

TAX BULLETIN

An update publication for our clients

13 July 2011

The new carbon tax scheme – what does it mean?

Overview

There has been considerable debate in recent months over the introduction of a carbon tax - much of it driven by the uncertainty as to: (i) who would be subject to it; and (ii) on what the tax might fall. On 10 July 2011 the Government announced the introduction of a price on carbon pollution, which will commence on 1 July 2012. Simultaneously, the Government released over 200 pages of detailed information on the operation of the new regime.

The Government states that around 500 of the biggest polluters in Australia will be required to pay for the greenhouse gases they produce under the carbon pricing mechanism. Liable businesses will need to buy and surrender to the Government a permit for every tonne of greenhouse gases they produce. Furthermore, modifications have been proposed to the fuel tax credit system that will impose an effective carbon tax equivalent for the use of certain fuels by most industries - with the exception of agriculture, fishing and forestry.

For the first three years the carbon price will be fixed - before moving to an emissions trading scheme in 2015. In the fixed price stage, which runs from 1 July 2012 to 30 June 2015, the carbon price will start at \$23 per tonne and will rise by 2.5 per cent a year in real terms.

From 1 July 2015 onwards, the price will be set by the market and the number of permits issued by the Government each year will be capped.

The Government has indicated that Exposure Draft legislation will be released by 31 July 2011 covering the new regime.

Implications of the new regime

As outlined above, the new regime will directly impact on at least 500 of the largest carbon emitters in Australia. Those entities will need to comply with the cost, administration and regulatory requirements of the new regime. In particular, there will be various audit, accounting, taxation and GST implications of the new regime for those entities.

For all other businesses outside of the top 500 carbon emitters there is likely to be both a direct and indirect cost of the new regime. In particular, the cost of inputs is likely to be influenced by a number of factors including (but not limited to):

- the level of the direct use of energy;
- the level of processing involved in producing the final product or service;
- whether the product or service is predominantly completed in Australia or overseas (i.e. import versus domestic production); and
- the effect of the regime on transportation costs (taking into account the level of transport required and the type of transport used).

Those entities most likely to be adversely effected by the new regime will be those:

- less able to pass on an increase in their costs to consumers; or
- who have entered into long term contracts with little (if any) room to change the price over the period of the contract.

Businesses are encouraged to consider, model, monitor and implement a plan in respect of the possible effects of the new regime.

The Government has outlined a number of support and grant packages that will be offered to businesses to assist in the transition to the new regime. For example, some small businesses (i.e. those with an aggregated turnover of less than \$2 million per year) will be provided a tax write-off of \$6,500 from 1 July 2012 for new assets they purchase on or after that date.

Business entities should thus, begin considering whether they will be eligible for any assistance under these packages - in particular, there will be many small businesses that do not qualify for the tax write-off of \$6,500 mentioned above but which will still have additional costs to absorb.

The Government has also simultaneously outlined personal tax rate cuts and assistance to be provided to low income earners and pensioners from 1 July 2012.

Further details of the above measures and what they mean are contained in the Attachment to this alert.

Our view on the new regime

We believe that the effect of a carbon tax on the thousands of businesses that operate in the middle market is not just an important question - it is a crucial one. The middle market is the largest employer group in Australia and any increases in the cost structures of businesses in this market will have a direct effect on not just the profitability of these businesses but also on the employment prospects of thousands of workers.

Whilst we doubt that any of our clients will actually be classified as 'polluters' (and thus bear the direct cost of the proposed carbon tax), we expect that the major challenge for most of our clients will be to model and quantify the indirect impact of the tax on their businesses.

In this regard, the carbon tax is not just an impost about which only our manufacturing clients need be concerned - service industries (including accounting, law and financial planning) will also bear the indirect costs of the tax and thus, should consider becoming familiar with how the tax will impact their operations.

As a number of commentators have pointed out, the costs which are likely to increase as a result of a carbon tax include power supplies, information technology, manufacturing inputs, transportation and general travel.

Repairs and maintenance costs are also likely to increase as the design and operation of existing plant and equipment may need to be modified - i.e. in order for it to become more energy efficient and reduce emissions.

In summary, in our view it is crucial that businesses consider the potential effect of the new regime on their operations well before 1 July 2012.

Attachment – details of the new regime

Impact on various business sectors

The new regime will have both a direct and an indirect impact on a number of entities within our economy - especially those entities who will be liable to pay a carbon tax (or an equivalent through a reduction in fuel tax credits). In addition, as any increases in costs from the new regime will be passed on to consumers (including other businesses), there will directly and indirectly be an impact on prices charged by almost all businesses in Australia. Accordingly, the new carbon tax will have a significant impact on many business sectors from 1 July 2012.

Direct effect on entities

Liable entities

Only businesses that release over a certain amount of carbon pollution a year, or are large suppliers of natural gas, will pay the carbon price. The Government has stated that around 500 of the biggest polluters in Australia will be required to pay for the greenhouse gases they produce under the carbon pricing mechanism.

Businesses that have direct greenhouse gas emissions of 25,000 tonnes a year or more (excluding emissions from transport fuels and some synthetic greenhouse gases) will be covered. There will be a lower threshold of 10,000 tonnes a year for certain landfill facilities.

Retailers of natural gas will be liable for carbon pollution from the use of the fuels they supply to customers.

The entity liable for direct emissions from a business will generally be the entity with operational control over that business (that is, authority to introduce and implement any or all of the operating, health and safety and environmental policies for that business).

As the Climate Change Plan material that has been released by the Government uses phrases/terms that are also used in the National Greenhouse and Energy Reporting Act, we expect that the measurement and reporting of the greenhouse gas emissions covered by the carbon pricing mechanism will be dealt with under that Act.

Changes to the fuel tax credit system

While fuels will not be subject to the carbon tax itself, the Government has determined that fuels will be subject to an equivalent tax when used for business transport and non-transport use. This is due to the use of fuel being a major contributor to carbon dioxide emissions.

The equivalent tax will be imposed by reducing the extent of fuel tax credits available to eligible entities by an amount comparable to the carbon tax. This measure will impact a wider range of businesses than the 500 large polluters that have been targeted for the carbon tax.

At present, entities engaged in a number of industries are eligible to claim a fuel tax credit in respect of the excise included in fuel used in their activities. For a number of these industries, their fuel tax credit entitlement will be reduced by a carbon tax equivalent amount. These reductions are intended to apply to fuels acquired after 1 July 2012.

Category	Fuel Tax Credits	Carbon tax equivalent reduction in credits*	Direct Cost Increase
Light road transport vehicles (4.5 tonnes or less)	No	N/A	No
Heavy Road Transport vehicles (more than 4.5 tonnes)	Yes	Yes	Yes
Agriculture	Yes	No	No
Fishing	Yes	No	No
Forestry	Yes	No	No
Mining	Yes	Yes	Yes
Marine transport	Yes	Yes	Yes
Rail transport	Yes	Yes	Yes
Construction	Yes	Yes	Yes
Manufacturing	Yes	Yes	Yes
Wholesale/retail	Yes	Yes	Yes
Property management	Yes	Yes	Yes
Landscaping	Yes	Yes	Yes

* The reduction in fuel tax credits will be adjusted each year as the carbon tax rate increases

Aviation Fuels

Aviation fuel excise will be increased by an amount equivalent to the effect of placing the carbon price on aviation fuel. This is because fuel tax credits are not available for aviation fuels so that mechanism is not available as a cost adjustment measure. This measure will only apply to fuel for domestic use and not international travel.

GAS fuels (CNG, LNG and LPG)

Where CNG, LNG and LPG gases are used in road transport, at present the fuel tax credit is offset by a road user charge. Accordingly, the fuel tax credit is effectively denied. As such an equivalent carbon tax charge will not be applicable on the use of these gases.

Where these gases are used in off road transport, at present a fuel tax credit is available. Accordingly, there will be a reduction in fuel tax credits equivalent to placing a carbon tax on the emissions.

Non-transport use of CNG, LNG and LPG is currently subject to an automatic remission of excise. This will be reduced through a partial remission to reflect an effective carbon price.

Indirect effect on entities

Increase in input costs

The various reports issued by Government indicate that the expected increase in cost (per household) will be approximately \$9.90 per week from 1 July 2012. However, the Government has also indicated

that tax cuts and other forms of household assistance will generally result in additional disposable income of approximately \$10.10 per week. The Government has stated that it believes that the price of most household purchases (other than electricity and gas), is likely to move by less than 1 per cent. Taking electricity and gas into account, the Government has estimated that the overall impact on the Consumer Price Index (CPI) is expected to be around 0.7 per cent in 2012-13. Accordingly, the Government has indicated that they believe the impact of the carbon tax will be marginal.

However, while the Government has tried to place a positive spin on the introduction of the carbon tax, the reality for many business entities will be that the new regime will result in increased input costs. The exact effect on any entity will be dependent on the industry sector that the entity operates in, the types of inputs used, as well as the ability to pass on those costs to consumers.

A number of recent reviews have indicated that many business entities, in various industries, may lose a modest amount of earnings per share (EPS) in the initial phase of the introduction of the carbon tax regime. Those most likely to be impacted will be those less able to pass on an increase in their costs to consumers. This will also be influenced by: the level of the direct use of energy; the level of processing involved in producing the ultimate product or service; whether the product or service is predominantly completed in Australia or overseas (i.e. import versus domestic production); and the effect of the regime on transportation costs (taking into account the level of transport required and the type of transport used).

Furthermore, assistance packages being offered to various industries will also have an effect. For example, assistance to the steel industry through the Jobs and Competitiveness Program (discussed later) will have an indirect effect on those industries that are heavily reliant on steel as an input.

Long term contracts

In the short to medium term, the carbon tax may have a significant impact on those entities that have entered/will soon enter into long term contracts - for example, long term construction contracts. This will occur if input prices rise significantly from 1 July 2012 and the contract does not allow those prices to be passed on. Businesses should thus, be reviewing their current long term contracts to determine if they allow for appropriate price adjustments. Where new long term contracts are currently being negotiated, it will be prudent for businesses to factor in the potential increases in costs that may arise due to the carbon tax.

Modelling and decision making

While the implementation of the carbon tax seems a while away (i.e. 1 July 2012), it will be prudent for businesses to start thinking about how the new regime may affect business operations.

While it may be difficult for many entities to understand the exact effect of the new regime in the short term (and therefore, model and predict the outcomes), businesses should at least start to consider appropriate modelling (e.g. sensitivity analysis and input cost identification) to determine what it may mean to the bottom line under various scenarios. In particular, it will be critical for businesses to understand the expected change to input prices, the affect on product demand and the ability to adjust prices.

Businesses will also need to put in place appropriate governance processes to ensure that the new regime and its business impact are continually monitored up to 1 July 2012 and beyond.

Support and incentives

Due to the impacts that the new regime will have on many businesses in various industries and sectors, the Government has also announced a number of assistance measures. The Government has indicated that it will allocate around 40 per cent of carbon price revenue to help assist businesses through these measures. The measures include job assistance packages, as well as other grants and incentives. Businesses should begin considering their ability to access these assistance packages.

Job packages

A number of job packages and incentives have been announced that are aimed at providing assistance to those businesses that are most affected by a carbon price.

Jobs and Competitiveness Program

One of the most significant of these packages is the “Jobs and Competitiveness Program”. The program will aim to provide assistance to those emission intensive industries exposed to international competition. Those industries include steel manufacturing, aluminium production, pulp and paper manufacturing, glass making, cement production and petroleum refining.

To provide assistance to these industries, the Government will allocate (free of charge) Australian carbon permits. Essentially, assistance will be provided through two measures depending on the type of entity. That is, the most emission-intensive and trade-exposed activities will initially be eligible for a 94.5% shielding from the carbon price. A second category of assistance (for less emissions-intensive trade-exposed activities) will be provided to cover 66% of the carbon price. The assistance rates will be reduced by a carbon productivity contribution of 1.3% a year to provide additional incentives over time for these industries to reduce pollution. This ongoing program will provide \$9.2 billion of assistance over the first three years of the carbon pricing mechanism.

Coal Sector Jobs Package

The Government has also announced a “Coal Sector Jobs Package”, which will provide transitional assistance to help the coal industry implement carbon abatement technologies for the mines that produce the most carbon pollution.

Steel Transformation Plan

Furthermore, Australian steel makers will receive assistance through the Steel Transformation Plan worth \$300 million over four years to: (i) encourage investment and innovation; and (ii) promote the development of workforce skills in the Australian steel manufacturing industry.

Grants and other incentives

A large number of other grants and incentives have also been announced by the Government to provide assistance to businesses.

Small business asset write-off

Following the Government’s 2010 election promise to introduce a tax write-off for business assets costing up to \$5,000 for small business entities (i.e. small businesses with an aggregated turnover of less than \$2 million per year), this threshold is proposed to be further increased to \$6,500 from the 2012/13 income year.

Clean technology program

The Clean Technology Program is proposed to help directly improve energy efficiency in manufacturing industries and support research and development in low pollution technologies. The program will cost \$1.2 billion and will include three programs:

- The Clean Technology Investment Program – competitive grants totalling \$800 million over 7 years from 2011/12 to be provided to manufacturing businesses to support investment in energy efficient capital equipment and low-emissions technologies, processes and products.
- The Clean Technology Food and Foundries Investment Program – competitive grants totalling \$200 million over 6 years from 2011/12 to the food processing, metal forging and foundry industries to invest in energy efficient capital equipment and low-emissions technologies, processes and products. These industries are trade exposed, and have higher exposure to energy costs than other general manufacturing businesses.
- The Clean Technology Innovation Fund – competitive grants totalling \$200 million over 5 years to be provided to support business investment in research and development in the areas of renewable energy, low-emissions technologies and energy efficiency.

Low carbon communities program

The Low Carbon Communities program will be redesigned and will provide additional funding of \$250 million over four years through competitive grants to local councils and community organisations to undertake energy efficient upgrades of buildings, facilities and street lights.

Energy efficiency information grants

In order to help small businesses understand the implications of the Government's clean energy plan and how they can reduce energy costs, the Government will establish a \$40 million program providing grants over four years to industry associations and non-government organisations which have established relationships with small businesses and community organisations.

Biodiversity fund

An ongoing Biodiversity fund will be established and will provide funding of \$946 million over the first six years for landholders to undertake projects that establish, restore, protect or manage biodiverse carbon stores.

Carbon farming futures initiative

As part of the ongoing Carbon Farming Futures initiative, the Government will invest a further \$201 million over the first six years, for research into new methods of storing carbon and reducing pollution on the land, including:

- Funding of \$20 million to convert research into practical methodologies recognised under the Carbon Farming Initiative.
- Grants of up to \$99 million for landholders to take action on the ground, including testing new ways to increase soil carbon and reduce pollution.

Farming

The Government has indicated that a carbon price will not apply to agricultural emissions. This means there will be no requirement for farmers to pay for emissions from livestock or fertiliser use.

Personal tax cuts

Proposed income tax cuts

The Government has proposed changes to the personal income tax rates with new rates taking effect over two stages commencing on 1 July 2012 and 1 July 2015 respectively. Significantly, the tax-free threshold will be increased from \$6,000 to \$18,200 for the 2012/13 income year and to \$19,400 for the 2015/16 income year.

When combined with changes to the low income tax offset outlined below, 2012/13 will see tax savings of up to \$600 for individuals earning less than \$20,000, reducing to \$300 for individuals earning \$65,000 and \$nil for individuals earning in excess of \$80,000.

The following table outlines the proposed new tax rates applicable to resident taxpayers for the 2012/13 and 2015/16 income years when compared to the current personal income tax rates (excluding the Medicare Levy).

2011/12 Personal income tax rates*		2012/13 Personal income tax rates		2015/16 Personal income tax rates	
Taxable income (\$)	Rate (%)	Taxable income (\$)	Rate (%)	Taxable income (\$)	Rate (%)
0 – 6,000	0.0	0 – 18,200	0.0	0 – 19,400	0.0
6,001 – 37,000	15.0	18,201 – 37,000	19.0	19,401 – 37,000	19.0
37,001 – 50,000	30.0	37,001 – 80,000	32.5	37,001 – 80,000	33.0
50,001 – 80,000	30.5				
80,001 – 100,000	37.5	80,001 – 180,000	37.0	80,001 – 180,000	37.0
100,001 – 180,000	38.0				
180,001 +	46.0	180,000 +	45.0	180,000 +	45.0

* Includes the impact of the flood levy applicable for the 2011-12 income year only

Low Income Tax Offset

The increase in the tax-free threshold from 2012/13 has been partly offset by a reduction in the low income tax offset (“LITO”) available to low and middle income earners. Together with the increase in the tax-free threshold above, the effective tax-free threshold after allowing for the LITO will increase from \$16,000 in 2011/12 to \$20,542 in 2012/13 and \$20,979 in 2015/16. A summary of the proposed changes to the LITO is provided in the following table:

2011/12 LITO		2012/13 LITO		2015/16 LITO	
Taxable income (\$)	LITO (\$)	Taxable income (\$)	LITO (\$)	Taxable income (\$)	LITO (\$)
0 – 30,000	1,500	0 – 37,000	445	0 – 37,000	300
30,001 – 67,499	\$1,500 reduced by 4% per \$1 of income over \$30,000	37,000 – 66,666	\$445 reduced by 1.5% per \$1 of income over \$37,000	37,000 – 66,999	\$300 reduced by 1% per \$1 of income over \$37,000
67,500 +	Nil	66,667 +	Nil	67,000	Nil

Pensioners

Pensioners will receive further assistance under the carbon tax scheme. The Government has firstly proposed a Clean Energy Advance which will see a tax exempt lump sum payment in May-June 2012 of up to \$250 for singles and \$190 for each eligible member of a couple.

Secondly, a Clean Energy Supplement will be paid from 20 March 2013 which will provide a 1.7% increase to the maximum pension rate. This supplement will result in an increase of up to \$338 for singles and \$255 for each eligible member of a couple per annum. The supplement will be indexed to CPI.

Accounting and taxation implications

For those businesses both directly and indirectly impacted by the new carbon pricing mechanism, there will be accounting and taxation implications. As the new regime will start from 1 July 2012, those affected business will need to start considering those impacts from now.

Accounting and reporting

The accounting and reporting requirements of many businesses will be impacted by the introduction of a carbon tax plan as detailed below.

Liable entities

The estimated 500 large businesses which will be subject to the carbon tax are likely to be already reporting under the National Greenhouse and Energy Reporting Act 2007. In order to comply with carbon tax plan requirements, these businesses will need to implement appropriate systems to reliably capture necessary data in relation to carbon emissions.

The accounting for carbon permits will result in new assets, liabilities and expenditures being recorded within the financial statements. In addition, timing differences may arise between the accounting income and expense and the tax assessability and deductibility of carbon permits, which will result in the recording of deferred tax amounts. The accounting for carbon permits will be in accordance with international accounting and audit standards as adopted in Australia. This requirement underlines the importance of the establishment of reliable data capture systems.

Indirectly impacted entities

Any entity that has assets subject to impairment testing will need to consider the impact of the carbon tax plan on their 30 June 2011 impairment models. Judgement will be required in assessing the level of

uncertainty in relation to the impact of the carbon tax plan. This assessment may result in the requirement to incorporate the impact into the impairment models or the disclosure of the uncertainties within the financial report.

Similar issues exist for an entity that is recording income under a long term contract. An assessment of the impact of the carbon tax plan on these calculations will be required where the contract extends beyond 1 July 2012.

Businesses that qualify for grants under the assistance program will account for such grants in accordance with existing accounting standards.

Taxation treatment

Specific provisions will be inserted into the income tax law to deal with the treatment of permits, including the acquisition and use of permits, as well as the sale and exchange of permits.

Deductions

The cost of purchasing a permit will be deductible, however, the deduction will be deferred until the permit is sold or surrendered. This will be achieved through an adjustment to taxable income similar to that required in respect of trading stock: described as a 'rolling balance method'.

Under the rolling balance method, taxpayers will be able to elect to value permits that they hold at either their historical cost or at market value, with the default being historical cost. Taxpayers will be able to change their choice of valuation method once during the fixed price period (the 2013 – 2015 income years). Thereafter, a change in valuation method will be permitted once every five years.

Expenditure incurred in becoming the holder of a permit will be deductible in the year the taxpayer starts to hold a permit. However, exceptions will apply where the permit is issued as part of an assistance arrangement or is an Australian carbon credit unit issued under the Carbon Farming Initiative.

A deduction will be denied for any penalties (including shortfall charges) imposed under the carbon pricing mechanism.

Assessable income

Where a permit is sold, rather than being surrendered, the proceeds of selling a permit will be assessable income on revenue account in the income year the permit is sold. The treatment of assistance grants (and the assessability of such grants) will be governed by the existing tax law.

Treatment of free permits etc.

Generally, the taxation rules will operate so that the value of a permit will be deemed to be its market value where it is: (a) transferred under a non-arm's-length transaction between related parties or a transaction with an associate; (b) issued to the taxpayer as part of an assistance arrangement; or (c) it is an Australian carbon credit unit issued under the Carbon Farming Initiative. If a taxpayer receives a free permit, this may mean that they are assessed upfront on the value of the permit - with a deduction then being claimed upon a subsequent surrender or sale.

However, permits that are freely allocated to entities undertaking an eligible emissions-intensive trade exposed (EITE) activity will be valued at zero where certain conditions are satisfied.

GST treatment

Supplies of permits under the carbon pricing mechanism will be GST-free. This is to ensure that the price and trading of the permits is not distorted through the imposition of the GST. GST-free treatment also means that an entity is not denied input tax credits in respect of any GST included in the cost of related acquisitions.

The Government has announced that application of the normal GST rules will apply to transactions in financial derivatives of permits and payments of grants of assistance. Financial derivatives are financial supplies and input taxed and so not subject to GST in any event though there may be a denial of any GST included in the price of related acquisitions. Grants may be subject to GST depending on the terms on which they are given to taxpayers.

Further Information

Please ask either your regular Pitcher Partners tax contact or any of the contacts in the Pitcher Partners firms below for further details on the issues raised in this Tax Bulletin:

Melbourne

John Brazzale
john.brazzale@pitcher.com.au
+61 3 8610 5110

Sydney

Chris Ardagna
cardagna@pitcher-nsw.com.au
+61 2 9223 1762

Adelaide

Richard Brooks
richard.brooks@pitcher-sa.com.au
+61 8 8179 2800

Perth

Julie Strack
strackj@pitcher-wa.com.au
+61 8 9322 12 62

Brisbane (Johnston Rorke)

Chris Ball
cball@jr.com.au
+61 7 3220 0355

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