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VAT & SUPERYACHTS – OPPORTUNITIES AND PITFALLS

PRESENTATION TO THE INSTITUTE OF CHARTERED SECRETARIES AND ADMINISTRATORS (ICSA), ISLE OF MAN BRANCH, ON TUESDAY 8 APRIL 2008 AT THE HILTON HOTEL, DOUGLAS, ISLE OF MAN AT 18.00 HOURS

1. Good Evening Ladies and Gentlemen. Thank you for turning up in such impressive numbers. Contrary to popular belief, VAT does not send many people to sleep! But I know that you all probably had a long day and you would rather be looking forward to your dinner. As Henry VIII said to each of his wives, “***I shan’t keep you long!***”
2. I want to talk to you this evening about value added tax (VAT) as it relates to large yachts. I hope that by the time I finish in the next 20 minutes or so, I will have taken you through what you may call ~~the~~ the VAT life of a business. I will highlight along the way the tremendous opportunities that this sector of activity now represents for our work, and the challenges and pitfalls to look out for. Many of you will already be involved in yacht administration. If not then, I daresay, you will be at some stage. It is important to realise that yachting as a business sector is a relatively young industry and that it is full of informal practices and folklore, which may not necessarily be compliant from a formal VAT perspective. This will become evident in a moment.
3. But first, here are some interesting statistics. As at December 2007 there are over 5,000 large yachts in circulation (> 30m). Nearly all of them are owned through corporate structures. About 70% of them were built in Europe. Over half of the yachts in circulation come to the Med every year, so seeking access into the EU. About 450 large yachts are currently under construction to be delivered between now and next year, and there is on average 7 . 10% growth in the market every year in the next 4-5 years. There is no doubt that yachting work is rapidly gaining in importance, and that it will continue to do so for the foreseeable future. We, service providers in International Finance Centres, will be the main beneficiaries of this growth.

OPPORTUNITIES

4. In the past 5 years or so, a significant proportion of this work is either happening directly in the Isle of Man or touching the Isle of Man to some extent. Why? I submit that it is largely to do with VAT.
5. How? Well, VAT is a consumption tax assessed on the value of goods and services bought and sold for use or consumption in the European Community. And, think of it, a super yacht is a floating centre of conspicuous consumption . it requires utilities (water, light, heating, communication) and provisions (wines, champagne). A large yacht is no doubt a magnet for VAT.
6. Now, the VAT system operates by allowing registered businesses to deduct or recover the VAT that they themselves have suffered, while paying over to the taxman the VAT that they have collected. So, a yacht owner who wants to recover VAT in the EU cannot register for VAT in Jersey or Guernsey or Gibraltar or Switzerland. These rival jurisdictions are outside the VAT territory of the EU.
7. And a yacht owner, if they can avoid it, would not want to register for VAT in the UK or in mainland Europe, because the owning company would attract direct taxes (corporation, capital gains, etc.) by virtue of their location there. But they can, and they do, register for VAT in the Isle of Man because they can recover VAT while operating the company tax-free. So that's Isle of Man's one-up against its rivals . it is a significant one-up when it comes to yachting.
8. Therefore we are all busy doing the relatively straightforward VAT structuring. We set up an Isle of Man company - no tax. We make the case and register the company for VAT. The company acquires a " 30 million yacht from Italy or the Netherlands or Germany, from where the acquisition is zero-rated. The VAT at 17.5% of purchase price (" 5.25 million) is accounted for and deducted simultaneously in the Isle of Man.
9. Or a Jersey, Guernsey, Gibraltar CSP would contact us about a yacht owning company they've already set up there. We would enter the company into the IOM Companies Register under Part XI of the Companies Act 1931. We would give it a place of business at our offices. We would make the case and register for VAT. We would import the yacht into the EU and account and deduct the VAT simultaneously in the Isle of Man. At the end of it all, our yachts are set afloat anywhere else but in the Isle of Man, while we happily earn income here. Those are the joys and the opportunities in yacht servicing from the Isle of Man. But what are the challenges and pitfalls?

CHALLENGES AND PITFALLS

10. It is worth asking the question really: what is a yacht? At a conference in Monaco the other day a lady mischievously described the large yacht as "*an unusually large, emotionally-charged appendage of the*

modern rich man.” Well, that has nothing to do with VAT . we can improve on that definition. I described a large yacht earlier as *a floating centre of conspicuous consumption*. True. But here’s what the VATman specifically says about a yacht: Article 15(2) of the Sixth Directive calls it a *pleasure boat* and a *means of transport for private use*. Under VATA 1994, Sch. 8, Group 8, Note A1(a)), it is a *pleasure craft* and **“...is [either] designed or adapted for use for recreation or pleasure.”**

11. That definition is critical. It is the starting point for any understanding of the place of the yacht within the EU VAT system. That definition provides the basis for differentiation between, on the one hand, the class of *qualifying ships* (cruise ships, submarines, hovercraft, light vessels, fire floats, dredgers, barges, lifeboats); and, on the other, *pleasure craft* (yachts, motor cruisers, power boats). Qualifying ships are exempt from VAT - with right of recovery (i.e. *zero-rated* in UK terms). Pleasure craft are **not** exempt from VAT . they are standard rated.
12. HMRC Notice 744C *Ships Aircraft and Associated Service* states the point categorically in paragraph 2.6: ***“Motor cruisers, powerboats or yachts are designed or adapted for use for recreation or pleasure. They therefore cannot be considered as qualifying ships even if they are ... supplied for business use.”***
13. This typecasting of yachts is important because it influences the attitude of the VATman towards yachts of whatever size. With respect to VAT registration, it means that a *yachting business* falls to be considered as a border activity between business and non-business, between private use and business use, between acceptable and unacceptable. In fact, most yachting businesses do involve mixed private and business use of the yacht.
14. You will know that the proper identification of an activity as a *business* is fundamental to the operation of VAT. Both a business’s liability to account for output tax (what they charge) and their ability to recover input tax (the VAT they suffer in their business), are dependent upon whether Customs see their activity as business.
15. So, obstacle number one? A yachting business must first pass the *business test* before it can be registered for VAT. Some of the cases in which we have been called upon to assist are ones where Customs have refused to register a yacht owner for VAT because the applicant has failed to make the business case. Often the applicant has wrongly assumed that yachting was just like any other business.
16. The *business test* derives from the courts - particularly the well-known **Lord Fisher** case. Is the proposed activity serious? Is it active and continuous? Is it substantial? Is it regular and does it involve taxable supplies? If the answer is no, then the application for a VAT number is most likely to be rejected.

17. However, even when the case for VAT registration is properly made and the business is registered, a number of other challenges may still lie along the way. In the time that I have left, I want to touch on **6** of these challenges. These are:

- a. **Non-accounting for acquisition goods and reverse charge services;**
- b. **Non-business or private use;**
- c. **Leasing schemes;**
- d. **Confusion between hiring a yacht as a means of transport and providing “passenger transport”;**
- e. **French commercial exemption; and**
- f. **The disposal of the yacht;**

A. NON-ACCOUNTING FOR ACQUISITION GOODS AND REVERSE CHARGE SERVICES

18. Although your yachting client will have an Isle of Man GB VAT number, their yacht will almost certainly be operating in sunnier places. Within the EU, it is more likely to be the Med. One of the major advantages of the VAT number is that your clients can purchase goods from VAT registered businesses in any of the other EU Member States without paying the VAT charge of that Member State. Instead, the suppliers would zero-rate so that the supplies can be accounted for in the Isle of Man.

19. Similar treatment, called **reverse charge** would apply to services such as the management services of yacht managers, the advertising services of brokers, the technical services of engineers and so on. The question is: are we aware of the nature of these services? Do we know how to account for them? And, if we do know how, are we **actually** accounting for them?

20. The question is critical to Isle of Man Customs, not just from a legal and a practical tax administration perspective. It is a bread-and-butter issue. You will know even from the most recent budget that VAT and customs receipts make up over 60% of the Islands total tax revenue. You may also know that these indirect tax revenues are allocated on the basis of the tax sharing agreement with the UK. What may not be readily apparent is that the formula used in the sharing is based on turnover figures rather than net receipts. If acquisition and reverse charge items are omitted in VAT returns then this impacts directly on Isle of Man's receipts from the sharing arrangement.

21. It is that basic a point, but it is very easily missed. You will have noticed that there is a note on acquisitions and reverse charges in notices that Isle of Man Customs send out each month with blank VAT returns. Failure to properly account for these items can mean trouble for a service provider.

B. NON-BUSINESS OR PRIVATE USE OF YACHT

22. This is a thorny issue and I have met people who have argued passionately that the beneficial owner using a yacht is just like anybody else chartering it. I wish the law supported that view.
23. Both Community and UK/IOM VAT law in fact assert the contrary about the private use of business goods and comparable situations. A yacht that is bought and the VAT deducted or reclaimed under the pretext that the business will exploit it for income on a continuing basis is by definition a business asset within the VAT system.
24. Article 5(6) of the Sixth Directive provides the following:

'The application by a taxable person of goods forming part of his business assets for his private use or that of his staff, or the disposal thereof free of charge or more generally their application for purposes other than those of his business, where the value added tax on the goods in question or the component parts thereof was wholly or partly deductible, shall be treated as supplies made for consideration.'

There is a similar provision regarding services in Article 6(2) of the Sixth Directive.

25. UK/IOM VATA 1994 Schedule 4, sub-paragraph 5(4) minces no words on the matter either: ***'Where by or under the directions of a person carrying on a business goods held or used for the purposes of the business are put to any use or are used, or made available to any person for use, for any purpose other than a purpose of the business, whether or not for a consideration, that is a supply of services.'***
26. These are anti-avoidance rules designed to prevent or cure abuse, such as in a situation where two identical yachts are sitting side by side at a harbour in Antibes. Peter owns one and Paul beneficially owns the other. Peter bought his yacht in his personal name for " 30 million and paid " 5.25 million VAT in the UK. Paul bought his yacht through an Isle of Man Company and got his service provider to present a business case to Isle of Man Customs and gets a VAT number. Paul therefore deducts the VAT that would otherwise have been payable. Then Paul never offers the yacht for charter. Instead, he enters into a contract with the company that enables him to use the yacht privately, VAT-free. You do not need to study VAT to sense that Paul's arrangements are wholly artificial and abusive. And decent yacht owners do recoil from such practices.
27. The correct and legal position is that the Isle of Man Company may indeed choose to register for VAT on the basis that it will exploit its yacht for both business and non-business use. The Company will have the right on purchase of that yacht to deduct VAT in full, however small the proportion of business use. But, as

the judge put it in the ECJ case on **Lennartz (Case C-97/90)** the business “**is subject to the corresponding obligation to pay VAT on any...such [private] use.**”

28. How to determine the value on which the VAT is charged to the beneficial owner is explained in *Revenue and Customs Brief number 14/07* published on 14 November 2007. Isle of Man Customs had already recognised and dealt with that issue in an industry circular dated 21 January 2000.
29. Artificial chartering to the private funder+ of VAT registered companies is a live and hot issue and to appreciate HMRC's feeling on these matters you may want to read their *Business Brief 11/07* of 6 February 2007.
30. I don't know about you, but I would be very uncomfortable being in the position of Paul's service provider in the Isle of Man where, in effect, he's got me to get him a VAT number under false pretences, so that he can use his yacht VAT-free.

C. LEASING SCHEMES

31. Leasing in relation to yachts and VAT is a long dissertation topic in itself. It comes in many forms, types and names - French leasing, Italian leasing, Dutch leasing, Maltese leasing, Mickey Mouse leasing, DIY leasingō But, fundamentally, leasing involves some form of agreement that gives somebody progressive ownership or use of a yacht without him paying for it all at once. Quite often banks or other genuine lenders are involved. But some DIY schemes are known to exist within the yachting industry, whose sole purpose is to avoid VAT.
32. Leasing has lowered the entry threshold for yacht owners into the industry. Its major advantage is that these yacht owners don't pay cash down for the yacht, thereby suffering a significant drain on their working capital. Instead, they pay for the yacht in instalments over periods usually from 5 to 10 years. From a VAT perspective, this means that the VAT burden is spread over the leasing period.
33. The trouble with VAT on leasing is its intricacies. The exact VAT treatment of a leased yacht depends on whether the lease is a **finance lease**, an **operating lease**, a **contract hire** or even a **hire purchase**. [A hire purchase, strictly speaking, is not a type of leasing despite some common features.] The VAT liability can fall under a supply of goods or a supply of services. Even institutional lenders have been known to struggle with VAT on leasing.
34. A common mistake is to over-estimate or over-extend the general exemption of financial services from VAT. The fact is, although the core financial services (currency issue, deposit taking, loans, etc.) are exempt from VAT, there are specific exclusions when it comes to supplies such as investment and advisory services, management consultancy, debt collection and the activities of the bank's service

companies. Asset leasing, in particular, or any credit advanced in connection with the supply of goods is **not** exempt from VAT.

35. A further VAT pitfall in yacht leasing, particularly when it is conducted, as is usually the case, across borders is the VAT place of taxation or place of supply rules. The correct VAT treatment of leasing of all forms of transport is for the supplier of the form of transport to tax it in his EU country of establishment (**ECJ Case C-190/95 ARO Lease BV; and Case C-155/01 Cookies World**). It is not unusual to find lenders who erroneously assume that VAT is not chargeable on the leasing of the yacht because the lessee is either based in another EU country or is using the yacht there.
36. Finally, there is the sheer plethora of VAT leasing schemes existing in the yachting industry, which can be very confusing to clients and service providers. Suffice it to say that not all of these schemes are legitimate. Before they are entered into, if at all, it is essential that they be scrutinised carefully.

D. CONFUSION BETWEEN HIRING MEANS OF TRANSPORT AND PASSENGER TRANSPORT

37. The difference between hiring a pleasure craft as a means of transport and providing passenger transport lies in the design of the means of transport and in the feature of the service being provided. In the UK/IOM, a passenger transport service for VAT purposes is deemed to be provided with crew in a vessel designed to carry 10 or more persons. A hire of a means of transport service on the other hand is provided **without** crew.
38. The VAT consequence of the supplies being made is also important. In the supply of a hiring service the place of taxation is where the hirer has his business establishment; whereas, in a passenger transport service, it is where the vessel physically operates.
39. There is a very strong case for arguing that yachts are not really designed to provide passenger transport at all, even if they are supplied with crew. In Notice 744C *Ships Aircraft and Associated Services*, for example, HMRC argue with some logic that a yacht is not designed to convey large numbers of passengers. In their circular dated 21 January 2000, Isle of Man Customs also state correctly that passenger transport is being supplied there will not normally be a written contract, not all of the vessel will be booked by an individual, there will be a fare structure or a range of prices for the accommodation booked (as in pleasure cruises), and the supplier will be marketing their supplies as cruises or passenger transport. Think of the difference between the Seacat and your typical superyacht!
40. Indeed, EU case law confirms that the sort of charters of yachts that we are all familiar with is a hire of a means of transport rather than a passenger transport service. One case in point is that of *Knut Hamann v Finanzamt Hamburg-Eimsbuttel* (ECJ Case C- 51/88):

41. Hamann owned a yacht-charter business established in Germany. The yachts are chartered for sailing, primarily in Danish and Swedish waters but also as far away as Norway and Finland and were therefore used by charterers mainly outside German tax jurisdiction. Hamann argued that the chartering of the sailing yachts was not subject to VAT under the German legislation on the ground that the turnover had occurred at the place where the yachts hired out were used and therefore outside German tax jurisdiction [i.e. claiming "passenger transport" taxation basis]. The German tax authorities disagreed, and the ECJ backed them, stating that the hiring out was of a form of transport, which should be regarded as a taxable service supplied in Germany.
42. Nevertheless, Isle of Man Customs do currently allow VAT registered companies that operate yachts which meet the 10-berth capacity requirement to account for VAT under the passenger transport rules. While this is fine, it may mean that the Isle of Man Company is exposed to a liability to register for VAT in other Member States where the vessel operates. I know of a case where an Isle of Man company was asked to register for VAT in Greece, despite its Isle of Man registration!

E. FRENCH COMMERCIAL EXEMPTION

43. As I mentioned before, yachts and other pleasure craft have traditionally been excluded from VAT exemption allowed for sea-going vessels under Article 15 of the Sixth Directive, even if the yachts were exploited as a business undertaking. The nearest that EU VAT and Excise law ever got to making any concessions to pleasure craft was to assimilate cruise ships into the VAT exemption. The rationale is principally that a cruise ship is designed to carry a large number of passengers and because it sails more in international high seas than in in-shore waters. This is why this type of exemption falls under the general exemption allowed in the law for exports. However, the advent of the super yacht is causing a rethink in some quarters. France has been a pacesetter of sorts, although at this stage it is not apparent that any other EU country will follow.
44. In May 2004, France introduced national provisions relating to VAT on commercial yachts. These provisions, which are contained in amendments to Article 262 of the *Code Général des Impôts* (CGI), as well as in tertiary law (*Bulletin Officiel de Douanes*), have effectively reclassified large commercial yachts meeting specified conditions as ships, with the result that commercially-operated yachts in France are now accorded the same VAT exemption as allowed for merchant ships.
45. The qualifying criteria against which commerciality is assessed so far include the yacht meeting three conditions: it should hold a commercial registration certificate from any flag state; it should have a permanent crew; and it should undertake charters as evidenced by charter contracts.
46. This French commercial exemption for yachts derives from the exemptions generally allowed for sea-going vessels under Article 15 of the Sixth Directive. It is however still untested, particularly as it relates to beneficial owner use and to the fact of commercial activity, as opposed to just appearance of

commerciality. If there were to be any change on the way the authorities currently enforce the French regime then it can only be towards tightening things up against the private users of the commercially registered. This is especially because there is an excise dimension to this relief in allowing the purchase of duty-free fuel. The authorities would want to ensure that only genuinely commercial yachts get this benefit.

47. It should be remembered also that the French regime applies only to operations in French territorial waters. It is not EU-wide. So a yacht that relies entirely on French commercial exemption will still have a certain exposure when it sails into other EU Member States territorial waters.
48. Finally, it is very easy to forget that privately registered yachts continue to be bound by standard EU VAT and Temporary Importation rules in France. Equally, the place of supply rules requiring the application of VAT on yacht sale transactions taking place in France, and on the broker's commission thereto, continue to be strictly applied in France.
49. In 2005 we were involved in a consultancy where a broker sold two privately registered yachts in Cannes. He had arranged for the MOA and the Bill of Sale (document of title) to be signed while the yachts were berthed in Cannes and for the Protocol of Delivery to be executed in International Waters on delivery. The French Customs concluded on the basis of the title documents that the yachts had been sold in France. But they could not immediately get hold of the buyers, so they went for the broker and managed to extract TVA at 19.6% from the broker. The mistake of the parties in this transaction was to assume that France had liberalised yachting so much to the point of ceasing to bother with VAT!

F. DISPOSAL OF THE YACHT AND VAT DE-REGISTRATION

50. Finally, I want to deal briefly with the sale of a yacht. In a sale, the place where VAT is due is normally deemed to be where the yacht is located at the time of sale (*ECJ Case C-68/03 Staatssecretaris van Financiën and D. Lipjes* [2004])
51. It is therefore essential that you pay particular attention to the location of a yacht at the time of its sale in order to avoid unnecessary VAT liabilities. Also watch out for disposals without any consideration being paid - to the beneficial owner, for example. Evidence of the sale of the yacht, its location and its value would normally be required when you apply to de-register for VAT. Service providers have been known to come unstuck for omitting to account for the whereabouts of the yacht when they apply for VAT de-registration! You should know and properly account for the VAT on disposal so as to ensure a smooth closure.
52. Finally, I want to conclude with one final point about the disposal of private yachts that are brought into a VAT registered business for operational reasons only

53. It is perfectly legitimate for a beneficial owner who owns a VAT paid yacht privately to transfer or assign it to a company so that the company can operate a charter business. If at the end of that business undertaking the yacht needs to be sold, it is essential that the yacht is first taken out of the business and out of the VAT system altogether. And in order to be able to remove the yacht from the business without triggering a VAT liability, you need to have primed the yacht for that exit at the time when you brought it into the business to start with.
54. If insufficient attention is given to these matters and a VAT registered company sells the yacht then VAT may be due on the sale! This is because under the law (Article 2(1) of the Sixth Directive (c/f Section 4(1) VATA 1994)), the sufficient and necessary condition for a supply to be taxable is that it is effected for consideration by a taxable person acting as such. It is quite irrelevant that the yacht supplied was subject to deduction of VAT at the time of purchase (ECJ Case: *Backsi*).
55. Here is an analogous case close to home to illustrate the point. It was a VAT Tribunal appeal case in Manchester (MAN/83/39). **Jodhi Singh Mittu** was a jeweller who sold some items of jewellery through his business, which, he claimed, belonged to his wife. The goods were sold from the retail premises and the proceeds paid into the business account. For these reasons the sale was found to be in the course or furtherance of the jeweller's business, irrespective of who owned the goods in question. Customs managed to claw the VAT from Jodhi Singh Mittu - the VAT that he had not charged!
56. I hope I have given you some indication of the pitfalls that you should look out for in the sort of yachting business that we operate from the Isle of Man.
57. Henry VIII might have said to each of his wives at this stage in the proceedings: **"I hope I've not kept you too long!"**

THANK YOU

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