UK Tonnage Tax and International Tax Update

16 JANUARY 2024

SUMMARY

Areas we are going to cover

- Tonnage tax overview and changes
- Transfer pricing update
- International tax update – global minimum tax reforms

Tonnage tax update

UK Tonnage Tax

A brief overview

- Introduced in 2000, tonnage tax is an alternative method of calculating corporation tax profits
- Deemed level of profits based on net tonnage of vessels “operated”, it replaces:
  - Profits/losses from the operation of vessels
  - Chargeable gains/losses on tonnage tax assets
- Low level of corporation tax, not dependent on operating profits
- Non-tonnage tax profits subject still subject to corporation tax in the normal way.

Net tonnage of ship (rounded down to nearest 100, for each complete 100 net tons):	Daily profit rate per 100 tons
Up to 1,000	£0.60
1,000 to 10,000	£0.45
10,000 to 25,000	£0.30
Above 25,000	£0.15

Example – 30,000 net tonnage vessel	£99.00
Operated for 365 days – taxable profit	£36,135
UK corporation tax (@ 25%)	**£9,033.75**

UK Tonnage Tax

Qualifying requirements

Qualifying vessels:

- "Seagoing" ship of 100 tons or more (gross tonnage)
- Used for carriage of passengers or cargo by sea
- Towage, salvage or other marine assistance carried out at sea
- Transport in connection with other services of a kind necessarily provided at sea

Qualifying conditions:

- Companies subject to UK corporation tax which "operate" qualifying vessels
- Vessels "strategically and commercially managed" in the UK.
- Strategic management:
  - Location of headquarters, including senior management, decision-making of directors/operational board
- Commercial management:
  - Chartering, technical management, crewing

Training commitment:

- Commitment to train cadets, administered by the DfT (not HMRC)
- 1 officer cadet per year for every 15 deck, engineer and electro-technical officer posts
- Cumulative training commitment each year.
- Payments In Lieu of Training (PILOT): can be made in certain circumstances, where the training commitment is unable to be met.

UK Tonnage Tax

Key developments

Flagging rules:

- Repealed from 1 April 2022
- UK flag considered when evaluating the commercial management test

Election opportunities from 1 April 2022:

- Election/re-election period reduced from 10 to 8 years
- Bridging renewal election and late election possible
- New election window of opportunity open from 1 June 2023 to 30 November 2024, (can apply to periods from 1 January 2023).

Ship management:

- Proposed introduction of ship management activities from 1 April 2024

UK Tonnage Tax

Ship management proposals

- Available to managers of tonnage tax vessels where it represents a "*significant contribution*" to the operation of the ship.
- Election required (after 1 April 2024)
- Deemed level of profits based on net tonnage of vessels managed, at a reduced rate compared to operators
- Companies still subject to normal UK corporation tax
- No cadet training requirement

Net tonnage of ship	Operator	Manager
Up to 1,000	£0.60	£0.12
1,000 to 10,000	£0.45	£0.09
10,000 to 25,000	£0.30	£0.06
Above 25,000	£0.15	£0.03

Example – 30,000 net tonnage vessel	£99.00	£19.80
Operated for 365 days – taxable profit	£36,135	£7,227
UK corporation tax (@ 25%)	**£9,033.75**	**£1,806.75**

Transfer pricing update

Current UK Transfer Pricing (TP) consultation

Overview and context

Why?

- No substantive legislative change since the early 2000s for TP and Permanent establishments (PE)
- Accumulated experiences in compliance work

Why now?

- International refinement of the Arm's Length Principle
- BEPS
- OECD (2020), Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10 (Chapter X)

Aims

- Ensure continued consistency with OECD Transfer Pricing Guidelines and Treaties
- Simplification and clarification
- Increased certainty

Overview of the key TP proposals

HMRC seeking views on improving certainty with respect to the application of the three key entry conditions:

- The ‘provision’ - remove the term from the UK transfer pricing legislation, for instance, directly adopting the phrase ‘conditions made or imposed between two enterprises in their commercial and financial relations’.
- The definition of connectedness (the ‘participation condition’) ie revisit the control test
- The tax advantage rule (the ‘one-way street’) - by applying the ‘one-way street’ by tax year, taxpayers may be disadvantaged i.e., disallowed the deduction of expenses because of a timing difference due to differences in accounting standards.

Overview of the key TP proposals

Changes are being considered in respect of the following:

- Taxation of intangibles – remove the need for two valuations on the transfer of intangible assets – market value, one arm's length.
- General exemption for UK-to-UK transactions.
- Thin capitalisation rules:
  - Permit account to be taken of implicit support from the wider group when determining the amount and terms of debt available at arm's length;
  - Permit guarantees that reduce the arm's length cost of borrowing to be taken into account when determining the terms of debt available at arm's length.
- Diverted Profits Tax:
  - Bring it into Corporation Tax ('CT'), whilst retaining the essential features of the existing DPT framework;
  - Ensure DPT's relationship to the UK's tax treaty network is made clearer.

UK documentation rules

Summary

- New Transfer Pricing documentation rules now in place for companies that are part of Group with €750m turnover and above.
  - Effective from 1 April 2023 (so first periods will be 31/3/24).
  - Requirement to have Master File and Local File as set out in the OECD guidelines.

- For **Large** businesses (Globally, over 250 employees or >€50m global turnover and >€43m net assets) who are below the CbCR threshold, and have material related party cross border transactions, our advice is to follow the rules on a voluntary basis. The HMRC guidance says:
  - "HMRC is of the view that an appropriate way to demonstrate that provisions between related parties adhere to the arm's length principle is to prepare documentation in line with the OECD's recommended approach even where the MNE group test is not met."

UK documentation rules

Practical issues in new HMRC guidance

- Aggregation of transactions in Local File:
  - The guidance confirms HMRC accept that controlled transactions may be aggregated into a single category.
- Materiality:
  - The guidance confirms that only material categories of controlled transactions need including in the Local File.
  - **HMRC have listed certain categories of transactions** they will always consider material regardless of value due to their nature and complexity.
  - For other categories of transactions, where the aggregate value of the transactions within the category does not exceed a £1 million de minimis threshold, those transactions do not need to be reported in the Local File.
- Country File:
  - HMRC's guidance confirms that the Local File is an entity specific document and should be prepared on an entity-by-entity basis.
  - However, an MNE group may prepare an amalgamated country specific Local File (a 'UK Local File').

UK documentation rules

Practical issues in new HMRC guidance

- Keeping up to date:
  - The Master File and Local File must be reviewed and updated annually to determine whether the functional and economic analyses remain accurate as the business evolves.
  - Financial data for the comparables should be updated annually to apply the arm's length principle reliably (this would mean rolling forward the financials for a comparable set for the latest financial data rather than a full refresh of the benchmarking).
- Providing TP records to HMRC:
  - Requests for the Master File and Local File (and SAT when introduced) may be made informally to support risk assessment activity or as part of a formal enquiry into a return.
  - The documentation will generally need to be provided within 30 days and failure to comply with an information notice may result in an initial penalty of £300 and daily penalties up to £60 a day.

UK documentation rules

Practical issues in new HMRC guidance

- SAO responsibility and consequences of compliance failures:
  - We expect to see tougher enforcement by HMRC of penalties for non-compliance under the new regulations.
  - A penalty up to £3,000 may be charged for each failure to keep or to preserve the specified transfer pricing records.
- Note that we are seeing HMRC ask for significant amounts of supporting documentation during Business Risk Reviews eg evidence of transfer pricing policies, processes and systems, identities of individuals who prepare transfer pricing records, who has signed off transfer pricing adjustments, internal manuals and instructions as well as formal compliance documents.

Transfer Pricing compliance

SAT and IDS have been threatened but haven't been introduced (as yet!)

Master File	Local File

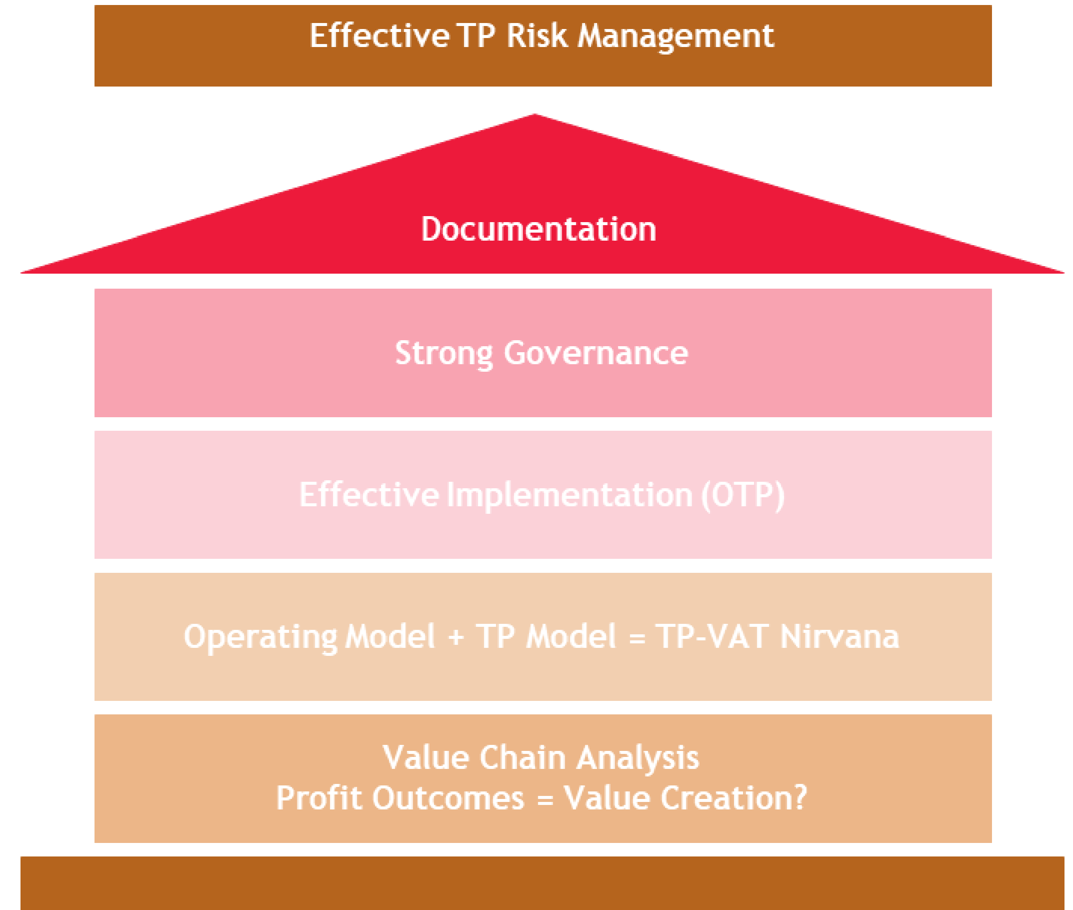
- Implementation for tax years commencing on or after 1 April 2023
- OECD compliant, for CbCR sized groups with UK operations
- To be produced in advance of UK corporate tax return date
- To be provided upon request within 30 days
- Exemption for UK-UK transactions (except Patent Box & ring fence trade)
- Only material transactions need to be documented in the Local File

Summary Audit Trail (SAT)

- Questionnaire (final format to be confirmed)
- Implementation postponed
- Further public consultation later in 2023

International Dealings Schedule (IDS)

- Details of cross-border transactions (excluding UK-UK)
- Carved out of scope of current legislation



International tax reforms

OECD international tax reform

"Tax Challenges Arising from the Digitalisation of the Economy."

Pillar One: reallocating taxing rights

- targeting issues of business presence and activities without physical presence
- profits taxed in the jurisdictions where customers and/or users are located – reallocation taxing rights to market jurisdictions

- Current position – proposed Multilateral Convention to update the international tax framework still in progress, aim to finalise this by March 2024 and approved by June 2024.

Pillar Two: Global anti-base erosion mechanism (GloBE)

- a minimum level of tax is paid by multinationals
- Minimum effective tax rate (ETR) of15%.

- Current position – UK and other countries have started to introduced legislation for accounting periods from 1 January 2024 onwards.

Pillar Two

Key points

- Multi-national enterprises (MNEs) with global revenues above €750 million in scope, where this threshold is exceeded in at least two of the four previous accounting periods.
- Designed to ensure a minimum tax rate on income within each jurisdiction in which the MNE operates.
- The framework imposes a Top-Up Tax on profits arising in jurisdictions where the effective tax rate (ETR) is below 15%.
- The core elements of Pillar Two are:
  - An Income Inclusion Rule (IIR), and
  - An Undertaxed Profits Rule (UTPR).
- Timing of implementation is country specific. Early opters are implementing the IIR first (UK from 1 January 2024).
- Qualified Domestic Minimum Top-up Tax (QDMTT), alongside the IIR. Several territories have now legislated for this, with commencement date generally aligned to the IIR.
- Implementation of the UTPR is expected to follow 12 months later – i.e. from 1 January 2025 at the earliest.
- A treaty based multilateral instrument introducing a Subject to Tax Rule (the STTR MLI) :
  - allows the source (or payor) jurisdictions to impose additional tax on certain cross-border intragroup payments when payments are subject to a nominal corporate income tax rate of below 9% in the residence (or payee) state.

Pillar Two

Core elements

Income Inclusion Rule (IIR):

- Calculate the effective tax rate in each jurisdiction and apply a additional charge on the parent entity (based on the difference between the effective tax rate and 15%)

- UK: multinational top-up tax
  - charged on UK parent entities with non-UK subsidiaries,
  - the group's profits arising in the subsidiaries' territory are taxed at an effective rate of less than 15%

Qualified Domestic Minimum Top-up Tax (QDMTT):

- A top-up tax charged on the profits of entities situated in that jurisdiction, up to the 15% minimum level of tax.
- Subsidiaries subject to QDMTT in their own jurisdictions (not the parent company jurisdiction)

- UK: domestic top-up tax
  - applies to UK subsidiaries of in-scope MNEs, so no charge under the IIR in the parent jurisdiction.

Undertaxed Profits Rule (UTPR):

- Backstop to the IIR
- The UTPR could apply where the parent is in a jurisdiction not adopting the IIR.
- Subsidiaries would be subject to UTPR in their own jurisdictions

- UK: UTPR rule
  - draft legislation issued in September 2023
  - applying no earlier than accounting periods beginning on or after 31 December 2024

Pillar Two

Effective tax rate calculation – key components

- Calculation of the effective tax rate in each territory is required.
- **Adjusted profit or loss**
  - accounting profit is adjusted for several items to remove the effect of permanent differences between the accounting profit and taxable profit
- **Adjusted covered tax balance**
  - Tax charge per financial statements plus allowances for permitted deferred tax amounts
- **Top-up amount adjustments**
  - Substance based income exclusion (SBIE) adjustment for eligible payroll costs and tangible fixed assets (5%)
  - Transitional provisions higher percentage reducing between 2023 to 2032, reaching 5% for 2033 onwards. The percentages are 10% and 8% respectively for 2023.
- The top-up amount is allocated in proportion for each member in the territory.

Pillar Two

Safe harbours and exceptions

Exclusion of international shipping profits

- Exclude both core and ancillary international shipping profits – profits generated from voyages in international traffic.
- Vessels must either be strategically or commercially managed in the member's territory in order to benefit from the exclusion
- Ancillary international shipping exclusion is capped at 50% of the core international shipping profits

Transitional safe harbour

- No top-up amounts or additional top-up amounts for an accounting period for all entities in the same territory
- Available for periods commencing on or before 31 December 2026 and ending on or before 30 June 2028.
- Qualifying country-by-country (CbC) report prepared for the territory in the given period.
- **Threshold test:** revenue of less than €10 million; aggregate profits and losses less than €1 million.
- **Simplified effective tax rate test:** at least 15% for a period beginning before 1 January 2025, 16% for a period beginning in 2025, or 17% for a period beginning on or after 1 January 2026.
- **Routine profits test:** aggregate profit is less than the substance based income exclusion (SBIE) amount

Pillar Two

Safe harbours and exceptions

- Transitional UTPR safe harbour
  - deem top-up amounts to be zero for a parent's jurisdiction that has an applicable corporate income tax rate of at least 20% for the transition period (ending before 31 December 2026)
- Exclusion from UTPR for groups with a presence in six or fewer territories
  - where the total value of tangible fixed assets is €50 million or less, after excluding the tangible fixed assets held by members in the reference territory (applies for 5 years)
- QDMTT safe harbour
  - deem the GloBE top-up for a jurisdiction with a QDMTT to be nil