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Committee of Experts on International Cooperation in Tax Matters
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Item 3(c) of the provisional agenda
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

Summary

This note is provided to the Committee for a ***second discussion*** at its Twenty-eighth Session, with a view to decisions on the issues raised below at this session and finalization at the Twenty-ninth Session.

At its Twenty-sixth Session, the Committee considered E/C.18/2023/CRP.14, which included an expanded Commentary addressing some Members' views in favor of source State taxing rights over income from international traffic and a possible revision of Article 8 (Alternative B), which would provide for such taxing rights. At the Twenty-seventh Session, the Committee considered E/C.18/2023/CRP.44, which set out a revision of the proposal in the earlier document, along with a draft Commentary explaining the new Alternative B.

To facilitate discussion, this note focuses on Alternative B and its draft Commentary. In order to present a complete draft of Article 8 and its Commentary for approval at the Twenty-ninth Session of the Committee, the Subcommittee needs guidance with respect to certain issues. The Committee is therefore asked to ***decide***:

1) Whether Article 8 (Alternative B) and its draft Commentary accurately reflect the range of views in the Committee;

2) Whether Alt B, paragraph 2 should cover both shipping and international air transport (as in the draft in paragraph 4) or only shipping;

3) If/when the revision to Article 8 (Alternative B) is finalized, should the UN Model continue to include Article 8 (Alternative A), which provides for exclusive residence State taxation of income from international traffic; and

4) If Article 8 is to continue to include Alternative A, should the order of the two alternatives be reversed.

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. At its Twenty-sixth Session, the Committee considered E/C.18/2023/CRP.14, which included an expanded Commentary addressing some Members' views in favor of source State taxing rights over income from international traffic and a possible revision of Article 8 (Alternative B), which would provide for such taxing rights. At the Twenty-seventh Session, the Committee considered E/C.18/2023/CRP.44, which set out a revision of the proposal in the earlier document, along with a draft Commentary explaining the new Alternative B.

3. This note focuses on the proposed revision of Article 8 (Alternative B) and its Commentary, set out in Sections II and III. After receiving guidance from the Committee on the issues raised in Section IV, the Subcommittee proposes to provide a complete version of Article 8 and its Commentary for approval at the Twenty-ninth Session of the Committee.

II. PROPOSAL FOR A SUBSTITUTE FOR THE EXISTING ALTERNATIVE B

4. The Committee is invited to discuss the following possible revision of Article 8 (Alternative B):

ARTICLE 8

INTERNATIONAL SHIPPING AND AIR TRANSPORT

ALTERNATIVE B

1. Income arising in a Contracting State from the operation by a resident of the other Contracting State of ships or aircraft in international traffic 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 the 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 that would be imposed by the taxation law of that State on the net profits from that income in the absence of this Convention, 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 shall not include items of income dealt with separately in other Articles of this Convention (other than Article 7).

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 that income is received for the carriage of passengers, livestock, mail or goods:

(a) from a location in that Contracting State to a location outside that Contracting State; or

(b) to a location in that Contracting State from a location outside that 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 or aircraft.

III. Proposed Commentary Changes to Reflect Revised Alternative B

5. The Subcommittee proposes the following changes to the Commentary on Article 8 (Alternative B) to explain the possible new Alternative B:

Paragraph 1 of Article 8 (Alternative B)

[17]. This paragraph provides that income arising in a Contracting State from the operation of ships or aircraft in international traffic by a resident of the other Contracting State may be taxed in that other State. It does not, however, provide that such income may be taxed exclusively in that State. Before [2025], this paragraph referred to "profits" of an enterprise because Alternative B contemplated a formulary allocation of the net profits of an enterprise engaged in the operation of ships or aircraft in international traffic. The change in approach that included a tax rate cap on the gross amount of the payment, which does not depend on whether the enterprise has net profits overall, required the change in terminology to "income".

~~15. This paragraph reproduces paragraph 1 of Article 8 of the OECD Model Tax Convention, with the deletion of the words "ships or". Thus the paragraph does not apply to the taxation of profits from the operation of ships in international traffic but does apply to the taxation of profits from the operation of aircraft in international traffic. Hence the Commentary on paragraph 1 of Article 8 (Alternative A) is relevant insofar as the operation of aircraft is concerned.~~

[18.] Paragraph 1 applies to both income from shipping and income from international air transport. The Committee did not see a basis to distinguish one form of international transport from another. They also believe that developments in information technology and information sharing have enabled transport companies to identify local revenue and that digitalization of filing and payment of taxes lowers compliance costs as compared to the 1920s when the policy of exclusive residence taxation of income from international traffic was adopted. They note that many countries provide for source State taxation of foreign air carriers notwithstanding the policy set out by the International Civil Aviation

Organization.[1] In their view, the principle of reciprocity that underpins the ICAO policy may not be fair for developing countries unless the number of flights operated in and out of a country are equally shared by foreign airlines and domestic airlines. They also note that neither shipping nor airline companies were exempted from source State taxation in the Inclusive Framework negotiations on Pillar One.

[19.] [A XX minority] of the Committee Members were of the view that Article 8 (Alternative B) should not apply to income from international air transport. In their view, the arguments in favour of source State taxation of income from shipping do not apply to income from international air transport. They point out that shipping companies frequently benefit from tonnage tax or other regimes in their countries of residence that result in relatively low taxation compared to the tax that would be collected from the companies if their profits were subject to the normal corporate income tax. They note that such regimes do not apply to air transport companies, which are generally subject to tax on their worldwide income. Moreover, they question whether the imbalance referred to in paragraph 5 of this Commentary applies equally to air transport, noting that many airlines are resident in developing countries. In addition, they argue that, unlike shipping companies, airlines do not have the same ability to choose where to establish themselves, as there is significant regulation on ownership of air transport companies, which ensures that they are truly resident and owned and managed in their home jurisdiction. Many airlines are national carriers, owned by governments. They also note that, unlike a ship, an aircraft could be present in several countries in a single day, this could result in not only double taxation but multiple taxation. Moreover, they believe that there are significant complexities and challenges in determining income arising in a given state for air transport companies (even after considering the proposed definitions in Alternative B): (i) increased number of sales channels/distribution methods, including online and via other airlines; (ii) multiple touchpoints of individual passengers; (iii) unique methods of collaboration between airlines such as interlining, code-sharing and joint ventures; (iv) significant ancillary sales; (v) revenue recognition and advance sales of one year; and (vi) no separate accounts maintained and challenges in preparing them. Finally, they argue that Article 8 (Alternative B) is directly in conflict with the official policy on taxation of the International Civil Aviation Organization (a specialized agency of the United Nations).

[20.] Countries that prefer to have Article 8 (Alternative B) apply only to income from shipping and not to international air transport can achieve that result by (1) deleting the words "or aircraft" throughout the provision and replacing paragraph 1 and the first part of paragraph 2 by the following:

> ***1. Profits of an enterprise of a Contracting State from the operation of aircraft in international traffic shall be taxable only in that State.***
>
> ***2. Income arising in a Contracting State from the operation by a resident of the other Contracting State of ships in international traffic may be taxed in that other State. However, such income may also be taxed in the Contracting State in which it arises and according to the laws of that State…***

[1] ICAO's Policies on Taxation in the Field of International Air Transport (2nd edition), Doc 8632-C/968, (1994); Supplement to Doc 8632 (2021).

Paragraph 2 of Article 8 (Alternative B)

[21]~~16~~. This paragraph allows ~~profits~~***income*** from the operation of ships ***or aircraft*** in international traffic to be taxed in the source country~~ if operations in that country are "more than casual"~~. It ~~also~~ provides an independent operative rule for ***income arising in a Contracting State from the operation of ships or aircraft in international traffic*** ~~the shipping business~~ ~~and~~ ***that*** is not qualified by Articles 5 and 7 relating to business profits governed by the permanent establishment rule. It covers both regular or frequent ~~shipping~~ visits and ***unplanned*** ~~irregular~~ or isolated visits ***by ships or aircraft***, provided the latter were 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.~~

[22]~~17~~. This paragraph lays down the principle that the Contracting State in which ***income from the operation of ships or aircraft in international traffic arises may tax the underlying payments in accordance with the provisions of its domestic law. However, if the beneficial owner of the income is a resident of the other Contracting State, the amount of tax imposed by the State in which such income arises is limited to the lower of two amounts. The first amount is 50 per cent of the tax that would have been imposed in that State in the absence of the convention on the net profits of the enterprise relating to the underlying payments. The second amount is determined by applying a negotiated rate to the gross amount of the payments underlying such income. Where there is an existing shipping or air services agreement between the Contracting States that provides for a different allocation rule, such as exclusive residence State taxation, States including paragraph 2 of Article 8 (Alternative B) should clarify how the two agreements interact, which may require modifying or terminating the tax provisions of such agreement in order to provide certainty.***

[23]~~8~~. ***Because the first limit refers to the tax that would have been imposed in the absence of the convention,*** ~~The overall~~ net profits ~~should, in general,~~ ***would*** be determined by the authorities of the ***source*** State according to its domestic law ~~of the enterprise (or the State in which the place of effective management of the enterprise is situated if the wording proposed in paragraph 10 above is used). 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 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 ***50*** per cent~~age~~ reduction in the tax computed on the basis of the ~~allocated~~ profits ***so determined*** is intended to achieve a sharing of revenues ***between the***

two Contracting States, particularly when each is a source State under the rule of paragraph 4. ~~that would generally reflect the managerial and capital inputs originating in the country of residence~~. ***For these purposes, it is understood that an enterprise may have net profits from its activities arising in a Contracting State within the meaning of paragraph 4 (calculated by determining the gross income from such activities and deducting related expenses) even if the enterprise as a whole has incurred losses in that year.***

[24]. The first limit, in subparagraph (a), was included in Article 8 (Alternative B) because it is a common approach adopted in those tax treaties that allow for source State taxation of income from international traffic. The second limit in subparagraph (b) was included to provide a cap on the amount of source State taxation that is not tied to the domestic law of the source State. Subparagraph (b) therefore provides certainty that source State taxation on income from the operation of ships or aircraft in international traffic will not exceed an amount envisioned by the two parties. Countries are free, in their bilateral negotiations, to provide for only one of the limits in subparagraph (a) or (b) rather than both. If the domestic law of one or both of the Contracting States does not provide for net basis taxation of income from the operation in international traffic of ships or aircraft, the parties should either not include subparagraph (a) or delete the word "net" (depending on the exact form of their domestic law) because in that case the inclusion of subparagraph (a) without modification could result in preventing taxation by the source State. Similarly, some countries already apply a reduced corporate tax rate to income from shipping; those countries may also choose to modify or omit subparagraph (a).

[25]. The maximum rate of tax under subparagraph (b) is to be established through the bilateral negotiations between the Contracting States. It is recommended, however, that it be set at a modest value. In addition, the rate should take into account the risk of multiple taxation arising from the source rule of paragraph 4, discussed in paragraph [31] below.

Paragraph 3 of Article 8 (Alternative B)

[26]. Paragraph 3 defines "income from the operation of ships or aircraft in international traffic" as the income directly obtained by the enterprise from the transportation of passengers, mail, livestock or goods in international traffic, whether the relevant ships or aircraft are owned, leased or otherwise at the disposal of the enterprise. In principle, paragraph 3 covers items of income derived from activities directly connected with such operations as well as profits from activities that are not directly connected with the operation of the enterprise's ships or aircraft in international traffic as long as they are ancillary to such operation, as described [in prior paragraphs of Commentary on Alternative A] above.

[27]. Paragraph 3 excludes from the article income that is dealt with separately under another article of the convention (other than Article 7). For example, Article 12, not Article 8 (Alternative B) will apply to income from the rental of containers and Article 11 will apply to interest. A [XX minority] of Committee Members believe that such types of income should be covered by Article 8 if such income is ancillary to the operation of ships or aircraft in international traffic. Countries sharing that view are free to delete the second sentence of paragraph 3 in their bilateral agreements.

[28]. Paragraph 3 specifies that the amount of income is reduced by the amount of commissions paid to sales agents. This is to take account of the fact that the amount received by the international transportation company from its agent often will have been reduced already by the agent's commission. It is not a true determination of net income as it will not take into account other expenses incurred by the transportation company.

Paragraph 4 of Article 8 (Alternative B)

[29]. Paragraph 4 lays down the principle that income from the operation of ships or aircraft in international traffic arises in a Contracting State if such income 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 to a location in a Contracting State from a location outside that Contracting State. That is, a Contracting State will be allowed to tax fees received for carriage when the journey of the passenger, livestock, mail or goods starts within it, and when the journey ends in that State. Under this definition, carriage from one Contracting State to the other Contracting State will result in income being taxable in both Contracting States; in that case, the limit imposed by subparagraph (a) will allow each State to impose a tax of no more than 50% of the tax otherwise imposed, effectively splitting the taxing rights. Moreover, because the rule focuses on "carriage" of the passengers, livestock, mail or goods, it will apply even if there are intermediate stops. For example, if a passenger buys a ticket to travel by ship from State A to State B, the entire revenue from that ticket is treated as arising in each of State A and State B, but not in any country in which the ship stops while voyaging between State A and State B.

[30]. There may, however, be more complicated situations where the 50% limit may reduce, but not eliminate, multiple taxation. For example, assume ManuCo, a company resident in Country H, pays ShipCo, a company resident in Country S, to pick up goods manufactured by its subsidiary in Country F and deliver them to Country M, where ManuCo's distribution subsidiary will sell them to unrelated parties. If the Country S-Country F treaty and the Country S-Country M treaty each includes Article 8 (Alternative B), Country F would be able to tax the fees received by ShipCo under subparagraph 4(a), while Country M would be able to tax the fees received by ShipCo under subparagraph 4(b).

[31]. Because of the risk of multiple taxation of the same income, some countries choose to tax only when carriage begins in that country or when carriage ends in that country; if both countries agree, paragraph 4 can be modified accordingly by dropping subparagraph (a) or (b), as appropriate. Otherwise, countries may want to take account of the risk of multiple taxation when establishing the withholding rate under subparagraph 2(b).

[32]. A [XX minority] of Committee Members did not agree that a Contracting State should be treated as a source State with respect to legs of a journey that do not begin or end in that State. For example, if a passenger buys a ticket to travel by ship from State A to State B, with a stop in State C, those Members believe that only the amount attributable to the State A-State C leg of the voyage should be treated as arising from sources in State A. The State C-State B leg should, in their view, be treated as arising in

State C and State B but not in State A. Countries that wish to reach that result may substitute the following language:

> ***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 that operation of ships or aircraft is:***
>
> ***(a) from a location in that Contracting State to a location outside that Contracting State; or***
>
> ***(b) to a location in that Contracting State from a location outside that State.***

[33]. Some countries that rely on withholding taxes may foresee difficulty collecting taxes under paragraph 4 when the payer of the fees is not a resident of their State and does not have a permanent establishment therein, as is the case of the payment from ManuCo to ShipCo in the example in paragraph 25. Some countries have solved this problem in the case of shipping by requiring proof of payment of taxes before permission to embark is granted. In some cases, responsibility for administration of the tax is delegated to the port authorities. However, taxpayers must have the ability to file returns after the close of the year in order to determine whether subparagraph 2(a) or 2(b) results in a lower tax (for example, as a result of losses).

V. Issues for the Committee

19. The Committee is asked to ***decide***:

1) Whether Article 8 (Alternative B) and its draft Commentary accurately reflect the range of views in the Committee;

2) Whether Alt B, paragraph 2 should cover both shipping and international air transport (as in the draft in paragraph 4) or only shipping;

3) If/when the revision to Article 8 (Alternative B) is finalized, should the UN Model continue to include Article 8 (Alternative A), which provides for exclusive residence State taxation of income from international traffic; and

4) If Article 8 is to continue to include Alternative A, should the order of the two alternatives be reversed.

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