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# Air Passenger Duty and Air Departure Tax - Highlands and Islands exemption

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This is a short note on the Air Passenger Duty exemption for passengers departing from areas in the Scottish Highlands and Islands and the Scottish Government's intention to put in place a similar exemption under Air Departure Tax.

12 October 2017  
SB 17-70

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# Background

Following the recommendations of the Smith Commission (2014), the [Scotland Act 2016](#) provides for the power to charge tax on air passengers leaving Scottish airports to be devolved to the Scottish Parliament.

The Air Departure Tax (Scotland) Bill was introduced in the Scottish Parliament on 19 December 2016 and received Royal Assent on 25 July 2017. The [Air Departure Tax \(Scotland\) Act 2017](#) introduces an Air Departure Tax (ADT) which is intended to replace Air Passenger Duty (APD) in Scotland. The [fiscal framework agreement](#) between the Scottish and UK Government states that APD will be devolved in April 2018. <sup>1</sup>

Tax bands and tax rate amounts are not provided for in the Act and will be set by secondary legislation.

The [Air Departure Tax \(Scotland\) Bill as introduced](#) <sup>2</sup> did not provide for exemptions. However, the Finance and Constitution Committee ("the Committee") stated in its Stage 1 report on the Bill: <sup>3</sup>

“ The Committee asks the Scottish Government to respond to the suggestion that flights to Highlands and Islands airports from other Scottish airports should be exempted from the definition of chargeable aircraft. ”

At Stage 2, the Scottish Government included almost all of the existing exemptions under APD in the Bill. The Act now contains the same exemptions as APD, except two:

- Flights departing from any region designated by order which has a population density of not more than 12.5 persons per square kilometre (referred to in this briefing as the "Highlands and Islands exemption")
- Flights to and from the same airport and lasting less than 60 minutes.

During Stage 2 deliberations of the Bill, Cabinet Secretary for Finance and the Constitution Derek Mackay explained:

“ ... the Scottish Government strongly supports an ADT exemption for Highlands and Islands flights. However, after careful consideration, the Government has concluded that the exemption must be notified to and assessed by the European Commission under state-aid rules before it is implemented, in compliance with European Union law. ”

For information, in relation to flights to and from the same airport and lasting less than 60 minutes, Derek Mackay stated: <sup>4</sup>

“ ... the Scottish Government is not minded to introduce an ADT exemption for passengers on flights that last less than 60 minutes and that depart from and arrive back at the same airport. It appears that that exemption would be to the singular benefit of airlines that operate fear-of-flying courses. ”

# Air Passenger Duty (APD) Highlands and Islands exemption

[Part I, Chapter IV \(Sections 28 to 44\) of The Finance Act 1994](#) provided for an air passenger duty to be charged on the carriage on a chargeable aircraft of any chargeable passenger.

[Section 31 \(subsections \(1\) and \(2\)\) of The Finance Act 1994](#) put in place an APD exception in relation to passengers making return journeys within the UK (a "return leg" exemption). On 23 June 1998, the European Commission issued a Reasoned Opinion on this exception and ruled that it was illegal according to EU Treaties on the basis that it did not provide the same effective tax treatment for all European Union flights.<sup>5 6</sup> [Section 19 of the Finance Act 2000](#) removed the return-leg exemption from the Finance Act 1994.

In his Pre-Budget statement in November 1999, the then Chancellor Gordon Brown stated:  
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“ 5.116 Air passenger duty was introduced under the last Government, but was implemented in a legally defective way. Seeking to rectify this breach of the Treaty by extending the return leg exemption to European Economic Area flights would mean that such flights bore no UK duty at all. So the Government will in the next Budget remove the return leg exemption and introduce duty rate reductions to ensure this change is revenue neutral. In the pre-Budget period HM Customs and Excise will consult on a reduced rate structure for lower fares to achieve that. 5.117 The Government also recognises the importance of air transport to the most remote areas of the UK. HM Customs and Excise will, therefore, also consult on introducing an exemption from air passenger duty for flights from airports in the Scottish Highlands and Islands when the return leg exemption is abolished.”

Mr Brown announced the outcome of this consultation in his Budget speech in March 2000: "on flights from the Scottish highlands and islands, I will abolish air passenger duty altogether."<sup>8</sup>

The exemption from duty for the Scottish Highlands & Islands was effected by [section 19 of the Finance Act 2000](#) which amends the Finance Act 1994 and states:

“ (4B) A passenger is not a chargeable passenger in relation to a flight if under his agreement for carriage (whether or not it is evidenced by a ticket) the flight is to depart from an airport which is in a region of the United Kingdom designated by order. (4C) An order may be made for the purposes of subsection (4B) above in respect of any region which has a population density of not more than 12.5 persons per square kilometre. (4D) In subsections (4B) and (4C) above, references to a region are references to an area which is determined by the Treasury to constitute a region for the purposes of those subsections.”

In other words, it put in place an exemption for flights departing from an airport which is in a region of the UK designated by order; and that an order could be made in respect of any region which has a population density of not more than 12.5 persons per square kilometre.

When the Finance Bill 2000 was debated in Committee, members firstly argued that it was unfair that only flights *departing from* these regions be exempt. For instance Oliver Letwin (West Dorset) stated: <sup>9</sup>

“ ... as currently drafted, the exemption contains an asymmetry, which-I think-is unintended but clearly erroneous. As a result, some flights to the highlands and islands would be exempt on outward and inward journeys, because the journey is from and to places within the region. In other equally remote communities, which have differently configured air routes, only the outward journey from the highlands and islands would be exempt. ”

Members also argued for an exemption for any UK island community rather than one that only covered the Scottish Highlands and Islands. For instance, Edward Davey (Kingston and Surbiton) stated: <sup>9</sup>

“ As the Government wish to put the exemption on an objective basis, the highlands and islands are not specifically referred to- but that is the only region that would fulfil the criteria on population density (...) Some island communities that are not in the Scottish highlands and islands are heavily dependent on air services. I am thinking particularly of the Isles of Scilly that are dependent on air services for three, four and sometimes five months a year. ”

Then Minister Stephen Timms responded: <sup>9</sup>

“ To be proof against legal challenge, any exemption must apply equally to any region in the European Economic Area meeting an objective set of criteria. The hon. Member for Kingston and Surbiton was right about using an objective test and that test is set out in new subsection (4C). Amendments Nos. 3 and 31 are both worded to apply to flights to United Kingdom airports only but, to avoid legal challenge, the exemption would also have to apply to flights to any part of the European Economic Area, thus meeting the sparsity threshold under new subsection (4C). The exemption would need to cover parts of Sweden, Finland, Norway and probably the whole of Iceland. That lack of targeting makes the proposed exemption pretty poor value for money. It is hard to argue that United Kingdom taxpayers should be subsidising flights to Iceland and Norway. It would be an expensive way in which to convey extra help to the highlands and islands because a large chunk of the money would support flights to other parts of the European Economic Area.”

Further discussion included: <sup>9</sup>

“ **Mr. Timms:** (...) To sum up the position in a nutshell, the only area that meets the sparsity threshold in proposed new subsection (4C), and which would therefore be exempt from APD, is the highlands and islands. That is why this measure is sound and proof against legal challenge. It constitutes a substantial improvement on the present position. Flights to, from and within the highlands and islands will bear significantly less duty than at present. Whether an arrangement involving negative duty could be implemented is an interesting speculation. **Mr. Edward Davey:** New subsection (4D) gives the Treasury the ability to define the region referred to in terms of population density. Given that the Treasury has that freedom, will he tell us whether the court has ever questioned definitions of regions made by national Governments, and against which criteria it has done so? **Mr. Timms:** I cannot quote the hon. Gentleman any precedents, but we understand that an arrangement conferred that benefit only on a region in the United Kingdom. Regions with the same characteristics in other parts of the European Economic Area would be liable to European Union challenge. **Mr. Davey:** It is an important point. Most flights from the UK to Iceland, Norway and Sweden are to cities with high population density and large, international airports. There must be few flights from UK airports to airports inside or outside the EU with low population densities, so I question the Financial Secretary's estimate of 10 million. It seems unbelievable. **Mr. Timms:** We are using an EU definition for population density, which is called NUTS 2—the nomenclature of units of territorial statistics 2. NUTS 2 areas have a population density of not more than 12.5 persons per sq km. That statistic is defined at a regional level. Some regions meet the NUTS 2 figure, but have reasonably sized populations.”

The exempt regions are designated by [Order \(SI 2001/808\)](#) which states:

“ 3. The areas described in article 4 below shall, for the purposes of section 31(4B) and (4C) of the [Finance Act 2000], constitute a region which is hereby designated for the purposes of section 31(4B) of the Act. 4. The areas referred to in article 3 above are— (a) the Highland Region, Western Isles Islands Area, Orkney Islands Area, Shetland Islands Area, Argyll and Bute District, Arran, Great Cumbrae and Little Cumbrae; and (b) in the Moray District, the parishes of Aberlour, Cabrach, Dallas, Dyke, Edinkillie, Forres, Inveravon, Kinloss, Kirkmichael, Knockando, Mortlach, Rafford and Rothes.”

HMRC's [Excise Notice 550: Air Passenger Duty](#) (Appendix 4) lists the main airports found within the region of Scottish Highlands and Islands and specifies: "This list may not be exhaustive."

# Air Departure Tax (ADT) exemption for the Highlands and Islands

On 5 October 2017 Derek Mackay announced in the Chamber: <sup>10</sup>

“ After very careful consideration, we have concluded that in order for the Highlands and Islands exemption to be compliant with EU law and state-aid regulations, it must now be notified for approval to the European Commission. As the UK is the member state, only the UK Government can do that (...) Since informing Parliament of the position in April [2017], I have had a series of discussions and exchanges of correspondence with UK Treasury ministers, most recently with the Financial Secretary to the Treasury on 25 September. Throughout the conversations and correspondence, I have been clear that although we remain committed to working with the UK Government to secure an acceptable resolution, it is for the UK Government to resolve the issue and, as the EU member state, only the UK can take forward any notification. The response, thus far, from the UK Government has been disappointing. The Financial Secretary to the Treasury made it clear in July that the UK Government has serious concerns about making an approach to the Commission; in correspondence, he stated that before the UK Government will agree to do so, the Scottish Government will need to accept full liability for all risks, including the potential for knock-on effects on Highlands and Islands business. ”

He further explained that this left the Scottish Government the following options:

- Not to introduce the exemption for Highlands and Islands flights which he noted "would bring an unacceptable cost to the fragile economies of the Highlands and Islands."
- To seek an alternative approach that would deliver "the same or better outcomes for the Highlands and Islands without a notification process." He explained: "... although there are solutions within state aid that would support the residents of islands and sparsely populated areas, we have no legal viable exemption that would support businesses and tourists and provide the good connectivity that is vital to the city of Inverness on the same terms that are currently available."

Derek Mackay added:

“ The exemption as it stands cannot continue, and the UK Government has not found a solution to that issue, other than to propose that the Scottish Parliament, the Scottish Government and, therefore, the people of Scotland should bear the risk of liability for the historical lack of compliance because of the lack of notification. ”

Asked by Kate Forbes MSP whether the Government would assure to attempt to put in place a "like-for-like replacement of the current exemption that covers residents, businesses and tourist visitors", Derek Mckay stated: "Yes, I will provide that assurance, and I hope that the statement makes clear that that is exactly what I am endeavouring to do."

Derek Mackay concluded:

“ ADT cannot be put into operation while significant uncertainty hangs over the Highlands and Islands. ”

Murdo Fraser (MSP) asked: <sup>10</sup>

“ ... as the Highlands and Islands APD exemption has existed without challenge for the past 16 years, why does the Scottish Government believe that there is suddenly, at this convenient point, an insurmountable legal problem that means that devolution of the tax might have to be delayed? ”

Derek Mackay responded:

“ The issue is of the UK Government’s making. The issue concerns the defective state of the function and the taxation proposition.”

# Fiscal framework considerations

The fiscal framework agreement between the Scottish and UK Government states the Scottish block grant will be reduced to reflect the devolution of APD through an annual "block grant adjustment." This will be calculated using a formula known as the Indexed Per Capita (IPC) method at least until there is a review of the fiscal framework in 2021-22.<sup>1</sup> Using this method, the Scottish budget will be the same as it would have been prior to the devolution of these powers if tax revenue per head grows at the same rate in Scotland and rUK.

The initial adjustment to reflect the disapplication of APD in Scotland (planned for 2018-19 according to the fiscal framework) will initially consist of indexing a "baseline" figure, equal to estimated APD revenue in Scotland in 2017-18. It is not possible to state the exact APD revenue accrued in Scotland given the way airlines report to Her Majesty's Revenue and Customs (HMRC) even once outturn data is available. Therefore estimated 2017-18 Scottish APD will be calculated using the average of the Scottish Government (as laid out in the annual report on Government Expenditure and Revenue Scotland or GERS) and HMRC's methodologies for apportioning UK APD revenues to Scotland applied to a forecast of UK-wide receipts.

For information, Table 1 shows the difference between the Scottish Government's and HMRC's estimates of APD in the whole of the UK and Scotland, in 2016-17 (most recent data available).

**Table 1: APD UK and Scotland, £ million, 2016-17 UK Government, 2017 Scottish Government, n.d.**

2016-17	Scottish Government	HMRC	Difference
Scotland	264	322	58
UK	3,228	3,183	-45
<i>Scotland as % UK</i>	8.2%	10.1%	

HMRC highlights that "HMRC apportions a higher amount to Scotland, typically around 0.5 to 2 percentage points" and that:<sup>13</sup>

"HMRC and GERS estimates are not directly comparable because of differences in data sources and methodologies applied to calculate APD. Methodological changes introduced in GERS 2016/17 report resulted in a significant downward revision of their estimates for Scottish share of APD."

Table 2 shows the Office for Budget Responsibility's March 2017 forecast of APD revenue from 2017-18 to 2021-22.

**Table 2: Forecast APD revenue in UK and Scotland, £ million, 2017-18 to 2021-22**

	2017-18	2018-19	2019-20	2020-21	2021-22
Whole UK APD	3,373	3,499	3,651	3,833	4,026
<i>of which:</i>					
<i>Scottish APD</i>	316	327	342	359	377
rUK APD	3,057	3,172	3,310	3,474	3,649
Scottish share of UK APD	9.4%	9.3%	9.4%	9.4%	9.4%

The BGA will subsequently be indexed to the previous year's BGA.

The indexation involves multiplying the baseline (if it is the first BGA) or the previous year's BGA *both* to the growth in APD revenue per capita in rUK *and* to the rate of population growth in Scotland. For example, if rUK APD revenues per capita grow by 5% and the Scottish population grows by 1%, the BGA in relation to APD will grow by approximately 6%.<sup>14</sup>

The Smith Commission and fiscal framework note there should be:<sup>1</sup>

- No detriment as a result of the decision to devolve further power: the Scottish and UK governments' budgets should be no larger or smaller simply as a result of the initial transfer of tax and/or spending powers.
- No detriment as a result of UK government or Scottish Government policy decisions post-devolution.

On 5 October 2017 Derek Mackay stated in the Chamber:<sup>10</sup>

“ Although under the terms of the fiscal framework this Government would, of course, bear the cost of any policy changes made by this Parliament, such as reducing rates to deliver economic growth, it should not cost this Government financially simply to deliver the tax as it currently is. That is the principle of no detriment that was set out by the Smith commission and which underpins the fiscal framework accompanying the devolution of powers. That principle is central to the operation of the block grant adjustment. However, the block grant adjustment mechanism for ADT does not take account of this potential flaw in the Highlands and Islands exemption. Currently, the block grant adjustment will see Scotland's block grant reduced by an amount forecast on the delivery of the tax as it currently operates. ”

He added:<sup>10</sup>

“ The UK Government has suggested that, instead of going ahead with notification or facing removing the exemption, we could defer implementation of the tax for an unspecified time period. A change to the timetable is certainly feasible—the UK Government must switch off the tax before ADT can be introduced in Scotland— and it might be unavoidable if a solution is not found. However, that is not our preference. ”

He noted he had written to the UK Government, suggesting that it amend the block grant adjustment "to enable the Scottish Government to deliver support for the Highlands and Islands in a way that ensures neither the Highlands and Islands nor Scotland's public finances suffer as a result of this apparent defect in air passenger duty."<sup>10</sup>

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