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Abstract

The Government's clean energy strategy, to commence from 1 July 2012, departs from the former Carbon Pollution Reduction Scheme (CPRS) in a number of ways. One key departure is the Carbon Farming Initiative (CFI). The CFI signals a change in approach to land use issues from the previous CPRS, as the Government has decided agriculture and other land-based activities will not be covered by the carbon pricing mechanism. Rather, changes in land use will be incentivised by way of the CFI. The CFI also goes well beyond the forestry-based activities included in the CPRS to cover many and varied project types.

This article explores the tax implications of key elements of the CFI. It describes the link between the CFI and the carbon price that forms the basis for the inclusion of units issued under the CFI in the taxation rules. It also outlines the key operation and taxation elements of the revised clean energy scheme and highlights key departures from the CPRS.

Keywords

carbon farming taxation, Carbon Farming Initiative (CFI), Clean Energy legislation, greenhouse gas tax

FARMING CARBON: TAXATION IMPLICATIONS OF THE CARBON FARMING INITIATIVE

CELESTE BLACK* AND MICHAEL DIRKIS**

The Government's clean energy strategy, to commence from 1 July 2012, departs from the former Carbon Pollution Reduction Scheme (CPRS) in a number of ways. One key departure is the Carbon Farming Initiative (CFI). The CFI signals a change in approach to land use issues from the previous CPRS. The Government has decided agriculture and other land-based activities will not be covered by the carbon pricing mechanism. Rather, changes in land use will be incentivised by way of the CFI. The CFI also goes well beyond the forestry-based activities included in the CPRS to cover many various project types.

This article explores the tax implications of key elements of the CFI. It describes the link between the CFI and the carbon price that forms the basis for the inclusion of units issued under the CFI in the taxation rules. It also outlines the key operation and taxation elements of the revised clean energy scheme and highlights key departures from the CPRS.

INTRODUCTION

The passage of the Clean Energy Legislative Package through the Senate on 8 November 2011,¹ and the subsequent grants of royal assent during November and

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¹ The Clean Energy Legislative Package consists of:

- *Clean Energy Act 2011 (CE Act)*;
- *Clean Energy (Consequential Amendments) Act 2011*, which amends other laws, in particular the income tax and GST laws, to ensure that the mechanism is integrated with existing regulatory schemes and processes, including the National Greenhouse and Energy Reporting System, the Carbon Farming Initiative, the Australian National Registry of Emissions Units, the regulation of financial services and competition and consumer laws;
- *Climate Change Authority Act 2011*, which sets up two advisory bodies, the Climate Change Authority, which will advise the Government on the setting of carbon pollution caps, periodic review of the carbon pricing mechanism and other climate change laws;

December 2011, was the culmination of a process that commenced in January 2004.² This article explores the tax implications of a key element of Australia's response to the challenges of climate change, the Carbon Farming Initiative (CFI).³

The CFI is the Federal Government's policy response to land use contributions to greenhouse gas emissions and potential land use abatement opportunities. In contrast to the previous Carbon Pollution Reduction Scheme (CPRS),⁴ the Government has decided to exclude agriculture and other land based activities from the carbon

and the Land Sector Carbon and Biodiversity Board, which will advise the Government on the implementation of land sector measures;

- *Clean Energy Regulator Act 2011* creates the Clean Energy Regulator, which will administer and enforce the carbon price mechanism, the National Greenhouse and Energy Reporting System, the Renewable Energy Target and the Carbon Farming Initiative;
 - Eight procedural Acts/Bills, consistent with the requirements of s 55 of the Constitution, dealing with the imposition of charges: *Clean Energy (Unit Shortfall charge-General) Bill 2011*, *Clean Energy (Unit Issue Charge-Fixed Charge) Act 2011*, *Clean Energy (Unit Issue Charge-Auctions) Act 2011*, *Clean Energy (Charges-Customs) Act 2011*, *Clean Energy (Charges-Excise) Act 2011*, *Clean Energy (International Unit Surrender Charge) Act 2011*, *Ozone Protection and Synthetic Greenhouse Gas (Manufacture Levy) Amendment Act 2011*, and *Ozone Protection and Synthetic Greenhouse Gas (Import Levy) Amendment Act 2011*;
 - Three Acts which provide an equivalent carbon price on business through fuel tax: *Clean Energy (Fuel Tax Legislation Amendment) Act 2011*, *Clean Energy (Excise Tariff Legislation Amendment) Act 2011* and *Clean Energy (Customs Tariff Amendment) Act 2011*; and
 - Three acts which legislate the household assistance measures announced on 10 July 2011 - *Clean Energy (Household Assistance Amendments) Act 2011*, *Clean Energy (Tax Laws Amendments) Act 2011*, and *Clean Energy (Income Tax Rates Amendments) Act 2011*.
- ² Although Australia ratified the *United Nations Framework Convention on Climate Change* opened for signature 9 May 1992, 1771 UNTS 107, (entered into force 21 March 1994) on 30 December 1992, the Howard Liberal Federal Government refused to ratify the *Kyoto Protocol to the United Nations Framework Convention on Climate Change*, opened for signature 16 March 1998, 2303 UNTS 148 (entered into force 16 February 2005). In response, the National Emissions Trading Taskforce (NETT) was established in January 2004 by the State and Territory governments to develop a multi-jurisdictional national emissions trading scheme reflecting Australia's target for greenhouse gas emissions set under the *Kyoto Protocol*. A key element in this process was the Commonwealth's ratification of the *Kyoto Protocol* on 3 December 2007 (see Prime Minister, 'Ratifying the Kyoto Protocol', Media Release, 3 December 2007 at <http://parlinfo.aph.gov.au/parlInfo/download/media/pressrel/215P6/upload_binary/215p61.pdf;fileType=application%2Fpdf#search=%22ratifying%20the%20kyoto%22>).
- ³ *Carbon Credits (Carbon Farming Initiative) Act 2011 (Cth) (CFI Act)*.
- ⁴ For a history of the CPRS see Michael Dirkis, 'Chapter 1: A taxing climate: The taxation aspects of the CPRS' in Pauline Sadler (ed), *Contemporary Issues in Law & Policy* (Curtin University 2010) 1-33.

pricing mechanism and instead provide incentives for changes in land use by way of free units issued under the CFI.⁵ The coverage of the CFI is also much broader than the forestry activities included in the CPRS and covers a variety of project types, as described below.

This article provides an overview of the CFI and eligible offsets projects. It describes the link between the CFI and the carbon price that forms the basis for the inclusion of units issued under the CFI, including the taxation rules applicable to carbon units issued under the Clean Energy Plan. It also analyses taxation issues that arise under the new Division 420 of the Income Tax Assessment Act 1997 (*ITAA 1997*) with respect to these units.

Key elements of Clean Energy Legislative Package

Although the scheme draws upon a number of key elements of the CPRS, there are some fundamental differences ranging from terminology to the two-stage implementation process. As the clean energy legislative package, when fully implemented, will consist of over 20 acts and numerous regulations, it is only possible to briefly explore the two-stage implementation and shift in surrender dates. With regard to the tax laws, this article highlights the changes from the former CPRS.

The key operative provisions are in the *Clean Energy Act 2011 (CE Act)*. As well as defining the scope of the legislation – coverage of persons ('liable entities'),⁶ and sources of pollution ('covered emission'),⁷ - the CE Act provides for:

- The carbon pricing mechanism consisting of a fixed charge;⁸
- Caps on the amount of carbon pollution from 1 July 2015;⁹
- International linking;¹⁰
- Monitoring, enforcement, appeal and review provisions;¹¹

⁵ Australian Government, 'Securing a clean energy future: The Australian Government's climate change plan' (2011) xxix <<http://www.cleanenergyfuture.gov.au/clean-energy-future/securing-a-clean-energy-future/>> at 5 February 2012.

⁶ *CE Act*, Part 2, Divisions 2 & 3.

⁷ *CE Act*, Part 2, ss 30 and 31. It generally includes greenhouse gases (which has the same meaning as in the *National Greenhouse and Energy Reporting Act 2007* (Cth), s 7) and legacy emissions from landfill, but excludes agricultural emissions.

⁸ *CE Act*, Parts 3 to 6.

⁹ *CE Act*, Parts 2 to 6.

¹⁰ *CE Act*, Part 4, Div 3.

¹¹ *CE Act*, Parts 15 to 21.

- Assistance for emissions-intensive trade-exposed industries,¹² and the coal-fired electricity generation sector;¹³ and
- The Opt-in Scheme for large fuel users.¹⁴

Structure of the scheme

The scheme starts on 1 July 2012 and, similar to the CPRS, will be implemented in two stages. For the first three years, the carbon price for each tonne of pollution will be fixed, and will operate like a carbon tax. The fixed charge will start at \$23 per tonne on 1 July 2012. In each of the next two years, it will rise by around 2.5% in real terms, assuming inflation of 2.5% a year - the mid-point of the Reserve Bank of Australia's target range for inflation. The carbon charge will be \$24.15 per tonne in 2013-14 and \$25.40 per tonne in 2014-15.¹⁵

Stage two commences from 1 July 2015, with a 'cap and trade' emissions trading scheme. During this flexible price period, an overall limit (or cap) will be placed on Australia's annual greenhouse gas emissions from all sources of pollution covered by the carbon price, to ensure that Australia meets its pollution targets. The cap is implemented by the Government issuing a fixed number of carbon units each year, via auction or by free allocations to strongly affected industries. The 'pollution cap', will be expressed as a carbon dioxide equivalence of a specified number of tonnes,¹⁶ and will be set for each eligible financial year (except for fixed charge years) by regulations.¹⁷

Setting the carbon price in the flexible charge period

Although it is intended that the carbon price will be set by the market, a price floor (a minimum carbon price) will apply for the first three years of the flexible charge period.¹⁸ The price floor will be implemented through a minimum auction reserve price and a fee on the surrender of international units. A price ceiling will also operate in this period and will be set by regulations at \$20 per tonne higher than the expected international carbon price.¹⁹

¹² *CE Act*, Part 7.

¹³ *CE Act*, Part 8.

¹⁴ *CE Act*, Part 3, Division 7.

¹⁵ *CE Act*, s 100 and *Explanatory memorandum to the Clean Energy Bill 2011* (CE Bill Memorandum), 118.

¹⁶ *CE Act*, s 13.

¹⁷ *CE Act*, s 14.

¹⁸ *CE Act*, s 111(5) and CE Bill Memorandum, 124.

¹⁹ *CE Act*, s 100.

Eligible international emissions units

‘Eligible international emissions units’ will only be permitted to be surrendered from the commencement of the flexible price period.²⁰ There are certain conditions, such as:

- The eligible international emissions units cannot be surrendered during the fixed charge period;²¹ and
- Until 2020, liable entities must meet at least 50% of their annual liability with domestic carbon units with any excess surrender of eligible international emissions units being disregarded and counted toward the calculation of the emissions number for the subsequent financial year.²²

Similarly, the export of carbon units will not be allowed in the fixed price period. Exports of carbon units are also not generally allowed in the first three years of the flexible price period (ie, prior to 1 July 2018) unless a bilateral linking agreement with another country is in place. If so, export may be allowed in the period commencing 1 July 2015.²³

Surrender of eligible emission units

As with the CPRS, liable entities meet their liabilities by either surrendering units or paying a shortfall charge. However, the timing differs extensively from that prescribed under the CPRS, because of the different processes operating in the fixed charge years and flexible charge years.

In the fixed charge years, as at 15 June, the liable entity must provide the Regulator with interim emissions numbers,²⁴ and surrender the required number of units covering its interim emissions numbers.²⁵ If a liable entity does not surrender enough units to cover its interim emissions by 15 June, a provisional unit shortfall charge is

²⁰ *CE Act*, s 5 defines ‘eligible international emissions units’ in terms of the *Australian National Registry of Emissions Units Act 2011* (ANREU Act), s 4. Eligible international emissions units to include: certified emission reductions (CERs), other than long-term or temporary CERs; emission reduction units (ERUs); removal units (RMUs); any further prescribed units issued in accordance with the Kyoto rules; and any other international unit (which is prescribed in regulations).

²¹ *CE Act*, s 122(8).

²² *CE Act*, ss 123 and 133(7).

²³ *CE Act*, s 108(3).

²⁴ Interim emissions numbers are either an actual estimate of its emissions or 75% of last year’s emission – see *CE Act*, s 126.

²⁵ *CE Act*, s 125.

due and payable within 5 working days,²⁶ and a late payment penalty starts to accrue.²⁷ Further, if that estimation proves to be wrong and the entity has not in fact surrendered 75% of its actual emissions, an estimation error shortfall charge can apply.²⁸ The estimation error shortfall charge is due and payable 5 business days after 1 February.²⁹

The liable entity, after supplying its final emissions to the Regulator by 31 October, is required by 1 February to surrender the balance of the emission units needed to meet its liability.³⁰ Again, if it does not surrender enough units to cover its emissions by 1 February, a final unit shortfall charge is due and payable within 5 working days,³¹ and late payment penalty starts to accrue.³²

However, during the flexible charge years the interim procedure disappears, with liable entities merely surrendering (by 1 February) the emission units needed to meet their liability.³³ If a liable entity does not surrender enough units to cover its emissions by 1 February, a final unit shortfall charge is due and payable within 5 working days³⁴ and late payment penalty starts to accrue.³⁵

Key tax provisions

Schedule 2 of the *Clean Energy (Consequential Amendments) Act 2011 amends the ITAA 1997 to include* Division 420. Division 420 is a discrete code that has primacy in prescribing the taxation treatment associated with the acquisition, holding and disposing of registered emissions units.³⁶

The major departure from the CPRS is with respect to the application of Goods and Services Tax (GST) to emission units. Under the CPRS, the supply of eligible

²⁶ *CE Act*, ss 125 and 134(1).

²⁷ *CE Act*, s 135.

²⁸ *CE Act*, s 129.

²⁹ *CE Act*, s 134(2).

³⁰ *CE Act*, ss 128 and 29.

³¹ *CE Act*, ss 128 and 134(2).

³² *CE Act*, s 135.

³³ *CE Act*, ss 133 and 134(1).

³⁴ *CE Act*, ss 133 and 134(3).

³⁵ *CE Act*, s 135.

³⁶ Where Division 420 of *Income Tax Assessment Act 1997* (ITAA 1997) covers an issue, it generally has priority over the rest of the income tax law in working out the income tax treatment of the acquisition, holding and disposing of units. Subdivision 420-E contains detailed rules to give effect to this object and sets out exceptions to the general primacy of Division 420, Explanatory Memorandum, *Clean Energy (Consequential Amendments) Bill 2011 (Consequential Amendments EM)* [2.105].

emissions units, or 'Kyoto units', were treated as taxable supplies. Under Schedule 2 of the *Clean Energy (Consequential Amendments) Act 2011*, a supply of eligible emissions units is GST free.³⁷ However, standard GST treatment continues to apply to derivative market products associated with the management of eligible emissions units (ie, the financial derivatives are input taxed).

Otherwise, the taxation rules remain broadly consistent with those proposed under the CPRS. Thus, the tax policy underlying the design of Division 420 is that:

- The cost incurred in acquiring a registered emissions unit would be tax deductible upon acquisition;
- If the registered emissions unit is banked, the effect of the deduction will be deferred until the time the registered emissions unit is surrendered or sold; and
- The proceeds from the sale of a registered emissions unit would be assessable income.³⁸

This approach effectively removes the potential for Capital Gains Tax (CGT) applying to registered emissions units, in most cases.³⁹ It simplifies the tax treatment, as characterisation issues between capital and income are removed. As under the CPRS, the receipt of free units is effectively treated as the derivation of income, where such units are still held at the year end. This is achieved by including those units in the rolling balance at a cost equal to the market value prevailing just after the units commence to be held.⁴⁰ If such units are sold in the year of receipt, the proceeds on sale are simply included in income.⁴¹ The 'no disadvantage rule' continues to be available for units provided under the Jobs and Competitiveness program (to energy-intensive, trade-exposed entities).⁴²

As with the CPRS, Division 420 provides that a taxpayer can deduct expenditure to the extent it is incurred in becoming a 'holder' of a registered emissions unit.⁴³ A

³⁷ *A New Tax System (Goods and Services Tax) Act 1999* (Cth) s 38-590.

³⁸ Department of Climate Change, Commonwealth, *Carbon Pollution Reduction Scheme: Australia's Low Pollution Future White Paper* (2008) (White Paper), Policy position 14.4 at <<http://pandora.nla.gov.au/pan/102841/20090728-0000/www.climatechange.gov.au/whitepaper/factsheets/index.html>>.

³⁹ *ITAA 1997* s 118-15 states that any capital gain or capital loss that a taxpayer makes from a registered emissions unit, from the right to a free carbon unit and from an Australian carbon credit unit is disregarded.

⁴⁰ *ITAA 1997* s 420-60.

⁴¹ *ITAA 1997* s 420-25.

⁴² *ITAA 1997* s 420-58.

⁴³ *ITAA 1997* s 420-15(1).

holder must be a registered holder under the *Australian National Registry of Emissions Units Act 2011*. Where the registered holder is a nominee for another entity, that other entity is the holder.⁴⁴ The expenditure is deductible in the income year that the taxpayer becomes a holder.⁴⁵ However, no deduction is available where you become the holder of free carbon units or Australian carbon credit units, or if the sale proceeds were not assessable.⁴⁶

A liable entity's assessable income includes an amount the entity is entitled to receive because they disposed of (ceased to hold) a registered emissions unit. The amount is assessable income in the income year it ceases to hold the unit, ensuring that the timing of assessment is matched to the income year in which the unit leaves the entity's rolling balance account.⁴⁷ If the consideration receivable in a non-arm's length transaction or in a transaction between associates is not equal to the market value of the unit, the consideration is instead taken to have that market value.⁴⁸

The treatment of international emission units remains broadly the same as under the CPRS, as does the methodology for dealing with emission units on hand at year end (the rolling balance method).⁴⁹ If a registered emissions unit is on hand at the end of the financial year, the deduction is deferred until the time the registered emissions unit is surrendered or sold. 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 registered emissions unit held at the beginning and end of the income year would be taken into account.⁵⁰ If there is an increase in value at the end of the

⁴⁴ *ITAA 1997* s 420-12.

⁴⁵ *ITAA 1997* s 420-15(2).

⁴⁶ *ITAA 1997* ss 420-15(3) to (5).

⁴⁷ *ITAA 1997* s 420-25.

⁴⁸ *ITAA 1997* s 420-30.

⁴⁹ Therefore, where the international emissions unit was trading stock or a revenue asset of the entity just before the transfer, the entity is deemed to have sold the unit for its cost just before it became a registered emissions unit and as having immediately bought it back as a registered emissions unit for the same amount (the original cost) – see *ITAA 1997* s 420-2. In these circumstances, the trading stock rules are also expressly overridden – see *ITAA 1997* s70-110(2). Where the international emissions unit was held on capital account before importation however, the importing entity is deemed to have sold the international emissions unit for market value and repurchased it for the same market value amount, just before it was entered on the Registry. The CGT provisions are also amended to insert a new CGT event K1, which expressly provides that the entity can make a capital gain or capital loss (i.e. a CGT event occurs) when they start to hold an international emissions unit as a registered emissions unit – see *ITAA 1997* ss 104-5, table item relating to CGT event K1, and ss 104-205.

⁵⁰ *ITAA 1997* s 420-45.

income year over the value at the start the income year, then that excess is assessable. However, if there is a decrease in the value over the year then the decrease is deductible. The potential for a tax accounting mismatch between the occurrence of an emission and the recognition of the liability, as existed under the CPRS, remains.

Similarly, the unit short-fall charge remains non-deductible.⁵¹ The government argues that this ensures that the entity liable bears the full cost of the charge.⁵² The PAYG instalment provisions operate in the same way. The relevant provisions are amended so that 'instalment income' includes all amounts included in assessable income from ceasing to hold (or from being taken to cease to hold) units. Income from an increase in the value of units on hand, and deductions from a decrease in the value of units on hand, will not be instalment income.⁵³ Despite this, the rules will create cash flow management issues for eligible entities in the first years of the operation of the scheme, as PAYG instalments will be inflated.

The CFI

Overview

The CFI operates to provide a financial incentive to undertake emissions reduction or sequestration activities. It issues Australian Carbon Credit Units (ACCUs) with respect to eligible projects. These units can be used to meet compliance obligations under the Clean Energy Plan or can be sold into international and domestic compliance and voluntary markets.

Under the CFI, recognised offset entities are entitled to the issue of an ACCU with respect to each tonne of CO₂-equivalent emissions avoided or sequestered with respect to an eligible offsets project.⁵⁴ Where the activity giving rise to the ACCU is recognised as relevant for Australia's obligations under the Kyoto protocol, the units will be identified as Kyoto ACCUs and may, with other 'eligible' units, be used to meet liabilities under the Clean Energy Plan.

During the fixed price period, liable parties may meet up to 5% of their emissions liability with eligible (Kyoto) ACCUs.⁵⁵ During the flexible price period there is no limit to the use of ACCUs.⁵⁶ These Kyoto ACCUs are also eligible for conversion into Kyoto units (such as assigned amount units, removal units or emissions reduction

⁵¹ *ITAA 1997* s 26-18.

⁵² Consequential Amendments Explanatory Memorandum, [2.103].

⁵³ *Taxation Administration Act 1953* s 45-120(5).

⁵⁴ *CFI Act* pt 2.

⁵⁵ *CE Act* s 125(7).

⁵⁶ *CE Bill Memorandum*, [4.68].

units),⁵⁷ thereby allowing the units to be exported. Non-Kyoto ACCUs may be sold into voluntary markets, such as for use under Australia's National Carbon Offset Standard.⁵⁸ The Federal Government has also committed \$250m over six years to a CFI non-Kyoto Carbon Fund that will purchase non-Kyoto ACCUs on a tender basis.⁵⁹ Both categories of ACCUs are bankable and do not have expiry dates. It is also significant that the CFI began operation in December 2011 whereas the carbon price does not commence until 1 July 2012, thereby providing lead time for methodologies and projects to be developed.

An 'offsets project' that may be eligible under the CFI is either a 'sequestration offsets project' or an 'emissions avoidance offsets project'.⁶⁰ A sequestration offsets project removes carbon dioxide from the atmosphere by sequestering it in living biomass (such as native trees), dead organic matter (such as leaf litter) or soil.⁶¹ An emissions avoidance offsets project may be an agricultural emissions offsets project (such as one aimed at reducing methane emissions from livestock or capturing and combusting methane from livestock manure),⁶² a landfill legacy offsets project,⁶³ or an introduced animal emissions offsets project.⁶⁴

Various processes have been developed to recognise offsets entities and eligible projects and to provide mechanisms for reporting, the issuing of ACCUs and potential relinquishment requirements. Although a detailed discussion of these features is beyond the scope of this article, two elements will be highlighted: the methodology process and the positive and negative lists.

Offset project methodologies will apply to specific types of projects and will establish, for example, the CO₂ net abatement amount for a described project type

⁵⁷ *CFI Act* s 157.

⁵⁸ The National Carbon Offset Standard provides a voluntary standard for those organisations that seek to become 'carbon neutral'. A review of the NCOS is currently underway. A recently released discussion paper includes the proposal that ACCUs be eligible under the Standard. Department of Climate Change and Energy Efficiency, *Review of the National Carbon Offset Standard: Discussion Paper* (30 August 2011) <<http://www.climatechange.gov.au/government/initiatives/national-carbon-offset-standard.aspx>> at 5 February 2012.

⁵⁹ *Securing a clean energy future*, above n 2, 94.

⁶⁰ *CFI Act* s 5 definition of 'offsets project'.

⁶¹ *CFI Act* s 54.

⁶² Early work in this area has focused on the capture and combustion of methane from commercial piggeries.

⁶³ Landfill emissions from landfill waste accepted after 1 July 2012 will be covered by the carbon pricing mechanism, but emissions from so-called legacy waste will be managed by way of the CFI: *CE Act* s 32.

⁶⁴ The focus project type in this category to date relates to the management of feral camels.

and the rules for monitoring, record keeping and reporting.⁶⁵ An application detailing the proposed methodology must be made to the Domestic Offsets Integrity Committee (DOIC), after which the application is made available for public consultation through the Department of Climate Change and Energy Efficiency (DCCEE) website. Once a methodology has been approved, specific projects can apply for endorsement under that methodology. To date, the majority of methodology proposals have been developed by DCCEE and the Department of Agriculture, Fisheries and Forestry in consultation with industry to cover areas that would have broad interest. Methodologies have already been approved for environmental plantings, destruction of methane generated from manure at piggeries and capture and combustion of landfill gas.

A proposed project must also be of a kind included on the 'positive list' and, conversely, not included on the 'negative list'. This listing mechanism will identify those project types considered to meet the test for additionality.⁶⁶ A project must be of a type on the positive list to be an eligible offsets project. The initial positive and negative lists have been included in the CFI regulations.⁶⁷ The negative list includes a forest that qualifies for income tax incentives as a 'forestry managed investment scheme',⁶⁸ and the cessation or avoidance of harvesting a plantation forest.⁶⁹ These types of projects therefore cannot generate ACCUs.

⁶⁵ *CFI Act* s 106.

⁶⁶ Additionality looks to see if the activity would not have been undertaken but for the incentive mechanism. Under the CFI, the additionality test takes the form of a 'common practice test' where the Minister will consider whether 5% or less of the relevant comparison group (industry, subsector or region) currently undertake the activity. Department of Climate Change and Energy Efficiency, Commonwealth of Australia (DCCEE) (2011) *Commentary on the exposure draft Regulations dealing with the positive and negative lists of activities under the Carbon Farming Initiative*. See <<http://www.climatechange.gov.au/en/government/submissions/closed-consultations/draft-regulations-positive-negative-lists-for-cfi.aspx>>.

⁶⁷ *Carbon Credits (Carbon Farming Initiative) Regulations 2011* (Cth).

⁶⁸ *ITAA 1997* Div 394.

⁶⁹ *Carbon Credits (Carbon Farming Initiative) Regulations 2011* (Cth) reg 3.36. The planting of a new monoculture (plantation) forest would not qualify under the CFI as the sequestration offset projects include the establishment of native forests and understorey species and other native vegetation. See the positive list at *Carbon Credits (Carbon Farming Initiative) Regulations 2011* (Cth) reg 3.28.

Taxation treatment of CFI activities

The taxation treatment of transactions involving ACCUs under the general rules of the ITAA could have raised many complex issues.⁷⁰ It is a welcome development that ACCUs are included in the meaning of 'registered emissions unit' to which the new Division 420 applies.⁷¹

This section of the article considers the following features of the taxation of ACCUs:

- The value of ACCUs are included in assessable income in the year of receipt;
- Expenses that relate specifically to the issue of an ACCU will only be deductible under Division 420;
- Expenses that relate more broadly to the offset generating activity will be subject to the ordinary rules of deductibility; and
- A transitional rule will apply to any units issued under the CFI prior to the commencement of the new tax rules.

Only those features of Division 420 that relate exclusively to ACCUs, and not to other categories of registered emissions units, are considered. Therefore, the focus will primarily be on issues relevant for the project proponent that would be the first holder of the ACCUs.

Income derivation

Not unlike other categories of units issued for free (such as units provided under the coal-fired electricity generation assistance scheme), the value of ACCUs issued to a project proponent that are still held by the year end will be included in the closing balance of units held. Where the cost method is being used for valuation, the 'cost' is taken as equal to the market value of the ACCU immediately after the entity begins to hold it.⁷² This approach therefore relies on a determination of a market value for ACCUs for a given day. At least in the early years of the CFI market, this may be difficult to identify because trading volumes may be small and trades may be occurring over-the-counter.

The operation of the rolling balance method has the effect of indirectly including the value (which then is taken to be the deemed cost) of the ACCU in income through the calculation of the increase or decrease in the balance of units held. That is, an amount

⁷⁰ See C Black and A Evans, 'A critical analysis of the tax treatment of dealings under Australian domestic emissions reduction and abatement frameworks' (2011) 26(2) *Australian Tax Forum* 278.

⁷¹ ITAA 1997 s 420-10.

⁷² ITAA 1997 s 420-60(3).

is included in assessable income if the balance has increased or a deduction is available if the balance has decreased.⁷³ If, alternatively, the ACCU is sold before the end of the year, the proceeds on the sale of the unit are included in assessable income.⁷⁴ The timing rule provides that this amount is included in the year in which the entity ceases to hold the ACCU (when it is no longer reflected in the entity's registry account). After this first year, the ordinary rules regarding unit valuation and the treatment of disposals will apply.

This has the effect of putting the receipt of ACCUs on the same tax footing as other business income or subsidies (where the amount or value of the subsidy is treated as assessable income to an entity carrying on business).⁷⁵ However, it may be relevant that the receipt of the unit itself is not treated as the income derivation event. Under general concepts, the receipt of ACCUs under the CFI could be characterised as the derivation of business income or a subsidy in kind. Such income would be derived either when it was earned or on receipt.⁷⁶ This treatment is overridden by Division 420,⁷⁷ where derivation may be deferred, but not beyond the year of receipt. Income may also be derived if the ACCUs are sold, where the income is derived when the units are no longer reflected on the entity's register. If the ACCUs are still held on the registry at year end, it is at this time that their receipt is taken into account through the calculation of the rolling balance. It may well be that in a given year the result of such a receipt will be a reduction in a deduction rather than an increase in assessable income.

Deductions

Division 420 has been designed to have the effect of a code with respect to transactions involving registered emissions units. This is illustrated by the exclusivity provisions in Subdivision E. The general rule is that expenditure incurred in becoming the holder of a registered emissions unit cannot be deducted, or taken into account, in calculating deductions or amounts of assessable income under any provision of the *ITAA* outside Division 420.⁷⁸ Such expenditure is made deductible by a specific provision,⁷⁹ but this rule has been adjusted with the incorporation of ACCUs into Division 420. The specific deduction provision only applies to allow for

⁷³ *ITAA 1997* s 420-45.

⁷⁴ *ITAA 1997* s 420-25.

⁷⁵ A subsidy may be ordinary income to the entity and therefore included in assessable income under *ITAA 1997* s 6-5 or by virtue of s 15-10.

⁷⁶ See Black and Evans, above n 69, 308-311.

⁷⁷ *ITAA 1997* s 420-70(4).

⁷⁸ *ITAA 1997* s 420-65(1) and (2).

⁷⁹ *ITAA 1997* s 420-15.

expenditure incurred in preparing or lodging an application for a certificate of compliance or an offsets report.⁸⁰ However, other CFI related expenditure is effectively saved.

The effect of this provision is to allow deductions for the nominated expense types that are clearly linked with the issue of specific ACCUs, but only when the ACCUs start to be held by the entity.⁸¹ This will result in a deferral of the deduction for these expenses, as they undoubtedly will have been incurred at an earlier time. Interestingly, there is no test in the specific deduction provision for a revenue character for the outgoing. The Commentary on Provisions prepared to accompany the exposure draft of the taxation amendments contained an example of relevant expenditure namely, amounts paid for specialised computer software used to prepare the report. This example was not, however, included in the final Explanatory Memorandum.⁸² There may be some expenditure, otherwise deductible over time under the ordinary rules, that may be deductible all at once under Division 420.

Expenditures that relate more broadly to establishing and running the project directed at generating ACCUs are 'saved' by virtue of a specific provision that limits the exclusivity of deductions rule to those expenses related to reporting that are specifically covered by the specific deduction rule.⁸³ Establishment and operating expenses, including up-front costs such as equipment or seedlings for forestry operations, would be subject to the usual rules of deductibility. Expenses may be incurred in relation to CFI activities within the context of a broader business, such as a primary producer installing equipment to capture and combust methane, or could be incurred by a special purpose business entity established solely to operate a CFI-based business. Although forestry managed investment schemes and plantation forestry have been excluded from the CFI by their inclusion on the negative list, forestry activities that meet the meaning given to permanent environmental plantings on the positive list,⁸⁴ would seem to potentially include activities eligible for the carbon sink forestry incentives.⁸⁵

⁸⁰ ITAA 1997 s 420-15(4).

⁸¹ CE Bill Memorandum, [2.33] - [2.34].

⁸² Compare Commentary on Provisions in Exposure Draft of the Clean Energy (Consequential Amendments) Bill 2011, [2.33], with that in the Consequential Amendments Explanatory Memorandum, [2.34].

⁸³ ITAA 1997 s 420-65(4).

⁸⁴ Environmental plantings are defined as a mix of native trees and undergrowth and can only include monocultures if such naturally occur in the area. *Draft Carbon Credits (Carbon Farming Initiative) Regulations 2011* (Cth) meaning of 'environmental plantings'. The permanency rule prohibits harvesting.

⁸⁵ ITAA 1997 Subdiv 40-J.

Transitional rules

As noted above, the CFI commenced in December 2011, whilst the *Clean Energy Act 2011* does not commence operation until July 2012. As a result, ACCUs (as well as other types of units such as Kyoto units) may potentially be held before Division 420 has come into effect. Therefore, the entity receiving ACCUs in this interim period will be required to determine the character of the units in its hands (ie, trading stock, revenue asset, or capital asset) and then apply the ordinary rules of the *ITAA*.

On commencement of Division 420, the ACCUs will become registered emissions units, so a transitional rule has been included to address the transfer into the new regime.⁸⁶ This rule effectively provides roll-over treatment, as it deems that the taxpayer has disposed of the unit just before commencement of Division 420 for its cost then, immediately after commencement, bought the unit for that same amount (where this deemed purchase would give rise to a deduction under Division 420). As most ACCUs would be held as revenue asset, this deemed sale and repurchase would ordinarily not give rise to the recognition of any gain or loss.⁸⁷

CONCLUSIONS

One of the ways in which the Government's Clean Energy Plan differs significantly from the CPRS is the CFI. Rather than merely deferring the inclusion of agriculture in the compliance scheme (as was proposed under the CPRS), agriculture and other specified land use activities are excluded from the carbon pricing mechanism altogether. Instead, the Government has developed the CFI to provide incentives for emissions abatement and sequestration in this sector by way of free ACCUs. The market for ACCUs is significantly bolstered by the eligibility of such units for both compliance and voluntary markets. The taxation rules have the effect of treating the receipt of ACCUs as assessable income, thereby putting these incentives on the same tax footing as other Government subsidies. In addition, by including ACCUs within Division 420 along with other registered emissions units, the objectives of simplifying taxation treatment and reducing compliance costs are also achieved.

⁸⁶ *Income Tax (Transitional Provisions) Act 1997 (Cth)* s 420-5.

⁸⁷ See Consequential Amendments Explanatory Memorandum, [2.158] – [2.160].