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The tax and commercial consequences of the CPRS – what businesses and their accountants need to know

The tax and commercial consequences of the CPRS are not clear. The recently released Green Paper raises significant tax and commercial issues.

Permits in Forestry will also raise complex tax issues.

Background - CPRS

The Federal Government has committed to reducing Australia's greenhouse gas (**GHG**) emissions by 60% below 2000 levels by the year 2050. The Government intends to achieve this by introducing a national emissions trading scheme. The scheme will be known as the Carbon Pollution Reduction Scheme (**CPRS**) and the Government is proposing that it commence on 1 July 2010. In July 2008, the Government released a Green Paper outlining its preferred positions for the design of the CPRS.

In summary, the Government will set a cap on the level of GHG emissions Australian industry can generate and then issue permits equalling the cap each year. The annual caps have not yet been set but will follow a downwards trajectory. Businesses in "operational control" of facilities which generate 25,000 tonnes or more of GHG emissions per year will be required to acquire and surrender a permit – to be known as an Australian Emissions Unit – for every tonne of GHG the facility emits. The price of permits will be determined by the market (subject to a temporary price cap), however about 30% of permits will be allocated for free to businesses undertaking emissions-intensive trade-exposed (**EITE**) activities.

Not all industry sectors will be required to acquire permits – the covered sectors will initially be stationary energy, transport, fugitive emissions, industrial processes, the importation and production of synthetic greenhouse gases and waste. Agriculture will be excluded until at least 2015 but forestry managers will be able to voluntarily "opt-in" to the scheme from the outset.

This means that about 1000 Australian companies will be required to acquire permits in the first phase of the CPRS. However, all businesses will be affected by the introduction of the CPRS in some way. The cost of doing business will almost certainly increase as electricity, fuel and other business inputs become more expensive.

The Tax Consequences of the Scheme

Chapter 11 of the Green Paper outlines the Government's preferred positions in relation to the tax consequences of the scheme and the framework relevant to the financial accounting treatment of such permits.

Despite the Government declaring that its primary tax objectives in implementing the CPRS are to ensure the scheme operates cost effectively, simply and in a tax neutral manner, the Green Paper raises a number of concerns in relation to the tax treatment of permits and the ability of the CPRS to achieve its intended goal of reducing Australia's GHG carbon emissions.

How will permits be treated for tax purposes?

It is proposed that new provisions be inserted into Australia's existing tax legislation. Interestingly, the Government's preferred position is to treat permits on

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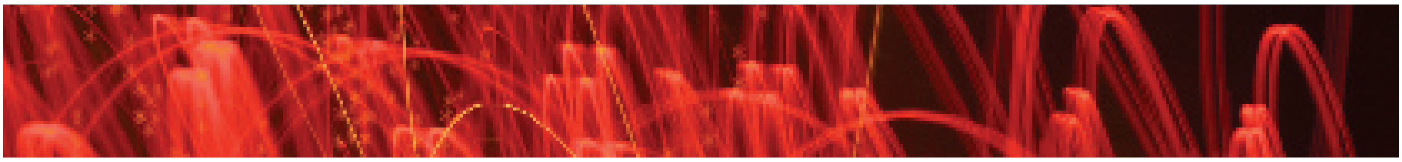

an income basis rather than on capital account. Under existing law, permits may come within the capital gains tax provisions. By providing otherwise, the Government will effectively prevent access to various concessions currently available in respect of capital gains (such as the 50% Discount and Small Business CGT Concessions).

The Green Paper suggests that EITE taxpayers will receive a percentage of their permits for free and/or cash grants. Under the proposed method of taxing permits, free permits and cash grants will be required to be included in a taxpayer's assessable income in the year the permit or cash grant is received. This raises cash flow concerns for the recipients. This would be a significant problem for SMEs.

Further, the preferred position in relation to permits acquired for value is that "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".

The Government suggests the adoption of a rolling balance method to ensure permits are brought to account for income tax purposes in the year they are surrendered or sold. This is similar to the current taxing regime for trading stock. Effectively, the rolling balance method would involve:

> the cost of permits being deductible in the year they are acquired;

> any proceeds from the sale of permits being assessable in the year permits are sold; and

> permits on hand at the end of the year will be included in assessable income.

Permits can be valued at cost or market value. If market value is used, any increase in the value of permits on hand at year end will be included in the taxpayer's assessable income while any decrease is deductible.

The Green Paper provides that a taxpayer will be able to choose between using the historical cost or market value of permits when using the rolling balance method.

Will GST apply to the supply of permits?

The Government has announced that its preferred position is to treat the supply of permits under the current Goods and Services Tax (GST) rules. This would result in:

> no GST arising on the issue of free permits or a taxpayer receiving a cash grant on the basis there is no consideration provided by the taxpayer;

> no GST payable on penalties arising under the scheme;

> no GST payable on the surrendering of a permit; and

> GST arising on the sale/auctioning of permits.

What are the tax consequences of reducing carbon emissions?

The intended outcome of the CPRS is to reduce Australia's total GHG emissions. Whether the proposed tax consequences of the CPRS are consistent with this objective is questionable.

Under the Government's preferred position, the costs of acquiring a permit will be deductible in the year the permit is acquired. However, it is expected that in many circumstances the costs incurred by a taxpayer to reduce carbon emissions (such as converting to solar energy and other alternative forms of energy) will be largely capital in nature and therefore depreciable over a number of years.

This mismatch in the character of expenditure leads to concerns that the CPRS will provide a disincentive to taxpayers as they may buy permits rather than reduce GHG emissions.

What about taxpayers who do not come within the CPRS?

The vast majority of taxpayers will not be required to purchase and surrender permits under the CPRS. However, the indirect impact on taxpayers may be significant.

It is expected that the CPRS will result in an increase in the costs of business inputs, in particular energy costs, for many taxpayers. The Government suggests that the increased costs will be minimal and the effect of the CPRS on the CPI will be largely a "one-off'. This has been disputed by many in the business community.

For taxpayers who have entered into long term contracts, there is uncertainty whether the potential costs arising from the CPRS will be able to be passed on. Whether the Government will implement a statutory remedy, akin to the legislative remedy provided following the introduction of GST, has not been announced. Accordingly businesses should ensure that existing long-term contracts are reviewed and that these issues are considered when drafting all new contracts.

Further, the pressure on taxpayers to be "green" is likely to result in some businesses purchasing permits for marketing or branding purposes. It is expected that such an expense will be deductible as an ordinary business expense.

What about the forestry industry?

The Green Paper states that the forestry industry will have a unique opportunity to "opt-in" to the CPRS. By opting to participate in the CPRS, taxpayers in the forestry industry will be able to acquire free permits equal to the net amount of carbon stored in the taxpayer's forest.

Only forestry activities within the ambit of the Kyoto Protocol (those established after 1990) will be eligible to earn permits.

From a tax perspective, the decision whether to opt into the CPRS will require careful consideration. Currently, in the normal course, individual trees grown to fell are treated as trading stock (i.e. on an income basis). Opting into the CPRS to generate permits suggests such trees could become capital assets. Further, if a taxpayer opts into the CPRS and subsequently fells its trees or the forest is destroyed for any reason, permits will need to be acquired and surrendered to the Commonwealth.

Whether opting in will be beneficial for forestry taxpayers is unclear and will require careful consideration of the final tax treatment.

The Federal Government has called for submissions on the Green Paper by 10 September 2008. If you would like to make a submission regarding the Government's preferred positions in regards to the CPRS, or any other aspect of the Green Paper, please contact one of the people below.

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