

Annex A: HM Treasury's review of the Isle of Man Customs and Excise's administration of VAT in relation to aircraft and yachts

1. Background

- 1.1** In Autumn 2017, the International Consortium of Investigative Journalists (ICIJ) released details from documents leaked from the law firm Appleby and its associates. Dubbed the 'Paradise Papers', these records later formed the basis of a number of media reports regarding tax authorities in offshore jurisdictions and the tax affairs of high-net worth individuals. In some cases, individuals named within the reports were alleged to have imported aircraft into the Isle of Man in order to benefit from its Value Added Tax (VAT) registration process.
- 1.2** Following this, the Isle of Man Government announced on 24 October 2017 that it had invited HM Treasury to conduct a review into the practice for the importation of aircraft into the EU through the Isle of Man. The Financial Secretary to the Treasury accepted this invitation on behalf of HM Treasury on 15 November 2017. Shortly after, HM Treasury and the Isle of Man Government agreed to expand the scope of the review to include the administration of VAT in relation to yachts in the Isle of Man.
- 1.3** This document summarises the findings and recommendations of HM Treasury's review and addresses two key themes:

 - the effectiveness of processes and procedures used by Isle of Man Customs and Excise (IOMCE) with regards to the VAT treatment of aircraft and yacht importations; and
 - the effectiveness of domestic and European VAT legislation with regards to international transport.
- 1.4** HM Treasury did not of course cover the VAT treatment of other tax jurisdictions named in the Paradise Papers. However, HM Treasury is aware that other EU Member States have cited difficulties in applying VAT rules for aircraft and yachts and welcomes further discussions with Member States to discuss the findings and recommendations of this review.

2 VAT and the Isle of Man

- 2.1 VAT is a broad-based tax on consumption that applies to most goods and services. Where there are exceptions to this rule they are strictly limited by EU rules under the Principal VAT Directive (PVD) which governs the VAT regime for all Member States, including the UK. Member States are required to transpose the provisions included within the PVD into their national legislation and the UK's transposition of the PVD is set out in the Value Added Tax Act 1994. In the UK, VAT administration is the responsibility of HM Revenue and Customs (HMRC).
- 2.2 The Isle of Man is a self-governing dependency of the British crown with a population of c.84,000 (2016 census). The Isle of Man is not a Member State of the European Union and is independently responsible for the administration of tax and for setting the legislative framework for the taxation of Isle of Man residents and businesses.
- 2.3 In 1979, the United Kingdom and Isle of Man Governments agreed that the United Kingdom and the Isle of Man shall be treated as a single tax area for the purposes of VAT. This arrangement brought the Isle of Man into the European Customs and VAT area with close regulatory alignment between the United Kingdom and the Isle of Man to ensure accordance with EU VAT law. The Isle of Man's VAT legislation therefore closely mirrors the UK's VAT Act 1994.
- 2.4 IOMCE are responsible for administering VAT in the Isle of Man. IOMCE maintains regular contact with HMRC, and Isle of Man legislation enables the exchange of information between both authorities to ensure the effective administration of VAT. Under these arrangements, HMRC policy and operational staff provide guidance and assistance on specific matters where requested by IOMCE.

3 The Paradise Papers allegations

- 3.1 Following the Paradise Papers leaks, media reports alleged that several high net worth individuals had imported aircraft into the Isle of Man in order to reduce their potential VAT liabilities. It was alleged that importations were arranged such that private aircraft were disguised as business assets available for chartering to third parties, thereby entitling the owner to recovery of the VAT paid on import.
- 3.2 Media reports suggested that such arrangements were contrary to the "spirit" of EU VAT law and created an inconsistency in the VAT treatment between high-net worth

individuals and normal consumers. Prominent cases included in the media reports were alleged to share the following common facts:

- Import of an aircraft into the Isle of Man in order to achieve free circulation within the EU VAT area.
- The aircraft and/or the Isle of Man entity were funded/owned by a high net worth individual.
- VAT was either chargeable on the import of the aircraft into the Isle of Man (20%) or it was VAT exempt under the EU VAT exemption for international travel.
- The Isle of Man entity then leased the aircraft to another entity, either offshore or in the Isle of Man.
- IOMCE repaid the import VAT incurred by the Isle of Man entity on the basis that it was used in making further taxable supplies of leasing services.
- A company in the supply chain then chartered the aircraft on commercial rates to the high net worth individual without VAT under the EU wide VAT exemptions for international and/or passenger transport.
- It was alleged that the high net worth individual was the exclusive user of the aircraft and in many cases used the aircraft for leisure purposes without incurring VAT.

- 3.3 The allegations indicated that if the above steps were implemented then no VAT liabilities would be incurred by the owner. It was suggested that, if the high net worth individual merely imported the aircraft without entering into any further arrangements they would incur irrecoverable VAT at the point of import. Specific examples were used to suggest a systemic problem within the administration of VAT in the Isle of Man and it was claimed that IOMCE have never turned down a request for VAT recovery on the importation of aircraft.

4 Scope of review

- 4.1 Following these allegations, in October 2017, HM Treasury accepted the Isle of Man Government's invitation to conduct a review into IOMCE's processes and procedures regarding the importation of aircraft. The review was expanded to cover the importation of yachts on the basis that these were also high value assets which may

be subject to similar rules. In February 2018, HM Treasury, the Isle of Man Treasury, HMRC and IOMCE signed a 'Terms of Reference' (Annex B) setting the scope of the present review. Under this agreement, HM Treasury agreed to review:

- the interpretation and application of relevant legal cases relating to the importation of aircraft and yachts;
 - the VAT treatment of ownership and leasing arrangements;
 - the effectiveness of information exchange between IOMCE and the UK and other tax jurisdictions;
 - the effectiveness of the legislative framework relating to the VAT treatment of aircraft and yachts imported in the Isle of Man; and
 - IOMCE's compliance with the policy and guidance given by HMRC.
- 4.2** Under the Terms of Reference, IOMCE agreed to share information pertinent to the scope of the assessment as well as dossiers relating to the development of their administrative practices. HM Treasury has used these documents as the basis of the review and held several meetings with IOMCE to further assess its administrative practices. HM Treasury has also reviewed relevant case law and trade literature to understand industry's perception of the legislation and how VAT rules are implemented and understood within the aircraft/yacht industry.
- 4.3** In conjunction with HM Treasury's review, IOMCE also agreed to provide HMRC with sight of relevant taxpayer records on site in the Isle of Man. HMRC have reviewed individual cases and, in line with taxpayer confidentiality, have not shared specific details with HM Treasury but have provided anonymised details where requested in order to assist HM Treasury's review. HMRC and IOMCE will continue their work regarding individual taxpayer cases as part of IOMCE's post-registration assurance project noted below.
- 4.4** It is important to note that HM Treasury's review only covers the VAT treatment of aircraft and yachts in the Isle of Man and all other taxes and regulations which are applicable within the Isle of Man are outside the scope of this review.

5 European, UK and Isle of Man VAT rules for aircraft and yachts and the compliance role of tax authorities

- 5.1** For the purposes of this review and the administration of VAT in the Isle of Man, the VAT treatment of aircraft and yachts at the point of importation is of primary importance. As is highlighted above, for aircraft or yachts to enter free circulation within the EU, they must be imported/registered in a jurisdiction within the EU VAT area. However, in most cases, the use of aircraft or yachts imported into the Isle of Man would not occur within the Isle of Man, and would instead occur in international airspace, the high seas, within EU Member States or other countries. In such cases, the Isle of Man may not be the relevant jurisdiction to determine the relevant VAT treatment of the use of the aircraft under common EU VAT rules. However, in order to assess the VAT treatment at importation/registration, tax authorities such as IOMCE should still aim to understand the intended use of the aircraft or yacht even if this takes place in other jurisdictions.

EU VAT rules – exemptions related to international transport

- 5.2** EU VAT rules provide a VAT exemption for the supply of certain aircraft and ships used for international transport (Article 148 PVD). EU VAT rules also permit Member States to maintain certain exemptions for passenger transport via derogations (Article 110 PVD). Most passenger transport in the UK is exempted from VAT under these provisions. These exemptions also allow a right to input tax recovery and are often described as ‘zero rates’ under UK and Isle of Man VAT rules.
- 5.3** Under EU VAT rules, exemptions relating to means of transport may apply to the supply of aircraft and related services (such as repair, hiring and chartering) where the aircraft is used by an ‘airline operating for reward chiefly on international routes’. Importers of aircraft who wish to apply this exemption must therefore demonstrate that the aircraft will be used by a business that provides predominantly international passenger transport services. In confirming this, tax authorities within Member States may therefore look to carry out reviews of the business plans of importers and other involved parties to ascertain whether genuine airline activity will take place on a commercial basis. For example, the exclusive or preferential use of the aircraft by the owner or the charging of non-commercial rates for use of the aircraft could suggest that there is no genuine use of the aircraft by an airline. In such cases, the exemptions related to international transport may not apply at the point of importation or further in the supply chain.
- 5.4** The timing and nature of compliance checks regarding these rules will depend on the administrative policies of the relevant tax authorities, but could take place prior to import or at another point in the life of the asset. However, as VAT is a self-assessed

tax, the onus is on importers and businesses to ensure that documentation and procedures are in place to demonstrate that the right VAT treatment has been applied.

- 5.5 Under UK and Isle of Man VAT law, the purchase/importation of yachts is unlikely to be VAT zero-rated as they are usually designed for recreation or pleasure rather than for use in providing international transport services.

Business use

- 5.6 In many cases, importers of aircraft or yachts do not seek to apply the exemption under Article 148 on importation. Instead, importers incur import VAT and apply to recover this as input tax by demonstrating intended use of the aircraft or yacht in taxable business activities. This treatment is in accordance with normal EU VAT principles for input tax recovery and, similar to the above, tax authorities in Member States may review relevant financial information and business plans of the parties involved to ascertain whether intended business activities provide right to input tax recovery. As above, the nature and timing of these compliance checks may differ between tax authorities. However, taxpayers would normally need relevant documents in place to evidence their VAT treatment if required.

VAT rules for passenger transport

- 5.7 In the UK, Isle of Man, EU Member States and in similar international VAT/GST systems, the use of the aircraft to transport passengers will often not be subject to VAT. National exemptions and exemptions with right to deduct are applied across Member States and are allowed under EU VAT law by derogation. The application and administration of this exemption will be a matter for the tax authority of the relevant Member State in which the use of the aircraft takes place.
- 5.8 The VAT exemptions for international passenger transport services aim to ensure that VAT is not a burden on international travel but are also an effective simplification for taxpayers and tax authorities. Aircraft and other means of international transport are international by their nature and their use may take place across different VAT jurisdictions. In the EU passenger transport is deemed to take place where the supply physically takes place. As such, if VAT was due, it could be complex to calculate and assess the correct VAT treatment as the aircraft flies across different countries and international airspace.

- 5.9 In administering the VAT on importation, tax jurisdictions are required to understand the intended use of the aircraft or yachts. This will involve reviewing whether aircraft or yachts are indeed used for transport services, other business purposes or are instead used solely by the owner for another purpose. If an aircraft or yacht is not used for a business purpose, then it is highly unlikely that the exemption would apply, or input tax charged on importation would be recoverable.

6 Review work and findings

- 6.1 As noted above, this review aims to understand the effectiveness of both IOMCE processes and procedures with respect to the importation of aircraft and yachts as well as the effectiveness of existing VAT rules under the PVD.
- 6.2 During the review, officials from HM Treasury and HMRC requested extensive information from IOMCE and held several meetings and conference calls with IOMCE to discuss relevant VAT processes and procedures in detail. During this work, HM Treasury carried out further work to understand the typical arrangements of importers of aircraft and yachts in Member States and the key administrative procedures that EU VAT authorities should carry out with respect to such arrangements. From this information, HM Treasury aimed to evaluate the effectiveness of IOMCE's processes and procedures with respect to aircraft and yacht importation under EU and UK VAT rules. Furthermore, HM Treasury aimed to understand the scope of VAT rules regarding aircraft and yachts and the difference to public perception.
- 6.3 The key findings of this work are summarised below.

Effectiveness of IOMCE processes and procedures - Pre-registration assurance processes

Key finding: IOMCE collect and examine extensive information regarding the use of aircraft and yachts at the point of VAT registration/importation. This process is carried out for every aircraft and yacht registration and is valuable in assessing the correct VAT treatment of aircraft and yachts at the point of importation.

- 6.4 HM Treasury's review has found that IOMCE collects extensive information prior to registration and importation in order to assess the correct VAT treatment. Arguably, this already enables IOMCE to go further than many other tax authorities in understanding and assessing the VAT treatment of the aircraft or yacht prior to importation. However, as is noted below, HM Treasury consider that this process

should be further strengthened through additional post-registration assurance processes to fully assess the correct VAT treatment.

- 6.5 As part of the Paradise Papers it was noted that in the period from 1 April 2012 to 31 March 2017, 472 aircraft had been registered with the Isle of Man Aircraft registry and it was alleged that this number for such a small jurisdiction was an indication of favourable VAT treatment in the Isle of Man. On review of the Isle of Man's procedures, HM Treasury understands that these registrations represent the number of registrations made with the Isle of Man Aircraft registry, a separate organisation with no overlap to the Isle of Man VAT system rather than VAT registration with IOMCE. Instead, during this same period there had been 233 VAT registrations with IOMCE and only 20 registrations had opted to exempt the importation of the aircraft under the VAT exemption for international transport (Article 148(f) PVD). As such, HM Treasury does not deem that the administration of the VAT exemption for importation of aircraft is a risk for the Isle of Man or indeed the UK and potentially other EU Member States. Instead most applicants incur VAT on import and then seek to recover this VAT by proving an intention to use the aircraft for business purposes.
- 6.6 In addition, the number of yacht registration/importations with IOMCE over the same five year period was 31. Given this low figure HM Treasury does not deem that the VAT treatment of yacht importations are a significant risk for the Isle of Man. The rest of this report therefore focuses on the VAT treatment of aircraft.
- 6.7 It should also be noted that IOMCE make available the use of an offset procedure for importers of aircraft and yachts who are liable for VAT on import but can demonstrate that they meet the conditions for input tax recovery at importation. This procedure allows importers of aircraft or yachts to net their VAT liabilities against their intended VAT recovery at the point of importation. This treatment differs from some jurisdictions, including the UK, where importers often pay the liability to HMRC before claiming this back at a later date through their VAT return. The cash flow and timing benefits of this system may be a factor in many importers choosing the Isle of Man as a jurisdiction in which to import aircraft and yachts. HM Treasury understands that similar offset procedures are also in use in other EU Member States.

Effectiveness of IOMCE processes and procedures - Post-registration assurance processes

Key finding: IOMCE has not carried out extensive, systematic and routine post registration compliance activities. HM Treasury notes that this activity is resource intensive and could be

difficult for many small jurisdictions but considers that additional post-registration compliance activities would provide further assurance over the correct VAT treatment of the aircraft or yacht after registration. HM Treasury notes that this does not necessarily mean that there has been an incorrect application of VAT rules of aircraft or yachts. Indeed, the information provided to HM Treasury from HMRC's work on specific taxpayer cases has thus far not identified any past case of non-compliance. However, more robust post-registration procedures would provide IOMCE and the wider public with further assurance that VAT was administered effectively.

- 6.8 The business plans and questionnaires collected by IOMCE at the point of registration provide a snapshot of expectations at the point of importation. Even if those expectations are declared honestly, tax authorities such as IOMCE should still aim to undertake targeted post-registration checks to ensure later use of an aircraft or yacht matches the intended use stated at the time of registration. This activity will help the authority assess whether an aircraft or yacht is genuinely used for business use.
- 6.9 The lack of post assurance compliance activity is a significant concern for HM Treasury, but it should again be noted that no specific cases of wrongdoing have yet been identified. As noted above, the international nature of aircraft and their use in other jurisdictions makes it difficult for the tax authorities to continually assess the actual use of the aircraft. This is more difficult for smaller jurisdictions, such as the Isle of Man, who have fewer resources to allocate to such work. IOMCE has however initiated a specific post-registration assurance programme for aircraft in October 2016 and for yachts in February 2017 prior to any allegations being made. This programme is ongoing and IOMCE is currently conducting more detailed assessments of individual taxpayer cases.

Effectiveness of EU VAT rules for aircraft

Key finding: The EU wide rules on aircraft and VAT exemptions in place throughout Member States mean that VAT is not always due on aircraft importation and use. If Member States wish to tax use of certain aircraft by owners, this may require a change to VAT rules at EU level.

- 6.10 As noted throughout this report, the Paradise Papers leaks led to allegations that high net worth individuals avoided paying VAT on the importation and use of aircraft they own. The media reports suggested that such treatment was contrary to the intentions of UK and EU VAT rules.

- 6.11** In 2013, the EU VAT Committee laid down guidelines, concluding almost unanimously, that aircraft used by the ultimate owner would not qualify for exemption for international transport (Article 148 PVD) unless the use of the aircraft is granted on the same basis as for any other client. This is outlined in the VAT Committee working paper 758:

"The VAT Committee is of the almost unanimous view that an airline operating for reward chiefly on international routes does not use an aircraft exclusively for its commercial activities and the exemption shall be denied when the owner of the aircraft, or any related person, has the right to claim use of the aircraft, unless there is clear commercial evidence that such use is only granted on the same basis as for any other client of the airline."

- 6.12** The UK Government was instrumental in ensuring that the VAT Committee guidelines were agreed and remains fully supportive. However, as is noted above, HM Treasury's review of the Isle of Man has shown that many importers of aircraft do not apply for VAT exemption at importation and instead incur import VAT and recover this as input tax to the extent that they use the aircraft for business activities. As such, tax authorities must check that there is a genuine business activity when assessing the VAT treatment of aircraft, but this activity may not need to be that of an airline.
- 6.13** Furthermore, the VAT treatment of the use of the aircraft will often be determined under different VAT exemptions which are in place via derogations throughout Member States. In UK law, for example, the use of an aircraft as passenger transportation will be VAT exempt to the extent it either enters or leaves the UK, or flies within the UK and has capacity for at least 10 passengers.
- 6.14** As such, under VAT rules in place across Member States, the supply and related services (such as hiring and chartering) of an aircraft on commercial terms will not be subject to VAT if it qualifies for exemptions related to international transport (i.e. the aircraft is used by an airline on international routes) and the use of the aircraft is likely to also qualify for VAT exemption under passenger transport. In such cases, the VAT rules in place across the EU, which were designed to alleviate VAT on international passenger travel, suggest that VAT is not due on certain use of aircraft.
- 6.15** With respect to yachts, it is worth noting that HM Treasury deems that the VAT is more likely to be charged on both importation and use. Unlike aircraft, yachts are

more likely to be used for purposes other than passenger transport and instead are used for leisure activities, more akin to accommodation. In such situations VAT will be charged on importation and/or use of the yacht, and the transport exemptions may not be applicable.

- 6.16 As is noted above, the application of VAT exemptions regarding the use of aircraft rather than the importation is the key point for wider consideration. Any change in VAT treatment may require a change in policy and/or law regarding use of an aircraft under EU and international VAT law. If private aircraft are instead viewed as more akin to yachts, and not as a means of transport, then VAT may become chargeable on its use. This treatment may be more difficult to implement for aircraft than for yachts, as the primary use of aircraft is transport and not accommodation or leisure.

7 Review recommendations

- 7.10 In light of the findings above, HM Treasury proposes the following recommendations:

Recommendation: IOMCE should continue to collect extensive information at registration /importation and should continue to develop aircraft specific post-registration compliance processes to provide further assurance over VAT administration in the Isle of Man.

- 7.11 HM Treasury notes that IOMCE have been engaged in post registration assurance activity since 2016 and this activity should be extended and become the norm for aircraft and yacht registrations. HM Treasury considers that it is important to regularly check high risk cases after registration to ensure that the intended activity and business or third party use of the aircraft were carried out in practice.

- 7.12 When conducting this post assurance work, a degree of unpredictability may be desirable for IOMCE. HM Treasury therefore recommends that IOMCE employ a risk based approach to post-registration assurance and, in some instances, use random sampling to ensure that the input tax recovery conditions are met at any point in time.

- 7.13 It is also important that the IOMCE have suitable expertise to review the commerciality of aircraft and yacht leasing arrangements. IOMCE should continue to employ staff to focus on and develop expertise in these areas and utilise HMRC's expertise where possible. HM Treasury understands that staff have recently been employed by IOMCE to focus on these areas and encourages this activity.

7.14 During the review, HM Treasury also noted many advisors claimed that they were able to access an expedited service from IOMCE and had strong working relationships with Isle of Man staff. While this is likely to be marketing activity and not amount to a material risk, IOMCE should be aware of these claims and adjust its compliance activity if necessary.

Recommendation: HMRC should continue to assist IOMCE where required in their compliance procedures to help ensure that any potential risks of non-compliance are mitigated.

7.15 HM Treasury's review found that there was a strong working relationship between HMRC and IOMCE on policy matters. HM Treasury found no evidence that IOMCE did not adhere to HMRC policy advice but notes that this is a complex area of VAT law and further cooperation between HMRC and IOMCE on these matters could be beneficial.

7.16 The exact nature of IOMCE's and HMRC's cooperation will need to be agreed between them in due course, however HM Treasury recommends that the following is considered:

- HMRC assist IOMCE with technical issues arising from post registration assurance work;
- HMRC and IOMCE consider whether specific technical assistance is provided for high value asset purchases and registrations; and
- HMRC and IOMCE continue to take part in regular policy and technical training and consider use of secondments to develop staff expertise between the two tax authorities.

Recommendation: The UK and EU Member States should discuss whether a review of the EU and international rules on aircraft and transportation would be appropriate.

7.17 HM Treasury notes that the use of an aircraft by its owner may not be subject to VAT under VAT exemptions in place across Member States. If Member States deem that this is not appropriate in some instances, then it may be worth considering further provisions for levying VAT on certain private use of aircraft. However, such additional steps are not likely to be possible under existing EU law and could be contrary to existing rules on international passenger transport. It may also be

difficult to define private use of an aircraft and determine the circumstances for which this private use differs from other services related to passenger transport.

- 7.18 HM Treasury is aware of the difficulties of changing rules at EU level across Member States and notes that this topic is made more complex by the international nature of aircraft. Any changes to VAT rules for private use of aircraft would need to be carefully drafted so as not to impact international passenger travel and genuine business activity. The UK Government therefore welcomes further discussions with the European Commission regarding whether existing rules should be amended and welcomes views on how this can be achieved either through specific derogations or at international level.

8 Conclusion

- 8.1 The work carried out on the HM Treasury review has provided a comprehensive understanding of both the VAT rules and procedures governing aircraft and yachts in the Isle of Man and the challenges faced by all Member States regarding the VAT administration of aircraft. HM Treasury is content that the Isle of Man have robust procedures in place regarding registration, however, further work must be carried out to ensure that there is sufficient assurance regarding the VAT treatment after the initial VAT registration. Based on these findings HM Treasury is content that the Isle of Man Government have implemented the relevant EU and UK VAT provisions regarding aircraft.
- 8.2 HM Treasury also notes that international nature of aircraft and the VAT rules regarding international transport, passenger transport and input VAT deduction across the EU, can mean that the private use of an aircraft is not always subject to VAT. HM Treasury welcomes any comments from EU Member States or the European Commission with respect to whether EU wide VAT rules should be amended to charge VAT on international transport in certain instances. The UK Government's expertise in this area, gained through extensive research as part of this review, means that it is well placed to consider the merits of any changes, if required.