

UK tonnage tax - the regime in context

The UK tonnage tax regime has many implications for the shipping industry. Mark Middleditch, of international law firm Norton Rose, examines the regime.

The introduction in the UK of a tonnage tax regime for shipping profits was heralded as creating a positive UK fiscal environment for international shipping groups when it became law in July 2000. Guidance from the Inland Revenue has clarified how the regime will operate in practice. This article assesses the impact of tonnage tax in the context of other issues affecting the UK shipping sector, and considers those aspects of the regime relevant to international shipping operations establishing a presence in the UK.

An alternative measure of profit

Corporation tax in the UK is normally payable on the actual profits of a company, calculated on a basis which, with some adjustments, broadly reflects the company's book profits. In contrast, a tonnage tax company does not pay corporation tax on the actual profit arising from the operation of its ships. Instead, an alternative measure of profit is used, calculated by reference to the weight of shipping tonnage operated. The tonnage-based measure of profit applies even where a tonnage tax company realises a loss from its shipping activities.

The fiscal perspective

Even before the introduction of tonnage tax, UK shipping companies normally paid little corporation tax. This was due to tax depreciation, in the form of enhanced capital allowances available on shipping expenditure.

Although entry into the tonnage tax regime may not result in large savings of UK tax, there may be other accounting and financial benefits.

- In tonnage tax, the level of tax payable is not dependent on deferral reliefs such as capital allowances. For accounting purposes, this reduces the need to make provision for deferred tax, and can therefore enhance book profits.
- Tonnage tax provides certainty. The ability to ascertain the level of tax payable at any particular time will prove attractive for investors and potential business partners. The reduced impact of tax should also provide for more flexible financing options for tonnage tax companies.

The wider picture

Tonnage tax may have improved the fiscal climate and encouraged shipping business to the UK. However, other issues can affect the incentive value of the regime, and the wider position needs to be considered.

- Although not a requirement for entry into tonnage tax, registering ships under the UK flag may assist in satisfying the commercial and strategic management tests described below. Recent reforms have removed the more onerous requirements for UK flagging, with equipment and safety regulations brought into line with rules applying to ships flagged with other IMO SOLAS signatories.
- Despite the tax and flagging reforms, little concerted action has been taken to reduce the cost of employing British seafarers. Employment, social security and other tax costs for UK employees can still place UK shipping operations at a competitive disadvantage when compared with other jurisdictions. Unique amongst tonnage tax regimes, the UK system adopts a training requirement (see below). The requirement

to train EEA nationals resident in the UK can raise employment law, tax and social security issues for staff and crew, as can the employment of UK land-based staff in order to manage UK operations to satisfy the strategic and commercial management test. In either case, compliance with employment rules, income tax and social security regulations can increase the overall costs of UK operations. Careful planning can help to minimise the impact of these issues.

Other aspects of tonnage tax can restrict the level of benefit to be obtained from the regime unless the shipping operation is appropriately structured. These are considered in the remainder of this article.

Shipping profits

Only relevant shipping profits and related expenses are excluded from a tonnage tax company's normal corporation tax profits. The level of benefit to be obtained from tonnage tax will depend on the sources of income from which shipping profits are derived. Activities should be organised so as to minimise non-qualifying items.

Relevant shipping profits include:

- Income from operating qualifying ships. A qualifying ship must be seagoing, of 100 tons or more gross tonnage, and used for carriage of passengers, cargo, towage, salvage, marine assistance or sea transport services. Certain categories of ship are excluded, such as fishing vessels, factory ships, offshore installations and dredgers. Special rules apply for offshore oil and gas activities;
- Income from certain other ship-related activities. This includes income from transport services not involving a ship, administrative and insurance services, crewing, embarking and disembarking passengers, excursions, package holidays, food and drink, entertainment, loading and breaking cargo;
- Income from other incidental activities which do not exceed 0.2 per cent of turnover;
- Subject to certain conditions, foreign dividends received by a UK tonnage tax company;
- Gains on the disposal of assets are relevant shipping profits if the asset is used wholly and exclusively for tonnage tax activities.

Investment and interest income is generally excluded from relevant shipping profits.

Group structure issues

The benefit of tonnage tax is only available to those companies which operate ships. In the case of a group of companies, consideration should be given to the group structure, and to the allocation of activity within the group, before entering the tonnage tax regime. For example, if a group overall carries on a qualifying activity, but certain functions (such as crewing) are provided by a subsidiary which does not operate ships, the profits of the subsidiary will be taxed on a conventional basis. Concentrating qualifying activities (including crewing) in a single company or in a limited number of companies each of which operates ships, increases the benefits of tonnage tax. Also, because each company is taxed by reference to tonnage operated, intra-group charters between companies within the regime should be avoided.

Qualifying for tonnage tax

A tonnage tax company must:

- Operate qualifying ships. A company operates ships which are owned by it or chartered to it. A company is not regarded as operating ships let out by it on bareboat charter, except where the charter is to a company in the same tonnage tax group or is of temporarily surplus tonnage. It must also not time charter in more than 75 per cent of its

tonnage. Both these requirements will put constraints on flexibility of source and use of tonnage;

- Be within the charge to UK corporation tax (i.e. the company must be UK tax resident or carry on a trade in the UK through a branch or agency) and have the commercial and strategic management of its ships run from the UK.

Level of UK presence required

The strategic and commercial management test will determine the level of UK shipping activity which must be undertaken by an international group entering the tonnage tax regime.

The Inland Revenue will consider the two elements separately. In terms of satisfying the tests:

- strategic management looks to the location of headquarters and senior management, decision-making at board level, and whether there is a UK stock exchange listing;
- commercial management looks to route-planning, bookings, provisioning, crewing, training, technical management, repairs and support facilities.

Although UK flagging is not a condition of entry to tonnage tax, regard will be had to where the ship is flagged, insurance placed and finance obtained.

For international shipping operations, where part of the fleet is not within UK tonnage tax, the UK proportion of management of the overall fleet must be examined. The level of activity in the UK must be in proportion to the UK tonnage tax fleet, as compared with the worldwide fleet.

Training

At least one UK resident EEA national officer cadet must be trained for each 15 officer posts on ships operated within tonnage tax. A number of reporting requirements must be complied with. There is a provision for payment in lieu of training.

Entering the regime

An election must be made to enter the tonnage tax regime. For groups with existing UK activities on introduction of tonnage tax on July 2000, the initial period for entering the regime expired on 27 July 2001. After this date, a company can still elect, but only where it becomes eligible to join the regime at some point after 28 July 2001 and elects within 12 months. Foreign companies with no existing UK presence will still be able to elect to enter the regime if they move part of their activities to the UK.

The election is for an initial period of ten years.

Elections must be made on a group-wide basis, which means that all UK qualifying activities within a group of companies will be taxed on the same basis. For tonnage tax purposes, a group will include all UK and non-UK companies under common control by an individual or company.

The Inland Revenue is operating a broad pre-clearance policy. This enables non-UK companies to determine whether they would qualify for the regime before taking steps to come within the charge to UK tax.

International issues

International groups which locate part of their shipping activities to the UK will need to ascertain the impact of UK tonnage tax on wider group activities.

- In order to ensure that only the right measure of profit falls out of conventional corporation tax and into the regime, special rules are

applied to ensure that a fair proportion of the cost base is brought into tonnage tax.

- Transfer-pricing rules (which deem a market value price to be paid) apply to transactions between the qualifying activities and non-qualifying activities of a tonnage tax company. The rules also apply to transactions between a tonnage tax company and a non-tonnage tax company, even where there is no ownership or common control.
- The overall financing (on- and off-balance sheet) of a group must be looked at to ensure that financing is fairly allocated between tonnage tax and non-tonnage tax activities.

Tonnage tax - an incentive?

The introduction of tonnage tax and other recent reforms to flagging requirements have improved the attractiveness of the UK as a base for international shipping activity. The size of the UK mainland register in tonnage terms has increased by 40 per cent in the first year of tonnage tax. However, tonnage tax cannot be viewed in isolation. A reform of the employment and regulatory environment for UK seafarers would be welcome, although careful structuring can mitigate this. A review of the allocation and management of shipping operations within international groups can also enhance the real potential for financial and accounting benefits offered by entry into the regime.

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