E/C.18/2025/CRP.18

Distr.: General
7 March 2025

Original: English

Committee of Experts on International Cooperation in Tax Matters
Thirtieth session

New York, 24-27 March 2025
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

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

Summary

At its Twenty-ninth Session, the Committee of Experts approved the proposal by the Subcommittee (E/C.18/2024/CRP.29), pursuant to which 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.)

However, the Subcommittee was asked to clarify the commentary and the text of article 8 (alternative A), if necessary, regarding (a) the treatment of journeys by air that involved multiple legs; (b) a circularity issue regarding the interaction of the definition in paragraph 3 and article XX; and (c) and the implications of including subparagraph 2 (a) if one or both parties to a bilateral convention did not tax on a net basis. This note includes the Subcommittee's proposals for addressing these three issues as well as two other technical issues that have arisen during the Subcommittee's discussions.

The Committee is now requested to ***approve*** the changes to Article 8 (Alternative A) and the Commentary to address the issues raised during the Twenty-ninth Session and the two technical issues addressed in paragraphs 11 and 12.

I. Introduction

1. At the Twenty-ninth Session of the Committee of Experts, the general approach of E/C.18/2024/CRP.29 was adopted, subject to any necessary technical drafting changes. One Committee Member raised a problem of circularity in the definition of income from international traffic in Article 8 (Alternative A) and Article XX. Other Members raised an issue with respect to the rule of paragraph 2(a) in the case of a country that does not impose tax on income from international transport on a net basis. Finally, there was a discussion regarding the determination of source with respect to air journeys involving multiple legs or unplanned stops.

II. Interaction with Article XX

2. One Member of the Committee raised a problem of circularity in the definition of income from international traffic and Article XX. The current definition reads as follows:

> 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).

The circularity arises from the second sentence, which originally was added to make it clear that the alternative allowing for source-State taxation under Article 8 would not apply to interest income covered by Article 11 or income from rentals of aircraft or shipping containers covered by Article 12, even if such income was treated as ancillary income under the exclusive residence-State taxation rule of then-Alternative A.

3. The Subcommittee discussed this issue at its meeting on 13 to 14 November 2024. It concluded that, as the provision has evolved, the second sentence no longer is necessary. It proposes to make the definition crisper by deleting the second sentence and modifying the remaining sentence. The proposed revision would read:

> 3. For the purposes of this Article, "income from the operation of ships or aircraft in international traffic" means the total gross amount received ***in consideration for*** ~~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. The Subcommittee also considered a corresponding change to Paragraph 21 of the Commentary. It is now proposed to read:

> 21. Paragraph 3 ***includes only income received in consideration for the carriage of passengers, mail, livestock or goods. It therefore excludes some income that is treated as covered by Alternative B because it is ancillary to the profits earned directly from the carriage of passengers or cargo in international traffic.*** ~~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.

III. Paragraph 2(a)

5. Paragraph 2(a) of Article 8 (Alternative A) provides a rule that is similar to that found in many of the tax treaties that allow for source State taxation of income from international traffic. At the Twenty-ninth Session, several Members questioned whether the rule operates correctly when a country does not provide for net taxation of income from international traffic. Although paragraph 18 of the proposed Commentary on Article 8 provided guidance for countries in such situations, in the Subcommittee meeting of 13 to 14 November it was argued that the issue should be addressed in the text of the Model itself. Accordingly, the Subcommittee recommends modifying the text of paragraph 2 of Article 8 (Alternative A) to read as follows:

> 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:
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> (a) ***if the taxation law of that State imposes tax on ~~the net profits from~~ such income <u>on a net basis</u>,*** 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
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> (b) __ per cent [the percentage is to be established through bilateral negotiations] of the gross amount of the payments underlying such income;
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> whichever is lower.

6. If this change is made to paragraph 2(a), then corresponding changes would need to be made to the Commentary, starting at paragraph 16. These paragraphs could read as follows:

> ***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~~ <u>limit applies only if the domestic law of the source State would tax the income covered by this ~~Article~~ paragraph on a net basis. In that case, the relevant amount</u> 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~~ limit is determined by applying a negotiated rate to the gross amount of the payments underlying such income.

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. This limitation may not be necessary or appropriate if the domestic law of a State already provides for reduced taxation of income from international transport; countries in that situation may consider modifying or omitting subparagraph (a).*** ~~. 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. Moreover, 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 condition for the

application of subparagraph (a) will not be met with respect to that State, so that the only applicable limitation on taxation by such a State would be the limit in subparagraph (b). 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. 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.

IV. Multi-leg air journeys

7. The Committee also agreed that it would be useful to provide greater clarity regarding the operation of the rule in the case of a multi-leg journey by air in the form of an additional example.

8. At its meeting of 13 to 14 November 2024, the Subcommittee considered a proposal to modify the language of paragraph 4. Some participants in the meeting took the view that the language was sufficiently clear without the change, but the Subcommittee ultimately concluded that it was worthwhile if it made things clearer for others. Accordingly, the Subcommittee proposes modifying paragraph 4 to read as follows:

> 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 is received for the carriage of passengers, livestock, mail or goods, ***where such carriage***:
>
> ***(a) starts*** from a location in that Contracting State and ***ends at*** ~~to~~ a location outside that Contracting State; or
>
> (b) ***ends at*** ~~to~~ a location in that Contracting State and ***starts from*** a location outside that State.

9. The Subcommittee also discussed how the source rule is applied in practice. It now proposes the following changes to the Commentary (paragraphs that have not been changed are included to provide context):

> ***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***

***in consideration* for the carriage of passengers, livestock, mail or goods, *where that carriage starts from a location in one State and ends at a location outside of that State, or ends at a location in a Contracting State and starts from a location outside that State. ~~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, *the simple case of* 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) of paragraph 2 will allow each State to impose a tax of no more than 50% *per cent* of the tax otherwise imposed, effectively splitting the taxing rights.**

23. ~~Moreover, because t~~The source rule of paragraph 4 focuses on "carriage" of the passengers, livestock, mail or goods, rather than on the operation of individual airplanes or ships~~it will apply even if there are intermediate stops~~. That is, the source rule of Article 8 (Alternative A) depends on the overall contract between the customer and the transportation company. In general, that agreement (ticket) will specify the place of departure and the destination. The "carriage" begins at the former and ends at the latter. The agreement/ticket usually provides for a return journey, which will constitute a separate "carriage" for purposes of these rules.

24. Because the relevant "carriage" focuses on the two endpoints of the journey, it is irrelevant whether the ticket provides for intermediate stops in other States. 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. In the case of air travel, this is true even if a traveler is required to disembark and board a different plane, which may be operated by another airline. It is also irrelevant if the passenger is re-routed through a different State because the flight that was booked was cancelled. If, however, the passenger has purchased two different tickets, artificially splitting up his or her journey, then paragraph four will be applied separately to each ticket because there is no ticket which covers the entire journey.

25. For example, if a traveler purchases a ticket from Airline A in State A, to fly from City X in State A to City Y in State B, State A and State B each are treated as source States under paragraph 4. If Airline A does not fly directly to City Y, but to City Z in State B, it would be common for the ticket to provide for the passenger to take a State B domestic airline from City Z to City Y. As long as the ticket issued by Airline A covers the entire journey from City X to City Y, this is treated as one contract for "carriage" that begins in State A and ends in State B. However, only Airline A, which issued the ticket, will receive payment and be required to pay tax under Article 8 (Alternative A).

26. Similarly, if a traveler purchases a ticket from Airline A in State A, to fly from City X in State A to City Y in State B, only State A and State B are treated as source States

under paragraph 4, even if the plane makes a stop in State C to drop off or pick up other passengers. Moreover, the amount of income that is treated as being from sources in State A and State B is the entire ticket price, even if multiple airlines are involved in the carriage of the passenger. However, in the example in paragraph 25, depending on circumstances, the passenger may find that the overall cost of his desired trip is lower if he or she buys an international ticket from City X to City Z and a separate ticket from the State B domestic airline to travel from City Z to City Y. In that case, only the ticket issued by Airline A is covered by paragraph 4 because, with respect to the portion of the journey constituting international traffic, the port of embarkation is City X and the port of disembarkation is City Z.

27~~3~~. There may~~, however,~~ also be more complicated situations where the 50~~%~~ per cent 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).

28~~4~~. 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).

29~~5~~. 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 airplane 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 trip 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.***

It should be noted that the consequence of using this language is that more States would tax a smaller portion of the income arising from the trip. That is, State A and State C would be treated as source States with respect to the portion of the ticket price attributable to the State A-State C leg while State C and State B would be treated as source States with respect to the State C-State B leg. This contrasts with the approach under paragraph 4, in which State C is not treated as a source State at all. It also increases the risk of multiple taxation if the States do not agree on the amount of the ticket price attributable to each leg of the trip.

30~~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).

10. As a result of these clarifications, it is also proposed that the minority view set out in paragraph 13 be modified as follows:

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, multiple airlines are often involved in the carriage of the passenger and air cargo and revenue from the sale of the ticket may be shared among airlines.~~an aircraft could be present in several countries in a single day, this could result in not only double taxation but multiple taxation.~~ As a result, the sourcing rule in paragraph 4 could result in multiple taxation and taxation of revenue which the airline issuing the ticket is contractually obligated to pay to another airline providing service for one of the legs of the journey. They note further that there is uncertainty in the sourcing rule regarding where the carriage "ends", especially in a multi-city journey. It increases the risk of multiple taxation if states do not agree on the

state or states in which the carriage starts and ends. 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).

V. Other technical issues

11. A question has also been raised regarding paragraph 18 of the Commentary on Article 8 of the OECD Model, which is replicated in paragraph 20 of the Commentary on Article 8 of the UN Model. That paragraph reads:

> 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.

In the OECD Model, including such activities within the scope of Article 8 would ensure that they are taxable only in the State of residence of the taxpayer. The same would be true of Article 8 (Alternative B) of the UN Model. However, it would not be enough to simply include such activities within the scope of Article 8 (Alternative A) as the source rules generally would not be appropriate. During a short discussion in the Subcommittee in February, it was suggested that the paragraph be deleted from its current position and added to the introductory material in the Commentary on Article 8. It is therefore suggested that a new paragraph be added after existing paragraph 10 as follows:

> 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 [ ] below, they may also want to cover inland waterways transport.
>
> ***11. Some countries also believe that profits from the operation of vessels engaged in fishing, dredging or hauling activities on the high seas should be treated as falling under Article 8. If the specific bilateral treaty includes Article 8 (Alternative B), providing for exclusive residence-State taxation, it would be a simple matter of adding a provision expanding the scope of the Article to cover the additional activities. If, however, the relevant bilateral treaty includes Article 8 (Alternative A), it would be necessary also to provide source and/or nexus rules to make such a provision operable as income from such activities would not be treated as arising in a Contracting State under the source rules of Article 8 (Alternative A).***

12. Finally, in connection with the discussion of the treatment of multi-leg air journeys, the Subcommittee has also had occasion to review the definition of “international traffic” in Article 3(1)(d)

and, in particular, the Commentary thereon. Beginning with paragraph 8, the Commentary on Article 3 states:

> 8. ***Subparagraph 1(d) defines the term "international traffic." The term means any transport by a ship or aircraft except <u>when the ship or aircraft is operated</u> ~~such transport is~~ solely between places within a Contracting State and the enterprise that operates the ship or aircraft is not an enterprise of that State. This definition is applicable principally in the context of Article 8 (International Shipping and Air Transport).*** ~~The definition of the term "international traffic" is based on the principle that the right to tax profits of an enterprise of a Contracting State arising from the operation of ships or aircraft in international traffic resides only in that State. This principle is set forth in paragraph 1 of Article 8 (Alternative A) (which corresponds to paragraph 1 of Article 8 of the OECD Model Tax Convention), and in paragraph 1and the first sentence of paragraph 2 of Article 8 (Alternative B), provided in the case of that first sentence that the shipping activities concerned are not more than casual.~~ However, the Contracting States may agree on a bilateral basis to modify the definition of "international traffic" to refer to the State in which the place of effective management of the enterprise is situated, as was the case before 2017. In such a case, as noted in paragraph 5 of the Commentary on Article 3 of the 2017 OECD Model Tax Convention, the definition would read: "the term 'international traffic' means any transport by a ship or aircraft except when the ship or aircraft is operated solely between places in a Contracting State in which the enterprise that operates the ship or aircraft does not have its place of effective management."
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> 9. Paragraph 6 of the Commentary on Article 3 of the 2017 OECD Model Tax Convention notes that "[t]he definition of the term 'international traffic' is broader than is normally understood. The broader definition is intended to preserve for the State of the enterprise the right to tax purely domestic traffic as well as international traffic between third States, and to allow the other Contracting State to tax traffic solely within its borders". A ship or aircraft is operated solely between places in the other Contracting State in relation to a particular voyage if the place of departure and the place of arrival of the ship are both in that other Contracting State. Thus, for example, a cruise beginning and ending in that other Contracting State without a stop in a foreign port does not constitute a transport of passengers in international traffic. Conversely, a cruise beginning and ending in that other Contracting State with a stop in a foreign port constitutes a transport of passengers in international traffic and for this purpose a "stop" has taken place if passengers are permitted to go ashore, even temporarily, but only at a scheduled intermediate destination.
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> 10. Also, paragraph 6.1 of the Commentary on Article 3 of the 2017 OECD Model Tax Convention explains that "[t]he definition was amended in 2017 to ensure that it also applied to a transport by a ship or aircraft operated by an enterprise of a third State. Whilst this change does not affect the application of Article 8, which only deals with profits of an enterprise of a Contracting State, it allows the application of paragraph 3 of Article 15 to a resident of a Contracting State who derives remuneration from employment exercised aboard a ship or aircraft operated by an enterprise of a third State."

VI. Issues for the Committee

13. The Committee is requested to ***approve*** the changes to Article 8 (Alternative A) and the Commentary to address the issues raised during the Twenty-ninth Session and the two technical issues addressed in paragraphs 11 and 12.