# Impact of BEPS 2.0 Pillar Two on international shipping business

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## In brief

The OECD released the BEPS 2.0 Pillar Two Global Anti-Base Erosion (GloBE) Model Rules[1] on 20 December 2021 which introduced a global minimum tax of 15% applicable to Multinational Enterprises (MNEs) with global revenue of EUR 750 million or more from 2023. The Commentary to the GloBE Rules[2], which provides technical guidance and elaborates on the application and operation of the GloBE Rules, was released on 14 March 2022.

Among others, the GloBE Rules provide an exclusion of International Shipping Income and Qualified Ancillary International Shipping Income. In order to qualify for the exclusion, a Constituent Entity 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.

Shipping groups with establishments in Hong Kong should take action now to assess the potential impact of the GloBE Rules on their different streams of income and whether their commercial substance is aligned with shipping income derived in Hong Kong.

## In detail

### International Shipping Income exclusion from GloBE Rules

The international shipping industry has long been subject to industry-specific tax rules. Due to the unique features of global shipping tax regimes, the GloBE Rules provide an exclusion of International Shipping Income and Qualified Ancillary International Shipping Income from the computation of GloBE Income or Loss. The Commentary to the GloBE Rules released on 14 March 2022 provides detailed guidance in this regard. In short, International Shipping Income and Qualified Ancillary International Shipping Income, as elaborated below, derived by a Constituent Entity shall be excluded from the computation of the GloBE Income or Loss for the jurisdiction in which it is located.

**International Shipping Income**

In line with the OECD Model Tax Convention, primary exclusion is given to net income from the transportation of passengers or cargo by ships in international traffic. However, transportation by ships within the same jurisdiction is not excluded. Other categories of profits in respect of the operation of ships also benefit from the exclusion, including slot-chartering, chartering of fully equipped, crewed and supplied ships, intragroup bare boat chartering, participating in a pool, a joint business or an international operating agency for the transportation of passengers or cargo by ships and sale of qualifying ships.

**Qualified Ancillary International Shipping Income**

The exclusion also applies to Qualified Ancillary International Shipping Income not exceeding 50% of all Constituent Entities' International Shipping Income derived in the same jurisdiction, which covers certain types of bare boat chartering, ticket sales, container leasing, engineering maintenance services and ancillary investment income.

The types of shipping income and ancillary income covered by the exclusion are indeed subject to complex rules and restrictions. MNE Groups should analyse whether the exclusion is applicable to their different streams of income.

It is worth noting that in order to qualify for the exclusion, a Constituent Entity must also demonstrate that the strategic or commercial management of all ships concerned is effectively carried on from within the jurisdiction where the entity is located. The strategic or commercial management activities required should be determined on the basis of the relevant facts and circumstances case by case.

### Potential impact on shipping groups enjoying shipping tax regimes or other tax concessions in Hong Kong

Section 23B of the Inland Revenue Ordinance (IRO) offers profits tax exemption in Hong Kong for ship operating income, subject to certain specified conditions. Tax concessions are also given to qualifying ship lessors and ship leasing managers under Section 14P and 14T. In anticipation of the upcoming implementation of global minimum tax, shipping groups should assess whether their shipping income currently enjoying profits tax exemption or tax concessions in Hong Kong can fall within the definition of International Shipping Income or Qualified Ancillary International Shipping Income for the exclusion from GloBE Rules. Otherwise, income not qualifying for the exclusion may possibly be subject to a 15% minimum tax in the future under the GloBE Rules or the domestic minimum top-up tax to be introduced in Hong Kong, as announced by the Financial Secretary in the 2022/23 Hong Kong Budget.

For the purpose of enjoying tax concessions under the shipping or ship leasing tax regime in Hong Kong as well as to fulfil the exclusion requirements under the GloBE Rules, it is important to have sufficient business substance in Hong Kong that is aligned with the shipping profits earned in Hong Kong. The substance condition imposed in the GloBE Rules is consistent with the tax concessionary regimes in Hong Kong and many other jurisdictions in order to establish an economic link between the shipping company and the jurisdiction of the shipping tax regime.

## The takeaway

Shipping groups whose global revenue reaches the EUR 750m threshold, in particular those with establishments in Hong Kong enjoying tax exemption or concessions, should take action now to assess the potential impact of the GloBE Rules on their different streams of income, i.e. whether or not such income falls within the scope of exclusion under the GloBE Rules. In order to qualify for International Shipping Income exclusion as well as local tax concessions, they should ensure their commercial substance is aligned with shipping income derived in Hong Kong.

It is important to note that even where the income qualifies as excluded International Shipping Income or Qualified Ancillary International Shipping Income, the MNE group will still be required to fulfil the relevant compliance obligations. In case the group also has other income that is not excluded, the other implications arising from the excluded income (e.g. exclusion of payroll costs and tangible assets attributable to excluded income) should be borne in mind.

## Endnotes

1. For details of the GloBE Model Rules, please refer to our *International Tax News Flash, January 2022, Issue 1*, which can be accessed via this link:
   https://www.pwccn.com/en/tax/publications/intl-tax-newsflash-jan2022-1.pdf

2. For details of the Commentary to the GloBE Rules, please refer to our *International Tax News Flash, April 2022, Issue 4*, which can be accessed via this link:
   https://www.pwccn.com/en/tax/publications/intl-tax-newsflash-apr2022-4.pdf

## Let's talk

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