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The Hon Wayne Swan MP
Treasurer
PO Box 6022
Parliament House
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Dear Treasurer

Carbon Pollution Reduction Scheme White Paper

The Taxation Institute of Australia (**Taxation Institute**) has a number of concerns with the tax policy approach adopted in the Government's *Carbon Pollution Reduction Scheme: Australia's Low Pollution Future White Paper (White Paper)* released on 15 December 2008. Although the interface with the tax system is not a primary policy driver, it is still crucial that the tax policy complements and supports the Carbon Pollution Reduction Scheme (CPRS) rather than creating unnecessary compliance costs which reduce the scheme's efficiency.

Despite extensive consultation in respect of the *Carbon Pollution Reduction Scheme Green Paper* the Taxation Institute urges Government to reconsider four key design features to ensure that compliance costs, and therefore the cost to the community, are minimised. The key concern is the application of GST to permits justified on the simplicity arising from the consistency in the application of the GST law. The three other concerns are the potential application of stamp duties to emission trading permits until 2013, the application of GST to CPRS based derivatives and unrealised gains arising from the holding of Kyoto permits.

1. GST Treatment

The decision to treat permits as a taxable supply needs reconsideration as little weight has been given in the White Paper to the associated compliance cost of the measures combined with the finance cost.

Currently finance trading markets do not apply GST to the items traded (share, options, etc). As a result they will need to incur substantial costs in developing systems that are able to capture the GST in an electronic trading environment where sellers are not aware of the identities of buyers. This makes the use of tax invoices in their current form problematic, in particular in a mature system with foreign entry where the CPRS permits will be GST free supplies when acquired by foreigners. It was these compliance difficulties that convinced the New Zealand Government to exclude permits from the GST net despite having a goods and services tax (GST), which applies to virtually all supplies of goods and services.

The case for GST free treatment equally applies in Australia. Although the markets will be closed to world trade for the first five years, by imposing the associated compliance cost to set up the systems with a chance of abandonment in five years times is short sighted. The system needs to be designed with that mature system in place.

Another concern is that the treatment of permits as being taxable will result in a permanent increase in the working capital requirements of companies (of \$1.15 billion in 2010) to fund the GST between the time of purchase and the BAS lodgement time (somewhere between 22 and 53 days) when the GST input credit is allowed. Businesses will be forced to recoup the high funding costs by higher prices to consumers.

Although it is assumed in the White Paper that for all businesses this cost will be offset by the cash generated by charging higher prices for affected goods and services, not all businesses will be able to increase prices. An example would be if the price adjustment is only going to reflect an average price of carbon for the preceding six months period. For example in the context of the oil industry, the sheer number of permits required to be purchased by the oil companies to meet the expected emissions (over 100 million tonnes) will require purchase of permits close to the time of the emission, potentially at prices greater than the average for the preceding six months. Potentially, the companies may need to purchase credits at the \$40 cap, yet the price charged to customers would be substantially lower and would not be recoverable from customers. Given profit margins in the oil industry were about 2.2 cents per litre in 2007 and will be lower in 2008 there is no margin for error. The GST finance cost merely adds to these risks.

Finally, the proposed GST treatment is far from simple as illustrated by the following table.

| Circumstance | GST treatment |
|---|---------------------------------------|
| Buying or selling a permit | Taxable supply |
| Supply of free permit | No GST (no consideration) |
| Import or Export of permits | No GST (out of scope or GST free) |
| Government Cash Grant | No GST (no supply) |
| Surrender of a permit | No GST (no consideration) |
| Payment of a penalty | No GST |
| Use of financial derivatives of permits | Input taxed supply (financial supply) |

From the above table, it is clear that some transactions are taxable and others are not. There is an overall increase in complexity, administration and tracking costs by not making all transactions GST Free. Distinguishing between the different types of transactions increases the likelihood of processing errors, rework, penalties etc for no added value.

In summary, in light of the compliance and financial cost, the imposition of GST where there is no intention to raise GST revenue makes little public policy sense and needs to be reviewed.

2. GST and Derivatives

The White Paper recommends the input taxation of CPRS based derivatives on the basis of simplicity and consistency. Given that the CPRS was preferred as the most efficient mechanism for delivering carbon reduction by the creation of deep secondary markets for permits and the associated derivative products, the input taxation of CPRS derivatives operates to undermine that strategy. The input taxation of the derivatives (in the estimated \$115 billion per annum secondary market) will give rise to large amounts of trapped GST and businesses will be forced to recoup this trapped GST by higher prices to consumers. There will be a GST windfall to the States and Territories. Further, the input taxation of this newly created class of derivatives seems to run counter to the Government's undertaking of not increasing the scope of the GST.

Again the Taxation Institute would urge the Government to reconsider its view on this issue.

3. Stamp Duty

Although the White Paper acknowledges that the Commonwealth has written to the States and Territories seeking agreement to not apply these taxes, the Taxation Institute notes, with some concern, that the Intergovernmental Agreement on Federal Financial Relations, which began on 1 January 2009, permits the States and Territories to levy stamp duties on the transfer of emission

trading permits until the abolition of all taxes listed in Clause B2 within each jurisdiction, that being until 2013 (see in clause B4). This seems to counter the statements in the White Paper. Therefore, the Taxation Institute urges the Government to urgent address this matter without delay.

4. Unrealised gains on imported Kyoto units

The purchase of Kyoto Units may lead to the payment of tax on unrealised gains. This can arise where the Kyoto price is cheaper than permits on the Australian market. The “gain” on the difference between the price paid overseas and market value of an equivalent permit/unit on the Australian exchange is treated as assessable income in the year the permit is purchased. However, the offsetting deduction for the higher Australian price for a permit is not allowed until the permit is actually physically surrendered.

Although this is viewed as an issue of taxpayer management (ie it was up to taxpayers to manage the importation of such units such that unrealized gains were minimised) there may be regulatory issues in respect of registers of permits overseas which may force an entity to import such units ahead of any need to utilise them. For example, changes in expiration dates, costs imposed in holding units in foreign registers etc.

Again, this is a cost of system issue that needs to be addressed.

If you require any further information or assistance in respect of our submission, please contact Joan Roberts on 03 9611 0178 or the Taxation Institute's Senior Tax Counsel, Dr Michael Dirakis, on 02 8223 0011.

Yours sincerely



Joan Roberts
President

Cc Senator the Hon Penny Wong, Minister for Climate Change and Water
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