July 9, 2021

PRELIMINARY RESPONSES TO DRAFT OECD PILLAR TWO SHIPPING CARVE-OUT DOCUMENT

This document provides preliminary responses of the World Shipping Council, the International Chamber of Shipping, the European Community Shipowners' Associations, and the Cruise Lines International Association to the draft write-up of the international shipping income exclusion from the OECD Pillar Two GloBE proposal forwarded by David Howell of the OECD Secretariat to Kenneth Klein of Mayer Brown LLP on July 5, 2021. All four organizations thank the OECD Secretariat for being given this opportunity to comment. It should be noted that Mr. Howell requested "feedback at this stage [i.e., as WP11 technical discussions continue], in particular with regard to the practical considerations of applying" the proposed rules.

Introduction.

In our prior submissions, we have requested that the international shipping industry be carved out from both the Pillar One and Pillar Two proposals for two primary reasons. First, application to shipping, as the OECD stated in the Pillar One Blueprint, would be inconsistent with the "longstanding international consensus that the profits of operating ships … in international traffic should be taxable only in the jurisdiction in which the enterprise has its residence." Second, application to shipping would be inconsistent with, and undermine the purpose of, the enactment by many OECD and other countries, for security, economic, employment, and other nontax policy reasons, of OECD and EU approved specific shipping tax regimes intended to bolster the countries' maritime sectors.[1] These reasons remain valid. As we have said, there is no profit shifting, base erosion, or intangible income of significance in the shipping industry.[2]

The draft provided by Mr. Howell takes the basic approach that international shipping income ("ISI") should be excluded from GloBE, as well as, subject to a limitation, Qualified Ancillary International Shipping Income ("QAISI"). These two terms are based on items of income treated as income from the

[1] As stated by the OECD earlier this month, the shipping exclusion is provided because shipping "activity benefits from [a] different taxation regime… due to … [its] specific nature….[Shipping is] still subject to all the other international tax standards on transparency and BEPS to ensure that tax authorities can tax … [shipping] effectively." *Highlights brochure: Addressing the tax challenges arising from the digitalization of the economy, July 2021* at 16 (oecd.org). Highlights brochure: Addressing the tax challenges arising from the digitalisation of the economy, July 2021 (oecd.org)

[2] While this document addresses the Pillar Two shipping carve-out, we believe that, for the same reasons described above, there should be a Pillar One shipping carve-out, as originally agreed to by the Inclusive Framework. We would note that the most recent proposal maintains carve-outs for the extractive and regulated financial service industries, and we respectfully request that shipping be added as a third carve-out.

operation of ships in international traffic, within the meaning of article 8 of the OECD Model Tax Convention, as interpreted by the article 8 commentary thereto ("Commentary"). The draft then carves back on, for GloBE purposes, certain types of article 8 income, providing limitations, exceptions, and special requirements ("Globe Carve-backs") that are not provided for in article 8 (or article 13, the capital gains article). The existence of Globe Carve-backs came as a surprise to us, because the various OECD statements on a shipping carve-out had referred to article 8 as the basis therefor.[3]

As a matter of principle, we believe that the scope of shipping income initially excluded under a GloBE shipping carve-out should be as broad as possible and cover items of shipping income that shipping companies already have to determine in applying article 8, statutory reciprocal shipping income exemptions, and tonnage tax and other statutory shipping tax incentives. We also believe that the Globe Carve-backs, if it is determined that they are needed at all, should be as narrow as possible because (1) the Globe Carve-backs are inconsistent with the longstanding principle of residence country only taxation of shipping companies and with the substance of the special shipping tax regimes, (2) the various OECD statements on a shipping carve-out have referred to article 8 as the basis of the carve-out, and (3) the Globe Carve-backs would require shipping companies to maintain a third set of books; i.e., (a) for article 8 and/or statutory reciprocal shipping income tax exemptions; (b) tonnage tax or other specific shipping tax regimes; and (c) Globe Carve-backs.

In this regard, as a starting point, we have previously[4] suggested the following somewhat more comprehensive definition of shipping income that encompasses the shipping income definitions that shipping companies routinely have to navigate:

> "Qualifying shipping income is:
> (1) income from the operation of a ship in international traffic (within the meaning of article 8 of the OECD Model Tax Convention on Income and Capital) ("MTC"); and
> (2) other income in respect of a ship that is subject to tax:
> (a) only in the country of residence under the MTC, an income tax treaty or agreement, or a domestic law reciprocal shipping income exemption; or
> (b) under a special shipping tax regime."[5]

We respectfully request that this shipping income definition be used as the GloBE exclusion starting point, prior to any GloBE Carve-backs.

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[3] As stated by the OECD earlier this month: "The GloBE rules also provide for an exclusion for international shipping income using the definition of such income under the OECD Model Tax Convention." *OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors – July 2021* at 11 (OECD, Paris). OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors (Italy, July 2021)

[4] This definition was included in our July 3, 2020, informal submission to the OECD Secretariat answering particular questions and was intended to be included in the Annex to our formal December 14, 2020, submission (but was inadvertently deleted by clerical error).

[5] For completeness' sake, it is noted that both the EU Code of Conduct Group and the OECD Forum on Harmful Tax Practices have issued guidelines with extensive "substance" conditions to analyze and approve existing and future special shipping tax regimes.

Our specific comments and questions on the draft provided by Mr. Howell are set forth below, separated by the paragraph numbers included in the draft.

Paragraph 1.

Paragraph 1 states that ISI and QAISI are excluded from GloBE Income or Loss "for the jurisdiction in which it is located." What does "for the jurisdiction in which it is located" mean? Is it meant to exclude any types of income? Shipping income is derived on the high seas and in many countries.

Paragraphs 2-3.

1. It is common that vessels are bareboat or time chartered from one group member to another (e.g., because an SPV is required for vessel financing purposes or because the overall third-party business is managed by a particular operating company or for other business reasons). Bareboat charters between group members (as opposed to third party charters) should be treated as generating ISI, to acknowledge that the division of vessel operation and ownership is merely a legal or operational division, and the combined operation generates ISI. These intra-group charters should not be subject to the proposed 3-year limitation on QAISI treatment. Bareboat charters to third parties may properly be considered to generate QAISI. However, due to the possibility that vessels being chartered out are held in separate entities, measurement of the 50% threshold should be made on a group basis. This will avoid different tax outcomes for groups that own vessels in a single entity from those that use separate entities.

2. In the liner shipping industry, the usage of vessel sharing arrangements is prevalent, and substantial income is derived through these arrangements that involve slot charters. A slot charter is the equivalent of a time charter or a voyage charter, just less than the entire vessel is being chartered. Under the Commentary, this income is directly connected income and not ancillary income. Thus, under GloBE, it should be treated as ISI and not as QAISI.

3. It should be made clear that shipping profits from a pool or joint business is ISI (as per article 8(2)).

4. A 10-year holding period for gains seems arbitrary. Shipping companies are increasingly acquiring or seeking to acquire vessels of different capacity, or more environmentally friendly vessels, in which case they may dispose of older vessels within 10 years in the ordinary course of the shipping business. Further, it is common that vessels are sold between members of the same group based upon the best place for the vessel to be deployed. In addition, vessels are sometimes sold and immediately leased back in financing transactions. A 10-year holding requirement will inevitably put an inappropriate tax twist to what should be a pure business decision as to when to sell a ship. The financial reporting treatment of a vessel as PPE (as opposed to inventory) should be sufficient for the gain to constitute ISI, irrespective of holding period. Alternatively, there are some countries that have a one-year holding requirement for

determining if the gain is treated as trading income. Whatever the holding period requirement, if any, there should be exceptions for (a) sales between members of the same group and (b) sale lease-back transactions.

5. Liner shipping companies charge "detention" when a customer does not return its shipping containers within an agreed upon time and "demurrage" if the customer does not pick up a loaded container within an agreed upon time. To be clear, the QAISI definition should read "leasing and short-term storage of containers, including detention and demurrage charges."

6. It looks like from the draft that investment income can be excluded only if the asset accumulation is required by law. Income from investments should qualify under the Commentary if the investment (a) is an integral part of carrying on the business (e.g. interest on working capital, funds accumulated for debt repayment or vessel acquisition, or advance deposits received for future passage) **or** (b) is legally required to carry on the shipping business. Further, because the investment is an integral part of carrying on the business or is legally required, we believe it should properly be treated as ISI, not QAISI.

7. We do not understand the exclusion of inland transportation from QAISI for several reasons. First, in practically all countries, this type of income is covered under article 8 (notwithstanding four country reservations), but only where the inland transportation is a leg of an international movement of cargo. Second, under the Commentary (as well as under the US reciprocal exemption provision (section 883)), the shipping company is not exempt if it transports the cargo inland itself (which is a practically nonexistent practice). Rather, a separate taxable entity must move the cargo (whether by truck, barge, or railroad). Third, arrangements for inland transportation are routinely made by a shipping agent, which is almost always a separate taxable entity. Fourth, very often door-to-door transportation is provided and it would be extremely difficult to segregate the sea and inland revenue of an all-inclusive freight rate. Fifth, even where inland haulage is invoiced separately, the profit attributable to inland haulage is not readily identifiable as shipping companies do not allocate costs to each activity when it is providing a single comprehensive service. Sixth, where a shipping company performs logistic services for itself, other group members, and/or third parties, the shipping company will almost always have a separate logistics company performing the services that is taxable and not eligible for article 8. Seventh, in the what we believe is the very unusual situation where a shipping company itself (as opposed to through a separate, taxable logistics company) performs logistics services for other persons, the amount of such income would need to be very small in order to be treated as ancillary income under article 8. Eighth, it would be extremely complicated administratively to attempt to determine the value added by the shipping company to on-land activity because almost all on-land income is derived by separate taxable entities, not the shipping company. In sum, this would seem to be the most substantial departure from the article 8 income classification and would be extremely difficult for taxpayers to account for, and comply with, and for taxing authorities to administer.

8. While income of tugs and dredgers normally is covered by article 7, not article 8, under most EU shipping tax regimes the transportation element of income derived by tugs and dredgers (e.g.,

transporting the dredged material), and some other vessel types with mixed activities, is qualifying income under the shipping tax regimes. Given the similarity of functions performed by such vessels, we believe treatment as ISI is appropriate.

Paragraph 4.

1. See comments 1-4 under **Paragraphs 2-3** and **6** above.

2. We believe it would be extremely unusual for a shipping enterprise to have QAISI exceeding 50% of ISI. However, it is possible that, due to the division of activities (e.g., vessel operation and management, mentioned above), a Constituent Entity may, on a separate company basis, have QAISI that exceeds 50%. Therefore, and because shipping companies would not in the ordinary course of business be determining such amounts and would only be able to do so through complicated accounting that would likely never result in an actual QAISI limitation, this cap seems inappropriate or should be applied by aggregation of all Constituent Entities within a shipping group.

Paragraph 5.

Costs attributable to another member of an MNE Group that are indirectly attributable to a Constituent Entity's income from excludible shipping activities are to be allocated in part to ISI and QAISI. What does this mean? Wouldn't the other member of the MNE Group be a taxable entity and wouldn't those costs be directly allocable to its income and therefore shouldn't they be fully deductible?

Paragraph 6.

1. This "substance" requirement contemplates an entirely new set of what would have to be very complicated rules on what can and cannot be done in a jurisdiction, what employment is created, and where.

2. This would be in addition to, and separate from, whatever elaborate tonnage tax, economic substance, or other requirements of domestic law would apply, even where the regime has been deemed not harmful by the OECD.

3. These rules could be very onerous to comply with and in many cases could conflict with the rules of the jurisdictions in which the company does business.

4. As we have said in our prior submissions, it is very common for vessels to be chartered from one group member to another. Often the charterer is the primary entity dealing with third party customers. As written in the draft, every Constituent Entity would have to meet the substance criteria in its own jurisdiction. Depending on how the strategic and commercial management, employment, etc. rules are drafted, the entity that charters the vessel to a

group member might not satisfy the requirement, even though the group would, as a whole. If the GloBE rules must have this type of burdensome provision, then the substance requirement (strategic and commercial management, employment, etc.) must not have to be met in every Constituent Entity's jurisdiction, but rather in at least one jurisdiction.

5. This is the most impractical rule in the draft.