TAXREP 9/00

TONNAGE TAX

Memorandum submitted in February 2000 by the Tax Faculty of the Institute of Chartered Accountants to the Revenue in response to a consultation package issued in December 1999

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INTRODUCTION

1 We refer to the consultation document issued on 23 December 1999 and welcome the opportunity to comment on the draft legislation. All references are to the clauses in the draft legislation.

GENERAL COMMENTS

Consultation

2 The draft legislation and the detailed commentary are helpful and comprehensive, and we congratulate the Revenue on adopting the drafting style used by the Tax Law Rewrite Project.

Areas of concern

3 The basic structure of the regime appears to be in line with Lord Alexander's proposals and as such should help to encourage regeneration of the UK shipping industry. However, some of the proposed measures to avoid conferring unintended benefits are disproportionate to the protection of the UK tax base. These measures create an excessive administrative burden and may deter prospective companies from electing into the regime, thus undermining the proposed incentives.

4 We also have a number of general concerns about the draft legislation. The draft legislation and consultation package contains three proposals that are unsatisfactory from a constitutional perspective and have a wider implication for the UK tax system. These are:

- Delegated legislation;
- Wide discretionary powers; and
- The general anti-avoidance rule.

These are all discussed further below.

Delegated Legislation

5 We note with concern the extensive use of delegated legislation. We believe that all tax legislation should be statutory and subject to the proper scrutiny of Parliament. The tonnage tax rules delegate law making authority, particularly to the Treasury and the Inland Revenue in respect of issues that are properly for Parliament. In particular, the powers to:

- provide further opportunities for election;
- exclude certain descriptions of vessels from the tax regime;
- exclude vessels to which special provisions do not apply;

- define qualifying secondary activities; and
- restrict capital allowances

are powers that should be exercised only in primary legislation.

Wide discretionary powers

6 We are opposed to the wide discretion given to the Revenue to interpret the rules. The structure of the tonnage tax regime as a whole appears to be designed to facilitate its operation by Revenue administrative fiat. The combination of new and vague expressions, excessively broad anti-avoidance rules and disproportionate and punitive penalties, effectively compel those seeking to qualify and operate within the system to obtain a clearance (as discussed in paragraph 21 of Part II – Supplementary Matters) in even relatively straightforward cases. That should not be necessary. The regime should be reasonably capable of operating within self assessment for corporation tax. The non-statutory and non-mandatory clearance system should operate as a backup, designed to be used for the more difficult cases, rather than employed as a matter of routine.

General anti-avoidance rule (GAAR)

7 We objected to the proposed GAAR for corporation tax, and also the 'mini' GAAR for VAT. The introduction of a GAAR in paragraph E5 of the proposed tonnage tax legislation, despite the recent withdrawal of both those earlier proposals, causes concern that the Revenue may still be aiming to introduce a GAAR for corporation tax on a piecemeal basis.

8 As in any other area of taxation, the possibility of avoidance in relation to the tonnage tax should be dealt with by properly targeted specific anti-avoidance rules.

9 We view with concern the above aspects of tonnage tax. The draft legislation as a whole shows that it is possible to produce well-drafted and understandable legislation. These drafting skills should be brought to define more closely the circumstances in which the incentives should and should not apply.

SPECIFIC COMMENTS

The Tonnage Tax Election

10 There are three elements of the draft legislation which run contrary to or inhibit its optional nature.

Once-off election

11 The once-off opportunity (as set out in paragraph B4) for existing companies to elect into the tonnage tax regime is unduly restrictive. It should be possible to elect into tonnage tax at any time. It must be remembered that tonnage tax is a new system of calculating shipping profits for the purposes of corporation tax and the full implications of the new rules may not be apparent at the outset. It is not completely clear, for example, who will

be within the regime. Further, the proposals contemplate the issue of a statement of practice and give extensive authority for the issue of delegated legislation.

12 Ship operators will not be in a position to assess the suitability of the regime until the statement of practice and initial secondary legislation are in place. Even then, there may well be fine-tuning of the rules to deal with unforeseen difficulties, which in due course would make election appropriate at that time, but not earlier. The need to elect for tonnage tax at the beginning is likely to discourage ship operators from participating.

Delegated legislation

13 There are a number of areas where substantial legislative authority is delegated to various Government departments, as follows:

> *The Secretary of State:*
> The training requirements as set out in paragraphs D2, D5, D6, D7, D8, D9, D10 and D11.
>
> *The Treasury:*
> B5 (Power to provide further opportunities for election);
> C6 (Power to exclude other descriptions of vessels); and
> K3 (Power to exclude vessels to which special provisions do not apply).
>
> *The Inland Revenue:*
> F4 (Qualifying secondary activities)) (NB. We note and approve the intention in F5 to legislate the permitted level of qualifying incidental activities);
> I17(3) (Provision as to the basis of writing down plant and machinery); and
> J11 (Quantitative restriction on capital allowances - power to alter amounts).

14 Taken together these provide unacceptable powers to the administration to alter the rules for their own convenience, and provide no certainty to taxpayers. Companies will be dissuaded from electing to enter into a regime that has so much in-built uncertainty.

15 This uncertainty could be reduced and the regime made more attractive if the legislation provides that a tonnage tax company or group is subject to the regulations made under these powers that were in force on the date that the company or group elected into the tonnage tax regime.

Tonnage Tax group

16 Broadly all qualifying companies within a 'group' (as defined in Part L) are compelled to join the tonnage tax regime (see paragraphs A1(2) and B1(2)). We think that this is a major disincentive. Some groups may find it appropriate to have companies within corporation tax but outside the tonnage tax group. An election on a company by company basis for groups with satisfactory ring fence arrangements would facilitate this without prejudicing the UK tax base.

17 The second sentence in paragraph A1(2) should be redrafted to make it clear that it is only the qualifying companies in the group which are required to join in a group election.

Self-Assessment

18 The legislation will introduce new concepts into the UK tax system. These include the reference to ships 'strategically and commercially managed in the United Kingdom' (see paragraph C1(1)(b) (Qualifying Companies). The test of control by individuals in paragraph L2(1)(c) when read with L2(2) is highly unsatisfactory. In particular, the test of 'does not have significant influence over the affairs of the company in question' is extremely vague.

19 In an era of self assessment, established concepts and precise parameters should be used instead of novel concepts that are vague and imprecise. It is not acceptable to substitute in place of clarity of rules an informal clearance procedure.

Jurisdiction

20 The tonnage tax may be applicable to both resident and non-resident companies. The relationship between this new concept of tonnage tax and existing principles of UK taxation is unclear. For example, under existing principles, companies are liable to corporation tax if they are either resident in the UK or, if non-resident, carrying on a trade within the UK through a branch or agency. We assume that a qualifying company which is outside the charge to corporation tax on that basis can have no liability under the tonnage tax regime even if it is covered by a tonnage tax election, for example one made during an earlier period when the company was UK-resident, but we would appreciate confirmation that this is the case.

21 However there are obvious difficulties in reconciling the two approaches, and possible risks involved in electing into the tonnage tax regime in the case of a non-resident company which does have some profits arising from a UK branch or agency. In that case it seems at least arguable that the effect of the tonnage tax election would be to replace the branch profits, as the basis for UK corporation tax, with tonnage tax calculated by reference to the company's whole qualifying tonnage. This is unreasonable, and a major disincentive to adoption of the regime by foreign companies. It may also discourage such companies from setting up a base in the UK, and thereby contributing to the regeneration of the UK fleet and to the UK economy generally.

22 One solution to this difficulty might be to calculate the tonnage tax in such cases by reference to a proportion of the company's total tonnage, corresponding to the proportion of its total turnover which is attributable to the UK branch or agency.

Ship Management Companies

23 Where the activities of a company are wholly on behalf of a tonnage tax group company and it is itself a group member, we do not see why such a company needs to own a ship in order to qualify for the tonnage tax regime.

24 We understand that there are often good commercial reasons for separating the ownership of a ship from the management of the ship. The requirement that the ship be owned by or chartered to a company to enable it to qualify may compel businesses to restructure their affairs in artificial and possibly non-commercial ways in order to qualify for the regime (see paragraph C3). The rules should allow wholly owned ship management companies to operate within a tonnage tax group where their activities would otherwise wholly qualify.

Transfer Pricing

25 It is unclear from reading paragraph G6 whether the application of Schedule 28AA, ICTA 1988 as between the tonnage tax company and another person is regardless of whether the provisions of paragraph 4 of Schedule 28AA apply (i.e. participation in management, control or capital of the other company). Transfer pricing should be restricted to its ordinary scope under paragraph 4 of Schedule 28AA, ICTA 1988 and we would welcome clarification that this is the case.

26 If on the other hand the provisions of paragraph 4 of Schedule 28AA are meant to be excluded so that it applies to all dealings by a tonnage tax company, then this appears to go beyond what is necessary to prevent abuse and will deter use of the regime.

27 If Schedule 28AA is imported into all dealings by a tonnage tax company, this will make dealing with a tonnage tax company unattractive, even where there is no attempted abuse of the arm's length principle in such dealings. All suppliers and customers of such companies will have to meet the documentation and other requirements in respect of their dealings with tonnage tax companies or groups. Increased exposure to the risk of this issue being the subject of enquiries will add to compliance costs not associated with doing business with any other kind of companies.

28 If transfer pricing is restricted to its ordinary scope under Schedule 28AA, then the normal transfer pricing rules will apply and we do not see why it is necessary to give a separate notice as set out in paragraph G7. If the requirement to give notice is retained and the uncertainties referred to in paragraphs 25 to 27 above are not clarified, tonnage tax companies may feel compelled to issue notices to all third parties, even where such persons may be wholly outside the charge to UK tax. Such notices may deter third parties from doing business with UK tonnage tax companies.

29 We would also note that the uncertainties contained within Schedule 28AA, including in particular as to who are the 'persons' within the scope of the Schedule, are automatically imported into the tonnage tax rules.

Anti-Avoidance

30 While we recognise that an incentive regime should be used in the manner intended, the anti-avoidance provision set out in paragraph E5 is disproportionate and highly uncertain in its application and is likely to inhibit commercial transactions. The provision bears many other undesirable characteristics of the earlier proposed GAAR for corporation tax.

31 This mini GAAR has additional inappropriate features. Only a single form of transaction is excluded from treatment as an avoidance transaction, which by implication means that any other transaction may fall foul of these rules. If there are areas of concern in relation to abuse which are not already expressed in the draft legislation which are of relevance to the industry, these should be indicated.

Withdrawal of relief

32 The provisions of Part M appear punitive and disproportionate to the issues to which they relate, particularly in view of the highly uncertain application of the mini GAAR found in paragraph E5. If there is to be an anti-avoidance rule, the appropriate remedy should be the loss of the tax advantage or payment of the appropriate amount of tonnage tax as the case may be, as is the case with other anti-avoidance provisions.

33 The precise application of paragraph M(1)(2a) is extremely unclear. It appears that these punitive measures will apply where a company simply decides for tax reasons not to renew the tonnage tax election after ten years have expired. We would not have thought that the provision should apply in such a circumstance, and we would welcome clarification of the circumstances in which this provision is intended to apply.

34 In addition, the application of Part M where a company no longer meets the 75% chartered in tonnage requirement (as set out in Paragraph M1(2)(b)) appears unduly harsh. We suspect that this situation could arise for sound commercial reasons and we think that the provision should not apply where this condition is breached for bona-fide commercial reasons.

35 The taxation of all disposals in the preceding six years (as set out in paragraph M2) is a particularly punitive measure that fails the test of reasonableness.

36 The ten-year disqualification from tonnage tax (as set out in paragraph M4) where any of the circumstances set out in paragraph M1(2) arise is also unreasonable. We do not think that such a provision is necessary, but if it is retained it should be limited to cases of tax avoidance under paragraph M1(2)(c).

37 With such a punitive penalty system in place, it is difficult to see that tonnage tax will act as an incentive to companies to base their shipping operations in the UK.

Treatment of finance costs

38 We are concerned that anomalies could arise under paragraphs G8 and G9 if an adjustment, which is in effect a part-disallowance of interest expense, is brought into account as a non-trading credit when the interest itself treated as a trading debit. We would have thought it better merely to restrict the interest relief.

39 We are particularly concerned about paragraph G9, where the credit may be brought into account in a different company from the one which bears the expense and has the debit. It would be better for the adjustment to be made by apportioning on a just and reasonable basis a disallowance of the finance costs to the company in which the charge was borne.

Double taxation relief

40 Is the Revenue satisfied that the modification of corporation tax by the introduction of the tonnage tax regime will not cause any other country to then regard corporation tax as no longer a tax on profits, with the result that it may then be non-creditable under the other country's double tax relief rules?

41 Our concern is not just about shipping companies but more generally. For example, the US might take the view that the mere possibility of charging corporation tax on something other than real profits means that it is no longer the same tax as it was when the treaty was negotiated, and that it is therefore non-creditable under US domestic law. The result would be that that **no** US corporation can claim a foreign tax credit for UK corporation tax. If countries adopted this stance in future treaty negotiations with the UK, the bargaining position of the UK will be weakened.

42 We understand that other countries operate similar regimes to the proposed UK tonnage tax. If the UK introduces tonnage tax, will tax regimes in other countries that are similar to tonnage tax now become creditable (assuming that they are not already creditable for the purposes of corporation tax)?

CONCLUSIONS

43 The tonnage tax rules appear to broadly achieve their objectives, and on the whole are well drafted.

44 We are concerned that in certain areas where the tonnage tax rules should be set out clearly in statute, the rules will instead be published in delegated legislation and backed by wide powers given to the Revenue to operate tonnage tax through a clearance system. We are opposed to the development of UK tax law in this way.

45 We are concerned also about the proposed mini GAAR for tonnage tax, and request that this provision is replaced with properly targeted anti-avoidance rules.

46 Many of the features of tonnage tax are highly novel and its application and interaction with other taxes uncertain. We suspect that many eligible companies may be reluctant to enter into the tonnage tax regime. If this is the result, tonnage tax will not achieve its stated purpose of encouraging the management and ownership of ships in the UK.

47 If you wish to discuss these points further, please let us know. We would also welcome feedback on the results of this consultation.

FJH
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