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The UN Proposal on Revision of Article 8 – Focus Airlines: Critical analysis and our take on whether it is in the Interest of Developing Countries?

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1. **What is the current Tax Framework under the UN Model for Taxation of International Shipping and Airline-related income?**

The current version of the United Nations Model Double Taxation Convention between Developed and Developing Countries ("UN Model 2021")[1] offers two alternatives under Article 8.

Alternative A aligns with the OECD Model Tax Convention on Income and Capital (OECD Model 2017)[2], advocating for the exclusive taxation rights of the Residence State over income derived from the operation of ships and aircraft in international traffic.

The commentary on the UN Model provides that several members endorse the approach outlined in Article 8 (Alternative A). They believe that *"shipping enterprises should not be exposed to the tax laws of the numerous countries to which their operations extend. They argued that if every country taxed a portion of the profits of a shipping line, computed according to its own rules, the sum of those portions might well exceed the total income of the enterprise. Consequently, that would constitute a serious problem, especially because taxes in developing countries could be excessively high…*"[3]

On the other hand, some countries contend that they cannot afford to relinquish the modest income gained from taxing foreign shipping companies, especially, when their domestic shipping sectors are underdeveloped. Therefore, another option is provided, that is, Alternative B which slightly deviates from the OECD Model.

While this alternative endorses exclusive residence-state taxation for income from international air transport, it provides for a formulary approach to allocate net profits from the operation of ships to the Source State, if this operation is "*more than casual*".[4] Thereafter, taxes will be paid on such allocated net profit[5]. The countries proposing this approach acknowledge the challenges in calculating taxable profit and propose that the calculation should be "*determined by the authorities of the State of the enterprise*" [6] (that is the residence State rather than the Source State).

Therefore, given the lack of agreement on a rule for taxing shipping profits, the UN Model offers two alternatives and leaves the matter of taxation to be resolved through bilateral discussions.

2. What is the UN Proposal for Revision of Article 8?

Recently, the UN Tax Committee ("UN") started engaging in discussions about the taxation of income from international shipping and air transport under Article 8 of the UN Model.

The UN noted that while some countries have entered into bilateral tax agreements permitting the Source State to tax income from international shipping, few of these agreements adhere to the specific guidance provided by Article 8 (Alternative B) of the UN Model. This observation led the UN to consider revising Article 8 (Alternative B) to align it more closely with the actual practices observed in bilateral treaties. Some members proposed that this effort might necessitate a broader re-evaluation of the entire article, not just Alternative B.[7]

Specifically, the document released in October 2023 discusses the possibility of a fundamental revision (including deletion of Alternative A) and a possible revision to Alternative B, aiming to make this provision more aligned with other UN Model provisions that permit Source State taxation.[8]

In a nutshell, the new Alternative B provides as follows. Paragraphs 1 and 2 read together provide for limited taxing rights to the Source State. Essentially, these paragraphs extend Source State taxation to include income from international air transport, in addition to shipping. Paragraph 3 provides a comprehensive definition of the income covered by the article. Paragraph 4 establishes a source rule. Paragraph 5 extends the application of Paragraphs 1 and 2 "*to income from the participation in a pool, a joint business or an international operating agency engaged in the operation of ships*".

Against this background, we will now discuss whether a fundamental revision of Article 8 is needed or whether Article 8 Alternative B needs to be modified.

3. Why a fundamental revision is not necessary – especially, for airlines?

First, one of the main arguments for a fundamental revision is that "*very few ships and aircraft used in international traffic are operated by enterprises of developing countries*"[9] and therefore by continuing with the existing formulation of Article 8, developing countries are not collecting enough revenue.

It should be noted that, at least in an airline context, this argument is not true. A simple Google search reveals that several developing countries have their own airlines (national-owned carriers or privately owned carriers). Many of these airlines fly to other countries. For example, Pakistan International Airlines[10] and Air India[11] fly to more than 20 jurisdictions and Air Senegal[12] flies to more than 15 jurisdictions. A fundamental change to Article 8 or a revision of Alternative B would expose all these airlines to unnecessary source-based taxation which would then deplete their profit margins / or enhance their existing losses.

Second, it is highlighted that shipping companies, in their residence State, benefit from tonnage tax systems.[13] Thus, they are not exposed to source taxation in developing countries and they pay lower taxes in their residence States. Thus, Article 8 needs to be changed.

This argument is flawed in an Airline's context. Airlines are not subject to "*tonnage tax*" regimes.

Moreover, from a Pillar Two (Global Minimum Tax Rules) perspective, income generated from large airlines is also not excluded from GloBE / QDMTT calculations in comparison to international shipping income. Thus, airlines are not only subject to regular corporate income taxes in their Home State but from 2024 onwards (depending on the country and their size) they are subject to the Global Minimum Tax Rules.

Third, an argument is made that the UN should change Article 8 because many provisions provide for source-based taxation, including, for example, the recently inserted UN provision on Automated Digital Services (ADS). Currently, this provision is not included in any tax treaty. One of the authors of this blog had already questioned whether this provision was in the interest of developing countries – available here. One of the key conclusions was that developed countries would be averse to signing up for such a provision with a developing country due to its complexities. Similar logic could be extended to the current situation, and one may conclude that a fundamental change would not gain support from many developed countries.

Fourth, a reference is also made to the work on Pillar I (assuming it is Amount A) and it is argued that if source rules can be developed in that project, then source rules can also be developed here for shipping and airline operations. Well on this point, one should note that around 140 countries participate in the work of the OECD BEPS Inclusive Framework. Keeping aside the question as to the number of countries which "*effectively*" participate, we would like to highlight that both developed countries and developing countries reached a compromise on a new system (which applies to all MNE Groups). Specific sourcing rules were developed for Air Transport Passenger and Cargo services which are different from the sourcing rules developed in the new proposed Alternative B. Asking developed countries to reach a compromise on the existing system as well as sourcing rules which deviate from the Pillar I Amount A project seems next to impossible. As the reader will observe in this blog (see next section), the sourcing rules developed in the context of the proposed Alternative B create major issues for airlines.

Fifth, it seems that only a minority number of members of the UN Tax Committee are proposing a fundamental revision of Article 8. However, as the majority of members have not agreed to such a change, the UN Tax Committee "*continued to support the inclusion of an exclusive residence-taxation alternative in the Model*". Thus, there seems to be a lack of consensus within the UN for a fundamental revision.[14]

In light of the aforementioned discussion, one may question why it is necessary to pursue a fundamental change which would not be acceptable to developed countries as well as many other developing countries (at least in an airline context).

Therefore, our first conclusion is that the existing version of Article 8 (perhaps, only Alternative A) should be retained unless a global / holistic solution is developed for the airline / shipping industry. Failure to do so will lead to fragmented double or multiple taxation.

We now zoom into the proposed Article 8 Alternative B.

4. Critical analysis of Article 8 Alternative B from the perspective of airlines

Our second main conclusion is that the proposed version of Article 8 (Alternative B) should be rejected as it is not simple, it creates tax uncertainty, it raises compliance costs, and it raises enforceability-related issues. This is because of the following reasons.

First, issues arise with respect to Paragraph 2. Paragraph 2 states that the Source State (the State where the income arises) can tax the income on a net or gross basis (whichever is lower).

The net approach provides that "*net profits* ***would*** *be determined by the authorities of the* ***source State****"****[15]*** and these profits would be subject to domestic corporate income taxes, albeit only up to 50% of the domestic corporate income tax payable. On the other hand, the gross approach provides that countries can decide on a tax rate on gross payments, e.g., 3% of gross receipts. The commentary states that the gross approach "*was included in order to provide certainty that source State taxation on income from the operation of ships or aircraft in international traffic would not exceed an amount envisioned by the two parties*". The commentary does state that countries are free to bilaterally agree on one of the limits rather than both.[16]

Given the fact that net profits would be determined by the Source State tax administration, it is very likely that this could lead to varying interpretations by different countries, complicating the process for Airlines operating internationally.

In particular, issues could arise with respect to attributing revenues (see discussion on sourcing rules below) and expenses, especially those incurred outside the Source State thereby increasing the complexity. For example, if an airline (which is resident in one country) transports passengers to 50 different countries, this means that it potentially has to deal with and comply with 50 different tax systems even if the airline flies on a casual basis to all these countries. In other words, airlines will need to register as taxpayers, calculate income, and file tax returns in countries where they have minimal economic presence, which seems disproportionate to the revenue generated from such operations. This is particularly burdensome for airlines with few flights to a specific country in a given year.[17]

On the face of it, the gross basis taxation approach appears as a simple approach which fosters tax certainty, especially for developing countries that may have underdeveloped tax administrations. However, beyond its apparent simplicity, it is not a secret that gross taxation may have a negative impact on cross-border transactions even to the point of dissuasion of performing cross-border activities.

In the context of the airline industry, this would mean less air connectivity to Source States which are more reliant on air transport. For instance, this is particularly true for airlines which are in the startup phase and are making losses. If such airlines are exposed to corporate income taxes on a gross basis (assuming the gross approach is adopted in the treaty only) then these airlines could be dissuaded from flying to certain source countries. Moreover, in other cases, airline MNEs that are subject to taxation on a gross basis may pass their costs to the consumer in the form of higher ticket / contract prices. This could make the cost of flying more expensive. As a comparison considering the Digital Service Tax, it should be noted that following the adoption of the DSTs in France and the UK, Amazon made it clear that it will pass on the cost to the sellers of the marketplace. With respect to the equalisation levy adopted by India, businesses such as Apple have already been passing on the cost to Indian consumers. A similar outcome could then be expected for the airline industry which could just increase the costs of travelling for a developing country consumer.

Second, issues can be identified with respect to the sourcing rules. As a start, it should be noted that Para 4 deems that income is considered to arise in a Contracting State (Pakistan in our examples below) under two distinct circumstances.

The first case is when " *such 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*"[18].

For example, Passenger Airline Co, resident in Norway, flies its passengers, who bought round trip tickets, to Pakistan (a developing country which has the new Alternative B in its tax treaty with Norway). In this case, one could possibly argue that the revenue derived by the airline for the travel leg of its passengers between Norway and Pakistan is not caught by this provision (and it is exclusively taxed in Norway).

In contrast, the revenue derived by the airline for the travel leg of the same passengers between Pakistan and Norway is caught by this provision as the passengers board the plane in Pakistan to fly to a location outside Pakistan. Put differently, the airlines would need to track their ticket sales and apportion their income for this travel leg as the sourcing rule in paragraph (a) is linked to the origin of "*passengers, livestock, mail or goods*" from Pakistan.

The second case is when "*income is received for the carriage of passengers, livestock, mail or goods: (b) from a location in a third state to that Contracting State*.[19]

For example, a Cargo Airline Co resident in Switzerland enters into a contract with a Pharma Co resident of Germany (a Third State). According to the contract, Pharma Co is required to pay the Cargo Airline to deliver its high-value goods to multiple States: Serbia, Croatia, Bulgaria, and Pakistan (a developing country which has the new Alternative B in its tax treaty with Switzerland). The goods are transported by trucks from the MNE Group warehouse in Switzerland to Zurich airport (100 units). These goods are loaded onto the plane. Thereafter, the plane takes off and lands in Munich, Germany where additional goods made by Pharma Co are loaded onto the plane (an additional 100 units). Thereafter, these goods are unloaded in all four States equally (50 units in each State). In this case, one may argue that the revenue derived by the airline for delivering the goods loaded in Germany (Third State) and unloaded in Pakistan would be caught by the provision. Once again, the airlines would need to track the number of goods loaded and unloaded and apportion their income to Pakistan.

It is quite obvious that the analysis would become extremely complicated with respect to operations that involve multiple legs/stops. Thus, the proposal does not seem to take into account the operational complexity of the airlines.

Furthermore, one may also question why the mere pick up of goods / passengers or delivery of goods / passengers from a Third State requires profit / income allocation to that country. From the perspective of the airlines, these steps are not the most value-creating in the value chain. In other words, the key value drivers typically are the functions performed in the country of residence of the airline.

Third, issues arise with respect to the determination of the income that is covered by this Article. According to Para 3, the term "*income from the operation of ships or aircraft in international traffic*" is defined to include the total gross amount received by an enterprise from its international transportation activities. This encompasses revenue from carrying passengers, mail, livestock, or goods across international borders. From this total gross amount, commissions paid to sales agents are deducted to arrive at the income covered by this provision. The mention of "*commissions paid to sales agents*" specifically identifies one type of deductible expense directly associated with generating the gross income.

The focus on commissions to sales agents as the primary deductible expense is too narrow. In the case of air transport, additional expenses need to be taken into account to determine the gross income (profit). The expenses include landing fees, airport terminal fees, navigation services fees, fuel charges and many others. These expenses are crucial for the airline's operation in international traffic and must be considered when calculating the income from such operations (see further discussion on the net profit approach below). Excluding these expenses from deductions could result in an inflated base for calculating taxable income, potentially leading to double taxation. The service providers (e.g., the entities collecting the fees for local ground services) would be taxed on their fees, and the airline would not be allowed to deduct these costs.

Fourth, now that some complexities associated with the sourcing rule have been identified, we would like to return to the net profit approach under Paragraph 2 and illustrate the complexities associated with attributing further expenses.

Consider the following case. Cargo Airline Co, a cargo transport airline company based in Switzerland, operates a route involving multiple States. The Airline loads goods in Switzerland and flies from Switzerland to France, where it also loads certain goods. It then transports the goods loaded from Switzerland/France to Pakistan, where it once again offloads some cargo and loads new goods. Then the plane continues its journey to its home base in Switzerland. Assuming that Switzerland and Pakistan have a tax treaty incorporating the revised Article 8 (B) of the UN Model, Pakistan has the right to tax income from the goods transported to Pakistan from France (a Third State) and then from Pakistan to Switzerland. The aircraft and crew remain the same throughout both journeys. The following issues may be identified.

In this case, an airline must determine its income based on the cargo transported from France to Pakistan and then from Pakistan to Switzerland. In order to make this determination, the airline must develop a method to accurately attribute revenue to the transport service from France to Pakistan and separately for the service from Pakistan to Switzerland, considering varying contracts and pricing for each cargo service.

With respect to the allocation of expenses, the main issue here is allocating both direct costs (such as aircraft fuel for each leg, crew salaries, airport / navigation fees in Switzerland, France, and Pakistan, aircraft maintenance, and depreciation) and indirect costs (including sales and distribution costs, ground package costs, communications and information technology, catering expenses, financial expenses and so on). Establishing an accurate method for apportioning both direct and indirect costs to each leg's income is complex. Factors such as flight distance, cargo weight, and time spent could influence the allocation, but each has its implications for fairness and accuracy in cost allocation.

In light of the above, there are many challenges in determining net profits for taxation by Pakistan under the revised Article 8 (B) which may lead to uncertainty in calculating taxable income. This undermines the principle of certainty, as taxpayers may struggle to predict their tax liabilities accurately as the rules to tax net profits among all countries could be different.

Fifth, the new Alternative could lead to multiple taxation. The UN itself acknowledges that the proposed sourcing rules contained in para 4 of Article 8 (Alternative B) may lead to multiple taxation.[20] To illustrate, assume:

- Fashion Co, a company resident in France mandates Airline Co, based in Switzerland, to transport goods manufactured by its subsidiary in Senegal to another subsidiary in Pakistan by aircraft.
- Tax treaties between Switzerland and Senegal, as well as Switzerland and Pakistan, incorporate revised Article 8 (Alternative B).

Based on para 4 (a) of Article 8 (Alternative B), Senegal has the right to tax income from the operation of aircraft in international traffic as the income is deemed to arise in a Contracting State if such income is received for the carriage of goods from a location in that Contracting State. Therefore, Senegal could argue that since the goods were picked up from within its jurisdiction, the income Airline Co earns from this leg of the transport (Senegal to Pakistan) arises in Senegal and is subject to its taxation.

Similarly, under para 4 (b) of Article 8 (Alternative B) State, Pakistan can claim taxing rights since income is deemed to arise in a Contracting State if it is received for carriage to that State from a Third State. This means that Pakistan could also tax Airlines Co's income from this transport operation, arguing that since the goods were delivered to Pakistan, the income associated with this leg of the journey (Senegal to Pakistan) arises in Pakistan.

As a result of these provisions, Airline Co faces the risk of being taxed by Senegal and Pakistan (in addition to Switzerland as a residence country) on the same income — the fees received for transporting goods from Senegal to Pakistan.

The proposal acknowledges this risk and suggests that some countries may opt to tax such income only when the carriage begins in their territory to avoid multiple taxation. Alternatively, adjustments to withholding rates under the Gross Approach could be negotiated to account for the risk of multiple taxation.[21] However, it should be noted that the withholding approach can only be enforced when payments are made from Senegal or Pakistan and not in cases where the payment is made from France to Switzerland.

However, despite these underdeveloped ideas to address the double taxation / multiple taxation issues, the example highlights the fundamental challenges in taxing international air transport according to the proposed Article 8 (Alternative B). For operations which are part of a larger logistical chain, pinpointing where the income/profit/expenses specifically arise could be challenging. This complexity could lead to situations where businesses face uncertainty over whether their income would be taxed by one jurisdiction, multiple jurisdictions, or potentially overlooked due to ambiguities in the rule's application.

Lastly, according to the new paragraph 5 of Article 8 (Alternative B), "*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*." This phrasing indicates that the intent was to apply the modified Alternative B exclusively to international shipping income. Thus, it appears that its extension to airlines was not thoroughly considered as the reference to "*airlines*" is missing in this provision.

Critical analysis of Article 8 Alternative B from the perspective of Governments

Enforcing tax on international transport activities requires clear jurisdictional rules to determine when a Source State has the right to tax income. The provision that income is considered to arise in a Contracting State if it is received for carriage from that State / to that State from a Third State broadens the scope for source taxation. However, this broad scope may complicate enforcement, as it involves detailed tracking of transport routes and profit attribution to specific journeys.

The capacity of tax administrations to enforce these rules effectively is another concern. Monitoring international transport operations, verifying the accuracy of income reported by non-resident companies, and ensuring compliance with local tax laws demand significant administrative resources and international cooperation.

It is also quite obvious that Governments will incur additional costs related to the enforcement and collection of taxes from international air transport companies under this proposal, especially those not resident in their jurisdiction. This includes costs associated with auditing, tax assessment, and dispute resolution, which may be significant given the complexities involved in this proposal. This may be particularly troublesome for developing countries which have very limited administrative capacity.

Based on the above we would like to argue that from a tax policy standpoint, the UN proposal ranks "*low*" from the perspective of the tax policy principles discussed in the Ottawa Framework.[22]. The proposal is indeed inefficient, simple on the face of it, but complex when you get into the details, and it creates room for substantial tax uncertainty, in particular, for Airlines.

Moreover, it seems that the proposal is not really in the interest of developing countries because i) in many situations developing countries will not be able to collect the much-needed revenues in simple bilateral cases (eg. when payments are made from developing countries to non-resident airlines for transporting goods to their countries); ii) it decreases the competitiveness of developing country airlines operating in the international market (eg. a customer needs to transfer goods/cargo from Senegal to Germany. If Pakistan and Senegal have the new Alternative B in their treaty then an airline in Pakistan which picks up cargo / goods in Senegal for delivery in Germany will be taxed in Senegal. It could well be possible that the Pakistani airline would pass the costs to the customer. However, if Mauritius and Senegal follow Alternative A in their treaty then an airline in Mauritius which picks up cargo / goods in Senegal for delivery in Germany will not be taxed in Senegal. Accordingly, there would be no additional costs to pass on to the consumers. All pricing factors remaining the same, the customer will not choose Pakistan Airlines but will prefer to choose the Mauritius airline); iii) the proposal relies on bilateral negotiations which could be time-consuming and perhaps not lead to the desired outcome; and iv) it is clearly not in the interest of the OECD Member States who will surely be reluctant to introduce this provision in their tax treaties due to the various issues surrounding it.

6. Why Article 8 (Alternative B) should not be changed, especially, for airlines?

From the perspective of airlines, it is quite obvious that the new Alternative B is quite radical, and it could lead to double or multiple taxation. We are of the view that maintaining the current formulation of Article 8 (Alternative B) makes sense due to the following reasons:

- **Stability in international tax agreements**

The current structure of Article 8 of the OECD and UN Model (Alternative A and Alternative B) provides a well-known framework for international air transport taxation. Stability is a key element in international tax law, giving countries and businesses the ability to plan and operate under established rules. Changing these rules without taking into account the operational reality of airlines could disrupt existing agreements and understandings, leading potentially to adverse effects on the international transport industry. Keeping the status quo of Article 8 (Alternative B) ensures continuity and predictability in international tax relations, which is particularly valuable for sectors that rely heavily on long-term planning and investment, such as air transport.

- **Simplicity and clarity**

The existing provisions of Article 8 offer, to a certain degree, a clear and straightforward approach to taxing income from international airline transportation. This relevant simplicity contributes to compliance and enforcement, reducing the administrative burden on both tax authorities and businesses. Introducing changes to the article could complicate the tax landscape, leading to increased compliance costs and potential multiple taxation.

- **International consensus**

The provisions on taxing international air transport income as they currently stand are the result of international consensus, balancing the interests of both source and residence countries in taxing income from international transport. It represents a carefully negotiated compromise that accounts for the unique aspects of air transport. Changing the provision risks undermining this balance, potentially leading to conflicts over taxing rights. Maintaining the existing provisions respects the consensus achieved and supports the cooperation necessary for effective international taxation.

[1] UN, Committee of Experts on International Cooperation in Tax Matters Twenty-Seventh session Geneva, 17-20 October 2023 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, 27 September 2023 ("Report: Proposal for a revision to Article 8 (Alternative B)");

[2] OECD, Model Tax Convention on Income and on Capital 2017 (Full Version), OECD Publishing, available at the following Website.

[3] Commentary to Article 8 of the UN Model (2021), para. 2

[4] Article 8 (B) para. 2 of the UN Model (2021).

[5] Commentary to Article 8 of the UN Model (2021), para. 3

[6] Commentary to Article 8 of the UN Model (2021), para. 17.

[7] Proposal for a revision to Article 8 (Alternative B), para. 2.

[8] Proposal for a revision to Article 8 (Alternative B), para. 3.

[9] Proposal for a revision to Article 8 (Alternative B), para. 4.

[10] Pakistan International Airlines, available at the following Website.

[11] Air India, available at the following Website.

[12] Air Senegal, available at the following Website.

[13] UN, Report: Proposal for a revision to Article 8 (Alternative B), para 8.

[14] UN, Report: Proposal for a revision to Article 8 (Alternative B), para 10 – commentary in Paras 5-7.

[15] UN, Report: Proposal for a revision to Article 8 (Alternative B), para 18 – commentary in Para 19.

[16] UN, Report: Proposal for a revision to Article 8 (Alternative B), para 18 – commentary in para 20.

[17] The sourcing rule is triggered in case of both regular or frequent shipping visits and irregular or isolated visits by ships or aircraft. See UN, Report: Proposal for a revision to Article 8 (Alternative B), para 18 – commentary in para. 17.

[18] Id.

[19] Id.

[20] UN, Report: Proposal for a revision to Article 8 (Alternative B), para 18 – commentary in para 27.

[21] UN, Report: Proposal for a revision to Article 8 (Alternative B), para 18 – commentary in para 28.

[22] The principles laid down by the Ottawa Framework in 1998 were: neutrality; efficiency; certainty and simplicity; effectiveness and fairness; and flexibility.

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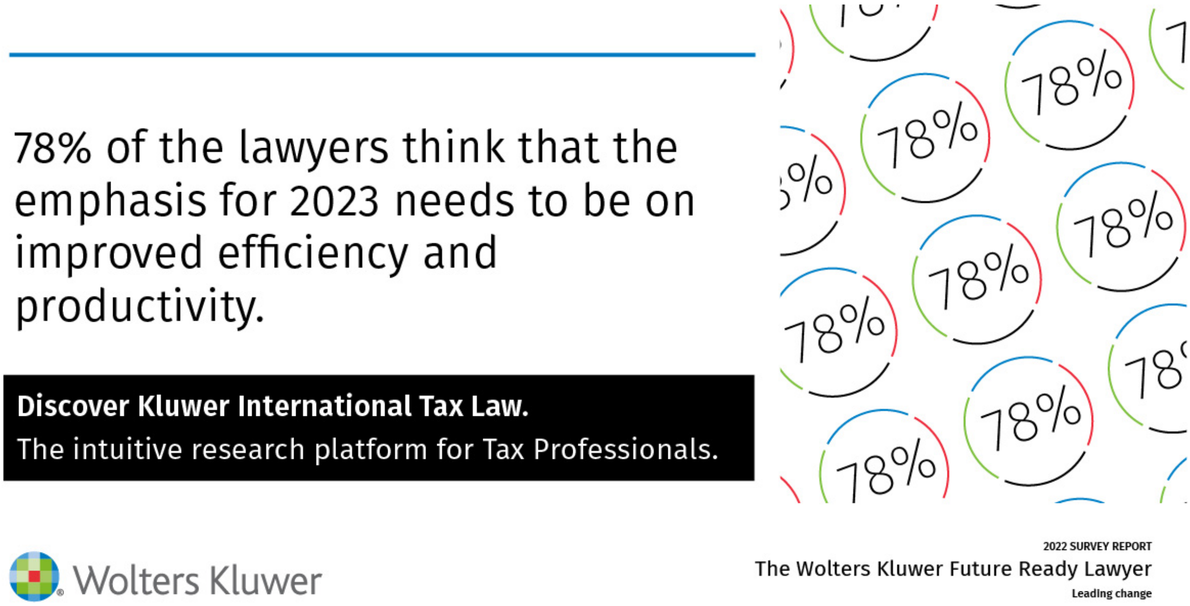

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