UK VAT TREATMENT OF VOLUNTARY CARBON CREDITS

HMRC has published new guidance on the VAT treatment of voluntary carbon credits, correcting the anomalous distinction between voluntary and compliance market credits. From 1 September 2024, voluntary carbon credits will generally be subject to VAT.

Key issues

- HMRC has announced that sales of voluntary carbon credits will be subject to VAT at 20% from 1 September 2024.
- Additional VAT costs will arise for exempt businesses, but the VAT recovery position will be simplified for taxable businesses generating revenue in this area.
- HMRC has also confirmed that trading in voluntary carbon credits on certain commodity exchanges will benefit from zero rating under the Terminal Markets Order (TMO).
- Market participants should review their contracts and systems to ensure that they are fully prepared when the new rules come into effect.

Background

VAT was officially outside the scope of the Government's recent consultation on tax issues around environmental land management and ecosystem service markets, but industry bodies nevertheless made representations on VAT following feedback from their contributors calling for clarity on the outdated treatment of voluntary carbon credits.

HMRC has traditionally applied different VAT treatments to units issued in the compliance and voluntary markets. In compliance markets, the form of unit is a "carbon allowance", which represents a permit to emit one metric tonne of carbon dioxide or equivalent (tCO2e). Carbon allowances derive from legal requirements and are subject to regulatory oversight. In contrast, "voluntary carbon credits" represent one tCO2e of emission reductions, avoidance or removals. They are optional and issued under independent schemes (rather than compliance market schemes). Carbon allowances from regulated schemes such as the EUETS and UKETS are subject to VAT at the standard rate, but voluntary carbon credits have been treated as outside the scope of VAT.

The reason for this distinction was that, unlike carbon allowances, which confer a tangible benefit on businesses as they are required to meet regulatory obligations, the voluntary nature and lack of verification associated with voluntary carbon credits resulted in them being viewed as providing only a general reputational or social benefit. HMRC did not regard this as a sufficiently identifiable service which could form a cost component of a business and part of an onward supply of the type envisaged by the VAT system and so treated trading in voluntary carbon credits as a non-business activity.

The new VAT treatment recognises that the old treatment was out of date (and out of step with other jurisdictions) due to significant developments in the voluntary carbon market in recent years. Voluntary schemes such as the Woodland and Peatland Carbon Codes are now better established and have independent verification, registration and management such that HMRC now accept that they can form part of the VAT supply chain. Another factor which has influenced this change is the growing secondary market in voluntary carbon credits.

The reference to "ex-post" and "ex-ante" credits in HMRC's updated internal manual suggests that all voluntary carbon credits are now potentially subject to VAT - whether for present or future delivery (an example of the latter being a Pending Issuance Unit issued under the Woodland Carbon Code).

Implications of new treatment

Under the new rules, additional VAT costs will arise for consumers and exempt/partially exempt businesses who purchase voluntary carbon credits. Applying a zero rate instead of the standard rate could have prevented this potential discouragement of what is for some a philanthropic activity. However, fully taxable purchasers or purchasers who intend to on-sell the credits should only suffer a cash flow cost as the VAT incurred should be recoverable.

This development will be seen as positive for many due to the improved VAT recovery position. As mentioned above, the reason why VAT was not previously charged on voluntary carbon credits was because trading in these credits was treated as a non-business activity. As VAT incurred on a non-business activity is not recoverable, concerns arose around the need to apportion overheads and the impact of adding carbon trading vehicles to existing VAT groups. Businesses trading in this space are likely to consider that the additional cash flow costs are worth the reduced risk of irrecoverable VAT.

HMRC say that certain transactions will still be treated as outside the scope of VAT under the new treatment, such as the holding of voluntary carbon credits as an investment where there is no economic activity (i.e. the same treatment applicable to passive holding companies) and credits generated from self-assessed projects with no independent or third party verification. In addition, HMRC outlines in its internal manual the factors to consider when assessing a scheme's VAT position (e.g. if a tradeable instrument is issued it is more likely to be subject to VAT) so in certain cases the particular terms of a scheme may need to be considered in order to work out the VAT treatment.

Place of supply

It should be noted that the usual place of supply rules apply so that VAT will only be chargeable where the supply is made in the UK. This means that UK domestic sales will be subject to VAT, irrespective of whether the relevant project or scheme is based in the UK or overseas. Sales to non-UK buyers should fall outside the scope of UK VAT (but now giving the seller an entitlement to recover its related input tax) but may be subject to VAT (or equivalent) under the reverse charge in the buyer's jurisdiction. UK businesses buying credits from non-UK sellers will have to account for VAT under the reverse charge procedure.

For completeness, sales of compliance market credits used to meet obligations under the EUETS and UKETS between UK established counterparties are subject to the "domestic reverse charge". Although this measure was designed to tackle Missing Trader Intra Community (MTIC) Fraud, there appears to be no plan for domestic trades in voluntary carbon credits to be brought within the reverse charge, which invites the question whether this market could be the next target for fraudsters.

Reverse charge

- A mechanism which typically applies to cross-border transactions where the responsibility for accounting for VAT switches from the seller to the buyer.
- The "domestic reverse charge" is an anti-fraud measure which, by way of exception, applies the reverse charge to UK domestic transactions in specified goods and services.

Terminal Markets Order

As trailed in the Spring Budget 2024 and as part of a wider consultation on modernising the Terminal Markets Order (TMO), HMRC also announced that trading in voluntary carbon credits will be brought within the scope of the TMO with effect from 1 September 2024. The TMO provides a zero rate of VAT for certain wholesale commodity transactions made by members of specified commodity exchanges. The legislation has yet to be published, but this should put voluntary carbon credits on the same footing as those compliance market credits which already fall within the TMO.

Recommended actions

The charging of VAT will clearly have compliance implications in terms of invoicing and accounting for VAT and businesses in the carbon market should ensure that their systems and procedures are updated accordingly. Market participants should also review the terms of their commercial contracts to ensure that the VAT cost is correctly allocated between the parties.

If you wish to discuss any of the issues outlined in this briefing, please contact your usual Clifford Chance Carbon Group or Tax contact.

Link to Guidance: Policy paper: Revenue and Customs Brief — VAT treatment of voluntary carbon credits – 9 May 2024

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