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5 March 2012

The Manager
Corporate Tax Unit
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir / Madam

SUBMISSION IN RESPONSE TO THE EXPOSURE DRAFT
TAX INCENTIVES FOR THE SHIPPING INDUSTRY

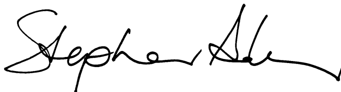
Moore Stephens welcomes the opportunity to provide a comment to Treasury in response to the exposure draft legislation and explanatory material in relation to the tax incentive for the shipping industry released on 20 February 2012.

By way of background, Moore Stephens Australia represents a number of prominent shipping, crewing and sea freight businesses in both the Australian and international market. We assist our clients with their ongoing compliance obligations and regularly advise on tax and commercial issues that are unique to domestic and international shipping operations. Moore Stephens Internationally is widely acknowledged as the world's leading shipping accountant and adviser. Moore Stephens is also a member of Australia's peak shipping body, the Australian Shipowners Association.

Our comments are set out in the attached submission.

Please do not hesitate to contact either myself or Simon Tucker on (03) 8635 1800 if you need clarification in respect of any of our comments.

Yours sincerely



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ATTACHMENT A

1. Tax incentives for the shipping industry

Moore Stephens' comments on the exposure draft legislation ('**ED**') and explanatory material ('**EM**') for the introduction of tax incentives for the shipping industry release on 20 February 2012 are set out below.

On a general note Moore Stephens acknowledges that the proposed legislation is a positive step towards reinvigorating Australia's diminished shipping industry and maritime workforce. We do note however that in our opinion some of the features of the proposed law do not do enough to put Australia on an equal footing with the rest of the world's prominent shipping nations and as a result may not achieve the objective of reinvigorating the industry.

2. Income tax exemption

2.1 Distribution of profits

A company that holds a Shipping Exempt Income Certificate ('**SEIC**') (refer to subsection 9(2) of the Exposure draft of the *Shipping Reform (Tax Incentive) Bill 2012* ('**SR(TI) Bill**')) that derives income from shipping activities will be exempt from tax on such shipping income ('**exempt shipping income**'). We note that the terms and conditions to obtain a shipping exempt certificate require that the entity applying is either a "trading or financial corporation" (refer to paragraph 8(1)(a) of the SR(TI)) Bill – as such only a company is eligible for such a concession. With this in mind the ordinary rules that are relevant to distributions from companies should be considered in conjunction with the proposed income tax exemption – of relevant to the present case is the operation of the Simplified Imputation System ('**SIS**').

Under the application of the existing provisions that deal with the operation of the SIS, a franking credit will arise only in the circumstances that are set out in the table in subsection 205-15(1) of the *Income Tax Assessment Act 1997* ('**ITAA 1997**'). This will generally be when a company has either paid income tax (be it as an instalment or final balancing payment) or when the company receives a dividend that is itself franked. When a dividend is paid by a company that has sufficient franking credits the recipient of the dividend will be able to apply the franking credit to offset the tax liability that arises. Furthermore, foreign resident shareholders that received franked dividends will not be subject to Dividend Withholding Tax ('**DWT**').

No franking credit will arise to the franking account of a company that holds a SEIC certificate and only derives exempt shipping income. This will mean that the distribution of profits (arising out of exempt shipping income) to resident shareholders will, prima facie, be subject to taxation at the taxpayers marginal rates, and distributions to foreign resident shareholders will be subject to DWT subject to the application of the *International Tax Agreements Act 1953.* This result nullifies the tax incentive for meeting the requisite conditions of a SEIC. A particular case in point would be the example of two corporate entities undertaking a joint venture shipping operation whereby shares in the joint venture entity are held by each of the corporate entities. Under the proposed rules shipping profits that are repatriated to each joint venturer as a dividend would be fully taxable. As such, it is only where a shipping business is conducted wholly within the confines of a tax consolidated group will the distribution of such exempt shipping income be shielded from tax, albeit temporarily. Distributions to shareholders outside a consolidated group will be taxed in the shareholders hands at their marginal tax rate which means that the same amount of tax as is being paid under the current tax system would be paid in the new "exempt" system. This negates the tax advantage (albeit in some circumstances a deferral benefit may exist) of the exemption and this may make the investment decision less attractive for investors and would not achieve the objective of promoting investment in Australian ships.

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Consideration should also be given to the tax systems (that deal with shipping profits) of the more prominent shipping nations around the world. If Australia cannot be genuinely competitive with these nations then it will be difficult to attract foreign capital to enhance Australia's international shipping presence. For example, Singapore provides significant income tax exemptions for companies that engage in both international and domestic shipping activities (refer to section 13A and 13F of the Singapore Tax Act ['**SITA**']). Furthermore, the distributions of profits arising out of these shipping activities are, prima facie, exempt from income tax when received as dividends (refer to paragraph 13(1)(za) of the SITA). In this respect it is difficult to understand why a shipping business would consider moving to or setting up in Australia (where the tax saving is merely temporary) when Singapore has an established income tax regime to permanently exempt shipping profits. In this regard if the Federal Government is genuine about taking responsibility for bringing Australia's shipping industry back from the brink, it may be time for a departure from Australia's existing corporate tax policy of taxing unfranked distributions.

In the context of the above it is recommended that the provisions of the ED are amended to provide a suitable mechanism that will ensure that the distribution of such exempt shipping income remains exempt in the hands of the ultimate recipient. Furthermore if the recipient is a foreign resident, such a payment should be exempted from dividend withholding tax. This would mean that the exemption would be permanent and would provide a real incentive for companies to seriously invest additional time and resource in the Australian shipping sector.

2.2 Loss wastage

Under the proposed provisions contained in the ED there is a limitation to the loss wastage rules in respect of a entity's net exempt income that relates to the entity's exempt shipping income (refer to proposed subsections 36-10(5) and 36-14(4A) ITAA 1997). We understand that this will ensure that, to the extent that the entity has current year or carried forward losses, these losses will be required to be recouped against 10% of the net exempt shipping income – thus limiting the wastage to 10%.

Given the partial limitation of the loss wastage rule, the income tax exemption should (in its current form) only be considered to be an economic partial exemption. In this respect if an entity has carried forward revenue tax losses ('**tax losses**') it is unlikely that such an entity would apply for the necessary certification in order to obtain income tax exempt status. The more likely reflex is that such an entity would either do nothing or (where the entity is an owner operator) apply for certification in respect of accelerated depreciation. It is more commercially likely that the entity would only seek application for tax exempt status once all of its carried forward losses have been recouped. Such an outcome would defer the entity's engagement into the requisite training management and crewing requirements [as required under the SR(TI) Bill] thus deferring the actualisation of the underlying policy intent of the law – to enhance Australia's currently diminished shipping fleet. We note in some circumstances that such a deferral may be significant especially where the entity has acquired losses, which are already subject to utilisation limitations (e.g. the available fraction that is acquired to loss bundles on consolidation).

In this respect we request that the current exemption mechanism is reconsidered such that there is no loss wastage in respect of the net exempt shipping income. This could be achieved by a specific carve out (similar to the proposed method), or alternatively such income from shipping activities could be treated as non-assessable non-exempt income, which under the existing provisions in Division 36 of the ITAA 1997 would not affect the way that tax losses are deducted or carried forward.

2.2.1 Bareboat bias

The extent of the loss wastage that will arise in a company that holds a SEIC and carries on shipping activities will be determined by the quantum of that company's net exempt income (defined by section 36-20 of the ITAA 1997). Under this definition net exempt income is broadly stated as the total exempt income less the losses and outgoings (that are non-capital) incurred in deriving the exempt income and any foreign taxes paid on that exempt income.

In the context of shipping this will create a rather distinct bias against a company actually owning the vessel it operates (as opposed to acquiring a vessel under a bareboat arrangement). This is because a vessel that is leased will ordinarily give rise to bareboat payments for the use of the vessel, which (when used by a shipping company that holds a SEIC) would ordinarily be an outgoing incurred to derive exempt shipping. The bareboat payments will reduce the net exempt income amount and therefore reduce the extent of the loss wastage.

Contrast this to the situation where the shipping company (that holds a SEIC) owns the vessel instead of leasing it, i.e. the company will not incur bareboat rentals for the use of the vessel. If the company was not subject to the exemption a depreciation deduction would ordinarily be available (being the decline in value of the vessel) to reduce the assessable shipping income. We note that where a SEIC is held the vessel will still decline in value, however, it is unlikely that this could ever be considered a loss or outgoing in the context of section 36-20 of the ITAA 1997. This will mean that a company that owns a vessel will not be able to reduce its net exempt income or loss wastage by what would otherwise be a standard tax deduction.

Given the above comparison (and assuming the 10% loss wastage rule remains) Moore Stephens submits that a statutory mechanism is included to allow for a reduction in net exempt income in relation to the depreciation expense that would otherwise be available thus ensuring suitable neutrality (i.e. bareboat vs. ownership) in the proposed legislation. We acknowledge that such a mechanism would be complex and in this regard we believe this provides additional support to the proposition that companies that hold a SEIC and derive income from shipping activities should have such income classed as non-assessable non-exempt income (rather than exempt income).

2.3 Balancing charge on disposal

It is understood that the ED provides for the income arising from shipping activities to be exempt from income tax. Shipping activities is defined to include core shipping activities and incidental shipping activities. Core shipping activities is broadly defined to as "activities directly involved in operating a vessel to carry shipping cargo or shipping passengers for consideration". Accompanying this definition is a list of 17 examples of what activities would be included plus a power to make regulations that can include and exclude certain activities in relation to what is a core shipping activity (refer to proposed section 51-100 of the ITAA 1997). What is not covered in this definition is income from the disposal of vessels. As such an entity that has a SEIC will in some cases need to treat the statutory income on disposal as incidental shipping income to avoid paying income tax.

We acknowledge that in the situation where a company is first issued a SEIC and subsequently acquires a vessel to derive exempt shipping income before it eventually disposes it will not be subject to an assessable balancing adjustment under Division 40 of the ITAA 1997 (i.e. because the vessel is used for a non-taxable purpose the balancing adjustment is reduced to nil per section 40-290 of the ITAA 1997). Nor will the disposal give rise to CGT event K7 (that would have occurred on disposal per section 104-235 of the ITAA 1997) because of the new carve out for holders of a SEIC per the ED (refer to proposed subsection 104-234(1AA) of the ITAA 1997).

However if a company is issued a SEIC after it has fully or partially depreciated a vessel, and then at some time later disposes of that vessel (in the ordinary course of upgrading its fleet) this would give rise to an assessable balancing adjustment. Whilst it is probably reasonable to assume that the disposal is incidental to the core shipping activity, and therefore an incidental shipping activity (refer to proposed section 51-115 of the ITAA 1997), it would not be unexpected if such an assessable balancing adjustment exceeded the 0.25% threshold permitted for incidental shipping activities (one would expect a large balancing adjustment to arise if the company initially chose to be certified for accelerated deprecation and then apply for income tax exempt status once the vessel(s) had been written off).

The prospect of paying Australian income tax on the disposal of a vessel is an unexpected outcome for a company that expects all of its shipping profits to be tax exempt. As such, we request the ED to be amended to specifically include assessable balancing adjustments arising on the disposal of vessels in the list of inclusion to core shipping activities at proposed subsection 51-100(2) of the ITAA 1997. Alternatively the balancing adjustment that arises could be disregarded in a similar manner to the proposed carve out to CGT event K7 that is already a feature of the ED.

2.4 Incidental shipping activities

The ED provides that both core and incidental shipping activities will be exempt from income tax. Incidental shipping activities are activities that are considered to be incidental to the core shipping activities. Such activities may include accommodation for passengers nearby the port of departure or transporting cargo by road prior to the loading on to the vessel. We note that there is strict limitation on the quantum of incidental shipping activities that can be consider exempt shipping income – that is the incidental shipping income must not exceed 0.25% of the core shipping activities.

The policy rationale for such a low threshold is not made clear in any of the explanatory material. In this regard Moore Stephens is at a loss to understand or to explain to it clients how such a low threshold is likely to achieve in the overall policy objective of encouraging shipping activities in Australia.

Moore Stephens submits that a 0.25% threshold test is too low to fairly capture the incidental activities that are required for the successful and profitable the operation of a shipping business. In this respect we put forward that the 0.25% threshold does not take into consideration all of the commercial realities of the operating of a shipping business.

In Moore Stephens' opinion such a low threshold will introduce a unnecessary complexity and would likely lead to an increase of compliance costs that are unlikely to be commensurate with the tax saving of having 0.25% of its incidental shipping income exempted from income taxation.

There are several examples in Australia's income tax law that provide threshold test to exclude or include certain amount in the computation of taxable income (e.g. the 5% Active Income Test per section 432 of the ITAA 1936 and 2% safe harbour exception in 102MC of the ITAA 1936). In this respect we believe a more reasonable threshold would be to set the threshold limit for incidental shipping income at 5% of core shipping activities.

3. Seafarers tax offset

It is understood that the ED will provide a refundable tax offset to a company that employs a seafarer whom is deployed for at least 91 days (in an income year) on international voyage(s) on a vessel for which a company (being the employer or the company to which the seafarer is subcontracted to) holds a certificate for under part 2 of the SR(TI) Bill.

Where such an entitlement exists the company will receive a refundable offset amount equal to 27% of the *gross payment amount* (i.e. salary, wages, commissions, bonuses or allowances – excluding Living away from home allowances[1] and expense payment fringe benefits) paid to seafarers as consideration for their employment as seafarers during the overseas voyages.

Moore Stephens recognises that this refundable tax offset will assist in alleviating the cost bias against the utilisation of Australian resident crew on international voyages, compared the deployment of crews that are foreign nationals. However, if the Federal Government is genuine in its commitment to reinvigorate Australia's shipping industry and its maritime workforce then it is our position that more needs to be done to ensure a more level playing field (from an international perspective).

[1] Note the living away from home allowance ("LAFHA") is expected to be included as assessable income from 1 July 2012 (and excluded from FBT). Where this occurs the *gross payment amount* will include the LAFHA that is paid to a seafarer.

3.1 Gross payment amount

The *gross payments amount* identified (which forms that basis for the calculation of the quantum of the offset) may only represents part of a seafarers total remuneration / package and certainly does not cover the other employee on costs that an employer must bear to deploy an Australian resident seafarer on an international voyage – when compared to their foreign counterparts.

It would not be uncommon for an Australian resident seafarer's total remuneration / package (i.e. the actual cost to employers) to exceed their respective gross payment amount. This would most commonly arise in respect of the statutory superannuation guarantee that the employer is required to pay each employee in addition to their salary. We note that such a cost would not be expected to be paid by an employer in relation to foreign employees on international voyages – this saving in relation to foreign resident only serves to emphasise this bias. Furthermore, if an employer allows a seafarer to package their salary this would decrease the amount of the refundable tax offset by the amount of the sacrifice and the associated Fringe Benefits Tax ('**FBT**') – yet the employers financial cost in relation to that seafarer does not change. From a practical and commercial viewpoint the seafarer's tax offset in the ED creates a clear disincentive for employers to allow its seafarers to salary package their remuneration. This of course introduces a bias against salary packaging for Australian seafarers and indirectly introduces tax inequality between Australia's maritime workers compared with other Australian workers – obviously this is counter to the overarching policy intent of the offset.

In addition to the seafarers remuneration there will also be other non-remuneration costs that an employee will incur in relation to Australian resident seafarers – these would include employee costs such as payroll tax as well as work cover insurance. Again it is unlikely that such costs would be expected to arise when employing foreign resident seafarers on international voyages

In this regard we are of the view that the current drafting of the EM does not take into account the usual employer costs that are incurred in retaining and deploying Australian resident seafarers on international voyages and fails to recognise the inequality that is created when doing so. It is therefore Moore Stephens' position that the seafarer offset provided by the ED (in its current form) is less likely to compensate employers for using more expensive Australian seafarers when compared to their foreign resident counterparts – as it fails to recognises these additional costs.

Moore Stephens submits that the definition of *gross payment amount* in the ED should be expanded to cover the total remuneration / package including the associated fringe benefits tax as well as other employer on costs, e.g. State Government tax payroll taxes and WorkCover (as the incidence of such statutory on costs are likely to vary from State to State we believe that the most appropriate legislative mechanism to include such costs in the computation of the gross payment would be by enactment of regulation).

Moore Stephens acknowledge that the Federal Government and Treasury will be hesitant to provide a tax offset in respect of State government revenues. Where this is the case is it requested as an alternative to increase the rate of the offset (which is currently proposed at 27%) to compensate employers for additional costs associate with employing Australian seafarers, which would not arise in respect of foreign seafarers.

3.2 Eligible voyages

We understand that the seafarer offset will arise in relation to employment on a vessel for the period of certain qualifying voyages. The period of the voyage is determined under proposed subsection 61-705(3) of the ITAA 1997 ('**voyage timing rules**'), such that:

- The voyage will commence on the day that passengers and/or cargo, first board / are loaded on to the vessel; and
- The voyage will terminate on the day that all passengers and/or cargo, disembark / are fully unloaded from the vessel.

Moore Stephens opinion is that the voyage timing rules are too simplistic a means of working out what is the actual voyage time (and employment cost of a seafarer). This is especially true where a company / employer deploys a seafarer on a vessel that performs a ballast voyage (refer below) following the delivery of cargo at a foreign port.

For example, if a tanker undertakes a voyage to carry crude oil from Australia to a foreign port but does not carry any cargo on the return trip to Australia (i.e. ballast voyages) the employer of the seafarers will be penalised. This is because the time that the seafarer is employed on the ballast voyage will not count towards the seafarer offset under the voyage timing rules. This shortcoming of the ED means that the tax offset available to compensate company for the financial disincentive of employing Australian resident seafarers is only 50% effective in certain situations. Similarly there is no tax offset or recognition (toward the threshold) of leave entitlements that are accrued during a voyage but are paid after the voyage. Given that most seafarers accrue at least one days leave for each day's service this further devalues the actual incentive being provided.

Moore Stephen's submits that the voyage timing rules in proposed subsection 61-705(3) of the ITAA 1997 are inadequate and do not take into account time spent by seafarers during ballast voyages or leave accrued during voyages. As such it is recommended that the mechanics of this rule be redrafted. The mechanics for the voyage timing rules could be to simply look at the actual time spent outside of Australia (on the vessel) where the dominant purpose for the voyage is for the carriage or cargo or passengers and then reduce the threshold by half.

4. Royalty withholding tax

Under the application of Australia's existing tax rules, but ignoring any double tax treaty (**"DTT"**), payments that are made in respect of a bareboat arrangement will be considered a payment of a royalty (refer to section 6 of the ITAA 1936). Where such a payment is made to a foreign resident the usual consequence is that the foreign resident will be subject to a final tax (i.e. no ability to claim deductions against the bareboat payments) of 30% of the gross payment in the form of a RWT (refer to section 128B of the ITAA 1936). We note for completeness the liability to RWT will also arise where the lessee of the vessel under the bareboat arrangement is a foreign resident of Australia (i.e. where the foreign resident lessee is carrying on business through an Australian Permanent Establishment ['**PE**']).

This tax outcome will be significantly altered if the foreign resident lessor (receiving the payment) is a resident of a country with which Australia is party to a DTT (a '**DTT country**'). Depending on the particular features of the relevant DTT the tax outcome will be altered as follows:

a. The rate of the RWT will be reduced below 30%;

b. The payment will be deemed not to be a RWT but will instead give rises to a PE (for example refer to Article 4(3)(b) of the Singapore Agreement as interpreted by the Full Federal Court in *McDermott's Case*[2]). As such the net bareboat payment (gross payments less allowable deductions) will be subject to income tax ('**ordinary assessment**'); and

c. The payments will not be subject RWT or ordinary assessment (for example refer to Article 12 and 5(4)(c) of the Finnish Agreement and paragraph 1.64 of the Explanatory Memorandum to the *International Tax Agreements Amendment Act (No. 2) 2007*)

As noted in the EM it is fairly common for the international bareboat agreements to require the lessor to be indemnified by the lessee in respect of any local tax that may arise in respect of the bareboat payments. As such, it will usually be the shipping operator that will be economically bearing the cost of the Australian tax (whether it be the RWT or the ordinary assessment).

[2] *McDermott Industries (Aust) Pty Ltd v. Commissioner of Taxation* 2005 ATC 4398; (2005) 59 ATR 358; (2005) 142 FCR 134; [2005] FCAFC 67

4.1 Taxation on assessment

We understand that the ED will provide a carve out in respect of the application of the RWT (i.e. the primary tax liability and the obligation to withhold) by including an additional exemption to the list at section 128B(3) of the ITAA 1936.

This legislative exemption will mean that foreign resident lessors, that are residents of either non-DTT countries; or DTT countries that have no inbuilt RWT exemption in their DTT will no longer have a liability to Australia RWT of their bareboat arrangement into Australia. This will reduce the cost (both monetary and compliance) for Australian shipping operators that have bareboat arrangements with these foreign resident lessors. The corollary of this is that shipping operators in Australia will have a bias to engage with foreign ship lessors / owners that are resident in non-DTT countries compared with those resident in countries with DTT whose DTT has a deemed substantial equipment PE clause similar to Article 4(3)(b) of the Singapore Agreement (i.e. as such an arrangement would deem a PE to arise which would make bareboat payments subject to Australian income tax by ordinary assessment).

It is recommended that Treasury reconsider the breadth of their proposed amendments by amending the ED to introduce a statutory carve out for foreign residents that would be subject to taxation under ordinary assessment in respect of purely passive bareboat arrangement. This is because the ED in its current form unduly prejudices residents of countries with which Australia has entered into a DTT's – which in itself is counter to the Australia's wider tax policy dealing with international taxation.

4.2 Foreign residents lessees

We note our understanding that the ED will exempt payments made to foreign resident in respect of bareboat arrangements from RWT, if the payment is made by an Australian resident.

We submit that this exemption should be expanded to cover payments made by foreign resident that are carrying on a business through an Australian PE in the same way that is exempts payments made by Australian residents.

We note the EM does not provide a policy reason for this particular limitation on the exemption. As such to the extent that a reason exists (and our comments are rejected) we would recommend that the EM is amended to explain the underlying policy reason for disadvantaging foreign residents in this way.

5. Issues in relation to the Shipping Reform (Tax Incentive) Bill 2012

In addition to the proposed changes to the ITAA 1997, Moore Stephens would also like to make comment in relation to some of the provisions contained within the proposed SR(TI) Bill.

5.1 Clarification of excluded vessels

The SR(TI) Bill includes at subsection 10(4) a list of excluded vessels that will not allow a company to qualify for a SEIT or accelerated depreciation.

In relation to this list of excluded vessels clarification and definitions are provided in relation to the following:

- Recreational vessel;
- Fishing vessels and fishing fleet support;
- Offshore industry vessels;
- Inland waterway vessels;
- Salvage vessels; and
- Government vessels.

No clarification or explanation is provided in relation to the following excluded vessels:

- Tugboats;
- Barges;
- Vessels operating wholly or mainly from a stationary position; and / or
- Vessels owned or operated by:
  - The Australian Defence Force; or
  - The Defence Force of another country.

Given the implications for owning and / or operating an excluded vessel we believe that further clarification is required in relation to what is meant by a "barge" (as we feel the classification of he remaining four (4) vessels is well understood). Moore Stephens' preferences for this clarification is by way of the inclusion of an additional statutory definition in section 5 of the SR(TI).

5.2 Clarity around certification requirements

Section 8 of the SR(TI) Bill contains the requirements that must be met in order for the Minister to issue a vessel certificate for accelerated depreciation or a SEIC. The conditions that must be met in order for the Minister to issue a SEIC require the company to meet certain management and training requirements. We understand that the terms of these requirements will be given application through enactment of regulations.

We note that the explanatory material to the SR(TI) Bill does provide some further clarification around the management requirements in clause 6. The only further mention in relation to the training requirements are made at clause 8 in parenthesis which indicates that the parameters for this requirement is not fully understood by the Minister.

We submit that further work needs to be done to set meaningful parameters around the training and management requirements that will eventually make their way into the regulations. Ideally better framed parameters will be included in the final version of the explanatory material that will be introduced to the Lower house of Parliament. This will enable business to plan in a more meaningful way ahead of the 1 July 2012 proposed start date.