

Flags of Convenience in the Context of the OECD BEPS Package

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I INTRODUCTION

Ships shall sail under the flag of one state only, and only fly the flag of the state they are entitled to fly.¹ Every state is required to effectively exercise its jurisdiction and control in administrative, technical, and social matters over ships flying their flags.² The flag state, a state whose flag a ship flies,³ is responsible for ensuring compliance with national and international laws and regulations concerning marine pollution and the construction, maintenance, and crewing of the vessel.⁴ Since the middle of the twentieth century, many global shipping companies have flagged ships in foreign countries intent on, for example, eroding corporate tax, avoiding national regulations on labour, environment, or safety, and hiring crews from low-wage countries.⁵ Many merchant ships are registered in a state other than that of the ship owner, and the

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¹See, the United Nations Convention on Conditions for Registration of Ships, Art. 4 adopted on 7 February 1986, TD/RS/CONF/23 (13 March 1986), (hereinafter, "UNCCRS"); Stephen Harwood, *SHIPPING FINANCE*, 3 (3d ed. 2006).

²See, the United Nations Convention on the Law of the Sea of 10 December 1982, Art. 91. (hereinafter, "UNCLOS").

³See, UNCCRS, Art. 2.

⁴Anderson H. Edwin, *The Nationality of Ships and Flags of Convenience: Economics, Politics, and Alternatives*, 21 TUL. MAR. L.J. 139 (1996).

⁵Harwood, *supra* note 1, p. 3.

ship that flies the flag of a country other than the country of ownership is called a flag of convenience ship (FOC).⁶ The flag of convenience is used to describe the flag of a ship whose ownership and control lies outside of the country of the flag.⁷ The flag of convenience has been beneficial for many developing countries, in particular, for the least developed countries.⁸ Globalization has helped to accelerate the use of flags of convenience and each new flag of convenience self-promotes by offering the lowest possible fees and the minimum regulation in an increasingly fiercely competitive global shipping market.⁹ However, ships flying under the flag of convenience are subject to International Workers Federation (ITF) agreements.¹⁰

The flag of convenience is one of a multinational corporation's international tax planning strategies. As corporate tax is levied at the domestic level, the interaction of domestic tax systems sometimes leads to 'double taxation' or 'double non-taxation.'¹¹ Multinational corporations often exploit differences in domestic tax rules and international tax standards, which provide them with opportunities to eliminate or significantly reduce taxation, so many multinational corporations use Base Erosion and Profit Shifting ("BEPS") to erode the corporate tax base.¹² However, there is a concern that base erosion will constitute a serious risk to tax revenues, tax sovereignty, and tax fairness for many countries.¹³ Thus, at the 2015 G20 Antalya summit, the BEPS Plan was

⁶The International Workers Federation (ITF) Seafarers, available at http://www.itfseafarers.org/what_are_focs.cfm.

⁷The International Workers Federation (ITF) Seafarers, *Glossary of Terms* available at <http://www.itfseafarers.org/glossary.cfm>.

⁸*Review of Maritime Transport 2016*, 44 UNCTAD (2017).

⁹The International Workers Federation (ITF) Seafarers, *Defining FOCs and the Problems they Pose*, available at <http://www.itfseafarers.org/defining-focs.cfm>.

¹⁰The International Workers Federation (ITF) Seafarers, *ITF Agreement*, available at http://www.itfseafarers.org/itf_agreements.cfm.

¹¹OECD, *OECD Work on Base Erosion and Profit Shifting*, (hereinafter "OECD BEPS") available at <https://www.oecd.org/ctp/TheOECDworkonBEPS.pdf>.

¹²See id.

¹³OECD, *Addressing Base Erosion and Profit Shifting*, (2013) available at <http://www.oecd.org/tax/beps/addressing-base-erosion-and-profit-shifting-9789264192744-en.htm>.

adopted.¹⁴ The BEPS package is designed to restore fairness to the tax system and is to be implemented domestically and through tax treaty provisions.¹⁵ The BEPS package is the first substantial overhaul of international tax standards in almost a century, and the first common response to international tax challenges by all OECD and G20 member states.¹⁶

This paper will review key issues on the flag of convenience with respect to international tax principles and the global shipping industry. This paper will also review BEPS in the context of international tax strategy and the BEPS Package. This paper will focus on key issues in the BEPS package, in particular CFC rules, and their effect on flags of convenience.

II

FLAGS OF CONVENIENCE IN MODERN GLOBAL SHIPPING INDUSTRIES

A. The Purposes of Flags of Convenience for the Global Shipping Industry

Ships shall have the nationality of the state whose flag they are entitled to fly,¹⁷ and every state exercises its jurisdiction and control in administrative, technical, and social matters over ships flying its flag.¹⁸ Ships flying under a flag of convenience are also subject to the International Workers Federation (ITF) Agreements.¹⁹ How, then, is a “flag of convenience” defined? When the ITF declares a

¹⁴PWC, *Flash News, OECD Action Plan for BEPS – the Package is Final*, (7 October 2015) available at <https://www.pwc.lu/en/base-erosion-profit-shifting/docs/pwc-beps-071015.pdf>

¹⁵OECD, *OECD/G20 Base Erosion and Profit Shifting Project Explanatory Statement 2015: Final Reports*, 4, available at <http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>.

¹⁶See *id.*

¹⁷See, UNCCRS, Art. 4; Harwood, *supra* note 1, p.3.

¹⁸See, UNCLOS, Art. 91.

¹⁹The International Workers Federation (ITF) Seafarers, *ITF Agreement*, available at http://www.itfseafarers.org/itf_agreements.cfm.

registry the flag of convenience, it examines:²⁰ (i) the ability and willingness of the flag state to enforce international minimum social standards on its vessels, including with respect to human and trade union rights, (ii) the flag state's social record focusing on the extent to which it has ratified and enforced International Labour Organization conventions and recommendations, and (iii) the state's safety and environmental record.²¹

Global shipping companies flag ships in foreign countries for many reasons, such as eroding corporate tax, avoiding national regulations on labour, environment, or safety, and hiring crews from low-wage countries.²² Although most developed countries have criticized flags of convenience, ship owners have usually registered ships in the flag of convenience states because those states offer cheap registration fees and low or no taxes, and allow ship owners to employ cheap labour, cutting costs by lowering standards of living and working conditions for crewmembers.²³

The major flag of convenience states normally impose an initial registration fee and annual renewal fee, but do not impose any financial burden on the operating profits arising from the ship's operation. Moreover, the flag of convenience states normally do not impose personal income tax on shareholders or crew residing outside the state, nor withholding tax on dividends paid to non-residents. Such a tax benefit has enabled shipping companies to flexibly respond to the shipping market by securing a smooth cash flow. To solve the problem of flagging out to these flag of convenience countries, traditional shipping countries have expanded financial support, such as tax reductions and government subsidies and provided similar benefits as flags of convenience with respect to vessel tax and national flag ship tax.²⁴

As the global shipping market has become increasingly competitive, global shipping companies are forced to look for the

²⁰See supra note 9.

²¹Factors include whether or not it has ratified and enforced International Maritime Organization conventions.

²²Harwood, supra note 1, p.3.

²³See supra note 9.

²⁴*Study on the Analysis and Evolution of International and EU Shipping Final Report*, iii, U. ANTWERP MARITIME-INSIGHT (September 2015).

cheapest and least regulated environments to operate their vessels in order to remain competitive.²⁵ In such a competitive global shipping industry, globalisation has helped to accelerate the use of flags of convenience and each new flag of convenience self-promotes by offering the lowest possible fees and the minimum of regulation,²⁶ and flags of convenience provide shipowners with an effortless solution.²⁷

B. World Ship Registries in Flags of Convenience

As of 1 January 2016, the vessels registered under a foreign flag comprised 1,252 million DWT (dead weight tonnage) out of a total 1,783 million DWT, i.e. 70.2% of the world's total tonnage.²⁸ 228 million DWT Greek vessels out of a total of 293 million DWT, 200 million DWT Japanese vessels out of a total of 229 million DWT, 85 million DWT Chinese vessels out of a total of 159 million DWT, and 108 million DWT German vessels out of a total of 119 million DWT respectively are registered in foreign countries. (See Table 1.)

²⁵See supra note 9.

²⁶See id.

²⁷See id.

²⁸See UNCTAD, supra note 8, p.44.

Table 1. Ownership of world 10 largest registered fleets as of 1 January 2016

Country	National flag (million DWT)	Foreign flag (million DWT)	Total (million DWT)	Foreign flag percentage (%)
Greece	64.7	228.4	293.1	77.9
Japan	28.8	200.2	229.0	87.4
China	74.1	84.8	158.9	53.4
Germany	11.3	107.9	119.2	90.5
Singapore	61.8	33.5	95.3	35.2
Hong Kong	67.5	19.9	87.4	22.7
Rep. of Korea	16.1	62.7	78.8	79.6
USA	8.2	52.1	60.3	86.5
U.K.	5.2	46.2	51.4	89.8
Bermuda	0.5	48.0	48.5	99.0

(Source: Review of Maritime Transport 2016)

Table 2. Flags of registration with 10 largest registered fleets as of 1 January 2016

Country	Number of vessels	Million DWT	Share of world total DWT (%)	Cumulated share of world total DWT (%)
Panama	8,153	333.4	18.5	18.5
Liberia	3,185	206.4	11.4	29.9
Marshall Islands	2,942	200.1	11.1	41.0
Hong Kong	2,515	161.8	9.0	50.0
Singapore	3,605	127.2	7.0	57.0
Malta	2,101	95.0	5.3	62.3
Bahamas	1,450	79.5	4.4	66.7
China	4,052	75.9	4.2	70.9
Greece	1,386	73.6	4.1	74.9
Cyprus	1,053	33.3	1.8	76.8

(Source: Review of Maritime Transport 2016)

Yet, the world fleet registered in developing countries, including many open registries, exceeds 76% of the total world fleet. Panama, the largest vessel registry with 334.4 million DWT makes up 18.5% of the total world fleet, followed by Liberia with 206.4 million DWT and Marshall Islands with 200.1 million DWT. The tonnage registered in these three countries accounts for 41.0% of world tonnage.²⁹ (See Table 2.)

²⁹See id. p.45.

C. Key issues for Flag of Convenience in the Context of International Tax Standards

The flag of convenience raises several international issues, with taxation among the most significant. Why is taxation at issue with respect to the flag of convenience? Because a paper company for a flag of convenience is established in a foreign country according to the procedures provided for by that flag of convenience and the ship is registered under the name of the paper company to acquire nationality in that foreign country. The issue is whether the vessel's reports to the port of entry for operation correspond to the income, and if the vessel registered with the flag of convenience is operated in accordance with the Customs Act, or by an illegal method.

In terms of taxation, the role of the flag of convenience country is not much different than the role of the offshore financial centre, which is designated or discussed as a tax haven. Yet, despite the widespread acceptance of the flag of convenience facilities, taxation by the principle of real taxation against the flag of convenience vessels, despite the nationality of the vessel's registration, is criticized as placing the marine shipping industry in a worse position in deepened international competition.

The flag of convenience country does not impose any kind of tax on the ship owner's income, except for the traditional registration tax and the small tonnage levied annually. The taxation systems of these flag of convenience countries has been used as a convenient device to allow taxpayers to avoid the burden of taxation when they register their vessels in their own countries³⁰ in other words, the flag of convenience acts as a tax haven. To counter this, the traditional maritime nations have been forced to create a similar environment to protect their own national flag registered ships from the flag of convenience, which is able to avoid imposing a tax burden on the vessel owner in accordance with political and economic needs. The efforts of the developed maritime countries to create such an environment distorted the fiscal policy of shipping relations, and resulted in tax reduction and subsidy support for

³⁰*Why so many Ship Owners find Panama's Flag Convenient*, BBC NEWS, (5 August 2014), available at <http://www.bbc.com/news/world-latin-america-28558480>.

domestic ships. The ITF believes that there should be a genuine link between the owner of a vessel and the flag the vessel flies, as stipulated in the United Nations Convention on the Law of the Sea. In the case of the flag of convenience registries, this “genuine link” does not exist.³¹

Flags of convenience have been accepted as a tax avoidance measure rather than tax erosion. Tax avoidance means that to achieve a specific economic purpose, a company takes a different form of action to reduce the tax burden without taking the form of action that generally should have been taken. Further, tax avoidance is an act to alleviate an unfair playing field. This is different from tax evasion, which is criminal and also beyond legal or socially acceptable limits in that it encompasses legitimate and illegal acts.³²

Using a flag of convenience as a BEPS method can serve as a corporate tax planning strategy. As a flag of convenience goes against the interests of the ship owners’ country, most developed countries criticized the practice and developed anti-tax avoidance measures. For instance, the United Kingdom’s Finance Act 2015 imposes a levy (better known as the “Google tax”) on company profits that are routed via contrived arrangements to tax havens. On 5 October 2015, the OECD and G20 countries agreed on the BEPS Package to stop and close BEPS opportunities. However, there is a concern that the BEPS Package and national Google tax measures might hinder flags of convenience and the development of the global shipping industry.

³¹See *supra* note 9.

³²Cécile Remeur, *Understanding the OECD Tax Plan to Address ‘Base Erosion and Profit Shifting’ – BEPS*, EPRS: European Parliamentary Research Service PE 607.288, Briefing (June 2017).

III

THE BASE EROSION AND PROFIT SHIFTING PACKAGE (THE BEPS PACKAGE)

A. What is BEPS?

BEPS refers to “tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity.”³³ In BEPS, multinational corporations aim to move profits to the country where taxes on profits are at lower rates, and to move expenses to countries that relieve expenses at higher rates.³⁴ International tax standards have not always kept pace with the global business environment and respective domestic laws and rules of respective countries are not co-ordinated, which has caused BEPS strategies to be used.³⁵ BEPS is a system in which economic entities actively use the blind spots of tax regimes, i.e. profit shifting and tax treaties, which have not been rearranged to take into account the content and speed of technology development and globalization.

Each legal jurisdiction is entitled to design its own corporate tax system. And, each state has the sovereignty to implement taxation measures that raise revenues to pay the necessary expenditures. It should be noted that jurisdiction to tax concerns international business, including international trade and foreign direct investment. Domestic competition should not be distorted by reverse discrimination against domestic companies.³⁶

In a globalized world where economies are increasingly integrated, domestic tax systems designed to be (internally) isolated will often have mismatches because they are not

³³OECD, *About the Inclusive Framework on BEPS*, available at <http://www.oecd.org/tax/beps-about.htm>.

³⁴See OECD, BEPS.

³⁵OECD, *OECD/G20 Base Erosion and Profit Shifting Project Explanatory Statement 2015: Final Reports*, 5, available at <http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>.

³⁶See e.g., C-107/94, *Asscher v. Staatssecretaris van Financiën*, para. 32; see also P. Stanley, *Review Essay: Case C-107/94, Asscher v. Staatssecretaris van Financiën*, COMMON MKT. L. REV. 713 (1997).

coordinated. These imbalances may result in double taxation, but they can also result in no taxation. In other words, these mismatches may conceal the results from showing income for tax purposes. This reduces overall taxation if all stakeholders are paid in full. It is often difficult to decide which individual country has lost tax revenue, but tax revenue would have been lost when the revenues from the countries concerned are consolidated.³⁷

In addition, a number of operators with cross-border economic activity and access through clever expert tax knowledge can benefit from these opportunities. Tax avoidance can also hinder competition when it provides a company with an unintended competitive edge over other companies, such as small and medium sized enterprises, which are dominant at the domestic level. It is therefore appropriate to think about how the tax systems influence and interact, not only to exclude barriers to cross-border trade and investment, but also to limit unintended tax exemption. Besides, the double taxation treaty, which is a bilateral instrument that countries use to coordinate the exercise of each country's taxation authority, would likewise create an opportunity for taxpayers to gain tax benefits in the form of lower taxation or exemption at the source or in the taxpayer's residence.³⁸

BEPS tax planning strategies typically ensure: (i) minimisation of taxation in a foreign operating or source country, (ii) low or no withholding tax at source, (iii) low or no taxation at the level of the recipient, and (iv) no current taxation of the low taxed profits (achieved via the first three steps) at the level of the ultimate parent.³⁹ The overall effect of BEPS tax planning strategies is to erode the corporate tax base of many countries in a manner that is not intended by domestic policy, even though they may technically be legal, and rely on carefully planned interactions of a variety of

³⁷European Parliament, *Tax Revenue Mobilisation in Developing Countries: Issues and Challenges*, 4 Directorate-General for External Policies of the Union Directorate B Policy Department, EXPO/B/DEVE/2013/35, PE 433.849 (April 2014).

³⁸OECD, *Survey of Trends and Developments in the Use of Electronic Services for Taxpayer Service Delivery-Survey Report*, 7–9, Centre for Tax Policy and Administration, Forum on Tax Administration: Taxpayer Services Sub-Group, (March 2010).

³⁹See OECD, BEPS.

tax rules and principles.⁴⁰ While there are many ways in which domestic tax bases can be eroded, a significant source of base erosion is profit shifting.⁴¹ However, for many countries base erosion constitutes a serious risk to tax revenues, tax sovereignty, and tax.⁴² There is growing concern that multinational enterprises make use of gaps in the interaction of different tax systems to reduce taxable income or to shift profits to low-tax countries where little or no economic activity is conducted.⁴³ Therefore, a concern is that BEPS may break domestic and international rules on the taxation of cross-border profits.

The 2012 G20 Los Cabos summit called for BEPS' prevention and the OECD developed an action plan.⁴⁴ At the 2013 G20 St. Petersburg summit, the G20 Leaders endorsed the ambitious and comprehensive Action Plan on BEPS.⁴⁵ The OECD BEPS package consisting of reports on fifteen actions was agreed at the 2015 G20 Antalya summit.⁴⁶ The BEPS Package is designed to restore fairness to the tax system and is to be implemented domestically and through tax treaty provisions.

B. What is the Purpose of the BEPS Package?

In the context of the OECD/G20 BEPS Project, the fifteen actions set out below equip governments with domestic and international instruments to address tax avoidance, ensuring that profits are taxed where economic activities generating the profits are performed and where value is created.⁴⁷ Multinational

⁴⁰See *id.*

⁴¹*Addressing Base Erosion and Profit Shifting*, OECD (2013), available at <http://www.oecd.org/tax/beps/addressing-base-erosion-and-profit-shifting-9789264192744-en.htm>.

⁴²See *id.*

⁴³*OECD/G20 Base Erosion and Profit Shifting Project 2015 Final Reports-Executive Summaries*, 5 OECD.

⁴⁴*Inclusive Framework on BEPS: Progress Report July 2016–June 2017*, 1 OECD Secretariat (2017).

⁴⁵*OECD/G20 Base Erosion and Profit Shifting Project Explanatory Statement 2015: Final Reports*, OECD, available at <http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>.

⁴⁶See *id.* at 4.

⁴⁷See *supra* note 44.

enterprises are required to report their revenues, pre-tax profits, income tax paid and accrued, number of employees, stated capital, retained earnings, and tangible assets in each country they operate a business.

At the OECD Committee on Taxation meeting in June 2012, the United States raised the concern that base erosion and profit transfer would cause a significant loss of corporate income tax. The BEPS project was launched as a cross-sector review of measures to prevent divergence between economic realities and taxation practices, and called for internationally coordinated countermeasures.⁴⁸

In July 2013, the OECD published an Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan, OECD, 2013) at the request of the G20,⁴⁹ and the G20 leaders endorsed the Action Plan on BEPS in September 2013.⁵⁰ The BEPS package provides fifteen actions to equip governments with the domestic and international instruments needed to tackle BEPS.⁵¹ The BEPS package is designed to ensure that profits are taxed where economic activities generating the profits are performed and where value is created.⁵² These tools also give businesses greater certainty by reducing disputes over the application of international tax rules and standardising compliance requirements.⁵³ OECD and G20 countries, along with developing countries that participated in the development of the BEPS Package, are establishing a modern international tax framework under which profits are taxed where economic activity and value creation occur. Work will be carried out to support all countries interested in implementing and applying the rules in a consistent and coherent manner, particularly those for which capacity building is an important issue.⁵⁴

⁴⁸*Corporate taxation—“New rules, same old paradigm: A plan to curb multinationals’ tax avoidance is an opportunity missed,”* THE ECONOMIST (Oct 10th 2015).

⁴⁹See *supra* note 43, at 5.

⁵⁰See *supra* note 45, at 4.

⁵¹See OECD, BEPS.

⁵²See *supra* note 45 at 4.

⁵³See OECD, BEPS.

⁵⁴*Id.*

The BEPS package seeks to tackle BEPS structures by comprehensively addressing their fundamental causes.⁵⁵ The BEPS package is expected to better align the location of taxable profits with the location of economic activities and value creation, and to improve the information available to tax authorities to effectively apply their laws.⁵⁶

IV

KEY ISSUES IN THE BEPS PACKAGE WITH REGARD TO FLAGS OF CONVENIENCE

A. Characteristics of Flag of Convenience

Since the maritime transport industry itself is international in character, much of its economic activity is exposed to international trade relations.⁵⁷ One of the primary purposes of a company is to maximize profit which in turn means that companies will endeavor to reduce taxes as much as possible, and a maritime transportation company will seek to find a tax avoidance method using the specificity of the business activity. The maritime transporter is classified as a business activity in which substantial capital is invested, but since the business is carried out all over the world, it is one of the main forms of tax havens because there is no difference in operation in any country.

As a multinational corporation establishes its management strategy with the aim of minimizing the tax burden across the entire corporation, the tax plan is also international in character. Since maritime transportation companies are also involved in the concept of a general enterprise, they can use the tax avoidance techniques of general companies. In particular, plans include changing transfer prices, holding overseas subsidiaries or overseas branch income, and trading through the title trust agreement for companies with many opportunities for international transactions.

⁵⁵See supra note 45, at 5.

⁵⁶*Id.*

⁵⁷United Nations Conference on Trade and Development, Review of Maritime Transport, UNCTAD/RMT/2016, 1–24 (2016).

Tax avoidance means that to achieve certain economic objectives, it takes a different form of action to reduce the tax burden without taking the form of action that should have been taken as it is, and it is an act to alleviate unfairness. This is different from tax evasion, which is criminal punishment beyond legal or socially acceptable limits in that it encompasses legitimate and illegal acts.

Tax avoidance is like tug-of-war on the border between lawfulness and illegality. Thus, companies seek to use sophisticated means and methods so that their likelihood of being caught in the eyes of the tax authorities should be reduced as much as possible. Even if the tax authorities recognize the move, a company should strive to have a reasonable explanation for its conduct from an economic point of view, and also one that is legally sustainable.⁵⁸

A tax planning method is a way to decide a specific intent at the level of enterprise management for minimizing tax burden.⁵⁹ The problem is a tax shelter that uses a loophole in the so-called law, which has no definite provisions in the tax law, no precedents, and no administrative transactional rules. A flag of convenience is a prime example.

B. The BEPS Package should not Result in Double Taxation

The BEPS package seeks to ensure that profits are taxed where economic activities generating the profits are performed and where value is created,⁶⁰ and is designed to deal with tax challenges of the digital economy (Action 1 of the BEPS Action Plan). As multinational enterprises have contributed to boosting international trade and overseas investment, supporting growth, creating jobs, fostering innovation, and providing pathways out of poverty, addressing BEPS should not result in double taxation which would increase the cost of capital and could deter investment.⁶¹ Considering that the BEPS package is meant to ensure proper

⁵⁸Scott D. Dyreng, *Long-Run Corporate Tax Avoidance*, 83 ACCT'G REV. 61 (2008).

⁵⁹Jasmine M. Fisher, *Fairer Shores: Tax Havens, Tax Avoidance, and Corporate Social Responsibility*, 94 BOS. L. REV. 338 (2014).

⁶⁰See *supra* note 45, at 4.

⁶¹*Id.*

taxation, not to impose double taxation, the BEPS package itself will not cause double taxation unless it is unduly implemented by the tax authorities concerned.

C. Controlled Foreign Company (CFC) Rules and Flags of Convenience

A tax avoidance attempt is made when the enterprise establishes overseas subsidiaries, and does not import the income into the home state from an overseas subsidiary company, but reserves the overseas subsidiary company for a long period of taxation, reinvests the income retained in the overseas subsidiary company, or converts it into income with low tax burden, and the like. A controlled foreign company (CFC) rule is being used to prevent such tax avoidance. The CFC rule is a taxation system that regards income held by a subsidiary in a low tax rate country as dividend income and taxes it on corporate income. The CFC rules are meant to deter taxpayers with a controlling interest in a foreign subsidiary from stripping the base of their country of residence by shifting income into a CFC. The CFC rules were first enacted in 1962, and 30 countries out of the OECD/G20 countries participating in the BEPS package have implemented the rules.⁶²

Action 3 of the BEPS package, which provides for CFC rules, is based on the recognition that multi-national corporations establish foreign subsidiaries to shift income there for tax avoidance or evasion. BEPS Action 3 sets out recommendations on the effective CFC rules in the form of six building blocks: (1) definition of a CFC; (2) the CFC exemptions and threshold; (3) definition of income; (4) computation of income; (5) attribution of income; and (6) prevention and elimination of double taxation. The recommendations are designed to ensure that each country will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries.⁶³

Under the definition of the CFC of the recommendation in BEPS Action 3, a foreign company that is controlled by shareholders in the parent jurisdiction is deemed to be a CFC.

⁶²See supra note 43 at 13.

⁶³Id.

The applicability of the CFC rules should be considered as to whether (1) the foreign company can be regarded as a CFC, and (2) whether the parent company has sufficient influence or control over the foreign subsidiary. In this case, the judgment of dominance should be judged by examining the minimum legal and economic power requirement. If the parent company has directly or indirectly owned 50% or more of the foreign subsidiary, it is judged to have control over the foreign subsidiary, with dominance between the parent and subsidiary firms regardless of ownership ratio in the case of economic or substantive domination.

In order to avoid the application of the CFC regulations, a parent company must retain a share of less than 50% in the company flagged in a foreign country and should not be economically or substantively dominant. As a company flagged in a foreign country that is normally wholly controlled by a shipping company in the parent country, CFC rules could apply to a flag of convenience. Therefore, CFC regulations will have a detrimental effect on the company flagged in a foreign country, which is the shipping industry's long-standing practice, which will result in the loss of global shipping companies. The global shipping industry has been stagnant since the global financial crisis in 2008. Therefore, if the CFC rules apply to companies flagged in foreign countries, this can accelerate the global shipping industry stagnation, which will inevitably lead to freight hikes, and the shipping charge increase can lead to a decrease in trade transactions. Since the main purpose of the introduction of the BEPS package is to limit the tax evasion of Internet companies (i.e. Google Inc.), it is desirable to strictly restrict the application of the CFC regulations in terms of those companies flagged in foreign countries.

V CONCLUSION

A flag of convenience which is a BEPS has been used as a useful corporate tax planning strategy. The flag of convenience goes against the interests of the country of the ship's owners, therefore most developed countries have criticized flags of convenience and BEPS strategy, and developed anti-tax avoidance measures.

However, the tax burden is completely different from ‘tax evasion’ prescribed by law. In modern society where production, distribution, and sales are internationalized, individual companies are moving to special areas where taxes and labour costs are less burdensome, in an effort to enhance their competitiveness. Many countries are developing as tax-free and provide other support projects to attract more companies. The shipping industry cannot be an exception. Shipping companies want to provide services by registering in low-cost countries, and every country wants to attract more fleets and thereby increase its own profits.⁶⁴

As the OECD is not a legislative body, the BEPS package is considered as “soft law.”⁶⁵ However, the BEPS package makes tax treaties, national tax norms, and the international tax standards more influential.⁶⁶

The widely used practice in the shipping industry of flags of convenience shall mean the establishment of a formal company in a country with loose regulations, for the sole purpose of avoiding the various regulations regarding tax, labor, and shipping policies. Many countries have a long history of offering a flag of convenience. These countries provide low enrollment costs, low minimum wages, technical conditions, or relaxed labor-related laws and the application of environmental laws.

As a result of the tax cut effort, the tax base of the tax authorities declines or disappears (base erosion). The circumstances under which BEPS may arise include: (1) when the classification of taxation on the nature of entities and financial instruments or channels are not internationally consistent; (2) applying tax laws or treaties that do not consider the digital economy for solving tax problems in the digital economy;⁶⁷ (3) the use of internal financial transactions, such as debt financing with foreign affiliates; and (4) existing anti-tax measures (e.g., GAARs, CFCs) cannot be effectively applied.

⁶⁴Philipp Doerrenberg and Denvil Duncan, *Tax Incidence in the Presence of Tax Evasion*, 1, DISCUSSION PAPER SERIES, (December 21, 2015).

⁶⁵PWC, *supra* note 14.

⁶⁶See *id.*

⁶⁷Christopher Williams, *Google Tax Targets Double Irish Tax Avoidance*, THE DAILY TELEGRAPH (10 December 2014).

If CFC rules of the BEPS package apply to a flag of convenience, it could accelerate the global shipping industry stagnation which started in 2008 of the global financial crisis. Since the main purpose of the introduction of the BEPS package is to limit the tax evasion of Internet companies, we need to strictly restrict the application of the CFC regulations in a flag of convenience.