December 2, 2019

OECD SECRETARIAT PUBLIC CONSULATION

(8 November 2019 – 2 December 2019)

"Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two"[1]

Submission by: The World Shipping Council ("WSC"), the International Chamber of Shipping ("ICS"), the European Community Shipowners' Associations ("ECSA"), and the Cruise Lines International Association ("CLIA")[2]

WSC, ICS, ECSA, and CLIA hereby submit preliminary[3] comments to the Tax Policy and Statistics Division of the OECD Centre for Tax Policy and Administration, in response to the OECD November 2019 Pillar Two Public Consultation Document. WSC, ICS, ECSA, and CLIA respectfully request that the shipping industry be carved out from the GloBE proposals because application thereof (1) would be inconsistent with and defeat the purpose of a long established (100 year) practice and principle of taxation of shipping income only by the country of residence and (2) would be inconsistent with, and undermine the purpose of, the enactment by many OECD and other countries, for nontax policy reasons, of special shipping tax regimes intended to bolster the countries' maritime sectors (which have been approved by the OECD).

International Taxation of Shipping Income

Shipping companies engaged in international trade derive almost all of their revenues from the carriage of cargo or passengers on the high seas, outside the territory of any country. However, because cargo and passengers must be loaded or unloaded in a port, or inland in the case of certain cargo, such as cargo shipped in shipping containers, shipping companies can derive income from dozens and often more than 100 countries. Because of the high probability of multiple and duplicative taxation, and extreme administrative complexity, special shipping tax regimes have been developed under which shipping profits are taxed only in the country of residence, even if the shipping company has a permanent establishment in other countries (which is often the case). While some countries do tax international shipping income,[4] taxation only by the country of residence has become almost an international norm. This norm is implemented by the widespread use of reciprocal income tax exemptions for shipping companies and airlines in comprehensive income tax

[1] "OECD November 2019 Pillar Two Public Consultation Document."

[2] WSC is the global trade association for the international liner shipping industry. ICS and ECSA are, respectively, the global and European trade associations for shipowners and operators (representing all sectors and trades). CLIA is the trade association of the cruise passenger transport industry.

[3] These preliminary comments should be treated as a draft, pending feedback from the OECD Secretariat, as discussed on October 14, 2019, and final approvals from our members.

[4] For example, some countries impose freight taxes on outbound or inbound freight. Further, many countries and other jurisdictions, in lieu of income taxes, impose a variety of charges such as departure taxes, user fees, and harbor taxes. In the case of a cruise line, for example, taxes and these other charges constitute more than 15% of net income.

treaties, domestic law, and limited income tax treaties or diplomatic exchanges of notes addressing the taxation of shipping and airlines only.

Application of the GloBE proposals – whether it be the income inclusion rule (or "top-up tax"), the "undertaxed payments rule" (denial of deductions or imposition of source based taxation), or the "subject to tax rule" (imposing withholding or other taxes) – would, in a manner similar to the proposed "Unified Approach" of Pillar One, subject a shipping company to multiple taxation, and extreme administrative complexity, in potentially over 100 countries in a manner inconsistent with, and defeating the purpose of, the long established (100 year) practice and principle of residence based taxation only for international transportation.[5]

Domestic Taxation of Shipping Income

In the country of residence, shipping companies are usually subject to one of three types of tax regimes. First, in many countries, the regular corporate income tax applies. Because shipping companies annually invest billions of dollars in ships, related equipment, and working capital, and because shipping revenues are highly cyclical,[6] shipping companies subject to regular corporate income tax often have substantial net operating loss carryovers. Second, in a "tonnage tax" regime under a regular corporate income tax statute, all expenses (e.g., depreciation, crew, fuel, and other operating expenses, and loss carryovers) are disallowed and the regular corporate income tax is imposed on a deemed or "notional" amount of net income, based upon the tonnage of the vessel. Third, in a shipping income exemption system, all of these expenses also are disallowed and no corporate income tax is imposed.

Special shipping tax regimes have been enacted by many OECD and other countries for "significant non-tax" policy reasons,[7] all intended to bolster their maritime sectors.[8] These countries have determined that having a domestic shipping fleet (and related maritime infrastructure) is important to the countries' economies and that financial incentives, including tax incentives, are needed to maintain employment and maritime know-how and to address strategic and national defense concerns. These policies, under national and international standards, also address other factors, such as vessel registration, regulatory arrangements, manning requirements, and seafarer training.[9]

In the United States, in addition to a tonnage tax incentive, subsidy payments are made, with both measures intended to encourage ownership of US flag ships crewed by US citizens for use in times of war and national emergency.[10]

The European Union has determined that special shipping tax regimes constitute legitimate state aid, and have supported the regimes, which have the aim of encouraging safe,

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[5] The shipping industry is a very capital intensive industry, with large expenses for capital, interest, and operating expenses. Even a small withholding tax on a shipping company's turnover often could exceed the company's entire net profits.

[6] For example, from 2008 through the second quarter of 2019, liner shipping companies posted negative net operating margins in 25 of 44 quarters. *Alphaliner Weekly Newsletter*, issue 37 (Sept. 4-10, 2019).

[7] OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: Final Report,* para. 84 (2015) ("2015 OECD Transparency and Substance Report").

[8] The OECD in 2004 provided an excellent summary of these regimes, their purposes, and their operation. OECD, *Consolidated Application Note – Guidance in Applying the 1998 Report to Preferential Tax Regimes*, chapter VIII: Shipping (2004).

[9] *Id*. at 78.

[10] See https://www.maritime.dot.gov/national-security/strategic-sealift/maritime-security-program-msp; S. Rep. No. 104-67 (1995); H.R. Rep. No. 104-229 (1995); H.R. Rep. No. 108-548, at 177 (2004).

efficient, secure, and environmentally friendly maritime transport, encourage the flagging or re-flagging to Member States' register, and improving maritime know-how, employment, and working conditions.[11]

In Singapore, various Singapore government authorities have set in place a variety of frameworks to allow shipping businesses to reliably locate and operate with confidence from Singapore. These frameworks include (but are not limited to) stable government policies,[12] a reliable legal system,[13] access to capital markets, a well-respected flag and ship registry, stringent maritime standards and controls (crewing, safety, bunkering, environmental, etc.), and advanced piracy detection and response initiatives.[14] These factors operate together with shipping tax incentives to encourage the Singapore maritime sector.

For many maritime countries, receipts of foreign income encouraged by the special shipping tax regimes is a significant factor in maintaining balance of payments equilibrium.[15] In Europe more generally, according to ECSA, 76 percent of the EU's trade is transported by shipping and various tax and nontax shipping incentives ensure the security of supplies in energy, raw materials and staple goods, while at the same time preventing the decline of the shipping fleet, encouraging flagging of vessels in national registries, stabilizing or improving employment opportunities for seafarers, encouraging investments in education, know-how, safety, and environmental performance, and improving the economy. [16]

As recently as July 2019, the OECD, in again approving shipping tax regimes under the BEPS Action 5 harmful tax practice survey, stated that "[t]he determination of substantial activity in the context of shipping regimes recognizes the significant core generating activities within shipping are performed in transit outside of the jurisdiction of the shipping regime, and that the value creation attributable to the core income generating activities that occur from a fixed location is more limited than for other types of regimes for mobile business income.[17]

Finally, as a result of BEPS Action 5,[18] and related European Union Code of Conduct directives,[19] companies in low or no tax jurisdictions cannot be utilized unless there are

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[11] *Commission Communication C (2004) 43 – Community guidelines on state aid to maritime transport, 13 Official Journal of the European Union* No. 3 (2004).

[12]The Effectiveness of Port-City Policies: A Comparative Approach, OECD Regional Development Working Papers, 2013/25, chapters 5 and 6.

[13] For example, including setting up a chamber of maritime arbitration and promoting arbitration as an alternative dispute resolution mechanism. See https://www.scma.org.sg/.

[14] See https://www.mindef.gov.sg/web/portal/mindef/news-and-events/latest-releases/article-detail/2019/May/14may19_fs.

[15] For example, in the case of Denmark, see Statistics Denmark, International Trade in Services (2019) at https://www.dst.dk/en/Statistik/emner/udenrigsoekonomi/udenrigshandel/udenrigshandel-med-tjenester.

[16] An Oxford Economics study estimated that in 2015 the shipping industry contributed directly €57 billion to the EU's DGP and employed 640,000 people, of whom 331,000 were EU nationals. The 2015 direct and indirect contribution was estimated to be €147 billion. Oxford Economics, *The economic value of the EU shipping industry* (2015).

[17] OECD, *Harmful Tax Practices – Peer Review Results* 17 (July 2019). In addition, the OECD noted that shipping tax regimes are designed to ensure that taxpayers meet corporate and regulatory obligations, such as International Maritime Organization ship registration, customs, and crewing requirements. *Id*.

[18] See 2015 OECD Transparency and Substance Report, chapter 4.

[19] See Council of the European Union, *Code of Conduct (Business Taxation) – Scoping paper on criterion 2.2 of the EU listing exercise,* FISC 274 ECOFIN 657 (June 22, 2018).

substantial activities with economic substance taking place in such jurisdictions; i.e., in the case of shipping, core income generating activities such as managing the crew, maintaining ships, overseeing and tracking deliveries, and organizing and overseeing voyages.[20] Numerous countries, such as Bermuda, the British Virgin Islands, Barbados, and the Marshall Islands, have enacted such economic substance legislation and regulations in the last few years.

Application of the GloBE proposals (the top-up tax, the undertaxed payments rule, and the subject to tax rule) would subject shipping companies in special shipping tax regimes to multiple taxation in numerous countries in a manner that would be inconsistent with, and undermine the purpose of, these special shipping tax regimes. Shipping companies have subsidiaries or branches in other jurisdictions for numerous nontax reasons.[21] And consider the illogic of the following not uncommon example: Parent company has vessels subject to a domestic special shipping tax regime (e.g., in France, Germany, or Denmark) and has two foreign subsidiaries subject to their own domestic special shipping tax regimes (e.g., in the US or Singapore). The top-up tax proposal could require the country of the parent company to tax the shipping income of the two foreign subsidiaries, even though the country of the parent company is giving special shipping tax treatment to the parent company. The special shipping tax regimes of the countries of the two foreign subsidiaries would be undermined.

Proposed Shipping Industry Pillar Two Carve-Out

Pillar Two is intended to provide a minimum tax rate to reduce the incentive for taxpayers to engage in profit shifting and to establish a floor for tax competition among jurisdictions.[22] In shipping, this incentive does not exist as the overwhelming majority of shipping income is earned on the high seas, not within the jurisdiction of any country, which makes shipping unlike almost any other industry. Shipping income is subject to tax in the country of residence, as described above, which provides a genuine tax link that functions as a standalone principle for the effective taxation of shipping income.

The OECD November 2019 Pillar Two Public Consultation Document contemplates the possibility of carve-outs from the GloBE proposals, including for regimes compliant with the standards of BEPS Action 5.[23] WSC, ICS, ECSA, and CLIA respectfully request that the shipping industry be carved out from application of Pillar Two because not to do so (1) would be inconsistent with, and defeat the purpose of, the long established (100 year) practice and principle of taxing shipping income only in the country of residence and (2) would undermine the significant economic development and defense policy reasons that led to the creation of the special shipping tax regimes. We respectfully request that income from the operation of a ship in international traffic (within the meaning of the article 8 of the OECD Model Income Tax and in Commentary Convention) be excluded from the top-up tax, the undertaxed payments rule, and the subject to tax rule.

As further support for this approach, the OECD November 2019 Pillar Two Public Consultation Document contemplates reductions in the top-up tax for certain permanent differences between income computed under financial accounting standards and under income tax rules.[24] A more complicated approach to a shipping carve-out would be that a)

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[20] 2015 OECD Transparency and Substance Report, paras. 84-85.

[21] See Menor Economics & DNV GL, *The Leading Maritime Capitals of the World 2019*.

[22] OECD November 2019 Pillar Two Public Consultation Document, para. 7.

[23] *Id*. at paras. 73-74.

[24] *Id*. at paras. 24-30.

income derived in special shipping tax regimes that (i) have been approved by the OECD as not harmful or (ii) approved by the EU as not constituting illegal state aid, b) income derived in a special shipping tax regime that is substantially similar to (i) or (ii) (e.g., the US tonnage tax), and c) shipping income derived in exemption systems that satisfy OECD economic substance standards, should be excluded from the top-up tax of GloBE as permanent differences. Similarly, in respect of the undertaxed payments rule and the subject to tax rule of GloBE, payments made to shipping companies in special shipping tax regimes (i) should be deductible by the payor and (ii) should not be taxed (including no withholding taxes) to the payee if (iii) the payment in the hands of the recipient qualifies for (a) a special shipping tax regime or (b) a reciprocal treaty or other residence based only tax regime. All such income and payments should be viewed as "minimum effective tax rate compliant."

Finally, the OECD November 2019 Pillar Two Public Consultation Document also contemplates the possibility of a carve-out for a return on tangible assets,[25] in a manner apparently similar to that in the so-called "GILTI" regime in the United States. WSC, ICS, ECSA, and CLIA support such a carve-out, although not as a substitute for a shipping industry carve-out, but in addition to a shipping industry carve-out. The shipping industry annually invests billions of dollars in ships and related equipment. A return on tangible asset carve-out should be based on amortized cost for financial reporting purposes, which generally looks at the expected useful life of the property (as opposed to adjusted tax basis). The use of adjusted tax basis would be inappropriate, at least in the case of vessels, because many countries provide for depreciation (amortization) schedules shorter than useful life. A 10-15% rate of return would be appropriate. The rate of return computation should be able to be done on a consolidated, rather than on a separate entity, basis. It would be very important for such a carve-out to allow leasehold interests in tangible property (e.g., in the form of ship leasing or bareboat chartering of vessels) to be treated as owned for this purpose.

[25] *Id*. at para. 74.

OECD Questions with Proposed Responses
December 2, 2019

In response to the questions you provided following our meeting October 14, we provide the following information.

1. Do you have any written material you could provide us that describes the various types of tonnage taxes (or equivalent taxes) imposed on international shipping? Is there an equivalent tax for the airline industry?

    - **Ernst & Young Shipping Almanac Provided**
    - **G. Maisto, Taxation of Shipping etc. referenced**
    - **OECD (2004) Consolidated Application Note**
    - **We are not aware of tax regimes equivalent to tonnage tax regimes in the airline industry.**

2. If tonnage taxes were treated as creditable taxes for purposes of determining the top-up tax liability, what would be the average effective rate of tax on financial net income for industry participants?

    - **As discussed in our call on Thursday, November 14, that this would be impossible to determine without considerable effort because tonnage and port taxes generally are included in operating expenses (even though tonnage taxes are income taxes).**

    - **Even if tonnage taxes alone were readily available, because they are imposed irrespective of profitability, the effective tax rate or the average effective tax rate would fluctuate wildly.**

3. How difficult would it be, as a practical matter, for taxpayers and tax administrations to calculate and verify an MNE's periodic liability for tonnage taxes based on the information available on the financial statements.

    - **Under International Financial Reporting Standards and United States Generally Accepted Accounting Principles, both tonnage taxes and taxes such as port-related or port-imposed taxes generally are included in operating expenses, even though tonnage taxes are corporate income taxes. Consequently, all are generally excluded from the income taxes disclosed in the financial statements. Information concerning the fact of their imposition is likely to be included in the financial statement notes. However, information from which the amount of all of these taxes may be estimated is generally not available in the financial statement footnotes.**

    - **We also note that many shipping companies are privately held and, consequently, the information available for those entities will be limited since the full disclosure required of publicly traded companies is not required.**

- **Determination of a company's liability for tonnage taxes and the associated income would likely require a dissection of the financial statements on an entity by entity basis and, within each entity a further analysis of income within and without the tonnage tax scope for each jurisdiction. Local taxes (e.g. freight taxes, port taxes, etc.) would also have to be extracted from the voyage accounting systems to provide a full picture of the taxes associated with the income in which the OECD is concerned. We also note that other conditions to participate in a tonnage tax regime may be imposed, such as cadet training, the cost of which are not included.**

4. Recognizing that tonnage taxes may yield volatile results when compared to actual net income in each year, could a carry-forward of taxes paid in excess of the minimum tax rate be devised to address that volatility?

    - **The carryforward of tax would be of little use because of the nominal nature of the taxes paid. This is because the numerator, the tax paid, is a fixed amount, while the denominator, earnings before income taxes, fluctuates fare more significantly in dollar terms. Stated differently, a tax of 1x might be due when a company incurs a loss of 1x or a loss of 1,000x and a carryforward of the tax alone does not reflect the appropriate economic charge against future profits subject to a top-up tax. The industry believes that a loss carryforward would be more appropriate if this is the course the OECD takes.**

5. To what extent would a carve-out for a return on tangible assets similar to the GILTI exclusion alleviate the need for specific rules for the shipping or airline industry?

    - **This is something to be considered. However, the nature of the business is that often assets are leased and some of the leases do not qualify as "capital" leases for accounting purposes. We note that for US State Income Tax Apportionment purposes, rent paid for capital assets times a multiplier is an accepted method.**

    - **We also note that for earnings from vessels to be subject to tonnage tax, they need not necessarily be owned or treated as capital assets. E.g. under the European tonnage tax regimes, tonnage tax is due on time chartered or bareboat chartered vessels based on tonnage, days in use and tax rate.**

    - **Similarly, under local GAAP in some countries (e.g. Japan), many leases that are capitalized in other jurisdictions are operating leases for which no carve out would be allowed unless capitalization or some factor-based capitalization is allowed.**

    - **Example – income inclusion rule**

      Company A has a foreign subsidiary B (tonnage taxed), that is leasing (bareboat-chartering) a vessel from (unrelated) company X. B is responsible for crewing, and is time-chartering the vessel to (unrelated) company Y. If

company B is not the owner of the vessel for income tax purposes, it will not qualify for a 10 per cent

(GILTI) deduction of the vessels value (if owned and leased vessels are not treated equally). Consequently, it is likely that the company will be subject to tax due to the income inclusion rule.

- **Example – subject to tax rule**

  Company X is leasing a vessel to (unrelated) company A (tonnage taxed), that is responsible for crewing, and is time chartering the vessel to a foreign affiliated company B (tonnage taxed). The payments from B to A can be within the scope of the subject to tax rule (subject to low/zero tax). If company A is not the owner of the vessel for income tax purposes, it will not qualify for a 10 per cent (GILTI) deduction of the vessels value (if owned and leased vessels are not treated equally). Consequently, it is likely that the payment will be subject to withholding tax / not deductible / no treaty benefits etc.

6. What effect did GILTI and other U.S. international tax reform have (or not have) on the shipping and airline industries?

   - **The application of GILTI, as with the former exemption for reinvested shipping assets under subpart F in the United States, depends on the regularity of ship reinvestment programs. The application of GILTI to U.S. controlled shipping companies varies but they will typically have at least some, and sometimes substantial, GILTI inclusions. The basis for calculation is the vessels' adjusted tax basis, meaning that ships are depreciated over 18 years (rather than 25-30 years generally used for financial statement purposes), far less than their useful life. As a result, if the timing of fleet replacement is uneven, the 10% return often does not prevent GILTI inclusions. Further, leased vessels are usually not treated as owned for tax purposes, further reducing the amount of tangible vessels.**

7. At the meeting, several industry representatives mentioned that Denmark had developed special rules for the treatment of shipping under its CFC rules. Can you briefly explain the issue under the Danish CFC rules, and how Denmark addressed it?

   - **This information is attached.**

We would be happy to have a call to clarify the questions if necessary. Once we have your answers, we could arrange a follow-up call or meeting, as you prefer.

Attachments:

Danish CFC regime explanation

Danish CFC regulations and shipping

The Danish CFC regulations stipulate that when a controlled foreign company's financial income exceeds a certain percentage of the total taxable income, the controlling company's share of the full income of the company calculated according to Danish tax regulations is taxed in the hands of the controlling company.

Credit is given for any underlying foreign corporate tax paid.

In the case of controlled foreign shipping companies eligible for a tonnage tax or other specific tax regime in its country of residence, the computed Danish corporation tax on EBT according to the general rules might potentially be significantly higher than the foreign tax paid by the foreign company. This would give rise to a significant Danish tax liability. The computed tax may also be significantly higher than the tax which would have been paid by a Danish shipping company under the tonnage tax regime. It could be considered discriminatory or inequitable to tax foreign activities at a higher effective tax rate than domestic activities. In response to a question from the Danish Shipowners' Association, the Danish Tax Ministry has confirmed that a controlled foreign shipping company's taxable income may be computed according to the rules of the Danish tonnage tax regime. This may give rise to additional tax in Denmark, but the combined effective tax rate will not exceed that of a Danish shipping company subject to the tonnage tax regime.