EXPLANATORY MEMORANDUM TO

THE VALUE ADDED TAX (EMISSIONS ALLOWANCES) ORDER 2009

2009 No. 2093

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

This memorandum contains information for the Select Committee on Statutory Instruments.

2. Purpose of the instrument

This Order introduces a new zero-rate for transactions in emissions allowances in respect of greenhouse gases (often colloquially referred to as "carbon credits") within the United Kingdom, in order to combat VAT fraud identified with such transactions.

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

3.1 This instrument breaches the '21 day rule'. The instrument has been made urgently and brought into force by the Treasury in exercise of powers under Section 30(4) of the Value Added Tax Act 1994 (read with section 96(9)).

3.2 This instrument is an exceptional measure designed to combat a significant fraud on the VAT system involving tradeable emissions allowances. Delay in acting leaves the UK VAT system exposed to the theft of large sums of VAT. If the 21 day rule were to be observed substantial VAT losses could accrue during the 21 day period because fraudsters would be on notice of the pending changes.

3.3 This instrument introduces a new zero-rate for the supplies specified in the instrument which should be introduced by the UK under a derogation. Derogations from the Principal VAT Directive (2006/112/EC) are permitted, but require an EU Council decision which would take some time, during which hundreds of millions of pounds in VAT could be lost.

3.4 The UK is in the process of applying for a derogation for this measure to apply retrospectively from the date on which this instrument comes into force.

4. Legislative Context

4.1 Subsection (2) of section 30 of the Value Added Tax Act 1994 zero-rates the supply of any goods or services specified in Schedule 8 to the Act, and subsection (4) of that section allows for Schedule 8 to be varied by Treasury Order, including amongst other things the addition of new descriptions of goods or services.

4.2 This Order adds a new Group 17 to Schedule 8, which zero-rates supplies of emissions allowances. The new Group covers the supply of emissions allowances relating to EU schemes and international schemes under the Kyoto Protocol designed to reduce greenhouse gases emissions and includes the supply of options relating to such allowances.

4.3 By applying a zero-rate, suppliers will not charge output tax on the supplies but will still be able to deduct their input tax (in EU terms this equates to exemption with the right to deduct). The effect is that neither the supplier nor the recipient of the allowance or option will suffer any additional VAT. The fraud is prevented because it relies on the ability to charge the recipient output tax which this instrument removes by means of zero-rating the supplies.

4.4 The effect of the Order is relieving. Taxpayers are relieved from having to charge output tax on the supplies to which the Order applies but retain the right to deduct input tax incurred in the making of those supplies.

5. Territorial Extent and Application

This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Financial Secretary to the Treasury, Stephen Timms, has made the following statement regarding Human Rights:

In my view the provisions of the Value Added Tax (Emissions Allowances) Order 2009 are compatible with the Convention rights.

7. Policy background

- ***What is being done and why***

7.1 Missing trader intra-community Fraud (or “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.

7.2 HMRC have tackled this fraud operationally, reducing its impact on VAT receipts and successfully catching and prosecuting the perpetrators. In order to stem the tide of criminal activity on such a scale, it was necessary to bring in legislative changes to provide for a domestic reverse charge for supplies of specified goods which were agreed at EU level in 2007.

7.3 In recent weeks, there has been evidence that a similar fraud is being carried out using trades in emissions allowances issued by Governments under schemes designed to reduce carbon emissions by businesses. These emissions allowances are intangible in nature and are traded in high volumes and at high values.

7.4 Whilst it is recognised at EU level that Community-wide legislative change is necessary to tackle this emerging fraud and the Commission is expected to table proposals in this regard later in 2009, this does not deal with the immediate problem for the UK. In June this year France announced urgent legal measures in response to evidence of significant fraud potential in its domestic market and the Netherlands followed suit early in July.

7.5 In the weeks immediately before making this instrument there has been a surge in the numbers of new entrants to the UK market. HMRC has also tracked a number of transaction chains and identified significant losses of VAT in recent months. HMRC estimates these losses to be of the order of low hundreds of millions of pounds. These estimates will be revised and published in due course alongside estimates of indirect tax gaps and fraud losses for 2009-10. The scale of the fraud has the potential to escalate rapidly and the Government has decided to act immediately to take the necessary action to stamp out this fraud in the UK.

7.6 Zero-rating supplies of emissions allowances removes output VAT from the transactions and with it the possibility for fraud. Zero-rating is an interim measure that the Government expects to remain in force until an EU-wide solution is implemented. Although zero-rating can be viewed as a relief from tax, most emissions allowances are consumed by businesses which can deduct the VAT charged to them in respect of acquiring the emissions allowances with the result that any output tax charged would be recovered in any event. Unlike most supplies of goods and services, there is no retail consumption of such allowances and so negligible net (irrecoverable) VAT is actually collected by the Government from final consumers in relation to these transactions (i.e. the chain is tax neutral).

7.7 This is different from the trade in mobile telephones where a zero-rate would lead to a loss of VAT collected at the retail stage (irrecoverable output tax charged to a final consumer). This was why, to combat mobile phone and computer chip MTIC fraud, the UK introduced a reverse charge of the VAT between businesses. It may well be that the agreed EU-wide solution to the MITC fraud involving emissions allowances will eventually be to introduce a similar reverse charge mechanism in all member States but UK legislation does not allow the Government to introduce such a measure quickly whereas the zero-rating approach can be applied with immediate effect.

- ***Consolidation***

7.8 This instrument does not amend any other instrument.

8. Consultation outcome

There has been no formal consultation on this measure although the issues have been discussed with stakeholders carrying on legitimate trade and with their representatives. Those discussions revealed a nervousness in the market and uncertainty in dealing with new customers. There is support for the Government to act quickly and the realisation that the ideal of an agreed EU-wide solution would take too long.

9. Guidance

A Revenue & Customs Brief and press release are being published alongside this instrument.

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

These changes are made on an interim basis pending a wider legislative solution to be agreed at EU level. Once an EU-wide solution is adopted it is expected that the effect of this instrument will be replaced by that solution.

13. Contact

Ted Castledine at HM Revenue & Customs Tel: 020 7147 0177 or email: ted.castledine@hmrc.gsi.gov.uk can answer any queries regarding the instrument.