Policy Advice Division of Inland Revenue

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Summary of main tax changes in the Climate Change Response (Emissions Trading and Renewable Preference) Bill

The introduction of the New Zealand Emissions Trading Scheme has taxation consequences. The bill contains provisions to clarify the tax treatment of dealing with emissions units in the forestry sector (clauses 47-55 amend the Income Tax Act 2004; clauses 56-64 amend the Income Tax Act 2007). In brief, the amendments have the following effect:

- *Post-1989 forest owners*: income and expenditure will generally be on revenue account. Income from allocation of units for carbon capture in forests will be taxable when the units are sold. Allocation itself will not produce taxable income. Any expenditure to purchase units will be deductible, generally on a cash basis.

- *Pre-1990 forest owners:* income from allocation and disposal of free emissions units will be tax exempt. Expenditure associated with emissions liabilities when land use changes from a forest to non-forest use will not be deductible.

- No tax deduction or liability generally arises on the surrender of units to the Government.

Post-89 forest owners

Transactions in emissions units relating to post-1989 forests will generally be on revenue account. A cash basis approach to recognising income and expenditure is a practical tax accounting method and consistent with the tax rules for forestry, where the cash basis is ordinarily applied.

It also reflects the nature of the emissions trading scheme (ETS) as it applies to post-1989 forests. Under the ETS, emissions units are periodically awarded by the government to forest owners in recognition of carbon capture in growing forests. However, that carbon capture is not permanent, and the carbon is treated as being released when the forests are harvested. This triggers a liability to surrender emissions units. This liability should never exceed the number of units awarded in respect of the forest.

Forest owners may choose to sell the units they received, on the basis that they have been allocated units in excess of their future liabilities, or because they wish to realise an immediate benefit from the units awarded to them and are prepared to take the risk of purchasing units to meet future liabilities at a later date. Taxation on the sale of units is appropriate. Similarly, where replacement units are purchased a tax deduction will be available in the year of purchase.

Pre-1990 forest owners

Transactions in emissions units relating to pre-1990 forests will generally be on capital account and so give rise to neither taxable income nor deductible expenses. The liability under the ETS is a one-off cost that must be met if forest land is converted to a non-forest use. It is akin to any other one-off land conversion costs or set up costs which arise in significantly changing the nature of a business operation. Costs of this kind are treated as being on capital account under ordinary principles. Because free units are received to partially compensate owners of forest land for these potential costs, receipt of the units should also be treated as being on capital account.

Forestry generally

The differences in the tax treatment reflects the distinctions made between forests established before and after 1 January 1990 in the emissions trading scheme design, which mirror the rules in the Kyoto Protocol.

Non-forestry tax issues and GST – process 2008

Any law changes necessary for non-forestry entrants to the ETS, residual matters relating to the forestry sector, and the GST treatment of emissions units will be determined following consideration of submissions on the broader tax issues arising from the ETS.