September 15, 2021

Strategic and Commercial Management

This paper responds to the August 16, 2021, request of David Howell of the OECD Secretariat for more detail on the practical difficulties of complying with the strategic management ("SM") and commercial management ("CM") (together, "S&CM") requirements in paragraph 6 of the draft Pillar Two international shipping carve-out document forwarded by Mr. Howell to Kenneth Klein of Mayer Brown LLP on July 5, 2021. Mr. Howell made the request in order for the OECD Secretariat to better understand the compliance issues mentioned in the July 9, 2021, collective submission on the July 5 draft by the World Shipping Council, the International Chamber of Shipping, the European Community Shipowners' Associations, and the Cruise Lines International Association. Mr. Howell also asked for a more detailed description of alternative substance criteria contained in other shipping regimes.

In summary, without developing very detailed definitions and operational rules, it would be impossible for businesses to comply with a proposed Pillar Two S&CM requirement. In those (mainly European) countries where the concept of S&CM is used, there exist no, or almost no, statutory definitions of SM or CM and there are no consistent interpretations of S&CM from country to country. As a result, without extensive guidance, shipping companies will not know what they must do to comply. Further, under many shipping regimes, S&CM is not even a relevant concept, in which case those shipping companies may have even less of an understanding of what they must do to comply. As will be seen below, providing such guidance would be a very difficult and complicated task, as different and inconsistent S&CM requirements exist in multiple countries.

In addition, shipping companies will be burdened in almost all countries with having to comply with two separate standards of substance – national standards and Pillar Two standards. Today, shipping companies will have S&CM in one or more countries determined by (1) what makes the most sense commercially, given the historic international norm of resident country only taxation of shipping companies, and (2) what is necessary to comply with existing shipping regimes. A separate Pillar Two S&CM standard in many cases may require changes in business operations in order to meet additional standards.

If Pillar Two is going to require shipping companies to do additional things beyond what they do in the ordinary course of business from a commercial point of view and in order to comply with existing shipping regimes, then shipping companies *will need very clear and granular guidance on what is required to meet Pillar Two S&CM for the various different operating models in the industry.* In addition, such guidance would need (1) to make clear that the Pillar Two S&CM regime applies in respect of both owned and chartered vessels, (2) special rules may be needed for (a) related person charters within groups and (b) ship pooling arrangements, (3) a mechanism would need to be provided so that shipping companies could obtain advance certainty from tax authorities in their countries of residence as to what

they must do in a country to meet the Pillar Two S&CM requirements, (4) the residence country determination regarding compliance with the OECD Pillar Two standard needs to be binding on the various countries in which the shipping company operates, and (5) Pillar Two SC&M should have no vessel registry requirement other than what may be required under a national shipping regime.

European S&CM Requirements

While S&CM currently is required under many European tonnage tax regimes, there is not a single such requirement. In none of the European statutes is SM or CM precisely defined. It is necessary to look at the underlying interpretations by the particular country. But even then, the national interpretations will look at many different factors (determined based upon national interests) and weigh their importance differently. Consequently, it is difficult to know when the S&CM requirements are met in the absence of a tax authority providing certainty by ruling or agreement, which most European countries will do. Set forth below is a brief summary of S&CM requirements in various European countries, with much of the information having been provided by Ton Stevens of Loyens & Loeff or various World Shipping Council members.

The Netherlands. The Netherlands considers four types of "management" to be carried out from The Netherlands. SM involves decisions about investing in, and disposing of, owned or chartered ships, as well as decisions about, and supervision of, other types of management. CM is activities relating to chartering and cargo transport. Technical nautical management concerns actual operation and maintenance of the vessel. Crew management involves hiring and deploying of crew. There is no mathematical weighting of the different types of management; however, SM is considered to be the most important. The test is assessed on a case-by-case basis, and it is possible to receive advance certainty from the Dutch tax authorities.

France. S&CM is deemed to be met in respect of a vessel that is registered in France. Otherwise, there is little French guidance. SM appears to look at the headquarter' location (top management team), where investment decisions are made, and where important contracts are entered into or global alliances formed. CM appears to look at where vessel management takes place, such as developing navigation plans, managing fuel, where orders are taken, where maintenance and repair decisions are made, etc. There is no mathematical weighting. Advance certainty does not appear to be available.

Denmark. SC&M is required in respect of owned and chartered ships in Denmark or in another EU country. SM looks at the main place of business and where senior management is located, focusing on strategic decisions such as significant contracts, purchase and sale of ships, and entering into strategic alliances with other shipping companies. CM involves management of sailing plans or routes, engaging in freight agreements, supplying and crewing ships, and technical operation and maintenance of ships. Advance certainty is available from the Danish tax authorities.

United Kingdom. SC&M is required in the United Kingdom or in other countries (depending upon the UK share of the worldwide fleet). SM focuses on sale and disposition of ships and other substantial equipment, award of major contracts, strategic alliances, and supervision of foreign offices. CM includes commercial and technical management. Commercial management involves route planning, bookings, insurance, finance, provisioning and victualling, and training. Technical management involves repair and maintenance of vessels, managing fuel and safety, recruiting and managing crew, ship registration, drydock management, etc. There is no mathematical weighting of factors, although greater weight is given to higher levels of decision-making (as opposed to day-to-day activities). The UK tax authorities will provide advance certainty as to whether S&CM is met.

Greece. Greek flag vessels are subject to the tonnage tax. Non-Greek flag ships must be managed by a company exclusively engaged in ship management activities in Greece.

Germany. Ship management is required to be carried out from Germany. This includes SM, CM, and technical management of owned and chartered ships. Ship management includes buying and selling of ships, contracting for chartering, monitoring financials, provisioning, hiring of officers, concluding freight contracts, fueling, ship maintenance, insurance, bookkeeping, safety, and security. The German tax authorities will provide advance certainty.

Belgium. Vessels must be managed in Belgium or the EEA. This includes buying, selling, and chartering of ships, supplying, maintenance, insurance, fuel, bookkeeping, crew management, training, and appointing officers. Mathematical weightings are provided for. The Belgian tax authorities will provide advance certainty.

As can be seen, there are a wide variety of standards in Europe, with some countries (like the United Kingdom and Belgium) providing far more detail and in almost all cases numerous factors must be looked at. There are not consistent standards on what is required or on weighting of factors. Much S&CM and other management can take place in other European countries.

Thus, there can be considerable ambiguity under, and differences between, existing rules, but, fortunately, advance certainty can generally be obtained from tax authorities in Europe. If there is also to be a separate, Pillar Two SC&M requirement, and we question whether that is a good idea, then there may be two separate standards for every country, which will create a compliance burden in and of itself (both for shipping companies and for tax authorities) and which in many cases may require companies to alter how they do business. But it is crucial, if this approach must be taken, (1) that there be clearly defined rules that take into account different ship operating models (what makes sense for one type of shipping may be too prescriptive for another), (2) that there is the ability to obtain advance certainty

from residence country tax authorities, and (3) that such resident country determinations regarding compliance with the OECD Pillar Two standard be binding on tax authorities in other countries in which the shipping company does business. Plus, please see the *Special Situations* discussion below.

It should be noted that the European regimes generally do not require vessels to be registered under the country's laws. However, there usually is a requirement that a certain percentage of ships be EU registered. In some countries, less S&CM is required in the case of a national flag vessel.

NonEuropean S&CM Requirements

The concept of S&CM is generally not included in the special shipping regimes of many maritime countries, as summarized below. If Pillar Two S&CM is required, then companies in such jurisdictions also will need clearly defined rules and the ability to obtain advance certainty from tax authorities. There also is a concern that Pillar Two SC&M will have standards different from the "economic substance" standards adopted by a number of countries, with the guidance and approval of the OECD, which could result in considerable hardship to both the shipping companies and the countries affected.

Singapore. Singapore's MSI-Approved Shipping Enterprise regime provides tax exemptions for non-Singapore flag vessels if substantial shipping operations are established in Singapore. The Singapore Government will look at past and projected Singapore investments and headcount in a variety of areas, including manpower, facilities, port activities, financial and legal, and other activities. In the application process, Singapore will look at SM, CM, and technical management activities. SM includes decisions on purchase and sale of vessels, registry, and ship financing. CM includes awarding of contracts, strategic alliances, pooling, securing cargo, route planning, appointing agents, collections, and insurance. Technical management includes crewing, maintenance, supplying, supervision of construction or registration, and safety. These latter management factors are not necessarily required, but are taken into account in connection with determining whether there will be sufficient Singapore investment and headcount.

In the case of a Singapore flag vessel, in lieu of the above, there must be a Singapore resident manager responsible for registration, crewing, government dealings, and communications. There also must be a technical manager responsible for safety and security. Technical management can take place within or outside Singapore.

United States. The US tonnage tax does not have a S&CM requirement. It applies only to income from US flag operations (plus some limited related or "secondary" income). A US flag ship must be owned by a US company, it's CEO and Chairman of the Board must be US citizens, no more than a minority of the Board can be non-US citizens, the licensed officers must be US citizens, and no more than 25% of unlicensed crew may be non-US citizens (but they must be lawful permanent US residents).

Japan. The Japanese tonnage tax does not have S&CM requirements. The vessel must be owned by a Japanese corporation (1) whose representatives and 2/3 of its directors are Japanese citizens or (2) all of whose representatives are Japanese citizens. The company must have a government approved plan to increase the number of Japanese owned and registered vessels, to maintain a certain number of Japanese seafarers per vessel, and to increasing that number. Training of seafarers is required.

Hong Kong. Hong Kong has no S&CM requirements. (However, there are some recent ship leasing and ship leasing management tax incentive programs that require a certain level of Hong Kong employment.)

OECD/EU Economic Substance Regimes. As a result of BEPS and EU guidance, there are OECD approved statutes requiring economic substance in the jurisdictions. If the economic substance requirements are not met, then substantial penalties are imposed and if deficiencies are not remedied, then the companies cannot continue to operate as companies in such jurisdictions. These include countries such as Bermuda, Barbados, and the Marshall Islands. These statutes do not have S&CM requirements, per se. However, they do require "core income generating activities" to take place in the jurisdiction. For a shipping company, these include CM-type activities, including crew management, overhauling and maintaining ships, overseeing and tracking deliveries, supplying, and organizing and overseeing voyages. In the case of a headquarters company (not restricted to shipping), there are SM-type requirements, including taking strategic or management decisions, incurring expenditures on behalf of affiliates, and coordinating group activities. As countries have devoted extensive effort and expense to changing their laws, and shipping companies have incurred extensive effort and expense to complying with these laws, all at the behest of the OECD to require economic substance, consideration should be given to deeming that complying with these statutes would be deemed to constitute Pillar Two SC&M.

As can be seen, Pillar Two S&CM requirements will be a new concept in many important maritime nations and, even in those jurisdictions where S&CM requirements exist, the definition adopted by the OECD will likely differ from that to which the company already is subject. If there is such a Pillar Two standard, then in many countries there will again need to be two standards applied (as would be the case with the European countries): the national standard and the Pillar Two standard, which may be different from what shipping companies engage in as a business matter or to meet the national standard. As a result, if there is to be a Pillar Two S&CM requirement, it is very important that it be very clear what the country requires, that advanced certainty be available from residence country tax authorities, and that such residence country determinations regarding compliance with the OECD Pillar Two standard be binding on other countries in which the shipping company does business. Plus, please see the *Special Situations* discussion below.

Please note that in these countries (except for the United States), registry of the vessel in the country of residence is not required.

Special Situations

This section addresses three special situations that should be considered if there must be a Pillar Two S&CM requirement.

Chartering. It is a very common practice for a shipping company to own vessels, to charter in vessels from other parties, or both. In addition, vessels can be chartered out to other parties. The various special shipping tax regimes apply to vessels that are both owned and chartered in and chartered out. Any SM requirements should make clear that they cover decisions in respect of both owned ships and chartered ships.

Intercompany charters. It is also a very common practice that a subsidiary will charter one or more vessels to a parent corporation or another group member that will separately and additionally perform many S&CM functions in respect of a large portion of the fleet, or of the entire fleet, which often is a practical necessity when the group operates dozens or hundreds of vessels. The subsidiary will engage in SM activities, such as making decisions on purchases and sales of ships. It also will engage in CM activities, such as chartering negotiations or actually operating the ships (however, in many cases, unrelated ship management companies perform actual operations of the ships).

Such intercompany charters are a practical business necessity for almost all large shipping companies with dozens or hundreds of ships. If there must be Pillar Two S&CM requirements, they should be drafted in such a manner that subsidiaries with intercompany charters are not prevented from satisfying the S&CM requirements. For example, in addition to the subsidiary's own S&CM activities (which themselves ought to be enough in these related party chartering circumstances), consideration should be given to also attributing the parent's or other group member's separate and additional S&CM activities, wherever they take place, to the subsidiary in order to prevent a tax authority from taking an aggressive position in this regard.

Pooling. "Pooling" of ships is also a very common practice in the shipping industry. While there are a number of pooling variations, a typical one involves a number of shipowners (or charterers) chartering their ships to a pooling entity for variable charter hire dependent on the pool entity's profits. A pool manager will manage the pool entity's shipping operations with third parties by entering into spot or time charters or contracts of affreightment. The pool manager pays expenses (such as for fuel and agents), receives a management fee, and remits any net profits to the ship owners (or charterers) pursuant to an agreed upon formula under the charters to the pool entity. In these circumstances, the

ship owners (or charterers) engage in SM activities, such as the purchase, sale, or chartering of ships. They also engage in CM activities, such as negotiating the charters with pool entities (or actually operating the ships).

If there must be Pillar Two S&CM requirements, they should be worded such that members of pools are not prevented from satisfying the S&CM requirement. For example, in addition to the ship owner's (or charterer's) own S&CM activities (which themselves ought to be enough in these pooling circumstances), consideration should also be given to also attributing the pool manager's separate and additional S&CM activities, wherever they take place, to the ship owner (or charterer) in order to prevent a tax authority from taking an aggressive position in this regard.

Ship Registry

While it is common for a special shipping regime to encourage national or EU registry of vessels, it is not an absolute requirement in all but a very few countries. Shipping companies register vessels in many different countries, determined by business reasons independent of tax considerations. The major shipping companies that would be covered by the Pillar Two revenue threshold pretty much universally utilize high quality registries that meet IMO and ILO standards and that are included on the Paris MoU's white or grey list or the Tokyo MoU's white or grey list. Any Pillar Two S&CM requirements should not be dependent on ship registration in any particular country.

Conclusion

Pillar Two S&CM requirements would be difficult for shipping companies to understand and would be difficult to comply with because, even if the rules are clear, companies would have to comply with two separate standards simultaneously – national standards and Pillar Two standards. The two standards in many cases would be inconsistent with each other and with what the commercial needs of the business might dictate. If there must be a Pillar Two S&CM requirement, it is very important that it be very clearly defined, it needs to have a mechanism under which shipping companies can obtain from their residence country tax authorities advance certainty that the requirements will be met, and such determinations regarding compliance with the OECD Pillar Two standard must be respected by other countries in which the shipping companies do business. In addition, any such Pillar Two S&CM requirements should (1) make clear the SM requirement covers decisions in respect of both owned and chartered in vessels, (2) make clear that intercompany chartering and pooling arrangements are not prevented from meeting the S&CM requirements, and (3) not include a ship registration requirement.

Providing this type of S&CM guidance to apply in all countries of the world and in respect of all typical shipping operating models would be a very difficult and complicated task. We continue to

question whether such an additional requirement, beyond requiring that the income be from the operation of a ship in international traffic under article 8 of the OECD MTC, is necessary or appropriate.