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Issues related to the United Nations Model Double Taxation Convention between Developed and Developing Countries

Co-Coordinators' Report: Proposal for a revision to Article 8 (Alternative B) of the United Nations Model Double Taxation Convention between Developed and Developing Countries

This note is provided to the Committee for ***discussion*** at its Twenty-sixth Session.

At its Twenty-fourth Session, the Committee approved the Subcommittee's work program, which included a reconsideration of Article 8 of the UN Model. This note sets out the Subcommittee's proposed draft of a revision of Alternative B, which would provide limited source taxation.

The Committee is asked to consider and discuss:

(a) how best to address the arguments set out in Section II regarding the appropriate approach under Article 8; and

(b) the drafting of the Subcommittee's proposal.

I. INTRODUCTION

1. The United Nations Model Double Taxation Convention between Developed and Developing Countries (the UN Model) provides two alternatives for the treatment of income from shipping and air transport. Article 8 (Alternative A), like the OECD Model Tax Convention on Income and on Capital (the OECD Model) provides for exclusive residence-State taxation of income derived from the operation of ships and aircraft in international traffic. Article 8 (Alternative B) provides the same exclusive residence-State taxation rule for income from international air transport, but allows for limited source State taxation of income from international shipping activities.

2. The 2017 version of the UN Model includes certain clarifications relating to the treatment of income from international traffic. Recently, some countries and members of civil society have called for a fundamental reconsideration of Article 8. At its meeting in January 2022, the Subcommittee noted that, while a number of countries have negotiated bilateral tax treaties that allow for source State taxation of income from international shipping activities, very few (if any) of those treaties follow the approach of Article 8 (Alternative B) of the UN Model. The Subcommittee decided to consider whether a different formulation of Article 8 (Alternative B), more consistent with actual treaty practice, should be included in the UN Model, although a few participants in the Subcommittee expressed the view that the project should be a reconsideration of the entire article. To assist the Subcommittee, several participants provided information regarding their countries' domestic law and recent treaty provisions that provide for source State taxation of income from shipping.

3. The arguments of those calling for a fundamental reconsideration of Article 8 are set out in Section II of this note. Section III explains why the provision allowing for source State taxing rights, currently found in Alternative B, needs to be changed, whether or not there is a change in fundamental approach under Article 8. Section IV sets out a possible draft of such a provision.

II. REQUEST FOR A RECONSIDERATION OF THE POLICY OF ARTICLE 8

4. The main argument for a reconsideration of the policy behind Article 8 is that very few ships and aircraft used in international traffic are operated by enterprises of developing countries, so that the effect of a residence-only rule with respect to income from international traffic is to require developing countries to give up much more revenue from international traffic than developed countries give up under the provision. The need to take into account the differing economic circumstances of developed and developing countries was one of the primary reasons for the development of the UN Model. In fact, a 1965 report by the Fiscal Committee of the Organisation for Economic Cooperation and Development, focused on increasing private investment in developing countries, acknowledged that certain provisions would not be appropriate:

> Existing treaties between industrialized countries sometimes require the country of residence to give up revenue. More often, however, it is the country of source which gives up revenue. Such a pattern may not be equally appropriate in treaties between developing and industrialized countries because income flows are largely from developing to industrialized countries and the revenue sacrifice would be one-sided.

5. When the UN Model was released in 1980, it provided for increased taxation at source, as compared to the OECD Model, of certain types of income, such as royalties. Since then, source State taxation in the UN Model has been expanded to cover fees for technical services and income from automated digital services, to address cases where substantial amounts of income can be generated by a non-resident without creating a permanent establishment in the source State. The logic underlying these expanded taxing rights applies (at least) equally to income from international traffic – a residence-only rule would heavily favor

developed countries, and income from international traffic is, by definition, highly mobile. For some developing countries, the "revenue sacrifice" from the exclusive residence State taxation of such income is substantial in view of their economic circumstances (whether or not the relevant amount would be viewed as substantial in developed countries).

6. Proponents of source State taxation of income from international traffic point out that the domestic laws of many countries provide for source taxation of such income, which would apply in the absence of a tax treaties or other agreements relating to the taxation of income from international transportation. The United States, for example, has a rule that provides for tax of 4% on U.S.-source transportation income,[1] defined as 50% of the revenue from any voyage to or from the United States. In India, 5% of airline revenue and 7.5% of shipping revenue sourced from India is considered as deemed income of a non-resident from airline and shipping and tax at applicable rate applies.[2]

7. They therefore question the administrative rationale for the rule, which is explained in the Commentary on Article 8 as follows:

> 2. With regard to the taxation of profits from the operation of ships in international traffic, many countries support the position taken in Article 8 (alternative A). In their view, shipping enterprises should not be exposed to the tax laws of the numerous countries to which their operations extend. They argued that 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 enterprise. Consequently, that would constitute a serious problem, especially because taxes in developing countries could be excessively high, and the total profits of shipping enterprises were frequently quite modest.
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> 3. Other countries 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. They recognized, however, that considerable difficulties were involved in determining a taxable profit in such a situation and allocating the profit to the various countries concerned in the course of the operation of ships in international traffic.
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> 4. Since no consensus could be reached on a provision concerning the taxation of shipping profits, the use of two alternatives in the Model Convention is proposed and the question of such taxation should be left to bilateral negotiations.

They argue that the development of agreed source rules would go far towards eliminating the risk of multiple taxation described in paragraph 2 of the Commentary. Moreover, they argue, work on Pillar One in the Inclusive Framework on BEPS shows that it is possible to reach general agreement on principles for such source rules.

8. They also find the allocation of exclusive taxing rights to the residence State to be particularly troubling in the case of income from international traffic because residence States frequently do not tax that income. Many developed countries have adopted "tonnage tax" regimes that result in much lower levels of taxation, particularly in recent years when gross revenues from shipping activities have skyrocketed. Moreover, while the industry argues that profit margins are "frequently quite modest", one might question whether that is true on a cash-flow basis that does not take into account the depreciation deductions

[1] Internal Revenue Code of 1986, section 887.
[2] See, section 44B and section 44BBA of the Indian Income Tax Act, available at https://www.incometaxindia.gov.in/pages/indiacode/income-tax-act.aspx

attributable to a company's hard assets (ships or aircraft). Although airlines are more often subject to normal corporate income tax rules than shipping companies, they often do not pay such tax because of the substantial losses resulting from generous depreciation rules.

9. Finally, they point to the important role that the UN Model serves as the "holy grail" for many developing countries; they expect that the provisions included in the UN Model are those that will be most beneficial to developing countries. Because of that role, in their view, the UN Model has failed developing countries by not taking a stronger position on Article 8. The current situation, in which fewer than 10% of existing bilateral tax treaties provide for source State taxation under Article 8, is seen by them as the result of the UN Model taking a neutral stance as between source State and exclusive residence State taxation, and not providing a workable version of source State taxation (as described further below). In their view, if the UN Model included only one option – a workable provision allowing for source State taxation of income from international traffic – developing countries would be able more easily to negotiate treaties that allow for source-State taxation under Article 8. Moreover, in their view, if more countries successfully negotiated for, and implemented, source State taxation in their treaties, it would become easier for other countries to negotiate similar provisions. Finally, in their view, that makes the argument that it is "realistic" to maintain the alternative of exclusive residence State, simply because most treaties include that rule, a self-fulfilling prophecy.

III. PROBLEMS WITH EXISTING ALTERNATIVE B

10. The paragraphs in the Commentary quoted above suggest that Article 8 (alternative B) can be seen as an attempt to allow for source State taxation while addressing the risk of multiple taxation described in paragraph 3 of the Commentary on Article 8. It does so by adopting a formulary approach to the allocation of net profits. Under Article 8 (alternative B), the host State may tax a portion of the "overall net profits" derived by an enterprise from its shipping operation if shipping activities in the host State are "more than casual".[3] Once the amount of profits that may be taxed in the host State is determined, the tax that otherwise would be imposed is to be reduced by some percentage as determined through bilateral negotiations. By contrast, in other cases where there is to be shared taxation, such as articles 10, 11 and 12 of the UN Model, the article anticipates that an upper limit on source State taxation, expressed as a percentage of gross income, will be established through bilateral negotiations and set out in the treaty itself.

11. Paragraph 2 of Article 8 (alternative B) states that the source State's taxing rights are based on an "appropriate allocation" of the enterprise's "overall net profits" from shipping activities. Neither the treaty text nor the Commentary contains a formula for calculating either amount. Rather, paragraph 14 of the Commentary notes various aspects of the calculation that should be negotiated bilaterally. It states:

> The overall net profits should, in general, be determined by the authorities of the State of the enterprise (or the State in which the place of effective management of the enterprise is situated). The final conditions of the determination might be decided in bilateral negotiations. In the course of such negotiations, it might be specified, for example, whether the net profits are to be determined before the deduction of special allowances or incentives which could not be assimilated to depreciation allowances but could be considered rather

[3] Although there has been some suggestion that "more than casual" is not adequately defined, paragraph 13 of the Commentary on Article 8 states that the term "covers both regular or frequent shipping visits and irregular or isolated visits, provided the latter were planned and not merely fortuitous. The phrase 'more than casual' means a scheduled or planned visit of a ship to a particular country to pick up freight or passengers." Casual visits therefore are those that are unplanned, perhaps emergency stops to pick up supplies or to allow a sick or troublesome passenger to disembark.

> as subsidies to the enterprise. It might also be specified in the course of the bilateral negotiations that direct subsidies paid to the enterprise by a Government should be included in net profits. The method for the recognition of any losses incurred during prior years, for the purpose of the determination of net profits, might also be worked out in the negotiations. In order to implement that approach, the country of residence would furnish a certificate indicating the net shipping profits of the enterprise and the amounts of any special items, including prior-year losses, which in accordance with the decisions reached in the negotiations were to be included in, or excluded from, the determination of the net profits to be apportioned or otherwise specially treated in that determination. The allocation of profits to be taxed might be based on some proportional factor specified in the bilateral negotiations, preferably the factor of outgoing freight receipts (determined on a uniform basis with or without the deduction of commissions). The percentage reduction in the tax computed on the basis of the allocated profits is intended to achieve a sharing of revenues that would reflect the managerial and capital inputs originating in the country of residence.

12. In order to implement Article 8 (alternative B) as suggested by the commentary above, the State of residence effectively would be required to audit each shipping company resident in its State each year to determine its net profits, as adjusted in accordance with the negotiated terms. While such an approach may function tolerably well in a multilateral context where the same "adjustments" to net profits are agreed, it is not terribly surprising that countries have been reluctant to agree to this obligation in bilateral negotiations. In addition, resolution of the issues set out in paragraph 14 in different ways in different bilateral treaties could result in the very types of over-taxation that formulary apportionment was meant to avoid.

13. Those countries that have successfully negotiated for source State taxation of income from shipping activities tend to adopt a simpler approach than Article 8 (alternative B), imposing tax at a low rate on payments made to ship goods to or from their ports. In some cases, an upper limit is set out in the treaty; however, in most, the upper limit is expressed as a certain percentage (usually 50%) of the tax that otherwise would have applied. In a few treaties, the limit is expressed as "the lower of" those two limits.

IV. PROPOSED DRAFT FOR DISCUSSION BY THE COMMITTEE

14. The Subcommittee has developed a proposal for a new provision allowing for source State taxation, that could either replace Article 8 Alternative B or serve as the only option under Article 8. It is based on several recent provisions relating to international shipping. However, the structure of the provision is more consistent with the other provisions of the UN Model that allow for source taxation. That is, it begins with the distributive rules, followed by a definition of the income covered, then a source rule. The Subcommittee intends to continue reviewing and refining these technical rules before presenting a revised paper to the Committee at its Twenty-seventh Session.

15. The provision also goes further than most current treaties as it includes references to aircraft used in international transport as well as to international shipping. One subcommittee participant noted that his country has some treaties that provide for source State taxation of income from international air transport, but the Subcommittee does not believe this practice is widespread. The Subcommittee is asking for guidance on this issue as some participants are in favor of including international air transport within the provision while other participants would limit the provision to international shipping activities.

16. The Committee is asked to have a first discussion of the following proposed provision, to be included in the text of the UN Model:

ARTICLE 8

INTERNATIONAL SHIPPING AND AIR TRANSPORT

[ALTERNATIVE B]

1. Income arising in a Contracting State from the operation of ships or aircraft in international traffic and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, income from the operation of ships or aircraft in international traffic arising in a Contracting State may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of such income is a resident of the other Contracting State, the tax so charged in the State in which the income arises shall not exceed:

(a) 50 per cent of the tax otherwise imposed by the taxation law of that State on the profits from such income, or

(b) __ per cent *[the percentage is to be established through bilateral negotiations]* of the gross amount of the payments underlying such income,

whichever is lower.

3. For the purposes of this Article, "income from the operation of ships or aircraft in international traffic" means the total gross amount received, less commissions paid to sales agents, arising from the carriage of passengers, mail, livestock or goods in international traffic. [The term also shall include income derived from the use, maintenance or rental of containers (including trailers and related equipment for the transport of containers) in connection with the transport of goods or merchandise in international traffic and, notwithstanding Article 11, interest on funds connected with the operation of ships and aircraft in international traffic.)

[The views of the Committee are invited on whether income from the rental of containers is most appropriately dealt with under Article 8 or under Article 12 as "consideration…for the use of, or the right to use, industrial, commercial or scientific equipment". In that regard, Members may want to consider existing paragraph 13 of the Commentary on Article 8 of the UN Model, quoting paragraph 9 of the Commentary on Article 8 of the OECD Model, and the contrary views expressed in paragraph 14 of the Commentary on Article 8 of the UN Model.]

4. For the purposes of this Article, income from the operation of ships or aircraft in international traffic shall be deemed to arise in a Contracting State if such income:

(a) is received for the carriage of passengers, livestock, mail or goods from a location in a Contracting State to a location outside that Contracting State; or

(b) is received by or on behalf of a resident of a Contracting State on account of the carriage of passengers, livestock, mail or goods from a location in a third state to the other Contracting State.

5. The provisions of paragraphs 1 and 2 shall also apply to income from the participation in a pool, a joint business or an international operating agency engaged in the operation of ships.

17. The Commentary would provide guidance on how to implement the provision, including the use of "sailing permits" or other documentation attesting that the tax has been paid before goods are able to leave a jurisdiction. It would explain the shift from "profits" to "income" and the reference to "payments underlying" (in a manner similar to the Commentary to Article 12B). It would also further explain the meaning of "income from the operation of ships or aircraft in international traffic". The Commentary would also note that the treaty will need to override or terminate any shipping or aircraft agreement between the parties that provides for exclusive residence State taxation.

IV. Questions for the Committee

18. The Committee is asked to consider and discuss:

(a) how best to address the arguments set out in Section II regarding the appropriate approach under Article 8;

(b) the Subcommittee's proposed text in Section IV regarding a revised provision allowing for source State taxation of income from international traffic, including, in particular:

(i) whether the text of Alternative B included in the UN Model should cover international transport by aircraft as well as by ships, or whether the international transport by aircraft should not be in the text of the provision but should be presented as an alternative position in the Commentary;

(ii) the circumstances under which income from the leasing of containers should be covered under Article 8 or Article 12.