9 March 2018

The National Treasury

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The Standing Committee on Finance

Parliament of the Republic of South Africa

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RE: COMMENTS ON SECOND DRAFT CARBON TAX BILL

1. Introduction

We set out our high-level comments on the Second Draft Carbon Tax Bill (Bill) in this submission.

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2. Certainty

Certainty will be needed in order for the Carbon Tax to be effective in achieving its objectives. Although Treasury has tried to clarify much of the uncertainties related to the carbon tax in the first draft, the revised version of the Bill still includes significant uncertainties. The supporting regulations for the Bill are still outstanding. It is our view that the Bill cannot be implemented without these regulations. In order for the Carbon Tax to be effective, certainty will be needed on all aspects of the Bill as well as the supporting regulations. Companies need to plan in advance, especially for projects with long life cycles, trade-exposed industries and industries who wish to participate in carbon offsets.

3. Initial implementation

We expect that the initial implementation process of the carbon tax will be quite onerous and complicated for taxpayers, SARS and the DEA. In businesses, financial management responsible for the tax compliance will have to liaise with operational management to obtain an understanding of which activities might trigger the carbon tax as well as to obtain the necessary information to report on and quantify the carbon tax. In large businesses, this could give rise to real coordination issues which would take time to resolve. We would like to suggest a phased approach to the implementation of the carbon tax so that taxpayers will have more time to implement the carbon tax. It is suggested that the first phase includes only fuel combustion emissions, a second phase adds on process emissions and the final phase adds fugitive emissions.

4. Persons subject to tax (section 3)

It appears clear from the wording of section 3 that the Carbon Tax is levied on a **"person"** as defined. In other words, a single individual, partnership, trust or other legal entity such as a company is the "taxpayer" as defined in section 1. For example, the Carbon Tax is levied on each company in a group of companies and not on the group as a whole. Although the wording of the draft bill is clear

on this point, wording used in the Explanatory Memorandum, the Response Document and the Department of Environmental Affairs (DEA) National Greenhouse Gas Emissions Reporting Regulations (NGERs) may create uncertainty and should be reconsidered.

For example, the draft bill makes reference to the NGERs. These regulations define a data provider as any person including –

a) Its holding company or corporation or legal entity, registered in South Africa in accordance with the legislation of the Republic of South Africa;

b) All of its subsidiaries and legally held operations, including joint ventures and partnerships where it has a controlling interest, or is nominated as the responsible entity for the purposes of reporting under these Regulations; and

c) All facilities generally over which it has operational control, which are not part of another data provider as provided for in these Regulations.

As such, under the NGERs, reporting is done at group level for all the facilities under the operational control of the group and not necessarily at legal entity level.

A person is only liable for Carbon Tax "if that person conducts an activity resulting in greenhouse gas emissions above the threshold…" This wording indicates that at least one activity of the person must result in GHG emissions above the threshold before the person becomes liable for Carbon Tax on any of its activities. In other words, if all the activities of a person are below the threshold the Carbon Tax will not apply even if they are above the threshold when added together. We support this *de minimus* rule. We suggest that any activity which falls below the threshold should be disregarded, even if the person is liable for Carbon Tax on its activities that exceed the threshold. This would be in line with the Regulations.

Clarity needs to be provided on who would be regarded as conducting the activity resulting in GHG emissions where there is a landlord-tenant relationship or any activity that is contracted out. Without sufficient clarity there is a risk on the one hand that both the landlord and tenant or on the other hand that neither the landlord nor the tenant would pay or be assessed for the carbon tax.

There is a similar risk in the case of an activity that is contracted out. Should National Treasury opt to define conducting the activity as having 'operational control' over the activity then it becomes important to clearly define this term. For example, in terms of the *Greenhouse Gas Protocol – Corporate Standard*, a company is defined as having operational control if it has full authority to introduce and implement its operating policies at the operation. However, this definition is open to interpretation and will most likely result in taxpayers adopting different approaches when determining what falls within their tax base. It is important that it is clear as to who is regarded as conducting an activity.

5. Tax Base (section 4)

The Draft Bill does not contain any jurisdictional limitation. In other words, any person, anywhere in the world, who conducts an activity resulting in greenhouse gas emissions above the threshold, could at least theoretically, be liable to South African Carbon Tax. Clearly this is not the intent. Would the intent not rather be to tax GHG emissions in the Republic, subject to certain exceptions? Clarity is specifically needed in relation to branches of foreign companies and even foreign companies with high emissions from South African activities.

The determination of the tax base is dependent on the reporting methodology approved by the DEA. However, there are currently uncertainties in relation to the NGERs which will, therefore, have an impact on the application of the legislation unless resolved. These uncertainties include the following:

- the regulations are too vague in terms of providing a clear definition for operational control,
- emissions must be reported at group level (vs. legal entity level defined in the Bill);
- the thresholds outlined in both the regulations and the Bill refer to the use of net heat input thermal design capacity, which is not a nameplate capacity and which must therefore be determined, often with difficulty.

The question also arises whether SARS will accept the reports that are accepted by the DEA. In terms of the need to reduce uncertainty it is important that SARS does not dispute reports which

have been accepted by the DEA and relied on as such by taxpayers when they perform tax audits at a later stage.

Section 4(2) provides a default method for determining the tax base should a reporting methodology not have been approved by the DEA. Assuming that there are no gaps in the Greenhouse Gas Reporting Regulations, what is the purpose to provide for a default method for determining the tax base in Section 4(2). This adds an extra layer of complexity purely for tax compliance purposes. We question whether this matter is not being over legislated. Should a default method be required it should not be more complicated than the DEA methodology.

The Bill states that the carbon tax must be levied in respect of the sum of the greenhouse gas emissions of a taxpayer in respect of a tax period. There is no reference to the activity resulting in greenhouse gas emissions above a threshold. We assume that it is the intention of National Treasury that the taxpayer be liable only for those greenhouse gas emissions associated with the activity that exceeds the threshold as specified in Schedule 2. We request that this is made clear in the Bill by amending section 4.

Along the same lines, reference is made to the tax base being the GHG emissions of a taxpayer. However, there is no definition of what constitutes the GHG emissions of a taxpayer. There is no reference in the Bill to Scope 1 or direct emissions as is common practice in terms of GHG emissions accounting. There is also no reference to GHG emissions from activities over which the taxpayer has operational control. We request that clarity be provided in the Bill of what constitutes the GHG emissions of a taxpayer.

6. Rate of tax (section 5)

We submit that any increase of the rate of tax with reference to an index should reference to the Producer Price Index (PPI) as opposed to the Consumer Price Index (CPI) as the vast majority of relevant activities would be production activities. The term "producer price inflation" should be defined with reference to the PPI. It is not apparent to us why the rate of tax is increased by consumer price inflation plus 2 per cent. We question why the additional 2 per cent is used.

7. Calculation of amount of tax payable (section 6)

The process of sequestration as envisaged in section 6(1)(d) should be subject to regulations governing the methodology to determine the greenhouse gasses sequestered and the process to obtain approval for the value of "S". It is important that the methodology and process is clear so that all taxpayers have equal opportunity to access this benefit.

8. Allowances (Part II)

All the regulations for the allowances need to be published for public comment/input before the carbon tax comes into effect in order to provide certainty.

The users of fuel are not directly liable for carbon tax as the fuel producers pay the carbon tax. However, this cost would effectively be passed onto the consumer of fuel in the price of fuel. We question whether this mechanism does not result in certain of the allowances effectively being forfeited purely due to the pass-through mechanism. For example, a producer who would otherwise be entitled to a trade allowance would not get the benefit of a trade allowance in the fuel price.

Currently there is no certainty on whether the allowances will remain the same throughout the first implementation period. It is recommended that the allowances for the first implementation period should be legislated in the Bill to provide certainty on these allowances. In addition, there is no clarity on how the allowances will change after the first implementation period, for which clarity should be provided. This is critical for long-term planning by taxpayers. We submit that there should be no objection to making this clear if the intention of the carbon tax is to change behaviour. Projects that reduce GHG emissions are sometimes large capex projects that require years of planning and it is important that the financial models for these projects can properly account for the impact of the carbon tax going forward – to change behaviour and move from more to less emissions-intensive technologies.

9. Trade exposure allowance (section 10)

We welcome the support for trade exposed entities under the Draft Bill. However, it will be important to provide clarity on the level at which a sector or sub-sector will be defined (i.e. which digit Harmonised System code will be used when defining a sector or sub-sector?). The level at which a sector or sub-sector is defined could have a significant impact on whether a sector or sub-sector is determined to be trade exposed. For example, calculating trade exposure at a sector-level may result in a sector not being identified as trade-exposed even though some sub-sectors within that sector are, in fact, trade-exposed.

Clarity should also be provided on the source of data to be used for total production by sector or sub-sector. This would enable entities to calculate whether they are trade exposed or not and the level of support for which they are eligible. It is also important to remember that the trade exposure of a sector or sub-sector can change over time. For this reason, it is important to state the year from which data will be used to determine trade exposure. The use of data from a specific year may or may not reflect the real trade exposed nature of a sector or sub-sector. For example, data from 2016 may or may not be reflective of the trade exposure nature of a sector or sub-sector in 2018. It would be useful to understand how this will be addressed.

Consideration should also be given to whether the quantum of support under the trade exposure allowance is sufficient to protect entities engaged in exporting or exposed to imports. For example, an entity that exports all its product would still be liable for a carbon tax under the current design of the trade exposure allowance. This would negatively impact on the competitiveness.

It seems that the sectoral method to determine the trade exposure allowance referred to in the Bill is too limited. A sector may be trade exposed to a different extent than the proxy contained in this method. It would be very difficult for a taxpayer to plan using this method to forecast the trade exposure allowance that it would be entitled to over the life of a project. There is likely to be significant lags between the period for which the data is available for the sector and the periods during which the projects are planned and executed. We recommend that the trade exposure allowance should be determined at a company level.

At this stage the regulations are not yet available which adds to the uncertainty. These regulations need to be released for public comment.

10. Carbon budget allowance (section 12)

As a practical matter, we note that the DEA should put an effective system in place to provide taxpayers with confirmation that they are participating in the carbon budget system for purposes of the allowance.

11. Offset allowance (section 13)

The term “carbon offsets” is used without being defined in the Draft Bill. A taxpayer must reduce the amount of the carbon tax by utilising carbon offsets as prescribed by the Minister. In our view the taxpayer should not be obliged to use carbon tax offsets but should be entitled to elect whether or not to utilise the offsets available to it. The updated regulations governing offsets should be released for public comment.

12. Administration (section 15)

It is proposed that SARS will administer the provisions of the Carbon Tax Act as if the carbon tax were an environmental levy as contemplated in the Customs & Excise Act, no. 91 of 1964. We are not convinced that it is ideal that the carbon tax administration be performed in terms of the Customs & Excise Act. In this regard we note that the carbon tax is a different tax to a customs or excise duty as evidenced by the fact that there is a separate Carbon Tax Bill. Furthermore, because of the nature of the customs and excise duties, the Customs & Excise Act contains very strict penal provisions. The carbon tax requires complex calculations with room for error. This could mean that an honest mistake in performing the complex carbon tax calculations and specifically an error on an allowance would be regarded as a serious offence under the Customs & Excise Act as it is seen as a “rebate” In addition, many businesses do not understand the Customs & Excise Act, especially if they are not currently subject to it, and would find it challenging to understand which parts of the Customs & Excise Act they would now need to comply with. Consideration should be given to providing separate administration provisions specifically for the carbon tax.

We are also not convinced that it should be SARS Customs who administers the carbon tax. We recommend that a dedicated team of carbon tax specialists be formed within SARS to focus on the carbon tax, given the specialised nature of the tax.

13. Tax period (section 16)

Carbon tax periods are defined to coincide with the calendar year. This is in line with the DEA reporting requirements which require reports for each calendar year to be submitted by 31 March of the following year. We note that the Department of Energy reporting periods align with the financial years of taxpayers. We recommend that, from a practical perspective, the reporting years should all be aligned, possibly to the calendar year in line with South Africa's reporting requirements under the United Nations Framework Convention on Climate Change.

14. Payment of tax (section 17)

Tax period is defined in section 16 effectively as a calendar year. However, in section 17 which deals with the payment of tax on a six-monthly basis, reference is made to a tax period from January to June and another period from July to December. This is likely to create confusion and we would recommend that different terms be used for the annual versus the six-monthly periods.

There will need to be time after June and December before payment is due as invoices for fuel used only come in the following month. In other words, companies will only get invoices for June in July and December in January. As such, there will need to be time for a taxpayer to determine its 6 monthly emissions and associated tax payment.

15. Impermissible tax arrangement (section deleted)

We welcome the deletion of the draft section on impermissible tax arrangements as it would have been counterproductive.

16. Revenue recycling

The environmental levy in respect of electricity generated in the Republic is deducted in determining the carbon tax payable by a taxpayer who generates electricity from fossil fuels. As a general matter, we question whether this environmental levy should not be scrapped when the carbon tax is introduced as it was intended to be a temporary measure until a form of carbon tax is introduced. Similarly, we suggest that the vehicle emissions tax should also be scrapped once the carbon tax is introduced as the carbon tax will be incorporated as an additional levy on fuel and will result in double taxation if the vehicle emissions tax remains.

We understand the energy efficiency incentive (section 12L of the Income Tax Act) will be offset against the carbon tax revenue. We recommend that the energy efficiency incentive should be incorporated into the Bill as an offset against the carbon tax. We also recommend that S12L be extended beyond 2020 on implementation of the carbon tax to ensure that there is long term certainty on revenue recycling. Reference is made to the provision of enhanced free basic energy and public transport. Further clarity should be provided regarding the earmarking of the carbon tax revenue as recommended by the Davis Tax Committee.

In the First Draft Carbon Tax Bill 2015: Response Document, there is a commitment to ensuring that the carbon tax does not impact the electricity price up to the 31st of December 2022. However, this is not explicitly stated in the Draft Bill. Instead there is a formula to be used by a taxpayer engaged in the generation of electricity from fossil fuels. This formula allows the taxpayer to reduce its carbon tax liability for a specific tax period by the renewable energy premium and the environmental levy that it paid for that same tax period. The application of this formula does not guarantee that the taxpayer will not pay a carbon tax and that this carbon tax will not be passed on to the user of the electricity. In order to provide certainty, we request that the Bill is amended to state that the carbon tax will not impact on the electricity price up to the 31st of December 2022. We also request that clarity is provided in the Bill as to what will happen post the first implementation period in terms of the electricity price being affected by carbon tax.

We request that a schedule be provided of the revenue to be collected from this tax and the anticipated allocation of this revenue, as is common in carbon pricing mechanisms in other countries around the world. In the First Draft Carbon Tax Bill 2015: Response Document, mention is made of

recycling of some of the revenue into a reduction in the electricity generation levy, a credit rebate for the Renewable Energy Premium and energy efficiency savings tax incentive. In the same document, it is stated that a reduction in the electricity generation levy and a credit rebate for the Renewable Energy Premium, plus the energy efficiency savings tax incentive, would leave very little if any additional revenue for further recycling during the first phase, up to 2022.

However, from the Bill, it is clear that a taxpayer generating electricity from fossil fuels is still paying the renewable energy premium and the environmental levy, only now deducting it from its carbon tax liability. This would mean that less carbon tax would be collected from taxpayers generating electricity from fossil fuels, but the revenue collected from the carbon tax imposed on these and other taxpayers would not be needed to facilitate a reduction in the electricity generation levy nor a credit rebate for the Renewable Energy Premium as the electricity generators would still be paying these. This leaves the energy efficiency savings tax incentive. Is it the intention of National Treasury that all the revenue collected from the carbon tax would be recycled into this incentive as per the comment that there would be very little if any additional revenue for further recycling during the first phase? If so then please clarify as the incentive comes to an end in 2019 (for years of assessment ending before 1 January 2020). Will this incentive be extended? We assume that this will be the case if it is in the intention that the revenue collected from the carbon tax will be recycled into this incentive in the first phase, leaving very little if any additional revenue for further recycling.

17. Schedule 2

Schedule 2 to the Bill should be referenced to the Addendum to the National Greenhouse Gas Reporting Regulations. There is a concern that the IPCC categories in Schedule 2 and those in the Addendum may become misaligned over time and the question arises whether cross-referencing is not preferred. The link between Schedule 2 and the Intergovernmental Panel on Climate Change (IPCC) 2006 Guidelines should be made clear. It should be clear that the activities listed in Schedule 2 refer back to the IPCC 2006 Guidelines in terms of their definitions.

Many of the thresholds in Schedule 2 are given as 10MW(th). Although, from the *Explanatory Memorandum*, we understand this to mean an installed capacity of 10 MW thermal net heat input,

the phrases '*installed capacity*' and '*net heat input*' do not appear in the Bill itself. We request that Schedule 2 be amended to include these phrases so that the thresholds are clearly defined.

When calculating if the threshold is exceeded, not only is it important that it is clear on how the net heat input installed capacity should be determined, but it is also important that it is clear which equipment should be included in the calculation. For example, should all stationary combustion equipment be included? Should the calculation of the threshold include equipment that is on-site, but no longer used (i.e. decommissioned equipment) and equipment that is only used for emergencies (i.e. stand-by/back-up generators that would in any event use diesel/petrol payable through the fuel levy etc.)? Please confirm as it is important that all legal entities include the same equipment when determining if they are a taxpayer for the purposes of the Act. It must be noted that the NGERs do not provide clarity in this regard.

In Schedule 2, there are thresholds given to several activities that have been allocated a 100% basic tax-free allowance. For example, *Forest Land Remaining Forest Land* and *Land Converted to Forest Land* both have a threshold of 100 Hectares of Plantations or Natural Forests, but they also have a 100% basic tax-free allowance. We would request that the thresholds for these activities are changed to *Not Applicable* or *NA* unless it is National Treasury's intention that taxpayers conducting these activities register as a taxpayer, report on their greenhouse gas emissions, but pay no tax on these emissions. If it is indeed National Treasury's intention that they register as taxpayers and report on their greenhouse gas emissions then it becomes important for National Treasury to amend the calculations in the Draft Bill to include greenhouse gas emissions that result from *Agriculture, Forestry and Other Land Use* and *Waste*. It must be noted that the NGERs do not outline the methodology to be used to calculate greenhouse gas emissions from *Agriculture, Forestry and Other Land Use*.

We appreciate the opportunity for engagement throughout the legislative process.

Yours sincerely

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