taxnotes® international

Volume 118, Number 17 ■ April 28, 2025

Pillar 2 Makes Waves for Vessel Sales and Shipping Income

by Karl Berlin

Reprinted from *Tax Notes International*, April 28, 2025, p. 513

Pillar 2 Makes Waves for Vessel Sales and Shipping Income

by Karl Berlin

Karl Berlin

Karl Berlin is a partner with CORIT Advisory in Kongens Lyngby, Denmark.

In this article, Berlin explains the potential difficulties in taxing shipping income and vessel sales under the OECD's pillar 2.

Introduction

The international shipping industry plays a pivotal role in global trade. Although vessels are held or controlled in different ways, it is primarily through ownership or leasing arrangements. Among the options, bareboat charter agreements are notable for granting operational control to the charterer (lessee) while the lessor retains legal ownership. Under international financial reporting standards, vessels leased for extended periods are classified as assets in the lessee's accounts, reflecting the entity's control of the economic resource.[1]

Charter agreements frequently include purchase options, allowing the charterer to acquire legal ownership of the vessel during or after the hire period. This influences the shipping industry, in which the sale and purchase of vessels is integral to maintaining modern and efficient fleets. Shipping companies often divest older vessels to invest in newer, more efficient models, to adapt to market demands, and to manage capital effectively.

Proceeds from the sale and purchase of vessels are typically included in shipping tax regimes, treated as an integral part of the business. However, the introduction of the OECD pillar 2 global anti-base-erosion (GLOBE) model rules[2] has imposed restrictions on when proceeds fall in scope of the international shipping income exclusion. This regulatory shift could create mismatches with European tonnage tax regimes, presenting a challenge for the industry and tax administrations.

Scope of Shipping Income Exclusion

Under pillar 2's article 3.3.1, a constituent entity's international shipping income is excluded from computation of its GLOBE income or loss for the jurisdiction in which it is located. Article 3.3.2 defines international shipping income as net income obtained by the constituent entity from certain activities including "the sale of a ship used for the transportation of passengers or cargo in international traffic, provided that the ship has been held for use by the constituent entity for a minimum of one year."

According to OECD pillar 2 commentaries,[3] this exclusion for international shipping also applies to capital gains or losses on the sale of qualifying ships used for the transportation of passengers or cargo in international traffic. However, there is a minimum holding period of one year "to prevent ship trading activities from qualifying for the exclusion."[4]

According to the commentaries, ships purchased with a view to reselling are usually

[1]IFRS 16; *see also* IFRS Conceptual Framework for Financial Reporting, paragraph 4.3.

[2]OECD, "*Tax Challenges Arising From the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two)*" (2021).

[3]OECD, "*Tax Challenges Arising From the Digitalisation of the Economy — Consolidated Commentary to the Global Anti-Base Erosion Model Rules (2023)*" (2024).

[4]*Id.* at 159.

recorded as inventory in the financial accounts under International Accounting Standard 2. Gains or losses on the sale of these ships, when the holding period is not met, do not qualify for the exclusion.

The commentaries further state that:

> Legally owned ships used for international shipping operations are recognized as Property, Plant & Equipment assets in the financial accounts under IAS 16 if they are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and are expected to be used during more than one period. Capital gains (or losses) on the sale of such ships recognized as Property, Plant & Equipment assets in the financial accounts would qualify for the exclusion, provided that they have been recorded as being held for use in the financial accounts of the Constituent Entity for one year or more.[5]

The question therefore arises as to whether pillar 2 requires that the vessel has been legally owned for a minimum of one year before it is sold by a shipping company, or if a situation in which a shipping company has held the vessel through a bareboat charter agreement with a purchase option for a number of years, and then exercised the purchase option, only to sell it within one month, would also be covered by the income exclusion.

The Specifics of Bareboat Charter Agreements

Under a bareboat charter agreement, the charterer assumes full control of a vessel, which is provided without crew or supplies. These agreements are occasionally referred to as "dry leases."

Under Barecon 2017, the most recent standard template from the Baltic and International Maritime Council (BIMCO) for bareboat charter agreements, the charterer is obligated, at its own expense, to secure the necessary permits and licenses. Also, the charterer must ensure that the vessel complies with safety standards, adheres to environmental regulations, and observes international maritime conventions. Typically, the charterer is responsible for maintenance and repairs throughout the charter period. Further, the charterer must obtain and maintain adequate insurance coverage, including hull and machinery insurance.

Should structural modifications or the installation of new equipment be required for the vessel's continued operation, these responsibilities also fall to the charterer. The charterer is permitted to paint the vessel in its own livery, install and display its funnel insignia, and fly its own house flag. With the owners' permission — not to be unreasonably withheld — the charterer may change the name of the vessel. Moreover, the charterer may, at its own expense and risk, fit the vessel with additional equipment.

A bareboat charter provides the charterer with many of the operational responsibilities and freedoms associated with ownership. However, it does not confer legal title or the long-term financial commitments that come with actual ownership of the vessel.

The Concept of an Asset Under IFRS

Pillar 2 rules specify that a vessel must "have been held for use" to qualify for the income exclusion. The ordinary interpretation of held for use implies control over the asset, but it does not necessitate legal ownership.

However, as mentioned above, the commentaries address legal ownership, albeit in a slightly different context, explaining that legally owned vessels can be recorded under either IAS 16 or IAS 2. This could indicate that it is merely a remark on the accounting treatment of legally owned vessels.

Notably, the commentaries seem to overlook IFRS 16, which governs the accounting for leased assets. This omission is significant given the prevalence of leasing in the shipping industry. Under IFRS 16, lessees must recognize a right-of-use asset and a corresponding liability on the balance sheet for all leases, except for short-term and low-value leases. The right-of-use asset represents the lessee's right to use the underlying asset for the lease term, measured at the present value of lease payments.

[5] *Id.*

The IFRS conceptual framework defines an asset as a present economic resource controlled by the entity as a result of past events.[6] Control, rather than legal ownership, is the critical factor. An economic resource is a right that has the potential to produce economic benefits.[7] Rights that produce economic benefits can take many forms, including rights over physical objects and rights to use these objects.[8] An entity controls an economic resource if it has the present ability to direct its use and obtain the economic benefits that may flow from it.[9]

While IAS 16 addresses the recognition and measurement of controlled assets in general, IFRS 16 focuses on recognizing assets and liabilities arising from leasing agreements. Leased assets are still considered assets and are used in the entity's business to produce income, similar to property, plant, and equipment.

The phrase "held for use" appears in IAS 16, while IFRS 16 uses "right to use." However, the effect is the same under both standards: An item is recognized as an asset because it is used in the entity's business to produce income.

Under a bareboat lease, charterers may be required to upgrade or modify the vessel. These costs are capitalized and accounted for under IAS 16, meaning the entire asset may be reflected on the charterer's balance sheet, albeit partly under IFRS 16 and partly under IAS 16.

In scenarios in which a vessel has been on a bareboat charter for many years, and the charterer has made structural modifications and fitted new equipment, a complex situation may arise if pillar 2 requires a legal ownership period of at least 12 months. If the charterer exercises a purchase option but sells the vessel a few months later, determining which parts of the vessel qualify for the exemption becomes challenging, especially when there is no indication that ship trading was the purpose of the transactions.

The EU State Aid Dimension

Within the EU, another dimension to consider is the state aid rules in articles 107-109 of the Treaty on the Functioning of the European Union. The rules generally prohibit any aid granted by a member state or through state resources that distorts or threatens to distort competition. This can happen by favoring certain undertakings or the production of certain goods, as long as it affects trade between member states. The prohibition maintains a level playing field and prevents EU market distortions.

However, the TFEU also recognizes that in some circumstances government interventions are necessary for a well-functioning and equitable economy. Therefore, it allows for some instances in which state aid can be considered compatible with the internal market.

The European tonnage tax regimes qualify as state aid that may be compatible with the internal market. The framework for state aid within the maritime transport sector is extensively laid out in Commission Communication C(2004) 43. This means that an EU country wishing to introduce a tonnage tax regime, or change the regime if already in place, must seek approval from the European Commission according to TFEU article 108(3). The detailed rules for applying TFEU article 108 are laid down in Council Regulation (EU) 2015/1588 (state aid regulation), which includes a formal, detailed notification procedure as well as a preliminary examination by the commission to determine whether the measure constitutes aid and, if so, whether it is compatible with the internal market.

As regards the State aid regulation, according to article 1(c), new aid is defined as aid not already existing, including alterations to existing aid. According to article 1(f), unlawful aid is defined as new aid (including alterations to existing aid) put into effect without following the required procedure. The standstill clause in article 3 prohibits putting notifiable aid into effect before the commission has made, or is deemed to have made, a decision authorizing the aid.

According to TFEU article 288, regulations are directly applicable in all EU member states without the need for national implementing legislation (direct effect). This means that

[6]IFRS Conceptual Framework for Financial Reporting, paragraph 4.3.

[7]*Id.*, paragraph 4.4.

[8]*Id.*, paragraph 4.6.

[9]*Id.*, paragraph 4.20.

individuals and companies can invoke EU regulations directly before national courts.

Within the EU, pillar 2 rules have been implemented through Council Directive (EU) 2022/2523 (minimum tax directive) and subsequent national implementing acts. In the minimum tax directive, the international shipping income exclusion is found in article 17, where the wording regarding when a sale of a ship is included in this income exclusion exactly mirrors pillar 2 commentary wording.

If EU tonnage tax regimes include the sale of vessels within the tonnage tax ring fence, the minimum tax directive and subsequent national implementing acts effectively change the existing state aid by narrowing the scope of application. The question here is whether the narrowing amounts to an unlawful alteration.

Concluding Remarks

Pillar 2 rules introduce significant ambiguities regarding the requirements for when the sale of vessels qualifies for the international shipping income exclusion. The rules' stipulation that a vessel must be held for use for at least one year to qualify for the exemption raises questions about whether this implies legal ownership or merely operational control. This lack of clarity suggests a potential conflation of control with legal ownership, which poses challenges for vessels operated under bareboat charter agreements.

Under these agreements, charterers assume full operational control of the vessel without acquiring legal title. They allow charterers to make substantial investments in the vessel, including structural modifications and equipment upgrades, which are capitalized and recognized in their financial accounts. However, pillar 2 ambiguity regarding the ownership requirement creates uncertainty about the tax treatment of gains or losses in a situation in which a purchase option is exercised, and the vessel is subsequently sold in less than 12 months.

The situation is further complicated within the EU, where the minimum tax directive mirrors pillar 2 rules' wording. The directive's implementation may effectively alter existing state aid regimes by narrowing the scope of the tonnage tax exemption. This raises the question of whether the alterations constitute unlawful aid under EU state aid rules, potentially leading to mismatches between national tax regimes and EU regulations. ■