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Submission to ETS Discussion Paper
Garnaut Climate Change Review Secretariat
Level 2, 1 Treasury Place
East Melbourne, Victoria 3002

contactus@garnautreview.org.au

Dear Sir

Discussion Paper No 6 - Emissions Trading Scheme Design

The Taxation Institute of Australia (Taxation Institute) is pleased to provide commentary in respect of the Garnaut Climate Change Review (the Review) proposed Australian Emissions Trading Scheme (AETS), as set out in Discussion Paper No 6.

By way of background, the Taxation Institute of Australia is a tax education body and was established in 1943. Our 15,500 members range from small rural and suburban accountants to senior members of the bar specializing in tax. Taken together with their clients, our members' views reflect the opinions of many tax professionals as well as small, medium and large businesses throughout Australia.

In making our comments in respect of the scheme outlined, it is important to note that as this submission is framed in the context of the recommendation by the Review for the introduction of an AETS as the central platform for Australia to address a carbon constrained economy, the submission does not address the merits of an AETS versus a carbon tax. Further, as the scheme outlined in the Discussion paper is limited to the AETS the submission also does not address:

- the issue of abatement, in particular the measures required to ensure that the current taxation laws facilitate early abatement activities (rather than inhibit them); and
- the measures required to ensure that the development of alternative energy sources is not impeded by the current tax laws.

Rather, the submission provides an independent analysis of how the greenhouse gas (GHG) permit and the AETS ought to be treated under Australia's taxation laws. The Taxation Institute believes that it is crucial in designing such a scheme that consultation with tax experts be undertaken early. This is to ensure that the policy does not give rise to tax compliance cost issues and as much as possible is accommodated within the current taxation rules.

As the introduction of an AETS will be such a major and long-lasting structural change to our Nation's economy, the Taxation Institute also recommends appropriate early legislative amendment or administrative interpretation of existing taxation laws to maximise the certainty for taxpayers in the operation of the new regime.

As mentioned above our submission is based upon the ATEs scheme as set out in Discussion Paper No 6. As the green paper is developed and submissions are considered for the final report of the Review the Taxation Institute would be happy to assist in these regards by providing additional comments on the areas of taxation not dealt with in the Discussion paper. We can draw on the expertise of our climate change technical committee, which consists of experts with an environmental tax focus drawn from both industry and the professions. Should you have any queries with respect to any of the matters raised above or in the attached appendix, please do not hesitate to contact Dr Michael Dirkis on (02) 8223 0011.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Sue Williamson', written in a cursive style.

Sue Williamson
President

Appendix: Submission on Discussion Paper No 6 - Emissions Trading Scheme Design

A. Executive Summary

The key recommendations discussed below are as follows.

Income Tax Treatment: The Taxation Institute submits that given the consumable nature of the permits that the acquiring, acquitting or selling of GHG permits should be dealt with in the income context with any loss or outgoing being a s 8-1 of the *Income Tax Assessment Act 1997* (ITAA97) allowable deduction in full at the time the payment is made. Where permits are retained across income tax years, the GHG permits would be trading stock of an entity. As a result the Taxation Institute recommends that the definition of “CGT asset” in s108-5 of ITAA97 be modified to exclude GHG permits. This treatment would ensure that a person who bought GHG permits to hold as a long term asset would not claim the CGT discount on any gain made upon their subsequent disposal.

Goods and Services Tax (GST) treatment: The Taxation Institute submits that the auction and sale of GHG permits, if subjected to GST, should be taxable: an entity registered for GST would claim a GST input credit for the acquisition of the GHG permit, the vendor would pay GST. Acquittal (surrender) of the GHG permit would not be a supply.

Stamp duty treatment: The Taxation Institute recommends that conveyance duty should not apply to the trading of permits. The matter needs to be raised with the States and Territories.

Taxation treatment of compensation payments: The Taxation Institute submits that the taxation treatment of any compensation payments needs to be a reflection of the underlying transaction the Government is seeking to compensate.

Taxation treatment of penalties: The Taxation Institute submits that the “penalty” for exceeding GHG rights should be a deductible penalty (i.e. not covered by s 26-5(1) of ITAA97), because it is subject to a make good (and indeed, could be used to acquire abatement).

B. Issues in Detail

1. Principles for interface with Australia’s taxation laws

- 1.1. It is noted that the review defines a “GHG permit” as a tradeable instrument with inherent value that can be acquitted by the holder or exchanged between buyers and sellers in an emissions market: Review, 2.1, p12.
- 1.2. The Taxation Institute is of the view that the following design principles adopted by the Review for the design of AETS, should also be adopted by Government for its interface with income tax and GST systems: principles 2 (tradability), 3 (credibility), 4 (simplicity), 5 (integration).
- 1.3. The Taxation Institute is of the view that to the maximum extent possible the Australian taxation laws should apply without distortion to GHG permits and hence to AETS design.

- 1.4. Accordingly, the Taxation Institute submits that the above design principles would require early legislative or administrative clarification of the existing laws in order to achieve the greatest certainty for taxpayers, ahead of the introduction of AETS.
- 1.5. As a governing principle, the Taxation Institute submits that existing (or future) taxation laws should allow taxpayers to adopt the income taxation treatment of GHG permits that fit their circumstances, and consistent with other rights held or traded by them (for example, water rights, or financial instruments or shares traded on the Australian Stock Exchange (ASX)), subject to GST considerations discussed in point 4 of this submission.
- 1.6. In the following discussion, this submission addresses:
 - Taxation of acquisition, acquittal or sale of GHG permits;
 - Banking (hoarding) and loaning of GHG permits;
 - Goods and Services Tax (GST); and
 - Compensation and penalties

2. Taxation of acquiring, acquitting or selling GHG permits

2.1. Acquiring GHG permits in the auction process

- 2.1.1. Auctioning of permits for ETS participants will be a regular (weekly, fortnightly, monthly or annual) event.
- 2.1.2. The Taxation Institute submits that given the consumable nature of the permits the payment by an entity for GHG permits in the auction by the Independent Carbon Bank (ICB) will be an outgoing of the entity incurred in carrying on business, or necessarily incurred in earning income. Therefore, the cost of acquisition, in light of a long line of courts decisions from *Sun Newspapers v Federal Commissioner of Taxation* (1938) 61 CLR 337 onwards, ought to meet the general test for deductibility in the ITAA97.
- 2.1.3. The Taxation Institute submits that according to settled analysis:
 - 2.1.3.1. The loss or outgoing for an entity under s 8-1 of ITAA97 should be the amount of the payment (i.e. the auction price) for the GHG permits (and not the acquittal of the GHG permits);
 - 2.1.3.2. The outgoing should be properly referable to year of acquisition, not the year (or first year) of permit use; and
 - 2.1.3.3. The loss or outgoing should be a s 8-1 allowable deduction in full at the time the payment is made.
- 2.1.4. The GHG permits may be trading stock of an entity – discussed below.
- 2.1.5. Although economists view pollution as an externality, and it will not be possible in future to be in any business that pollutes without holding GHG permits, nonetheless from a taxation perspective the activity of polluting is so closely tied to the productive process that it would be entirely inappropriate to treat the acquisition of emissions rights as an outgoing on capital account.

2.1.6. The Taxation Institute recommends that the definition of “CGT asset” in s108-5 of ITAA97 be modified to exclude GHG permits. This treatment would ensure that a person who bought GHG permits to hold as a long term asset would not claim the CGT discount on any gain made upon their subsequent disposal.

2.2. Acquiring GHG permits in the AETS

2.2.1. The Taxation Institute submits that there ought to be no conceptual difference between the acquisition of GHG permits via auction from the Carbon Bank, and the acquisition of GHG permits from another participant(s) in the AETS.

2.2.2. The Taxation Institute notes that the AETS design philosophy appears to be that the acquisition of a GHG permit in AETS is primarily for the purpose of enabling an entity to make up the number of GHG permits it needs to acquit against its current or anticipated pollution – for these reasons, fundamentally, it ought to be treated differently to a share on the ASX.

2.3. Acquitting GHG permits

2.3.1. Entities covered by AETS will be required to acquit their GHG emissions with GHG permits surrendered to the Carbon Bank.

2.3.2. Acquittal of GHG permits equivalent to GHG emissions will be compulsory – it will be a crime to pollute without the right(s) to pollute.

2.3.3. Once an entity surrenders GHG permits to the ICB (who will cancel them) the entity loses all rights in those GHG permits – they will no longer hold those particular GHG rights.

2.3.4. If the surrender occurs in the fiscal year of acquisition of the GHG permits, then the entity obtains the benefit in that year of an income tax deduction for the GHG permits.

2.3.5. If the surrender occurs in a fiscal year after the year of acquisition, then a normal application of the trading stock rules will result in the entity obtaining an income tax deduction in the year of surrender.

2.4. Selling GHG permits

2.4.1. GHG permits may be sold into the AETS, or it appears, by private treaty.

2.4.2. The proceeds of sales of GHG permits ought to be assessable income under s 6-5(1) of ITAA97.

2.4.3. For any entity, the excess of the sales proceeds over the purchase price should be treated as ordinary income; conversely, any loss should be an allowable deduction (and not a capital loss).

2.5. Offsets

2.5.1. The Taxation Institute submits that the acquisition, acquittal and sale of offsets should be taxed on the same basis as GHG permits.

2.6. International linkages

2.6.1. The GHG permit issued by the ICB will have an Australian source.

2.6.2. The Taxation Institute submits that the existing non-capital taxation rules that apply to non-residents, including treaty protection for ordinary business profits, should apply to GHG permits.

2.6.3. The purchase, acquittal or sale of GHG permits acquired in an overseas ETS should not alter their taxation treatment in Australia.

2.7. Corporate groups

2.7.1. The operation of the income tax consolidation rules also need to be examined as the GHG permits acquired by individual entities will be treated as being acquired by the head entity of the consolidated group.

2.7.2. Consideration needs to be given to the applicability of the transfer pricing rules where GHG permits are transferred within international corporate groups.

3. Banking and borrowing GHG permits

3.1. The Taxation Institute recommends that the last day in any fiscal period for acquittal be aligned with the last day of an entity's financial year for accounting purposes.

3.2. A GHG permit may be held as an asset on an entity's balance sheet, for example, because the entity's year end occurs before the date for acquittal, or because an entity decides to bank (hoard) the GHG permit.

3.3. Transparency in the AETS means that it will be possible to mark the GHG permit to market at balance date.

3.4. The Taxation Institute notes that opinion may diverge as to whether the GHG permit is a consumable (i.e. because it is an externality) or whether the GHG permit should be treated as trading stock.

3.4.1. In s 70-10 of the ITAA97, *trading stock* includes:

“(a) anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of a *business”

3.4.2. The Taxation Institute submits that the better view is that the GHG permit will be acquired for exchange (acquittal) or sale, and so will be trading stock of an entity.

3.4.3. The sale or exchange may occur in the same fiscal period as acquisition (temporal) or in a later fiscal period (intertemporal).

3.4.4. It is noted there is an argument that the GHG right is primarily acquired for release or to discharge (an entity) from the statutory obligation attached to polluting – and this is not an exchange. It is recommended a legislative or administrative clarification of the treatment to put the treatment beyond doubt.

3.5. The Taxation Institute submits that the lending by the ICB of a GHG permit is not income of an entity, or an allowable deduction – it is a transaction on capital account.

3.6. It is noted that the Review recommends that the ICB may charge interest on loans of GHG permits (although the interest may be paid “in kind” (i.e. in GHG permits)). The Taxation Institute submits that any interest costs associated with borrowing of GHG permits from the ICB ought to be an allowable deduction under s 8-1 of ITAA97 at the time the GHG permits are repaid to the ICB.

3.7. The Taxation Institute further submits generally that any interest costs associated with borrowings by an entity to acquire, and/or hold, GHG permits ought also to be an allowable deduction.

4. GST

4.1. The key question will be whether emissions trading should be taxable or input taxed under the GST scheme.

4.2. If a permit assumes the form of a “tradable instrument with inherent value that can be exchanged between buyers and sellers in an emissions market”, such an instrument appears to fall within the concept of a “derivative”.

4.3. The result will be that trading in permits will (in the absence of an underlying deliverable) be input taxed. This seems an odd result in the light of the economic rationale for input taxation (which is to input tax businesses whose “value add” is difficult to ascertain).

4.4. Given that the businesses most likely to be subject to an ETS will be businesses whose “value add” will generally be easily ascertained (such as energy producers), the policy reason for input taxation seems absent.

4.5. It appears accepted that the ETS will, as it stands, produce a major new cost element in the economy. To add to those costs through the denial of input tax credits on acquisitions related to trading seems unsound policy where the overall policy thrust is to provide relief to those most affected rather than to compound the cost.

4.6. It should be noted that in the case of the European Union, emissions trading is generally taxable so that no trapped VAT cost is borne by business. The EU model that was initially proposed contemplated that emissions trading could be VAT exempt (i.e. input taxed) but the final position was that trading would be taxable. This was a position that the EU VAT Committee eventually agreed to following a period of debate on the matter.

4.7. In summary, the auction or sale of GHG permits is a supply of an emission right: for the entity, it is an input into the productive process, albeit the GHG permit is acquitted or sold. The Taxation Institute submits that the auction and sale of GHG permits, if subjected to GST, should be taxable: an entity registered for GST would claim a GST input credit for the

acquisition of the GHG permit, the vendor would pay GST. Acquittal (surrender) of the GHG permit would not be a supply.

- 4.8. Where cross border trading occurs, the current GST legislation will provide a taxation framework of sorts. To the extent that the consumer is overseas, the rules for GST free treatment under s 38-190 of *A New Tax System (Goods and Services Tax) Act 1999* provide an obvious framework for dealing with such trades.
- 4.9. However, where the underlying subject matter of the trading is a "carbon right" in the nature of land interests in Australia, it is not clear that GST free treatment will always be available. Consistency in this regard is desirable so that trading in GST permits and carbon rights are treated in the same way.
- 4.10. The GST treatment of an initial acquisition of a permit through the auction process also needs to be settled as a policy matter. Under general principles, that initial allocation would be a supply recognised for GST.
- 4.11. Whether this should be the case is a different matter. It should be noted that in some EU countries, the initial allocation of permits is not subject to VAT. This appears to be a logical approach.
- 4.12. The GST treatment of payment of compensation to persons adversely affected by the proposed ETS is another matter requiring consideration. A supply of money in isolation under the GST scheme will not be taxed. If this is how a compensation payment will work, no GST consequences should flow.
- 4.13. However, if something is required to be done by the payee this may give rise to a taxable supply. As a question of policy, there may be little reason to collect tax if all that moves from the payee is a release or discharge of claims, such as those given on a damages claim being settled (see for example Goods and Services Taxation Ruling GSTR Ruling 2001/4).
- 4.14. The treatment of any financial penalty for non-compliance will also require clarification. One approach could be to treat the payment as not being consideration for a taxable supply under Division 81.
- 4.15. There may be good policy reasons for treating all dealings in permits as GST free.

5. Stamp duty

- 5.1. An emissions permit as described appears to answer the description of a statutory permit to the extent that the permit operates as a right under statute to emit greenhouse gasses.
- 5.2. The concept of dutiable property, in a number of jurisdictions will capture such an instrument and tax trading of a permit as a transfer of dutiable property if there is a nexus with the jurisdiction. A nexus arises in New South Wales, where the rights under the permit "have been exercised, during the previous 12 months, in respect of New South Wales or in an area that includes New South Wales or a part of New South Wales". The nexus with Queensland arises if the permit is "used, exploited or exercised in Queensland". In Western Australia, a similar outcome is conceivable. Thus, in New South Wales, Queensland and Western Australia transfer duty will potentially apply on a transfer of a permit.

- 5.3. While these duties are earmarked for abolition during the next few years (NSW 1 July 2012, Queensland 1 January 2012 and WA 1 July 2010), the incidence of these taxes may for a time overlap with the operation of the ETS.
- 5.4. These jurisdictions distinguish between a transfer of dutiable property (which is taxed) and the creation of new property on grant (which they do not in the circumstances tax). To this extent, the initial acquisition of permits should not be taxed.
- 5.5. In South Australia, however, conveyance duty potentially applies both upon the creation of new property and on a subsequent transfer. Assuming that a permit can be characterized as "property" in the general sense (as is conceivable e.g. *2Day FM Australia v CSD* 89 ATC 4840) duty could apply both on the initial acquisition and subsequent transfer of a permit if there is a jurisdictional nexus. The relevant duty in SA is expected to be abolished from 1 July 2010.
- 5.6. To the extent that conveyance duty will apply to trading of permits at rates of up to 5.5%, this will be an additional cost for business once at ETS commences. As a policy matter, it is questionable why this cost should be added to the significant economic dislocation that an ETS is likely to already entail. The outcome would be particularly harsh given that the relevant stamp duties will be abolished within the next few years. The matter needs to be raised with NSW, Queensland, WA and SA.

6. Compensation and penalties

6.1. Compensation to TEEII

- 6.1.1. The Taxation Institute notes that it is proposed that TEEII entities may receive a free allocation of GHG permits, or cash equivalent.
 - 6.1.2. The principles governing the deductibility of costs of GHG permit acquisition do not under our current taxation laws imply that a mirror treatment ought to apply to TEEII entities to turn the compensation into income or a non-cash business benefit.
 - 6.1.3. The Taxation Institute submits that a free allocation or cash subsidy ought to be treated as the acquisition of GHG permits for zero consideration: this means that no allowable deduction will be available to entities.
 - 6.1.4. If a free allocation or cash subsidy were to be assessable, the taxation treatment would require an appropriate adjustment to the compensation formula to reflect the after-tax position of TEEII entities.
- 6.2. If the Government were to provide other forms of compensation, for example, to low-income households, then it would be open to Government to decide the tax profile of such other forms of compensation.
 - 6.3. However, the taxation treatment of these payments needs to be a reflection of the underlying transaction the Government is seeking to compensate.

6.4. “Penalty”

6.4.1. The Taxation Institute recommends that the “penalty” for exceeding GHG rights should not be a deductible penalty (i.e. not covered by s 26-5(1) of ITAA97), because it is subject to a make good (and indeed, could be used to acquire abatement). To do so would be inequitable.

6.4.2. Accordingly, the Taxation Institute recommends a legislative amendment to s 26-5(2) of ITAA97.

7. Pass through

The introduction of emissions trading will leave some businesses in the position of having to bear a significant new cost (including tax costs) without the ability to pass it through. A supplier of energy under a long term energy supply contract may be in this position if the contract has no mechanism for review of pricing for such a cost increase. The Taxation Institute recommends that serious consideration be given to determine whether a statutory right to pass through the costs will be appropriate in the circumstances.