

**EXPLANATORY MEMORANDUM TO  
THE TONNAGE TAX (FURTHER OPPORTUNITY FOR ELECTION) ORDER 2005**

**2005 No. 1449**

1. This explanatory memorandum has been prepared by the Commissioners of Her Majesty's Revenue & Customs and is laid before the House of Commons by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. **Description**

- 2.1 This Order provides a further opportunity for shipping companies to elect in to tonnage tax.

3. **Matters of special interest to the Joint Committee on Statutory Instruments**

- 3.1 None.

4. **Legislative Background**

- 4.1 When tonnage tax was introduced in 2000 there was a time limit of twelve months from the passing of Finance Act 2000 ("the Act") for existing shipping companies to elect in to the regime. After that time only companies commencing a shipping business could elect in to tonnage tax.

- 4.2 Paragraph 11 of Schedule 22 of the Act provides that the Treasury may provide for further periods during which elections may be made by companies who previously chose not to elect in to tonnage tax. This is the first occasion on which the power to provide a further opportunity for election has been used.

5. **Extent**

- 5.1 This instrument applies to all of the United Kingdom.

6. **European Convention on Human Rights**

This instrument is subject to annulment and does not amend primary legislation. Accordingly the Paymaster General is satisfied that no statement as to compliance with the Convention rights is required.

## **7. Policy background**

7.1 Tonnage Tax is an alternative method of calculating corporation tax profits by reference to the net tonnage of the ship operated. Tonnage tax replaces both the corporation tax on profit/loss of the shipping trade and any chargeable gains/losses made on tonnage tax assets. Other profits of a tonnage tax company are taxable in the normal way.

7.2 In December the Inland Revenue and Department for Transport published a Post Implementation Review of Tonnage Tax together with proposals for legislative changes to improve the regime and ensure its continued compliance with the EU guidelines on state aid to the maritime industry. Following successful consultation with the shipping industry the necessary changes to primary legislation were included in the Finance Act passed before the election.

7.3 The review proposed a new window of opportunity for companies to elect in to tonnage tax. Representations received in response welcomed the new window, but felt that the proposed period of nine months starting on 1 July 2005 was too short for companies to make the necessary restructuring of their operations to permit their entry. It was therefore agreed to extend the period to 18 months, from 1 July 2005 to 31 December 2006. This was announced on 24 March in the summary of responses to the consultation and has been welcomed by the shipping industry.

## **8. Impact**

8.1 A Regulatory Impact Assessment prepared for the Post Implementation Review of Tonnage Tax which includes this proposed new window of opportunity is attached.

8.2 There is no impact on the public sector.

## **9. Contact**

Geoff Barnard at HM Revenue and Customs Tel: 020 7147 2734 or e-mail: [geoff.barnard@hmrc.gsi.gov.uk](mailto:geoff.barnard@hmrc.gsi.gov.uk) can answer any queries regarding the instrument.

**REGULATORY IMPACT ASSESSMENT (RIA)**  
**Tonnage Tax - Implementation of revised Community guidelines on State aid to maritime transport (2004/C 13/03) Purpose and intended effect of the measure**

*The policy objectives*

1. To ensure that the UK Tonnage Tax regime for shipping remains consistent with Community guidelines on State aid to maritime transport.
2. These guidelines are intended to enable Member States to operate schemes (including tonnage tax regimes) to sustain and promote safe, efficient, secure and environmentally sensitive maritime transport, while ensuring that such schemes do not undermine the Single European Market.

*Background and introduction*

3. The UK Tonnage Tax regime introduced in 2000 was implemented as part of a package of measures to reverse the decline in the UK merchant fleet and to allow the UK shipping industry to achieve its full economic potential. It created a positive fiscal environment for UK shipping, competitive with that provided by a number of newer centres for ship operations outside Europe. This was achieved by giving companies the option to elect to have their taxable profits from shipping activities determined at fixed rates by reference to the tonnage of their ships, rather than on the basis of variable business results.
4. The UK Tonnage Tax was designed to comply with the Community guidelines on State aid to maritime transport current at the time (97/C 205/05). The Regulatory Impact Assessment for the Tonnage Tax regime as a whole is available on the Inland Revenue web site at: [http://www.inlandrevenue.gov.uk/ria/ria\\_tonnage.pdf](http://www.inlandrevenue.gov.uk/ria/ria_tonnage.pdf)
5. In January 2004 the European Commission published revised guidelines in Commission communication C(2004)43 – Community guidelines on State aid to maritime transport (2004/C 13/03). This sets a deadline of 30 June 2005 for Member States to amend their existing schemes to comply with the revised guidelines. The revised guidelines are available on the European Union web site at: [http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/c\\_013/c\\_01320040117en00030012.pdf](http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/c_013/c_01320040117en00030012.pdf)

*The risk(s)/harm being addressed*

6. UK Tonnage Tax rules need to be updated to reflect the revised State aid guidelines, to ensure that the UK Tonnage Tax regime continues to be effective in sustaining and promoting the UK shipping industry.
7. If the rules were left unchanged, then certain aspects of the UK Tonnage Tax would no longer comply with the State aid guidelines. Tonnage Tax benefits made available to companies in such circumstances would be recoverable subsequently under State aid rules, counteracting the purpose of the regime and creating uncertainty for the shipping industry.

## Options

### Baseline "Option" - do nothing

8. Doing nothing is not a viable policy choice, as it would place the UK in breach of European Commission State aid guidelines, which are backed up by European law. However, "do nothing" has been included in the analysis of the benefits and costs to provide a baseline for assessing the options for change.

9. Two broad options for change have been considered:

### Option 1- Minimum changes to comply with revised State aid guidelines

This would involve making three changes to the UK Tonnage Tax rules, with effect from 1 July 2005, to:

- Exclude port towage activities from the scope of the UK Tonnage Tax regime. (A company currently operating a tug within the regime, would be required to apply ordinary tax rules to calculate profits arising from their operation in the future, unless the tug spends more than 50% of its operational time engaged in towage at sea.)
- In specified financial years where the Community flagged share of global tonnage eligible for tax relief in the UK has decreased, make it a condition of bringing new non-Community flagged ships into the UK Tonnage Tax regime that companies at least maintain the proportion of the total tonnage of their shipping fleet operating under a Community flag at the same level, where this proportion is below 60%.
- Enable Regulations to be made requiring companies operating non-Community flagged shipping within UK Tonnage Tax to provide evidence of compliance with Community and international standards relating to health, safety and the environment, or working conditions. (A continuing failure to comply with the requirements of any such Regulations could result in revocation of a company's election into Tonnage Tax, requiring the company to apply ordinary tax rules to calculate profits arising from their shipping activities.)

### Option 2 – As option 1 plus some optional changes

10. This would involve making the three changes under option 1, plus additional changes to the UK Tonnage Tax, with effect from 1 July 2005, to:

- Extend the scope of the UK Tonnage Tax regime to include the transport activities of certain dredgers that are currently excluded from the regime. (Companies would be able to bring within UK Tonnage Tax dredgers that spend more than 50% of their operational time on transport activities at sea.)
- Revise the scope of the UK Tonnage Tax regime to include certain activities of vessels engaged in offshore activities, such as in the North Sea oil and gas industry, rather than as previously only including certain categories of vessels.

The activities will include offshore supply, towage, anchor handling, carriage of gas and liquids and safety services as well as any combination of these activities.

- Establish arrangements to manage the exit of companies leaving the regime. (In particular, these arrangements would enable shipping businesses to give notice, by 31 March 2006, that they want to withdraw from the UK Tonnage Tax regime in advance of the end of their original election into the regime. This provides any company adversely affected by the changes with the option of reverting to applying ordinary tax rules. The rules applying to an exit under these circumstances, or at the expiry of a tonnage tax election would be amended to remove some existing tax disincentives to voluntary withdrawal from tonnage tax.)

11. The full detail of the changes proposed by Option 2 (and some further, minor technical clarifications that would also be made) are set out in the Finance Bill.

### **Business sectors affected**

12. The options have direct implications for the UK shipping industry and indirect implications for customers of the shipping industry.

13. Seventy-six shipping businesses have joined the UK Tonnage Tax regime and these businesses operate over 750 ships in the regime. Other shipping businesses may be currently operating outside Tonnage Tax, but might have new opportunities to participate in the regime in the future, if they are undertaking activities such as the transport of aggregates or the operation of North Sea specialist vessels.

### **Issues of equity and fairness**

14. A key purpose of Community State aid guidelines is to support the Single European market and prevent unfair competition. Changing UK Tonnage Tax rules to ensure that they continue to comply with State aid guidelines will contribute to ensuring fair competition.

15. However, there is also an issue of fairness in respect of businesses adversely affected by the changes. If implemented, the element of option 2 enabling companies to withdraw from the UK Tonnage Tax regime would make the changes fairer for port towage operators who made 10 year elections into UK Tonnage Tax in the expectation that the regime would continue as now. They would no longer be subject to certain measures designed to discourage voluntary exits from tonnage tax.

### **Benefits**

16. The baseline “option” (doing nothing) would have no economic, social or environmental benefits.

## *Economic*

17. Option 1 (minimum changes) would generate a tax yield for the Exchequer of up to £5m per year after three years. It could have some marginal benefit to port towage operators outside UK Tonnage Tax, by providing a fairer basis for competition.

18. Option 2 (minimum plus optional changes) would have benefits to industry arising from a reduction in tax, (matching the cost to the Exchequer) of up to £5m per year, This would benefit shipping companies undertaking activities brought into the scope of UK Tonnage Tax for the first time (transport by some dredgers and certain activities undertaken by vessels engaged in offshore activities, e.g. in the North Sea oil and gas industry). This would help sustain and promote the role of the UK shipping industry in competing in these activities, giving rise to wider, indirect economic benefits.

## *Social*

19. The recent review of UK Tonnage Tax discusses some of the social benefits associated with the UK Tonnage Tax. In particular, there has been an increase in the number of cadets being trained. By extending the scope of UK Tonnage Tax to include some dredgers and certain extra offshore activities, option 2 could deliver more social benefits in the future than the baseline “option” or option 1.

20. If, under either option, any new Regulations were to be introduced in the fields of health, safety, environment or working conditions, there might be additional social benefits.

## *Environmental*

21. Option 1 (minimum changes) is unlikely to give rise to any environmental benefit. Option 2 could give rise to some marginal environmental benefit by helping to sustain and promote the role of the UK shipping industry in transporting aggregates and undertaking certain North Sea activities.

## **Costs**

### *Economic*

22. The baseline “option” (doing nothing) would be expected to lead to future costs to companies. This is because although the UK Tonnage Tax was designed to comply with the State aid guidelines current at the time, the UK is now required to update the regime by 30 June 2005 to reflect the recent changes to the State aid guidelines.

23. If the regime is not updated, the European Commission could be expected to require subsequent recovery of tax benefits received after the revised State aid

guidelines take effect, to the extent that those tax benefits might no longer be permitted under the revised guidelines. In the long run these costs could be expected to be the same as for option 1, though with the added economic impact of creating financial uncertainty for the shipping industry and giving rise to unnecessary legal and administrative costs for the industry and for Inland Revenue.

24. Option 1 (minimum changes) would have costs to the shipping companies undertaking port towage no longer eligible for UK Tonnage Tax matching the yield to the Exchequer, rising to up to £5m per year after 3 years.

25. Option 2 (minimum and optional changes) would have a direct cost to the Exchequer of up to £5m a year, matching the benefit to the shipping industry.

26. Under both Options 1 and 2, there could be some additional costs to shipping companies in UK Tonnage Tax operating non-Community flagged vessels, if any additional regulation of health, safety and environment, and working conditions is required.

27. There will be some administrative costs to shipping companies in UK Tonnage Tax, for instance arising from the new requirements to monitor the proportion of their fleet operating under Community flags.

### *Social*

28. By keeping all dredgers and certain North Sea vessels outside UK Tonnage Tax, the baseline “option” (do nothing) or option 1 (minimum changes) could lead to operators with no UK presence increasing their share of these markets, and the loss of social benefits being delivered by existing UK operators.

### *Environmental*

29. By keeping all dredgers and certain North Sea vessels outside UK Tonnage Tax, the baseline “option” (do nothing) or option 1 (minimum changes) could lead to operators with no UK presence increasing their share of these markets, leading to increases in vessel travel distance and fuel consumption.

### **Small Business impacts**

30. From the information available to the Inland Revenue, none of the 76 businesses currently in Tonnage Tax have been identified as a small business (eg under the European Commission definition of small businesses used for State aid purposes). So, there should be little direct impact on small businesses. However, many of the businesses make multiple tax returns because they operate through a series of companies, and this will be taken into account in developing the details of the administrative and compliance arrangements.

31. If any small businesses operate vessels, or want to start up operations, that would be brought within UK Tonnage Tax under option 2 (ie aggregate transport and certain offshore activities), then that option would benefit those small businesses.

## **Competition assessment**

32. The competition filter test described in Cabinet Office guidance (<http://www.cabinetoffice.gov.uk/regulation/ria-guidance/content/competition/index.asp>) has been applied and no significant adverse impacts on competition have been identified for either option.

33. There is existing competition in the markets affected by the changes, and the UK Tonnage Tax regime is open to new entrants to the market.

34. By extending the scope of UK Tonnage Tax to some dredgers and certain additional offshore activities, option 2 would enhance the ability of the UK shipping industry to compete in these fields, while keeping within the Single European Market rules.

## **Securing compliance**

35. Inland Revenue already has compliance systems in place in respect of businesses' obligations to correctly assess and pay tax under Corporation Tax rules, including UK Tonnage Tax rules.

36. The detailed compliance arrangements will be designed to fit in with the existing systems, to keep compliance costs to the minimum for the shipping industry and for the Inland Revenue.

## **Consultation**

37. The Inland Revenue and Department of Transport published a joint Post Implementation Review of tonnage tax on 22 December 2004 together with legislative proposals and a partial RIA. Comments were invited from all interested parties. Industry representative bodies and others welcomed the proposed changes. A summary of the responses is available on the Inland Revenue website [http://www.inlandrevenue.gov.uk/consult\\_new/index.htm](http://www.inlandrevenue.gov.uk/consult_new/index.htm) (Responses to Consultations)

## **Monitoring and evaluation**

38. The UK Tonnage Tax has recently been reviewed more generally, and the optional changes in Option 2 take account of the findings of the review, which is being published at the same time.

39. Future monitoring and evaluation of changes will be achieved through monitoring and evaluation of the UK Tonnage Tax as a whole. It is envisaged that this work will be co-ordinated with the next review of the Community guidelines on State aid to maritime transport (due before January 2011).

Summary and recommendation



40. Option 1 (minimum changes) would result in a yield to the Exchequer but work against the Government's objective to sustain and promote the UK shipping industry. Option 2 would result in an Exchequer cost, but would consolidate and expand the successful role of UK Tonnage Tax in sustaining and promoting the UK shipping industry, within the bounds set by Community State aid guidelines.

41. The Government proposes to pursue Option 2, and has worked closely with the shipping industry to design the detail and implement the changes in a way that will maximise the benefits and minimise the costs, disruption and administration for the industry. Administrative costs of complying with the regime and the amendments stemming from this report will be subject to a further review in June 2007.

### **Contact point**

Geoff Barnard  
Revenue Policy International  
Inland Revenue  
3C / 18  
1 Parliament Street  
London SW1A 2BQ  
Tel: 020 7147 2734  
E-mail: [Geoff.Barnard@ir.gsi.gov.uk](mailto:Geoff.Barnard@ir.gsi.gov.uk)

## **REGULATORY IMPACT ASSESSMENT**

**Tonnage Tax - Implementation of revised Community guidelines on State aid  
to maritime transport (2004/C 13/03)**

### **Statement of Ministerial Approval**

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

Dawn Primarolo