



Commercial & Corporate Legal Update

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Australia's Carbon Pollution Reduction Scheme (CPRS): a first look at the CPRS draft legislation

The introduction of a CPRS in Australia from 1 July 2010 will be one of the most significant economic and environmental reforms in decades. The changes are anticipated to directly affect over 1,000 business entities Australia wide and cause many others to strategically consider new ways of doing environmentally effective business. As Senator Wong, the Minister for Climate Change and Water, has said, the CPRS will put a price on carbon and encourage investment in new, low pollution technologies.

Over the past six months the Australian Federal Government has issued two consultation and information reports on the CPRS – the *Green Paper* and the *White Paper*. With the unveiling of draft legislation on 10 March 2009, the CPRS is finally starting to taking shape. This paper looks at the operation of the CPRS in its first draft.

The CPRS

Purpose of the CPRS

- the Scheme's target is to reduce greenhouse gas emissions in Australia by at least 5% from 2000 levels by 2020 (with an offer to increase the cut to 15% if a global agreement on carbon reductions can be reached). This translates to a per capita carbon reduction of between 27% and 34%. It ultimately seeks a reduction by 60% below 2000 levels by 2050.

Operation of the CPRS

- the Scheme is scheduled to start 1 July 2010.
- the Government proposes a "cap and trade" system, similar to the EU emissions trading scheme.
- from 1 July 2010, each entity in a covered sector (stationary energy, transport, fugitive emissions, industrial processes, waste and forestry) will be required to acquire and surrender annually a single permit for each tonne of CO₂ equivalent emitted. Failure to surrender the requisite permits will attract a penalty.
- all liable entities will be required to report the emissions for which they are liable under the Scheme. The report must be submitted to the Australian Climate Change Regulatory Authority by 31 October following the relevant financial year.

- it is expected that the CPRS will cover approximately 75% of Australia's greenhouse gas emissions. It will apply to the entities in a covered sector and all six greenhouse gases covered by the Kyoto Protocol. It is anticipated that there will be around 1,000 firms covered by the CPRS.
 - the Scheme will not apply to:
 - agriculture, which is excluded until at least 2015
 - deforestation (but the Government will explore opportunities to allow offset credits for certain reforestation activities on an opt-in basis), or
 - combustion of biofuels and biomass for energy.
 - entities liable under the Scheme are responsible for their own direct (Scope 1) emissions, but are not responsible for indirect (scope 2) emissions, such as emissions from purchased electricity, heat and steam that occur outside the boundaries of an operation.
 - the entity with "operational control" of a facility will be liable to surrender permits in respect of the facility's emissions, with permit liability to be aggregated at the "controlling corporation" level (ie the company at the top of the corporate group in Australia). The draft legislation also allows entities with "financial control" to opt-in as the responsible entity and allow allocation of permit responsibility within corporate groups.
 - generally, the emissions threshold for direct obligations under the Scheme is 25,000 tonne of CO₂ (or equivalent) or more a year.
 - where an entity emits more than 125,000 tonne of CO₂ (or equivalent) or more a year it will be required to have an independent audit completed to verify its pollution levels
- ### **Pricing of permits**
- unlike a carbon tax, the price of permits will be determined by the market, either at the regular Government permit auctions (held monthly) or via the secondary markets, which are expected to be very active.
 - the draft legislation puts the opening permit price at A\$25 per tonne. However, to limit the scope of upward pricing pressure, the Scheme will include two important safety valves - it will be subject to a five-year price cap (initially \$40 per tonne, then indexed annually at 5%) and will not include a make-good obligation. This price cap will be effected by the availability of an unlimited store of carbon permits at the price cap.
- ### **Carbon Budget**
- similar to the yearly Federal financial budget, the annual national emissions target will be converted into a carbon budget, with a corresponding number of permits made available to the market.

- a significant portion of the initial annual budget (in excess of 25%) will be provided free to qualifying entities as compensation (see below). The balance of the permits will be auctioned.

Holding and banking of permits

- the Scheme will allow for unlimited banking (ie surrendering permits from an earlier year in a subsequent year). Borrowing (ie surrendering permits from a subsequent year) will be permitted for up to 5% of an entity's obligations.
- permits will be treated as personal property and will be tradeable.
- permits will be regulated as financial products and carbon market participants will, in common with other financial markets, be subject to oversight by the Australian Securities and Investment Commission.

Taxation treatment of the CPRS

- the intention of the Government is that the taxation of the CPRS will be relatively consistent with the existing taxation system.
- in an effort to provide clarity and reduce complexity there will be a limited discrete taxing scheme introduced.
- the overarching policy is that the Scheme will generally provide the same tax treatment for permits purchased by tax payers who are carrying on a business or other income-earning activity as would occur under existing legislation.

Tax consequences of acquisition and disposal of permits

- under the CPRS the cost incurred in acquiring a permit will be tax deductible upon acquisition and the proceeds from the sale of a permit would be assessable income.
- the effect of this approach is to remove, although not expressly, the potential for CGT applying to permits and simplifies the treatment as characterisation issues between capital income are removed.
- if the permit is on hand at the end of the financial year, the deduction is deferred until the time the permit is surrendered or sold. Future date of permits also remain non-deductable unless they are used to satisfy a permit short-fall as permitted under the less than 5% borrowing rules. This is to be achieved through a rolling balance method similar to that used in respect of trading stock.
- under the rolling balance method the value of permits held at the beginning and end of the income year would be taken into account. The introduction of the rolling balance method is not without complexity as it does give rise to a potential tax accounting mismatch between the occurrence of an emission and the recognition of the liability. This is because the liability for tax purposes does not occur until the permit is actually surrendered, which at its latest is the acquittal date, being 15 December of each year.

- currently, there is no special timing rules which designate when a permit is to be surrendered. As such tax payers can choose to surrender the permits well ahead of 15 December and gain the benefit of the deduction in the previous year.
- the problem with this approach is that the permit surrendered will not be able to be revived from its surrendered status for the purpose of holding a transfer. This gives rise to a potential wastage of permits where an entity surrenders more permits than required to meet its obligations.

Valuing permits under the rolling balance method

- there are two methods prescribed for the valuation of permits under the rolling balance method - historical costs or market value. Once chosen, entities have limited opportunity to alter the valuation method adopted. They can only vary their choice once and that choice window will only be used in the first five years of the Schemes operation.

Application of GST

- under the draft legislation the GST Act will be amended so as to define permits (and eligible Kyoto units) as personal property rights and be treated as taxable supplies for GST purposes.
- the Government's rationale behind making permits a GST taxable supply is that the GST washes through and therefore lowers the trapped GST costs which would have occurred if the permits were input taxed.

Treatment of a administrative penalty

- administrative penalties arising from the failure to surrender eligible carbon pollution permits remain non-deductable.

Application of state taxes

- the Government is currently seeking state and territory agreement not to apply taxes (such as duties) to CPRS transactions as this would undermine the CPRS objectives by making the Scheme more costly and complex.

Other taxation issues

Foreign residents holding permits

- any income from trading permits will be treated as having an Australian source. This situation is not subject to special amendments or provisions within the draft legislation but will be dealt with by the current common law principles relating to ordinary income.

Consolidated groups of entities

- where permits are held by entities joining or leaving a consolidated group it is proposed to treat them as reset costs base assets in a similar way to the current treatment of trading stock.

Taxation of financial arrangements (TOFA)

- TOFA will not apply to the acquisition, holding and disposal of permits.

Taxation of free permits

- as discussed previously, the first year of the CPRS will involve the allocation of free permits to emission-intensive trade exposed industries (EITE industries). Importantly, the draft legislation differentiates the treatment of EITE industries from coal fire electricity generators.
- the value of administratively allocated permits issued to coal fire electricity generators that are on hand at the end of the income year they receive will be included in the tax payer's assessable income through the rolling balance mechanism in that year.
- the value of administrative allocated permits issued to EITE industries will be zero at the end of an income year ending before the last surrendered date for the emissions year for which they were issued. If administratively allocated permits are held at the end of later income year, the permit will be valued according to the election the tax payer makes between the historical costs and market value. The historical cost value would be the market value of the issue date.
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Timetable

- the Government tabled draft legislation on March 10 2009 with an express view to passing the legislation later in 2009. However, recent media reports suggest that the legislation is likely to face close scrutiny in the Senate, where both the Coalition and the Greens have flagged significant, but different, concerns.
- the Government hopes to have an interim carbon regulator established early in 2009, with the national permit registry operating by early 2010. The first compliance year will commence on 1 July 2010, with the first permit acquittal date set for 15 December 2011.

Moving forward

Companies should consider their potential exposure to the CPRS. Given the proposed timing, it is critical that companies begin to focus on their business activities and ask the relevant CPRS questions. These should include:

- What level of pollution do we currently emit?
- What pollution levels do we expect to reach by the start of the CPRS?.
- Will we be a CPRS liable entity and be subject to the CPRS?
- Do we meet the definition of a business operating in an EITE industry?
- What are the business and financial ramifications of the CPRS going to be?

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Some businesses should immediately be considering their current levels of pollution, and in some cases, be engaging auditors and consultants to truly understand the full impact of the CPRS. Such steps will assist with adaptation to and strategic preparedness for the introduction of the CPRS on 1 July 2010.

Watch this space

CBP will continue to keep clients advised of the latest developments and progress of the CPRS legislation.

Should you require any further assistance please contact Michael Russell.

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