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UK tonnage tax

The UK tonnage tax regime provides an alternative way of calculating taxable profits of companies operating qualifying ships that are strategically and commercially managed in the UK. This factsheet sets out the main points of the legislation, contained in the Finance Act 2000, and supplemented by Tonnage Tax Regulations 2000, a Statement of Practice and Tonnage Tax (Training Requirements) Regulations 2000, and the most recent Finance Act 2005.

Calculation of tonnage tax profits

Taxable profits are calculated by reference to the net tonnage of the vessels a company operates.

Net tonnage of ship (rounded down to nearest 100)	Daily profit rate per 100 tons
0 – 1,000	£0.60
1,000 – 10,000	£0.45
10,000 – 25,000	£0.30
Above 25,000	£0.15

Profits and activities covered

Relevant shipping profits

The following types of profits are covered by the tonnage tax regime:

- income from tonnage tax activities, comprising core qualifying activities, qualifying secondary activities and qualifying incidental activities;
- qualifying dividends or other distributions from overseas shipping companies;
- certain financial income arising as part of the trading income from tonnage tax activities; and
- capital gains on tonnage tax assets.

Core qualifying activities are:

- activities in operating qualifying ships; and
- other ship-related activities that are a necessary and integral part of the company's business of operating qualifying ships.

Qualifying incidental activities are shipping-related activities that are:

- incidental to its core qualifying activities; and
- not qualifying secondary activities.

The total turnover from which does not exceed 0.25% of the company's turnover from its core qualifying activities and qualifying secondary activities.

Dividends from overseas shipping companies

Dividends, or other distributions, received by a tonnage tax company from a company that is not UK tax resident are within the regime provided that a number of conditions are satisfied.

Incidental financial income

This refers to income from loan relationships, foreign exchange transactions and interest rate and currency contracts which arises as part of the company's shipping trade comprised in its tonnage tax activities. Strictly, this would not be income from tonnage tax activities but it is specifically included in the regime where it would be treated as part of the company's trading income under the relevant UK tax rules.

Qualifying ships

To qualify for inclusion in the regime, a ship must be seagoing and over 100 gross tons used for:

- the carriage by sea of passengers;
- the carriage by sea of cargo;
- towage, salvage or other marine assistance carried out at sea; or
- transport by sea in connection with other services of a kind necessarily provided at sea.

It is envisaged that qualifying ships might include vessels certified for navigation at sea, or in UK waters categorised as category D waters by the MCA, or similar waters elsewhere. There must be in force a valid International Tonnage Certificate (1969) or other valid certificate recording its tonnage as measured in accordance with the above regulations.

'Ship' means any vessel used in navigation, including a hovercraft. A ship does not qualify if the main purpose for which it is used is the provision of goods or services of a kind normally provided on land. The following kinds of vessel are specifically excluded:

- fishing vessels;
- factory ships (a vessel providing processing services for the fishing industry);
- pleasure craft (a vessel of a kind whose primary use is for the purposes of sport or recreation);
- harbour or river ferries (a vessel used for harbour, estuary or river crossings);
- offshore installations (within the meaning of the Mineral Workings (Offshore Installations) Act 1971 but not limited to controlled waters);

Revenue & Customs has adopted a common sense interpretation of the location of strategic and commercial management.

- tankers dedicated to a particular oil field (determined in accordance with section 2 of the Oil Taxation Act 1983 (dedicated mobile assets)); and
- dredgers other than qualifying dredgers.

Qualifying dredgers and tugs were able to enter tonnage tax from 1 July 2005. As required by the EU, dredgers and tugs must be flagged under an EU flag within three months of the company first starting to operate the ship. In addition, a dredger must transport extracted materials at deep sea and a tug must tow ships at deep sea for more than 50% of its operational time.

Qualifying companies and groups

A company qualifies if it operates qualifying ships, and those ships are strategically and commercially managed in the UK. A group qualifies if it includes one or more qualifying companies.

Definitions

Operating a ship: a company is regarded as operating any ship owned by, or chartered to, the company, unless the ship is chartered out on bareboat charter terms other than to a member of the same group. A company is not, however, regarded as ceasing to operate a ship bareboat chartered out if it is temporarily surplus to the company's requirements and the term of the charter does not exceed three years.

Strategic and commercial management: Revenue & Customs has adopted a common sense interpretation of the location of strategic and commercial management. They take into account the location of the various types of management activity that can be carried out in respect of a ship. A number of factors will be considered.

Bareboat charter terms: for the purposes of the regime, this means "hiring of a ship for a stipulated period on terms which give the charterer possession and control of a ship including the right to appoint master and crew."

EU flag requirement

Where a tonnage tax company or group starts to operate a new vessel, the vessel must be flagged under an EU flag if the following conditions are satisfied:

- broadly, less than 60% of the tonnage tax company or group's fleet is flagged under an EU flag; and
- the tonnage tax company or group's fleet contains a lower proportion of EU Member State registered tonnage than during the first period it entered tonnage tax; and
- the financial year in which the ship is first operated is one which has not been exempted from the rules by the Government. The Government will exempt a financial year if the percentage of the UK tonnage tax fleet which is EU flagged has not decreased on average over a previous three year period.

These rules will apply with effect from 1 April 2008.

Training requirement

Companies must commit to a minimum training obligation as a pre-condition of electing into the tonnage tax regime, as follows:

Officers: companies must recruit and train one UK cadet per year for every 15 officer posts entered on the Safe Manning Certificates/Safe Manning Documents for all vessels in the regime. In addition, companies must continue to train recruits from the previous two years, so that once a company has been in tonnage tax for three years it will be training three UK cadets for every fifteen officer posts.

Ratings: companies must review annually the feasibility of adopting each of the ratings' employment and development options agreed by the tripartite Ratings Task Force. It is recognised that training obligations applying to ratings need to be flexible.

A 'UK cadet' must be (i) a national of an EEA State, or a British citizen from the Channel Islands or Isle of Man, and (ii) ordinarily resident in the UK. Companies must produce an annual statement setting out their specific training obligations and how they are to be met. This is subject to approval by the Department for Transport (DfT). In exceptional circumstances where a company is unable to provide training it may be able to make payments in lieu of training (PILOT). There is a system of stepped surcharges in the event of significant failure to comply with training commitments.

The training commitment for all companies or groups will start on 1 October following their entry into tonnage tax. The annual plan will need to be submitted to the DfT so that they can consider it prior to the 1 October deadline. In order to make a valid election a company or group must have received approval of its training plans from the DfT.

Mandatory employment link

The possibility of including a mandatory employment link for UK seafarers is being considered by the Government, who are also considering a training commitment for ratings.

75% limit on chartered in tonnage

Not more than 75% of the net tonnage of the qualifying ships operated can be chartered in other than on 'bareboat charter terms'. In the case of a group, the limit is applied to the aggregate tonnage of the qualifying ships operated by the group and does not apply to charters from members of the same UK group. A company could therefore, for example, have up to 75% of its net tonnage chartered in on time charters with the remaining 25% being chartered in on bareboat charters.

A non-mandatory system of clearances is operated and preliminary applications can be made at any time.

An election or renewal of an election to apply tonnage tax is invalid if the 75% limit is exceeded at the time. If the limit is exceeded on average over each of two or more consecutive accounting periods of a single company, Revenue & Customs may (but are not obliged to) exclude the company from the regime. A group may be excluded if the limit on a group basis is exceeded over two or more consecutive accounting periods of a tonnage tax member of the group.

Special rules apply to companies which have made a tonnage tax election recently. The exit charge provisions do not apply on exclusion for this reason.

Anti-avoidance requirement

It is a condition of remaining within the regime that a company is not a party to any transaction or arrangement that is an 'abuse' of the regime. This is aimed at deliberate cases of serious or repeated abuse.

Election to apply tonnage tax

A qualifying company or group can elect to enter into the regime. If an election is made, all qualifying companies within the group must be party to the election. The notice must contain such information and be supported by such evidence as Revenue & Customs may require.

The definition of a 'group' is not one of the normal definitions of 'group' for tax purposes and, broadly, can include all companies under common control of an individual and/or his associates.

Time limits

When the tonnage tax legislation was originally introduced there was a 12 month 'window' during which an election could be made for companies or groups already carrying on qualifying activities. This window was for the year ended 27 July 2001.

There was power under the legislation for the Treasury to specify further periods during which an election can be made. A new window of opportunity to elect for tonnage tax was introduced for the period from 1 July 2005 to 31 December 2006. It is not clear whether there will be any further opportunity for groups already carrying on tonnage tax activities to make an election.

In addition, where a single company or group first starts to be a qualifying company or group, there will be a 12 month window from the date that the single company or group first started to qualify. In the case of a group this will not apply if the group was, or is, substantially the same as a previously qualifying group.

When election takes effect

An election will take effect from the beginning of the accounting period in which the election is made. Revenue & Customs may agree that it takes effect from the beginning of an earlier accounting period, or from the beginning of the succeeding accounting period, or,

exceptionally, from the next accounting period. This will depend on the circumstances.

In the case of a newly qualifying company or group the election is effective from the time when the company concerned becomes a qualifying company.

Period for which in force

Elections will normally remain in force for 10 years but will cease to apply on the earlier of:

- the company or group ceasing to qualify;
- the 75% limit on chartered tonnage being exceeded (at Revenue & Customs' discretion); and
- exclusion due to tax avoidance arrangements.

Renewal election

A renewal election may be made for the same company or group at any time while an existing election is in force, provided a non-compliance notice regarding the training requirement is not in force. The original election is then superseded and tonnage tax continues to apply for ten years from the date of the renewal election, subject to earlier termination.

Clearances

A non-mandatory system of clearances is operated and preliminary applications can be made at any time.

Finance and operating leases

There are special rules for a ship leased to a company within the regime.

Restrictions on capital allowances

A lessor is entitled to writing down allowances for each ship separately:

- first £40 million of expenditure: 25% p.a. on a reducing balance basis;
- £40 million – £80 million: 10% p.a. on a reducing balance basis; and
- expenditure over £80 million: no allowances.

On disposal, sale proceeds are allocated between the 25% pool and the 10% pool in the same proportions as the acquisition cost was allocated to those pools.

Defeased leasing

A lessor is not entitled to capital allowances where the whole, or the greater part of, any non-compliance risk has been removed under the terms of the lease or by any transaction or series of transactions of which the lease forms a part. A non-compliance risk is a risk that a loss will be sustained if payments under the lease are not made in accordance with its terms.

Sale and leaseback arrangements

A lessor is not entitled to capital allowances where there is a sale and leaseback arrangement. This does not apply to new ships of less than four months old. However, specific advice should be obtained. These restrictions do not apply to operating leases entered into before 19

Who to contact

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December 2002, or to operating leases where the lessor remains responsible for operating the ship at all times, or the lessor grants the lease due to short term fleet over capacity and the lease does not exceed three years.

New leasing rules

New leasing rules were introduced in the Finance Act 2006. Broadly, capital allowances are no longer available to lessors for certain types of leases, called 'long funding leases,' but will be available to the lessee instead. These rules do not apply to ships leased to tonnage tax companies if certain conditions are satisfied. Specific advice should be obtained.

Ring-fencing

As tonnage tax is a low tax regime, activities falling within the regime are 'ring-fenced' from the rest of the corporation tax system. The transfer pricing rules apply to transactions between tonnage tax and non-tonnage tax activities. For example, if a non-tonnage tax company makes a loan to a tonnage tax company in the same group, the transfer pricing rules could apply to deem notional taxable interest income arising on the loan. Specific advice should be obtained.

Entry

Capital gains and losses

On the disposal of an asset that is or has been a tonnage tax asset, a capital gain or loss crystallises only for the period that the asset was not a tonnage tax asset, on a time apportionment basis. A company will not lose capital losses that crystallised before it entered the tonnage tax regime.

Tonnage tax assets are not regarded as 'new assets' for the purpose of rollover relief for replacement of business assets.

Where rollover relief for the replacement of business assets has already been claimed on a 'new asset' which later becomes a tonnage tax asset, then the 'rolled over' gain will crystallise on the disposal of the tonnage tax asset.

Capital allowances – ships and other plant and machinery

On entry all tax written down values and free allowances relating to tonnage tax activities are transferred to a single frozen 'tonnage tax pool'. This pool is not written down. Where vessels held on entry are disposed of, the lower of original cost, sale proceeds or market value of the vessel on entry is deducted from the tonnage tax pool. If the sale proceeds exceed the amount of the tonnage tax pool then a balancing charge will arise. A company's tonnage tax pool can be surrendered to other group companies. If a balancing charge arises, it is reduced depending on the number of whole years that the company has been subject to tonnage tax prior to the disposal:

Number of years	Percentage reduction
1	15%
2	30%
3	45%
4	60%
5	75%
6	90%
7 or more	100%

Any remaining balancing charge may be deferred against the acquisition of a new qualifying ship by the company during the period from one year before to two years after the date of disposal provided certain conditions are satisfied.

Exit

Detailed rules apply on exit from the regime and specific advice should be obtained.

Ten year disqualification from tonnage tax

A company or group cannot elect to enter the tonnage tax regime again until ten years after exit. This will also apply where a company leaves tonnage tax early for commercial reasons or makes a withdrawal notice.

We believe the information in this factsheet to be correct at the time of going to press, but we cannot accept any responsibility for any loss occasioned to any person as a result of action or refraining from action as a result of any item herein.

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