

An explanation of the United Kingdom & Isle of Man Indirect Tax Final Expenditure Revenue Sharing Arrangements (FERSA)

13 August 2020

1. Introduction

- 1.1. The 1979 Agreement between the Governments of the United Kingdom (UK) and the Isle of Man (IoM) sets out the framework for UK/IoM relations in respect of customs and excise matters. The 1979 Isle of Man Act gives effect to the 1979 Customs and Excise Agreement and lays down the general basis for certain tax revenue streams known as “common duties” being pooled and then shared. The IoM Treasury is therefore entitled to a share of common duties collected in both the UK and IoM that are attributable to goods consumed or services supplied on the island.
- 1.2. The common duties are: Value Added Tax (VAT), Beer Duty, Wine Duty, Spirits Duty, Cider and Perry Duty, Tobacco Products Duty, Customs Duty, Pool Betting Duty and the Soft Drinks Industry Levy (SDIL).
- 1.3. The detailed formula and accounting procedures employed since 1 April 2020 are set out in the Final Expenditure Revenue Sharing Arrangements (FERSA), agreed between the UK and IoM and signed on 24 March 2020, superseding all previous provisional agreements and the previous agreement dated 2 March 2016.

2. Purpose of this document

- 2.1. This document is published to provide transparency on the principles and methodology underpinning the FERSA.

3. Principles of FERSA

- 3.1. Under the 1979 Agreement, for the purposes of VAT, customs and most excise duties, the UK and the IoM are treated as one territory. This arrangement negates the need for customs barriers between the UK and IoM.
- 3.2. VAT and common duties that relate to goods and services consumed in the IoM can be collected in the UK; and similarly VAT and common duties that relate to goods and services consumed in the UK can be collected in the IoM.

- 3.3. The VAT and common duties collected are therefore pooled and the aim of the FERSA is to establish the IoM's share of these based on the goods and services actually consumed in the IoM.
- 3.4. Data collected by HM Revenue and Customs (HMRC) and Isle of Man Customs and Excise (IOMCE) does not specify in which jurisdiction goods and services are being consumed, therefore a calculation methodology is required.
- 3.5. This methodology has been jointly developed by the UK and the IoM Governments to ensure that the revenue arising from common duties is clear, robust and capable of examination and analysis by the Governments of the Isle of Man and the United Kingdom.
- 3.6. The FERSA is based on the VAT Total Theoretical Liability (VTTL) model, which is an internationally recognised method for calculating the theoretical amount of VAT that should be received by a jurisdiction.

4. Common duties covered by FERSA

4.1. The "common duties" are:

- Customs duties chargeable on goods imported into the UK or the IoM;
- Excise duties chargeable on goods imported into or produced in the UK or the IoM;
- Pool Betting Duty and Lottery Duty chargeable under the law of the UK or the IoM;
- Value Added Tax chargeable under the law of the UK or the IoM except tax chargeable in accordance with s.23 of the Value Added Tax Act 1994 (gaming machines).
- The Soft Drinks Industry Levy has been added to the common duties from 1 April 2019.

4.2. Lottery Duty and Hydrocarbon Oil Duty are shared on the basis of actual consumption as both can be accurately measured.

4.3. Air Passenger Duty and Machine Games Duty are outside the scope of the FERSA.

5. VAT under FERSA

5.1. Value Added Tax (VAT) is a consumption tax charged on goods and services. Ultimately it is the final consumers that pay VAT, however the VAT system is designed so that businesses collect and account for the tax and pass the tax collected to the relevant tax authority.

- 5.2. As VAT is a tax on consumption, the aim of FERSA is to share the total VAT collected by the authorities in the IoM and UK between the two jurisdictions based on where goods and services are consumed rather than where VAT is collected. Sharing VAT between the UK and the IoM purely based on where it is collected would not be a suitable method of calculating the VAT on consumption in each jurisdiction as IoM residents and businesses will purchase goods and services from the UK and vice versa.
- 5.3. VAT returns rendered in the UK and IoM contain only high-level information and do not provide information on the goods and services that VAT is being charged on or where those goods and services are being consumed. It is therefore necessary to undertake periodic surveys in the IoM to determine the level of goods and services which are being consumed in the IoM and then calculate the amount of VAT that would have been applied to those goods and services.

6. Definition of IoM Consumption

- 6.1. The IoM and UK agree that, for the purposes of FERSA, goods and services consumed 'in the IoM' (IoM consumption) are those goods and services which are purchased, whether from suppliers in the IoM or elsewhere (including within the UK), primarily for consumption in the IoM.
- 6.2. This includes goods purchased outside the IoM (for example goods purchased over the internet) that are delivered to the IoM, and goods purchased in person in the UK and carried back by the purchaser to the IoM for use and enjoyment primarily in the IoM. It also includes services provided directly to IoM households and businesses such as subscription television services and digital downloads.
- 6.3. IoM consumption does not include non-exportable goods and services, consumed, used or enjoyed outside of the IoM for example UK hotel and restaurant services, admission to UK events or cinemas and so forth.

7. Surveys

- 7.1 To establish "IoM consumption," surveys are undertaken at intervals not exceeding 5 years. The year covered by a survey is referred to as the 'survey year'.
- 7.2 For each of the survey years the IoM will undertake surveys of household and business expenditure to enable an estimate to be made of the VTTL. The surveys consist of the following:
- An Isle of Man Household Expenditure Survey (UK equivalent – The Living Costs and Food Survey);

- An Isle of Man Passenger Survey (UK equivalent – International Passenger Survey); and
- A survey of Isle of Man business and charity expenditure sufficient to identify the level of irrecoverable VAT within these sectors, including irrecoverable VAT incurred by sole traders, partnerships and companies operating below the VAT registration threshold.

7.3 These surveys are conducted in accordance with the standards and practices of the UK's Office for National Statistics.

8. VAT Calculation

8.1. The information from the surveys is used to establish the amount of VAT that would ordinarily be consumed in the IoM for the survey year.

8.2. Several adjustments are made to the data collected which include:

- Inflater and deflator adjustments which are made to the raw survey data as necessary (e.g. to take account of such factors as purchases from non-VAT registered suppliers).
- In respect of the Household Expenditure Survey, an adjustment is made for under-recording (at detailed spending level), as seen between the UK Family Expenditure Survey and the UK Household Final Consumption Estimate.
- An adjustment is made for the proportion of Household Final consumption expenditure that relates to IoM residents' tourist spending in the United Kingdom where this data is not captured in the survey.
- An adjustment for the "VAT gap". This is the difference between the amount of VAT due and the amount of VAT that we would actually expect to collect. This takes into consideration an estimate of revenue loss due to tax fraud, tax evasion and tax avoidance, but also due to bankruptcies, financial insolvencies or miscalculations. In each of the survey years the IoM will produce an estimate of the IoM VAT gap to be applied to the adjusted VAT survey results.

8.3. The results of the survey and the adjustments including the IoM's estimate of the VAT gap will be agreed between the IoM and UK Governments.

9. Calculation of common duties other than VAT

9.1. The IoM's revenue share of Customs Duty, Excise Duty and Pool Betting Duty, as listed in paragraph 4.1, is calculated by multiplying the average of the achieved IoM VAT and population fractions in the relevant survey year by the sum total of the actual common duty receipts (i.e. including VAT) in the UK and IoM in that year.

Step 1

$$\frac{\text{IoM VAT fraction} + \text{population fraction of the relevant survey year}}{2}$$

Step 2

IoM actual common duty receipts excluding VAT + UK actual common duty receipts excluding VAT

Step 3

Step 1 × Step 2 = IoM's share of common duties other than VAT

- 9.2. The "IoM VAT fraction" is the proportion of the IoM VAT share (as calculated by FERSA), of the total of the UK and IoM VAT receipts in the same survey year.
- 9.3. The "IoM population fraction" is the proportion of IoM residents of the total of residents in the UK and IoM during the survey year.
- 9.4. This calculation is used to determine the IoM's share of common duties other than VAT for the survey year.
- 9.5. The "IoM VAT fraction" and the "IoM population fraction" are used to calculate the IoM's share of common duties to ensure account is taken of population size on the Island and the level of consumption. These are both significant factors influencing the amount of common duties collected.
- 9.6. Lottery Duty and Hydrocarbon Oil Duty is shared on the basis of actual consumption in the respective territories as this is easily measurable.

10. Indexation

- 10.1. The years in-between survey years are known as "indexed years". The IoM share of the common duties (including VAT) is calculated by taking the survey year as a base and adding an agreed percentage to account for potential growth in revenue. The agreed percentage of growth is only provisional and the percentage agreed for the growth in VAT receipts can differ to that agreed for the growth in other common duties. In addition, the IoM and the UK have agreed that indexes will be reviewed annually.
- 10.2. Once the next survey has been completed, the actual rate of growth can be established and the indexed years will be revisited. Each of the indexed years will then be adjusted on a straight line basis to account for the actual rate of inflation. As surveys have to be completed at least every 5 years there are normally 6 indexed years to allow time for survey year results to be agreed and applied within FERSA.

10.3. If there is a difference between the agreed indexed rate and the actual rate of revenue growth, the resultant underpayment or overpayment is made on the 21st of the month, or closest working day thereto, after the IoM share of the common duties has been agreed following the survey year results. This process remains in force unless both parties agree otherwise.

11. Annual account and audit

11.1. In accordance with the 1979 Isle of Man Act, HMRC are required to prepare the IoM account each year under a direction issued by HM Treasury. These accounts are subject to audit by the Comptroller and Auditor General and can be found on HMRC's website.