



Climate change

Current accounting and
tax issues for Australian
business leaders

AUSTRALIA

KPMG reviews climate change taxation,
accounting and corporate reporting issues
relevant to the capital markets in the lead up
to the 2010 introduction of emissions trading

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Glossary of terms and abbreviations

- AASB – Australian Accounting Standards Board
- AETS – Australian Emissions Trading Scheme
- ATO – Australian Taxation Office
- CDLI – Climate Disclosure Leadership Index
- CDM – Clean Development Mechanism
- CDP – Carbon Disclosure Project
- CDSB – Climate Disclosure Standards Board
- CERs – Certified Emissions Reductions
- CEO – Chief Executive Officer
- CO₂-e – Carbon dioxide equivalent
- EACs – Early Action Credits
- ERUs – Emissions Reduction Units
- ETS – Emissions Trading Scheme
- EU – European Union
- FBT – Fringe Benefits Tax
- FTC – Fuel Tax Credits
- GHG – Greenhouse Gas
- GST – Goods and Services Tax
- IASB – International Accounting Standards Board
- IFRIC – International Financial Reporting Interpretations Committee
- IFRS – International Financial Reporting Standards
- JI – Joint Implementation
- M&A – mergers and acquisitions
- MRET – Mandatory Renewable Energy Target
- NGER – National Greenhouse and Energy Reporting
- P&L – profit and loss
- R&D – research and development
- RECs – Renewable Energy Certificates
- TOFA – Taxation of Financial Arrangements Stages 3 and 4
- WBCSD – World Business Council for Sustainable Development
- WRI – World Resources Institute

Introduction

Australia's climate change policy gathers a sense of urgency

In Australia, 2007 was a watershed for the political realities of climate change. The science that had dominated the policy debate for the previous decade was subsumed by the commercial reality that many of Australia's largest corporations will be operating in a carbon-constrained economy from 2010. The Government's action on the Kyoto Protocol has formalised their commitment to taking action and responding to climate change. With this comes the formalisation of Australia's pledge to reduce greenhouse gas (GHG) emissions to a target of 60 percent of 2000 levels by 2050¹.

Achieving this target demands comprehensive and complementary strategies. They range from modifying energy consumption patterns and developing low emissions technologies through to promoting abatement activities to offset emissions and increasing investment in renewable energy sources.

Much of the policy framework and additional fiscal stimulus for these strategies will depend on the recommendations of the Garnaut Climate Change Review, which is due to report in September 2008. However, one key policy initiative is firmly set in stone. An Emissions Trading Scheme (ETS) will operate in Australia from 2010 to provide the economic mechanism to direct capital investment flows and research and development activity with the objective of reducing GHG emissions to the defined levels at the lowest possible cost.

Some enterprises are already reconfiguring their business models and investing in lower-emissions production processes in anticipation of 2010. Others are adopting a wait and see approach, perhaps wary of the earlier experiences in Europe, and therefore seeking to avoid some of the potential risks associated with adopting a first mover strategy. These organisations are instead preferring to focus on the consultation process once the design of the Australian Emissions Trading Scheme (AETS) is released.

Whatever strategy is pursued, contemplating a carbon-constrained economy is now part of the corporate planning horizon and, increasingly, an agenda item in engaging key stakeholders in the capital markets.

Climate change timetable

2007	2008	2009	2010	2020	2050
Australia ratifies Kyoto (December)	Garnaut Review NGER commences (July)	AETS legislation proposed	AETS commences	20% Renewable energy targets	60% Emissions reduction target

Like many of its clients, KPMG in Australia (KPMG) is reducing its emissions with the aim of becoming carbon neutral. This commitment is not without an economic cost. The carbon equation is complex: balancing social contracts and legislative commitments to reduce emissions with the financial and fiscal discipline expected by the capital markets.

When KPMG announced its commitment to becoming carbon neutral, it initially formed a core working group of people from wide ranging backgrounds to plan and prioritise the firm's response to reducing emissions. It quickly became apparent that an effective response would have to span many functional boundaries across the business. For instance, how should KPMG measure and report on its progress in attaining a carbon neutral status? What are the implications for financial reporting? What are the after-tax consequences of going carbon neutral?

Going carbon neutral

KPMG's journey to becoming carbon neutral

Many organisations are voluntarily adopting a carbon neutral goal in response to concerns about the risks associated with a warming world.

Whilst emissions reduction is the main driver, there are many other factors leading an organisation down this path, including the opportunity to improve operating efficiencies.

KPMG is taking a strong position. We have a stated goal to become carbon neutral by the end of the 2008 financial year. KPMG formed a dedicated Carbon Neutral Working group involving people with wide ranging backgrounds to define the challenge and to develop an implementation approach.

KPMG has adopted the Australian Government's *Greenhouse Friendly*TM program as the standard to follow. This program offers an independent, nationally consistent and thorough approach to achieving certified carbon neutral status.

KPMG is on track to meet its goal with its draft carbon footprint being refined for submission to an independent verifier over the coming months.



Fiscal policy, accounting and corporate reporting — the traditional pillars supporting the global capital markets — will be critical for the effective operation of the AETS and to the calibration of economic scorecards kept by analysts on corporate Australia's response to the Government's climate change policies.

This white paper elevates a number of important accounting, reporting and taxation messages that need to be understood, debated and factored into the practical actions that businesses and the Government take as Australia transitions to an ETS.

At a glance

The value created by a company's response to climate change, and the value perceived by the capital markets, may differ

The current Australian tax system is not particularly climate change friendly

Accounting and reporting

- The uncertainty about how we should account for emissions trading is widely documented. What is certain however, is that climate change is driving corporate strategy particularly in those sectors which will be covered by the proposed AETS. It should be a key item on every company's executive agenda – both in terms of risk and opportunity.
- The value created by a company's response to climate change and the value perceived by the capital markets, may differ. Financial reporting plays an important part in informing the market through 'true and fair' financial statements. Yet until we gain clarity around the accounting and reporting that reflects economic reality, we run the risk of capital markets making judgements based on incomplete information.
- This is a clear opportunity to reconcile the economics of accounting for carbon with conventional measures of performance. Of course, there will continue to be considerable debate on the relevant accounting and reporting issues. While the outcome may be uncertain, the course is set. Companies are engaging in emissions reduction activity, and they should ensure these actions are appropriately communicated to provide capital markets with sufficient information to understand the underlying financial and economic consequences of this activity.

Tax

It is important that the Australian tax system should not impede the adoption of emissions reduction practices. As a starting point, KPMG believes the Australian Government should take a tax-neutral approach to climate change policy.

- Already we are seeing deficiencies in the tax system vis-a-vis climate change. Organisations undertaking voluntary climate change strategies, including early abatement activities, are finding that the tax treatments are unclear. A main concern is that their costs may not be deductible.
- Based on experiences in Europe, the implementation of an ETS and the operation of the scheme thereafter will give rise to a range of tax issues every step of the way. The Australian tax system needs to be updated in line with the development of an AETS to minimise uncertainties and to ensure tax does not distort the emissions reduction objectives.
- There is also a place for tax incentives, if they are responsibly integrated into the Government's emissions reduction policy. Investors in large capital intensive projects involving new emissions reduction or abatement technology will be looking for tax incentives to mitigate their risks and perhaps 'kick start' investment in low emissions technologies. These incentives might include favourable tax depreciation rates, research and development (R&D) tax concessions and possibly an investment allowance.

Accounting and reporting – getting the message across

Introduction

The current uncertainty about the appropriate accounting treatment of GHG emissions and abatement activities has been widely discussed and documented. The impetus for clarity in Australia has gained momentum following the announcement of the proposed AETS. With the anticipated start date of the scheme less than two years away, affected entities are understandably seeking guidance on how the design of the AETS should be reflected in their financial statements. This white paper, however, does not aim to add to the technical accounting aspects of this debate, noting only that the European Union (EU) ETS has been operating without specific accounting guidance for three years. Therefore there continues to be a number of accounting treatments, two of which are set out below.

Potential accounting treatments

- After the withdrawal of IFRIC 3 Emissions Rights, there is currently no definitive accounting guidance in relation to emissions rights or schemes.
- With the IASB's decision to put the issue of accounting for emissions trading schemes back onto its active agenda, it is hoped that development of a replacement standard for the withdrawn IFRIC 3 is in the pipeline.
- Accounting treatment currently varies significantly and involves the assessment and interaction of several existing accounting standards.
- The following accounting approaches are considered to be acceptable in practice:
 - Recognise allocated emissions permits as intangibles at market value when received; corresponding entry to government grant, which is released to income as GHGs are emitted; subsequent measurement of permits at cost or market values; recognise liability when emissions are produced based on the market value or based on the carrying amount of permits on hand plus the market value of any shortfall between permits held and permits required.
 - Recognise allocated emissions permits at cost (nil) initially and subsequently; recognise liability at the carrying amount of permits on hand (nil) plus the market value of any shortfall between permits held and permits required.
- Further guidance is available in KPMG's publication *Insights into IFRS*.

However, for companies to take the lack of an accounting standard as an excuse to relax their efforts in this area may be a significant error of judgement.

While it may be said that those tasked with setting international accounting standards are potentially guilty of lagging behind the commercial requirements of those who have to apply them, the climate change debate, and carbon emissions in particular, are clearly far broader subjects – and afford far broader challenges and opportunities – than just getting the debits and credits right.



National Greenhouse and Energy Reporting Act 2007

- The National Greenhouse and Energy Reporting System establishes a national reporting framework.
- From 1 July 2008, if a corporation or facility* meets the reporting thresholds (see below) then it must report its GHG emissions, energy production and energy consumption to the Greenhouse and Energy Data Officer.
- In addition, corporations may voluntarily provide a report in relation to GHG projects detailing the reduction and offsets of GHG emissions.

* As defined in Part 1, Section 8 and 9 of the Act.

Climate change policies and the AETS – adopting market-based solutions

A common feature of international policy formulation on environmental issues has been the use of market-based principles as the preferred public policy instrument to price, allocate and manage natural resources². The most notable example is the EU ETS – a cap and trade scheme designed to facilitate a reduction in total GHG emissions by allocating a limited number of ‘permits to emit’ and allowing market forces to set the price. The process of auctioning permits between companies with excess permits and those with a deficit provides the ‘price discovery’ mechanism, thereby facilitating investment decisions.

Similarly in Australia, market forces will ultimately drive the price of permits, albeit not until clearer targets are set and further details of the AETS are released. Due to the lack of detail around these targets and the AETS itself, sections of the Australian business community are lamenting a perceived lack of action. But this is somewhat missing the point. As experience in Europe has shown, a massive over-allocation of permits led to a collapse in the carbon market, temporarily undermining the whole policy objectives of the scheme. Understanding the base emissions data is critical.

This data is part of the carbon accounting equation. It is to this end that the Government has already introduced the *National Greenhouse and Energy Reporting Act 2007* (NGER). From 1 July 2008, this Act makes it mandatory for companies within stated thresholds to report their emissions, energy consumption and energy production to a centrally regulated registry.

National Greenhouse and Energy Reporting³ obligation criteria

Financial Year	Corporations		Facilities	
	Kt CO ₂ -e	TJ	Kt CO ₂ -e	TJ
2008-09	125	500	25	100
2009-10	87.5	350		
2010-2011	50	200		

Kt CO₂-e – kilotonnes of carbon dioxide equivalent emitted

TJ – terajoules of energy consumed or produced

² There are a range of instruments available to governments to implement public policy from laws and regulation, social instruments (especially education) through to tax and fiscal policies and market-based principles.

³ *Regulations Discussion Paper, National Greenhouse and Energy Reporting System*, Department of the Environment and Water Resources, Australian Greenhouse Office, October 2007.



Penalties for non-compliance with the NGER include fines of up to \$220,000, and personal liability for CEOs, although this risk can be mitigated by conducting due diligence on reporting systems and commissioning external assurance.

The NGER is just one of several federal and state level schemes. While each has its merits, and each provides further opportunity for data capture and reporting, it is hoped the AETS will provide much-needed clarity in this crowded and confusing regulatory space.

Emerging opportunities

While the NGER is mandatory, a government discussion paper⁴ issued in September 2007, sets out a suggested methodology to encourage companies to voluntarily pursue abatement policies in the lead up to 2010, and to avoid an increase in emissions ahead of the allocation of permits. The discussion paper suggests that companies covered by the AETS which can provide independently verified evidence of additional abatement will be assigned Early Action Credits (EACs) and that these EACs would then be available for use, or for sale within the AETS.

Of particular note within the discussion paper is this comment, "...it is likely that a range of unexploited additional abatement opportunities exist now in both the covered and uncovered sectors which will not be taken up unless there is the prospect of achieving returns in terms of avoided permit liability under the future scheme or the prospect of selling offset credits into the scheme (in effect, bringing forward the carbon price incentive from 2011 to today)."

No clearer declaration is needed that there are opportunities for all entities – both those covered by the AETS, and those not covered – and that these opportunities are in existence today. Despite the fact that the Early Abatement Incentives paper is still in discussion format, we believe that it, or something similar, is inevitable if the Government is to encourage companies to continue abatement, and avoid an emissions 'ramp-up' prior to the introduction of an AETS.

In addition, the Australian Government has ratified the Kyoto Protocol, which provides further opportunities for Australian companies to generate Certified Emissions Reductions or Emissions Reduction Units that can be traded on international carbon markets.

Potential Early Abatement Incentives

- The discussion paper on *Abatement Incentives prior to the Commencement of AETS* released by the Department of the Prime Minister and Cabinet (PM&C) on 24 September 2007 considers two issues:
 - ensuring allocation rules maintain abatement incentives (e.g. definition of assets eligible for compensation)
 - positive incentives to undertake additional abatement in the lead up to the commencement of emissions trading.
- It suggests that EACs can be generated by sectors covered by the AETS until commencement of the AETS and may then be exchanged for emissions permits dated for use in the first year of the Scheme.
- It also suggests Offset Credits can be generated by uncovered sectors (agriculture, forestry, land use) and could be sold into the AETS.
- The Australian Government's *Greenhouse Friendly*TM program would be used as an administrative mechanism for approving Offset Credits and EACs.

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Abatement Incentives Prior To the Commencement of the Australian Emissions Trading Scheme, Department of Prime Minister and Cabinet, September 2007

Kyoto Protocol

Australia ratified the Kyoto Protocol in December 2007, and will consequently become a full member in March 2008. The Kyoto Protocol includes different mechanisms which may help Australia to meet its GHG emissions target.

Under the Clean Development Mechanism (CDM) industrialised countries with a greenhouse gas reduction commitment (Annex I parties) could implement projects which reduce emissions in non-Annex I countries.

If a CDM project is approved, Certified Emissions Reductions (CERs) will be issued to the project participants based on the verified emissions reduction.

Joint Implementation (JI) is another project-based mechanism under the Kyoto Protocol. JI allows Annex I countries to finance projects that reduce emissions in other Annex I countries. If a JI project is approved, Emissions Reduction Units (ERUs) will be issued to the project participants based on the verified emissions reduction.

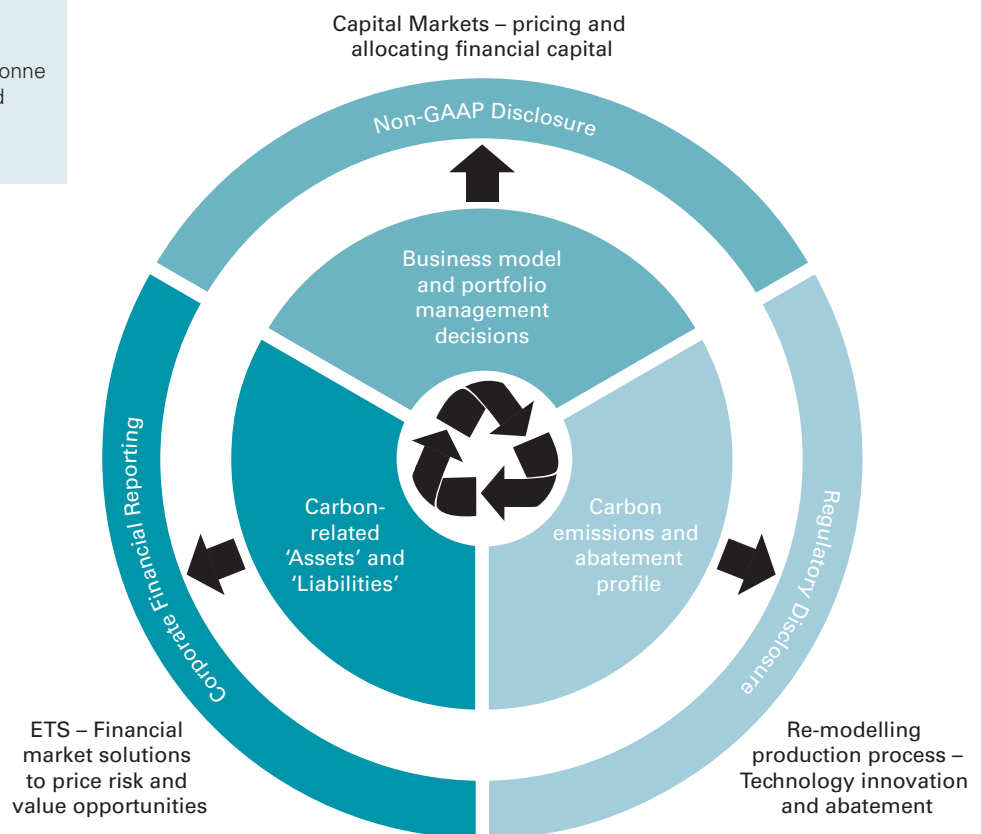
One CER or one ERU equate to an emissions reduction of one metric tonne of CO₂ equivalent (CO₂-e). CERs and ERUs can be traded on international carbon markets.

Corporate report on climate change activities – a strategic imperative

To date the accounting profession’s deliberations have primarily focused on accounting for tradeable rights arising from the AETS. Little attention has been given to the broader question of the measurement and reporting framework required to assist investors, rating agencies and analysts link carbon assets and exposures with capital allocation decisions.

Nevertheless, key components of the reporting framework for climate change are taking shape. They reflect the mandatory reporting framework of the NGER on a company’s carbon emissions and abatement profile, the opportunities provided by early abatement schemes, and the many state and federal schemes currently in place. The AETS will provide an important component of the carbon accounting equation – the mechanism to price emissions and provide a measurement framework to guide valuation of recognised carbon-related assets and liabilities. Indeed, the global capital markets are already fine-tuning their financial models to incorporate their assessment of the carbon equation for Australian corporations.

Companies who wish to benefit most from this environment will not only be acting now, but also ensuring their actions are recognised by the markets. We believe it is a strategic imperative that companies provide clear and robust communications to their stakeholders, and that those communications are subject to independent assurance.



The need for this communication is made clear by this excerpt from one investment bank’s own valuation framework:

“[We] will increase our commitment to systematically incorporate environmental...criteria into fundamental analysis of companies. We believe that companies’ management of environmental and related social risks and opportunities may affect corporate performance. We further believe that the management of risks and opportunities arising from climate change and its regulation will be particularly significant and will garner increasing attention from capital market participants.”

This bank is not alone. Clearly the capital markets are factoring in climate change responses to their investment decisions. It therefore makes sense for companies to provide the information the market requires about their carbon assets and carbon liabilities in economic terms, and not leave the market to use 'best estimates' to drive investment decisions.

On the path to clarity

Companies aspiring to achieve clearer communication of climate change issues to the capital markets are not without guidance. There are a number of organisations which have publicly available information setting out metrics, parameters and suggested best practice. A leading international initiative which KPMG contributed to the development of, is the WBCSD/WRI GHG Protocol – a Corporate Accounting and Reporting Standard. Other best practice guidelines for reporting and disclosure include the *Global Framework for Carbon Risk Disclosure*, the *Carbon Disclosure Project* and the associated *Climate Disclosure Standards Board*.

KPMG supports these initiatives and recommends that companies make themselves aware of the frameworks and resources available to them. We set out below the elements which are common to the different frameworks, and based on KPMG's experience, also summarise the key information sought by stakeholders.

- **GHG emissions:** Management of carbon emissions begins with the measurement of a company's existing carbon footprint. This includes direct and indirect emissions. It is preferably verified in accordance with a credible standard. In its pursuit of becoming carbon neutral, KPMG has undertaken to adopt the Australian Government's standard for organisations focused on making their products and services carbon neutral, known as the *Greenhouse Friendly™* program. Whatever standard is adopted, companies should disclose this fact and their rationale for using it.
- **Strategic analysis:** Following carbon measurement, companies should disclose actions being taken to reduce emissions. These actions should be categorised as short, medium and long-term, and should include information on carbon abatement projects, engagement with government and other agencies, and the corporate governance processes adopted by the organisation. Full details should also be provided of opportunities open to companies under, for example, any forthcoming early abatement scheme.
- **Regulatory risk:** This will include, but not be limited to, the company's response to the NGER and AETS. Details should be provided on the level to which current and proposed regulations will affect the entity and the actions taken to comply. It should also discuss the consequences of indirect restrictions on the company's operations, such as customer trends and supplier restrictions.
- **Physical risk:** While more relevant to some sectors (e.g. agriculture, transport, electricity generation) than others, disclosure of the assessment of physical risks of climate change (e.g. changing weather patterns, water shortages etc) should be provided by sector, where appropriate, to enable full analysis.

We acknowledge that Australian companies are providing some of this information already – principally as separate sustainability reports. But as the focus on climate change grows – and it is surely nearing critical mass – voluntary disclosure will lead to demand for formal reporting (via European style Management Discussion and Analysis in financial statements) and eventually recognition in the financial statements of corporate Australia.

How prepared will your company be? Clear and robust communication will not only unlock value in your company today, and encourage investment, but will also reap efficiency and competitive advantage benefits in a carbon-constrained future.

Clearly the capital markets are factoring in climate change response to their investment decisions

Clear and robust communication will not only unlock value in your company today, and encourage investment, but will also reap efficiency and competitive advantage benefits in a carbon-constrained future

Tax – removing the impediments and kick starting change



An ideal tax system should reinforce policy outcomes and facilitate emissions reductions by removing tax impediments

Tax neutrality means that the decisions of the market are not unduly influenced by tax factors

The introduction of new climate change initiatives, such as the introduction of an AETS, challenges Australia's tax system as it struggles to accommodate these unfamiliar concepts.

The big challenge from a taxation perspective is to ensure the introduction of an AETS does not result in adverse tax outcomes for participants and, indeed, for the broader community. An ideal tax system should reinforce policy outcomes and facilitate emissions reductions by removing tax impediments.

The tax framework accommodating the AETS and associated climate change initiatives should be based on achieving neutral after-tax outcomes for participants. Tax neutrality means that the decisions of the market are not unduly influenced by tax factors. Also, there should not be material tax differences between those covered by the AETS as opposed to those who will fall outside the scheme.

In practice, it may not be feasible to achieve pure tax neutrality. Responsible tax concessions can provide incentives to drive appropriate climate change behaviour. Indeed, in KPMG's view, the tax system itself can play a significant role to promote and instigate changes to corporate behaviour by influencing responses to climate change. It can do this through the development of appropriate tax incentives and complementary reforms to the current tax system.

To help organisations understand some of the tax issues, the case studies included in this paper are examples of actual situations where companies are facing difficulties due to tax uncertainties encountered in the 'carbon transactions' they are now contemplating.

We have outlined below a number of key tax issues to consider in the drafting of the detailed rules of the AETS. These will be of particular interest to future participants in the carbon trading market.

As we believe that the necessary tax reforms and tax incentives should be considered concurrently with the development of the AETS, this white paper canvasses specific changes to the tax system, including a selection of possible tax concessions, to stimulate a robust debate on this important issue.

Voluntary and early abatement activities prior to the introduction of an AETS – tax issues being encountered now

The AETS will commence in 2010. Businesses are starting preparations in advance of the regulatory scheme's introduction. Such preparatory activities include steps to reduce their GHG emissions and their overall carbon footprint. While no one disputes the broader benefits to the community of such activities, unless they can be clearly linked to the generation of taxable income of the business, such costs may not be tax deductible under current Australian income tax rules.



A key premise in our current tax system is that tax deductibility revolves around business expenditure that is either required to be incurred (i.e. not voluntary) or is incurred for a 'profit-making purpose'. Such principles do not easily accommodate voluntary expenditure, and businesses pioneering in the climate change arena may, in turn, run the risk of adverse tax consequences. This is largely because the tax system does not contemplate the relatively recent carbon oriented transactions which are now occurring. As new transactions are developed, new unintended constraints in the current tax system are coming to light. The following case studies highlight some of the tax problems being encountered.

As new transactions are developed, new unintended constraints in the current tax system are coming to light

Going carbon neutral

Also tax neutral?

In assessing the impact of 'going carbon neutral' it is important to consider the after-tax position. Ideally, a tax neutral position is desired.

The Australian Taxation Office (ATO) has published a private binding ruling indicating that the costs of acquiring carbon credits to offset GHG emissions associated with a director's necessary business travel was not deductible under the specific environmental protection activities provisions. The ATO, bound by the wording of the existing law, considered that the expenditure on the carbon credits was directed towards general environmental pollution and not the actual pollution resulting from the director's travel.

The question remains as to whether the costs of the carbon credits are deductible under the general deduction provisions as a business expense? Whilst the ATO has separately ruled in another instance that an entity regulated under the Mandatory Renewable Energy Target (MRET) was entitled to claim a general business deduction for the cost of purchasing renewable energy certificates, it is not as clear cut for those not regulated by a scheme. The difference with this situation and the one described above is that the entity concerned was covered by a mandatory scheme and its actions were not purely voluntary.

The challenge for organisations taking a voluntary path to becoming carbon neutral is that they will need to establish that the associated costs, including the cost of purchasing carbon credits and other abatement activities, are 'necessarily incurred' in carrying on an income-producing business. Many businesses will argue that their carbon neutral strategies are significantly contributing to their profitability through efficiencies, increased sustainability, and the overall enhanced relations with employees, customers and the community.

Nonetheless, such tax issues present uncertainties that should be addressed through ATO guidance and, if necessary, reform of the tax legislation.

Taking early abatement action

Establishing a carbon sink forest

Deficiencies in existing tax laws in coping with climate change were recently illustrated in the case of an electricity generator that had voluntarily invested in a carbon sink for the purpose of carbon sequestration.

The taxpayer sought tax relief under the environmental protection activities deduction rules (which allow an immediate deduction for capital expenditure incurred to remedy pollution resulting from a taxpayer's earning activity or site). The ATO considered the expenditure incurred in establishing the carbon sink forest did not qualify as eligible 'environmental protection activities' as the GHG pollution being remedied by the taxpayer's carbon sequestration activities represented 'general' pollution, rather than pollution directly emitted by the taxpayer (a nexus the current tax legislation requires).

The above scenario highlights the deficiencies in the current tax laws in accommodating new climate change initiatives such as investment in carbon sequestration projects. The previous Australian Government had proposed new legislation to provide tax relief for establishing carbon sink forests for the purpose of carbon sequestration (subject to conditions being satisfied). Unfortunately, the introduction of this legislation was delayed with the announcement of the federal election.

It is anticipated this legislation will be reintroduced into parliament, however we must wait to see how it will address this specific problem. It is hoped that more comprehensive tax legislation will follow to ensure that the whole range of climate change costs to be borne by businesses are provided with adequate tax relief.

The above experience highlights that taxpayers wishing to undertake early abatement activities prior to the AETS should seek advice to understand the uncertainties and confirm the tax treatment of such investments. Further, the tax system must be updated to accommodate new climate change initiatives such that there is an alignment between government climate change policy, the tax laws and tax administration.

Remunerating your people with carbon credits

Who bears the tax burden?

Employers are looking at innovative ways to involve their employees in climate change activities. This may involve the purchase of carbon credits to offset the emissions from an employee's use of their own salary-packaged motor vehicle. A number of tax issues emerge:

- Does the provision of the carbon credits give rise to an FBT liability and, if so, who pays it – the employer; or is it passed on to the employee?
- Does the FBT exemption for motor vehicle 'operating costs' apply on the basis that the carbon credits are an 'outgoing to do with operating a motor vehicle'? When the FBT laws were drafted last century, carbon credits were not in contemplation.
- Alternatively, can the employee claim a tax deduction for the cost of purchasing the carbon credits? Work deductions are generally not available for home-to-work and other private travel costs.
- Or can the employer claim a tax deduction for the cost of purchasing the carbon credits when the cost is salary sacrificed?

Given that the effective FBT rate is 46.5 percent on the grossed-up taxable value of benefits it is important to get these issues right. Under salary packaging principles, the burden of FBT is generally passed onto employees. To ensure good employee relations are maintained, the correct tax treatment needs to be understood and communicated up front.

Some tax considerations for AETS participants

The AETS will directly affect large GHG emitters. As well as focusing on the business effects of emissions constraints, these businesses will also need to consider the tax consequences of a range of actions occurring under the AETS. Below are some examples.

Initial allocation of permits	<p>Any initial free allocation of permits to AETS participants will need to be examined to determine the appropriate income tax/capital gains tax treatment, including the timing of the derivation of any gain.</p> <p>A number of elements will influence the outcome, and a full understanding of the structure of the AETS and the nature of the rights arising under such permits is required. For example, different outcomes may arise depending on whether the permit allocation is in the nature of a compensatory receipt, or is really a government incentive grant to facilitate changes in business operations.</p> <p>Critically, it will be important to ensure there is no risk that any such allocations may be considered to generate any upfront unfunded tax liabilities. Further, to the extent possible, tax treatments should minimise any after-tax distortions arising between those businesses participating in and those outside the AETS.</p>
Acquisition, sale and acquittal of permits	<p>There are several issues surrounding the tax treatment of the acquisition, sale and acquittal of permits, including capital/revenue issues. For example, at what point (if ever) can an AETS participant claim a tax deduction for the cost of a permit? It would be helpful for early guidance to be provided by the ATO.</p>
Trading in permits	<p>A key element of any ETS is that the permits should be tradeable – both domestically and internationally – with the carbon price set by the market. A wide range of financial products is expected to be developed, raising issues of the tax treatment of derivatives and other financial instruments, including the potential application of the <i>Taxation of Financial Arrangements Stages 3 and 4</i> (TOFA) and appropriate GST treatments.</p>
Exceeding allowable emissions	<p>The tax treatment of any fee or charge payable in the event an AETS participant breaches its emissions allowance will also need to be considered. If it is in the nature of a fine or penalty, such amount is unlikely to be tax deductible. The treatment may be different if the participant is merely required to acquire additional permits (albeit at a higher cost).</p>
Transitioning from current schemes	<p>Linkages between current emissions schemes and tax incentives such as the Fuel Tax Credit (FTC) scheme also need to be considered. For example, currently companies claiming more than \$3 million in FTCs must be registered with the Government's <i>Greenhouse Challenge Plus™</i> program to claim the credits. It will be important to ensure the appropriate transitioning of existing credits (where relevant) and consistency of existing greenhouse programs with the AETS.</p>
Generating offsets – research and development	<p>Currently there are 125 percent/175 percent R&D tax concessions for companies investing in new technologies or developing techniques and methods to reduce the environmental effects of operations. It will be important to ensure, where possible, the work undertaken meets the R&D definitions and the appropriate planning documentation is prepared.</p>

The tax system must be flexible, pro-active and responsive if it is to accommodate and facilitate action on climate change rather than be a mere afterthought once regulations are introduced

The Australian tax system should support and facilitate the AETS's objectives. It is imperative the various tax issues are considered and resolved in conjunction with the development of the AETS to ensure tax outcomes do not create unintended impediments. There is potential for tax to inadvertently affect the objectives of fiscal neutrality for both AETS participants as well as those outside the AETS bearing increased carbon costs.

Tax will continue to have a significant effect in the years post-implementation of the AETS having regard to the various nuances of the new domestic and international carbon offsets markets emerging in response to the various trading schemes. The trading of permits, or the possible 'banking' of permits for future acquittal, will all have tax consequences that will need to be considered now to ensure the carbon markets operate as efficiently and fluidly as possible without any hindrance from the tax system. Similarly, over time we can expect to see 'carbon assets and liabilities' factored in for business acquisitions, and the tax implications of this, as outlined in the following example.

M&A transactions – Carbon assets and liabilities

Businesses are starting to include projected carbon assets and liabilities in their financial modelling of investment activity. This includes:

- Factoring in the tax treatment of acquiring/generating/acquitting AETS permits/offsets into financial modelling. The interaction of the tax consolidation rules with the type and quantum of a target company's carbon assets and liabilities may give rise to some uncertain outcomes.
- Considering the appropriate effective lives of significant capital assets (and hence tax depreciation rates) potentially applying having regard to expected technological advancements and/or changes in business viability due to changes in direct/indirect operating costs and/or demand.
- Considering how any initial allocation of permits under the AETS will be taxed (if at all) and the P&L impact of any such allocation.

Businesses are in a position to start factoring key carbon issues into their acquisition and investment decisions and communicating key issues to their investment and due diligence teams.



Tax policy considerations – broad ranging reform of the whole tax system and tax incentives

The scope of tax issues surrounding climate change initiatives such as the AETS illustrates the challenges faced by our current tax system in adapting appropriately to these new issues. The tax system must be flexible, pro-active and responsive if it is to accommodate and facilitate action on climate change rather than be a mere afterthought once regulations are introduced. As such, KPMG recommends the tax system be progressively updated to keep in line with government policy in order that Australia's emissions reduction objectives can be achieved as smoothly and efficiently as possible.

In short, KPMG advocates a climate change friendly tax system.

Potential tax reforms for a climate change friendly tax system

- Definitions of terms such as 'taxable purpose' or 'profit-making purpose' in the tax legislation as the underlying principles determining eligibility for tax deductibility should be amended to take into account expenditure incurred in emissions reduction activities that may not clearly or directly achieve these financial objectives.
- Expanding the scope of the 'environmental protection activities' (refer case study above) to extend eligibility for these tax concessions.
- Ensuring the tax amendments to allow a tax allowance for the costs of establishing a carbon sink forest operate appropriately.
- Clarifying the tax law to ensure that the granting of emissions rights do not trigger assessable gains to the recipient or crystallise unexpected gains to the recipient over time.
- Consider the interaction of emissions trading and the TOFA provisions to ensure the market operates efficiently upon introduction of the AETS.
- Global emissions trading under the Kyoto Protocol requires consideration of cross-border taxation issues such as withholding taxes, transfer pricing and application of tax treaties in relation to emissions abating investments, offsets and other climate change initiatives.
- Ensure the GST treatment of the AETS is considered well in advance of the commencement of carbon trading.
- Co-ordinate the review of federal and state taxes concurrently with the development of the AETS, including state stamp duties.
- For FBT purposes, consider whether the cost of carbon credits should be included in exempt operating costs under the concessionary motor vehicle fringe benefits rules.
- Consider whether salary sacrifice arrangements could be extended to include long-term public transport tickets.
- The tax effect of any penalties or levies (e.g. for exceeding emissions caps) will need to be considered in the AETS design.
- Consider the deductibility of carbon credits for personal income tax purposes.

KPMG recommends the tax system be progressively updated to keep in line with Government policy in order that Australia's emissions reduction objectives can be achieved as smoothly and efficiently as possible

Tax incentives to consider

Tax concessions could provide a kick start to early abatement activities ahead of the AETS in 2010

As organisations look for ways of reducing emissions, new technologies and practices are being developed. For example, geo-sequestration is a major emerging technology which should mitigate emissions from coal-fired power stations. Tax incentives may be considered as a way of ameliorating the high risks and costs associated with such capital-intensive projects. Industry will need to make a compelling case for tax incentives to assist GHG abatement to justify a departure from a general tax neutrality policy objective.

In Europe, for example, tax incentives are provided in the form of accelerated depreciation for renewable energy plant, such as in France, where a 100 percent write-off for the cost of wind-farm plant is available in the first year of use⁵.

One approach to consider is the use of targeted tax incentives as an encouragement for changing business practices and manufacturing techniques to drive emissions reductions. Tax concessions could provide a kick start to early abatement activities ahead of the AETS in 2010.

Possible tax incentives to kick start emissions reduction activities	
<ul style="list-style-type: none"> Accelerated tax depreciation 	<ul style="list-style-type: none"> Accelerated tax depreciation deductions for eligible abatement technologies and renewable energy projects could encourage capital investment in these areas.
<ul style="list-style-type: none"> Targeted Investment Allowance 	<ul style="list-style-type: none"> Consider providing an additional 10 percent deduction in the first year for the capital cost of large climate change infrastructure projects such as geo-sequestration ventures.
<ul style="list-style-type: none"> R&D concessions 	<ul style="list-style-type: none"> Extend R&D concessional treatment for capital expenditure incurred on GHG reducing activities through the expanded definition of eligible R&D expenditure/activities to encourage innovative responses to climate change.
<ul style="list-style-type: none"> Immediate tax deductions 	<ul style="list-style-type: none"> Introduce immediate tax deductions for specified abatement expenditure, possibly for a concessionary period, to encourage early action.
<ul style="list-style-type: none"> Indirect tax impacts 	<ul style="list-style-type: none"> Consider indirect tax concessions relating to GST, customs and state taxes for early abatement projects/activities, or to ensure these taxes do not create impediments to early action.
<ul style="list-style-type: none"> Black-hole deductions 	<ul style="list-style-type: none"> Extend or clarify the scope of 'black-hole expenditure' provisions to allow taxpayers a deduction for abatement activities where no relief is provided elsewhere.

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