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

Co-Coordinators' Report: Proposal for revisions to Article 8 of the United Nations Model Double Taxation Convention between Developed and Developing Countries

Summary

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

At its Twenty-eighth Session, the Committee considered E/C.18/2024/CRP.12, which presented a new Article 8 (Alternative B), which would provide source State taxing rights over income from international traffic, and its draft Commentary. The Subcommittee requested guidance on four questions:

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.

In light of the discussion in the Twenty-eighth Session and input received afterwards, the Subcommittee now proposes that the new provision allowing source taxation will cover both shipping and international air transport and be the first alternative (Alternative A) under Article 8. The article will continue to include an alternative providing for exclusive residence State taxation of both shipping and international air transport (What was formerly Alternative A will be unchanged, except that it will become Alternative B.)

The Committee is requested to ***discuss and approve*** the proposed new Article 8 including its Commentary.

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 Committee considered a possible revision of Article 8, including 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 its Twenty-sixth, Twenty-seventh and Twenty-eighth Sessions. Those discussions demonstrated a wide range of views within the Committee. The Subcommittee therefore proposes an approach to the issue that provides significant flexibility for countries to choose the approach that they feel will best achieve their economic and development goals. Under this approach, the new provision allowing source taxation would cover both shipping and international air transport and be the first alternative under Article 8. The article would continue to include an alternative providing for exclusive residence State taxation of both shipping and international air transport.

3. Section II of this note includes proposed new Article 8. Section III sets out the proposed revised Commentary.

II. PROPOSAL FOR A REVISED ARTICLE 8

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

ARTICLE 8

INTERNATIONAL SHIPPING AND AIR TRANSPORT

Article 8 (Alternative A)

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 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.

Article 8 (Alternative B)

1. Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

2. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

III. Proposed Commentary Changes to Reflect the Changes to Article 8

5. The Subcommittee proposes the following changes to the Commentary on Article 8:

A. GENERAL CONSIDERATIONS

1. Two alternative versions are given for Article 8 of the ~~United Nations~~ Model ~~Tax Convention~~, namely Article 8 (Alternative A) and Article 8 (Alternative B). Article 8 (Alternative A) ***allows income arising in a Contracting State from the operation of ships or aircraft in international traffic by a resident of the other Contracting State to be taxed in the first-mentioned State.*** ~~reproduces Article 8 of the OECD Model Tax Convention.~~ Article 8 (Alternative B) ***reproduces Article 8 of the OECD Model Tax Convention***, ***which provides for exclusive residence State taxation of income from the operation of ships and aircraft in international traffic.*** ~~introduces substantive changes to Article 8 (Alternative A), dealing separately with profits from the operation of aircraft and profits from the operation of ships in paragraphs 1 and 2, respectively. Paragraph 3 reproduces paragraph 2 of the 2017 OECD Model Tax Convention, with minor adjustment to reflect the additional paragraph added in Alternative B.~~

2. ***When the former Ad Hoc Group of Experts considered*** ~~with regard to~~ the taxation of profits from the operation of ships in international traffic, many ~~countries~~ ***members*** supported ~~the position taken in Article 8 (Alternative A)~~ ***exclusive residence State taxation of such profits***. 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***, in their view,*** taxes in developing countries could be excessively high, and the total profits of shipping enterprises were frequently quite modest.

3. Other ~~countries~~ ***members of the Ad Hoc Group*** asserted that ~~they~~ ***developing countries*** 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.

4. Since no consensus could be reached on a provision concerning the taxation of shipping profits, it was decided to ***include*** ~~use the~~ two alternatives in the ~~United Nations~~ Model ~~Tax Convention~~***, one providing for exclusive residence State taxation of income from international shipping and the other allowing source State taxation of shipping income, leaving*** ~~and to leave~~ the question of such taxation to bilateral negotiations. ***Under both alternatives, however, profits from the operation of aircraft in international traffic were subject to exclusive residence taxation.***

5. In connection with the [2025] revision of the Model, the Committee of Experts returned to the issue of whether exclusive residence State taxation of income from international transport is justified. Proponents of source State taxation of income from international traffic noted that, since the original work of the Ad Hoc Group, source State taxation in the 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. In their view, the logic underlying these expanded taxing rights applies equally to income from international traffic – a residence-only rule heavily favors 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. They also questioned the administrative rationale for exclusive residence-State taxation. They pointed out that the domestic laws of many countries provide for source taxation of such income, which would apply in the absence of tax treaties or other agreements relating to the taxation of income from international transportation. They argue that the development of agreed source rules would help to reduce the risk of multiple taxation. They also find the allocation of exclusive taxing rights to the residence State to be troubling in the case of income from international shipping 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 than would apply under normal corporate income tax rules. For these reasons, a [XX minority] would have eliminated entirely the alternative providing for exclusive residence State taxation.

7. Other members noted that the vast majority of tax treaties currently in place provide for exclusive residence taxation on income from international traffic. This is especially true for income from operation of aircraft in international traffic. They noted that the operation of ships and aircraft typically involve large expenses and expressed a concern that taxing on a gross basis, with no recognition of expenses, could lead to over-taxation. In addition, they expressed concern that the sourcing rule and administrative challenges, including with the allocation payments, could potentially lead to double and multiple taxation.

8. As a result of these discussions, the current Model continues to include two alternatives for the taxation of income from international transport, although the alternative allowing source State taxation is now presented as the first option as it was the preference of a majority of the Committee. Countries should consider carefully their economic circumstances in deciding on their policy in this area. For example, they may want to consider the extent to which they rely on international shipping and air transportation for essential goods, and whether a source State tax on shipping income would affect the cost of such goods. Similarly, a country that relies heavily on tourism should consider the potential impact of taxing international air transport or cruise lines at source, possibly on a gross basis, on a core sector of its economy.

~~5~~***9***. Until 2017, the text of both Article 8 (Alternative A) and Article 8 (Alternative B) referred to the "place of effective management of the enterprise". Taking into account the practice of most countries, the Committee then decided to follow the wording of other Articles and to refer instead to an "enterprise of a Contracting State" and the wording of both alternatives was changed accordingly. Some countries may, however, prefer to continue to use the previous formulation and to refer to the "State in which the place of effective management of the enterprise is situated" (see paragraph ~~10~~***29*** below).

~~6. Although there was a consensus to recommend the two alternatives, some countries who could not agree to Article 8 (Alternative A) also could not agree to Article 8 (Alternative B) because of the phrase "more than casual". They argued that some countries might wish to tax either all shipping profits or all airline profits and that the acceptance of Article 8 (Alternative B) might thus lead to a revenue loss, considering the limited number of shipping companies or airlines that are enterprises of those States. Again, in such cases taxation should be left to bilateral negotiations.~~

~~7~~***10***. Depending on the frequency or volume of cross-border traffic, countries may, during bilateral negotiations, wish to extend the provisions of Article 8 to cover rail or road transport. As explained in paragraph ~~18~~***35*** below, they may also want to cover inland waterways transport.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 8 (ALTERNATIVES A AND B)

Paragraph 1 of Article 8 (Alternative A)

11. 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. As described below, new Alternative A allows taxpayers to pay the smaller of two amounts, one based on net profits arising in a State and the other determined by applying a negotiated tax rate to the gross amount of the payment. Accordingly, the Committee agreed that use of the term "income" is more appropriate.

~~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.~~

12. 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 State 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.

13. [A XX minority] of the Committee Members were of the view that Article 8 (Alternative A) 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, while shipping companies may benefit from tonnage tax or other regimes in their countries of residence, 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. Further, they note that airlines historically have had modest profits and operating an airline involves large expenses, such that taxation on a gross basis, with no recognition of expenses, may result in over-taxation. 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

[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).

taxation. Moreover, they believe that there are significant complexities and challenges in allocating income among the states for air transport companies: (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 A) is directly in conflict with the official policy on taxation of the International Civil Aviation Organization (a specialized agency of the United Nations).

14. Countries that prefer to have Article 8 (Alternative A) 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…***

Paragraph 2 of Article 8 (Alternative A)

15~~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.~~

16~~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 A) should clarify how the two agreements interact, which may require modifying or terminating the tax provisions of such agreement in order to provide certainty.***

17~~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.***

18. The first limit, in subparagraph (a), was included in Article 8 (Alternative A) 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).

19. 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 A)

20. Under Paragraph 3 "income from the operation of ships or aircraft in international traffic" means the income obtained by the enterprise from the transportation of passengers, mail, livestock or goods in international traffic, irrespective of whether the relevant ships or aircraft are owned, leased or otherwise at the disposal of the enterprise. As in the case of Article 8 (Alternative B), the term includes income obtained by leasing a ship or aircraft on charter fully equipped, crewed and supplied.

21. 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 11 will apply to interest and Article 12, not Article 8 (Alternative A) will apply to income from the rental of containers or the leasing of a ship or aircraft on a bare boat charter basis. The scope of Article 8 (Alternative A) therefore will be narrower in certain respects than the scope of Article 8 (Alternative B), as described in paragraph [ ] below. In part, this is because it would be difficult to apply the source rule of paragraph 4 to certain types of ancillary income.

Paragraph 4 of Article 8 (Alternative A)

22. 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.

23. 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 A), 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).

24. 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).

25. 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.***

26. 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).

Paragraph 1 of Article 8 (Alternative ~~A~~B)

27~~8~~. This paragraph, which reproduces paragraph 1 of Article 8 of the OECD Model Convention, has the objective of ensuring that profits from the operation of ships or aircraft in international traffic will be taxed in one State alone. The paragraph's effect is that these profits are wholly exempt from tax at source and are taxed exclusively in the Contracting State of the enterprise engaged in international traffic. It provides an independent operative rule for these activities and is not qualified by Articles 5 and 7 relating to business profits governed by the permanent establishment rule. Articles 12A and 12B, which allow source taxation of fees for technical services and income from automated digital services, respectively, are also subject to the operation of Article 8 (see paragraph 2 of Article 12A

and paragraph 49 of ***the*** Commentary on Article 12A, paragraphs 2 and 3 of Article 12B and paragraph 38 of the Commentary on Article 12B).

28~~9~~. The exemption from tax in the source country is predicated largely on the premise that the income of ~~these~~ shipping enterprises is earned on the high seas, that exposure to the tax laws of numerous countries is likely to result in double taxation or at best in difficult allocation problems, and that exemption in places other than the home country ensures that the enterprises will not be taxed in foreign countries if their overall operations turn out to be unprofitable. Considerations relating to international air traffic are similar. Since a number of countries with water boundaries do not have resident shipping companies but do have ports used to a significant extent by ships from other countries, they have traditionally disagreed with the principle of such an exemption of shipping profits and would argue in favour of Alternative ~~B~~***A***.

29~~10~~. Paragraph 2 of the Commentary on Article 8 of the 2017 OECD Model Tax Convention notes that while paragraph 1 is based on the principle that the taxing right shall be left to the Contracting State of the enterprise, some countries may wish to refer instead to the place of effective management of the enterprise and draft the paragraph along the following lines:

> Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

30~~11~~. As noted in paragraph 3 of the Commentary on Article 8 of the 2017 OECD Model Tax Convention, countries wishing to refer to the "place of effective management of the enterprise" in paragraph 1 may also want to deal with the particular case where the place of effective management of the enterprise is aboard a ship, which could be done by adding the following provision:

> If the place of effective management of a shipping enterprise is aboard a ship, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship is a resident.

31~~12~~. Referring to the meaning of the term "profits from the operation of ships or aircraft in international traffic", the Commentary on Article 8 of the 2017 OECD Model Tax Convention sets down two categories of profits which should fall within the scope of paragraph 1 of Article 8. The first relates to profits directly obtained by the enterprise from the carriage of passengers or cargo in international traffic and the second to profits from activities to permit, facilitate or support international traffic operations. Within the second category, the Commentary distinguishes two different types of activities: those directly connected with such operations and those not directly connected but "ancillary" to such operations. The Committee considers that the following part of the Commentary on Article 8 of the 2017 OECD Model Tax Convention, which provides additional explanations as regards these different categories of profits, is applicable to Article 8 ***(Alternative B)*** of this Model:

4. The profits covered consist in the first place of the profits directly obtained by the enterprise from the transportation of passengers or cargo by ships or aircraft (whether owned, leased or otherwise at the disposal of the enterprise) that it operates in international traffic. However, as international transport has evolved, shipping and air transport enterprises invariably carry on a large variety of activities to permit, facilitate or support their international traffic operations. The paragraph also covers profits from activities directly connected with such operations as well as profits from activities which 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.

4.1 Any activity carried on primarily in connection with the transportation, by the enterprise, of passengers or cargo by ships or aircraft that it operates in international traffic should be considered to be directly connected with such transportation.

4.2 Activities that the enterprise does not need to carry on for the purposes of its own operation of ships or aircraft in international traffic but which make a minor contribution relative to such operation and are so closely related to such operation that they should not be regarded as a separate business or source of income of the enterprise should be considered to be ancillary to the operation of ships and aircraft in international traffic.

32~~13~~. Applying the principles set out above, the Commentary on Article 8 of the 2017 OECD Model Tax Convention deals with a number of activities in relation to the extent to which paragraph 1 will apply when those activities are carried on by an enterprise engaged in the operation of ships or aircraft in international traffic. The Committee considers that the following part of the Commentary on Article 8 of the 2017 OECD Model Tax Convention is applicable to paragraph 1 of Article 8 ***(Alternative B)*** of this Model (the modifications that appear in italics between square brackets, which are not part of the Commentary on the OECD Model Tax Convention, have been inserted in order to provide additional explanations or to reflect the differences between the provisions of the OECD Model Tax Convention and those of this Model):

5. Profits obtained by leasing a ship or aircraft on charter fully equipped, crewed and supplied must be treated like the profits from the carriage of passengers or cargo. Otherwise, a great deal of business of shipping or air transport would not come within the scope of the provision. However, Article [12], and not Article 8, applies to profits from leasing a ship or aircraft on a bare boat charter basis except when it is an ancillary activity of an enterprise engaged in the international operation of ships or aircraft.

6. Profits derived by an enterprise from the transportation of passengers or cargo otherwise than by ships or aircraft that it operates in international traffic are covered by the paragraph to the extent that such transportation is directly connected with the operation, by that enterprise, of ships or aircraft in international traffic or is an ancillary activity. One example would be that of an enterprise engaged in international transport that would have some of its passengers or cargo transported internationally by ships or aircraft operated by other enterprises, e.g. under code-sharing or slot-chartering arrangements or to take advantage of an earlier sailing. Another example would be that of an airline company that operates a bus service connecting a town with its airport primarily to provide access to and from that airport to the passengers of its international flights.

7. A further example would be that of an enterprise that transports passengers or cargo by ships or aircraft operated in international traffic which undertakes to have those passengers or that

cargo picked up in the country where the transport originates or transported or delivered in the country of destination by any mode of inland transportation operated by other enterprises. In such a case, any profits derived by the first enterprise from arranging such transportation by other enterprises are covered by the paragraph even though the profits derived by the other enterprises that provide such inland transportation would not be.

8. An enterprise will frequently sell tickets on behalf of other transport enterprises at a location that it maintains primarily for purposes of selling tickets for transportation on ships or aircraft that it operates in international traffic. Such sales of tickets on behalf of other enterprises will either be directly connected with voyages aboard ships or aircraft that the enterprise operates (e.g. sale of a ticket issued by another enterprise for the domestic leg of an international voyage offered by the enterprise) or will be ancillary to its own sales. Profits derived by the first enterprise from selling such tickets are therefore covered by the paragraph.

8.1 Advertising that the enterprise may do for other enterprises in magazines offered aboard ships or aircraft that it operates or at its business locations (e.g. ticket offices) is ancillary to its operation of these ships or aircraft and profits generated by such advertising fall within the paragraph.

9. Containers are used extensively in international transport. Such containers frequently are also used in inland transport. Profits derived by an enterprise engaged in international transport from the lease of containers are usually either directly connected or ancillary to its operation of ships or aircraft in international traffic and in such cases fall within the scope of the paragraph. The same conclusion would apply with respect to profits derived by such an enterprise from the short-term storage of such containers (e.g. where the enterprise charges a customer for keeping a loaded container in a warehouse pending delivery) or from detention charges for the late return of containers.

10. An enterprise that has assets or personnel in a foreign country for purposes of operating its ships or aircraft in international traffic may derive income from providing goods or services in that country to other transport enterprises. This would include (for example) the provision of goods and services by engineers, ground and equipment-maintenance staff, cargo handlers, catering staff and customer services personnel. Where the enterprise provides such goods to, or performs services for, other enterprises and such activities are directly connected or ancillary to the enterprise's operation of ships or aircraft in international traffic, the profits from the provision of such goods or services to other enterprises will fall under the paragraph.

10.1 For example, enterprises engaged in international transport may enter into pooling arrangements for the purposes of reducing the costs of maintaining facilities needed for the operation of their ships or aircraft in other countries. For instance, where an airline enterprise agrees, under an International Airlines Technical Pool agreement, to provide spare parts or maintenance services to other airlines landing at a particular location (which allows it to benefit from these services at other locations), activities carried on pursuant to that agreement will be ancillary to the operation of aircraft in international traffic.

[…]

12. The paragraph does not apply to a shipbuilding yard operated in one country by a shipping enterprise having its place of effective management in another country.

[…]

14. Investment income of shipping or air transport enterprises (e.g. income from stocks, bonds, shares or loans) is to be subjected to the treatment ordinarily applied to this class of income, except where the investment that generates the income is made as an integral part of the carrying on of the business of operating the ships or aircraft in international traffic in the Contracting State so that the investment may be considered to be directly connected with such operation. Thus, the paragraph would apply to interest income generated, for example, by the cash required in a Contracting State for the carrying on of that business or by bonds posted as security where this is required by law in order to carry on the business: in such cases, the investment is needed to allow the operation of the ships or aircraft at that location. The paragraph would not apply, however, to interest income derived in the course of the handling of cash-flow or other treasury activities for permanent establishments of the enterprise to which the income is not attributable or for associated enterprises, regardless of whether these are located within or outside that Contracting State, or for the head office (centralisation of treasury and investment activities), nor would it apply to interest income generated by the short-term investment of the profits generated by the local operation of the business where the funds invested are not required for that operation.

14.1 Enterprises engaged in the operation of ships or aircraft in international traffic may be required to acquire and use emissions permits and credits for that purpose (the nature of these permits and credits is explained in paragraph 75.1 of the Commentary on Article 7 [of the 2017 OECD Model Tax Convention]). Paragraph 1 applies to income derived by such enterprises with respect to such permits and credits where such income is an integral part of carrying on the business of operating ships or aircraft in international traffic, e.g. where permits are acquired for the purpose of operating ships or aircraft or where permits acquired for that purpose are subsequently traded when it is realised that they will not be needed.

33~~14~~. Some members of the Committee do not fully agree with the interpretation of the phrase "profits from the operation of ships or aircraft in international traffic" in paragraphs ***31*** ~~10.2~~ and ~~11~~ ~~of the Commentary on Article 8 of the OECD Model Tax Convention quoted in paragraph~~ ***32*** above. Some of those members consider that activities of an ancillary nature are not covered by the text of Article 8 as such activities are not mentioned in the text of that Article of the ~~United Nations~~ Model ~~Tax Convention~~. Others consider that ~~only~~ some of the examples given in the OECD Commentary quoted above ~~do not~~ ***may*** fall within the definition of "profits from the operation of ships or aircraft in international traffic" ***while others do not***.

Paragraph 5~~2~~ of Article 8 (Alternative A) and paragraph 2~~3~~ of Article 8 (Alternative B)

34~~22~~. Paragraph ***5~~2~~*** of Article 8 (Alternative A) reproduces paragraph 2 of Article 8 of the OECD Model Tax Convention***, with one adjustment, namely, the replacement of the phrase "paragraph 1" by the words "paragraphs 1 and 2".*** Paragraph ***2~~3~~*** of Article 8 (Alternative B) also reproduces the latter paragraph~~, with one adjustment, namely, the replacement of the phrase "paragraph 1" by the words "paragraphs 1 and 2"~~. The Committee considers that the following part of the Commentary on Article 8 of the 2017 OECD Model Tax Convention, which provides additional explanations with respect to paragraph 2 of that Article, is applicable to paragraph ***5~~2~~*** of Article 8 (Alternative A) and to paragraph ***2~~3~~*** of Article 8 (Alternative B) of this Model:

23. Various forms of international co-operation exist in shipping or air transport. In this field international co-operation is secured through pooling agreements or other conventions of a similar kind which lay down certain rules for apportioning the receipts (or profits) from the joint business.

24. In order to clarify the taxation position of the participant in a pool, joint business or in an international operating agency and to cope with any difficulties which may arise the Contracting States may bilaterally add the following, if they find it necessary:

… but only to so much of the profits so derived as is attributable to the participant in proportion to its share in the joint operation.

Operation of boats engaged in inland waterways transport

35 ~~18~~. Profits of an enterprise of a Contracting State derived from inland waterways transport fall within the scope of paragraph ***3*** ~~1~~ of Article 8 (Alternative A) or paragraph ***1*** ~~2~~ of Article 8 (Alternative B) only to the extent that such transport constitutes international traffic pursuant to the definition of that term in Article 3. Some countries (e.g. countries where foreign enterprises are allowed to carry on cabotage operations on a river that flows through them) may wish, however, to extend the treatment provided for in paragraph 1 of Article 8 (Alternative ***B*** ~~A~~) to the profits derived from any transport on rivers, canals and lakes; these countries may do so by including the following provision in their bilateral treaties:

Profits of an enterprise of a Contracting State from the operation of boats engaged in inland waterways transport shall be taxable only in that State.

Where such a provision is included, the title of Article 8 should logically be amended to read “Shipping, inland waterways transport and air transport”.

36 ~~19~~. Other countries, however, consider that inland waterways transport that does not constitute international traffic should not be treated differently from other business activities taking place within their borders. These countries consider that although it is possible that inland waterways transport that does not constitute international traffic could give rise to problems of double taxation, such problems can be addressed through the rules of Articles 7 and 23 A or 23 B in the cases where foreign enterprises are allowed to carry on such transportation activities.

37 ~~20~~. The rules set out in paragraphs ***2***9 to ***32*** ~~11.1~~ above relating to taxing rights and profits covered apply equally to the alternative provision set forth in paragraph ***35*** ~~18~~ above. The Committee considers that the following part of the Commentary on Article 8 of the 2017 OECD Model Tax Convention is applicable with respect to the application of that alternative provision (the modifications that appear in italics between square brackets, which are not part of the Commentary on the OECD Model Tax Convention, have been inserted in order to provide additional explanations or to reflect the differences between the provisions of the OECD Model Tax Convention and those of this Model):

16. The above provision would apply not only to inland waterways transport between two or more countries (in which case it would overlap with paragraph 1), but also to inland waterways transport carried on by an enterprise of one State between two points in another State. The alternative formulation set forth in paragraph 2 [of the Commentary on Article 8 of the 2017 OECD Model Tax Convention] according to which the taxing right would be granted to the State in which the place of effective management of the enterprise is situated also applies to the above provision. If this alternative provision is used, it would be appropriate to add a reference to "boats engaged in inland waterways transport" in paragraph 3 of Articles 13 and 22 in order to ensure that such boats are treated in the same way as ships and aircraft operated in international traffic (see also paragraph 9.3 of the Commentary on Article 15 [of the 2017 OECD Model Tax Convention]). Also, the principles and examples included in paragraphs 4 and 14 [of the Commentary on Article 8 of the 2017 OECD Model Tax Convention] would be applicable, with the necessary adaptations, for purposes of determining which profits may be considered to be derived from the operation of boats engaged in inland waterways transport. Specific tax problems which may arise in connection with inland waterways transport, in particular between adjacent countries, could also be settled specially by bilateral agreement.

17. Whilst the above alternative provision uses the word "boat" with respect to inland waterways transport, this reflects a traditional distinction that should not be interpreted to restrict in any way the meaning of the word "ship" used throughout the Convention, which is intended to be given a wide meaning that covers any vessel used for water navigation.

18. It may also be agreed bilaterally that profits from the operation of vessels engaged in fishing, dredging or hauling activities on the high seas be treated as income falling under this Article.

Enterprises not exclusively engaged in shipping or air transport

38*~~21~~. The Committee considers that the following part of the Commentary on Article 8 of the 2017 OECD Model Tax Convention, which deals with enterprises not exclusively engaged in shipping or air transport, is applicable to both ***alternatives ~~paragraph 1 of Article 8 (Alternative A) and, as regards only profits from the operation of aircraft in international traffic, of paragraph 1 of Article 8 (Alternative B)~~ of this Model (the modifications that appear in italics between square brackets, which are not part of the Commentary on the OECD Model Tax Convention, have been inserted in order to provide additional explanations or to reflect the differences between the provisions of the OECD Model Tax Convention and those of this Model):

19. It follows from the wording of paragraph 1 that enterprises not exclusively engaged in shipping or air transport nevertheless come within the provisions of this paragraph as regards profits arising to them from the operation of ships or aircraft belonging to them.

20. If such an enterprise has in a foreign country permanent establishments exclusively concerned with the operation of its ships or aircraft, there is no reason to treat such establishments differently from the permanent establishments of enterprises engaged exclusively in shipping or air transport.

21. Nor does any difficulty arise in applying the provisions of paragraph 1 if the enterprise has in another State a permanent establishment which is not exclusively engaged in shipping or air transport. If its goods are carried in its own ships to a permanent establishment belonging to it

in a foreign country, it is right to say that none of the profit obtained by the enterprise through acting as its own carrier can properly be taxed in the State where the permanent establishment is situated. The same must be true even if the permanent establishment maintains installations for operating the ships or aircraft (e.g. consignment wharves) or incurs other costs in connection with the carriage of the enterprise's goods (e.g. staff costs). In this case, even though certain functions related to the operation of ships and aircraft in international traffic may be performed by the permanent establishment, the profits attributable to these functions are taxable exclusively in the State to which the enterprise belongs. Any expenses, or part thereof, incurred in performing such functions must be deducted in computing that part of the profit that is not taxable in the State where the permanent establishment is located and will not, therefore, reduce the part of the profits attributable to the permanent establishment which may be taxed in that State pursuant to Article 7.

22. Where ships or aircraft are operated in international traffic, the application of the alternative formulation in paragraph 2 [of the Commentary on Article 8 of the 2017 OECD Model Tax Convention] to the profits arising from such operation will not be affected by the fact that the ships or aircraft are operated by a permanent establishment which is not the place of effective management of the whole enterprise; thus, even if such profits could be attributed to the permanent establishment under Article 7, they will only be taxable in the State in which the place of effective management of the enterprise is situated […].

V. Issues for the Committee

19. ***The Committee is requested to discuss and approve the proposed new Article (i.e., new Alternative A and old Alternative A becoming Alternative B) including its Commentary.***