7 December 2021

INTERNATIONAL SHIPPING – PILLAR ONE RECOMMENDATIONS

This document provides recommendations on several important Pillar One issues as relevant to the international shipping industry, as discussed with the OECD Secretariat on November 10, 2021: (1) Sourcing; (2) Averaging; (3) Elimination of freight tax double taxation; and (4) One country Pillar One administration.

Sourcing

We propose a sourcing methodology that fairly apportions international shipping income to where it is earned, but which also provides a simplification mechanism for cargo shipping.

a. Fair Apportionment Principles

A very substantial percentage of international shipping income is earned on the high seas, transporting goods or passengers between ports. Such income derived on the high seas should not be allocated to any jurisdiction other than the country of residence of the shipping company.

Allocation of income to the high seas (and thus the resident country) is supported by article 8 of the OECD Model Tax Convention, which allows international shipping income to be taxed by the residence country only, reflecting the fact the most income is earned on the high seas (even in the case of a permanent establishment in a port jurisdiction). In addition, precisely in the context of the OECD/G20 two pillar project, four separate OECD authorities support sourcing services income to where it is earned.

1. Paragraphs 281-282 of the *October 2020 Pillar One Blueprint* state that services are sourced to the jurisdiction of the use of the service; i.e., where the services are performed. The majority of international shipping services are performed on the high seas.

2. Page 6 of the OECD July 2021 *Highlights Brochure* said that Pillar One carve-outs for extractives and regulated financial institutions were based upon those industry's "profit[s] … [being] tied to the place where … [they] are earned." The substantial majority of international shipping profits is earned on the high seas.

3. In a summer 2021 OECD Podcast, a senior OECD official, in justifying the Pillar Two international shipping carve-out, said that "ships are in the middle of the ocean." That is correct and that is how they should be sourced.

4. The July 1, 2021, OECD/G20 *Statement on a Two-Pillar Solution* states that "revenues will be sourced to the end market jurisdictions where goods or services are used or consumed." In the case of international shipping, almost all of the services are used on the high seas, in transit, and thus should be sourced to no jurisdiction other than the residence jurisdiction.

By analogy, it is necessary in the United States to apportion transportation income among the various states and there is much law and experience on proper apportionment. To be constitutional, and

thus equitable, apportionment must meet certain standards. The underlying apportionment principles require nexus, nondiscrimination, fair taxation of only that which happens in a state, and a fair relationship to services provided by a state. A typical state statute intended to satisfy these principles apportions transportation income based upon miles transporting goods or passengers within the state as a percentage of all miles transported. Such a fair method, which would meet US constitutional standards, apportions a majority of international shipping income to the high seas.

Sourcing most international shipping income to the high seas also would be consistent with the statement on page 6 of the 0ECD/G20 October 2021 *Two-Pillar Solution* document that sourcing "must… [be] reliable … based on the MNE's specific facts and circumstances." The facts and circumstances applicable to shipping are clear: income is primarily earned on the high seas and to a much lesser extent is earned in ports.

b. Proposed Sourcing Methodology

We propose the following two-part sourcing methodology: (1) to port (and, in the case of cargo shipping, certain other) jurisdictions and (2) the remainder to the high seas (and thus the residence jurisdiction).

Allocation of income to port (and, in the case of cargo shipping, certain other) jurisdictions generally could be done on the basis of miles or time. Shipping companies can make these determinations, although it would be administratively difficult. In lieu of an allocation based upon actual miles or time, a simpler, perhaps elective, alternative would be to just allocate a fixed, fair portion to the port jurisdictions; for example, 25%. A 25% fixed allocation in almost all cases would be more than what actually tracking miles or time would result in, but it could be a fair trade-off for companies not having to track miles or time for thousands of shipments annually.

In the case of cargo shipping, the income would be allocated among the jurisdictions of the destination of the cargo. Allocation to the jurisdiction of the destination of cargo (as opposed to the jurisdiction of the origin of cargo) would be a better way to carry out the intention of Pillar One – to allocate a portion of residual profits to market jurisdictions. Because the allocation would be destination based, cargo transhipped in a port in jurisdiction A for delivery to a port in Jurisdiction B would be treated as destined for Jurisdiction B. Cargo would be measured by volume of cargo delivered (unless a company had the ability to measure on the basis of revenue). Cargo would be deemed to be delivered to the jurisdiction of the port of unloading the cargo, unless the shipping company has contractually agreed to cause the cargo to be delivered at another destination (such as in the case of a through bill of lading). In the case of liner shipping companies, shipping containers delivered empty would not be taken into account.

For passenger shipping, income would be allocated among jurisdictions of ports on which a vessel calls.

Averaging

In the November 10, 2021, call, it was indicated that the Pillar One 20 billion Euro/10% profitability thresholds needed to be met in the relevant taxable year. In addition, it was indicated that some sort of an averaging mechanism would be utilized such that, even where the thresholds were met

in a taxable year, if the thresholds were not met when averaged over a number of years, then the Pillar One tax would not apply in that taxable year that the thresholds were otherwise met.

On the November 10 call, we discussed the shipping cycles that are prevalent in the shipping industry (so-called "trough," "recovery," "peak," and "collapse"). As we discussed, tonnage tax regimes, understanding the cyclical nature of shipping economics, typically require a shipping company to remain in the regime for 10 years in order for net earnings to even out. We were asked what would be the shortest possible averaging period that would take into account the typical shipping cycle.

There are no definitive studies (of which we are aware) estimating a typical shipping cycle, and the cycle likely will vary within different sectors of the shipping industry. However, in the liner shipping sector, the shipping sector most likely (based upon post-2019 pandemic related events) to potentially be subject to Pillar One, several companies have indicated that, based upon their financial results, a five-year averaging period would be most appropriate to reflect the typical liner sector cycle.

Freight Tax Double Taxation Relief

In the November 10 call, we discussed the intention of the Pillar One regime to generally provide residence country relief, likely (but not necessarily) in the form of a tax credit, for market country taxes imposed on residual profits. This credit system of course should apply to shipping companies. However, we spent most of the time talking about the problem of over-taxation by jurisdictions that impose "freight taxes."

A number of countries, primarily in some parts of Asia, Latin America, and Africa, subject shipping companies, in lieu of the regular corporate income tax, to gross income-based income taxes that are typically called freight taxes, but which may have other names (such as withholding tax, corporate income tax, or foreign contractor tax). These gross-basis in lieu of income taxes almost always presume an inherent profit margin on inbound or outbound freight (or both) that is substantially in excess of what a shipping company actually derives from the movement of cargo to or from the jurisdiction. To allocate additional Pillar One residual profit to such jurisdictions we believe would be inappropriate because profits allocated to the jurisdiction would be substantially exaggerated, resulting in double counting of profits and double taxation.

The *October 2020 Pillar One Blueprint* addressed this type of over-allocation in section 7.4 (page 158) in the "marketing and distribution profits safe harbour" under which the amount allocated under Pillar One would be reduced. However, on November 10, we were told that this safe harbor was not intended to apply to an in lieu of corporate income tax such as a freight tax. It also was indicated that the issue would be looked into by the OECD Secretariat.

We urge you to address this issue to provide double taxation relief either in the form of a reduced Pillar One allocation to a freight tax country or requiring the freight tax jurisdiction to provide a tax credit against the freight tax for any Pillar One tax imposed.

One Country Pillar One Tax Administration

As we discussed on the November 10 call, we strongly urge that companies not be required to have to file tax returns and potentially be examined by dozens and potentially hundreds of jurisdictions that are allocated Pillar One residual profit. We urge that the Pillar One system be administered by one

taxing authority (presumably the residence country jurisdiction) and that only one tax payment be required to be made. This is an issue particularly concerning for shipping as, because of article 8, complete tax returns are not required to be filed in most countries.

Please let Kenneth Klein (kklein@mayerbrown.com) know if you have any questions. We are happy to discuss these issues further with you.