

CORRS IN BRIEF

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EMISSIONS TRADING SCHEME – KEY TAX ISSUES

SUMMARY

The proposed emissions trading scheme will have significant tax implications.

There are many unresolved issues including the potential for unfunded tax liabilities, double taxation, adverse impacts on tax losses, stamp duty and GST leakage.

Organisations operating in affected industries should:

- analyse the potential tax implications based on their specific circumstances;
- factor this into their climate change strategy and modelling; and
- seek to engage in the consultation process with a view to resolving any tax issues and adverse impacts.

The Government's approach to the design of Australia's emissions trading scheme (**Scheme**) is outlined in its Green Paper of 16 July 2008. In this edition of Corrs In Brief, we analyse key tax issues arising from the Scheme.

THE SCHEME

The following features of the Scheme are relevant from a tax perspective.

- The Government issues carbon pollution permits (**Permits**) equal to the total emissions cap for the covered sectors of the Australian economy on an annual basis.
- Approximately 70% of Permits are issued by sale at auction.
- The remaining Permits are issued for free to organisations expected to be most adversely impacted by the Scheme (potentially aluminium smelting, cement clinker production, integrated steelmaking, alumina refining, silicon smelting and some activities in ceramics, chemicals, pulp and paper and non-ferrous metals smelting).
- Permits are tradeable.

- Emitters must surrender a Permit for every tonne of greenhouse gas that they emit during a year.
- Emitters who fail to surrender sufficient Permits are liable to a penalty.
- Each Permit will be date stamped to a particular year meaning that it can be surrendered in that year or carried forward indefinitely for surrender in future years (known as "unlimited banking").
- Cash grants may be provided to assist certain emissions intensive industries with transition into the Scheme.
- The Scheme is proposed to commence in 2010.

SPECIFIC INCOME TAX RULES

The Green Paper concludes that application of existing income tax principles to Permits issued or traded under the Scheme would be complex and uncertain. This is due to the need for careful characterisation based on individual circumstances which may change over time. The range of potential tax treatments of Permits include allowing an outright deduction for their acquisition, treating the Permits as trading stock, or dealing with their acquisition and disposal under the capital gains tax regime.

To manage this, the Government proposes to enact specific rules for the income tax treatment of Permits. We commend this as a sensible approach.

ROLLING BALANCE

The proposed specific rules (known as the rolling balance) are similar to the tax trading stock rules:

- the cost of a Permit is deductible in the year of acquisition;
- proceeds from sale are assessable; and
- any difference between the opening and closing balance of Permits for a year is either assessable (if the balance increases) or deductible (if the balance decreases).

Based on this approach, the timing of the deduction for the cost of a Permit is matched with the year in which it is either surrendered or sold. For example if a Permit is acquired and then surrendered in the same year, its cost would be deductible in that year. However, if a Permit is acquired and then “banked” for a future year it will be reflected as an increase between the opening and closing balance for that year. This effectively defers the deduction for the cost of the Permit until it is either surrendered or sold.

The capital gains tax rules would not apply to Permits.

VALUATION METHODS

The Government has flagged two possible methods for valuing Permits under the rolling balance rules:

- historic cost; or
- market value at year end.

The Green Paper analyses benefits and issues for each method. At this stage the Government has not nominated a favoured method.

A key issue for the market value method is that unfunded tax liabilities can be triggered if Permit values rise above historic cost. This could compromise the desired tax neutrality of the Scheme. A solution would be to allow an annual choice between the valuation methods so that organisations can manage such liabilities in accordance with their funding capacity in a given year. The trading stock rules (the model for the rolling balance rules) have allowed a choice of valuation method for decades.

FREE PERMITS

The Green Paper proposes the following treatment of free Permits:

- the value of free Permits is included in assessable income in the year of receipt;
- an offsetting deduction is allowed if the Permits are surrendered in the year of receipt (or the following year in certain cases);
- banked Permits are included in the rolling balance rules with a deemed historic cost equal to the value of the Permit when issued; and
- proceeds from the sale of free Permits will be included in assessable income in the year of sale.

The above treatment could trigger significant unfunded tax liabilities where free Permits are banked or are unable to be surrendered because, for example, they are date stamped for a future year. This is acknowledged in the Green Paper which offers as a potential solution the sale of Permits on a secondary market to fund the tax. There are several issues with this approach as outlined below.

- A key policy reason for issuing free Permits is to assist organisations most adversely impacted by the Scheme (eg. emissions intensive industries). To require such organisations to sell free Permits to fund tax liabilities would appear to be contrary to this objective.
- There are significant risks in relying on a secondary Permit market to fund tax liabilities created by the Scheme. The highest proportion of free Permits are to be issued when this market will be in its infancy and hence more likely to be volatile and liquidity constrained. The market will be subject to various factors outside Government control. A spike in Permits offered for sale by affected industries (to fund tax liabilities) could create downward pressure on the Permit price necessitating the sale of further Permits and creating further downward pressure.
- The Green Paper’s comments on taxation of free Permits leave open the potential for double taxation if Permits are sold in the year they are issued (once on issue and again on the sale proceeds). Presumably this is unintended and should be clarified by the Government.
- The sale of Permits could have tax ramifications beyond the transaction itself, such as jeopardising carried forward tax losses (see below).

Potential solutions include:

- deferring the taxation of free Permits until they are used or sold;
- exempting free Permits from tax; or
- providing cash grants that could be used to acquire Permits, rather than issuing free Permits.

Whilst the above options have been considered to some extent in the Green paper, they warrant further analysis given the significant issues with the Government's proposed tax treatment of free Permits.

CASH GRANTS

Cash grants are to be included in assessable income in the year of receipt. Any resulting tax liability could be funded from the grant itself, in contrast to the unfunded liabilities arising from free Permits. However, adverse tax timing differences will likely arise if grants are used for capital expenditure (eg. emission reduction technology) which is deductible over an extended period.

NO DEDUCTION FOR PENALTIES

Penalties imposed for failure to surrender the required number of Permits will not be deductible. This is consistent with the general tax treatment of penalties.

IMPACT ON TAX LOSSES

A key test for the carry forward of company tax losses is the new transaction test (a limb of the same business test). This test is failed if a company derives income from a transaction of a kind it had not entered into in the course of its business before the relevant test time (generally a change of majority ownership).

The sale of Permits (for example to fund tax liabilities from the issue of free Permits) may well be a new kind of transaction that would cause the test to be failed. This would render carried forward tax losses unusable. This issue is not addressed in the Green Paper.

STAMP DUTY

The Green Paper does not address stamp duty.

The Government proposes that Permits will be personal property created by legislation. Several states impose stamp

duty on Commonwealth statutory licences and permits that could apply to the Permits. Although such duties are scheduled for abolition, the timing overlaps with the introduction of the Scheme. Hence stamp duty could apply to Permits in NSW, QLD, WA and SA for at least a year or two.

The imposition of stamp duty on Permits would create a windfall for these States at the expense of Scheme participants. It would also add complexity to Permit transactions. Permits should be specifically exempted from stamp duty in all states and territories either by the individual States or by overriding legislation of the Commonwealth.

GST

The Government proposes that the existing GST rules would generally apply to Permits as follows:

- GST would apply to Permits acquired by auction or in the secondary market;
- purchasers would be entitled to claim input tax credits for GST on Permits so that there is no irrecoverable (or "embedded") GST in the system; and
- GST would not apply to the issue of free Permits, surrender of Permits, unconditional cash grants and Scheme penalties.

However, whilst it is said that the above treatment flows from the general GST rules, in the absence of specific amendments, the following issues may arise:

- the Permits may fall within the definition of a "derivative" and dealings with Permits could therefore be financial supplies. If this is the case, irrecoverable/embedded GST will arise and add to the cost of the regime;
- if anything is required to be done by the recipient of a compensation payment, or if other conditions attach to such a payment, GST may be payable on compensation payments;
- the Government has assumed that no consideration is payable for the surrender of Permits in concluding that their surrender will not be taxable. However, given the broad concept of consideration in a GST context, this is the very question on which the GST consequence turns; and
- the treatment espoused by the government for penalty payments depends on the Commissioner of Taxation amending a determination under the GST legislation. Presumably such an amendment would be made as a matter of course.

WHAT NEXT?

Submissions on the Green Paper are due by 10 September 2008. The Government is scheduled to issue a white paper and draft legislation for the Scheme in December 2008. Consultation on these documents is proposed to run until February 2009, with a Bill to be introduced into Parliament in March 2009.

In parallel with the above process, the Government has asked the Henry Review of Australia's tax system to consider the Scheme. The Henry Review is due to report by the end of 2009. Given the proposed 2010 commencement of the Scheme, it would seem impacted organisations will have little opportunity to factor in outcomes from this review.

RECOMMENDED ACTION

The Scheme will have significant tax implications and there are many unresolved issues. Organisations should:

- analyse the potential tax implications based on their specific circumstances;
- factor this into their climate change strategy and modelling; and
- seek to engage in the consultation process with a view to resolving any tax issues and adverse impacts.

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