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Attention: Alana Pekar

Dear Ms Pekar

Submission in respect of Exposure Draft - Tax Incentives for the Shipping Industry

Thank you for the opportunity to provide a submission to Treasury regarding the Exposure Draft of the *Tax Laws Amendment (Shipping Reform) Bill 2012* (“**Draft Bill**”), which sets out the amendments to the Tax Act to implement the taxation elements of the shipping reform package (“**Draft Provisions**”). We welcome the Draft Provisions and the Government’s objective of reforming and revitalising coastal shipping in Australia including creating a competitive environment attractive to investors.

The nature of our comments reflects our position as a legal adviser to many clients who will be affected by the new rules.

References to the Tax Act should be read as references to the *Income Tax Assessment Act 1997* (“**1997 Act**”) or the *Income Tax Assessment Act 1936* (“**1936 Act**”) (as appropriate). In addition, references to the “**EM**” are to the Explanatory Memorandum accompanying the Draft Bill.

1 Overview

- 1.1 Our comments in this submission are focused on providing additional certainty for all participants in the shipping industry, including financiers, operators and investors, in relation to accessing and retaining the benefit of the tax incentives proposed under the Draft Bill.
- 1.2 In particular, we submit that consideration be given to the following:
 - (a) clarifying that owners of a vessel used by a third party in a qualifying manner (e.g. financiers) are entitled to obtain a certificate (“**Certificate**”) under Part 2 of the *Shipping*

Reform (Tax Incentives) Bill 2012 (“**SR(TI) Bill**”) (and therefore claim the benefit of accelerated depreciation) in respect of such vessels;

- (b) clarifying that the Minister for Infrastructure and Transport (“**Minister**”) may issue more than one Certificate in relation to an eligible shipping vessel;
- (c) clarifying the royalty withholding tax exemption so that bareboat lease rentals received by non-resident lessors entitled to that exemption are treated as non-assessable non-exempt income;
- (d) treating dividends sourced from exempt income generated by qualifying operations as exempt income so as to ensure the benefit of the income tax exemption is retained by shareholders / investors;
- (e) modifying the list of excluded vessels to ensure that the tax incentives apply to a wider range of vessels consistent with international practice; and
- (f) providing an exemption from Australian interest withholding tax for interest paid on borrowings made to acquire eligible shipping vessels which are used in the manner required under Part 2 of the SR(TI) Bill.

1.3 Each of these matters is discussed in further detail below.

2 Accelerated depreciation for financier

- 2.1 It is not explicitly clear in the Draft Bill and SR(TI) Bill whether a company can meet the requirement in section 8(1)(c) of the SR(TI) Bill (so as to be eligible to obtain a Certificate) where, rather than using the shipping vessel itself in the manner stipulated under section 8(1)(c), the company provides the vessel to another entity which uses the vessel in the stipulated manner. A common example of this situation is where the vessel is owned by a financial institution which leases the vessel to a shipping operator.
- 2.2 We recommend that the Draft Provisions should be amended to clarify that, in such circumstances, the owner will meet the requirement in section 8(1)(c) of the SR(TI) Bill and hence, will be entitled to the benefits of accelerated depreciation, provided that all other conditions in that section are met by the user of the vessel.
- 2.3 While such an interpretation is open on the current drafting of section 8 of the SR(TI) Bill, and is consistent with proposed section 40-102(4A)(b) of the 1997 Act (which limits the availability of accelerated depreciation where an associate’s ordinary income from its shipping activities is exempt from income tax), clarification of this issue would provide increased certainty for financiers and should assist with the intended aims of attracting new investors into Australian shipping.
- 2.4 This approach is consistent with that taken by other countries in relation to the operation of their shipping tax incentives including the United Kingdom. Under the UK Tonnage Tax regime, owners of eligible shipping vessels, including financiers, are permitted to claim capital allowance deductions in respect of vessels leased under certain arrangements to companies within the Tonnage Tax regime.

2.5 This approach would also be consistent with the special tax exemptions provided to leasing companies in Singapore. In particular, under the Maritime Sector Incentive - Maritime Leasing Award, we understand certain leasing companies may have access to tax concessions for up to 5 years on their qualifying leasing income.

2.6 Accordingly, we recommend that the Draft Provisions are amended to clarify that an owner of an eligible vessel will be entitled to a Certificate (and therefore claim the benefit of accelerated depreciation) where the vessel is provided to a shipping operator (including under a non-hire purchase lease arrangement) who uses that vessel wholly or mainly for business or commercial activities involving carrying shipping cargo, or shipping passengers, on voyages.

3 Multiple Certificates in respect of one vessel

3.1 Consistent with our submission relating to accessing accelerated depreciation, we recommend that the Draft Provisions are amended to clarify that more than one Certificate can be issued by the Minister to different entities (whether or not those entities are associates of each other) in respect of a single vessel.

3.2 This is in line with proposed section 40-102(4A) of the 1997 Act, which provides that a taxpayer cannot benefit from accelerated depreciation in respect of a vessel, even if it has the relevant Certificate in respect of the vessel, where its associate is deriving income in respect of the same vessel that is exempt from income tax under the proposed section 51-100 of the 1997 Act. In order for this section to have any application, both entities (being the taxpayer and its associates) would be required to hold a Certificate in respect of the same vessel. This suggests that, at any one time, two entities can each be issued a Certificate in respect of the same vessel.

3.3 Further, Example 3.3 in the EM provides a fact scenario whereby one entity obtains two Certificates from the Minister (albeit at different times) in respect of the same vessel.

4 Exemption for dividends paid from exempt shipping income at investor level

4.1 We welcome the income tax exemption that will be available to shipping operators of eligible shipping vessels in respect of their income derived from specified shipping activities.

4.2 We submit however, that the intended objectives of this exemption and the wider reforms may not necessarily be achieved unless the benefit of the tax exemption is able to be passed on to the ultimate shareholders / investors. As franking credits will not be generated in respect of the exempt income, dividends paid by the shipping operators from that exempt income will be unfranked and taxable in the hands of the recipients or subject to withholding tax at the appropriate rate (unless another exemption applies).

4.3 As stated in the announcement by the Minister on 9 September 2011, the aim of the “Stronger Shipping for a Stronger Economy” reform package is to make the Australian shipping industry internationally competitive, and to reform and revitalise coastal shipping in Australia to create a competitive environment attractive to investors. Paragraph 2.11 of the EM (titled “Rationale for changes [in respect of the income tax exemption]”), states that in recent years, Australia has observed a flight from its national shipping register to other jurisdictions and that “a key goal” of the exemption was to “attract existing vessels and newer vessels to be registered in Australia”.

- 4.4 In our view, there is a significant risk that the proposed reforms may not fully achieve their stated objectives if a key benefit of the reforms (being the income tax exemption) is not able to be carried through to the ultimate owners of the shipping operator (because the benefits are effectively clawed-back in the form of taxation of unfranked dividends).
- 4.5 In our view, we can see no compelling policy reason to limit the benefits of the income tax exemption to the shipping operator. For example, in the United Kingdom, certain distributions made by UK corporates (including UK Tonnage Tax companies) to other UK resident companies are not subject to Corporations Tax and dividends paid from such profits to a non-resident investor are not subject to dividend withholding tax. Similarly, under the shipping exemptions in the Income Tax Act in Singapore, dividends paid to shareholders from the exempt income of a shipping enterprise are also exempt from taxation: see section 13A(6) of the Income Tax Act.
- 4.6 Therefore, we strongly recommend that the Draft Provisions be amended to include specific tax relief for investors who receive dividends paid from exempt shipping income to provide the provisions with the maximum chance of success. We consider that it is particularly important to ensure that the proposed regime provides the maximum possible benefits given that Australia is a relatively late starter in introducing such concessions with many of Australia's major trading partners having already introduced similar or equivalent concessions for their shipping industry.

5 Extension of royalty withholding tax

- 5.1 We welcome the introduction of a royalty withholding tax exemption under the Draft Bill for lease payments made by Australian resident companies to non-residents under bareboat leases in respect of qualifying vessels.
- 5.2 We submit however that the benefit of this exemption may be unduly limited unless these lease payments (which are covered by the proposed royalty withholding tax exemption) are also exempt from other Australian taxing provisions. This is because, as noted in paragraph 6.16 of the EM, such payments, while exempt from royalty withholding tax, may nevertheless be subject to Australian taxation under other provisions if, for example, the exempted lease payment is considered to have an Australian source.
- 5.3 Given that the intended aim of the royalty withholding tax exemption is to reduce the cost for Australian shipping operators of securing foreign vessels so as to increase the ability of Australian operators to crew those vessels with Australian workers (see paragraph 6.6 to 6.8 of the EM), the failure to provide a comprehensive exemption for lease payments may, in our view, curtail the ability of the proposed regime to achieve its intended objectives.
- 5.4 This is further exacerbated by the current uncertainty regarding the taxation of certain cross border lease arrangements under Australian case law and statutory provisions. For example, there is still some uncertainty regarding the circumstances in which leasing activities constitute a permanent establishment in Australia (even though the issue was considered in *McDermott Industries (Aust) Pty Ltd v. Federal Commissioner of Taxation* [2005] FCAFC 67). Accordingly, the royalty withholding tax exemption, in its current form, may introduce uncertainty for non-residents in respect of whether and in what circumstances the lease payments will remain taxable in Australia.
- 5.5 One option for dealing with this uncertainty would be to amend section 128D of the 1936 Act to provide that royalties (or payments that would be considered to be royalties under Australia's

domestic taxing provisions in the absence of an applicable double tax agreement) within the scope of proposed section 128B(3)(m) of the 1936 Act, are not assessable income and not exempt income of the non-resident. This is consistent with the treatment of interest payments which are exempt from withholding tax in accordance with section 128F of the 1936 Act.

6 Extending the list of eligible shipping vessel

6.1 The list of excluded vessels in section 11(4) of the SR(TI) Bill currently prevents certain vessels from being an eligible shipping vehicle for the purposes of these tax incentives.

6.2 It is our submission that such the list of excluded vessels be reduced to increase the number of vessels entitled to the tax incentives provided by this shipping reform, so that the scope of the regime is in line with its international counterparts. For example, barges, government vessels, salvage vessels, tugboats and vessels owned or operated by a defence force are currently not excluded under the Tonnage Tax system in the United Kingdom.

7 Interest withholding tax exemption

7.1 The Draft Bill does not currently provide an exemption from Australian interest withholding tax for interest paid on borrowings made to acquire eligible shipping vessels which are leased to Australian shipping operators and used in the manner required under Part 2 of the SR(TI) Bill.

7.2 We submit that the introduction of such an exemption would assist the Draft Bill in more effectively achieving its intended goals of removing barriers to investment by Australian financiers in Australian shipping and encourage investment in newer vessels. Such a change is also consistent with the exemption from royalty withholding tax for certain lease rental payments made to non-resident lessors (being merely another form of financing arrangement). As noted in paragraph 3.6 of the EM, the average age of Australian coastal trading fleet has increased from 14 to 20 years since 1996, while the international average has fallen from 15 years to 12 years. In our view, the introduction of an interest withholding tax exemption in this regard would assist, together with the accelerated depreciation benefits and royalty withholding tax exemption, to address this issue, thus encouraging new enhancements in technology and reduced environmental impact: see paragraph 3.7 of the EM.

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We have sought, in this submission, to provide you with a high level overview of our recommended approach. Accordingly, whilst we have not fully articulated all our reasons for making our submissions, we would be pleased to meet and discuss these with you if you would like us to do so.

Please do not hesitate to contact us if you have any questions, or would like to discuss any aspect of the submission in further detail.

Yours faithfully

A handwritten signature in blue ink that reads "King & Wood Mallesons".

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