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TAXATION INSTITUTE *of* AUSTRALIA
IT'S ESSENTIAL

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The CPRS Exposure Draft Team
Emissions Trading Division
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Dear Sir or Madam

Exposure draft of the Carbon Pollution Reduction Scheme legislation

The Taxation Institute of Australia (**Taxation Institute**) is pleased to provide its submission in relation to the exposure draft of the legislation to implement the Carbon Pollution Reduction Scheme (CPRS), in particular the draft *Carbon Pollution Reduction Scheme (Consequential Amendments) Bill 2009* (**Consequential Amendments Bill**).

The Taxation Institute has a number of concerns with the exposure draft bills. 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 CPRS rather than creating unnecessary compliance costs which reduce the scheme's efficiency.

That said, many of the key tax issues identified, such as those associated with the operation of the register and those associated with the application of the Goods and Services Tax (GST) and First-in First-Out method, have the potential of undermining the key policy drivers of the scheme through the imposition of unnecessary compliance and financing costs, which will only add to the cost to consumers of the CPRS without delivering any carbon pollution reduction.

1. Issues with the broader scheme

Prior to commenting on four key concerns with the operation of the CPRS it is important to make some general observations on the structure and drafting style of the exposure draft of the *Carbon Pollution Reduction Scheme Bill 2009* (**Main Bill**). The Main Bill is very prescriptive containing many provisions which, given their prescriptive nature may be better placed in regulation. An example is the proposed paragraph 95 of the Main Bill which takes 15 lines to explain that when a change of ownership occurs the new owner is recorded in respect of the emission units now held in that owner's account and the former owner's details in respect of those emissions units removed. This over prescription is repeated in paragraphs 96, 97, and 108.

Often such over prescription is the result of a lack of time. The Taxation Institute would recommend that the exposure draft bills be reviewed to further refine the law so that it is clear, concise and reflects the key policy objectives .

1.1 Operation of the Registry

Issue: In light of the policy to create deep secondary markets in emission units it would be expected that, given the nature of electronic trading, the registration of changes in ownership of Emission Units in the National Registry of Emissions Units, like share and futures markets, would be recorded in real time. However, early observations from the Department of Climate Change's representative at the Treasury sponsored consultation in Sydney on 26 March 2009 indicated that registration in the ordinary course may take up to three working days. Given the volumes of transfers and surrenders around key dates such as 30 June and 15 December (potentially in excess of 287 million permits on 15 December) a three day "business as usual model" may result in registrations taking many days if not weeks. Given that registration is fundamental to the system and underlies the taxation treatment, any such potential inadequacy of the proposed National Register will adversely impact trade and increase finance costs for effected entities which will need to pre-empt such bottlenecks by registering trades early.

Solution: The design of the National Registry must ensure that it can handle real time transfers of ownership. If this is considered to costly, an alternative may be to treat registration or transfers of registration to have occurred upon electronic lodgement of appropriate documentation with the Registry.

1.2 Requirement to hold a financial services licence.

Issue: As a result to the proposed changes to the *Corporations Act 2001* and the *Australian Securities and Investments Commission Act 2001* arising under the proposed Schedule 1 of the Consequential Amendments Bill, there would appear to be a requirement that if an affected entity wishes to participate directly in the auction process that it would need to have a financial services licence.

Such licences carry extensive additional reporting requirements such as a solvency requirement and the need to keep separate accounts (deemed necessary for financial institutions), which are unnecessary for affected entities whose primary business may be manufacturing and the trading in financial products is engaged in to manage the business' exposure. As a result of these extensive additional requirements, associated compliance costs will be incurred and potentially passed on to consumers. Further, the requirement would severely restrict the level of trading thereby impacting on the ability of the market to provide the lowest economic price, a key policy aim of the CPRS.

Solution: Consideration should be given to enable affected entities to participate directly in the auction processes and the trading of permits without the need to have a financial services licence.

1.3 Reporting of significant holding

Issue: Under the proposed Part 16 of the Main Bill regime there are requirements that significant holding of Emissions Units be reported within five business days or face civil penalties. Such reporting of holdings or movements in holdings will create unnecessary compliance costs even where it is clear that the entity will have such holdings, such as upstream liquid fuel suppliers. Again these unnecessary compliance costs will impact upon the cost to the community.

Solution: Reporting of significant holdings from entities with significant liabilities, such as upstream liquid fuel suppliers, should be by exception only as there is an underlying assumption that they will have significant holdings of Emissions Units.

1.4 Information gathering powers

Issue: The 14 days minimum compliance period for the supply of information (proposed paragraph 296(3) of the Main Bill), the contravention of which gives rise to civil penalties, is too short given the size and complex nature of the structure of many affected entities.

Solution: On fairness grounds a longer period needs to be prescribed with a shorter period being only available in exceptional cases such as fraud.

2. Issues with the Consequential Amendments Bill

As mentioned above, the Taxation Institute has a number of concerns with the interface between the CPRS and the tax system. It is crucial for the success of the CPRS that the tax policy complements and supports the scheme rather than creating unnecessary compliance costs which reduce the scheme's efficiency.

2.1 Scope of deduction provision too narrow.

Issue: The proposed paragraph 420-15 of the Consequential Amendments Bill allows a deduction for expenditure "to the extent the taxpayer incurs it in becoming the holder of a registered emissions unit". This is viewed as too narrow as certain expenditure incurred after registration, for example in on-going maintenance and protection of the registered units, would be excluded. Such expenditure could also be capital in nature and denied under the general provisions.

Solution: The scope of paragraph 420-15 should be expanded to include on-going costs incurred after registration.

2.2 "Cost" of permit uncertain

Issue: It is not clear from the Consequential Amendments Bill which expenditure is included in the "cost" of a permit. This is unlike other existing specialised regimes under the income tax law (such as the Capital Gains Tax, tax depreciation and trading stock provisions) which provide guidance that has been clarified further by detailed rulings issued by the Australian Taxation Office.

Solution: In order to ensure certainty, the scope of the term "cost" needs to be clarified by expanded provisions in the legislation and additional examples in the explanatory materials.

2.3 The FIFO (first-in first-out basis) methodology

Issue: Under the proposed paragraphs 420-55(7) and 420-56(8) of the Consequential Amendments Bill, the FIFO (first-in first-out basis) methodology is required to be used under the cost method when determining the value of units on hand. This is problematic for a number of reasons.

First, the prescription of this methodology prior to the determination of the IFRS methodology has the potential to create extra administration costs in working out the timing differences (eg one ledger for tax and another reflecting reality) if the eventual IFRS methodology is divergent. This may occur as, unlike a stockpile of homogenous goods (eg coal), under the legislative scheme the units when surrendered are clearly identifiable and the transfer needs to be registered.

Second, FIFO is also inconsistent with other provisions of the tax legislation that allow specific identification and with the proposed paragraphs 94 and 95 of the Main Bill, which from the plain meaning of the words, contemplate the registration of transferred units on a individual number identification process.

Further, given that the scheme has a policy driver of creating deep secondary markets by encouraging the non-retention of units, any concern about potential distortions arising from the retention of "low cost" Emission Units is at best overstated.

These concerns are real as illustrated by the following examples.

The first example of where the proposed tax rule would create problems is if an entity has sought to cover its position by acquiring units before it receives free units (given that you may not necessarily know the number you may receive). In this circumstance it is more likely that the free units will be on hand at the end of the ' no disadvantage' period under the first in first out tax rule and therefore a taxpayer will be subject to tax on the market value of such units.

A second example is that traders are likely to sell parcels of units without reference to date of acquisition. This will result in units deemed to be sold that are still on an affected entity's asset register, and units deemed to be held that have been sold. This could lead to questions being raised by the entity's auditors about the accuracy of the accounts.

Thirdly, in the context of tax consolidated groups, this rule creates further complexity. A consolidated entity may own mixed facilities (ie, an EITE facility and another facility). In such circumstances a facility by facility register would likely be kept due to the existence of free permits. The impact of both FIFO and tax consolidation means that free permits may need to be applied to meet the other facilities emissions liabilities.

Solution: In summary, the FIFO test is inappropriate and should be deleted from the bill.

2.4 Discrete code

Issue: The boundaries of this code and the operation of the anti-overlap provisions of the Consequential Amendments Bill are currently uncertain. Certainty is crucial, as whether expenditure is in or out of the code may give rise to potentially different tax treatments under Division 420 compared with the normal tax rules.

An example is the breadth of the proposed paragraph 420-15 (3) (what you can deduct) as modified by paragraph 420-65. The interaction between paragraphs 420-15(3) and 420-65 seems to provide that the costs incurred in receiving free EITE permits are not deductible under Division 420, but rather may be deductible under the general provisions (refer Explanatory Materials paragraphs 2.29 & 2.91).

Solution: To ensure certainty in respect of such outcomes notes need to be added to the legislation to specifically state that deductions may be available for such expenditure under other provisions of the normal tax rules.

2.5 Interface with the consolidation regime

Issue: On top of the FIFO issues discussed above, the one off valuation election (in paragraph 420-56 of the Consequential Amendments Bill) has an adverse impact on consolidated entities arising under the single entity rule, both in the context or entering and leaving entities for all groups and in the context of MEC groups. In any consolidated group there may exist two distinct entities (eg a trader and a manufacturer) each with different valuation needs. However, the rules require only one valuation rule to apply.

This problem is compounded for MEC groups where different ownership chains may have different valuation requirements (eg the manufacturer may be owned by the Asian Division of the multinational corporation while the trading entity by the European Division).

Further, the movement of companies between consolidated groups will result in valuation rules changing for those permits despite the paragraph 420-56 prohibition.

Solution: To reduce complexity, the "one-off" valuation election in the consolidation context needs to be removed.

2.6 Financial assets threshold

Issue: Given the likely significant increase in the use of derivatives associated with Emission Units, it is likely that affected entities will breach the financial assets threshold under the TOFA rules.

Solution: To reduce the potential compliance costs associated with a breach of the financial assets threshold, the threshold needs to be significantly raised for affected entities.

2.7 Stamp Duty

Issue: Although:

- the White paper acknowledges the Commonwealth has written to the States and Territories seeking agreement to not apply these taxes; and
- Treasury has advised the Taxation Institute that the States and Territories have agreed not to impose stamp duty despite the Intergovernmental Agreement on Federal Financial Relations, which began on 1 January 2009, permitting them to do so until 2013 (see in clause B4),

uncertainty about the issue remains in the absence of a formal statement. Clarity on the scope of undertakings by the States and Territories is also necessary. If the undertakings are limited ti Emission Units under the CPRS then States, such as New South Wales, will continue to impose duty on Torrens registered carbon credits.

Solution: To remove uncertainty there is a need for formal advice from the Minister that the States and Territories agree not to impose stamp duty in relation to Emissions Units. If the exemption is limited to Emission Units under the CPRS, then legislative protection will be required to ensure all carbon permits are exempt from Stamp Duty.

2.8 Unrealised gains on imported Kyoto units

Issue: Under the proposed paragraph 420-30 of the Consequential Amendments Bill 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 current market value of an equivalent permit/unit on the Australian exchange is treated as assessable income in the year the permit is imported and registered on the Australian register. 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 unrealised 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 (eg, changes in expiration dates, costs imposed in holding units in foreign registers and the like).

Solution: This again is an issue that needs to be addressed in the Consequential Amendments Bill by allowing the Kyoto units to be “acquired” at cost.

The Taxation Institute is happy to meet with Departmental representatives to further discuss our concerns. If you require any further information or assistance in respect of our submission, please contact the Taxation Institute's Senior Tax Counsel, Dr Michael Dirkis, on 02 8223 0011.

Yours faithfully

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