



Inland Revenue

Te Tari Taake

POLICY ADVICE DIVISION

Wāhanga Tohutohu Kaupapahere

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Tax treatment of emissions units

Background

Emissions trading rules are contained in the Climate Change Response (Emissions Trading) Amendment Act 2008 (Climate Change Act). This legislation inserts provisions into the Climate Change Response Act 2002. Under these provisions:

- businesses in certain sectors will be required to surrender emissions units based on their actual emissions, or emissions treated as being made as a consequence of their activities; and
- the government may allocate “free” emissions units to businesses in certain sectors.

Amendments to income tax legislation are needed to ensure that the tax treatment of emissions units is clear, income and expenditure are recognised appropriately, and no unintended distortions, such as a mismatch of recognition or timing of income and expenditure, arise.

Legal status of emissions unit tax treatment – forestry and non-forestry sectors

The Climate Change Act amends the Income Tax Act 2004, the Income Tax Act 2007, and the Goods and Services Tax Act 1985 to address:

- the income tax consequences of dealing with emissions units for the forestry sector, and
- the GST consequences of dealing with emissions units for all sectors.

The income tax amendments took effect on 26 September 2008, and the GST amendments will take effect on 1 January 2009.

Amendments to address the income tax position of non-forestry sectors were introduced in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill (Lapsed Tax Bill) in July 2008. This bill has now lapsed as a result of Parliament rising for the 2008 general election, and so is subject to change.

The rules discussed in these pages apply to New Zealand Units, Kyoto units, and any unit issued by an overseas registry which can be transferred to an account in

the New Zealand registry. They do not apply to voluntary, or “unofficial” units, which remain subject to ordinary income tax and GST rules.

Income tax treatment of forestry businesses

Different tax treatment applies to emissions units which relate to post-1989 forestry land and those which relate to pre-1990 forestry land.

Income tax treatment of emissions units relating to post-1989 forestry land

Emissions unit transactions relating to post-1989 forestry land are generally treated as being on revenue account. This means that taxable income arises, and tax deductions are created, as a result of these transactions. Timing rules apply to these liabilities and deductions. Specifically:

- no taxable income arises on the receipt of units which are allocated by government in relation to carbon capture
- the sale of any units gives rise to taxable income. If the units sold are allocated units, or units purchased to replace units sold previously, then the entire proceeds will be subject to income tax. Otherwise, any “profit” on the sale will be taxable income
- the purchase of units to replace units which were previously sold is deductible
- the purchase of units in excess of those sold will not give rise to a deduction at that time.

Example 1: tax treatment of post-1989 forest business emissions units

DE Forestry has an exotic forest plantation planted in 1991. DE Forestry has elected into the emissions trading scheme, so the income tax rules for post-1989 forest land will apply to it. For the 2009 emissions year, DE Forestry receives an allocation of 100 emissions units. The election and the receipt of units have no taxation consequences.

It sells 30 units immediately for \$10 each, and retains 70 units. The proceeds from the sale of 30 units \times \$10 = \$300 derived in 2009 are taxable, and there is a nil cost base.

In 2011, DE Forestry buys 30 units on the market for \$15 each.

The purchase cost of $30 \times \$15 = \450 is deductible in 2011 and, as the units are “replacement” units (units purchased to replace post-1989 units previously sold), the year end valuation rule provides that they can be valued at nil, rather than cost. This gives a net deduction in 2011 for these units.

In 2012, DE Forestry harvests its forest, and is required to surrender 100 units. The harvest and the subsequent settling of the emissions obligation have no taxation consequences.

Income tax treatment of emissions units relating to pre-1990 forestry land

Emissions unit transactions relating to pre-1990 forestry land are generally treated as being on capital account, which means that no income tax liabilities

arise, and no tax deductions are created by transactions in emissions units. Specifically:

- no taxable income arises on the receipt of units allocated by the government
- no taxable income arises if any government-allocated units are sold by the recipient
- no income tax deduction arises if additional units are purchased to satisfy a deforestation liability
- no income tax deduction arises on the surrender of units.

The exception to the rules described above is the small number of businesses which hold pre-1990 forest land on revenue account – typically property developers and similar businesses. Their transactions will be on revenue account.

Income tax treatment of non-forestry businesses

The income tax treatment of non-forestry businesses is part of the Lapsed Tax Bill, and so is subject to change.

Income tax treatment of emissions units allocated to non-forestry businesses

Certain non-forestry businesses will be allocated “free” emissions units by the government. In some instances these businesses will have a liability to surrender emissions units, and other businesses will simply be facing increased costs for inputs, such as electricity (and will probably sell the “free” emissions units to benefit from the allocation).

This allocation of emissions units is on revenue account, so taxable income will arise. This tax liability does not arise immediately on allocation of the units, but is treated as arising on an emerging basis over the period to which the allocation relates, tracking the emissions liability, or increased cost, for which the award of free emissions units is intended to compensate. Example 2 shows this in practice.

Income tax treatment of liability of non-forestry businesses to surrender emissions units

A deduction is available for a business’ liability to surrender emissions units. The business does not have to wait until the emissions units are actually surrendered; the deduction is available as the liability to surrender emissions units arises, following normal accrual accounting principles.

A business which simultaneously receives “free” emissions units and accrues a liability to surrender emissions units will find that the income and deduction amounts at least partially offset.

Income tax treatment of sales and purchases of emissions units by non-forestry businesses

The sale of emissions units by a non-forestry business is on revenue account, so where units are sold for a price in excess of their cost, taxable income will be generated.

The purchase of units by a non-forestry business is also on revenue account, so a deduction will arise on their purchase. However, if the units are held at the end of the relevant income year, they will be treated in the books as an asset valued at cost, thereby offsetting the deduction.

Example 2: tax treatment of non forestry business emissions units

AB Co manufactures product Z for export. Carbon dioxide is emitted as part of manufacturing product Z, and the Climate Change Response Act 2002 requires AB Co to surrender the commensurate number of emissions units following the end of each emissions year.

The government issues an allocation plan under the Climate Change Response Act 2002, under which businesses which make product Z for export are entitled to receive “free” emissions units.

AB Co is issued 100 free units for the emissions year which runs from 1 January to 31 December 2015. AB Co’s expected emissions liability for the emissions year is 800 units. AB Co has a 30 June balance date. On 30 April 2015, AB Co buys a further 150 emissions units for \$8 each. On 30 June 2015, emissions units are trading at \$10 each.

The following calculations are required for AB Co’s 2014-15 tax return.

AB Co will be entitled to a deduction on an emerging basis for its emissions obligations. Assuming emissions are exactly the same level every month, at the end of the 2014-15 income year, the proportion of the emissions liability to be recognised is $6/12 \times 800$ units = 400 units. The fraction 6/12 is simply the number of months in the 2015 emissions year which have elapsed at the end of the 2014-15 income year.

The 2014-15 income year deduction for the accrued liability to surrender 400 units is calculated as follows:

- $150 \text{ units} \times \$8 = \$1,200$. This is the portion of the liability matched to the 150 units which have been purchased, valued at the cost price of those units;
- $250 \text{ units} \times \$10 = \$2,500$. This is the remaining portion of the liability, valued at the market value of those units at balance date. Any variance between the year end market value and the eventual actual cost of the 250 units required will be brought to account in the following income year.

The 100 free units are not relevant to the calculation of the deduction.

The total deduction for the liability accrued in 2014-15 to surrender 400 units is therefore $\$1,200 + \$2,500 = \$3,700$.

The approach taken to recognition of the income from the 100 free units is similar. Income from the 100 allocated units will be recognised over the period to which the allocation applies, on a basis which matches the allocated units to the costs that they are intended to compensate for.

AB Co will therefore recognise as income the value of $400/800 \times 100$ units = 50 units at the end of its 2014-15 income year. The fraction 400/800 is the number of units of emissions actually emitted in the 2015 emissions year at the end of the 2014-15 income year, divided by the number of units of emissions expected for the entire 2015 emissions year.

The balance date market value of the units is used to calculate the income, which is 50 units \times \$10 = \$500.

However, if the 100 units were sold immediately upon receipt for \$8 each (and this might occur where the business does not have a direct emissions obligation, but is awarded emissions units to compensate it for increased energy costs), then the sale proceeds of \$800 would be income. The units sold would have no cost base.

GST treatment of emissions units – all sectors

The supply of emissions units is zero-rated. This means that emissions units are treated as being subject to GST for the purposes of measuring taxable supplies made by the business, but the amount of GST actually charged is zero.

Transactions which are treated in this way include:

- the allocation of emissions units by the government to a business
- the surrender of emissions units by a business to the government
- a sale of emissions units by a business, whether to a buyer in New Zealand or overseas
- the purchase of emissions units by a New Zealand buyer from an overseas vendor.

In some instances, deemed or actual supplies will be made in exchange for emissions units. These supplies will also be zero-rated where they are:

- made by the recipient of “free” units allocated by the government – such as foresters who receive units from the government for carbon capture in growing forests
- made by the government in exchange for the surrender of units by businesses.