until the time the permit is surrendered or sold.

Any proceeds received on the sale of a permit would be treated as assessable income.

Most submissions from tax professional bodies commented that the Government's preferred position to delay the deduction until the permit is sold or surrendered might create a timing mismatch. A mismatch occurs when the emissions that give rise to the liability occur in one income year while the deduction occurs at the point of surrender in the following income year (Taxation Institute of Australia, Submission 119, p. 4).

Submissions suggested that the timing mismatch may also introduce a distortion, as emitters would estimate the carbon cost of their emissions throughout a given year in order to reflect that cost in the prices they charge customers. Emitters would be assessed on the resulting increased revenue. A distortion occurs if the commercial cost of those emissions was not reflected in a tax deduction for the same year (National Institute of Accountants, Submission 441, p. 2).

Stakeholders maintain the timing mismatch is incongruous with the fundamentals of accrual accounting and taxation. Several submissions wanted deductions in the year the obligation arises, rather than the year permits are surrendered (Corporate Tax Association and PricewaterhouseCoopers, Submission 863, p. 3; Taxation Institute of Australia, Submission 119, p. 2; Energy Supply Association of Australia et al, Submission 715, p. 28; Institute of Chartered Accountants in Australia, Submission 847, p. 14).

Some stakeholders argued for moving to an accrual methodology to better align tax outcomes with the accounting treatment, which would make the Scheme simpler for companies to administer because they already use that methodology (Corporate Tax Association and PricewaterhouseCoopers, Submission 863, p. 3).

CPA Australia (Submission 800, p. 20) sought to bring forward the deduction for the cost of acquiring permits where the permits are purchased soon after the end of the income year in which the emissions occur and are subsequently surrendered to offset those emissions. CPA Australia (Submission 800, p. 25) made the case that liable entities will almost invariably have very significant difficulties in accurately determining their specific emissions liability at 30 June each year, as the liability will depend on both the specific volume of emissions (driven by dynamic market demands for their goods and services) and the prevailing market value of permits at year end. Babcock & Brown Power (Submission 488, p. 16) suggested that having this option would enable entities to eliminate the timing mismatch.

There is not considered to be a substantial timing disadvantage, as entities can surrender permits at any time throughout the financial year, thereby matching deductions with their actual emissions.

Allowing a deduction at the time of purchase for the cost of acquiring permits would introduce a major departure from existing income tax law principles. Where revenue assets are still on hand at the end of the income year, currently the deduction would generally be deferred until they are used.

Furthermore, allowing a deduction in the income year that a permit is purchased could encourage entities to hold more permits than would be optimal. This would reduce the cost-effectiveness of the Scheme, as permits would not be used or traded when they are most valuable, thus restricting market flexibility. Also, if there was a gap between when the cost of the permit is deducted and when income from the disposal of the permit is recognised, taxpayers could employ a tax minimisation strategy; they would get the benefit of the deduction before they had to pay tax on the proceeds of the permit.

An accrual method of recording transactions can match the tax treatment with the accounting treatment. It provides a direct link between the year in which the emissions occur and the year in which the cost of permits and the resulting deduction are recognised. Accordingly, emitters are effectively allowed to deduct an amount reflecting the value of the permits that would need to be surrendered by the final surrender date to completely offset the emissions during the relevant emissions year.

However, the argument for matching the tax treatment to the accounting treatment is not compelling. As permits can be sold or surrendered at any time during the financial year, taxpayers can already choose to recognise their expense by surrendering permits during the emission year. Therefore, a timing mismatch will occur only if taxpayers choose to bank permits.

Some emitters will receive higher revenue by passing on the estimated cost of permits in prices charged to consumers. They can then choose to offset their emissions in the same income year by surrendering permits and receiving a deduction for the cost of the permits. Alternatively, they can take advantage of the cash-flow benefit of using that revenue before they are required to surrender permits to meet their liability under the Scheme.

Implementing an accrual method of recording transactions would give taxpayers a further cash-flow gain, because bringing forward the deduction to align with the emissions liability would allow them to profit from an early deduction before they have surrendered, or even acquired, permits.

Emissions-intensive trade-exposed industries may be affected by a timing disadvantage, as they are constrained in their ability to pass through cost increases. However, those industries are being given assistance through administratively allocated permits, and any timing disadvantage will be dealt with by a 'no disadvantage' rule. This is discussed further in section 14.3.

Using an accrual method of recording transactions would require an estimation of permit price and emissions obligation. Such estimation may be complicated. Entities may find it very difficult to accurately determine the expected cost of the permits that need to be surrendered to offset their emissions, as that cost will depend on various market factors. Inaccurate estimations would need to be rectified, increasing compliance costs.

Allowing a deduction where there is no presently existing liability, and the amount of the liability is not ascertained until the next income year, would introduce a significant departure

from the existing tax law. It would also introduce complexity and significantly undermine the effectiveness of the rolling balance method as a single treatment for all taxpayers.

Departing from the Government's preferred position in the Green Paper would undermine the effectiveness and simplicity of the rolling balance valuation method. It would provide special treatment for emitters, as financial intermediaries would not have an emissions liability under the Scheme, and would thus create distortions in the Scheme. It would increase the complexity of the legislation, which would need to make provision for determining the nature of the entity holding the permit and the purpose for which the permit was held. There would be difficulties in characterising taxpayers that hold permits for different purposes—for example, an emitter that both surrenders and trades permits.

The Government's preferred position in the Green Paper allows taxpayers sufficient flexibility and the choice to match their emissions under the Scheme with deductions for surrendered permits, while upholding the simplicity and tax-neutrality principles. The Government believes that the preferred position should be retained.

Policy position 14.4

- The cost of acquiring a permit will be deductible when the taxpayer starts to hold the permit.
- If the permit is banked, the effect of the deduction will be deferred until the time the permit is surrendered or sold.
- Any proceeds received on the sale of a permit will be treated as assessable income.

14.3 Income tax—treatment of direct government assistance

The Government is committed to providing direct assistance to emissions-intensive trade-exposed industries and coal-fired electricity generators to help them adjust to the introduction of the Scheme (see Chapters 12 and 13). Direct assistance will be in the form of an allocation of permits.

A longstanding principle in the income tax system is that assessable income should include the value of benefits obtained, whether in the form of money or assets, that are directly related to a business or income-producing activity. This includes benefits obtained from Government.

To ensure that the tax system supports the achievement of cost effective reductions in greenhouse gas emissions, the treatment of administratively allocated permits and purchased permits must be tax neutral to the greatest extent possible.

Where an administratively allocated permit is received and surrendered in the same income year, the rolling balance produces no effect on taxable income because the permit is not on hand at the end of the income year and the taxpayer is not entitled to a deduction for the permit as the taxpayer did not incur a cost for it. Amendments to the tax law will ensure that the existing provisions which may otherwise have applied to Government assistance will not apply to administratively allocated permits.

Green Paper position

The value of administratively allocated permits would be included in the taxpayer's assessable income in the year the permits are received.

Many submissions sought income tax exemption for administratively allocated permits on receipt (Institute of Chartered Accountants in Australia, Submission 847, p. 5; Taxation Institute of Australia, Submission 119, p. 2; National Institute of Accountants, Submission 441, p. 1). Some argued that exempting administratively allocated permits was necessary to prevent cash-flow and timing disadvantages.

It was argued that cash-flow and timing disadvantages arise if entities are allocated a large number of administratively allocated permits and they choose to hold those permits, rather than surrender them at the end of the income year. This will result in a larger tax liability due to the recipient being assessed on the value of the administratively allocated permits that they might not surrender before the final surrender date for the emissions year the administratively allocated permits were issued for. If the recipient of administratively allocated permits is assessed on them in the year of receipt via the rolling balance they will be entitled to a deduction in the year when they are surrendered or sold as the value of the rolling balance would have been reduced.

These timing problems are significantly reduced by administratively allocated permits being provided to emissions-intensive trade-exposed entities on an annual basis and to coal-fired electricity generators over a number of years rather than in the one year. Permits can also generally be surrendered at any time throughout a year, subject to the borrowing limitation on future vintages, and any over surrender of permits will be offset against the next emissions year obligations.

Stakeholders argued that, because taxing administratively allocated permits results in a reduced level of compensation, the permits are not 'free' and that the level of compensation is not the face value of permits. For example, the National Institute of Accountants (Submission 441, p. 1) argued that administratively allocated permits (particularly those issued to coal-fired electricity generators) should not be assessable, as they effectively represent compensation for diminished capital value.

Other stakeholders argued that administratively allocated permits should have a zero cost applied in the rolling balance and no corresponding deduction allowed on surrender (Corporate Tax Association and PricewaterhouseCoopers, Submission 863 p. 6; Energy Supply Association of Australia et al, Submission 715, p. 28).

Some recommended that administratively allocated permits be exempted (Minerals Council of Australia, Submission 884, p. 48). At consultation meetings, there was also support for the application of a 'first in, first out' rule where administratively allocated permits were exempt or had a zero cost in the rolling balance to limit any possible distortion in the tax treatment of administratively allocated permits and purchased permits.

Emissions-intensive trade-exposed entities will receive permits on an annual basis. Where entities are allocated fewer permits than their expected emissions liability any cash-flow

problems will be the result of their decision to bank the permits, rather than surrender them, before the end of the income year.

Emissions-intensive trade-exposed industries are being provided with assistance in the form of administratively allocated permits because, as price-takers on the world market, they are constrained in their ability to pass through cost increases. The assistance is intended to ensure that the Scheme will have minimal impact on a company's decision on whether to continue to produce in Australia. Stakeholders argued that it was possible that these companies could be required to pay tax on their administrative allocation at the end of the year the permits were received, even though the permits would be surrendered before the last surrender date for the emissions year for which they were issued.

Administratively allocated permits issued to emissions-intensive trade-exposed entities will be valued at zero in the rolling balance when held at the end of an income year that ends before the last surrender date for the emissions year for which they were issued. This is referred to as the 'no disadvantage rule'. It ensures that an emissions-intensive trade-exposed entity that receives administratively allocated permits in an income year that ends before the last surrender date and chooses not to surrender them will not be assessed on their value in that income year.

Administratively allocated permits on hand at the end of the income year in which that last surrender date occurs (and later income years) will be included in the rolling balance using the normal valuation method; that is, the permits will be valued at market value or historical cost, depending on which method the taxpayer has chosen. The historical cost of an administratively allocated permit will be considered to be the market value at the date of its issue (that is, what it would have cost to purchase a permit on that day).

Box 14.2 sets out the tax treatment of administratively allocated permits issued to an emissions-intensive trade-exposed entity.

Box 14.2: Tax treatment of administratively allocated permits issued to an emissions-intensive trade-exposed (EITE) entity

Example

In August 2011 the Regulator issues 1 million administratively allocated permits with a 2011-12 vintage to an EITE entity. The market value of a permit at issue (as per the secondary market) is \$21.

In October 2011 the entity sells 400,000 of the administratively allocated permits for \$22 each. The entity has an emissions liability for the 2011-12 emissions year and surrenders 400,000 permits in June 2012 and a further 100,000 in December 2012 to avoid a permit shortfall penalty (for not surrendering sufficient permits by the due date, 15 December 2012).

The entity sells the remaining 100,000 permits in July 2013 for \$25 each.

For income tax, the entity has a standard income year ended 30 June and has chosen to value all units held at the end of an income year at historical cost.

Box 14.2: Tax treatment of administratively allocated permits issued to an emissions-intensive trade-exposed (EITE) entity (continued)

For simplicity purposes this example concentrates on the group of administratively allocated permits with a 2011-12 vintage and ignores any other permits acquired, held or surrendered by the entity.

Income tax treatment

Income year ended 30 June 2012: the proceeds of selling permits (400,000 @ \$22 = \$8.8 million) are assessable income. The surrender of permits has no effect on taxable income because none of the permits were held at the start of the income year and no amount is included in assessable income. The remaining 200,000 permits held at year end are valued at zero in the rolling balance under the “no disadvantage” rule. The net effect on taxable income is an increase of \$8.8 million.

Income year ended 30 June 2013: The surrender of permits has no effect on taxable income because the opening balance is zero and no amount is included in assessable income. At year end the no disadvantage period has finished because the last surrender date for the 2011-12 emissions year (15 December 2012) has passed. Consequently, the remaining 100,000 permits held at year end are valued in the rolling balance at their deemed cost, the market value at the date of issue (100,000 @ \$21 = \$2.1 million). The net effect on taxable income is an increase of \$2.1 million.

Income year ended 30 June 2014: the proceeds of selling permits (100,000 @ \$25 = \$2.5 million) are assessable income. The entity deducts the decline in the value of permits held in the rolling balance (100,000 @ \$21 = \$2.1 million). Therefore, the net effect on taxable income is an increase of \$400,000.

Limited direct assistance for coal-fired electricity generators will be provided over a number of years. This is a form of transitional assistance. It is not intended to affect the recipient’s production decisions. It is provided to offset some of the loss in asset value.

The permits will be tradeable, and there is likely to be an active secondary market. An entity will be able to ameliorate cash-flow problems by selling permits in that market.

Exempting administratively allocated permits from taxation or giving them a zero cost in the rolling balance may create an unnecessary distortion. Proceeds from the sale of an administratively allocated permit are assessable income, as the taxpayer receives a financial gain. If a permit remains banked, its market value is likely to rise while its book value remains at zero. Not taxing the permit could create an incentive to hold the permit when other taxpayers might value the permit more highly.

Furthermore, if an administratively allocated permit were exempt from income tax, the taxpayer would not get a deduction. If a liable entity could choose between using a purchased permit it had banked and using an administratively allocated permit it had banked, it might choose to use the purchased permit because of the deduction it could claim for that permit’s use.

Administratively allocated permits issued to coal-fired electricity generators that are on hand at the end of the income year they are received will be assessed through the rolling balance. Adopting this approach will ensure consistency between the current approach to taxing industry assistance generally and the intended tax-neutral treatment of administratively allocated and purchased permits. It will ensure that a banked administratively allocated permit has the same value for tax purposes as a purchased permit, and therefore will not distort a liable entity's choice to surrender or sell the administratively allocated permit. Administratively allocated permits that are banked will be dealt with under the rolling balance method. The taxpayer can choose to value the administratively allocated permits at their market value at the end of the income year or at historical cost. The historical cost of administratively allocated permits will be their market value at the date of issue.

If administratively allocated permits are sold, the sale proceeds will be assessable income in the year of sale, as are the proceeds from the sale of purchased permits. To avoid double counting when banked permits are sold there is a corresponding decrease in the value of the rolling balance at the end of the income year. This creates, in effect, an offsetting deduction for the amount that was assessed in the year of issue.

For the reasons outlined above, assessing administratively allocated permits on hand at the end of the income year they are received by coal-fired electricity generators via the rolling balance is considered to be the most cost-effective, simple and tax-neutral approach.

Policy position 14.5

- The value of administratively allocated permits issued to coal-fired electricity generators that are on hand at the end of the income year they are received will be included in the taxpayer's assessable income through the rolling balance mechanism in that year.
- The value of administratively allocated permits issued to emissions-intensive trade-exposed entities will be valued at zero at the end of an income year ending before the last surrender date for the emissions year for which they were issued. If administratively allocated permits are held at the end of a later income year, the permit will be valued according to the election the taxpayer makes between historical cost and market value. The historical cost value will be the market value at the issue date.

14.4 Permits surrendered for non-commercial purposes

Entities can acquire permits for private or domestic purposes. For example, a person can acquire a permit to voluntarily offset an individual carbon footprint.

A deduction is allowed for any expenditure incurred in purchasing a permit; the deduction is in effect deferred if the permit is banked. However, where an individual or a business surrenders a permit for non-commercial purposes, they will in effect not be entitled to a deduction for the cost of that permit. This is consistent with the non-deductibility of private or non-commercial liabilities for tax purposes.

In these cases, the proposed tax legislation will claw back the deduction by including an amount in assessable income in the year of surrender.

Policy position 14.6

If a permit is surrendered for a non-commercial purpose an amount equal to the original deduction will be included in assessable income.

14.5 Permits created from reforestation and destruction of synthetic greenhouse gases

Forestry is included on an 'opt-in' basis from the start of the Scheme. Chapter 6 sets out the requirements and the consequences of opting into the Scheme. The destruction of synthetic greenhouse gases will be included from the start of the Scheme. Chapter 6 sets out the requirements for the issue of permits for that destruction.

Expenditure on forestry activities and the destruction of synthetic greenhouse gases leads to the issue of permits and the inclusion of such permits in the rolling balance method is important for their income tax treatment.

The tax law already recognises expenses incurred in relation to establishing and maintaining a Kyoto-compliant forest. Those provisions will continue to apply to avoid:

- changing the timing of deductions for forestry expenditures
- apportioning expenses between any permits issued in relation to Kyoto-compliant forests and other purposes for which those forests are created.

Expenditure incurred in forestry sequestration activity will be deducted under the provisions that apply to the particular forestry activity, for example, the carbon sink provisions. This will not change the timing of the write-off of forestry expenditure, and deductions will not be delayed until the income year that a permit is issued by the Regulator.

Similarly, expenditure incurred in destroying synthetic greenhouse gases will also be deductible under the existing provisions that apply expenditure of that kind.

Permits issued for carbon sequestered in Kyoto-compliant forests and destruction of synthetic greenhouse gases, known as 'created permits', will be treated similarly to administratively allocated permits to ensure that the use of permits on hand is not distorted.

If created permits are:

- surrendered in the income year they are issued, they will not enter the rolling balance, will not be assessable on receipt and no deduction will be allowed for their surrender
- sold in the income year they are issued, the proceeds from sale will be fully assessable and no deduction will be allowed for their sale
- held at the end of the income year they are issued, they will be included in the rolling balance at the following values:
 - if historical cost is the valuation method, the market value at the date of issue
 - if market value is the valuation method, the market value at the end of the income year.

The value included in the rolling balance is effectively included in the holder's taxable income for that income year. When the permit is used (sold or surrendered) in a later income year, the reduction in the rolling balance effectively results in a reduction in taxable income in that income year. Proceeds from the sale of permits will be assessable income.

Using the market value on the day of permit issue is conceptually simple and straightforward to apply, avoiding the complex cost-allocation procedures required by determining the actual cost of producing a permit. It also ensures a comparable costing method between purchased, created and other administratively allocated permits that will reduce distortions in the behaviour of entities holding permits. Although an entity might not sell or surrender a created permit until substantially after issue, the permit's value at the time of issue is appropriately recognised. The created permit is a reward or return for the entity's forestry activities or destruction of synthetic greenhouse gases and is immediately convertible to cash on the secondary market.

Policy position 14.7

The tax law already recognises expenses incurred in relation to establishing and maintaining a Kyoto-compliant forest or synthetic greenhouse gases.

The value of created carbon pollution permits will be included in the rolling balance and included in the entity's taxable income for that year, with a corresponding reduction in taxable income in the year the permits are used (sold or surrendered). Proceeds of selling the permit are assessable income.

If created permits are on hand at the end of the income year they are issued, they will be included in the rolling balance at the following value:

- if historical cost is the valuation method, the market value at the date of issue
- if market value is the valuation method, the market value at the end of the year.

14.6 Transferring eligible Kyoto units into and out of the Australian registry

An entity holding eligible Kyoto units will be able to transfer the units into the Australian National Registry (commonly called importing). This will usually occur where the entity intends to surrender the units to acquit an Australian emissions liability. The rolling balance treatment will only apply to units registered in Australia because they are the units that can be used to acquit Australian emissions obligations. Where an eligible Kyoto unit is transferred into the Australia registry, the rolling balance treatment will apply from when the unit is held in the registry; normal income tax rules will apply while the unit is held in a registry outside Australia. This will be achieved by treating the entity as having sold the unit just before it is registered in Australia for its market value at that time and as having immediately repurchased the unit at the same value.

In the early years of the Scheme, exporting Australian carbon pollution permits will not be allowed. However, an entity holding eligible Kyoto units in the Australian registry may transfer them to an overseas registry. Similarly to importation cases, the rolling balance

treatment will apply while a unit is held in the Australian registry; normal income tax rules will apply for the period after the unit ceases to be registered in Australia. This will be achieved by treating the entity as having sold the unit just before it ceased to be held in Australia for its market value at that time and as having immediately repurchased the unit at the same value.

14.7 Income tax—treatment of penalties and price cap

Liable taxpayers will be subject to an administrative penalty if they fail to surrender sufficient eligible compliance permits by the final surrender date for each emissions year.

14.7.1 Penalties

The income tax law does not generally allow a deduction for the payment of a penalty imposed under an Australian law. Consequently, a penalty imposed under the Scheme, including one imposed on a liable entity for failing to surrender sufficient eligible compliance permits, will not be deductible.

The penalty will also have a ‘make-good’ provision. A make-good provision requires that, in addition to the monetary penalty, the noncompliant liable entity must surrender permits equal to the difference between its emissions for the relevant year and the number of permits surrendered within time in respect of those emissions.

A number of stakeholders argued that penalties that have a make-good provision should be deductible (Energy Supply Association of Australia et al., Submission 715, p. 29; Business Council of Australia, Submission 812, p. 8). For instance, the Taxation Institute of Australia (Submission 119, pp. 9-11) argued that any penalty shortfall amount and any make-good permits that have to be acquired for failing to surrender sufficient eligible compliance permits should be deductible.

The Government considers that the penalty for non-compliance should provide a clear monetary disincentive to minimise non-compliance with the Scheme.

Permits purchased to satisfy a make-good provision would be deductible in the same way as any other permits acquired by an emitter.

14.7.2 Transitional price cap

The Scheme will have a price cap for the period from 2010–11 to 2014–15. The price cap will take the form of the issue of additional permits at a fixed price in the period between the final reporting date (31 October) and the final surrender date for an emissions year (15 December). Details of the price cap are outlined in Chapter 8.

The permits that are issued must be used for the purposes of immediate surrender; and they cannot be banked or traded. The cost of purchasing these permits will be deductible.

Policy position 14.8

A penalty imposed under the Scheme, including one imposed on a liable party for failing to surrender sufficient eligible compliance permits, will not be deductible.

For the first five years of the Scheme fixed price permits issued under the price cap arrangements will be available for purchase between the final reporting date and the final surrender date for each emissions year. The cost of these permits will be deductible but they cannot be banked or traded, they can only be surrendered.

14.8 Other income tax issues

The other income tax issues that relate to the treatment of carbon pollution permits are:

- how the new income tax provisions for permits will interact with other income tax provisions
- whether State and Territory governments may levy taxes on the allocation, auctioning and transfer of permits.

14.8.1 Interactions with the income tax system

Introducing a discrete set of provisions in the income tax law to cover the treatment of carbon pollution permits raises questions about how those provisions interact with the rest of the income tax law. This is not unusual as interaction issues arise with any new income tax provisions.

In submissions and consultation meetings on the Green Paper, stakeholders raised the following main interaction issues:

- the application of the proposed ‘taxation of financial arrangements’ provisions to permits and derivatives of permits
- the application of the rules about consolidated groups of entities to permits held by entities that enter or leave a consolidated group
- international tax issues, including the application of the provisions about controlled foreign corporations and foreign investment funds to entities holding permits
- the ability of managed investment trusts to invest or trade in permits without becoming subject to the public trading trust provisions
- the application of the Pay As You Go (PAYG) instalment provisions to entities that sell permits.

Taxation of financial arrangements

Industry has sought clarification on whether the proposed Taxation of Financial Arrangements (TOFA) legislation, released as an exposure draft on 1 October 2008 (called ‘TOFA stages 3

and 4'), will apply to permits and derivatives of permits. In consultations conducted by Treasury and in submissions in response to the Green Paper, the favoured treatment was that the TOFA provisions should not apply to permits (for example, CPA Australia, Submission 800, p. 26.). The Corporate Tax Association and PricewaterhouseCoopers (Submission 863, p. 10) suggested that permits could be included in TOFA on an opt-in basis. The Taxation Institute of Australia (Submission 119, p. 3) said that either the TOFA threshold should be lifted or both permits and derivatives should be excluded from TOFA.

The Government has decided that the TOFA provisions and other tax provisions that could apply to the acquisition, holding and disposal of permits will not apply. Instead, gains and losses from permits will be worked out exclusively under the rolling balance provisions which will provide a clear and uniform treatment that will be easy for taxpayers to apply.

Derivatives of permits that are 'cash settleable' may be 'financial arrangements' under the draft TOFA legislation. Therefore, they may be subject to the TOFA regime where they satisfy other relevant conditions (including relevant thresholds). As derivatives of permits are one of many types of derivative traded, the normal rules that apply to derivatives should apply to them.

Consolidated groups of entities

Submissions sought clarification on how permits held by an entity that joins or leaves a consolidated group will be treated. CPA Australia (Submission 800, p. 25) and the Institute of Chartered Accountants in Australia (Submission 847, p. 13) said that when an entity joins a consolidated group, permits should be treated, like trading stock, as reset cost base assets.

This approach could be implemented as follows. If an entity that holds permits joins a consolidated group part way through an income year, its income year ends at the time it joins the group. The value of the permits at that time will be the joining entity's terminating value, which will be the value of the permits at the start of the income year in which the entity joined the group plus the amount paid to acquire additional permits during that income year.

Under the tax cost setting rules, permits held by a joining entity will be reset cost base assets. However, the tax cost setting amount will not exceed the greater of the market value of the permits and the joining entity's terminating value for the permits. The head company will be taken to have held the permits from the start of the income year in which the entity joined the group. The value of the permits at that time will be equal to the tax cost setting amount. The head company will value the permits at the end of the income year based on the choice that it has made for valuing permits in its rolling balance account. This choice will override any choice made by the joining entity.

When an entity holding permits leaves a consolidated group, the permits will be taken to be an asset of the head company at the end of the income year in which the leaving occurs, but not at the start of the next income year. The value of the permits at that time will be the terminating value for the permits at the time of leaving.

Under the exit history rule, the opening value of the permits for the leaving entity will be the terminating value for the permits at the leaving time. In addition, the leaving entity will inherit the head company's choice to maintain its rolling balance account using the historical cost method or the market value method.

The exposure draft legislation will contain more detail about these consolidation entities.

International tax—controlled foreign companies, foreign investment funds and foreign residents

Few submissions commented on international tax matters, although some issues arise from introducing specific provisions for permits.

The controlled foreign company and foreign investment fund rules ensure that entities cannot accumulate specified foreign source income offshore to defer, or avoid, paying Australian tax.

The Board of Taxation has reviewed these rules and provided a final report to the Government. The Government will decide on the appropriate treatment of permits in its response to the Board's review.

The treatment of foreign residents holding carbon pollution permits held on the Australian National Registry raises a technical issue. This issue attracted little comment in submissions. Permits will generally be used to acquit an Australian emissions obligation, and registration on the Australian registry is a clear and verifiable link to Australia. Consequently, permit sale proceeds and increases in the rolling account balance over an income year will be treated as having an Australian source and, therefore, as assessable income of a foreign resident. For a resident of a country with which Australia has a tax treaty, this outcome will be subject to the treaty terms. Australia's taxing rights to a foreign resident's permits connected to a permanent establishment in Australia may be limited by the relevant tax treaty. Other residents from treaty countries would not maintain a rolling balance account for their permits or be able to claim a deduction for the cost of acquiring permits.

Public trading trusts

The ability of managed investment trusts to invest in or trade permits without becoming subject to the public trading trust provisions in Division 6C of Part III of the *Income Tax Assessment Act 1936* was raised in some submissions. These provisions treat public trading trusts like a company for income tax purposes if the trust does not carry on an 'eligible investment business'. An eligible investment business includes investing in land for rent, and investing or trading in certain financial instruments.

Submissions argued trusts should be able to invest and trade in permits without these provisions applying (for example, Corporate Tax Association and PricewaterhouseCoopers, Submission 863, p. 10). This policy issue is within the scope of the Board of Taxation's review of tax arrangements applying to managed investment trusts. The Board will provide a final report to the Government in mid-2009.

The Government will consider the Board of Taxation's report in deciding whether managed trusts can invest in and trade in permits without the public trading trust provisions applying.

The amendments to the tax law through the *Tax Laws Amendment (2008 Measures No. 5) Act 2008* which was recently passed by Parliament provides a two per cent 'safe harbour' allowance for managed funds at the whole-of-trust level for non-trading income, which would include investment in permits. The amendments broaden the range of financial instruments in which a trust can invest or trade without becoming subject to the public trading trust provisions to include financial instruments that are 'financial arrangements' as defined in the

Income Tax Assessment Act 1997, other than certain excepted arrangements. However, it is doubtful whether permits would be financial arrangements because it is not clear that the holder of a permit has, under an arrangement, a cash settlable right to receive a financial benefit.

Pay As You Go instalments

Some submissions raised the need to amend PAYG instalment provisions to clarify their application to entities dealing in permits. The submissions did not indicate a preferred position although the Institute of Chartered Accountants in Australia (Submission 847, pp. 14-15) suggested carving out the proceeds of permit sales from instalment income.

Instalment income primarily includes ordinary income that is assessable. Proceeds from selling permits would mainly be ordinary income. One possible exception is for permits acquired for the purpose of resale at a profit. In such cases the rules will include gross proceeds in the taxpayer's assessable income, whereas the net gain or loss would be brought to account under the tax law's ordinary income principles.

The exposure draft legislation will set out how the PAYG instalment provisions will apply to the sale of permits.

Petroleum resource rent tax

The Government's position on the interaction between the Scheme and the petroleum resource rent tax will be finalised once consultation on the income tax treatment of permits has been completed. This will ensure consistent treatment across income tax and the petroleum resource rent tax.

The Government will continue to consult relevant stakeholders on petroleum resource rent tax as the income tax legislation for the taxation treatment of permits is finalised.

Other interactions

Other, mainly technical, interaction issues will be dealt with in the exposure draft legislation for the Carbon Pollution Reduction Scheme and explained in the accompanying draft explanatory memorandum.

14.8.2 State and Territory taxes

Many stakeholders were concerned that States and Territories potentially may levy taxes on the allocation, auctioning and transfer of carbon pollution permits.

If the States and Territories apply taxes to these transactions, trading would be more costly and complex. Such taxes would undermine the Scheme's objectives.

The Commonwealth Government has written to the State and Territory governments seeking agreement to not apply these taxes.

14.9 Goods and services tax

The Government's preferred approach in the Green Paper was to treat Scheme transactions under the normal GST rules, which would generally result in:

- GST not applying to administratively allocated permits, unconditional government assistance (including grants)¹, surrendering of permits, penalty for non compliance, imports² of permits and their financial derivatives, and exports³ of permits and their financial derivatives
- GST applying to purchased permits or permits otherwise supplied for consideration
- input taxed treatment for financial derivatives of permits that are connected with Australia.

Green Paper position

Scheme transactions would be treated under the normal GST rules. This would ensure that scheme transactions would receive the same treatment as similar transactions in the broader economy. It would also be consistent with the underlying principles of the GST, including its broad-based nature, minimise compliance costs for entities and avoid complexity in the law.

The treatment of permits under the normal rules would generally not lead to embedded GST for registered entities and, from a GST perspective, those entities would be indifferent as to whether permits were auctioned or administratively allocated.⁴

14.9.1 Stakeholders' comments on the application of the normal GST rules

Some stakeholders supported the Government's preferred position to apply the normal GST rules to Scheme transactions but emphasised the need for certainty.⁵ For example, CPA Australia (Submission 800, p. 27) argued that subjecting the supply of permits to the normal GST rules, articulated in a discrete set of provisions, would provide certainty and be tax neutral.

Other stakeholders suggested amending the GST law to make Scheme transactions GST-free or non-taxable to avoid cash-flow and compliance costs, and in the case of financial derivatives of permits, to avoid businesses facing embedded taxes.⁶ For example, the Taxation Institute of Australia (Submission 119, p. 8) noted the significant GST costs, including financing costs and compliance costs, of the Government's preferred position and recommended making the trading of permits and associated derivatives GST-free.

This section outlines stakeholders' concerns about uncertainty, cash-flow and compliance costs, and embedded tax for financial derivatives.

Uncertainties

A small number of stakeholders raised the need for certainty in the GST treatment of Scheme transactions. Some proposed inserting specific provisions on Scheme transactions into the GST law to ensure the law was interpreted as the Government intended it to be. For example,

Babcock & Brown Power (Submission 488, p. 17-18) preferred codifying the GST law similar to the approach proposed for income tax to eliminate uncertainty associated with the GST consequences of transactions under the Scheme.

The key uncertainty stakeholders raised was about how to characterise permits to apply the normal GST rules. This characterisation is critical to determine the tax status of imports and exports of permits.

Cash-flow and compliance costs

Some stakeholders claimed that applying the normal GST rules to Scheme transactions would put pressure on cash-flows and result in substantial financing costs, including interest and opportunity costs. The delay between paying a GST-inclusive price for permits and recovering the GST costs by claiming an input tax credit could give rise to a cash-flow cost. For instance, the Taxation Institute of Australia (Submission 119, p. 5) argued that if the covered sector's input tax credits amounted to \$191 million per year then interest costs arising from the delay in claiming input tax credits could amount to \$16.2 million per year.

Stakeholders also claimed that applying the normal GST rules would increase compliance costs as entities would need to satisfy GST administrative obligations, adjust systems to track transactions receiving different GST treatments, determine the residence status of entities involved in cross-border transactions and, in some cases, register for GST purposes to claim input tax credits.

Stakeholders suggested amending the GST law to make supplies of permits GST-free or non-taxable to avoid cash-flow and compliance costs.

Some stakeholders argued if the normal GST rules apply, the Government could consider introducing a special matching mechanism, such as a reverse charge scheme or a deferral scheme (like that applying to imports)⁷, to remove cash-flow costs. For example, CPA Australia (Submission 800, p. 27), while supporting the application of the normal GST rules, suggested including specific measures to mitigate any adverse cash-flow effects.

Other stakeholders supported the Government's preferred position of applying normal GST rules, despite potential cash-flow and compliance costs consequences. For example, the National Institute of Accountants (Submission 441, p. 2), while describing the cash-flow costs as significant and noting that a deferral scheme or a reverse charge are options, concluded that for simplicity, normal GST rules should apply as far as possible.

Input taxed treatment of financial derivatives—embedded tax

Stakeholders noted that the derivatives market is critical to the Scheme's success and claimed the input taxed treatment of financial derivatives of permits will adversely affect the market by leading to embedded tax. Embedded tax arises because input tax credits are not available for GST paid on acquisitions related to a supply. This would increase costs for industry that might not be passed on to consumers and introduce a different GST treatment to that applying to permits. For example, the Australian Financial Markets Association (Submission 550, pp. 29-30) claimed that normal GST rules impose a non-recoverable tax on cash settled derivatives through input taxation, increasing the cost of market transactions and imposing a Scheme related tax burden on business.

Caltex (Submission 734, p. 25) raised a concern that companies trading in financial derivatives to hedge against the cost of permits may exceed the threshold for claiming full input tax credits on acquisitions relating to the making of financial supplies and thus would be denied input tax credits. Caltex claimed that companies breaching the financial acquisitions threshold would need to calculate the proportion of input tax credits that relate to financial supplies and not claim these.

Stakeholders suggested the Government amend the GST law to make supplies of financial derivatives of permits GST-free or non-taxable or raise the financial acquisitions threshold substantially.

CPA Australia (Submission 800, p. 28), while supporting the input taxed treatment of financial derivatives of permits as it is tax neutral compared to other derivative products, suggested introducing a transitional measure (providing either GST-free treatment or an entitlement to a reduced input tax credit) for the first two years of the Scheme.

14.9.2 Analysis of stakeholders' concerns

The Government considered stakeholders' concerns about:

- how permits would be characterised when applying normal GST rules
- the GST system's effects on business cash-flow and compliance costs
- whether financial derivatives should be GST-free or subject to special rules.

Uncertainties

The main area of uncertainty about the GST treatment of Scheme transactions is how to characterise permits for the purposes of applying the normal GST rules.

If permits are characterised for the purposes of the normal GST rules as personal property rights (and not rights within the meaning of real property in the GST law), the normal GST rules generally would treat supplies of purchased permits as taxable supplies, imported permits as non-taxable supplies and exported permits as GST-free supplies. This delivers the Green Paper's GST outcomes by ensuring entities acquiring permits in the course or furtherance of an enterprise generally can claim input tax credits, including if they purchase permits for investment as part of their enterprise. It also addresses uncertainties about the treatment of cross border transactions.

As the nature of permits is critical to determine their GST treatment, the GST law will be amended to characterise permits as personal property rights (and not rights within the meaning of 'real property' in the *A New Tax System (Goods and Services Tax) Act 1999*).

The Government does not support establishing a discrete set of GST rules for Scheme transactions. While such provisions might provide certainty, they would add complexity without achieving a tax result different from that achieved by applying the normal rules.

Cash-flow and compliance costs

In general, the GST system is designed to tax private consumption in Australia. However, the application of GST at every stage in the production and distribution chain affects the cash-flow of businesses and imposes compliance costs on them.

The GST system may have either a positive or a negative effect on a business's cash-flow, depending on when in a business activity statement reporting cycle the business makes taxable supplies and acquisitions for which it can claim input tax credits, and whether it trades on a cash basis or has extended terms for payment. The design of the GST recognises the potential for cash-flow costs, which is why businesses can claim input tax credits on taxable supplies in the same tax period that they receive a tax invoice.

Compliance costs will arise regardless of whether the normal GST rules, GST-free treatment or other special rules apply to Scheme transactions. Taxpayers will need to determine the tax status of permits, as they do with any other business inputs, and remit GST and/or claim input tax credits accordingly.

Changing the GST law to make Scheme transactions either GST-free or subject to special rules to remove the cash-flow effect on businesses or to minimise their compliance costs would have significant negative impacts on the GST system without providing a commensurate reduction in compliance costs. It would undermine the broad-based nature of the GST, provide different GST treatments for like transactions in the economy (including purchasing more energy efficient assets), and add complexity to the GST law.

Input taxed treatment of financial derivatives—embedded tax

While the input taxed treatment of financial derivatives leads to embedded tax, this treatment is consistent with that of other financial derivatives. In general, financial supplies are input taxed because valuing and taxing such supplies transaction by transaction is difficult. Most value added tax systems apply input taxation to financial derivatives.

Changing the GST law to make financial derivatives GST-free or subject to special rules including on a transitional basis would give the supply of financial derivatives of permits GST preferential treatment over other financial supplies, including other derivatives. This would compromise market neutrality, undermine the GST's broad base and add to the complexity of the GST law. It might increase compliance costs because businesses would need to distinguish between the GST-free treatment of derivatives of permits and the input taxed treatment of other forms of derivatives.

Increasing the financial acquisitions threshold would have broader implications for the taxation of financial services in general and is not supported.

Policy position 14.9

The Government will amend the GST law to characterise carbon pollution permits and eligible Kyoto units for GST purposes as personal property rights (and not rights within the meaning of real property in the *A New Tax System (Goods and Services Tax) Act 1999*) to promote certainty.

The normal GST rules will apply to Scheme transactions, including the input taxed treatment of supplies of financial derivatives of permits.

14.10 Accounting for emissions-related assets and liabilities

Accounting systems will need to take into account the introduction of emissions obligations and a carbon market.

In the Green Paper, the Government outlined a proposed way forward. It proposed that the International Accounting Standards Board (IASB), which is currently making progress on this issue, would determine accounting requirements in Australia. This is consistent with Australia's policy on the international harmonisation of accounting standards to ensure globally consistent accounting policies. The Australian Government is actively engaging the IASB on this issue and will continue to monitor the IASB's progress through the Australian Accounting Standards Board (AASB).

The Government also suggested that interim Australian-specific accounting requirements be issued closer to the Scheme's start date, depending on the status of the IASB project.

Some submissions in response to the Green Paper (CPA Australia, Submission 800, p. 6; Institute of Chartered Accountants in Australia, Submission 847, p. 2; Business Council of Australia, Submission 812, p. 9) strongly supported the accounting requirements for emissions-related assets and liabilities in Australia being in line with the requirements issued by the IASB.

This will ensure that Australian companies have the same reporting options as overseas companies and will provide them with financial reporting options for emissions-related assets and liabilities. This is consistent with other accounting requirements in Australia that have also been harmonised with the requirements of the International Financial Reporting Standards (IFRS) issued by the IASB.

The submissions generally did not support issuing Australian-specific accounting requirements, if that results in Australian companies' financial statements no longer being IFRS compliant. This would negatively affect the international credibility of those statements.

Based on this analysis, the Australian Government has decided that the IASB should determine the accounting requirements for emissions-related assets and liabilities in Australia. The IASB is expected to issue an exposure draft outlining its proposals in 2009. Once the IASB issues the exposure draft, the AASB will reissue it for comment in Australia.

Policy position 14.10

The International Accounting Standards Board will determine accounting requirements for emissions-related assets and liabilities in Australia.

The International Accounting Standards Board will issue an exposure draft of the proposed accounting requirements in 2009, and the Australian Accounting Standards Board will reissue the draft for comment in Australia.

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- 1 Administratively allocated permits and government assistance will not be subject to GST provided they are not supplied for consideration.
 - 2 For example, acquiring a permit or financial derivative from a non-resident entity that is not required to register for GST.
 - 3 For example, supplying a permit or financial derivative to a non-resident entity outside Australia, or for use outside Australia.
 - 4 This is because, in general, neither taxable nor non-taxable treatment of transactions involving permits would impose any net GST burden on registered entities (as any GST included in the price of inputs can be claimed by such entities as a credit).
 - 5 Stakeholders supporting the Government's preferred position of applying the normal GST rules to Scheme transactions included the Business Council of Australia (Submission 812, p. 9), CPA Australia (Submission 800, p. 27), National Institute of Accountants (Submission 441, p. 2), BP Australia (Submission 355, p. 16), Babcock & Brown Power (Submission 488, p. 17), Telstra (Submission 853, p. 8) and ExxonMobil Australia Pty Ltd (Submission 254, p. 12).
 - 6 Stakeholders concerned with aspects of applying the normal GST rules to Scheme transactions and suggesting amending the GST law to make those transactions GST-free or exempt from the GST definition of 'supply' included the Taxation Institute of Australia (Submission 119, p. 8), the Institute of Chartered Accountants in Australia (Submission 847, p. 2), the Corporate Tax Association and PricewaterhouseCoopers (Submission 863, p. 11), the Minerals Council of Australia (Submission 884, p. 49), the Energy Supply Association of Australia (Submission 715, p. 27), the Australian Financial Markets Association (Submission 550, p. 30), the Australian Chamber of Commerce and Industry (Submission 786, p. 8), KPMG (Submission 545, p. 12), Westpac (Submission 695, p.10) and CSR Limited (Submission 735, p. 25).
 - 7 Under the 'reverse charge' rule, a recipient entity is required to charge itself GST on its acquisitions from non-resident entities. For example, under Division 84 of the *A New Tax System (Goods and Services Tax) Act 1999*, imported services used to make input taxed financial supplies are subject to a GST reverse charge. The reverse charge removes the incentive for a financial supply provider to import services rather than source GST inclusive services domestically. Under the 'deferral scheme' an importer liable for GST on imported goods can defer paying this until its monthly business activity statement is lodged rather than paying the GST liability when the goods enter Australia.