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Taxing Profits From International Transport In Africa: Past, Present and Future of Article 8 (Alternative B) of the UN Model

Summary of Working Paper 133 by Tatiana Falcão and Bob Michel

International maritime shipping is an essential part of global trade and business. The international maritime shipping industry was valued at approximately $12 trillion in 2017. It operates an inherently globalized business with over 60,000 sea vessels, transporting goods and passengers across the world and calling at numerous different ports and countries.

The standard of exclusive residence state taxation: Article 8 of the OECD Model/Article 8 (Alternative A) of the UN Model

Since the inception of the current international tax regime by the League of Nations in the 1920's, there has been a remarkably stable consensus in the international tax community that the profits generated by this trillion-dollar business is taxable not in the port states – the 'source' states – but in the states where the ownership of the vessels is located, *i.e.* the 'residence' state. This consensus is reflected in the income allocation rule in Article 8 of the OECD Model and Article 8 (Alternative A) of the UN Model tax conventions. As a result, a rule modelled on these provisions is a standard feature of nearly all bilateral tax treaties currently in force.

The decision in the 1920s to make exclusive residence state taxation the standard for the allocation of taxing rights on international shipping income was based on two justifications. First, it was in line with the historic tradition of states to grant reciprocal exemption of profits generated in local ports by non-resident shipping enterprises resident in the other country. Secondly, and more importantly, the Technical Experts of the League of Nations believed that it would be too difficult to apportion profits, particularly in case of companies operating in a number of countries. Hence, exclusive residence state taxation for business profits from international maritime shipping was deemed a suitable solution.

The UN Model's impractical source taxation alternative: Article 8 (Alternative B) of the UN Model

The solution of exclusive taxing rights instead of shared taxing rights and exemption by the source state instead of the residence state makes perfect sense in case of equal-size mercantile fleets and equal flows of shipping traffic. In reality, the bulk of mercantile vessel ownership has always been mainly located in a handful of developed countries. In recent decades, the biggest flows of maritime shipping transport involve the shipping of goods to and from developing countries, and countries without substantial mercantile fleets.

Concerns about this very one-sided revenue sacrifice for the sake of an 'efficient' allocation rule led the drafters of the original UN Model tax convention in 1980 to come up with an alternative to exclusive residence state taxation. The alternative is found in Article 8 (Alternative B) of the UN Model ('Article 8B'), which provides that profits from international maritime shipping can be taxed in the source state if the shipping activities in the source state are more than casual.[1]

From its conception, Article 8B of the UN Model has been referred to as impractical due to the lack of guidance on core issues, like rules on profit attribution to the source state. Yet, many countries have such rules in place in their domestic tax systems. These rules are only rarely applied, because they are overridden whenever non-resident shipping profits are derived by a shipping enterprise located in a country with which a treaty is in place incorporating a provision modelled on the OECD Article 8 or UN Article 8A.

Thriving practice of source taxation of shipping income in South/South-East Asia

A survey of the global tax treaty network based on ICTD's Tax Treaties Explorer further reveals that the global

[1] See Article 8 (Alternative B) of the UN Model (2017).

incidence of tax treaties including Article 8B is low: out of 1876 tested tax treaties in force on 1 January 2020, 266 treaties grant taxing rights to the source state with regard to profits from international transport by sea and/or air, equaling an implementation rate of 14%.

However, further analysis shows that eight countries are responsible for 75% of the tax treaties with source taxation of shipping income. The eight countries – all situated in South/South East Asia – are (in alphabetical order, and with implementation rate in the countries' tax treaties): Bangladesh (91%); India (17%); Indonesia (19%); Myanmar (100%); Pakistan (43%); the Philippine (100%); Sri Lanka (95%); and Thailand (86%).

All of these countries subject non-resident shipping income to tax in their domestic income tax laws and all countries except India and Indonesia are able to exercise their domestic tax laws in a cross-border situation in relation to the ten biggest shipowner states, either because they have a tax treaty in place with an article 8B provision or alternatively because there is no treaty and thus no restriction of domestic law.

Building on the Asian experience: policy considerations for source taxation of international shipping income

The fact that source taxation of non-resident maritime shipping income thrives in the region of Southeast Asia begs the question whether this policy could also be adopted by similarly-situated developing countries in other regions, such as the coastal countries of Sub-Saharan Africa, which do not levy similar taxes.

Whether it is advisable that they should depends on a number of factors, like their position in the global shipping network, revenue potential from the measure and development potential of the domestic mercantile fleet. Countries should in any case approach this issue on a regional level to avoid beggar-thy-neighbour effects: if a cluster of countries adopts source taxation, shipping companies will be less likely to re-route traffic for the purpose of avoiding it. The potential of source taxation as a policy tool to deal with the local environmental externalities caused by the shipping industry is another important consideration.

Building on the Asian experience: best practices for an Article 8B like tax treaty provision

The Article 8B treaty practice reveals that none of the treaties incorporate the exact wording of the UN Model's provision. The best practices derived from the relevant tax treaties signed by the South/South-East Asian countries that were scrutinized allow the drawing up of some best practices.

As to whether tax treaties are necessary at all, it is important to note that the inclusion of a source taxation provision in the tax treaty is necessary for the purpose of obliging the residence state to provide relief for double taxation. In return, the source state generally accepts to limit the amount of tax levied on the income. Most countries follow the suggested proportional reduction in the Model. The percentages vary between 40 and 66%. Inserting an absolute reduction of tax is not advisable.

Another crucial aspect of the treaty provision is the sourcing rule, i.e. the rule that determines which income is deemed to be derived from sources in the source country and which income can thus be taxed in the country. In treaty practice, there is a wide variety of sourcing rules applied, ranging from covering only income from activities taking place in the source state to also covering payments made in the source state for activities taking place in other countries. It is believed that countries should focus only on income from activities taking place in their territories, in line with the PE rule.

An additional issue is whether the source rule should be restricted to outbound transport only. Certain countries only tax outbound transport income. There is a general consensus that source countries should be careful in increasing the tax burden on inbound transport of goods as it might increase the cost of trade of goods that are scarce in the country.

Other aspects to be considered in the tax treaty provision are an activity threshold – none of the Asian countries implement the 'more than casual' requirement included in Article 8B of the UN Model – and the method of taxation. The choice of method should be left open in the tax treaty. Arguably, a dual approach of gross taxation with net taxation alternative is optimal and would mirror the dual system of an optional tonnage tax system in the residence state. Just like gross taxation in the source state, a tonnage tax system typically does not allow losses and expenses to be taken into account.

Further reading

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Credits

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