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Updates for Shipping Industry

The Maritime and Port Authority of Singapore (MPA) issued a Shipping Circular (No. 16 of 2018) (the Circular) in relation to the enhancement of the Maritime Sector Incentive–Shipping Enterprise (Singapore Registry of Ships) (MSI-SRS) on 12 December 2018. The MSI-SRS scheme concerns Singapore-flagged ship owners that are assessed under Section 13A of the Singapore Income Tax Act (SITA).

Background

The perennial issue of whether the charter of a vessel can be equated to lease of a vessel for tax purposes is a recurring concern within the shipping sector. There are practical repercussions if a charter is to be regarded as a lease. For tax purposes, a lease will need to be classified as either a finance lease or an operating lease and this can affect the corresponding tax treatment based on the outcome on the determination of the lease.

The term “charter” is a unique technical term used in the maritime industry that has a specific meaning and is not defined anywhere in the SITA. As such, it may not be practical to regard a charter as a lease even though there may be overlapping similarities between both.

The shipping sector has also been further impacted by the introduction of Financial Reporting Standards (FRS) 115 and 116, and the corresponding FRS 115 and 116 tax treatments in Singapore. In particular, the issuance of e-Tax Guide on “Tax Treatment from Adoption of FRS 116 or SFRS (I) 16 – Leases” dated 8 October 2018 (FRS 116 e-Tax Guide) has raised concerns within the shipping industry, particularly with regards to withholding tax implications on lease payments. The [FRS 116 e-Tax Guide](#) indicates that finance lease payments are subject to Singapore withholding tax and the tax

exemption for charter fee payments does not apply in such context.

Enhancements

The Circular provides the following enhancements that will be made to the MSI-SRS to provide greater tax certainty and to ease the administrative burden for the shipping sector:

- Scope of withholding tax exemption for charter payments for ships and container lease payments will be expanded to cover finance lease payments. The expanded scope will only be available to MSI companies;
- Scope of income tax exemption under the MSI-SRS will be expanded to cover finance lease income from leasing of ships; and
- MSI-SRS companies may make an irrevocable option to adopt a simplified tax treatment for MSI-SRS. Upon election, the MSI-SRS company shall, on a bundled basis:
 - Rely on the FRS 116 classification of sublease income and does not need to reclassify the qualifying sublease of ships and containers based on the underlying asset for tax purposes; and
 - Does not need to claim contractual lease payments, interest expenses and capital allowance (as the case may be) in respect of qualifying assets for tax purposes as these claims will be disregarded.

Expansion in scope of withholding tax exemption to cover finance lease payments

Broadly, the expansion of withholding tax exemption to cover finance lease is summarised as follows:

Payments made to non-resident	Withholding tax exemption for payment made prior to 12 December 2018	Withholding tax exemption for payments made on or after 12 December 2018[^]
Charter of any ship classified as operating leases for tax purposes	✓	✓
Rents or other payments for the use of qualifying containers for the carriage of goods under agreements entered into on or before 31 December 2022 and classified as operating leases for tax purposes	✓	✓
Qualifying payments made in respect of qualifying financing arrangements including	✓ A self-declaration	✓ No longer required to

charter payments which are classified as finance lease treated as a sale for tax purposes	form is required to be submitted in order to enjoy the withholding tax exemption.	submit self-declaration forms to avail themselves of the withholding tax exemption on qualifying charter payments under arrangements classified as finance lease treated as a sale for tax purposes (including hire purchase).
Charter of any ship or rents or other payments for the use of qualifying containers classified as finance lease not treated as sale	x	✓ No separate application is required to enjoy the exemption.

^Subject to conditions imposed in the Circular such as the period of qualifying agreements/arrangements, Singapore flag restriction and tenure of withholding tax exemption.

Expansion in scope of tax exemption of charter income to include finance lease

Broadly, a summary of the above is as follows:

Tax exemption on income derived from the charter of Singapore flagged ships plying in international water	For income derived before 12 December 2018	For income derived on or after 12 December 2018
Operating lease	✓	✓
Finance lease	x	✓ Expanded scope does not apply to income derived from incidental container leasing activities undertaken by MSI-SRS companies.

Other conditions under MSI-SRS continue to remain the same.

Irrevocable election to opt-in, on a bundled basis, to dispense with the need to reclassify income derived from the subleasing of ships or containers based on underlying asset; and NOT claim tax deduction and/or capital allowance on the lease of qualifying assets

To ease the administrative burden for MSI-SRS companies to distinguish between a finance lease and an operating lease, an irrevocable option will be applicable.

Under the election (also known as the FRS 116 election), an MSI-SRS company would be given the option to dispense the need to reclassify qualifying income derived from the subleasing of ships and containers based on the underlying asset, and instead would adopt the accounting classification of the sublease based on the Right of Use (ROU) asset from the head lease before applying the appropriate tax treatment; and not claim tax deduction on (i) contractual lease payments; (ii) interest expenses; and (iii) capital allowances, as the case may be, in respect of the lease of qualifying assets. Qualifying assets refer to (a) ships and on-board equipment that are integral to the operation of the ships; and (b) containers, intermodal equipment and other equipment that are integral for the operation of containers, which are used to derive incentivised income.

Topics	Things highlighted
Period of election	May be made at any time during the MSI-SRS company's incentive period and will apply to qualifying income derived and lease payments incurred on or after 12 December 2018 or the first day of the basis period relating to the Year of Assessment (YA) in which the election is made, whichever is later.
Restriction imposed upon election	Election is irrevocable throughout the MSI-SRS company's incentive period. Appeals for a revocation of the option exercised earlier will not be considered under any circumstances. Normal tax rules shall apply for all leases going forward (regardless of when such leases are entered into) should the MSI-SRS company cease to own or operate any Singapore flagged ships.
Scope of election	<p>MSI-SRS company will not be required to:</p> <ul style="list-style-type: none">(i) Reclassify qualifying income derived from the subleasing of ships and containers based on the underlying asset; and(ii) Classify lease payments on qualifying assets as OL or FL for tax purposes by agreeing to disregard its claims for such lease payments. <p>For (i), notwithstanding the election, MSI companies are still required to classify the subleases that are accounted for as</p>

finance lease into either **finance lease treated as sale**, or **finance lease not treated as sale** for tax purposes and make the appropriate tax adjustments.

For (ii), the election will apply to **all qualifying assets** that are leased in by the MSI-SRS company, including existing assets and assets used to derive both incentivised and non-incentivised income.

Lapse of election

The election will automatically lapse when the MSI-SRS company ceases to own or operate any Singapore flagged ships, regardless of the reasons; and

Capital allowances in respect of qualifying asset should be claimed based on the remaining tax written down value after taking into account notional capital allowances for those YAs under election, notwithstanding that no claim for such allowances was made. Where the MSI-SRS company ceases to own or operate any Singapore-flagged ships mid-YA, the capital allowance claim for that YA should be apportioned accordingly.

Disposal of qualifying assets

No balancing adjustments is required during MSI period.

Balancing adjustment apply upon exit from MSI scheme. Any balancing charge will be capped at the amount of capital allowances actually claimed.

Illustrations can be found in the Circular.

Extension of enhancements to MSI-Approved International Shipping Enterprise (MSI-AIS) companies

The enhancements for MSI-SRS companies will also be applicable to MSI-AIS companies as highlighted below:

Enhancements

Additional things to note

Expansion in scope of withholding tax exemption

Applies to foreign flagged ships only. Singapore-flagged ships will be covered under MSI-SRS.

Cessation of withholding tax exemption, whether for charter payments for ships or container lease payments, will be earlier of (i) end of charter agreement/ arrangement; or (ii) date of withdrawal/ termination if incentive status is withdrawn/terminated before expiry.

Expansion in scope of tax exemption of charter income to include finance lease	<p>Similar tax exemption for MSI-SRS companies is also available for charter income classified as finance lease income for tax purposes and derived by MSI-AIS companies.</p> <p>Section 13(12) tax exemption of dividend income, share of profits and branch profits received from MSI-AIS (Approved Network Company or ANC) that are paid out of qualifying shipping profits (including from finance leasing arrangements) will be applicable if it is derived by the MSI-AIS company and paid out of qualifying shipping profits derived by the MSI-AIS (ANC) on or after 12 December 2018.</p> <p>Dividend income, share of profits and branch profits derived by the MSI-AIS company prior to 12 December 2018 and paid out of shipping profits (from finance leasing arrangements) derived by the MSI-AIS (ANC) prior to 12 December 2018 will continue to be assessed based on the prevailing Singapore corporate income tax, regardless of the date of remittance.</p>
Irrevocable election to opt-in for FRS 116	<p>No additional conditions imposed other than those already mentioned for MSI-SRS companies.</p>

Clarification on the FRS 115 tax treatment for shipping companies

Under the FRS 115—Revenue from Contracts with Customers, entities recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration that the entity expects to be entitled in exchange of satisfactory delivery of those goods or services. FRS 115 is effective from annual periods beginning on or after 1 January 2018 and does not apply to lease contracts within the scope of FRS 116, amongst others.

In this context, the MPA has clarified that where the charter contract is required to be split into a “lease” component and a “service” component (e.g., under a time charter contract), the service component will be accounted for separately under FRS 115 and the lease component under FRS 116. Both the lease and service components will continue to be incentivised under the MSI despite the change in classification/presentation in the financial statements arising from the changes in the

accounting standards. Certain disclosure should be made in the income tax computation in this context.

Deloitte Singapore's views

The enhancements made to both MSI-SRS and MSI-AIS, which will largely apply on a prospective basis, should help alleviate the burden of classifying charter income and expenses into operating versus finance leases for tax purposes. They will also provide assurance to shipping players that the shipping regime in Singapore continues to remain competitive and relevant as compared to countries that provide tax exemption on shipping income or have tonnage tax regimes.

However, MSI-SRS and MSI-AIS companies will need to be aware of the following:

- The need to segregate income derived from incidental container leasing activities if any, undertaken by MSI-SRS and MSI-AIS companies. Incidental container leasing income derived under finance lease arrangement will continue to be assessed based on the prevailing Singapore corporate income tax.
- Notwithstanding the FRS 116 election, MSI-SRS and MSI-AIS companies that have subleases that are accounted as finance leases are still required to classify the sub-leases into finance lease treated as sale or finance lease not treated as sale for tax purposes and make the appropriate tax adjustments.
- As the FRS 116 election is irrevocable, MSI-SRS and MSI-AIS companies will need to consider carefully the benefits and costs involved before making such election. For example, to the extent that the MSI-SRS and MSI-AIS companies derive non-qualifying income (e.g., income derived from operations within Singapore port limits), it may not be worthwhile to make the FRS 116 election. No claim will be allowed on the relevant share of lease expenses/capital allowance attributable to such non-qualifying income, which will hence lead to a higher tax burden despite the expected lower administrative or tracking costs arising from making such election.

For shipping companies that do not qualify for the MSI schemes, they will continue to be subject to the normal tax rules, i.e., they will not be eligible for the withholding tax exemption on finance lease payments as well as tax exemption on charter income derived from operating or finance leases for tax purposes. They will also not be eligible to make the FRS 116 election and will first need to determine if the vessel chartered-in relates to an operating or finance lease for tax purposes, despite the accounting classification as an ROU asset. This may lead to higher compliance costs.

We anticipate that the provisions in the legislation and the FRS 116 e-Tax Guide will be amended to reflect the enhancements in due course.

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For more information on the above or any other matters, please contact either the listed contacts below, or any member of the [Singapore Tax & Legal team](#).

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