Income Tax Treatment of Emissions Trading Permits

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Emissions Trading Schemes

- First choice policy response for controlling GHG
- Objective – use market forces to achieve lowest cost GHG abatement
- Basic features
  - Regulatory authority sets global cap of emissions
  - Permits are issued allowing one unit of emissions for each permit held
  - Permits (usually) issued either via auction or for free (grandfathering)
  - One permit must be surrendered per unit of emissions
  - Permits may be traded on a secondary market
    - Free permits may be restricted
  - Penalties for non-compliance

Income Tax

- Generally overlooked aspect
- Important interaction
  - Acceptance of environmental measures dependent on business acceptance
    - Income tax = business cost
    - Influences business position
  - Inappropriate treatment may distort behaviour
    - Undermine environmental objectives
      - Setting cap on emissions
      - Compare with carbon tax
    - Undermine lowest cost abatement objective

Income Tax

- Three broad approaches
  - ETS outside income tax completely
    - “Implicit assumption” (OECD)
  - Subject to general provisions
    - New Zealand, United Kingdom
  - Specialist provisions
    - Australia (prior to 2014 repeal)

Income Tax Issues

- Treatment of permits upon acquisition
- Treatment of abatement costs
- Treatment of income from selling permits
- Treatment of freely allocated (grandfathered) permits
- Treatment of penalties for non-compliance
- Recognition (timing) issues
- International harmonisation

Acquisition costs

- Capital v revenue?
  - Intention?
  - Compliance? Trading profits? Capital growth?

- Business v private?
  - Voluntary acquisition

Treatment of Abatement Costs

- Similar issues re permit acquisition costs

- Probably more likely to be capital than acquisition costs
  - Eg investment in more efficient machinery/processes

- Main issue: alignment with acquisition costs?
  - Potential for distortionary incentives
    - Capital costs normally non-deductible
      - Possible deductible over time (how long?)
    - May be cheaper to abate than emit (pre-tax)
    - Non-deductibility of abatement cost may cause after tax cost of emitting (with permit) to be lower than abatement
    - Undermines objective of lowest cost abatement

Treatment of income from sales

- Capital v income
  - Trading v investment
  - Treatment if intention changed?
    - Eg initially compliance purpose, but sold as permit price increased above abatement cost
    - Should sell in this situation
    - Tax treatment may undermine this purpose
      - Gains assessable, cost of permit not deductible?

- Gross receipt v profit? Losses?

Treatment of Grandfathered Permits

- Income?
  - Government grant?
  - Valuation issues
    - Market value if functioning secondary market
      - Which market value?
    - What if no market?

- Issue around barrier to entry
  - Non-tax, but influenced by tax treatment
  - Entrenchment of past behaviour
  - May undermine environmental objectives

Treatment of Penalties

- Penalties for non-compliance
  - Deductible?
    - Penalties often not
      - Eg s 26-5 of the ITAA 1997 (Aust)
    - Double penalty?

- How to set?
  - Fixed or floating (ref to MV of permits)?
    - Floating – timing issues?
  - Fixed may be below MV
    - Operate more like a carbon tax
    - Undermine environmental objective

Recognition Issues

- Timing of deductions
- Matching to income produced (by emissions)?
- Frequent – deduction upon surrender
  - See Australia
  - May be after year end
    - Yr 1 = income, Yr 2 = permit deduction
- Caused by need for annual reporting
  - Solution?
    - Backwards attribution
      - Compliance permits only
    - Different compliance year v income tax year

International tax

- Tax treaty issue
  - Article 7 (business profits) v 13 (capital gains)
    - OECD – no difference
  - Article 6 (immovable property)
    - More of a problem
    - Potential for some jurisdictions to attach permits to specific location

- Harmonisation
  - Potential for leakage due to more favourable tax treatment
  - Undermines both environmental and lowest cost goals