Emission Critical

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Emissions Trading Tax Issues

The tax consequences of the Government's proposed emissions trading scheme (ETS) are the subject of an Officials' Issues Paper released for public consultation on 24 September 2007.

Tax issues arising from the proposed ETS include the treatment of emission obligations, the consequences of the allocation of emission units, the timing of recognition of income and expenditure, and the GST consequences.

The Issues Paper recognises that there are various ways tax issues arising from the scheme can be approached. These range from developing a comprehensive tax code to relying primarily on existing law. Officials' preference is to focus on areas where clarification of the law may be required, contemporaneously with the staged implementation of the ETS.

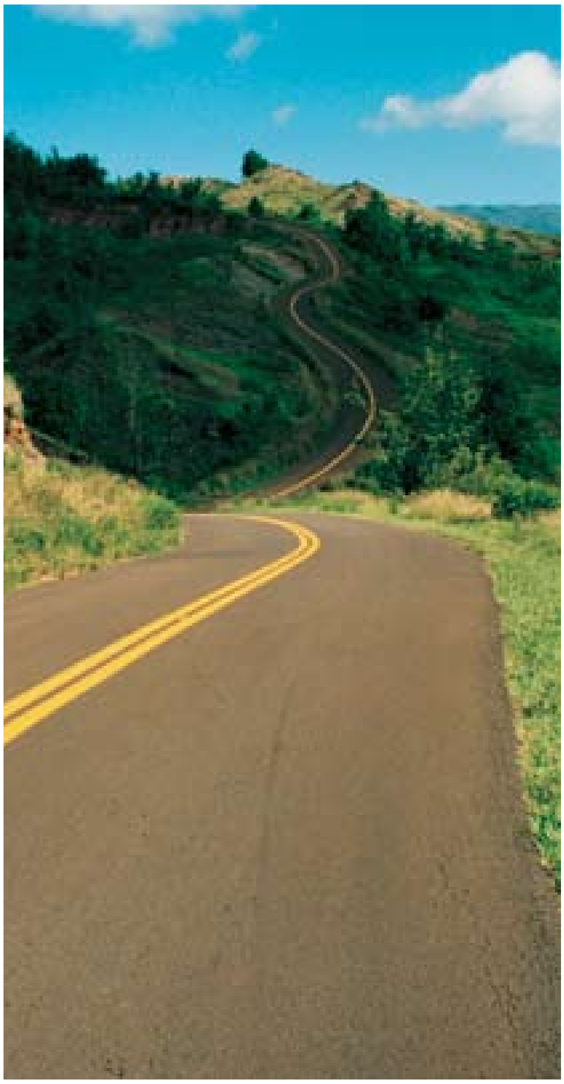
The Paper recognises that many of the design features of the ETS are still under discussion. Therefore, development of an appropriate tax code will be a progressive process.

Timing for submissions on the Issues Paper is tight. Submissions on the forestry issues must be made by 28 October 2007 and on general tax issues by 30 November 2007.

Scheme design

The detailed design features of the proposed ETS were highlighted in our Emission Critical, Issue 3, released on 21 September 2007. In summary:

- the New Zealand scheme will follow a cap and trade model.
- the primary unit of trade will be a New Zealand unit (NZU).
- scheme participants will have an obligation to surrender one NZU to cover each metric tonne of carbon dioxide equivalent (CO_2e) emissions.
- the scheme will operate on an annual 31 December compliance period.
- participants must maintain sufficient records to allow verification and reporting of emissions in an annual report for each compliance period.
- the Crown will allocate NZUs either free of charge or by auction. NZUs can also be purchased on the secondary market.
- the scheme will be linked to international trading markets.
- non-compliance will attract penalties.



Core tax issues in sectors other than forestry

Expenditure associated with a participant meeting obligations under the ETS is considered to be part of the cost of doing business and should be a deductible expense. The Issues Paper grapples with the timing of this deduction and suggests it should be recognised on an accruals or emerging basis over time.

Under the design features of the ETS, certain sectors will be given a free allocation of NZUs in order to protect them from adverse international competitiveness issues. The Issues Paper suggests that income from the free allocation of NZUs should be recognised as taxable income on an emerging basis over time. This income is to be recognised on a systematic basis, in the same periods as the expenditures which the NZUs are intended to compensate the participant for are recognised.

The design of the proposed timing rules for recognition of both income and expenditure are intended to safeguard many participants and avoid mismatches with early recognition of income and delayed deductibility for expenditure. However, the issues surrounding these timing rules are complex and could result in adverse implications for some participants. Specifically, the rules require market values to be used to determine the value of accrued income or expenditure at balance date. These amounts could be very different to actual income or liability amounts. Although the proposed rules correspondingly include a wash-up calculation in the year subsequent to balance date, timing implications, and in practice early recognition of income, may still arise. This is likely to be particularly relevant for participants not eligible for the allocation of free NZUs who will be required to purchase NZUs on the market. These participants are likely to use their treasury management expertise to determine the most advantageous timing for purchase of units. They may hold additional units as at their financial balance date.

Participants will need to do a reasonable part-year greenhouse gas inventory analysis to determine the quantum of emissions arising to balance date. Under the proposed timing rules for recognition of income and expenditure, appropriate tax accrual adjustments will be required in taxpayers' returns of income.

Core tax issues for pre-1990 forestry

The Kyoto Protocol does not recognise any sequestration from forests planted before 1990. However, to the extent pre-1990 forests are removed, a Kyoto liability will arise on the reduction in carbon stocks that result from any change in land use from forestry to some other purpose.

In order to compensate pre-1990 forest owners for the impact of these rules on their land values, the Government is proposing a one-off free allocation of NZUs, using an agreed pro-rata rate mechanism. Depending on the age of these forests, the NZUs may be issued for either, or both, the first Kyoto commitment period to 2012 and the second period commencing in 2013.

The Issues Paper suggests that the issue of free NZUs is effectively compensation for the impact on land values and should generally be treated as capital. Similarly, any liabilities arising from the change in land use from forestry to some other purpose should be capital in nature and non-deductible.

Core tax issues – forestry post-1989

The Government's proposed ETS gives post-1989 forest owners the option to elect into participating in the ETS. To the extent an election is made, any removal of carbon occurring as a result of forestry will result in entitlement to NZUs. Similarly, any deforestation from either harvest or other activity, including fire, will result in an increase in carbon requiring the surrender of NZUs to meet the carbon liability.

The Issues Paper proposes that units received as a result of carbon sequestration will be taxable as they are earned. Similarly, the cost of meeting obligations as a result of a decline in carbon stocks should be a tax deductible expense.

A number of timing issues arise as a result of the recognition of accruing obligations for harvesting post-1989 forests. The Issues Paper suggests two options to address this:

- recognising income from NZUs as it is received and allowing a deduction for expenditure on an emerging basis providing there is an intention to harvest; or
- deferring recognition of income from, and deductions for expenditure on, NZUs until the unit is used to settle an obligation arising under the ETS or is sold.

Officials have sought submissions on point and are interested in engaging with industry to discuss how best to manage this timing complexity.

Goods & Services Tax

The Issues Paper provides broad proposals for the GST consequences of NZUs. These consequences are based on the assumption that NZUs will be issued by a public authority which is registered for GST and has an obligation to charge GST on the supply of goods and services.

The key GST proposals are logical and in line with international norms. In summary:

- NZUs will be treated as a supply of services.
- NZUs allocated at no charge will be treated as a supply for no consideration.
- NZUs auctioned by the Crown will be subject to GST.
- Registered persons acquiring NZUs for the principal purpose of making taxable supplies will be entitled to claim input tax deductions.
- NZUs sold by registered persons to non-residents will generally be zero-rated.
- NZUs acquired from non-resident businesses and foreign agencies by persons in New Zealand will be treated as an imported service. A GST liability may arise on the importer under the reverse charge rules.

The Issues Paper acknowledges that NZUs may be traded by entities normally providing financial services, which are generally exempt for GST purposes. It requests submissions from this sector.

Compliance and enforcement

As outlined in Issue 3 of Emission Critical, the Government's preferred approach for compliance within the proposed ETS is similar to that used in the New Zealand tax system – one of self-assessment with reporting undertaken at least annually. Annual reports will need to be submitted by 31 March of the following year and emissions surrendered at the same time. Timeframes will be tight and businesses will need sound systems in place to be able to comply.

The penalty regime under the ETS is significant. Civil penalties will be imposed on participants who fail to meet their obligations and a participant who does so knowingly will face criminal liability. In a situation where a participant fails to surrender the required units, there is a requirement to make good the shortfall within 90 days of a determination of a breach by the administering agency, a financial penalty of $30 per tonne of shortfall, as well as a "name and shame" procedure.

These penalties may have severe consequences. Businesses will need to upskill quickly to ensure they understand their emission profile and how they will identify on a timely basis any potential shortfalls that they may need to make good.

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