Taxing emissions: VAT and voluntary carbon credits

Environmental | Indirect Tax



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We consider the consequences for businesses supplying or purchasing voluntary carbon credits and discuss examples where the VAT position becomes more complicated.

Key Points

What is the issue?

A voluntary carbon credit is a tradeable unit issued by an independent verified carbon-crediting programme which guarantees the reduction or removal of one metric tonne of carbon dioxide (or equivalent greenhouse gases) from the atmosphere. Voluntary carbon credits are used by businesses and individuals who choose to offset emissions outside the formal emissions trading schemes.

What does it mean for me?

HMRC has changed its guidance on the UK VAT liability, with voluntary carbon credits changing from being treated as outside the scope of VAT to being subject to the standard rate of UK VAT from 1 September 2024.

What can I take away?

Affected businesses have had to consider VAT issues beyond simply adding 20% to the price, including pre-registration input VAT, the intending trader position for VAT registration, the VAT position for supplies that straddle the change in rules, reselling VCCs and the risk of a recurrence of VAT fraud in the emissions markets.

A fundamental tenet of regulated emission trading schemes is that some businesses can reduce emissions at a lower cost than others, and the atmosphere is indifferent to the source of emissions. Thus, the market should decide how and by whom emission levels are reduced. Voluntary carbon credits take this principle one step further, applying it to a global scale and trying to value prevented emissions in the same way as actual emissions.

HMRC’s guidance on the VAT treatment of voluntary carbon credits has evolved from treating the credits as outside the scope of VAT (which was practically useful but perhaps technically difficult to justify) to treating them as being subject to UK VAT from the 1 September 2024.

The changes to voluntary carbon credits will impact:

- generators of voluntary carbon credits, such offset developers, landowners, farmers and land management agents;
- traders of voluntary carbon credits, such as trading houses, brokers and exchanges; and
- businesses offering consumers the ability, for a charge, to offset their carbon emissions via voluntary carbon credits.

Voluntary carbon credits

Voluntary carbon credits are one of several emission-reducing products available for purchase and trading on the voluntary carbon market. Usually, a voluntary carbon credit is linked to the removal of one tonne of carbon dioxide (or equivalent other

greenhouse gas) from the atmosphere.

These gains can be achieved by means of ecological improvements over a long-term period; for example, planting more trees in a defined area of land so that more carbon is removed from the atmosphere than would have happened if it were not for the environmental project. They can also be generated by new technologies such as direct capture and storage of carbon dioxide from the atmosphere.

Voluntary carbon credits allow businesses and individuals to offset their carbon emissions beyond the regulated carbon credit compliance market (which in the UK is the UK Emissions Trading Scheme).

The Voluntary Carbon Market is seen as a key method of channelling finance to developing countries to accelerate their transition to net zero economies, and to put a value on avoided emissions minimising overall emissions and achieving the goals of the Paris Agreement. (The Paris Agreement itself contains a section dealing with the trading of carbon allowances – Article 6.)

Whilst currently small, the Voluntary Carbon Market is backed by a wide range of institutions such as the World Bank, the United Nations and the Sustainable Markets Initiative (set up by King Charles III). The market was estimated to be worth $1 billion to $2 billion a year in 2023, but according to Citigroup is predicted to grow to up to $50 billion a year by 2030 (see tinyurl.com/43wp48nd). Many companies, especially in hard-to-abate sectors, are likely to use voluntary carbon credits to offset emissions to achieve their sustainability goals in the short and medium term.

With the predicted growth, and the pressing need to transmit funding from those making sustainability commitments to those with the ability to reduce and remove carbon, there is a significant pressure to develop this market and make it as liquid as possible. Key to this is a push to have robust and standardised verification processes to ensure that voluntary carbon credits are both credible and standardised, so easily tradeable on exchanges.

Change in VAT liability

HMRC published Revenue and Customs Brief 7 (2024) ‘VAT treatment of voluntary carbon credits’ (see tinyurl.com/53pydsuy) on 9 May, which indicated a change in its view on the VAT treatment of voluntary carbon credits. Previously, they had been

treated as ‘outside the scope’ of UK VAT, but from 1 September 2024, they have been subject to VAT at the standard rate. Where the supply of voluntary carbon credits is in a commodities market within the scope of the Terminal Markets Order, the supply is zero-rated.

Prior to 1 September 2024, HMRC did not see voluntary carbon credits as the making of economic supplies and treated any income as a non-business activity. Guidance supporting this treatment dated back to shortly after a period when there was Missing Trader Intra-Community VAT fraud in the regulated carbon market (EU emissions trading allowance) resulting in very significant losses for the UK and European tax authorities (see HMRC Brief 28 (2010) VAT: liability of non-carbon credits).

An outside the scope treatment removed the possibility of VAT fraud from the voluntary market. However, as the sector evolved and expanded and the UK’s VAT treatment of voluntary carbon credits differs from many other countries, HMRC accepted that supplies of voluntary carbon credits could be incorporated into a business’s onward supplies, and acknowledged the increase in trading of credits in secondary markets.

It should be noted that not all income related to voluntary carbon credits is standard rated. HMRC’s definition of a voluntary carbon credit requires third-party verification. As such, credits sold without external verification will continue to be outside the scope of UK VAT. HMRC updated its VAT Supply and Consideration Manual at VATSC06584 (see tinyurl.com/3223hjhy) and VATSC06586 (see tinyurl.com/mrzwnr3y) to provide examples of activities related to voluntary carbon credits where the income remains outside the scope of VAT post 1 September 2024.

VAT registration for intending traders

In many cases, when a business registers for VAT, it will have either already started making taxable supplies, or it has an intention to make such supplies in the near future. With voluntary carbon credit projects, the ecological sites can take many years to develop before the envisaged carbon sequestration levels are reached – for example, 20 to 30 years of tree growth – and some sites will only sell credits at this later stage. However, site developers will incur upfront taxable costs, such as the purchase of opted land, trees and plants, fencing and maintenance. As they have an

intention to make future taxable supplies, they may want to register from the time they start incurring taxable costs to recover the input VAT.

Where a VAT registration application discloses an intention to make taxable supplies at a date many years into the future, a business should expect that HMRC will raise further questions and request evidence. In principle, though, there should be no reason why a business with an intention to supply verifiable voluntary carbon credits in the future should be refused registration.

Input VAT recovery

Where a business has received non-business voluntary carbon credit income prior to the changing rules, and taxable credit income after 1 September 2024, HMRC expects businesses to apply the existing apportionment rules for input VAT set out in the VAT Business/Non-Business Manual at VBNB30500 (see tinyurl.com/3d698uy7). A business/non-business apportionment calculation should be set up to work out the percentage of input VAT on costs that can be claimed where the cost is used for the making of both non-business and business supplies.

VAT fraud and a domestic reverse charge

As part of an informal consultation with industry stakeholders, questions were raised as to why voluntary carbon credits are not subject to the domestic reverse charge in the same way as other emissions allowances (see tinyurl.com/45rm4kz4). The domestic reverse charge is a VAT anti-fraud measure that shifts the responsibility for declaring VAT on a supply from the supplier to the VAT registered customer. Without a settlement of VAT between counterparties it removes the possibility of Missing Trader Intra Community fraud in the markets to which it is applied.

HMRC’s current view is that the voluntary carbon credit market was not historically a target of VAT fraud and operates in a different manner to compliance market credits. This assumption probably holds at the moment, with supplies primarily being bespoke trades between individual traders or consumers rather than exchange traded.

However, as discussed above, this market is expected to expand significantly and there is a strong emphasis on making this market more attractive to external capital through the standardisation of credits and promoting exchange trading.

Missing Trader Intra Community fraud has usually required moving physical goods around the world, or at least finding a willing purchaser for specific goods at the end of a chain of transactions. As such, the most attractive markets for this fraud are ones which have high value items of ideally identical goods – so that only price is the determining factor when picking a supplier.

VAT fraud has been a significant issue in the carbon market in the past. From 2008 onwards, the EU emissions trading allowance market was subject to notable VAT fraud, with fraudulent activity at one point accounting for the majority of trading volumes (see tinyurl.com/2tk7eemm). EU emissions trading allowances were ideally suited for Missing Trader Intra Community fraud, with EU emissions trading allowances being completely fungible and traded on exchanges. The exchange trading allowed rapid chains of purchases and sales to be executed on an anonymous basis, and the exchanges would settle VAT on trades daily. The total amount of VAT lost to such fraud in the carbon market was estimated at €5 billion to €10 billion between 2008 and 2009 alone. The UK share of this ran to hundreds of millions with £83 million lost from a single participant (see tinyurl.com/2nsxpsun).

A large and liquid market with a standardised product is the stated aim of the Voluntary Carbon Market. That this market is now subject to VAT would appear likely to attract VAT fraudsters. Ironically, the more successful the market is, the more attractive it becomes for VAT fraud. In 2008, the total size of the EU emissions trading allowances market was around €20 billion, with around 50% of trades being conducted on exchange (see tinyurl.com/kuh9nyum). Whilst significantly bigger than the current size of the Voluntary Carbon Market, this is within the expected growth range over the next couple of years.

HMRC’s notice does extend the zero-rating of the Terminal Markets Order onto exchange traded credits; however, this may not provide substantial defence against VAT fraud as the conditions for zero-rating do not apply to all trades. As observed in the EU emissions trading allowances market, a large exchange trading market (zero-rated) tends to also be accompanied by a large non-exchange (standard-rated) trading market.

Where traders are involved in chains of transactions which involve fraud, there is a risk of HMRC denying input tax recovery on the basis of the ‘knew or should have known’ test. All participants in this market will now need to be vigilant to ensure that their checks on their counterparties are sufficiently robust to demonstrate the business rationale for the trades, and that they knew who they were dealing with. Fraud is often obvious in hindsight, and documentation that these checks took place in advance of any trading is the key defence to any challenge on input VAT recovery by HMRC.

Businesses should make sure that any contractual arrangements are able to adapt to a changing VAT reporting obligation, should the domestic reverse charge position change in the future.

VAT treatment of offsetting

Carbon offsetting balances the carbon footprint of activities by funding projects that remove or reduce carbon dioxide from the atmosphere. This is a common way in which consumers interact with voluntary carbon credits. When booking flights or using certain services, customers may offset their carbon emissions through a small additional fee. This creates the usual VAT challenges of single vs. multiple supply, especially in the travel sector where underlying supplies are zero-rated.

HMRC has added offsetting arrangements to the VAT Supply and Consideration Manual at VATSC06585 (see tinyurl.com/7vsejt4d) – see below.

Scenario 1: Airline-sold carbon offset as a single supply for VAT purposes

In this scenario, a UK airline offers passengers the option to offset the carbon emissions from their flight directly through the airline’s booking process. The airline has partnered with a voluntary carbon credit provider but acts as the contractor with the customer, bundling the cost of the credit with the flight ticket as a single supply. This means that the customer pays for both the flight and the carbon offset in one transaction, so this will usually be a single supply of zero-rated passenger transport.

The HMRC manual at VATSC06585 implies that if the offset is ‘optional’, then the supply of the voluntary carbon credit will be a separate supply of offsetting and now subject to UK VAT. However, this seems open to interpretation on single vs. multiple supply points as the offset is clearly a means to better enjoy the principal transaction, rather than a separate aim in its own right.

Scenario 2: Airline-directed carbon offset with two separate supplies for VAT purposes

In the second scenario, the airline facilitates the carbon offsetting process by directing customers to a third-party carbon offset provider. The airline does not include the cost of the carbon offset in the flight ticket price, resulting in two separate transactions and supplies for VAT purposes. The customer pays the airline for the flight and pays the carbon offset provider separately for the voluntary carbon credit.

The VAT treatment of the supply by the voluntary carbon credit provider will depend on the exact nature of the offset provided. If they are fulfilled by credits which are then ‘retired’ by the provider, this will be subject to UK VAT. However, if the offset provider does not fulfil these explicitly with voluntary carbon credits, but only makes a promise that the money provided would be used in carbon offset projects (which may or may not be generating credits), then this would still be seen as outside the scope of UK VAT.

This appears to be a very fine line for HMRC to tread, and we would expect this treatment to evolve further to align the VAT treatment of offsetting services independent of the exact mechanism of how the offsets are achieved.

The place of supply for services to non-business consumers is complicated, and where the offset provider is established outside the UK, the supply may be subject to VAT in the UK or the country of establishment of the offsetter, depending on whether it is seen as electronically supplied or not. This further complicates the aim of fiscal neutrality as many countries still treat voluntary carbon credits as outside the scope of VAT.

Conclusion

The sustainability sectors are rapidly developing and we anticipate that we could see VAT introduced on other types of ecologically-based credits in the future. Given the evolving nature of the voluntary carbon credit market, it is likely that HMRC guidance will further develop as the implications of charging VAT become clearer. The learning from the voluntary carbon capture experience should assist businesses when considering contractual arrangements to ensure that agreements are adaptable should the VAT liability position change.

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