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Submission on the Clean Energy legislative package

CPA Australia represents the diverse interests of more than 132,000 members in 111 countries throughout the world. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders.

Against this background, we provide the following comments regarding the above mentioned exposure draft legislation recently released by the Department of Climate Change and Energy Efficiency. These comments are made not only on behalf of our members but also for the accounting profession generally and the broader public interest.

The recommendations in the submission are made in the context improving the outcomes of the *Clean Energy Plan* and improving Australia's productivity growth. The submission addresses the following issues:

- + Reviewing the cost effectiveness of the current 230 climate change programs and policies and re-directing the funding of the least cost-effective policies towards market-based technology policy options, such as a premium research and development tax credit
- + Building tools to assist small business manage the introduction of the carbon price
- + Giving the Minister the discretion to delay the start of the carbon price in extraordinary circumstance
- + The need for longer-term guidance on the carbon price through emission gateways beyond the 5-year carbon pollution cap
- + Bringing forward the last date that the carbon pollution cap for the first five years of the flexible charge period is to be announced
- + Exempting liable entities from the need to hold an Australian Financial Services Licence for the disposal of carbon permits
- + Requiring all emissions disclosure under the carbon price mechanism to be subject to independent external audit before submission of such data to the regulator
- + Amendments to allow taxpayers to have the choice to make annual changes to the method they use to value carbon permits
- + Amendments to the safe harbour rules under the thin capitalisation provisions rules to reduce the risk of entities with significantly impaired assets due to the carbon price, breaching the thin capitalisation regime

Each of these issues is explored in more detail in the attached submission.

If you have any queries regarding this submission, please do not hesitate to contact Gavan Ord, Business Policy Adviser on (03)9606 9695 or gavan.ord@cpaaustralia.com.au.

Yours faithfully



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CPA AUSTRALIA'S SUBMISSION ON CLEAN ENERGY LEGISLATIVE PACKAGE

Recommendations on the *Clean Energy Plan*

Complementary policy options

CPA Australia believe that the Australian Government should consider a package of policy responses to climate change, not just a carbon price, to assist Australia meet its greenhouse gas emission reduction target and assist in boosting Australia's productivity growth.

We acknowledge that the Government's *Clean Energy Plan* has a number of complementary measures, however we believe that the Government should consider re-prioritising these complementary measures. Complementary policy measures should focus on those policies that achieve the most significant benefit (in terms of emissions reduction) for the least cost and address market failures of a carbon price. In particular, we believe that the *Clean Energy Plan* should have a greater focus on market-based innovation policies as a means of encouraging innovation in new low-emission technology and encourage the early commercialisation and adoption of such technology.

As Professor Garnaut noted in his seventh paper updating his 2008 report this year, *'Many studies find that either innovation policy or carbon pricing on its own is unlikely to yield outcomes that are as good as a combined package that balances both elements.'*

Further, for innovation policies to achieve their optimal outcomes, it should be the market and not governments that pick preferred low-emissions technology. In other words, policies should encourage business and public research institutions to explore research in all manner of potential low emissions technologies and leave it to the market to choose to develop the most promising technologies. As Professor Garnaut states *'Government is never well placed to determine which technology is going to be worthy of such patronage'*.

Why is a re-focus on market-based innovation policy important?

Professor Garnaut states that private under-expenditure in developing new low emissions technology is especially large and therefore the case for a higher rate of public subsidy is especially strong.

Why not just rely on the carbon price to encourage innovation?

As Professor Garnaut notes, even though a carbon price will lead to an increase in innovation, on its own it will not increase innovation by what he considers necessary. He forecasts that a special case for higher funding for innovation in low-emissions technology will go on for 'perhaps ten years' after a carbon price is introduced.

What market-based innovation policies should be considered?

Australia is part of a growing trend amongst developed economies to increase the use of entitlement-based schemes (such as the R & D tax credit) to increase assistance on innovation. In part due to such approaches being less likely to distort private decision making than more targeted direct support and overcoming the compliance issues associated with grants. Failure of technology is an inherent feature of innovation, hence technology policy must accommodate this. Grants are therefore not well suited to technology policy as the complex criteria for grants is partly attributed to the low tolerance for project failure by governments. Thus, allowing the market to decide the best low emissions technologies, as opposed to governments picking technology winners,.

We therefore recommend the Government re-prioritise its spending on complementary measures towards market-based innovation policies. Such policies are likely to yield a greater return to society, both in terms of reduced emissions for the least cost and productivity gains. Such policies could include:

- + a premium Research and Development tax credit for R&D into low emissions technology. This could be delivered through a 60 per cent tax credit (fully refundable), administered under the existing R&D tax credit regime.
- + accelerated depreciation for capital expenditure on replacing or upgrading existing plant and equipment with lower emissions technology
- + upfront investment allowance of 20 per cent for capital expenditure on low emissions technology

Recommendation:

The Government should re-prioritise its spending on complementary measures towards market-based innovation policies. Such policies could include:

- + ***a premium Research and Development tax credit for R&D into low emissions technology. This could be delivered through a 60 per cent tax credit (fully refundable), administered under the existing R&D tax credit regime.***
- + ***accelerated depreciation for capital expenditure on replacing or upgrading existing plant and equipment with lower emissions technology***
- + ***upfront investment allowance of 20 per cent for capital expenditure on low emissions technology***

Review of existing climate change policies

We are concerned that many of the approximate 230 plus climate change policies at both Federal and State levels do not provide taxpayers value for money in terms of taxpayer money spent for the emissions reductions achieved.

Further the sheer number of policies at different levels of government leads to policy overlap and higher compliance costs. As the Productivity Commission stated at page xvi in its research report titled *Carbon Emission Policies in Key Economies*: “While sheer numbers of policies say nothing in themselves about the materiality or effectiveness of the aggregate response made by governments, they indicate how complex the policy environment can be and, particularly in federal systems, the potential for overlapping policies with high administration and compliance costs.”

The Climate Change Authority should therefore be given the power to review existing and proposed climate change policies at both state and federal levels for their cost effectiveness at reducing emissions and make recommendations to government on such policies. The Authority should be given the power to recommend to Government that a policy should be discontinued.

As discussed above, where a complementary policy is of little effectiveness, the Government should shift the money allocated to that policy to more effective programs. In particular, such money should be re-directed towards funding a premium research and development tax credit for research into low emission technology.

Recommendations:

- + ***The Climate Change Authority be given the power to review and make recommendations on the effectiveness of all existing climate change policies at both state and federal government level.***
- + ***The resources given to climate change programs that are not cost effective in terms of the emissions reduction, should be re-directed to more cost effective programs, including a premium research and development tax credit for low emissions technology.***

Capacity building – tools for small business

CPA Australia supports the announcement in the *Clean Energy Plan* of funding for a campaign to assist business and community organisations with the introduction of the carbon pricing mechanism. Such funding should assist small business to build its capacity to respond to a carbon price, changing consumer sentiment and supply chain pressure.

We therefore recommend that part of that funding be allocated to the development of schedules that give businesses (non-liable entities under a carbon price mechanism) an accepted estimate of greenhouse gas emissions that each of their different items of plant and equipment emit.

Such estimates would be based on an agreed emissions figure that the average use of such plant and equipment would generate. Businesses would, therefore, need only to consult these schedules to determine the accepted emissions from the plant and equipment they use, rather than having to determine emissions using complex calculations. An example of a similar product is the effective life of assets schedules produced by the Australian Taxation Office. These tables give the accepted effective life of an asset where a taxpayer does not want to self-assess.

Recommendation:

The government develop comprehensive schedules that articulate single quantitative measures of emissions for specific items of plant and equipment, for use by businesses that are not reporting entities under the National Greenhouse and Energy Reporting Act 2007.

Recommendations on the *Clean Energy Bill 2011*

Commencement date of the carbon pricing mechanism

Given the current global economic uncertainty and Australia's patchwork economy, the Government should consider amending the *Clean Energy Bill 2011* to give the appropriate minister the discretion to delay the start of the carbon pricing mechanism if economic circumstances change significantly following passage of the *Bill* through Parliament.

Given that this may create further uncertainty, such discretion should only be used if extraordinary circumstances warrant the delay of the carbon price. Further, the discretion should only be available to be exercised by 31 December 2011 to reduce uncertainty.

Recommendation:

The Government consider amending the Clean Energy Bill to give the appropriate Minister the authority to delay the start of the carbon pricing mechanism in extraordinary circumstances.

Extending the carbon pollution caps

Having five-year carbon pollution caps for the flexible charge period of the carbon price mechanism does not provide business the level of certainty they require to make investment decisions. The adoption of a five or ten year emissions gateway beyond the five-year carbon pollution caps would provide business a greater degree of certainty on the trajectory of the carbon price over a 10 to 15 year period.

As many business assets have economic lives beyond five years, liable entities can make more informed investment decisions if they have greater certainty around what range the carbon price may trade in beyond the five-year carbon pollution cap period.

Recommendation:

The government, under the advice of the regulator, set a five to ten year emission gateway beyond the five-year carbon pollution cap. Such emission gateway way be extended by five years at each five-yearly independent review of the carbon pricing mechanism.

Tabling of regulations for the for the first five years of the carbon pollution cap numbers

We are concerned that under sub-section 16(1) of the Bill, the last date upon which regulations must be made by for the carbon pollution caps for the first five years of the flexible charge period, being 31 May 2014, is too late. Business desires more certainty on the carbon pricing, therefore the earlier such pollution caps can be made, the better. The date in the sub-section should therefore be brought forward a year.

Recommendation:

Sub-section 16(1) of the Clean Energy Bill 2011 be amended so that regulations setting out the carbon pollution caps for the first five years of the flexible charge period be made by 31 May 2013 instead of 31 May 2014.

Recommendations on the Clean Energy (Consequential Amendments) Bill 2011

Amendments to the Australian Securities and Investments Commission Act 2001

By proposing to define carbon unit as 'financial products' under subsection 764A(1) of the *Corporations Act 2001*, any entity that deals in such 'units', which includes acquiring or disposing of such units (see section 766C) is taken to provide a 'financial service' under paragraph 766A(1)(b) of the Act.

Under section 911A, a person that carries on a 'financial services business' must hold an Australian financial services licence (AFSL) covering the provision of that service. Entities that dispose of 'units' (including sale on a secondary market or by surrendering or relinquishing such units to the regulator) may be defined as undertaking a 'financial services business'. If so, such entities will either need:

- to hold an AFSL, or
- engage an AFSL holder to conduct the disposal on their behalf.

For a liable entity to become licensed (it is very unlikely that most liable entities are licensed) is an expensive exercise that comes with significant on-going compliance requirements. Also, engaging an AFSL holder to conduct the disposal of units on their behalf, also comes at a cost. This may well be a significant deterrent for non-liable entities, except AFSL holders to become involved in the purchase and trade of permits, possibly impacting upon the emergence of a liquid secondary market.

It is important for ASIC in consultation with affected entities, to determine whether entities that wish to dispose of carbon units are required to hold an AFSL so that those entities can better plan how they are going manage the disposal of such units. If ASIC finds that under the current law, liable entities are required to hold an AFSL, then Parliament should consider exempting liable entities from having to hold an AFSL in relation to the selling, surrendering or relinquishing of carbon units. This would reduce the costs and compliance burden associated with the carbon price mechanism.

Recommendations:

- + ***ASIC provide advice on whether entities that dispose of carbon units to third parties, surrender units to the regulator or are required to relinquish units to the regulator, carry on a 'financial services business' and if so, be required to hold an AFSL.***

+ If the surrendering or relinquishment of carbon units requires the entity to hold an AFSL, then the Corporations Act 2001 should be amended to ensure that liable entities are not required to hold an AFSL for that carbon unit.

Amendments to the National Greenhouse and Energy Reporting Act – Audit requirements

CPA Australia remains concerned that various issues we raised on ‘audit’ in our various submissions on the Carbon Pollution Reduction Scheme (CPRS) and the National Greenhouse Energy Reporting System have not been incorporated into the exposure draft of the *Clean Energy (Consequential Amendments) Bill 2011*. In particular, we remain concerned that the government remains committed to only imposing mandatory auditing of emissions reports for the largest of liable entities (see paragraph 1.80 of the commentary on the exposure draft).

We recommend that the assurance of emissions reporting be undertaken by independent third-party assurers, for all liable entities, prior to the submission of such reports. We make this recommendation for the sake of the integrity of the carbon pricing mechanism and to ensure that a stable and credible scheme is created.

Recommendation:

The emission reports of all liable entities be undertaken by independent third-party assurers, for all liable entities, prior to the submission of such reports to the regulator.

Amendments to various taxation acts

This section of the submission addresses a range of tax issues arising under proposed Division 420 of Schedule 2 of the draft consequential Bill.

We will also refer to various additional amendments which we recommend be included in the Bill to ensure that the interaction of proposed *Clean Energy Bill* and the *Income Tax Assessment Act (1997)* (the ITAA (1997)) are appropriately addressed.

Proposed Division 420

CPA Australia confirms that it is broadly supportive of most of the specific design features of the income tax regime for the purchase, surrender, relinquishment and sale of units under the carbon price mechanism as set out in the provisions of proposed Division 420 which is to be inserted into the ITAA (1997).

However, we believe that the draft consequential Bill and the accompanying commentary require amendment to clarify the application of proposed Division 420 to ensure that it operates as intended.

Our specific recommendations are as follows:

Proposed section 420-15

Proposed section 420-15 sets out the circumstances in which a liable entity will be entitled to claim a deduction upon incurring expenditure to hold a registered emissions unit.

Broadly, proposed sub-sections 420-15(3) and 420-15(4) respectively provide that expenditure incurred in becoming the holder of a unit will not be deductible under proposed Division 420 where the unit was issued because of the Jobs and Competitiveness Program, coal-fired electricity generation assistance or in accordance with the *Carbon Credits (Carbon Farming Imitative) Act 2011*.

Prima facie these provisions may therefore be interpreted on the basis that any other costs incurred in holding units under the above sub-sections would be non-deductible whereas the commentary on the draft provisions states that such expenditure may be allowable under other provisions of the income tax law.

Accordingly, there could be uncertainty or confusion on the deductibility of such costs if there is no reference in the provisions to that effect.

We believe that the above sub-sections should be amended to make it expressly clear that expenditure incurred in the above circumstances may be allowable under the general deductibility provisions in section 8-1 or the capital allowance provisions in Sub-Division 40-J of the ITAA (1997). Such amendments could be made by way of an additional paragraph or note to each sub-section.

Recommendation:

Amend sub-sections 420-15(3) and 420-15(4) to insert an additional paragraph or a note to make it expressly clear that expenditure incurred by entities which is not allowable under proposed Division 420 may be deductible under section 8-1 or Sub-Division 40-J of the ITAA (1997)

Proposed sub-section 420-50(2)

Proposed sub-section 420-50(2) provides that the value of a unit at the start of an income year is nil if the unit was not taken into account in calculating the closing balance of units in the prior year.

Paragraph 2.75 of the commentary to the draft provisions notes that such an outcome could arise where the entity has made an error in calculating the prior year's closing balance of units resulting in the omission of some units from that closing balance.

We believe that paragraph 2.75 of the commentary should be amended to make it expressly clear that entities can amend prior year returns for such omissions provided that such corrections were made within the four year period available in which an entity can request an amendment of an assessment to correct a prior year adjustment. Such an amendment would confirm that entities would be given a reasonable amount of time in which to correct inadvertent errors.

Recommendation:

Amend paragraph 2.75 of the commentary to the draft provisions to make it expressly clear that an entity can correct any omission of units in the calculation of a prior year's closing balance provided the error is corrected within the four year amendment period in which an entity can request an amended assessment.

Proposed sub-section 420-57 – Options for valuing permits

CPA Australia is concerned that proposed sub-section 420-57 limits the choice of valuation method for carbon permits by limiting the frequency with which a taxpayer may elect to change their valuation method. In practice both liable entities and traders of carbon permits should be able to apply the valuation method which best reflects their own circumstances. Further, the choice of method might change over time in parallel with the taxpayer's own changing circumstances.

Arguably, historical cost may be attractive to liable entities who have set up complex embedded systems to account for trading stock at cost, whereas market value may be attractive to financial intermediaries in the secondary market who may apply 'mark to market' practices in valuing financial products.

For example, if a taxpayer could only use historical cost for a set period of time, there could be a disincentive to surrender permits if their market value increased significantly as the deduction received would be less than the sale price of the permits if traded in the market. In this case affected entities may prefer to use a market value approach to reflect the underlying value of the permits.

In our view such distortionary behaviour can be best be minimised by amending proposed sub-section 420-57 to allow taxpayers to annually elect to value their permits under any three of the valuation methods. Such an approach is similar to the current position on trading stock under Division 70 of the ITAA (1997), which allows entities to annually elect to use one of three valuation methodologies.

Recommendation:

Sub-section 420-57 be amended to allow taxpayers to annually elect to value carbon permits under any three of the valuation methodologies.

Other proposed taxation amendments

Broadly, CPA Australia concurs with the raft of consequential amendments to the *Income Tax Assessment Act* (1936) and (1997) and the *Tax Administration Act* (1953) as currently set out in Schedule 2 of the exposure draft.

However, we believe that other amendments should be inserted into the draft consequential Bill to ensure that the interaction of proposed Division 420 with both the thin capitalisation provisions and certain capital gains tax provisions under the ITAA (1997) does not create adverse income tax consequences for liable entities.

Thin capitalisation provisions and asset impairment

CPA Australia notes that the book value of many tangible assets of entities in industries affected by the introduction of the carbon price mechanism may be required to be written down for book purposes under Australian Accounting Standard AASB 136 *Impairment of Assets* as their carrying value will have been impaired by the mechanism.

This AASB 136 states:

In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

- (b) *significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.*

For example, entities in the coal fired electricity sector may be required to write down the value of assets such as generators which may significantly diminish in value due to the carbon price mechanism.

This impairment of assets may also adversely impact liable entities which currently rely on the safe harbour provisions in claiming debt deductions (being principally interest deductions) under the thin capitalisation provisions set out in Divisions 820 of the ITAA (1997).

Very broadly, the safe harbour provisions only allow affected entities to fully claim debt deductions to the extent that the entity's aggregate debt does not exceed 75% of the entity's total assets as reduced by certain non-debt liabilities. To the extent aggregate debt exceeds this 75% threshold the amount of debt deductions will be commensurately reduced.

In determining the value of such assets and liabilities for thin capitalisation purposes, entities are required to have regard to accounting standards in determining the application of the safe harbour test under section 820-680 of the ITAA (1997).

Accordingly, where the value of certain assets has been impaired under the accounting standards there will be a reduction in the value of the entity's assets under the safe harbour provisions and a subsequent reduction in the entity's borrowing capacity from a tax perspective.

This could be extremely detrimental to many entities whose assets have been significantly impaired as a result of the introduction of the carbon pricing mechanism to the extent the scheme's introduction has proportionally reduced their allowable debt deductions.

Given the uncertainties generated by the mechanism, we recommend that the application of the safe harbour tests in Division 820 be amended to include a transitional provision in section 820-680 which does not require liable entities to recognise any impairment in the value of assets when applying that provision during the initial four years of the carbon pricing mechanism.

In our view such transitional relief provides affected entities with an appropriate period of time in which to develop appropriate commercial and funding strategies where the value of assets has been impaired.

Recommendation:

Amend section 820-680 of the ITAA (1997) to include a transitional provision that the valuation of assets for the purposes of the safe harbour tests in Division 820 does not include any reduction in value of the assets of a liable entity resulting from any impairment in the value of assets during the initial four years of the carbon pricing mechanism.

Capital Gains Tax

We note that the application of the Capital Gains Tax (CGT) rollover provisions in sub divisions 124-B and 126-B provide that an asset rolled over cannot be trading stock after an asset transfer in which case an equivalent exclusion should be inserted for registered emissions units.

As the treatment of such units is intended to be significantly similar to trading stock, the above rollover provisions should also be amended to exclude registered emissions units.

Likewise, the calculation of any capital gain arising under CGT Event K6 pursuant to section 104-230 excludes trading stock in determining the market value of a company or trust's property that was acquired on or after 20 September 1985.

It is contended that this provision be amended so that registered emissions units are similarly excluded from the application of this test under section 104-230 thereby ensuring equivalent treatment to the exclusion of trading stock for CGT Event K6 purposes.

Recommendation

Amend Sub Divisions 124-B and 126-B and section 104-230 of the CGT provisions of the ITAA 1997 to ensure that existing exclusions in those provisions for trading stock are extended to also exclude registered emissions units.

Other

- A liable entity with a substituted accounting period should be allowed to synchronise its compliance year end for the purpose of the carbon pricing mechanism with its accounting and tax year end to avoid unnecessary cost and duplication.