

EXPLANATORY MEMORANDUM TO
THE VALUE ADDED TAX (EMISSIONS ALLOWANCES) ORDER 2010
2010 No. 2549

1. This explanatory memorandum has been prepared by HM Revenue & Customs and is laid before the House of Commons by Command of Her Majesty.

2. **Purpose of the instrument**

This instrument, with effect from 1 November 2010, abolishes the VAT zero-rate for transactions in emissions allowances for greenhouse gases (often colloquially referred to as “carbon credits”) in the United Kingdom.

3. **Matters of special interest to the Select Committee on Statutory Instruments**

None.

4. **Legislative Context**

4.1 Council Directive 2006/112/EC¹ (“the Principal VAT Directive”) establishes a common system for VAT in the European Union. This is implemented in the United Kingdom by the Value Added Tax Act 1994 (“VATA”) and secondary legislation made pursuant to powers in VATA.

4.2 Subsection (2) of section 30 of VATA zero-rates the supply of any goods or services specified in Schedule 8 to the Act, and subsection (4) of that section permits Schedule 8 to be varied by Treasury Order, including, amongst other things, by the addition of new descriptions of goods or services.

4.3 In 2009 evidence emerged that emissions allowances and other units which are recognised for the purposes of the European Union greenhouse gas emission allowance trading scheme (“the EU ETS scheme”)(see paragraph 7.5) were being used as a vehicle for missing trader intra-community fraud (“MTIC fraud”) (see paragraphs 7.2 to 7.4). Urgent action was required to prevent substantial loss to the revenue pending an EU wide solution to the problem.

4.4 The application of the zero-rate to supplies of goods and services used in MTIC fraud frustrates the operation of the fraud since it removes any possibility for the fraudulent supplier to retain output tax due on the supply. The UK therefore, by the Value Added Tax (Emissions Allowances) Order 2009², zero-rated the supply of emissions allowances by inserting a new group, Group 17, into Schedule 8 of VATA. The zero-rate applied with effect from 31 July 2009. A zero-rate for such supplies requires a derogation from the Principal VAT Directive and the UK made an application for a derogation for this measure to apply retrospectively from the date on

¹ OJ L 347, 11.12.2006, p.1

² S.I. 2009/2093

which the zero-rate came into force. There has as yet been no determination of this application.

4.5 On 20 March 2010 Council Directive 2010/23/EU³ inserted a new article, Article 199a, into the Principal VAT Directive. Article 199a permits all member States, until 30th June 2015, to apply a reverse charge to the transfer of allowances and other units that are recognised for the purposes of the EU ETS scheme. A reverse charge requires the recipient of supplies of goods or services to account for the VAT on the supply (this obligation would otherwise normally fall on the supplier). A reverse charge frustrates MTIC fraud in a similar way to the application of a zero-rate and this strategy has been used in the past to combat MTIC trading in goods such as mobile phones.

4.6 The Value Added Tax (Section 55A) (Specified Goods and Services and Excepted Supplies) Order 2010⁴, with effect from 1 November 2010, applies a reverse charge to supplies of emissions allowances pursuant to powers in section 55A of VATA as amended by section 19(1) of the Finance Act 2010 (c.13.).

4.7 This instrument, with effect from 1 November 2010, removes supplies of emissions allowances from the ambit of the zero-rate by deleting Group 17 from Schedule 8 to VATA.

5. Territorial Extent and Application

This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Exchequer Secretary to the Treasury, David Gauke, has made the following statement regarding Human Rights:

“In my view the provisions of the Value Added Tax (Emissions Allowances) Order 2010 are compatible with the Convention rights.”

7. Policy background

- *What is being done and why*

7.1 This instrument abolishes the application of the zero-rate to supplies of emissions allowances. The zero-rate was introduced as an exceptional measure, pending a European wide legislative solution, to combat losses arising from MTIC fraud trading in emissions allowances.

7.2 MTIC fraud is a highly sophisticated and well organised criminal attack on the VAT system. The fraud is perpetrated through contrived transaction chains involving

³ OJ L 72, 20.3.2010, p. 21.

⁴ S.I. 2010/2239

supplies of high value goods or services with the tax loss occurring when the VAT charged by the supplier is not paid to HMRC but can be reclaimed by the recipient.

7.3 MTIC fraud has been used by criminals to steal billions of pounds in VAT from Governments throughout the European Community. In recent years this was most significant in trade in mobile telephones and computer chips known colloquially as “carousel fraud”, with an estimated impact on UK VAT receipts of up to £4.5bn in 2005-2006.

7.4 HMRC has tackled and continues to tackle this fraud operationally, reducing its impact on VAT receipts and successfully catching and prosecuting the perpetrators. However in order to stem the tide of criminal activity on such a scale, it has been necessary to bring in legislative changes.

7.5 In summer 2009 evidence emerged that MTIC fraud was being carried out using trades in emissions allowances issued by Governments under a European scheme, the EU ETS scheme, designed to reduce carbon emissions by businesses. These allowances are used by certain taxpayers to comply with their obligations under the scheme. They are intangible in nature and are traded in high volumes and at high values. Whilst it was recognised at EU level that a European-wide legislative counter-measure would be necessary to combat this fraud the UK, pending that solution, needed to prevent imminent and very substantial losses to the revenue.

7.6 A zero-rate frustrates the fraud because it removes any possibility for the fraudulent supplier to retain output tax due on the supply. Since there is negligible retail consumption of allowances, the application of the zero-rate to them results in a negligible reduction in revenue.

7.7 A zero-rate for allowance trading was therefore introduced with effect from 31st July 2009 as an interim measure to tackle the fraud in the United Kingdom. France and the Netherlands similarly introduced their own national measures to deal with the fraud. The scope of the zero-rate also included options for emissions allowances as “belt and braces” although there was no evidence of fraud in options trading at the time. The zero-rate successfully prevented further MTIC fraud in emissions allowances.

7.8 In order to combat this fraud on a Europe-wide basis the Principal VAT Directive was amended with effect from 16 March 2010 by the insertion of Article 199a which permits Member States, until 30th June 2015, to apply a reverse charge to supplies of emissions allowances and similar units used by businesses to comply with the EU-ETS scheme. A reverse charge requires the recipient of a supply, rather than the supplier, to account for VAT on that supply. It operates in a similar way to the zero-rate to frustrate MTIC fraud.

7.9 Domestic vires for the application of a reverse charge to the supply of services used in MTIC fraud were introduced by the Finance Act 2010 and a reverse charge will be applied to trading in emissions allowances and other units with effect from 1 November 2010 by the Value Added Tax (Section 55A) (Specified Goods and Services and Excepted Supplies) Order 2010. This instrument will repeal the zero-rate applicable to such supplies from the same date. It will also remove the zero-rate

from options for emissions allowances but there is no evidence of fraud in options nor does the options trade lend itself to fraud. Along with futures trades, options are largely transacted in the UK on the markets to which a different zero-rate applies under the Value Added Tax (Terminal Markets) Order 1973⁵.

- *Consolidation*

None.

8. Consultation outcome

An informal consultation was conducted with the emissions trade sector which was supportive of the introduction of a reverse charge to combat MTIC fraud in place of the zero rate.

9. Guidance

Guidance is being published to cover the changes brought about by these instruments.

10. Impact

10.1 The impact on business, charities or voluntary bodies is negligible.

10.2 The impact on the public sector is negligible.

10.3 An Impact Assessment has not been prepared for this instrument.

11. Regulating small business

11.1 The legislation applies to small business.

11.2 Technically, the changes do not discriminate between businesses but few, if any, small businesses are affected.

12. Monitoring & review

The supplies which have been subjected to the zero-rate (other than options) will be subject, from 1 November 2010, to a reverse charge. It is a requirement of exercising the option to apply the reverse charge under the Directive 2010/23/EU that an evaluation is provided to the Commission by 30th June 2014. HMRC continues to monitor whether MTIC fraud may spread to other goods or services and what further measures may be appropriate.

13. Contact

Nick Chambers at HM Revenue & Customs Tel: [020 7147 0179] or email: nick.chambers@hmrc.gsi.gov.uk can answer any queries regarding these instruments.

⁵ S.I. 1973/173