SHIPPING INDUSTRY SUBMISSION REGARDING PILLAR TWO SUBSTANCE-BASED INCOME EXCLUSION FOR MOBILE ASSETS AND EMPLOYEES

On behalf of the Cruise Lines International Association, the World Shipping Council, the International Chamber of Shipping, and the European Community Shipowners' Associations, this document responds to the OECD Secretariat's request for industry input relating to possible options for the Substance-based Income Exclusion ("SBIE"), as set forth in Article 5.3 of the GloBE Rules, as applied to mobile assets and employees, and in particular to ships and their crew. As discussed below, we respectfully request that the OECD adopt an approach that would allocate ships and the payroll costs associated with their crew to the jurisdiction where the Constituent Entity ("CE") is located if such CE both (1) legally owns the ships and/or employs the crew, and (2) regularly carries on substantial management activities in respect of such assets and/or crew. Such an allocation key would comport with the policy rationale for the SBIE, namely, "to exclude a fixed return for substantive activities within a jurisdiction from the application of the Globe Rules," while also "help[ing] to level the playing field across industries that use varying types of tangible assets in their business."[1] Any allocation key that would effectively result in the loss of all or substantially all, of the SBIE for the shipping industry would inappropriately and unfairly disfavor the shipping industry in favor of other industries. Such a result would be exacerbated merely by reason of the shipping industry utilizing assets and employees that, given the nature of the industry, rarely may be physically located in the jurisdiction where the CE that legally owns the assets and employs the crew is located. The global shipping industry operates more than 70,000 vessels in global itineraries, whose assets and workforce will potentially be excluded from the benefit of the SBIE under an unfavorable allocation key.

We understand that the OECD has been considering an allocation key for the transportation industry that would allocate mobile assets/employees to the CE that owns the asset and/or incurs the payroll costs for such employees but only with respect to voyages that begin or end in the jurisdiction of such CE. For example, assume that a CE located in, say, France owns a single ship and that ship is used in 6 voyages during the relevant Fiscal Year. One of the voyages begins in France and another one of the voyages ends in France. The other four voyages begin and end in other countries. Under the allocation key under consideration, the CE located in France would be allocated one-third of the ship and the associated payroll costs for purposes of the SBIE. The other two-thirds would not be allocated to any jurisdiction, including any jurisdiction where the Main Entity may have a CE (such as a Permanent Establishment described in Article 10.1(a) to (c)). If instead the relevant CE is located in a land-locked country, such as Switzerland or Luxembourg, then it would be allocated no portion of the asset and/or payroll costs for purposes of the SBIE. As observed above, such an allocation would significantly disfavor the shipping industry as compared with other taxpayers in the transportation sector. For example, in the case of a shipping enterprise, it is often likely that no or only few voyages may begin or end in the jurisdiction where the CE is located. This is a

[1] *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), First Edition* (the "Commentary"), at paras. 25 and 37 of Article 5.3.

function of the mobile nature of the ships and is driven primarily by market demands (*e.g.*, popular itineraries for a cruise and/or cargo routes dependent on the place of manufacture/supply and demand for goods).

Accordingly, we respectfully request that the OECD consider an alternative allocation key for the transportation sector, or at least for the shipping industry.[2] The alternative allocation key would allocate ships and the payroll costs associated with their crew to the jurisdiction where the CE is located if such CE both (1) legally owns[3] the ships and/or that employs the crew, and (2) regularly carries on substantial management activities in respect of such assets and/or crew. We believe that the management activities requirement addresses any perceived concerns of the OECD resulting from an allocation of assets and/or payroll costs to a CE based exclusively on the legal ownership of the assets and/or incurring of the payroll costs without more.[4] Rather, requiring management activities in respect of the assets and payroll costs conforms to the stated desire of providing a SBIE for "substantive activities" conducted by the CE.

We observe that if a shipping enterprise qualifies for the International Shipping Income exclusion set forth in Article 3.3 of the GloBE Rules, then such shipping enterprise would not need to rely on the SBIE. Article 3.3.6 of the GloBE Rules provides that, "in order for a [CE's] International Shipping Income and Qualified Ancillary International Shipping Income to qualify for the exclusion from its GloBE Income or Loss under Article [3.3], the [CE] must demonstrate that the strategic or commercial management of all ships concerned is effectively carried on from within the jurisdiction where the Constituent Entity is located" (the "SCM requirement"). As noted in several of our prior submissions, the application of the SCM requirement is highly uncertain, primarily because of the very subjective facts-and-circumstances nature of the requirement. Given these uncertainties, shipping enterprises may need to rely on the SBIE.[5] In this regard, we suggest that our proposed management activities requirement for purposes of the SBIE would be satisfied if the relevant CE regularly carries on in the jurisdiction where the CE is considered to be located one or more of the strategic and/or commercial management activities described in paragraphs 183 and 184 of the Commentary to Article 3.3.6. Such strategic management activities include making decisions on significant capital expenditure and asset disposals (*e.g.*, purchase and sale of ships), award of major contracts, agreements on strategic alliances and vessel pooling, and the direction of foreign establishments, taking into account the location of decision-makers, including senior management staff, location of

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[2] The OECD may consider whether to retain the allocation key described in the preceding paragraph for airlines but use the allocation key described in this paragraph for the shipping industry. For example, the *Pillar One – Amount A: Draft Model Rules for Nexus and Revenue Sourcing* (February 2022) adopt industry-specific rules for airlines and shipping.

[3] Per Model Rules 5.3.4.(c), for these purposes "owns" should be considered to include a lessee's right of use of tangible assets (e.g., a ship that is bareboat chartered in by the relevant CE).

[4] To be sure, we continue to believe that an allocation based on legal ownership of the assets and/or the employer of the employees is sufficient for purposes of the SBIE, but we are providing an alternative allocation key to acknowledge our understanding that such an approach may not be acceptable to the OECD and/or country delegates.

[5] Even if a CE satisfies the SCM requirement, certain categories of income may not qualify for the International Shipping Income exclusion.

company board meetings, location of operational board meetings, and residence of directors and key employees. Such commercial management activities include route planning, taking bookings for cargo or passengers, insurance, financing, personnel management, provisioning and training, taking into account the country of residence of key management staff, including company directors.

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If you have any questions or comments regarding the above, please contact Rafic Barrage at Baker & McKenzie LLP at rafic.barrage@bakermckenzie.com or at + 1 202 452 7090. We would also be pleased to arrange at your convenience a follow-up meeting to discuss our recommendations.