[2013] UKFTT 313 (TC)

TC02716

Appeal number: TC/2012/03605

Tonnage tax – credits arising from cash collateral – relevant shipping profits – loan relationship credits – whether received in the course of activities forming an integral part of shipping activities – yes – bareboat charter – over-capacity – meaning.

FIRST-TIER TRIBUNAL
TAX CHAMBER

EUROCEANICA (UK) LIMITED **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE RACHEL SHORT
RICHARD THOMAS

Sitting in public at Bedford Square on 4 – 6 March 2013

Giles Goodfellow QC and Ms Zizhen Yang, instructed by Mazars LLP, for the Appellant

David Yates, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. This case is an appeal against a closure notice issued on 13 November 2011 and concerns the tax treatment of interest income arising to the Appellant ("Euroceanica") for the accounting periods comprising the calendar years 2006, 2007, 2008 and 2009 amounting to $4,094,648. The interest in question arose from cash collateral deposited by Euroceanica with two Italian banks as part of its loan arrangements with those banks for the financing of its shipping fleet. The question for the Tribunal is whether that interest fell for UK tax purposes to be treated as within the favourable tonnage tax regime, or within the normal, and less favourable, corporation tax regime in the UK.

Agreed Facts.

2. Euroceanica was a tonnage tax company in a tonnage tax group (both terms as defined by paragraph 2(1) Schedule 22 Finance Act 2000. ("Schedule 22")). Between May 2005 and December 2006 it entered into a number of loans with two Italian banks – Sanpaolo IMI SpA ("Sanpaolo") and Unicredit Banca d'Impresa ("Unicredit"). All of the relevant loans have now been repaid or refinanced.

3. The loans from Sanpaolo were used to finance the purchase of seven "Euro" vessels which were operated by Euroceanica as part of its tonnage tax business (the "Euro Fleet"). There was an initial short term facility for the purchase of three vessels, followed by long term (12 year) loans replacing that facility, and 12 year loans for the four other vessels. The Unicredit loan was a short term loan (12 months) used to finance indirectly the purchase of five "Crystal" vessels which were owned and operated by a 100% subsidiary of Euroceanica, Crystal Pool (UK) Limited ("Crystal"), as part of its own tonnage tax business. The Unicredit loan was on lent interest free by Euroceanica to Crystal and used by that company to finance the purchase of the Crystal vessels. (the "Crystal Fleet").

The Sanpaolo Loans

4. We were given illustrative details of the terms of the Sanpaolo loans (both the short term facility and the 12 year loans) and a copy of the documents for the Sanpaolo short term advance facility (dated 10 May 2005) and for the loan to purchase the Euro Atlantica (dated 23 June 2005). In particular we noted that the short term Sanpaolo loan granted a charge to the lender over a bank account into which Euroceanica was obliged to deposit a certain sum (initially set at $31.8m but reduced to $25m in September 2005, clause 2(e) of the loan document). The amount borrowed was $53m reducing in September 2005 to $47.6m. This is one of the Sanpaolo deposits in respect of which the disputed interest income arises. In the case of the seven long-term loans we noted that Euroceanica was required (Article 19, paragraph 1(b)) to maintain in its own name with Sanpaolo's London branch liquid assets which might be accessed at short notice. This took the form of a cash deposit which is also a deposit in respect of which disputed interest arises. The total of the long-term borrowing for all seven vessels was $132m, and the deposits were in total

$14.5m for the first five years then $7.25m thereafter. We were also informed that Euroceanica granted a mortgage over the vessels to Sanpaolo, and the bank required charterers of the vessels to channel freights directly to Sanpaolo as part of the security for the loans.

5. Euroceanica also entered into a floating to fixed interest rate swap with Sanpaolo from 8 July 2005 with a termination date of 29 July 2017 to hedge its interest rate exposure on the $27.2m loan entered into for the purchase of the Euro Atlantica (which was one of the Sanpaolo loans).

The Unicredit Loan

6. We were also given illustrative details of the Unicredit loan. The terms of the Unicredit loan, which was for €90m obliged the borrower to pledge a sum of $20m in a specified Unicredit bank account. This is the Unicredit deposit in respect of which the disputed interest income arises. We were provided with a copy of the Unicredit Bridging loan documents dated 22 December 2006. Clause 5 of this agreement relates to the cash deposit. The Unicredit loan was in euros, all of the other loans were in dollars, the group's functional currency.

7. Crystal purchased the Crystal Fleet at the end of December 2006 but from the date of purchase until about 1 March 2007 it chartered this fleet out on bareboat charter to companies within the same group as the sellers of the Crystal Fleet. From March 2007 the Crystal Fleet was chartered out by Crystal on time or voyage charter through the Crystal management company, Crystal Pool Limited which was purchased, also from the sellers of the Crystal Fleet, in or around February 2007.

8. In mid-2010 Euroceanica attempted to refinance both the Sanpaolo and the Unicredit loans and during 2010, as a result of Euroceanica failing to make the payments due on the Sanpaolo loan, Sanpaolo called on the deposits held to remedy Euroceanica's failure to pay.

9. The total amount of disputed interest arising for the four relevant periods in respect of both the Sanpaolo and Unicredit loans is $4,094,648.

The Law

10. The relevant legislation is Schedule 22 Finance Act 2000 ("Tonnage Tax"), related regulations and parts of the legislation relating to loan relationships. Schedule 22 provides a rather convoluted and interlinking set of definitions to determine, among other things, a company's tonnage tax profits. The arguments of both parties rest to some extent on the interpretation and interaction of these rules and therefore it is necessary to set out the relevant parts in some detail here.

11. The charge on tonnage tax profits is a nominal charge, based on the tonnage of each ship falling within the scope of the legislation. For this reason the tonnage tax regime is recognised as a relief from corporation tax. In the only other reported case

on the Tonnage Tax legislation, (*Western Ferries (Clyde) Limited v HMRC* [2011] UKFTT 541 (TC)) the Tribunal said:

> 170. *The statutory tonnage tax regime does not, in any real sense, impose a fiscal liability on the taxpayer. Rather, it exempts certain of his profits from liability to mainstream corporation tax, and substitutes a regime which appears to impose minimal liability; putting it another way it relieves the taxpayer of a substantial fiscal liability. Generally, exemptions tend to be construed restrictively rather than broadly. Exceptions to an exemption tend to be construed broadly otherwise the scope of the exemption may be unintentionally expanded.*

And this is how we approach the legislation.

The Legislation

12. Paragraph 3(1) sets out the general approach of the Tonnage Tax legislation:

> *"In the case of a tonnage tax company, its tonnage tax profits are brought into charge to corporation tax in place of its relevant shipping profits….".*

Paragraph 16 defines a company which can utilise the tonnage tax regime:

> *"(1) For the purposes of this Schedule a company is a "qualifying company" if—*
>
> > *(a) it is within the charge to corporation tax,*
> >
> > *(b) it operates qualifying ships, …*
> >
> > *…."*

Paragraph 18 explains when a company is **operating a qualifying ship:**

> *"(1) A company is regarded for the purposes of this Schedule as operating any ship owned by, or chartered to, the company, subject to the following provisions.*
>
> *…*
>
> *(3) A company is not regarded as the operator of a ship that has been chartered out by it on bareboat charter terms, except as provided by the following provisions.*
>
> *…*
>
> *(5) A company is not regarded as ceasing to operate a ship that has been chartered out by it on bareboat charter terms if—*
>
> > *(a) the ship is chartered out because of short-term over-capacity, and*
> >
> > *(b) the term of the charter does not exceed three years.*
>
> *…"*

Paragraph 19(1) explains what activities a ship must carry on for it to be a "qualifying ship" within the tonnage tax regime, and these are the "**activities in operating qualifying ships**" which count as "core activities" in Part VI (see below). The only relevant one for this case is in paragraph (b): *"the carriage by sea of cargo"*

Part VI of Schedule 22 defines "**Relevant Shipping Profits**" and is the core of the parties' disagreement. We therefore set the relevant paragraphs out in full.

"PART VI

INTRODUCTION

***44**--(1) For the purposes of this Schedule the relevant shipping profits of a tonnage tax company are--*

(a) its relevant shipping income (as defined below), and

(b) so much of its chargeable gains as is effectively excluded from the charge to tax by the provisions of Part VIII of this Schedule.

(2) The "relevant shipping income" of a tonnage tax company means--

(a) its income from tonnage tax activities (see paragraphs 45 to 48), and

(b) any income that is relevant shipping income under--

paragraph 49 (distributions of overseas shipping companies), or

paragraph 50 (certain interest etc),

but subject to paragraph 51 (general exclusion of investment income).

TONNAGE TAX ACTIVITIES

***45**--(1) References in this Schedule to the "tonnage tax activities" of a tonnage tax company are to--*

(a) its core qualifying activities (see paragraph 46),

(b) its qualifying secondary activities to the extent that they do not exceed the permitted level (see paragraph 47), and

(c) its qualifying incidental activities (see paragraph 48).

(2) Sub-paragraph (1) has effect subject to paragraph 51(2) (exclusion of activities giving rise to investment income).

CORE QUALIFYING ACTIVITIES

***46**--(1) A tonnage tax company's "core qualifying activities" are--*

(a) its activities in operating qualifying ships, and

(b) other ship-related activities that are a necessary and integral part of the business of operating its qualifying ships.

(2) A company's activities in operating qualifying ships means the activities mentioned in paragraph 19(1)(a) to (d) by virtue of which the ship is a qualifying ship.

QUALIFYING SECONDARY ACTIVITIES

47--*(1) The Inland Revenue may make provision by regulations as to*--

(a) the descriptions of activity that are to be regarded as qualifying secondary activities, and

(b) the permitted level in relation to any such activity or description of activity.

(2) The regulations may set the permitted level or provide for its determination by reference to such factors as may be specified in the regulations."

The regulations so far as relevant are:

TONNAGE TAX REGULATIONS 2000 (SI 2000/2303)

3—*(1) The descriptions of activity to be regarded as qualifying secondary activities shall be determined in accordance with the following paragraphs.*

(2) A tonnage tax company's qualifying secondary activities means its ship-related activities, other than commercial activities which form part of the operation of a port carried on for profit, that—

(a) have a substantial connection with the company's core qualifying activities or, where the company is a member of a tonnage tax group, the core qualifying activities of another qualifying company in that group,

(b) fall within the descriptions in paragraph (3) or (4), and

(c) in the case of paragraph (3) are carried on at any level and in the case of paragraph (4) are carried on at the permitted level.

(3) The descriptions in this paragraph are—

…..

(k) activities carried on by the company in relation to a qualifying ship operated by another qualifying company in the same tonnage tax group, which would be core qualifying activities of the first-mentioned company if carried on in relation to a qualifying ship operated by that company.

QUALIFYING INCIDENTAL ACTIVITIES

48--*(1) A company's incidental activities means its ship-related activities that*--

(a) are incidental to its core qualifying activities, and

(b) are not qualifying secondary activities.

(2) If the turnover in an accounting period of the company from its incidental activities (taken together) does not exceed 0.25% of the company's turnover in that period from--

(a) its core qualifying activities, and

(b) its qualifying secondary activities to the extent that they do not exceed the permitted level,

the company's incidental activities in that period are qualifying incidental activities.

RELEVANT SHIPPING INCOME: DISTRIBUTIONS OF OVERSEAS SHIPPING COMPANIES

49--*(1) Income of a tonnage tax company consisting in a dividend or other distribution of an overseas company is relevant shipping income if the following conditions are met.*

…..

RELEVANT SHIPPING INCOME: CERTAIN INTEREST ETC

50--*(1) Income to which this paragraph applies is relevant shipping income only to the extent that it would apart from this Schedule fall to be taken into account as trading income from a trade consisting of the company's tonnage tax activities.*

(2) This paragraph applies to--

(a) anything giving rise to a credit that would fall to be brought into account for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships); and

(b) ...

(c) any credit falling to be brought into account under Schedule 26 to the Finance Act 2002 (derivative contracts).”

Sub-paragraph (2) as set out above applies up to and including 2008. For 2009 it reads:

“(2) This paragraph applies to—

(a) anything giving rise to a credit that would fall to be brought into account for the purposes of Part 5 of the Corporation Tax Act 2009 (loan relationships); and

(b) …

(c) any credit falling to be brought into account in accordance with Part 7 of the Corporation Tax Act 2009 (derivative contracts)

GENERAL EXCLUSION OF INVESTMENT INCOME

51--*(1) Income from investments is not relevant shipping income.*

(2) To the extent that an activity gives rise to income from investments it is not regarded as part of a company's tonnage tax activities.

(3) For the purposes of this paragraph "income from investments" includes--

(a) any income chargeable to tax under Schedule A or Case III of Schedule D, and

(b) any equivalent foreign income.

(4) "Equivalent foreign income" means income chargeable under Case V of Schedule D that—

(a) consists in income of an overseas property business, or

(b) is equivalent to a description of income chargeable to tax under Case III of Schedule D but arises from a possession outside the United Kingdom."

Sub-paragraphs (3) and (4) as set out above apply up to and including 2008. For 2009 a substituted sub-paragraph (3) reads:

"(3) For the purposes of this paragraph "income from investments" includes anything chargeable to tax under—

(a) Part 4 of the Corporation Tax Act 2009 (property income),

(b) section 299 of that Act (loan relationships: non-trading profits),

(c) Chapter 5 of Part 10 of that Act (distributions from unauthorised unit trusts), or

(d) Chapter 7 of that Part (annual payments not otherwise charged)."

Subsection (5) applies for all years in this form:

"(5) Sub-paragraph (1) above does not affect income that is relevant shipping income under--

paragraph 49 (distributions of overseas shipping companies), or

paragraph 50 (certain interest etc)."

Paragraph 51 is the last in Part VI. Of the remaining relevant paragraphs, paragraph 53 deems the tonnage activities to be a separate trade:

"*(1) The tonnage tax activities of a tonnage tax company are treated for corporation tax purposes as a separate trade (the company's "tonnage tax trade") distinct from all other activities carried on by the company."*

Paragraph 61 deals with the apportionment of finance costs:

"(1) This paragraph applies to a tonnage tax company which is a single company carrying on tonnage tax activities and other activities.

(2) An adjustment shall be made if it appears, in relation to an accounting period of the company, that the company's deductible finance costs outside the ring fence exceed a fair proportion of the company's total finance costs.

(3) The company's "deductible finance costs outside the ring fence" means the total of the amounts that may be brought into account in respect of finance costs in calculating for the purposes of corporation tax the company's profits other than relevant shipping profits.

(4) A company's "total finance costs" means so much of the company's finance costs as could, if there were no tonnage tax election, be brought into account in calculating the company's profits for the purposes of corporation tax.

(5) What proportion of the company's total finance costs should be deductible outside the ring fence shall be determined on a just and reasonable basis by reference to the extent to which the funding in relation to which the costs are incurred is applied in such a way that any profits arising, directly or indirectly, would be relevant shipping profits.

(6) Where an adjustment falls to be made under this paragraph, an amount equal to the excess referred to in sub-paragraph (2) shall be brought into account as if it were a non-trading credit falling for the purposes of Chapter II of Part IV of the Finance Act 1996 (loan relationships) to be brought into account in respect of a loan relationship of the company in respect of non-tonnage tax activities.”

The relevant provisions of the Finance Act 1996 are in section 82 which deals with the way amounts are brought into account:

“(2) *To the extent that, in any accounting period, a loan relationship of a company is one to which it is a party for the purposes of a trade carried on by it, the credits …. given in respect of that relationship for that period shall be treated ….*--

(a) as receipts of that trade falling to be brought into account in computing the profits of that trade for that period;”

in section 103(1) which defines a “**creditor relationship**” as:

“in relation to a company, means any loan relationship of that company in the case of which it stands in the position of a creditor as respects the debt in question”

and in section 103(2) which says that, for the purposes of section 82(2) (amongst others) a company is treated as being party to a creditor relationship for the purposes of a trade carried on by that company:

“only if it is party to the relationship in the course of activities forming an integral part of the trade”.

For the accounting period ended 31st December 2009, the loan relationship legislation is found in Part 5 Corporation Tax Act 2009, in sections 297(1) and (2), 298(1) and (2) and 302(5).

The Witness Evidence

13. On behalf of Euroceanica we heard from three expert witnesses, all of whom had considerable experience of ship financing and were involved in arranging the financing of the Sanpaolo and Unicredit loans.

14. Mr Costalas (a non executive director of Euroceanica and a qualified master mariner) explained that Euroceanica had entered into a number of earlier loans to finance the Euro Fleet, including on terms which had not required the provision of cash collateral. However, it was common for Italian ship financing firms to require cash collateral and many loans from other financing firms had some form of what Mr Costalas described as a “cash trap”. He explained that while there was a mortgage granted on the ships as security for the loans, it was very difficult for a lender to take over a ship and sell it, so the lender tended to look for liquid assets as well. He stated that in theory it might have been possible to obtain a loan without the need for a cash deposit, but this would have meant significantly more stringent loan covenants, a lower loan-to-value ratio (i.e. a smaller percentage of the asset’s value would have been financed: Mr Costalas estimated that only 60 – 65% of the vessel’s asset value could have been loan financed without the cash collateral, as compared to the 80% which was actually financed), or a higher interest rate. He also stated that the loan terms on offer from the two Italian banks in question at that time were particularly favourable.

15. This was corroborated by Mr Biale (the Managing Director of an entity which held a significant percentage of the shares in Euroceanica) who explained why these Italian banks were particularly keen to finance Euroceanica’s ships on such favourable terms, namely the very competitive nature of the banking market in Genoa (where these bank branches were based) and the desire of both banks to regain the foothold which they previously had in the ship financing business. Mr Biale also supported the statements of Mr Costalas that while the provision of cash collateral was not universal in ship financing, the lack of a cash deposit would mean a lower loan-to-value ratio or reliance on a parental guarantee (which was not possible for Euroceanica, since it was the parent company). From Euroceanica’s perspective, as a commercial matter it was easier for them to give cash collateral than to agree to more restrictive loan covenants. Mr Biale stated that there had been an attempt to negotiate away the need for cash collateral, but this had been resisted by the lenders.

16. Mr Browne, a non executive director of Euroceanica, stated that the cash deposited as collateral as part of these agreements was not intended to be an investment. Euroceanica had never discussed the interest rate which could be obtained on these deposits. The company’s expected rate of return from its shipping activities was substantially higher at that time than the rate on the deposits, and the company would have preferred to use the cash to generate shipping income. Mr

Costalas said that when the cash collateral was under consideration, tax advice was taken, but it had not been Euroceanica's assumption that the income from the collateral would fall within the tonnage tax regime.

17. Finally, Mr Costalas also explained in some detail why it had been necessary to bareboat charter back the Crystal Fleet; purchasing a fleet for immediate operation under time charter required significant due diligence, including actual inspection of the vessels. This was not required for a bareboat charter at inception. When asked why Euroceanica had not simply contracted in the required skills to undertake these tasks, he explained that this was not practicable for the relatively short time between the vessels' purchase and the purchase date of the operating company.

The Arguments

18. The essential argument between the parties is whether the income arising from the cash collateral deposited with the two Italian banks falls within paragraphs 46 (or 47 in the case of the Unicredit deposit) or paragraph 50 of Schedule 22. The Appellant argues that they fall within both; HMRC argues that they fall within neither.

Euroceanica's business as a shipping company

19. Mr Goodfellow on behalf of the Appellant explained that Euroceanica was set up in 2004, originally owning two active vessels and involved in the dry cargo business. In 2005 the Appellant moved into the chemical tanker market, which was perceived to be a less volatile market. By the end of 2008 the Appellant's fleet had expanded to 18 ships, financed to some degree some debt funding, including the Sanpaolo and Unicredit loans under consideration here.

20. Mr Goodfellow also took the Tribunal through the detailed provisions of both a Sanpaolo and Unicredit loan agreements as entered into by Euroceanica, stressing particularly the provisions of the May 2005 $53m facility from Sanpaolo and the cash deposit provisions at clause 2(e), including the lender's charge over the cash deposit and clarified that there was no provision for setting off amounts paid on the cash deposits against interest due on the loan itself. It was also stressed that the terms of the loan meant that it could only be drawn down for the purchase of a particular vessel (in the example given, that was for the vessel Isola Atlantica). Similar provisions were contained in the Unicredit loan documents, dated 22 December 2006, including at clause 5 an obligation to deposit cash with the lender of $20m.

Does the operation of a ship include its purchase?

21. Mr Goodfellow's contention is that the purchase of all the vessels which were financed by the Sanpaolo and the Unicredit loans was part of Euroceanica's tonnage tax activities because the concept of "operating ships" is defined by paragraph 18 of Schedule 22 as including owning ships as well as chartering them in.

22. In Euroceanica's view, the ships could not have been chartered out if they had not been purchased, and they could not have been purchased without the loan financing. The loan financing would not have been available if Euroceanica had not provided the

cash collateral. So making the deposits is a part of the activity of financing, and that in turn is part of the activity of purchasing the ships which is a ship-related activity that is a necessary and integral part of the business of operating the qualifying ships.

23. Mr Goodfellow, in support of his position, referred to HMRC Statement of Practice SP 4/00 which states that

> "For example, it is accepted the buying and selling ships is part of the normal operation of ships and is a core qualifying activity" [paragraph 74(vii)]

for the purposes of the tonnage tax regime.

24. HMRC's argument is that the overall structure of the tonnage tax regime shows that tonnage tax activities comprise types of receipts which would be treated as trading income under general income tax (and corporation tax) principles. The sale and purchase of vessels cannot give rise to such receipts, being a capital matter. In particular Mr Yates referred to paragraph 64 ("Chargeable Gains – Tonnage Tax Assets") of Schedule 22 in support of his arguments to show that capital assets are outside the general remit of Part VI (and especially paragraph 44) of Schedule 22.

25. For HMRC, the conclusion to be drawn from the references in Part VI to income from types of activity which qualify as "secondary activities" and the reference in paragraph 48 of Schedule 22 to "turnover" is that these paragraphs are looking at trading income only. Any other type of income can only be brought within the tonnage tax regime if it is specifically picked up in another paragraph. As far as HMRC are concerned, the "activities of operating qualifying ships" does not include their purchase, and this is supported by the Explanatory Notes to Schedule 22.

26. In relation to whether the interest arises from "other ship-related activities that are a necessary and integral part of the business of operating its qualifying ships" and so a qualify core activity (paragraph 46(1)(b)), HMRC take a restrictive view of what it means for activities to be "necessary and integral" to activities of operating ships. They draw on *HMRC v Banerjee* ([2010] STC 2318) for a definition of "necessary", as meaning an activity which is "essential" to the operation of the trade and they limit the term to those activities which are common to all ship operating companies (in Mr Yates' words the "Platonic ideal" of ship operating). In HMRC's view the fact that the Tonnage Tax regulations impose a restricted definition of "secondary activities" supports their view that the ambit of Part VI of Schedule 22 is narrow.

27. HMRC's view is that, while the loan agreements including the cash collateral might have been commercial, the giving of a deposit was not a mandatory or "necessary" part of the ship financing and therefore it cannot be treated as part of the Appellant's "other" ship related activities which are core qualifying activities.

The Interaction of Paragraphs 44, 46 and 50

28. Mr Goodfellow's interpretation of paragraph 44 of Schedule 22 and the definition of "relevant shipping income" is that the income arising from the cash collateral falls, for the purposes of the Euro Fleet within paragraphs 45(1)(a) and 46(1)(b) as a "ship

related activity which is a necessary and integral part of operating a qualifying ship", as well as potentially within paragraph 50, as interest income.

29. As respects the Crystal fleet, the same basic approach should be applied but in that case the income arises from qualifying secondary activities within paragraph 47 and the Tonnage Tax Regulations 2000. Regulation 3(3)(k) means that this interest should also be treated as arising from "activities carried on by the company in relation to a qualifying ship operated by another qualifying company in the same group". This is because they would be core qualifying activities (within paragraph 46(1)(b) of Schedule 22) of "the first-mentioned company" (Euroceanica) if they had been carried on in relation to a qualifying ship operated by Euroceanica. (In this instance, the activities are carried on by Euroceanica, but they relate to the Crystal Fleet which was operated by Crystal, another group company). The Unicredit deposit interest also falls within either paragraph 45(1)(b) as well as paragraph 50.

30. As far as the application of paragraph 50, dealing with interest income, is concerned, both parties accepted that the collateral in question was properly treated as a loan relationship and that the rules in section 82 Finance Act 1996 and the definition of loan relationship trading credits in section 103(2) were in point. On Mr Goodfellow's interpretation, the credits in question did arise from activities "in the course of" Euroceanica's tonnage tax trade. In the his view, paragraph 50 makes it quite clear that loan relationship credits can be relevant shipping income for these purposes. He argued that paragraph 61(5) of Schedule 22 supports this interpretation, suggesting that it is possible to have trading credits within the tonnage tax ring fence. Paragraph 51, dealing with investment income, is not relevant to the case; the putting of money on deposit should not necessarily be treated as the making of an investment. In any event, paragraph 51 is only in point if it is considered that the interest is from tonnage tax activities and not within paragraph 50.

31. HMRC's argument is that interest income cannot fall within both paragraphs 46(1) and paragraph 50. Irrespective of whether or not the interest potentially falls within paragraph 46(1), (and HMRC say that it cannot because the purchase of a vessel is not a core qualifying activity), the only relevant paragraph is paragraph 50. This is an exclusive and overriding rule applying to all loan relationship credits and not in any way subject to paragraph 46. Paragraph 46 is not relevant if the income in question arises from a loan relationship. Equally, the exclusion of "investment income" in paragraph 51 applies to both paragraphs of sub-paragraph (1) of paragraph 46, so that if paragraph 50 did not apply, but somehow paragraph 46 did, Euroceanica would still not succeed, as "income from investments" is defined to catch all non-trading interest income irrespective of whether it is from an investment in any more general sense of that word. Thus the only relevant provision for interest income of any type is paragraph 50; and to determine whether it applies the relevant provision is section 103(2) of the Finance Act 1996.

32. HMRC support their view that, in Mr Yates' words, "*all roads lead to paragraph 50*" on the basis of general principles of statutory interpretation. Paragraph 50 is a specific provision and so should take precedence over the more general rules in the

rest of Part VI (and paragraph 46) of Schedule 22, (as to which we were referred to Bennion on Statutory Interpretation 5th edition, pg 1164).

33. HMRC's approach to paragraph 50 is that the interest income cannot fall within it because it is related only to the purchase of the vessels, and this is not a trading activity for the purposes of the tonnage tax legislation, and so not something which can be taken into account as trading income from a trade consisting of the company's tonnage tax activities. The company is not party to the loan relationships giving rise to the interest in the course of activities forming an integral part of any trade, whether the company's actual trade or its deemed tonnage tax trade.

The Decision in *Nuclear Electric*.

34. Both parties referred to the *Nuclear Electric* case (*Nuclear Electric plc v Bradley* 68 TC 670) as relevant to the interpretation of paragraph 50 of Schedule 22 and section 103(2) Finance Act 1996 and the extent to which interest income can be treated as trading income, but had different approaches to its relevance.

35. HMRC relied heavily in this case on the statements of Millett LJ in the Court of Appeal decision that *"the nature of the trade must be such that it can fairly be said that the making and holding of investments at interest is an integral part of the trade".* In their view, Euroceanica was a ship operating company and the placing of deposits at interest could not be treated as an integral part of its tonnage tax trade.

36. HMRC argued that since the Court of Appeal decision was contemporaneous with the issue of draft clauses for the (then) new loan relationship code incorporating what became section 103(2), it should be assumed that the statute was intended to be a codification of Millett LJ's statements and should be interpreted in the light of those statements. They relied in this regard on decisions including *Goodes v East Sussex County Council* ([2000] 1WLR 1356), to indicate that it is possible to import existing case law into the meaning of contemporaneous legislation. They also stated that while the House of Lords did not endorse the approach of Millett LJ, neither did they specifically overrule it.

37. Mr Goodfellow considered that it was misconceived to attempt to argue that section 103(2) should be interpreted in line with the statements of Millett LJ in the *Nuclear Electric* case. These statements did not represent the final position of the UK courts; the House of Lords judgment superseded this. In any event, the wording of section 103(2) is not the same as that used by Millett LJ, whose statements were only intended to apply to financial concerns such as banks and insurance companies. The 1996 loan relationship legislation was new law and there was no basis to assume that it was intended to be a codification of existing case law, or the view of one particular judge in one particular case.

38. In Mr Goodfellow's view, the salient test, taken from the House of Lords judgement in the *Nuclear Electric* case (and following the line of reasoning from *Bank Line Ltd v Commissioners of Inland Revenue,* ([1974] STC 342)) is whether the

funds in question were being held apart from, and not employed in, the business. In the *Nuclear Electric* decision, this was the case, whereas Euroceanica was utilising the cash deposits as a current asset in the trade. The relevant question on the basis of those authorities was, what was the nature of the taxpayer's business and what was the purpose for which the funds in question were held.

"**In the course of activities" – s 103(2) Finance Act 1996.**

39. In relation to section 103(2), Mr Goodfellow suggested that the inclusion of the term "in the course of activities" means that the test is a broad test, and that section 103(2) should be taken to apply to activities which are "a series of actions or steps which are intended to carry out the activities of the trade". In his view, the cash collateral credits fulfilled this test because they ensured that the loan financing was provided on terms which were commercially acceptable to Euroceanica, particularly taking account of the loan-to-value ratios applied by the lenders. Mr Goodfellow referred to the case of *Barnetts (a firm) v Revenue & Customs Commissioners* ([2010] UKFTT 286 (TC)) as supporting the statements of Lord Jauncey in *Nuclear Electric* and the meaning of interest arising "in the course of" activities, in that instance the professional activities of a conveyancing solicitor.

40. HMRC's interpretation of the meaning of "in the course of activities" for these purposes was different, suggesting that the test should be applied at a high level of abstraction and not on a loan by loan basis, impacting the qualitative nature of the activities, rather than their temporal scope.

The Bareboat Charter period.

41. Paragraph 18 of Schedule 22 sets out a number of circumstances in which vessels will not be treated as being within the tonnage tax regime, including if they are out on "bareboat charter". (A "bareboat charter" is defined for these purposes at paragraph 143 of Schedule 22. There is no dispute about whether or not the vessels were so chartered out). However, if a vessel is put out on bareboat charter terms for less than three years and the reason why it is chartered out is as a result of "short term over-capacity", the tonnage tax rules will still apply during that period. (Paragraph 18(5) of Schedule 22).

42. Mr Goodfellow explained that in December 2006 Euroceanica negotiated the purchase of five chemical tankers from a Finnish vendor (the Crystal Fleet). Taking on five new ships was a significant undertaking for Euroceanica, including the amount of due diligence which was required before the vessels could be purchased. In order to solve this problem, the five new vessels were bareboat chartered back, on 28 December 2006, to the vendor group until Euroceanica was in a position to manage them itself, at which stage the bareboat charters fell away. The bareboat charter was always intended to be a "temporary expedient".

43. Therefore, while accepting that bareboat chartering otherwise takes shipping activities outside the scope of the tonnage tax regime, Mr Goodfellow argued that the reason for the bareboat charter in this instance was "over-capacity" i.e. Euroceanica

had more vessels than it could manage from December 2006 until March 2007 and therefore the exception at paragraph 18(5) of Schedule 22 applies.

44. From HMRC's viewpoint, the Appellant's interpretation of paragraph 18(5) was incorrect for two reasons, first because the reference to "over-capacity" in that paragraph is intended to be a reference to over-capacity in the market, not an over-capacity of ships in the hands of the taxpayer and second because it applies to prevent a tonnage tax company being treated as having "ceased to operate" ships, whereas in respect of the Crystal Fleet, Euroceanica had not yet started operating them. Therefore, for the period of the bareboat charter at least, the Unicredit collateral interest should be excluded from the tonnage tax regime. It was accepted by both parties that, if HMRC are right on this point, there may be other adjustments to be made, including under paragraph 61 of Schedule 22(finance costs).

Decision

45. This is a boundary dispute, concerning what types of income can be included within the favourable tonnage tax regime set out in Schedule 22. The receipts in question are interest receipts arising on cash collateral given as part of ship financing transactions. For the purpose of this decision we are applying our reasoning to the interest under both the Sanpaolo and Unicredit loans. Although (at least on Mr Goodfellow's arguments) different paragraphs of Schedule 22 apply to each bank loan, we consider that the arguments in respect of the collateral and interest receipts under these loans are the same.

The commercial agreement

46. In sum, the expert witness evidence has led the Tribunal to conclude that the giving of collateral under these loans was part of a genuine commercial agreement which was common at least in the Italian banking sector for ship finance and that the terms of the loans would have been different (and less favourable to Euroceanica) had the collateral not been given.

47. We heard a significant amount of evidence for the Appellant about whether it was normal to give cash collateral as part of a ship financing loan. The Tribunal does not consider whether or not this was standard market practice is particularly relevant. The only relevant question is what was the actual commercial deal entered into by Euroceanica; in this instance that included the giving of collateral. This was integral to the financing deal done by Euroceanica. The deal could have been done on different terms (lower loan-to-value ratio, higher interest rates, more restrictive covenants), but the cash collateral was a significant component of how the loan was priced and its other terms.

The meaning of "operating a ship"

48. On the question of the meaning of "operating ships", the Tribunal agrees with the Appellant that the tonnage tax regime only makes sense if it includes within its remit the acquisition and sale of qualifying ships, which are the fundamental framework for the tonnage tax activities (and dealing with any other ownership rights). This is

supported by HMRC's own statements in Statement of Practice SP 4/00 and their Tonnage Tax Manual at TTM06060 that "activities involved in the acquisition or disposal of ships" are core qualifying activities.

The interaction of paras 44, 46, 50 & 51

49. The Tribunal accepts that the drafting of Part VI of Schedule 22 is not entirely straightforward, but considers that the most natural and straightforward reading of the relevant paragraphs is that credits arising from loan relationships and derivative contracts i.e. from asset financing activities of this kind, fall to be tested only by reference to paragraph 50 and to no other paragraph. In this regard they accept HMRC's point that specific provisions should usually be taken to override more general legislation. On this basis the Tribunal considers that the only significant issue is whether the reference in section 103(2) Finance Act 1996 to a company being a party to a creditor relationship "in the course of activities forming an integral part of the trade" applies here to make the interest credits under consideration income which falls to be taken into account as trading income from a trade consisting of the company's tonnage tax activities.

50. Accepting the argument that paragraph 50 is an exclusive provision, it is not strictly necessary for the Tribunal to consider the question of whether the interest receipts could be treated as falling within either paragraph 46(1)(b) or 47(1) as core or secondary tonnage tax activities. Were it necessary to consider this point the Tribunal would have concluded, for the reasons set out below in respect of section 103(2), that the interest income should be treated as falling within paragraph 46(1)(b) as income from "*other ship related activities which are a necessary and integral part of the business of operating its qualifying ships*", which we consider to be in substance the same test as the test applied by paragraph 50 relating to loan relationship income.

51. In relation to the application of paragraph 51, again it is not strictly necessary to consider this, as, finding as we do that the interest credits fall within paragraph 50, they cannot be excluded by paragraph 51. But on the basis of the evidence given to the Tribunal, we have concluded that it is not correct to treat this interest income as "income from investments" in the general sense of the words. We do not consider that the cash deposits carried any of the characteristics of investments: their purpose was not to provide a long term return to the "investor". This is reflected by the fact that the rate of return was neither favourable nor negotiated by the "investor" (based on the evidence of Mr Browne and Mr Costalas). There was no element of choice or interest in what the long term return on these cash deposits might be, they were a mandatory component of a commercial transaction which supported the day to day business of Euroceanica. The fact that they generated interest income was incidental to their purpose. This is an instance in which it is not correct to assume that the existence of an interest return means an investment purpose. The real commercial "return" on these deposits was the income return generated by the vessels which the Sanpaolo and Unicredit loans financed.

52. To the extent that the interest was wrapped up in the overall financing, we do not think it can be correct to treat the interest arising as "investment income". We say

this despite the evidence that the interest payments were included as “investment income” in the accounts of Euroceanica which we were shown (for 2007). We recognise however that had we found that paragraph 50 did not apply, the interest credits would have fallen to be non-trading credits for the purposes of the loan relationships legislation and therefore for the purposes of paragraph 51(3) or (4) (in the pre-2009 version) or paragraph 51(3)(b) (in the 2009 version), and would not be relevant shipping income.

The significance of the Nuclear Electric case.

53. The Tribunal does not accept HMRC’s argument that there should be some read across from the specific statements of Millett LJ in *Nuclear Electric* into the interpretation of section 103(2). No admissible evidence has been provided that this was the intention of the drafter of the legislation in 1995 and 1996. Even if there was any such evidence, there is no rule of statutory interpretation which suggests that it is necessary to import current case law into the drafting of contemporaneous legislation. The decisions of both the House of Lords and Court of Appeal in *Nuclear Electric* can provide guidance on this point, but cannot be treated as giving a definitive view of the intended application of section 103(2). In any event, even if it could properly be shown that the drafter was instructed to codify the statements of Millett LJ (and which ones), it is for the Tribunal to determine whether they were successful.

54. The authorities cited by HMRC (principally the *Goodes* decision) do not support their position that a read across from contemporaneous case law is always a legitimate approach to statutory interpretation. The *Goodes* decision (concerning the meaning of “maintaining a highway”) referred back to a clear body of common law which had been established since the days of Dickens and Mayhew. It is not clear to the Tribunal that a similar approach should be taken when the relevant body of common law (the meaning of investment as compared to trading income for tax purposes) is itself complex and in places contradictory, with few agreed principles.

Was the interest income an “integral part of Euroceanica’s trade”?

55. To the extent that the decisions in *Nuclear Electric* are relevant, we take the most relevant point to be that made by Lord Jauncey in the House of Lords decision, that there is no hard and fast rule for determining when investment income can be treated as a trading receipt and that at the end of the day the question is always one of fact.

> *“I know of no formula which can discriminate in all circumstances what are and what are not the profits of a trade”* Earl Loreburn in *Liverpool & London & Globe Insurance Company v Bennett* ([1913] 6 TC 327)

56. In particular the Tribunal would treat the statements of Millett LJ with some caution because his approach is premised on the existence of an investment which gives rise to interest income. As made clear above, we have concluded that the cash deposits under consideration here should not be treated as “investments” and therefore the test as formulated by Millett LJ is not entirely appropriate.

57. The Tribunal accepts that for a non-financial trader, determining whether interest income should be treated as trading or investment income is a difficult distinction to make. It is clearly not the case that only financial traders can treat interest income as trading income. Whether a non-financial trader can will depend on the facts and circumstances of each individual case, but we do not accept the suggestion of HMRC, reflecting the approach of Millett LJ in *Nuclear Electric*, that the character of the income is entirely determined by the nature of the trade being undertaken.

58. Our view is that, on the basis of the reasoning in the *Bank Line* decision, which was carried through to the House of Lords in *Nuclear Electric* whatever the nature of the taxpayer's trade (from solicitor, to ship owner, to utilities company) a fund and its related income can be treated as part of a taxpayer's trading activities to the extent that it is currently actively supporting that trade. On that premise, it would be perfectly possible for the interest from a fund to be treated as trading income for one period and investment income for the next, depending on whether the trader was accessing the funds for current trading purposes. That the issue comes down to one of timing rather than characteristics seems correct to us, reflecting as it does the fundamental distinction made for tax purposes between trading and investing.

59. On that basis, we consider the crucial question to be: are the funds from which the interest income arises being currently used for the purposes of the taxpayer's trading activities? To use the terminology from those earlier cases, does the interest arise from cash which was "at risk" in Euroceanica's trade?

> "*The interest and dividends constituted trading receipts only when they arose from capital which, in the relevant accounting period had been actively employed in the trade in question and was in a real and practical sense at risk in the ordinary course of that trade*" Lord President Emslie in the *Bank Line* decision.

60. The Tribunal's view is that there are a number of distinguishing facts in Euroceanica's case which point to the interest income fulfilling these tests: unlike in *Nuclear Electric*, the interest arose from funds which were being used for current purposes, namely to collateralise the financing of ships which were being used for the trade. The cash deposits and related loans were of a relatively short term nature and were in some instances use to fund current liabilities, including, in some instances the interest due on the loans themselves. In Euroceanica's position, the Tribunal has concluded that the capital in question (the Sanpaolo and Unicredit cash deposits) were being actively employed in the trade in question during the relevant accounting periods and that the relevant interest income should be treated as trading income.

61. The taxpayer set some store by the meaning of "in the course of activities" under section 103(2). We are not convinced that this extends the scope of section 103 in the way that the taxpayer argues (in length as well as breadth), but we are not overly concerned with this, since in our view the credits are both commercially and legally an intrinsic part of the taxpayer's trade and it is not necessary to rely on an over strained interpretation of "in the course of" to conclude this.

62. HMRC referred us to the *Banerjee* decision and the meaning of "necessary activities" in the context of employment income. We do not consider that decision to be sufficiently analogous to the facts and legislation to be relevant here. In our view it is clear that the giving of cash collateral was a necessary part of Euroceanica's ship financing, that financing was necessary for the purchase of the ships and the ships were a necessary part of Euroceanica's shipping activities.

63. This view is supported both by the (agreed) treatment of the payments under the interest rate swap which the Appellant entered into as part of the financing arrangements (which has been treated as falling within the Tonnage Tax regime by virtue of we assume paragraph 50(2)(c) of Schedule 22) and HMRC's statements in their Tonnage Tax Manual concerning the treatment of interest payments arising from a defeased finance lease. HMRC did not attempt to argue that there was any distinction between the latter case and the cash collateral arrangements here and we cannot see one either. Not for the only time in this case Mr Yates was forced to submit that the Manual must be wrong.

64. Therefore, the interest income arising should be treated as "arising in the course of activities which are an integral part of the taxpayer's trade" for the purpose of section 103(2) Finance Act 1996 and therefore of paragraph 50 of Schedule 22.

65. For these reasons we conclude (subject to the bareboat charter period relevant to the Unicredit loan referred to below), that the interest credits in respect of the collateral held under both the Sanpaolo and the Unicredit loan financing constitute relevant shipping income under Part VI of Schedule 22 and fall to be taxed under the Tonnage Tax regime and excluded from the general corporation tax on profits.

The Bareboat Charter.

66. On the basis that they failed to convince the Tribunal of their main arguments, HMRC suggest that for the period from 28 Dec 2006 until the Crystal Fleet was fully operated under time charter by the Appellant (around 1 March 2007), credits in respect of the Unicredit loan were outside the scope of Tonnage Tax because of the restrictions in paragraph 18 of Schedule 22 relating to bareboat chartering.

67. The Appellant argues that the reason for the bareboat charter was outside of their control and falls within the definition of over-capacity for the purposes of paragraph 18(3) of Schedule 22 – the over-capacity being the Appellant's having more ships than they were able to manage themselves.

68. On this point the Tribunal agree with HMRC. First the "over-capacity" envisaged by paragraph 18(3) is not apt to cover the Appellant's position, which was more an under-capacity of management ability than an over-capacity of ships. Second, paragraph 18 is premised on a relevant shipping activity having commenced in relation to a particular ship before the bareboat charter is entered into, which was not the case here, save for the scintilla of time between the signing of the agreement for the acquisition of the Crystal Fleet and the entering into the bareboat charter, which all occurred on the same day (28 December 2006). For this reason we conclude that

the interest receipts for that period relating to the Unicredit loan should be excluded from the Tonnage Tax regime and any relevant apportionment under paragraph 61 and any other adjustments required should be made and agreed between the parties.

69. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

RACHEL SHORT
TRIBUNAL JUDGE

RELEASE DATE: 26 April 2013