May 1, 2023

RECOMMENDATIONS OF THE WORLD SHIPPING COUNCIL ("WSC"), THE INTERNATIONAL CHAMBER OF SHIPPING ("ICS"), AND THE EUROPEAN COMMUNITY SHIPOWNERS' ASSOCIATIONS ("ECSA") IN RESPECT OF POSSIBLE REVISIONS TO ARTICLE 8 OF THE UNITED NATIONS MODEL TAX CONVENTION

This document provides the recommendations of WSC, ICS, and ECSA[1] in respect of the attached March 10, 2023, note of a Subcommittee ("March 2023 Subcommittee Note") of the Committee of Experts on International Cooperation in Tax Matters ("UN Tax Committee")[2] concerning possible revisions to article 8 (international shipping and air transport) of the United Nations Model Double Taxation Convention between Developed and Developing Countries ("UN Model").

Summary

In summary, WSC, ICS, and ECSA primarily recommend[3] that (1) Alternative A (residence country taxation only of international shipping income) of article 8 be retained and (2) Alternative B (source country taxation of an appropriate allocation to the source country of the overall net profits of the shipping company) of article 8 not be revised to permit source country taxation under local law, including taxation of the gross amount of shipping revenues. Such a change inevitably would result in excessively high taxation of shipping income, including taxation in the absence of net profits. Taxation under Alternative B should remain based upon a fair allocation of the overall net profits of the shipping company.

Discussion

Article 8 of the UN Model provides two alternatives for the taxation of international shipping income. Under Alternative A, profits from the international operation of ships are taxable only in the country of residence of the shipping company. Under Alternative B, international shipping profits can be taxed in the source state;[4] however, the profits to be taxed

[1] WSC is the global trade association of the liner shipping industry. More information about WSC may be obtained at www.worldshipping.org. ICS is the global trade association for shipowners and operators, with a membership of 40 national shipowners associations, representing over 80 percent of the world merchant fleet. More information about ICS can be found at www.ics-shipping.org. ECSA is the voice of the European shipping industry. ECSA promotes the interests of 20 member associations of the European Union and Norway. More information about ECSA can be found at www.ecsa.eu.

[2] The March 2023 Subcommittee Note (E/C.18/2023/CRP.14) was discussed at the 26th session of the UN Tax Committee in New York on Tuesday, March 28, 2023.

[3] Other recommendations are also made below.

[4] If the source state shipping activities are more than casual.

are determined on the basis of an appropriate allocation of the overall net profits of the shipping company and at an unspecified reduced rate (to be established through bilateral negotiations).

The March 2023 Subcommittee Note raises the possibility of a new Alternative B that would either replace current Alternative B or, alternatively, serve as the only option under article 8. Under the possible new Alternative B, source country taxation of international shipping income would be permitted[5] either (1) at 50% of the tax determined under local law or (2) at an unspecified percentage (to be established through bilateral negotiations) of the gross amount of the payments underlying the shipping income. Thus, Alternative B, if so revised, would no longer require taxation of an appropriate allocation of the overall net profits of the shipping company.

The Commentary to article 8 of the UN Model ("Article 8 Commentary") explains why Alternative A exists. In 1980, many countries believed that shipping companies should not be exposed to the tax laws of the numerous countries in which they operated because "if every country taxed a portion of the profits of a shipping line, computed according to its own rules, the sum of those portions might well exceed the total income of the"[6] shipping company. This was viewed as "a serious problem, especially because taxes in developing countries could be excessively high, and the total profits of shipping enterprises were frequently quite modest."[7] As a result, in 1980, Alternative A provided for residence country taxation only of international shipping income.

It is widely recognized that the underlying reasons for residence country only taxation of shipping companies apply just as much today as they did in 1980, as explained further below. That is why the overwhelming majority of over 3,500 tax treaties today provide for residence country only taxation of international shipping income. WSC, ICS, and ECSA recommend that Alternative A be maintained.

Other countries in 1980 "asserted that they were not in a position to forgo even the limited revenue to be derived from taxing foreign shipping enterprises as long as their own shipping industries were not more fully developed."[8] However, those countries also "recognized … that considerable difficulties were involved in determining a taxable profit … and allocating the profit to the various countries."[9]

Because there was no consensus in 1980, two alternatives were provided in article 8.[10] However, Alternative B was drafted such that source country taxation would only apply where there were overall net profits and it was stated that countries could negotiate as to whether prior year losses should be taken into account in determining overall net profits.[11] Negotiations also could determine how overall net profits should be allocated to countries, based "on some

[5] The "more than casual" requirement would be deleted.
[6] Article 8 Commentary ¶ A.2.
[7] *Id*.
[8] *Id*. ¶ A.3.
[9] *Id*.
[10] *Id*. ¶ A.4.
[11] *Id*. ¶ B.17.

proportional factor…, preferably the factor of outgoing receipts."[12] Finally, the percentage reduction in the tax was intended to "reflect the managerial and capital inputs originating in the country of residence."[13] If there is to be source country taxation, WSC, ICS, and ECSA believe that these factors expressed in respect of the 1980 UN Model continue to make sense – taxation should only occur when there are overall net profits, prior year losses should be taken into account, and overall net profits should be allocated proportionally and in a consistent fashion.[14]

Experiences with source country taxation

WSC, ICS, and ECSA strongly oppose the possible changes to Alternative B suggested in the March 2023 Subcommittee Note. Our members have considerable experience with very high taxation of international shipping income where a tax treaty does not provide for residence country only taxation. Applying local country tax law in many countries routinely today results in excessively high taxes, just as referred to in the Article 8 Commentary.[15] Our members also have considerable experience with gross basis taxation imposed on international shipping income, such as outbound freight, inbound freight, or both. Where gross basis taxes are imposed, extremely high taxation is almost always present.

Shipping companies have extremely high costs of capital in acquiring ships and other equipment (such as shipping containers), resulting in very high annual depreciation expense, in addition to other very substantial operating expenses, such as fuel, crew and other employee expense, and the like.[16] Shipping companies tend to show operating losses in five out of every ten years. In most years over the last 40+ years since the UN Model was adopted, a 4% annual profit has been a good year. If source country taxation of international shipping income is to be permitted in a tax treaty, the shipping company should be able to recover its costs before taxation is imposed.

Member companies have experienced extremely high rates of taxation in those countries that allow source country taxation. Where gross basis taxes[17] are imposed and the shipping company has an operating loss, the gross basis tax becomes yet another cost.[18] Where the shipping company makes a typical modest profit, the effective tax rate can often exceed 50% and in many cases can be 80-90% or higher, particularly where gross basis taxes are imposed.

Here are two examples in respect of one particular country (which we will not identify but will call Country X). Country X has a 30% corporate income tax rate. It also imposes a 5% freight tax. Assume that Company Y has a typically low profit year with $1,000 of gross income and $990 of deductible expenses allocable to Country X, with net income of $10. The Country X corporate income tax would be $3. Instead, the 5% freight tax is imposed by Country X on the

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[12] *Id*.
[13] *Id*.
[14] This proportional issue is addressed later in this memorandum.
[15] *See* note 7 *supra* and accompanying text.
[16] The only expense that the March 2023 Subcommittee Note would appear to allow are commissions to sales agents, which are a very small fraction of the total expenses of a shipping company.
[17] There are different types of such taxes. In some cases, the tax is imposed in the actual amount of gross income. In some cases, there is a presumed or deemed amount of gross income.
[18] Such added cost can have different effects in different situations; e.g., causing the shipping company to raise its prices or causing the shipping company to be uncompetitive.

$1,000. The freight tax of $50 is 500% of Company Y's profits. If a tax treaty reduced the freight tax in half to 2.5%, the resulting $25 freight tax would be 250% of profits.

Assume instead that Company Y has a very good year, with $1,000 of Country Y source income and only $920 of allocable deductible expenses, for net income of $80 on which a $24 corporate income tax would have been imposed. Instead, Country X imposes the 5% freight tax of $50. The freight tax of $50 is 62.5% of Company Y's profits. If a tax treaty reduced the freight tax in half to 2.5%, the resulting freight tax of $25 still would exceed what the corporate income tax would have been.[19]

The collective experience of our members is that allowing source country taxation in the manner suggested by the March 2023 Subcommittee Note would be a recipe for excessively high taxation. Such high taxation has the effect of double or multiple taxation.[20] This would be "a serious problem," just as was said in the Article 8 Commentary.[21] We believe that allowing such taxation would not be fair, would be contrary to the goal and purpose of tax treaties (i.e., the avoidance of double taxation), and the UN Model should not sanction it.

If source country taxation is to be permitted, the reasonable and fair way to do it is in essentially the same way as current Alternative B does. Taxation should be imposed only where there are overall net profits. Prior year losses should always be allowed, as shipping companies incur operating losses in about half of all years. And gross basis taxes should never be allowed.

If Alternative B were to be modified in any way, WSC, ICS, and ECSA believe that the only improvement would be if there could be a specific, uniform method for allocating overall net profits to the various jurisdictions in which an international shipping company operates and is subject to source country taxation. Even where only overall net profits are taxed, different allocation methods also can result in excessive taxation.[22] Sourcing/apportioning can be rather complicated because cargo unloaded at a port in one country may be destined for ultimate delivery in one or more other countries. Further, cargo is often transshipped in one country to another ship for ultimate delivery in one or more other countries. A productive change to Alternative B would be to devise rules that would allocate shipping income in a consistent fashion to various countries, thereby specifically addressing the income allocation difficulties raised in the Article 8 Commentary by the proponents of Alternative B.[23]

<u>Shipping container rentals and certain investment income</u>

Finally, the March 2023 Subcommittee Note also raises the possibility of whether shipping container rentals and certain investment income should be covered under article 8 or under another article of the UN Model. The Article 8 Commentary provides that profits from the lease of containers are usually directly connected or ancillary to the operation of ships and are

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[19] It should be noted that the first example is a much more likely scenario than the second scenario, given the frequency with which shipping companies post operating losses or de minimis profits. It would be a rare year for a 2.5% freight tax to be less than a 30% corporate income tax on net income.
[20] The effective tax rates are so high in these type of situations that significant double taxation relief, such as through foreign tax credits, typically is not available, as a practical matter.
[21] *See* note 7 *supra* and accompanying text.
[22] *See* notes 6 and 9 *supra* and accompanying text.
[23] *See* note 9 *supra* and accompanying text.

covered by article 8. This includes profits from the short-term storage of containers (e.g., where the shipping company charges a customer for keeping a packed container in a warehouse pending delivery ("demurrage" charges)) or from "detention" charges for the late return of containers.[24] Similarly, investment income integrally connected to carrying on a shipping business is covered by article 8 (e.g., interest on working capital or from posting security legally required to carry on the shipping business).[25]

WSC, ICS, and ECSA believe strongly that this income should be covered by article 8. Container rentals, particularly detention and demurrage charges, are every day, necessary charges for carrying on a container shipping business. The same is true for interest on working capital and the like. One cannot operate a container shipping business without deriving these types of income on a daily business. They should be treated like other types of shipping income.

Not all countries agree with this treatment.[26] Our members have had some very difficult experiences in this regard in certain countries, particularly in respect of detention and demurrage charges. Certain countries assess very high rates of taxes, including gross basis taxes, on such income. In some countries, the gross basis taxes are an astonishingly high 20-30%. WSC, ICS, and ECSA recommend that income from such activities, because they are part and parcel of the everyday business of a shipping company, should be treated as international shipping income under article 8 of the UN Model.

If you have any questions or would like to discuss, please contact Kenneth Klein at Mayer Brown LLP at kklein@mayerbrown.com or at +1 312 493-2342.

Attachment

[24] Article 8 Commentary ¶ B.13(9).
[25] *Id*. ¶ B.13(14).
[26] *See id*. ¶ B.14 and the March 2023 Subcommittee Note at 6.