Reducing Your Carbon Tax Liability Through Offsetting !

National Treasury released a long-awaited paper on carbon offsets on 29 April 2014 for comment by the public before the 30th of June 2014. The policy paper provides detail on what carbon offsets can potentially be used to reduce a company's carbon tax liability. The paper must be read in the context of the pending carbon tax in South Africa in order to provide a clear understanding of its impact on companies.

South African National Treasury has for a long time been considering implementing a carbon tax in South Africa. In the 2013 Budget Review, National Treasury outlined the proposed design of the carbon tax. Implementation of this tax was scheduled for 2015, but postponed to 2016 in the 2014 Budget Review.

Once the carbon tax is introduced, eligible companies will be expected to pay for their greenhouse gas emissions (released as a result of the use of fossil fuels like coal and diesel). The current design proposes a tax rate of R120 per ton CO_2e on scope 1 emissions. Scope 1 emissions are typically greenhouse gas emissions that are released as a result of the consumption of fossil fuels on-site or in company-owned vehicles or equipment.

Given the high tax rate and in order to reduce the initial impact of the tax, National Treasury has introduced the concept of 'tax-free thresholds.' Companies eligible for tax-free thresholds will only pay the carbon tax on a portion of their greenhouse gas emissions. Initially, until 2020, companies will have a basic tax-free threshold of 60%. This means that companies will only pay tax on 40% of their greenhouse gas emissions. This tax-free threshold can be increased to a maximum of 90%.

One of the ways to increase the tax-free threshold is to purchase of carbon offsets. The use of carbon offsets can result in a 5 to 10% increase in the tax-free threshold. A carbon offset is an external investment that allows a firm to access greenhouse gas reductions in a manner that is cheaper than investment in its own operations.

An example of a carbon offset would be a company investing in a solar water heating project in a low-income community. The use of solar water heaters would displace the use of electricity or fossil fuels which, in turn, means a reduction in greenhouse gas emissions. This saving in greenhouse gas emissions could be used to increase the company's tax-free threshold and reduce its carbon tax liability. Typically, companies would only do this if it was cheaper to invest in the solar water heating project than to achieve reductions in their own operations or to pay the carbon tax.

Although the concept of a carbon offset may be simple from the above example, the reality is far from that. Carbon offsets must be real, additional and permanent – each one of which holds its own challenges. For example, demonstrating additionality requires that you prove that the project would not have occurred under a 'business- as-usual' scenario. This alone presents a number of challenges which entities such as the United Nations Framework Convention on Climate Change (UNFCCC) have spent years working on overcoming.

Given the complexity of the world of carbon offsets and in order to provide a level of clarity, National Treasury has defined certain eligibility criteria for what carbon offsets can be used in the South African carbon tax regime. Some of the main eligibility criteria are:

• Only South African-based carbon offsets will be eligible in this carbon tax regime;
• Projects that generate carbon offset credits must occur outside the scope of activities that are subject to the carbon tax. In other words, the projects that generate carbon credits cannot be subject to carbon tax as this would lead to double-counting; and
• A list of eligible and ineligible projects will be provided. Eligible projects will most likely focus on energy and energy efficiency, waste, transport and agriculture, forestry and other land uses.

Ineligible projects will include projects that are subject to a carbon tax, projects that focus on industrial gasses and projects that have received any other government incentive.

Navigating the world of carbon is complicated and rife with jargon. To cut through the noise, this is what we recommend companies start to do in preparation for the carbon tax and the carbon offsets:

• Companies must measure their greenhouse gas emissions. This is also called the carbon footprint. The carbon footprint is the starting point for any company wanting to understand the impact of a carbon tax on their operations.
• Using the carbon footprint, companies can quantify their carbon tax liability. This allows companies to understand the impact on their operations and to start to investigate their options. Companies should start to understand the potential to access higher tax-free thresholds and the associated cost thereof.
• Companies need to start understanding what other current incentive and grant opportunities exist to help reduce their carbon footprint (e.g. section 12L of the Income Tax Act, the Manufacturing Competitiveness Enhancement Programme, section 11D of the Income Tax Act etc.).
• Understand the impact of the carbon tax and offsetting on their business to determine whether it is worth submitting a response (individually or with another association, chamber etc) to the carbon offsetting paper by 30 June 2014.