The VAT treatment of private jets and yachts imported into the Isle of Man

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For many years individuals have imported private jets and yachts into the Isle of Man with a structure that meant no VAT was payable (or if it was, it could be reclaimed). Whilst the Isle of Man's VAT legislation does not differ significantly from that of the UK, the local registration process proved to be more user friendly. In Autumn 2017 leaked documents – colloquially known as the "Paradise Papers" – put a spotlight on the importation of aircraft and yachts to the Isle of Man. The media took the view that this practice amounted to unacceptable tax avoidance. The Treasury then began to investigate, releasing a review in September 2019 **(the Treasury Review)**. This article examines the findings of the Treasury Review, and the implications for those involved in the importation of aircraft and yachts into the Isle of Man.

The constitutional status of the Isle of Man

The Isle of Man is not part of the United Kingdom or the European Union **(EU)**. It has special constitutional status as a "crown dependency", whereby its defence and foreign affairs are handled by the UK Government. The constitutional status of the Channel Islands – which are, like the Isle of Man, crown dependencies – was considered by the Supreme Court in *Routier v HMRC* [2019] UKSC 43.

The UK's rules on VAT do not apply in the Isle of Man, but in 1979 the UK and Isle of Man agreed – pursuant to the Customs and Excise Agreement 1979 – that they would form a single VAT area. Pursuant to this agreement, the law of VAT in the Isle of Man (under the Value Added Tax Act 1996 **(VATA 1996)**) mirrors that in the UK (under the Value Added Tax Act 1994 **(VATA 1994)**). There are some limited exceptions, but none relevant for present purposes. References in this Article are generally to VATA 1994, but the mirroring provisions can be found in VATA 1996 (and usually with the same section numbers).

Under the terms of the Treaty of Accession (22 January 1972), Protocol 3, the Isle of Man is effectively part of the EU Customs Union. That is reflected in the Treaty on the Functioning of the European Union **(TFEU)**, Art 355(5)(c). This remains the case during the transition period agreed as part of the UK's departure from the European Union: see the Withdrawal Agreement, Arts.3(1)(c), and 126-127.

VAT due on the importation of aircraft

The supply of certain aircraft and ships for international transport is exempt from VAT under the Principal VAT Directive (2006/112/EC) **(the PVD)**, Art.148(f). The aircraft must be *"used by airlines operating for reward chiefly on international routes"*, and so the exemption does not apply to the purchase of private jets. This is reflected in domestic law by the zero-rating of the supply of qualifying aircraft (VATA 1994, Sch 8, Group 8, Item 2), and the definition of 'qualifying aircraft' (see Note(A1)).

The PVD also permits member states to exempt the supply of passenger transport from VAT: PVD, Art.110. In the UK, passenger transport is zero-rated: VATA 1994, s.30 and Schedule 8, Group 8, Item 4. **(1)** This includes the charter of private jets.

But if an individual wishes to purchase – as oppose to charter – a private plane or yacht, VAT is payable as the individual (or their company) will not be an airline operating for reward and nor will the purchase be for business purposes. This was not always so. The UK legislation, as originally enacted, provided for zero-rating of the supply of any aircraft which weighed at least 8 tonnes, unless it was designed or adapted for recreation or pleasure: VATA 1994 (as originally enacted), Sch 8, Group 8, Item 2.

Why 8 tonnes? In 1994 it was rare, given the cost, for anyone other than an international airline to own an 8 tonne aircraft. The UK therefore enacted the 8 tonne rule as an attempt to reflect the spirit of the PVD, whilst also providing a bright-line rule. But in the years that followed it became more common for private individuals to own (through their companies) **(2)** heavy aircraft, and the current formulation was substituted with effect from 1 January 2011 by the Finance (No 3) Act 2010, s.21(2).

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1 In the Isle of Man, the equivalent provisions are VATA 1996, s.30 and Schedule **9**, Group 8, Item 2 (and see Note (A1)). There are some limited exceptions to zero-rating, for which see VAT Notice 744A.

2 Aircraft are rarely (if ever) purchased by an individual directly (as opposed to through a corporate vehicle) because of the risk of unlimited liability in the event of a crash or other unforeseen event.

This left an opportunity for careful tax planning. Those who directly supplied 8 tonne aircraft to individuals were now required to charge VAT at 20%. This is unsurprisingly a significant amount of money, given that the value of such aircraft is often in the £10s of millions, and the UK's VAT rate has been 20% since 4 January 2011.

The structure commonly entered into was not complicated. It involved a company **(the Charter Co)** purchasing the aircraft and chartering it to the individual. The individual paid no VAT when chartering the plane as it amounted to passenger transport. The Charter Co escapes VAT on the purchase of the aircraft in one of two ways:

(1) The Charter Co operates as *"an airline operating for reward chiefly on international routes"* and is accordingly zero-rated for VAT, or

(2) The Charter Co pays VAT, but recovers it as input tax on the basis that the cost was incurred in taxable business activities.

From April 2012 to March 2017, 233 aircraft were registered with Isle of Man Customs and Excise **(IOMCE)**, and only 20 registrations claimed VAT zero-rating (ie, the first of the two routes outlined above): Treasury Review, para 6.5. This was in spite of a decision of the ECJ in 2012 which held that the first route is open to airlines which charter flights for companies and persons: *A Oy* (C-33/11) (29 July 2012), [22], [29]-[30]. The second route was the more popular.

Business activity

Under VATA 1994, ss.24-26, a person is entitled to a credit for input tax paid which is attributable to the supply of taxable supplies by that person in the course of his business. The supply of a zero-rated service (such as passenger transport) is still the supply of a taxable service: VATA 1994, s.4(2).

Business is defined in VATA 1994, s.94(1) as including *"any trade, profession or vocation"*. There is no further statutory definition, and guidance from case law is often more contradictory than illuminating. HMRC's view is that there must be:

> "a continuing activity which is mainly concerned with making supplies to other persons for a consideration ... the activity must have a degree of frequency and scale and be continued over a period of time"
>
> VAT Notice 700, para 4.6.2

A profit-making motive is not essential: *C&E Comrs v Morrison's Academy Boarding Houses Association* [1978] STC 1, 6.

It is not difficult to ensure that the Charter Co is carrying on a business activity. But it does require some thought and careful planning: the aircraft should be advertised as available for charter; the individual should not be the only one who charters it; the individual should not pay lower rates for its use; there should be adequate (commercial) insurance; regulatory requirements for commercial charter should be followed.

The EU's VAT Committee has issued guidelines ('working paper 958') which state that the VAT is payable where the owner of the aircraft (or a related person) has a right to use 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"* (see para 4). The VAT Committee's Guidelines have no legal status, but are indicative of the EU school of thought.

The VAT Committee also state that:

> "an airline operating for reward chiefly on international routes does not use an aircraft exclusively for its commercial activities..."

At first blush this statement is hard to decipher. It perhaps makes more sense the other way around: a company (e.g. a bank) using an aircraft exclusively for its commercial activities (e.g. to transport its executives and clients) is not an airline operating for reward. That is right, although the bank could arrange for a subsidiary to own the aircraft and for that subsidiary to provide transport services to the bank as an airline.

Tax avoidance and media outrage

If these plans are put in place, and followed, there is no objectionable avoidance being carried on by the individual. The individual may have "avoided" VAT compared to the position if they had purchased the aircraft directly, but no VAT has been avoided compared to the individual booking a flight from a commercial operator (because VAT is not, in general, chargeable on passenger transport).

It is for this reason that the media outrage which accompanied the Paradise Papers was misplaced, at least in relation to VAT on private jets. Media reports *"suggested that such arrangements were contrary to the spirt of EU VAT law and created an inconsistency between high-net-worth individuals and normal consumers"* (Treasury Review, para 3.1). But EU VAT law expressly provides for the possibility of zero-rating for passenger transport, and normal consumers are not treated any differently as they too are entitled to the zero-rating.

Unsurprisingly, none of this was made clear in much of the media coverage. An article in *The Guardian* from 5 April 2019 described *"tax breaks for owners of private jets"* as a result of *"an allegedly illegal loophole"* which had been *"kept wide open"*. There is of course no loophole: the VAT rules for the importation of aircraft (and yachts) are the same in the Isle of Man as in the UK. And those rules in turn reflect the provisions of the PVD. The Treasury Review found that the Isle of Man complied with UK and EU laws in relation to both aircraft and yachts.

In my contribution to the most recent edition of the *Gray's Inn Tax Chambers Review*, I discussed the importance of the public relations battle in the tax world. This is another good example: media outrage creates a misleading impression of tax avoidance by the wealthy, which in turn leads to the Treasury taking action to tackle the purported avoidance. In this case, at least, the Treasury Review did not endorse the media's view, noting that:

(1) National exemptions are permitted across the EU by EU law (para 5.7);

(2) The rules attempt to ensure that VAT is not a burden on international travel, and if VAT was due it could be complex to calculate due to its cross-border nature (para 5.8);

(3) The primary use of aircraft is transport and not accommodation or leisure (para 6.16);

(4) Charging VAT on the private use of aircraft likely to be impossible under EU law and so changes may have to be made at an EU level (para 7.17);

(5) If any such changes were thought to be appropriate they should be carefully drafted to ensure that they did not affect international passenger travel and genuine business activity (para 7.18).

This does beg the question: why were aircraft and yachts imported to the Isle of Man rather than the UK, or other EU jurisdiction? There are a few reasons. First, it helps that English is the primary language spoken in the Isle of Man. Secondly, the IOMCE has developed a reputation for being user-friendly and transparent. HMRC does not have this reputation. And the Isle of Man (like some other EU countries, but unlike the UK) offers an "offset procedure", whereby importers can offset the VAT payable on importation against the amount that they would be able to recover. In the UK, the VAT must be paid and then recovered later, which is a significant disadvantage in cash-flow terms.

The EU Commission was less nuanced in its response to the Paradise Papers than the UK Treasury. A Press Release (from 8 November 2018) described the Isle of Man's VAT practices in relation to the supply and lease of aircraft as *"abusive"*. Commissioner Pierre Mosovici was quoted as saying that the position was *"simply not fair"*, and that the *"favourable tax treatment*" was *"clearly at odds with our commonly agreed tax rules"*. The Press Release was tilted *"Commission follows up on illegal tax breaks for yachts and aircraft"*.

Given the UK's departure from the EU on 31 January and the Treasury's rather different view, taxpayers are safe to put these comments to one side.

The impact of Brexit, and environmental concerns

The UK will, depending on the nature of the trade agreement struck with the EU, be able to set its own indirect tax policy from the end of the transition period. That could mean scrapping VAT altogether, or the removal of zero-rating for air transport. There is little indication that either of those courses of action is currently a priority for the UK Government.

Air travel is already subject to Air Passenger Duty, introduced by the Finance Act 1994. APD raised £3.7bn in the last financial year. Those amounts are not ring-fenced for environmental or aviation spending. A 2015 report by PWC found that it supressed demand for flying by 10%.

The implications of the Treasury Review

The Treasury Review implicitly endorsed the tax planning outlined above, and explicitly endorsed the IOMCE VAT procedures on registration and importation (para 6.4).

HMRC were less happy with IOMCE's post registration compliance activities. IOMCE had not, in HMRC's view, been checking whether the position as stated on importation had been carried through.

The IOMCE has however been conducting compliance checks from October 2016 (for aircraft) and February 2017 (for yachts). This process is on-going and taxpayers should be braced for these checks.

Yachts

The supply of a yacht will only be zero-rated if (a) the gross weight is 15 tonnes or more, and (b) it is not designed or adapted for recreation or pleasure: VATA 1994, Schedule 8, Group 8, Note (A1). It is difficult to argue that a luxury yacht is not designed for recreation or pleasure. For that reason, the preferable tax planning route is for VAT to be paid on the importation of the yacht by the Charter Co, which then reclaims the VAT as input tax on the basis that it was incurred in taxable business activities.

This structure was challenged by HMRC in *Heath House Charter Ltd v HMRC* [2009] UKFTT 305 (TC), but the Tribunal allowed the taxpayer's appeal, holding that the company was carrying on a taxable business. The fact that the yacht, when chartered, was used for recreation and pleasure was of no relevance in determining whether the charterer was conducting a business: *Heath House*, [93].

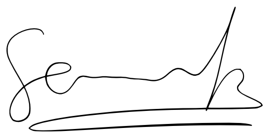
The Tribunal reached the opposite conclusion in *Ocean Charters Ltd v HMRC* [2011] UKFTT 854 (TC), holding that the Charter Co was not carrying on a business. Key considerations include the lack of appropriate commercial insurance and required coastguard 'coding', the fact that the charters were all made to the individual's friends and business connections, and the absence of a serious business plan (combined with a failure to follow good business practice).

The IOMCE have stated, in a Practice Note dated 26 April 2010, that they consider yacht leasing structures to be abusive if the yacht is **solely** leased to the individual who funded the purchase (directly or indirectly) or to persons connected with that individual. The structure will not be abusive if the yacht is also chartered to third parties, provided that such activity has sufficient continuity and substance to amount to business activity. HMRC's views are not dissimilar, and were published in Revenue and Customs Brief 56/09.

Conclusions

Those who have imported aircraft and yachts into Isle of Man are unlikely to face a challenge to the integrity of the a chartering structure as a matter of principle. But there is likely to be an increase focus on whether the proposed structure was properly implemented, and whether the Charter Co can properly be said to have carried on a business. The time is ripe for taxpayers to update their advice and check compliance records.

This article is not legal advice, but if you have been affected by the issues in this article please get in touch with me at sam.brodsky@taxbar.com



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