International Chamber of Shipping
Shaping the Future of Shipping

ECSA
European Community Shipowners' Associations

David Bradbury
Head of Division
Tax Policy and Statistics Division
Centre for Tax Policy and Administration
OECD
2 Rue André Pascal
75016 Paris
France

12 August 2019

RE: ADDRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY

Dear Mr Bradbury,

The International Chamber of Shipping (ICS) and the European Community Shipowners' Associations (ECSA) are – respectively – the global and regional (European) trade associations for shipowners and operators, representing all sectors and trades.

ICS and ECSA wish to submit comments on behalf of the international ocean transportation industry in respect of the Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, as agreed upon by the Inclusive Framework on 'Base erosion and profit shifting (BEPS)' and published in May 2019.

These comments are intended to be complementary to the submissions made by the International Air Transport Association (IATA) and Norwegian Shipowners' Association during the public consultation, in respect of the taxation of profits from the operation of ships and aircraft in international transport held in March 2019.

In summary, international transportation is perhaps the oldest cross-border activity and the allocation of taxing rights in respect of profits from international transportation have long since been dealt with exhaustively in domestic legislation and treaty provisions. The international ocean transportation industry respectfully submits that the special rules in relation to the allocation of taxing rights for profits from the operation of ships and aircraft in international shipping should be carried over into new provisions introduced in the context of the digitalisation tax project to the extent that these may apply to traditional businesses outside the original scope of social media platforms, search engines and online market places.

It is important to acknowledge that profits generated in the business of international transportation derive from the physical transportation of goods and people using tangible physical assets. To artificially assign some portion of this income to, for example, use of an

online booking system, or to assign nexus in a jurisdiction where such a system can be accessed (even if transportation does not take place there) would not be in accordance with commercial reality. It would assign income or find nexus on the basis of a component cost of the transport operation, not a separate income generating activity. Even if, arguably, the activity could be assigned some element of profit, that activity would be ancillary to the business of operating ships or aircraft and would fall within the scope of Article 8 of the OECD Model Tax Convention.

In the Tax Challenges Arising from Digitalisation – Interim Report published in March 2018, the OECD analyses the changes to business models and value creation arising from digitalisation. The characteristics of highly digitalised business models are identified as:

1. cross-jurisdictional scale without mass;
2. heavy reliance on intangible assets, especially intellectual property; and
3. the importance of data, user participation, and their synergies with intellectual property.

As has been pointed out in the IATA submission, these are not the characteristics of the international transportation industries, whose activities are satisfactorily addressed under existing domestic and international tax principles which have long ago crystallised into the principles elucidated in the OECD Model Tax Convention and Commentary and customarily applied in domestic legislation and bilateral tax treaties.

Pillar One:

1. New Profit Allocation Rule

It is submitted that these market-based transfer pricing methodologies would not be appropriate for use in connection with international transportation enterprises.

Firstly, any allocation along these lines would frustrate the customarily accepted allocation of taxing rights between residence and source countries in respect of profits from international transportation, which have been generally incorporated into both bilateral treaties and domestic legislation. The OECD Model Tax Convention allocates the taxing rights to the country of residence of the transportation enterprise, as does the primary alternative in the UN Model Tax Convention. The UN Model Tax Convention also contains an Alternative B in respect of shipping, which allocates limited rights of taxation to the source country. The methodology for this allocation is outlined in the Commentary to the UN Model Convention. This means that in the specific case of international shipping, there is already an accepted process for determining the allocation methodology for source country taxation where the respective countries agree that this is appropriate. Thus, in this case, there is no need for policy intervention within the framework of BEPS Action 1 (The digital economy). These allocation principles are discussed more extensively in relation to Proposal 2, Nexus.

Secondly, the major part of the transportation activity is carried out either on or over the high seas and not in the markets served, while the management of the enterprise is conducted in the country of primary tax residence. This has been a major motivation for the practice of allocating taxation rights to the country of residence, which may exercise its right to tax the global income of its residents. It has also been a factor influencing the establishment of special tax regimes for the international shipping industry. The specific rules on the taxation of international shipping operations in most residence countries acknowledge that a significant proportion of the income earned in connection with the movement of goods and passengers occurs outside the jurisdiction of any country. The level of taxation applied to international transportation enterprises has generally been accepted as a policy matter to be decided by the country of residence.

As noted by the OECD in its latest report on potentially harmful tax practices:

"The determination of substantial activity in the context of shipping regimes recognises that significant core income generating activities within shipping are performed in transit outside of the jurisdiction of the shipping regime, and that the value creation attributable to the core income generating activities that occur from a fixed location is more limited than for other types of regimes for mobile business income."

(Source: OECD Harmful Tax Practices – Peer Review Results Update as of July 2019, p17)

Thirdly, given that international transportation enterprises are active in many countries, reaching a consensus agreement on appropriate allocation keys would be fraught with difficulty.

Finally, while highly digitalised business models are reliant on intangible assets, shipping is reliant on tangible assets including the ships themselves. There is no difficulty in ascertaining the presence of commercial activities and applying taxation in the source country in accordance with domestic legislation and applicable tax treaties, since substantial physical vessels that call at ports are subject to customs formalities and dependent agents are required to have signing authority for commercial reasons, so there is no uncertainty in relation to Article 5, Permanent Establishments. It is then up to each country to tax in accordance with its domestic regulations, reciprocal agreements and applicable tax treaties.

2. Standalone Nexus Rule

Of particular interest to the international ocean transportation industry is paragraph 2.1 b) of the programme, concerning the possible development of a "standalone rule establishing a new and separate nexus, either through a new taxable presence or a concept of source". It is of great importance to the tax position of the international ocean transportation industry that Article 8 of the OECD Model Tax Convention – International Shipping and Air

Transport continues to have priority with regard to the taxation of profits from international transportation.

Under the Shipping and Air Transport article of tax treaties following the principles OECD Model Tax Convention and the UN Model Tax Convention's Alternative A, the right to taxation of profits from the operation of ships or aircraft in international transport is allocated to the country of residence of the enterprise. Treaties following the principles of the UN Model Tax Convention's Alternative B allocate a restricted right of taxation to the other contracting state, where activities in that state are more than casual. These provisions permit a certain level of source country taxation of profits from international transportation, but do not permit the application of Article 7 to these profits.

In practice, situations often arise where the activities of an international transportation enterprise qualify as a permanent establishment in accordance with the criteria of Article 5 of the Model Tax Convention and/or domestic tax legislation. The profits arising in such permanent establishments would normally be taxed under Article 7, Business Profits.

State practice predating and subsequent to the OECD Model Tax Convention has consistently granted priority for treaty and/or domestic law provisions concerning the taxation of profits from the operation of ships – and subsequently aircraft – in international traffic, in relation to taxation rights pertaining to taxation of business profits from branches or permanent establishments. This is enshrined in the domestic legislation of many countries, individual bilateral diplomatic notes and friendship, commerce and navigation treaties, bilateral tax treaties and the League of Nations draft, and Mexico/London model tax conventions dating back to the early decades of the last century.

Article 7.4 of the OECD Model Tax Convention contains the following rule of priority:

"Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article."

The Commentary to Article 7 of the OECD Model Tax Convention states under point 10:

"As explained below, however, paragraph 4 restricts the application of these rules by providing that Article 7 does not affect the application of other Articles of the Convention that provide special rules for certain categories of profits (e.g. those derived from the operation of ships and aircraft in international traffic)…".

Further, under point 74:

"…it has therefore been decided to include a rule of interpretation that ensures that Articles applicable to specific categories of income will have priority over Article 7. It follows from this rule that Article 7 will be applicable to business profits which do not belong to categories of income covered by these other Articles...".

Some OECD member countries have entered observations on the Commentary or Reservations to the Article. These, however, relate to the scope of the article rather than its priority over Article 7. Two Non-Member countries have entered observations on the Article specifically wishing to apply Article 7 “in exceptional situations”. Several other countries have reserved the right to tax profits from international transport in accordance with domestic law, although most of the positions relate to the scope of the Article.

The United Nations Model Tax convention and commentary contain almost identical language to the OECD model in its Alternative A for Article 8. However, a source country may be allocated a limited taxing right in respect of profits from international shipping only where the contracting states have adopted Alternative B.

“Profits of an enterprise of a Contracting State from the operation of ships in international traffic shall be taxable only in that State unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by ___ per cent. (The percentage is to be established through bilateral negotiations.)”

It is noteworthy that a limitation on the taxing right is proposed and this has been observed in treaty practice. The UN Manual for the Negotiation of Tax Treaties observes that “[a] reduction of 50 or 60 per cent is typically provided for in the very small number of treaties that include [Alternative B].”

In the Commentary to the UN Model Article 8 points 13 and 14, the following explanation is given “This paragraph allows profits from the operation of ships in international traffic to be taxed in the source country if operations in that country are “more than casual”. *It also provides an independent operative rule for the shipping business and is not qualified by Articles 5 and 7 relating to business profits governed by the permanent establishment rule.* It covers both regular or frequent shipping visits and irregular or isolated visits, provided the latter were planned and not merely fortuitous. The phrase “more than casual” means a scheduled or planned visit of a ship to a particular country to pick up freight or passengers.

The overall net profits should, in general, be determined by the authorities of the State of the enterprise (or the State in which the place of effective management of the enterprise is situated). The final conditions of the determination might be decided in bilateral negotiations……. The percentage reduction in the tax computed on the basis of the allocated profits is intended to achieve a sharing of revenues that would reflect the managerial and capital inputs originating in the country of residence.” (Italics added.)

There are numerous judgements by courts in a variety of jurisdictions supporting this position of priority for the relevant provisions in respect of international shipping and air transportation in bilateral tax treaties.

The Technical Explanation to the 2006 U.S. Model Tax Convention specifically states in relation to Article 8:

"Because paragraph 6 of Article 7 (Business Profits) defers to Article 8 with respect to shipping income, such income derived by a resident of one of the Contracting States may not be taxed in the other State even if the enterprise has a permanent establishment in that other State. "Paragraph 6 of Article 7 of the 2006 U.S. Model is substantially identical to Article 7.4 of the OECD Model. Identical language is now contained in Paragraph 4 of Article 7 of the 2016 U.S. Model."

It could be argued that the provision of and priority for special taxing provisions for international transport has become a part of customary international law, based on state practice and arguably the general principles of domestic law dating back to the early 1900s. The overriding rationale behind this special treatment mentioned in various studies and reports made in the 1950s is the circumstance that such activities are carried out to a large extent on or above the high seas and not in the territory of any source state. In fact, the tax paradigm currently in effect was to counter the impacts that would follow if the Pillar One principles were applied to international transport. This supports the view that the right of taxation of the country of residence should take precedence.

It is our view that unless the scope of any new Article in relation to the International Transportation Article is clearly defined, situations may arise where source countries decide to tax in accordance with the new article, resulting in the adoption of incompatible allocation methods, a multiplicity of taxable presences related to physical transportation activities in large numbers of countries and double taxation, giving rise to increased transportation costs detrimental to the development of global trade.

Therefore, ICS and ECSA request that the OECD gives careful consideration to including a tie-breaking provision similar to Article 7.4 of the current OECD Model Tax Convention, in any new standalone rule establishing a new and separate nexus, either through a new taxable presence or a concept of source.

Pillar Two

1. **Inclusion Rule**

For policy reasons, the international ocean transportation industry is subject to special rules of taxation in many seafaring nations, such as those approved by the EU under the State Aid Guidelines. These tax regimes all contain substantive qualification requirements in relation to the international nature of the business conducted, corporate activities and flagging. In certain situations, these special rules give rise to a lower effective rate of taxation than would apply under the general rules of corporate taxation.

With regard to 2.1 2) b, "the tax base would in principle be determined by reference to the rules applicable in the shareholder jurisdiction….", ICS and ECSA would suggest that the

shareholder jurisdiction should either calculate the tax base in accordance with its own rules for taxation of profits from international shipping transportation, if these exist, or otherwise in accordance with the source country's rules. The rationale behind this is that such shipping tax regimes exist only in seafaring nations and the whole purpose of these regimes would be defeated if a second layer of taxation is added in shareholder jurisdictions without such rules. This would effectively exclude investors in jurisdictions without shipping tax regimes from investing in international shipping enterprises in third states, since market forces will typically bring the after-tax return to shareholders on such investments into line with investments in other industries.

As mentioned above (under Pillar One), the major part of international transportation activity is carried out either on or over the high seas and not in the markets served, while the management of the enterprise is carried on in the country of primary tax residence. This has been a factor influencing the establishment of special tax regimes for the international shipping industry. The specific rules on the taxation of international shipping operations in most residence countries acknowledge that a significant proportion of the income earned in connection with the movement of goods and passengers occurs outside the jurisdiction of any country and that the economic benefit of encouraging the location of headquarters operations domestically exceeds the benefit of taxing extraterritorial income. The level of taxation applied to international transportation enterprises has generally been accepted as a policy matter to be decided by the country of residence of the transportation enterprise.

ICS and ECSA have the following comments in relation to point 3): "The possible use and effect of carve-outs, including for: a. Regimes compliant with the standards of BEPS Action 5 on harmful tax practices, and other substance based carve-outs, noting however such carveouts would undermine the policy intent and effectiveness of the proposal." The adoption of this carve out would be the best solution for the shipping industry. Shipping tax regimes within the EU are subject to approval procedures by the European Commission in accordance with the State Aid Guidelines as set by the European Commission.

Outside the EU, ICS and ECSA also note that most shipping taxation regimes have been subject to review by the OECD's specialists in harmful tax competition. Therefore, ICS and ECSA do not consider that such a carve out would undermine the policy intent and effectiveness of the proposal. There is no difficulty in ascertaining the presence of commercial activities and applying taxation in the source country in accordance with domestic legislation and applicable tax treaties, since substantial physical vessels that call at ports are subject to customs formalities and dependent agents are required to have signing authority for commercial reasons, so there is no uncertainty in relation to Article 5, Permanent Establishments. It is then up to each country to tax in accordance with its domestic regulations, reciprocal agreements and applicable tax treaties.

ICS and ECSA respectfully suggest that a carve out should be considered for the shipping industry in relation to the inclusion rule.

2. Tax on base eroding payments

The proposal includes two elements, where ICS and ECSA suggest that special consideration should be given to international transportation.

Undertaxed Payments Rule

This rule would deny a deduction or impose source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at a minimum rate.

For similar reasons to those raised with respect to the inclusion rule, ICS and ECSA suggest that either a carve out or special consideration should be given to approved shipping taxation regimes. The special consideration could take the form of a clear indication of the priority of Article 8 along the lines of the current Article 7.4 in relation to Article 7, Business Profits. Within the shipping industry there are a great number of cross-border bareboat and time charter payments between related parties for commercial fleet management reasons. In the case of two related shipping companies in different countries, both subject to a shipping tax regime, there is a risk that the one company paying time charter charges to the other would have to deduct withholding tax, which would undermine the achievement of the policy objectives of the residence country in relation to domestic taxation and both countries in respect of the allocation of taxing rights determined by Article 8.

Furthermore, if a resident taxpayer enjoying the benefits of a tax treaty exemption under Article 8 makes interest and/or royalty payments to a low-taxed recipient, these should not be qualified as base erosion payments, as such payments can be taxed under the applicable interest and royalty stipulations in the applicable tax treaty.

Subject to Tax Rule

This rule would apply to payments to unrelated parties. The subject to tax rule could complement the undertaxed payment rule, by subjecting a payment to withholding or other taxes at source and denying treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate.

For similar reasons to the undertaxed payments rule, it is suggested that Article 8 should have priority over this rule in respect of profits from the operation of ships and aircraft in international traffic.

ICS and ECSA hope that the OECD will give careful consideration to the comments and recommendations hereby submitted on behalf of the international ocean transportation industry.

ABOUT ICS AND ECSA

International Chamber of Shipping

Shaping the Future of Shipping

The **International Chamber of Shipping (ICS)** is the global trade association for merchant shipowners and operators, representing all sectors and trades. ICS membership comprises the world's national shipowner associations.

ECSA

European Community Shipowners' Associations

The **European Community Shipowners' Associations (ECSA)** is the regional trade association for merchant shipowners and operators, whose membership comprises national shipowner associations in Europe.