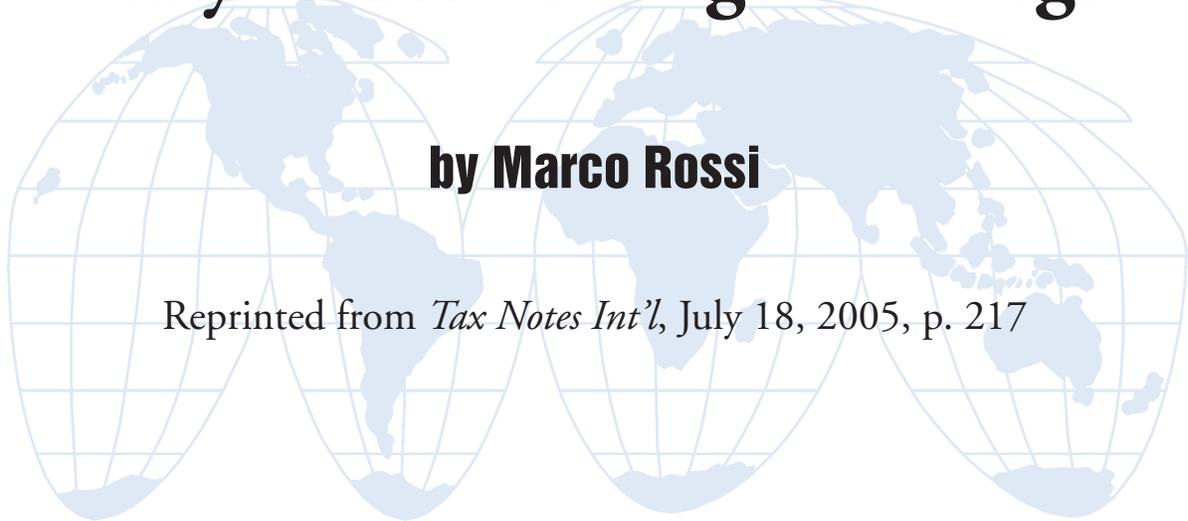


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by Marco Rossi

Reprinted from *Tax Notes Int'l*, July 18, 2005, p. 217





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The Italian government has issued regulatory provisions for the application of the tonnage tax. A decree issued by the Ministry of Economy and Finance and published in official gazette no. 153 of July 4 sets out specific rules implementing the general statutory provisions of Tax Code sections 155 through 161, enacted as part of the tax reforms of 2003-2004, which give vessel operators the option to compute taxable income derived from the use of vessels in international commerce on a conventional basis, by multiplying some amounts by the vessel's net tonnage and adjusting the resulting amount by factors related to the vessel's age. Income determined according to that formula is taxable at the statutory corporate income tax rate of 33 percent, without any allowance for deductions.

The statute and the decree identify companies and vessels eligible for the tonnage tax and the types of income or income-producing activities covered by the tax. They also establish the timing and procedure for the election to be taxed on a conventional basis as described above, and identify situations in which the election cannot be made or, if already in place, will be terminated. The basic rules governing the Italian tonnage tax are described below. Each deserves specific attention to ensure that the taxpayer's business actually fits the criteria for election to the tax regime.

Eligible Companies

Companies that can elect the tonnage tax are: domestic (resident) companies organized in the form of joint stock companies, limited liability companies, or limited partnerships with stock divided by shares that are separate taxable entities subject to corporate income tax; and foreign (nonresident) entities of any kind that carry out shipping operations in Italy

through a permanent establishment in Italy and that are subject to corporate income tax in Italy on the income attributable to their Italian PE. Companies that are members of a tax-consolidated group cannot elect to apply the tonnage tax regime. Furthermore, only vessel operators can benefit from the tonnage tax regime; non-vessel-operator common carriers (NVOCC) are not eligible.¹

Eligible Vessels

The tonnage tax rules apply to determine the taxable income of vessels registered in the Italian International Register of Ships, which was instituted in 1998. Three types of vessels can be registered in the Italian Register of Ships:

- commercial vessels owned by persons (individuals or entities) resident in Italy or another EU member state;
- commercial vessels owned by persons resident in a foreign country outside the European Union and operated through a PE in Italy; and
- commercial vessels owned by persons resident in a foreign country outside the European Union that are bare-boat chartered to Italian or EU residents and are temporarily flying the Italian flag (a "bare boat charter-in").

¹An NVOCC is an entity that undertakes the entire carriage of goods from door to door by issuing a combined transport bill of lading, usually in its capacity as freight forwarder, and then subcontracts the sea carriage to a vessel operator by entering into a contract for the carriage of goods by sea in its own name, but in the interest of the buyer and final recipient of the goods.

Vessels eligible for registration in the International Register of Ships must be used solely for international commerce (that is, commerce between Italian and foreign ports or between foreign ports (as opposed to commerce between national ports)).² The tonnage tax rules take an “all in-all out” approach, meaning that once chosen, the tonnage tax regime applies to all eligible vessels owned or operated by companies belonging to the same group (that is, all companies under common control, as defined in Civil Code section 2359).³

Income and Income-Producing Activities

The tonnage tax applies to all income derived from the use of eligible vessels in international commerce for the transportation of goods and passengers, salvage services, towing services, the installation of offshore equipment, and other assistance at sea. Income derived from some other activities (as specified in the decree) that are incidental to or connected with the above-mentioned activities is also included. Those incidental or connected activities include the operation of cinemas, restaurants, bars, and shops on board the vessel; the granting of licenses to third parties for the operation of shops or similar commercial activities on board the vessel; cargo booking and passenger ticket services; the loading, unloading, and handling of goods within the port area; container leasing; the grouping and degrouping of goods before and after the sea passage; and cargo land transportation immediately before and after sea passage.

Conventional income covered by the tonnage tax also includes gains realized from the sale or exchange of eligible vessels. However, in the event of a

transfer of one or more vessels as part of the sale of an entire business or line of business, the provision applies only if the value of the vessel or vessels transferred constitutes at least 80 percent of the total value of the business sold.⁴ In any event, any appreciation or built-in gain existing at the time of the election (that is, the excess of the fair market value of the vessel over its adjusted tax basis in the hands of the seller at the time of the election) is recaptured separately, added to the tax base, and subject to tax. Income derived from any other activities related to the operation of a vessel is not included in the tonnage tax, but is computed separately according to the ordinary rules and added to the tax base.

Most important, income from the operation of casinos, gambling and betting activities, sales of luxury goods, and sales of goods and services that are not consumed or used on board a vessel is not considered to be conventional income covered by the tonnage tax. Moreover, income from the bare-boat charter party of a vessel to a third party is not included in the tonnage tax.⁵ The general clause of Tax Code section 157(4) provides that the conventional income determined in accordance with the tonnage tax rule does not cover any items of income that are not derived from the operation of an eligible vessel and from the activities referred to above.

Computation of Conventional Income

Taxable income under the tonnage tax regime is computed on a conventional basis, by multiplying a conventional amount by the ship's metric tons and then multiplying the resulting amount by a given factor related to the ship's age. The conventional amounts are:

- from zero to 1,000 metric tons: €0.0090 per metric ton;
- from 1,001 to 10,000 metric tons: €0.0070 per metric ton;

²The International Register of Ships includes both tax benefits and restrictions with respect to the nationality of the crew. Regarding the tax benefits, 80 percent of the income derived from the use of the vessel, or from incidental or connected activities (including the operation of shops or boutiques on board cruise vessels), is exempt from income tax; the vessel operator is granted a (nontaxable) tax credit for an amount equal to the tax withheld from wages paid to the crew, and both the vessel operator and members of the crew are relieved of the obligation to pay social security contributions on crew wages. Regarding the restrictions, all crew members (for vessels transferred to the international register from the ordinary Italian ship register), or at least six members of the crew, including the captain and all officers (for all other vessels), must be Italian citizens.

³According to which “control” exists under either of three tests: ownership of more than 50 percent of the votes that can be exercised at a company's ordinary shareholders meeting; ownership of a sufficient number of votes to exercise a dominant influence over a company; or the ability to exercise a significant influence over the company's contractual arrangements or relationships.

⁴Although the decree does not expressly clarify it, reference is made to gross fair market value (that is, fair market value including liabilities).

⁵A bare-boat charter party is a contract by means of which the registered owner of a vessel transfers all of the rights and obligations related to the use of the vessel to another party (the bare-boat charterer) in consideration of a rental payment (hire), and the bare-boat charterer takes responsibility for all the activities required for the proper operation of the vessel, including enrolling the crew, carrying out maintenance and repairs, and for all related costs, including wages, insurance, and so on, and becomes liable (usually by operation of law) to third parties for all damages arising from the use of the vessel. It is similar to a net long-term lease of real estate. The tonnage tax applies only to income from the operation of a vessel, and does not cover the hire paid to the registered owner under a bare-boat charter party contract.

- from 10,001 to 25,000 metric tons: €0.0040 per metric ton; and
- 25,001 metric tons and higher: €0.0020 per metric ton.

The ship's age factors are:

- from zero to 5 years: 0.90;
- from 6 to 10 years: 0.95;
- from 11 to 25 years: 1.05; and
- beyond 25 years: 1.10.

Periods of maintenance or repair and temporary layovers are not included for purposes of calculating the ship's age.

Exercise and Renewal of the Election

The election must be exercised by the end of the third month of a tax year, and it takes effect from the first day of that tax year. If two or more vessels are operated by companies belonging to the same group, all of them must be included in the election. For that purpose, each controlled company of the group must provide to its parent company, in writing, its consent to the election, and the parent company must file the election with the tax administration for all vessels of the group on behalf of all companies of the group. The election is irrevocable for a period of 10 years. If terminated earlier for any reason, it cannot be exercised again until after the full period of 10 years from the original election. The effects of the election remain in effect if a company becomes a controlled or controlling company of a group. In that event, provided that all of the requirements for the tonnage tax are met, the election is extended to the company of the group that did not originally exercise it, and includes all vessels operated by that company and must be reported to the tax administration.⁶ The election can be renewed in the same way as above, within the third month of the first tax year following the last tax year of the 10-year period for which the initial election was in effect.

Exclusion and Termination of the Election

The election cannot be exercised or, if already in place, is terminated with effect from the first day of the tax year if more than 50 percent of the vessels operated by a company or companies of the same group are let on bare-boat charter party terms to third parties for a period exceeding (for each vessel)

50 percent of the days of actual navigation in a financial period. The calculation of the disqualified bare-boat charter period is made on a vessel-by-vessel basis. Bare-boat charter party contracts between companies of the same group are not relevant. Furthermore, for the election to be exercised, one petty officer must be on board each vessel covered by the election for training purposes, or the vessel operator must pay a specified amount to a fund established for the training of cadets. The election also is terminated with effect from the first day of the tax year if the vessel operator ceases to be an eligible company during the election period.

Reorganizations

A merger or spinoff does not terminate an election, provided that the acquiring company is also an eligible company. If a company that had opted into the tonnage tax regime is merged into an existing or newly formed company, the effects of the election are automatically transferred to the acquiring company. Similarly, if a company that had opted into the tonnage tax regime transfers its business to an existing or newly formed company in exchange for the stock of that company (in a transaction similar to that outlined in U.S. Internal Revenue Code section 351), the effects of the election are transferred to the transferee company. The liquidation or bankruptcy of a company member of a group that opted for the tonnage tax regime does not terminate the effects of the election for the other companies of the group.

Conclusion

The new tonnage tax regulations are expected to provide additional support to the national fleet by providing a tax-favorable regime following measures undertaken in connection with the establishment of the Italian International Register of Ships; they are also expected to attract both foreign ship owners and Italian ship owners that are keeping their fleet under foreign flags of convenience.

However, a case-by-case analysis would be needed to determine whether the tonnage tax regime is really favorable. Furthermore, some nontax factors that discourage the registration of a vessel under the Italian flag still remain, including the fact that all crew members of Italian-flagged vessels are subject to Italian labor law principles and Italian court jurisdiction on labor law matters, which are notable for their lack of flexibility and extreme protection of crew members. Those labor law principles make it difficult and, in some cases, overwhelmingly expensive to dismiss or fire crew members in periods of crisis, as they require extensive and time-consuming negotiations with Italian seafarers' unions. ♦

♦ *Marco Rossi is a founding member of Marco Q. Rossi & Associati in Italy and New York.*

⁶Acquisitions involving ship-owning companies that elected the tonnage tax regime should be carefully considered, bearing in mind this provision, to avoid any unfavorable consequences related to the automatic extension of the tonnage tax regime to all other members of the corporate group as a result of the acquisition.