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17 March 2023

Indirect and Industry Tax Policy Unit
Personal and Indirect Tax and Charities Division
Treasury
Langton Cres
Parkes ACT 2600

Dear Madam/Sir,

CONCESSIONAL TREATMENT OF AUSTRALIAN CARBON CREDIT UNITS FOR PRIMARY PRODUCERS - BDO SUBMISSION

BDO refers to the invitation by Treasury to provide comments on the Government's Consultation (**the Consultation**) on proposed legislation that will allow concessional tax treatment for certain primary producers that generate revenue from the sale of Australian Carbon Credit Units (**ACCUs**).

BDO is pleased to provide comments on the proposal to provide concessional tax treatment to eligible primary producers.

These measures will allow primary producers to treat certain carbon abatement income generated from the sale of ACCUs they first held on or after 1 July 2022 as primary production income for the purpose of Farm Management Deposit (**FMD**) scheme and accessing income tax averaging as outlined in ***Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Tax accounting for primary producer registered emissions units***.

We believe that the proposed legislation presents an opportunity to expand the definition of 'registered emission units' under Section 420-10 of the *Income Tax Assessment Act 1997* so that it aligns with contemporary carbon credit units other than ACCUs widely used in Australia, and also – increasingly – created on farms in Australia.

In section C of the attached Appendix, we note some concerns and suggested changes for the proposed measures for your consideration, including:

- Broaden the definition of 'registered emission units' under section 420-10 to include other types of high integrity carbon credit units.
- Clarify wording in exposure draft legislation, including
    - the replacement of the phrase 'the trust's assessable income' with the more appropriate words 'net income of the trust'.
    - What is included in 'primary producer deductions'
- Clarify the definition of 'primary producer registered emissions unit', and

- Clarify the stated policy objective of the proposed measures and extend subdivision 420-D amendment to all farmers.

In addition, in Sections A and B of the attached appendix we provided BDO's summary of Australia's Carbon Farming Initiatives over recent times and the current classification of ACCUs and Kyoto Units.

Should you have any questions or wish to discuss any of the comments made in our submission, please do not hesitate to contact me on 07 3237 5811 or Andrew.Jones@bdo.com.au.

Yours sincerely
Andrew Jones

Partner
Corporate & International Tax

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Appendix

BDO Submission to Treasury
Concessional treatment of Australian Carbon Credit Units for primary producers: Consultation

BDO has considered the proposal to amend the legislation to treat proceeds from selling ACCUs and income derived from on-farm carbon abatement activities supporting such units as primary production income for primary producers eligible for concessional tax treatment under the Farm Management Deposit Scheme and income tax averaging arrangements. We provide the following background and comments in relation to the consultation.

All legislative references are to the *Income Tax Assessment Act 1997*, unless otherwise stated. All references to proposed materials are to the Exposure Draft Legislation and Explanatory Memorandum.

A. Background - Carbon Farming Initiative

In Australia, the regulatory framework governing on-farm carbon abatement evolved from the Carbon Farming Initiative (**CFI**), a voluntary carbon abatement scheme which began in 2011. The CFI was originally part of the 'Direct Action Plan' of the former Gillard Government. Originally focusing on a narrow range of land and waste projects, the *Carbon Farming Initiative Amendment Act 2014* (**2014 Amendments**) vastly expanded the CFI to other sectors of the economy. The 2014 Amendments also provided a simpler, more streamlined process for assessing and determining approved methods for emissions reduction activities.

The 2014 Amendments established the Emissions Reduction Fund (**ERF**). The ERF 'aims to provide incentives for a range of organisations and individuals to adopt new practices and technologies to reduce their emissions.' Under the ERF, eligible offset projects generate ACCUs that are registered on the Australian National Register of Emissions Units **(ANREU)**.

In broad terms, ACCUs are issued to 'project proponents', who have an approved project established under the ERF and who are verified (by the Clean Energy Regulator (**CER**)) to have adequately undertaken the approved project's 'method'. The project proponent is the entity to whose ANREU account ACCUs are credited.

ERF Methods available to register new projects

There are several methods relevant to carbon farming. The latest details may be obtained from the CER's website, cleanenergyregulator.gov.au/ERF methods.

They include:

- Beef cattle herd management
- Estimation of soil organic carbon sequestration
- Human-induced regeneration of a permanent even-aged native forest
- Avoided clearing of native regrowth

Due to the technical complexity of the methods, it is commonplace for multi-disciplinary project developers to assist landholders to undertake carbon farming projects. Landholders must also determine whether they (or their related party) will be the project proponent, or whether this will be a third party (such as the developer). Project aggregators work with multiple landholders to establish a project across multiple land parcels, and typically the aggregator is the project proponent in such arrangements. A diverse range of fee structures apply to third-party arrangements, and in recent years arrangements to be paid in ACCUs have become commonplace. There are also equally diverse landholder rights and obligations within these arrangements.

Despite the complexity of the methods, landholders also may project manage their own carbon farming projects. This requires the landholder to engage with specialist advisors (such as ecologists, land use advisors, and carbon market advisors), and to register the project with the CER.

Issue and treatment of ACCUs (access to and dealing with)

The process to undertake an activity for the issue of ACCUs is broadly as follows:

- Engage with a project developer or aggregator, or appoint a panel of advisors if not engaging a project developer, and determine the project proponent
- Evaluate the site and select a project method
- Undertake a feasibility study
- Register the project
- Fulfil method and reporting requirements (e.g. audits)

Once ACCUs are issued to the proponent's ANREU account, they may be held, traded or retired (cancelled/surrendered). Where royalty or developer/landholder payments are made in ACCUs, there is a subsequent transfer of ACCUs to satisfy those requirements.

It was originally the case (at least, since 2014) that the CER restricted the sale by project proponents of ACCUs generated from carbon farming by utilising 'fixed delivery' contracts. Broadly, under these contracts the CER purchases all the ACCUs generated by a project, with the purchase price set via a reverse auction process. Note that if a project proponent is unable to deliver ACCUs by the due date under the fixed delivery contract, they may face financial penalties.

Since March 2020, the CER has offered 'optional delivery' contracts, whereby project proponents have the right but not the obligation to sell ACCUs to the CER. In effect, under optional delivery contracts, project proponents can sell ACCUs on the open market to the highest buyer. In 2022, the CER negotiated with project proponents to permit them to exit fixed delivery contracts.

Kyoto Units

The Australian Government's ACCU is but one type of carbon offset. Within other schemes, there are two subsets:

- International units recognised under the Kyoto Protocol (Kyoto Units); and
- Other international and domestic units.

It is relevant to note that Kyoto Units are those which Australia can use towards meeting its emissions target under the Kyoto Protocol, and may be able to be registered on the ANREU.

Kyoto Units include:

- Certified Emissions Reduction credits (**CER credits**) issued under the United Nations Clean Development Mechanism for emissions reduction projects that occur in developing countries.
- Removal Units (**RMU**) issued by developed countries for removals of emissions (e.g. through forest sequestration).
- Units issued under any market-based mechanism established under the United Nations Framework Convention on Climate Change.

Whilst Australian taxpayers may acquire Kyoto Units, they generally relate to projects undertaken outside Australia.

Other carbon credits

There are several other types of carbon credit frameworks operating internationally. These other types of credits cannot be registered on the ANREU and include offset units generated by projects undertaken under other international frameworks, or under purely voluntary frameworks.

Projects generating credits falling into this category have been less common in Australia to date. However, a growing public awareness of carbon footprint and desire for certified emission offsetting, along with a broader range of available methodologies, may lead to more of these projects being undertaken.

In very general terms, other types of carbon offset units feature a methodology and an issuer. The issuer will generally undertake approval and verification roles. These units are registered on various registries, and some utilise blockchain for registry verification.

Compliance requirements for emitters

Currently in Australia, some companies and other entities must use offsets to comply with caps on the total amount of carbon dioxide they are legally allowed to emit. Only ACCUs, CER credits and RMUs (but practically speaking, only ACCUs are relevant) can presently be used to satisfy these compliance requirements. Demand for ACCUs from such entities is referred to as compliance demand.

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Very recently, countries agreed on rules for international cooperation through carbon markets at the 2021 United Nations Climate Change Conference held in Glasgow (COP26). The agreement, constituting a new article to the Paris agreement, contemplates that countries around the world be able to trade carbon credits for the purposes of meeting their commitments under the Paris agreement. The Australian Government is consulting on how to implement this agreement, including how to include high-integrity international units in compliance arrangements.

In this regard the *Safeguard Mechanism Reforms Position Paper* (January 2023) states on page 34:

> *International offsets are not proposed to be part of the initial reforms, but the Government may consider including them in the future, so long as they are of high integrity and can contribute to Australia's Paris commitments … In 2023 the Government will consult on amending legislation to allow for high integrity international units to be included in the [ANREU] and provide a mechanism for such units used for compliance at a future time.*

Voluntary certification: Climate Active

In Australia, most businesses do not have a cap on the amount of carbon that they are legally able to emit. However, it is possible for these businesses to obtain 'carbon neutral' certification in relation to products, buildings, events etc under the Climate Active Carbon Neutral Standard (https://www.climateactive.org.au/be-climate-active/tools-and-resources/climate-active-carbon-neutral-standard-organisations). Eligible offset units for the purpose of the Climate Active Carbon Neutral Standard include:

- ACCUs
- Some types of CER credits issued as per the rules of the Kyoto Protocol from Clean Development Mechanism projects
- RMUs issued by a Kyoto Protocol country based on land use, land-use change and forestry activities
- Verified Emissions Reductions (VERs) issued by the Gold Standard.
- Verified Carbon Units (VCUs) issued by the Verra Standard (officially, the Verified Carbon Standard).

The Climate Change Authority conducted a review of the Climate Active standard in 2022 (https://www.climatechangeauthority.gov.au/consultations/previous-consultations/review-international-offsets), and recommended that the use of CER credits and RMUs should be phased out by 2025 as they are no longer able to be issued under the Paris agreement. It also found that international carbon credits generated by the Gold Standard and Vera schemes demonstrated high integrity and should continue to be used.

Taking into account the comments in the Safeguard Mechanism Reform consultation paper regarding future usage of high integrity international units, it is expected that Gold Standard and Vera credits will feature in the range of eligible international units eventually permitted to be used as offsets in

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both compliance and voluntary certifications. Australian farmers will play an increasing role in the creation of such units on farmland in Australia.

B. Current classification and tax treatment of ACCUs and Kyoto Units

Division 420 sets out the code applicable to 'Registered Emissions Units (**REUs**). Section 420-10 lists two categories of units which can be classified as REUs:

> *420-10 A **registered emissions unit** is:*
>
> *(a) (Repealed by No 83 of 2014)*
>
> *(b) a *Kyoto unit; or*
>
> *(c) (Repealed by No 83 of 2014)*
>
> *(d) an *Australian carbon credit unit;*
>
> *for which there is an entry in a Registry account (within the meaning of the Australian National Registry of Emissions Units Act 2011).*

Division 420 applies to the holder of the REUs for carbon farming arrangements and ACCUs are issued to the project proponent (i.e. the entity that holds the legal rights and responsibilities in relation to a project and has the right to be issued with ACCUs).

Tax treatment of ACCUs and Kyoto Units

Under Division 420, ACCUs and Kyoto Units (but not international voluntary units) have the following income tax treatment:

a. Treated as revenue assets
b. The gross proceeds for ceasing to hold a registered emissions unit are assessable income
c. The gross expenditure on acquiring a registered emissions unit is deductible (but the deduction is effectively deferred until the unit ceases to be held)
d. The difference between the value of registered emissions units held at the start and at the end of the income year is brought to account under the 'rolling balance mechanism' in subdivision 420-D. This is done in such a way that:
    a. Any increase in value is included in assessable income; and
    b. Any decrease in value is a deduction.

Subdivision 420-E states that Division 420 is the exclusive taxing provision for income arising from ACCUs, and the exclusive deduction provision for direct costs relating to registration and reporting costs.

C. Submissions

Broaden ‘eligible offset units’ under section 420-10 - Registered emissions units

BDO generally welcomes the proposed changes to provide concessional tax treatment to certain primary producers that generate revenue from the sale of ACCUs.

However, our first concern is with the definition of ‘registered emissions units’ in section 420-10. We consider that the definition of ‘registered emissions units’ should be broadened to include other types of high integrity carbon credit units, following the contemporary dialogue which contemplates that such units should be eligible for offsetting in Australian for both compliance and voluntary certifications. In this regard, we note the current Bill[1] proposes to include safeguard mechanism credit units in the definition of 'registered emissions units’.

Therefore, we submit that the Government should use this proposed bill as an opportunity to include, at a minimum, all of the types of ‘eligible offset units’ under the Climate Active Carbon Neutral Standard in the definition of ‘registered emissions units’ in section 420-10. Additionally, consider altering the defined term from ‘registered emissions units’ to ‘eligible emissions units’ to reflect this change.

Alternatively, we would request the Government consider expanding the definition of registered/eligible emissions units in section 420-10 as and when international units are able to be used for compliance offsetting (i.e. under the safeguard mechanism).

Clarify wording in exposure draft legislation

Assessable primary production income

We refer to the proposed amendment to subsection 392-80(2) which relates to ‘assessable primary production income’. This provision brings an amount you are entitled to receive because you cease to hold a registered emissions unit, in your assessable income under section 420-25 for the income year in which you cease to hold the unit.

Our concern with this amendment is with the meaning of the phrase *‘a trust’s assessable income’* in proposed paragraph 392-80(2)(c):

> *‘any amount of your basic assessable income for the current year that resulted from an amount included <u>in a trust’s assessable income</u> under section 420-25 because the trust ceases to hold a primary producer registered emissions unit’*

The meaning of this phrase is unclear because a trust does not have an assessable income *per se*. If this phrase is intended to be included in the amending provision, its meaning should be clearly defined. Alternatively, we request that consideration be given to amending this phrase to be consistent with

[1] *The Safeguard Mechanism (Crediting) Amendment Bill 2022*

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comparable provisions such as in Division 6 of Income Tax Assessment Act 1936 and subsection 115-215(1), copied below (emphasis added):

> *'The purpose of this section is to ensure that appropriate amounts of* ***the trust estate's net income*** *attributable to the trust estate's *capital gains are treated as a beneficiary's capital gains when assessing the beneficiary, so:*
>
> *(a) the beneficiary can apply *capital losses against gains; and*
>
> *(b) the beneficiary can apply the appropriate *discount percentage (if any) to gains.'*

We submit that the phrase *'in a trust's assessable income'* in proposed subparagraph 392-80(2)(c) be changed to *'in a trust estate's net income*.

Primary production deductions under proposed section 392-80(3)

We submit that the amendment to primary production deductions under proposed subsection 392-80(3) do not go far enough to cover circumstances where primary production activities and carbon abatement activities are conducted alongside one another.

In this regard we consider that proposed paragraph 392-80(3)(c) should be amended to specifically include:

- any other costs incurred in relation to undertaking eligible offset projects; and
- costs incurred in complying with the terms of a third-party agreement where a developer requires the primary producer to do something in relation to the project.

Clarification of quasi-ownership required

We request that consideration be given to clarifying the amendments to proposed subsection 392-80(3)(d) (iii) which states that:

> *'so much of any other amounts you can deduct for the current year in relation to expenditure you incur under an *arrangement with an entity to the extent that:*
>
> ……….
>
> III. the expenditure does not relate to a *quasi-ownership right over land.'

At paragraph 1.18, the Explanatory Memorandum (EM) also states that:

1.18 If the eligible offsets project is carried on in an area over which there is a quasi-ownership right (that is, a lease or rental arrangement for the area) then carbon abatement income derived from that area is excluded. This exclusion does not include land held in the Australian Capital Territory, which is held on leasehold by the primary producer.
[Schedule #, item 2, subparagraphs 392-80(2)(d)(iii) and 392-80(3)(d)(iii)]

It is not immediately clear why such payments should be excluded from primary production deductions. *Prima facie* this exclusion appears to exclude any lease payments for an area of land used for carbon abatement activities under an arrangement with a third party. It is not clear from the proposed amendments or the proposed explanatory material whether lease payments under crown leases, share farming agreements, and related-party passive landholders, are also potentially excluded from 'primary production deductions' if they relate to a carbon abatement project.

Clarifying this requirement would be of assistance in applying the proposed changes.

Meaning of Primary Producer registered emissions unit

Proposed paragraph 420-13(c)

The 'primary producer registered emissions unit' designation is applicable only to the project proponent – that is, the taxpayer into whose ANREU account an ACCU is first entered.

Where arrangements with third parties (e.g. project developers) have payment in ACCUs as a feature of the arrangement, the project proponent (which may be the project developer) would receive the initial issue of ACCUs, and then (more or less) immediately transfer a number of ACCUs to the landholder. In these arrangements, the landholder would not hold primary producer registered emissions units, and a subsequent sale of those units would be excluded from primary production income.

This fact pattern is arguably not covered by proposed subsection 392-80(2)(d) – that is, an amount of an individual's assessable income that resulted from an arrangement with an entity whereby the entity started to hold or ceased to hold an ACCU that would have been a primary producer registered emissions unit. Proposed subsection 392-80(2)(d) is *prima facie* only operative in relation to a landholder sharing the profit of a third-party project developer from the sale of ACCUs. It does not appear to contemplate the landholder being compensated by way of receiving ACCUs.

We submit that the proposed amendment should be adjusted so that ACCUs received from a third party are also primary producer registered emissions units where there is an arrangement relating to the third party starting to hold an ACCU that would otherwise have been a primary producer registered emissions unit, had the individual started to hold it.

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Proposed paragraph 420-13(d) - meaning of 'at all times which the project is carried on'

We consider that the meaning of the words 'at all times which the project is carried on' in proposed paragraph 420-13(d) needs to be clarified particularly in relation to primary production and carbon abatement projects that may have a long duration.

Further details should be provided as to how the time is to be assessed. For example, if an eligible carbon project runs for 25 years, must the primary production business be carried on for the full duration of the project? This could only be determined at the end of the project period, which seems impractical. For example, this could mean that a primary production business carried on in years 1 to 9 (inclusive) of the project, but ceased in year 10, could mean the ACCUs generated in years 1 to 9 will no longer be eligible as 'primary producer registered emissions units' (to the extent that they are still on hand after the end of year 9).

We submit that the drafting in relation to establishing eligibility for primary producer registered emissions units must be precise, and therefore this test should be clarified.

Proposed subparagraphs 420-13(d) and (ii)

The tests considering a connection of areas should be clarified, either in the legislation or in the Explanatory Material.

For example, is the contemplated nature of the connection physical, legal or temporal? Presumably physical. However, if farming activities are conducted on several disparate properties, and a single aggregated carbon farming project is carried out on land encompassed by all of the properties, is there a sufficient connection? What if the carbon farming project is only on one of the properties - the only connection being via public roads?

In this regard, we submit that before the amendments are finalised, Paragraph 1.12 of the proposed Explanatory Memorandum needs further clarification by way of more examples.

Extend subdivision 420-D amendment to all farmers

We have concerns with the statement made in paragraph 1.17 of the proposed Explanatory Memorandum (below).

EM Paragraph 1.17

> 1.17 Incorporated farms are excluded. The policy objective of the concessional tax treatment is to encourage individual farmers to undertake additional carbon abatement activities. The tax treatment set out in existing subdivision 420-D is intended to continue to apply for units held by excluded entities.

We submit that this statement is inaccurate. The proposed amendments insofar as they relate to eligibility for farm management deposits and primary producer tax averaging are available only to

individuals. It seems unlikely that there would be a specific policy to encourage individual farmers to undertake carbon abatement activities to the exclusion of encouraging incorporated farms to so act.

At paragraph 1.7 of the proposed Explanatory Memorandum, it states “In particular, the Government is providing concessional tax treatment for the net proceeds of sale of Australian Carbon Credit Units and income derived from farm abatement activities supporting such units.”

BDO submits that the proposed amendments to the rolling balance mechanism in subdivision 420-D should be available to all types of farmers, regardless of whether individual or incorporated. This would be more congruous with the policy objective expressed in paragraph 1.7 which speaks to “farm abatement activities”, not the legal structure of the farmer.