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Article 8: Transportation issues

Auxiliary Activities under Article 8

Note by the Secretariat[1]

Introduction

This note is essentially an updated version of note E.C18/2013/CRP.4 ("the 2013 paper") provided for consideration at the ninth annual session of the Committee in 2013. Its purpose is to address the issues involved in elaborating the concept of "auxiliary activities" under Article 8 of the United Nations Model Double Taxation Convention between Developed and Developing Countries (The UN Model).

2. At the seventh annual session of the United Nations Committee of Experts on International Cooperation in Tax Matters (the Committee) in 2011 the Committee agreed to update the UN Model Commentary to Article 8 (*Shipping, inland waterways transport and air transport*) with the wording found at Attachment A to this paper. The revisions proposed in document E/C.18/2011/CRP.2[2] were only accepted in part. The Committee discussion is summarized in the seventh session report on Article 8 as follows:[3]

> *Article 8: Shipping, inland waterways transport and air transport*
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> 37. Several members expressed concern over the comprehensive changes proposed in the commentary on article 8. It was argued that the changes would widen the scope of the article and therefore needed to be discussed in detail in order to assess their implications.
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> 38. Consequently, the OECD commentary paragraphs added in 2005, which referred to the income from directly connected and ancillary activities of shipping and

* E/C.18/2014/1

1 This paper was prepared by the Secretariat. It is a preliminary analysis solely to assist Committee consideration and should not be taken as necessarily reflecting concluded views.

2 At pages 136-145. Available at: http://www.un.org/esa/ffd/tax/seventhsession/CRP.2_12Oct.pdf

3 E/2011/45-E/C.18/2011/6, available at: http://www.un.org/esa/ffd/tax/seventhsession/index.htm

air transport enterprises, were removed. It was decided to include in the catalogue of issues for future discussion the term "auxiliary" in the context of the auxiliary activities that would come within the operation of the article.

39. It was agreed to delete the proposed paragraph 8 on the issue of including fishing, dredging or hauling activities on the high seas under the commentary on this article. Concerning paragraphs 12 and 13 it was agreed to retain the text in strikethrough in the update, which meant that the correct reference for quoted paragraphs 4 to 14 would be to the 2003 OECD commentary[4]

3. At the eighth annual session of the Committee in 2012, paper E/C.18/2012/5 was presented by the Mr. Ron van der Merwe, then a Member of the Committee, and by the Secretariat. The Committee discussion is summarized in the report on that session as follows:[5]

93. As requested by the Committee, Ron van der Merwe, with Michael Lennard of the secretariat, introduced a note on auxiliary activities under article 8 (E/C.18/2012/5). It was noted that at the seventh session of the Committee concern had been expressed about updating the commentary on article 8 (Shipping, inland waterways transport and air transport) on the "auxiliary activities" sufficiently closely connected to the direct operation of ships and aircraft to come within the ambit of the article. Some members felt that updating the commentary in a way that was similar to the updates made to the OECD Model could, in effect, broaden the scope of the article and give a greater exception to the normal treatment under articles 5 and 7 than was justified.

94. In his presentation, Mr. Lennard compared the current wording used in both the United Nations Model and the OECD Model commentaries, highlighting that OECD refers to "ancillary" activities rather than "auxiliary" activities, perhaps in order to distinguish these activities from the "preparatory or auxiliary" activities under article 5(4) of its Model. He indicated that some usages in the commentary, such as references to advertising as "propaganda" and single-use hotels, as well as to containerization as a recent phenomenon, clearly needed updating.

95. During the discussion, some Committee members expressed the view that the terms "auxiliary" and "ancillary" are not interchangeable and that referring to the latter would broaden the scope of application of the aforesaid provision, and thus reduce source State taxing rights. In addition, it was stated that "auxiliary", being a more precise word, was easier to interpret than "ancillary". Others expressed support for updating the terminology in the Model commentary along the lines of the current language adopted in the OECD Model commentary, thus referring to "ancillary" activities instead of "auxiliary" activities. As a result, the Committee agreed to ask the secretariat to revise the abovementioned note in order to reflect those views, and to that end it invited comments by the end of 2012. Moreover, as the current membership of the Committee is due to expire on 30 June 2013, it was agreed to

[4] That is, the last version of the OECD Model before the 2005 changes [secretariat note].
[5] E/2012/45, available at: http://www.un.org/esa/ffd/tax/eighthsession/index.htm

include the aforesaid issue of revising the commentary in relation to "auxiliary activities" in the catalogue of issues to be further considered by the members of the Committee at the next annual session. Mr. van der Merwe and the secretariat were thanked by the Committee for their work on the matter.

4. The only comments received on the issue were in the the joint submission from the International Chamber of Shipping (ICS) and the World Shipping Council (WSC) included at Attachment B to E.C18/2013/CRP.4, and also attached at Attachment B of this paper, as well as the submission from the International Air Transport Association (IATA) attached at Attachment D of this paper.

The Article

5. Article 8 as it appears in the current UN Model reads as follows (no changes were made to the text of the Article itself as part of the 2011 UN Model Update):

SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

Article 8 *(alternative A)*

1. 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.

2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

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

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

Article 8 *(alternative B)*

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

2. Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall

be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by ___ per cent. (The percentage is to be established through bilateral negotiations.)

3. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

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

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

Comparing the Most Recent UN Model and OECD Model Commentaries

Background to the Commentaries

6. The changes made as part of the 2011 UN Model Update all relate to the Commentary to the Article. They incorporate by reference many of the OECD 2010 Model changes since the previous version of the UN Model was effectively settled in 1999 and published in 2001 ("the 2001 UN Model"), but as noted above, the Members of the Committee did not agree to make some proposed changes on the meaning of "auxiliary activities", a term drawn from earlier versions of the OECD Commentaries. More current OECD usage is to speak of "ancillary activities" which distinguishes this issue more from the "preparatory or auxiliary" activities addressed in Article 5(4). In the note provided to the eighth annual session in 2012 (E/C.18/2012/5) at para 4 the secretariat expressed the view that this would be "a change that could be usefully made if the quotations from the OECD Model are updated in other respects." The secretariat took this view as it did not consider there was any interpretational benefit from using the same term as in Article 5(4) but that there were some risks. It also noted (at footnote 6) that paragraph 10 of the UN Model Commentary to Article 5 actually uses "ancillary" as a synonym for "auxiliary".

7. Not all Members agreed with this view during discussions at the eighth annual session, as the report of the session indicates;[6]

95. During the discussion, some Committee members expressed the view that the terms "auxiliary" and "ancillary" are not interchangeable and that referring to the latter would broaden the scope of application of the aforesaid provision, and thus reduce source State taxing rights. In addition, it was stated that "auxiliary", being a more precise word, was easier to interpret than "ancillary". Others expressed support for updating the terminology in the Model commentary along the lines of the current language adopted in the OECD Model commentary, thus referring to "ancillary"

[6] E/2012/45 at pp. 20-21.

activities instead of "auxiliary" activities. As a result, the Committee agreed to ask the secretariat to revise the abovementioned note in order to reflect those views, and to that end it invited comments by the end of 2012.

8. The joint submission from the International Chamber of Shipping (ICS) and the World Shipping Council (WSC) included at Attachment B to the 2013 paper and this paper addressed this issue as follows:

> At the meeting in October 2012 a discussion took place about the terms ancillary vs. auxiliary. As ship owners we are not concerned with the term as such but find that the latest elaboration from the OECD provides a pragmatic understanding of the activities that are clearly related to international transport without constituting a separate business for the shipping company. It is for example customary for shipping companies to charge shippers for late redelivery of containers, cargo storage etc. to ensure the smooth flow of cargo and equipment. Similarly, the income from the use, maintenance or rental of containers, including equipment for the transport of containers such as trailers and chassis, should be taxed only in the country of residence, provided that the containers are used for the international transport of cargo.

9. The submission more generally calls for consistency with the OECD approach as much as possible when it notes:

> ICS and WSC therefore welcome the efforts of the UN Committee to reach a consensus on the scope of Article 8. However, it is important to understand that any inconsistency with the OECD approach, or any new restriction on the scope of the current Shipping Article, would be extremely problematic for the industry since this could lead to different treatment by local authorities in the various ports of call on a voyage. Given the large number of ships and cargoes involved in international trade this would be chaotic, for tax authorities as well as shipping companies. This could seriously distort international trade which very much depends on common rules and an interpretation of such rules which allows market participants to offer cost-effective and efficient services.

10. The submission from the International Air Transport Association (IATA) included at Attachment D of this paper addressed the issue as follows (*footnotes in the quoted paragraphs are omitted*):

> 14. Much of the discussion leading to the changes to the OECD Commentary related to the application of the Article 8 exemption to income that was not from the direct operation of aircraft in international traffic but was from activities sufficiently closely connected to that operation to be considered to fall within the scope of the exemption.
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> 15. Prior to 2005, paragraph 7 of the OECD Commentary used the term "auxiliary" to refer to such activities. The 2005 OECD Commentary changed the terminology for that concept to "ancillary". It was IATA's understanding that the primary reason for this change was to avoid confusion with the concept of

"preparatory or auxiliary" under Article 5, particularly since the latter is interpreted as referring to activities that are "remote from the actual realisation of profits".4 It was clear that the examples of so called "auxiliary" activities described at paragraph 8 of the pre 2005 OECD Commentary on Article 8 (e.g., the sale of passage tickets on behalf of other enterprises, the operation of a bus service connecting a town with its airport, etc.) did not meet the description of being remote from the actual realization of profits. The term "ancillary" to the operation of aircraft in international traffic, adopted at paragraph 4.2 of the 2005 OECD Commentary, was considered a more appropriate description of the activities intended to be covered by Article 8.

16. The 2005 OECD Commentary included elaborations on the types of income that would be considered directly related or ancillary to the operation of aircraft in international traffic.5 This was done to update the Commentary to reflect more usefully the actual state of cooperation among airlines. IATA had provided background information to the OECD to explain the need for this greater clarity, including the following:

> The practice of airlines to perform various ancillary activities for one another at airports around the world has existed for many decades and has intensified with the growing development of strategic alliances. The reasons for this practice are basically economic. Everywhere a foreign airline flies it must operate, or otherwise provide for, terminal facilities, baggage and ground handling, load control and communications, ramp services, security services, catering, aircraft servicing and maintenance, hangars, and other capital intensive functions and equipment. These functions must be performed and equipment provided even where the airline's service of a particular airport is minimal. Similarly, pilots, flight attendants, mechanics, baggage handlers, reservation agents, gate agents, security guards, cooks, cleaners, and other personnel, usually highly unionized, must be provided in each location notwithstanding thin traffic. The evolving demands of modern travelers also require the airlines to provide other amenities, including in terminal lounges, eating facilities, business facilities, and in flight entertainment. Almost from the beginning of commercial aviation, airlines have entered into cooperative arrangements to perform these activities for one another in order to maximize the efficient use of available resources. This practice, which has been recognized and encouraged by governments for decades, improves the economic situation of the airlines and their customers alike.

17. IATA urges the UN similarly to recognize that income attributable to these types of activities carried out by airlines on behalf of their passengers and on behalf of one another falls within the scope of the Article 8 exemption for income from operation of aircraft in international traffic.

11. A selection of extracts from dictionaries on the terms "auxiliary" and "ancillary" were included at attachment C to the 2013 paper and the same document is included for convenience at Attachment C to this paper. The two terms appear to be largely used as alternatives in modern usage, and to the extent that there may be any difference in usage in

technical areas it seems to be that "auxiliary may mean something held in reserve and not activated" while ancillary means something used but in a subsidiary capacity. Such a distinction appears irrelevant in the current context, where both usages are by definition referring to actual activities. As noted in note E/C.18/2012/5 (at footnote 6), paragraph 10 of the UN Model Commentary to Article 5 already uses "ancillary" as a synonym for "auxiliary". Works such as the *Oxford Thesaurus*[7] and the *Roget's 21st Century Thesaurus*[8] also treat the two terms as synonyms.

12. In view of the potential for confusion with the concept of "preparatory or auxiliary" activities under article 5(4) of the UN Model, the secretariat remains of the view that if changes are made to Article 8, consideration should at least be given to making this change to "ancillary". While such changes should not be automatically driven by OECD changes, it is a relevant factor that linguistic consistency is useful where no substantive difference is intended. It is noted, however, that he term "ancillary revenue" as used in the airline industry means revenue from items other than ticket revenue, and not all such revenue might meet the test of arising from an auxiliary/ ancillary activity. So even that term has some risk of confusion.

13. While the secretariat does find it useful that the words "auxiliary" and "ancillary" are widely regarded as synonyms, any Commentary using either term needs, of course, to make some attempt to clarify the type of activity likely to meet the necessary level of relatedness to the primary activity before it is regarded as either auxiliary or ancillary –those words alone do not give sufficient clarity and are really a "short-form" way of describing more nuanced concepts. Any change of terminology need not (and would better not) be left unexplained: the UN Model Commentary could indicate, for example, that the change was not intended to signify any change in the operation of Article 8 and was, in particular, not intended to expand the operation of the exception beyond "auxiliary activities" as previously understood.

14. Ultimately, of course, the really critical issue is not which term is used, but what is intended to be meant by the term. The more important issue for taxpayers and administrators in applying Article 8, is what is included as part of the exception to the normal operation of Articles 5 and 7, and whether there is in principle any difference in view about what is covered under the UN and OECD Models. In particular, is the UN exception narrower than the OECD exception to Articles 5 and 7 (in which case a different term has some merit, though there would still be an issue of whether it should be the same as the term used in Article 5(4) "auxiliary")? If there is no intended difference in scope, the arguments for using the term "ancillary" are all the stronger, especially if it is accepted that there is no intended link to the "preparatory and auxiliary" concept in Article 5(4). An examination of the OECD changes in 2005 is useful in this regard.

15. The changes made to the OECD Model in 2005, and which are not included in the 2011 UN Model Update, were based on the OECD report: *"Proposed changes to the Commentary on Article 8"*. That report was first released for public comments in April 2004. Some changes were made on the basis of the comments received and the final version of the

[7] http://www.oxforddictionaries.com/us/definition/english-thesaurus/ancillary
[8] http://www.thesaurus.com/browse/auxiliary

report was released on 15 December 2004.[9] Paragraph 6 of the OECD Model Commentary was changed in 2005 from the wording that was quoted in the 2001 UN Model Commentary. The earlier text referred to "additional activities more or less closely connected with the direct operation of ships or aircraft" which (as noted above) it termed "auxiliary activities". The new formulation is: "[a]ctivities 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."[10]

16. Members might consider that the OECD formulation has the benefit of clarifying that the test is *not only* one of (i) the closeness of relationship with the primary transportation activities, but also of (ii) the relative contribution made to the business operations as a whole. In other words a closely related activity may, it seems, cease to be treated as "ancillary"/ "auxiliary" when its contribution is no longer minor in the context of the overall business operations. This creates some level of uncertainty as to when the threshold has been met but it has some conceptual justification. This justification is found in the idea that when an activity that is not of itself covered by Article 8 ceases to be conducted to facilitate the main transportation activity, and instead becomes a business with its own strategy and direction, it has emerged from the wings of the Article 8-protected parent activity and falls for consideration under the normal rules of Articles 5 and 7.

17. The 2001 UN Model Commentary, in quoting the pre-2005 version of OECD Model, includes the following examples which are stated to be "auxiliary activities which could properly be brought under the provision":

(*a*) the sale of passage tickets on behalf of other enterprises;
(*b*) the operation of a bus service connecting a town with its airport;
(*c*) advertising and commercial propaganda;
(*d*) transportation of goods by truck connecting a depot with a port or airport.[11]

18. The wording (especially the use of the word "could" rather than "would") is a little ambiguous as to whether or not such examples *inherently* are covered by the paragraph, but the context (and lack of reference to other decisive factors) seems to suggest that these examples are treated as inherently "more or less closely connected with the direct operation of ships or aircraft" and therefore covered by the paragraph as closely enough related to the primary activities. This conclusion might be subject, perhaps, to the issue of their relative contribution to the business, something that might change over time. These issues might usefully be clarified in any update to the Article 8 Commentary.

19. The 2005 version of the OECD Model gives more elaborated versions of these examples. An issue for the Committee is whether the OECD's 2005 examples are expressed more narrowly (by limiting the types of such activity regarded as ancillary) or more broadly

[9] See http://www.oecd.org/dataoecd/20/53/34083450.doc
[10] Paragraph 4.2 of the current OECD Model Commentary.
[11] At paragraph 8 (1997 OECD Model Commentary as quoted in the 2001 UN Model Commentary).

(by more firmly stating that such activities are ancillary, rather than potentially ancillary) than in the existing UN Model Commentary, as updated in 2011, and if so what is the significance of any differences. The examples given in the 2005 OECD Model Commentary are as follows:

Bus services

20. The OECD Model provides that: "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."[12] The UN Model Commentary, in contrast, merely provides as one of the example of auxiliary activities: "the operation of a bus service connecting a town with its airport".

21. Members may consider it a useful elaboration to make clear (as the OECD Model now does) that the reference to coverage of a bus service refers to bus services for the *international passengers of the relevant carrier*, not bus services for domestic and international passengers of all carriers. Both examples refer to bus services connecting "its airport". Many airports predominantly servicing cities are long distances from the city and not readily accessible (The *Beauvais-Tillé* Airport used by some budget operators to service Paris is some 85 km (53 mi) north of Paris, for example) and buses to such airports, particularly for low-cost operators, could form a profitable part of operations. The likelihood is, however, that operations will be provided by third party providers anyway, with only commission-type payments made to the airline in return for the tie-in with the airline, use of the website for bookings, etc.

22. Likewise bus services open to persons generally, not merely passengers of that airline with international flights, are likely not to fall within this exception, although this analysis is complicated by the fact that such bus services in practice are rarely available only to one's passengers, let alone international passengers only, and proof of a ticket on that carrier is rarely a condition of entry to the bus service. There have been examples of "intermodal" flight bookings, where the flight cost includes a bus service to the departure or arrival airport (for both domestic and international passengers)[13] and there are sometimes *complimentary* services for passengers on international services (almost inevitably through third party providers)[14] but it might be questioned whether, in modern conditions, bus services run by airlines themselves for use of their international passengers on a paying basis only exist at all, or at least to an extent justifying this example in the UN Model Commentary going forward.

[12] At paragraph 6.

[13] See for example, Gregory Karp, "Airlines Merger could Halt Bus Flight", *The Morning Call*, 4 May 2010*; http://articles.mcall.com/2010-05-04/news/all-a1_5airlines.7261946may04_1_continental-flight-continental-passengers-bus-service*

[14] See for example: http://www.emirates.com/us/english/plan_book/to_and_from_airport/free_shuttle_service_dubai.aspx

International transportation legs operated by other carriers

23. The OECD Model Commentary now notes[15] that one example of activities covered by the provision: "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." A slot charter is a maritime term for a charter party where the shipper leases one or more "slots," aboard a container ship. Each slot is generally capable of holding a 20-foot container.

24. The submission from the International Air Transport Association (IATA) included at Attachment D to this paper addressed this issue as follows (*a footnote in a quoted paragraph is omitted*):

> 18. Another important issue addressed by the OECD's 2005 Commentary relates to the income earned by airlines from the extraordinarily common cooperative arrangements that have grown up with respect to the actual provision of transport, including code sharing arrangements. Code sharing is a form of marketing arrangement in which airlines agree to allow each other to put their own designator code on flights operated by the other airline in order to be able to sell itineraries they otherwise could not offer to their customers. For example, if a European airline ("EuroAir") and a US airline ("StatesAir") had a code-sharing arrangement, they might both be able to market themselves as offering a Paris-Chicago-Detroit itinerary without regard to which airline was going to operate the individual legs. Thus, a customer purchasing the trip from EuroAir might receive a ticket showing Flight EU123 from Paris to Chicago and Flight EU456 from Chicago to Detroit, and a customer purchasing the same trip from StatesAir might receive a ticket showing Flight ST123 from Paris to Chicago and Flight ST456 from Chicago to Detroit. Airlines that enter into these kinds of code sharing arrangements typically negotiate a split of revenues and/or profits from the code shared flights that could take into account various factors, such as which airline operates the actual flights, which airline sells the tickets, relative contributions to marketing expenses, increased revenue and profitability due to code share, etc.
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> 19. The OECD's 2005 Commentary recognizes the application of Article 8 to income realized by an airline from a code sharing arrangement in which its passengers are transported internationally on aircraft operated by another enterprise where that arrangement is directly connected or ancillary to the airline's operation of aircraft in international traffic, and IATA likewise urges the UN to adopt this clarification.

25. There is no equivalent of this example in the pre-2005 OECD Model, and it does not appear in the UN Model Commentary. That is not in itself significant, as the examples are not expressed to be exhaustive under either Model, but an issue for Members is whether this should be explicitly given as an example in the Commentary. If the answer is "yes", there might need to be some elaboration of the OECD wording.

[15] At paragraph 6.

26. The coverage of code sharing and slot chartering appears unlikely to be controversial for most countries. The same would apply for cases where original bookings were made on the enterprise's vessels or aircraft, and these were later changed to, for example, address a delay in the sailing or flight. The reference to "taking advantage of earlier sailings" might be more open to question, however. If an enterprise systematically booked cargo space or flights on entirely unrelated ships/ aircraft (*e.g.* non-code shared flights or where there is no slot charter in place) on the basis of more convenient timings for passengers, there could be issues as to whether the profits are auxiliary to the direct operation of ships or aircraft.

27. It can be suggested, however, that this example has to be read in the context of the opening sentence of paragraph 6 of the current OECD Model Commentary, and an enterprise that systematically booked cargo space or flights on entirely unrelated ships/ aircraft would not be covered by that paragraph: "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."

28. The issue for the Committee is whether the formulation relating to "earlier sailings" has the benefit of greater certainty, while remaining consistent with the words of the Article itself, or whether it appears to give a self-standing rule and instead needs to be more explicitly conditioned by the ideas in that opening sentence (if the opening sentence used by the OECD, or something similar, is to be incorporated in any package of UN Model changes).

29. In fact, a general issue for Members in considering further examples of auxiliary activities will be that it needs to be clear whether the examples given are examples of situations inherently meeting the "auxiliary test" or that *may* meet the test, depending on the circumstances and the existence (or lack) of particular factors. The latter seems to be the intention but that could be elaborated and clarified to ensure greater certainty for both administrators and taxpayers. Explicitly clarifying the supervening aspect of the opening sentence in the case of the examples would, *prima facie*, address any issues in a case such as the taking advantage of earlier sailings by other operators. If some wording on "earlier sailings" is adopted, perhaps earlier *flights* should also be mentioned, although this is likely to be less of a practical issue with passengers than with cargo – the treatment of airline code sharing is likely to be more of an issue.

30. Members should note that a considerable part of the joint submission from the International Chamber of Shipping (ICS) and the World Shipping Council (WSC) included at Attachment B to the 2013 paper and to this paper was devoted to this issue of aircraft and shipping operators making arrangements for another carrier to carry people or goods on part of the international legs of a journey. The submission notes:

Vessel Operating Ocean Carriers Should Qualify for Article 8 Regardless of the Commercial Arrangements under Which They Provide or Obtain Vessel Capacity Used to Transport International Traffic

In addition to the inland transportation issue addressed above, there was also discussion at the most recent Committee of Experts meeting of the application of Article 8 to vessel space provided through vessel sharing arrangements. Specifically, there was a suggestion that Article 8 should not protect from double taxation revenues derived by an ocean carrier that transports a particular shipment using vessel space obtained from another carrier under a Vessel Sharing Agreement[16] or "VSA". The shipping industry believes that this suggestion is unworkable as a practical matter and could have serious implications for the level of service available to cargo interests if it were adopted.

Vessel sharing arrangements have become one of the most common features of the liner shipping industry, with over half of the containerized liner services offered worldwide being offered through such alliances. Because of the capital intensive nature of the shipping business, and because economies of scale have driven the industry towards the use of larger vessels in order to optimize fuel efficiency, it is cost-prohibitive for carriers to offer stand-alone services in many markets. By sharing vessel space, however, multiple carriers can maintain geographic coverage, vessel call frequency, and overall system capacity at levels beyond what they could provide individually, while at the same time those carriers continue to compete commercially for business. These arrangements provide more options, better service and thereby more competition for the carriers' shipper customers.

Within a VSA each of the carriers typically participates in the joint service with a certain number of their own (or chartered) vessels. Each carrier has the right to use a specified amount of the container carrying capacity (TEU capacity / deadweight, whichever is reached first) on board of each of the vessels included in the joint service. The carriers share the capacity with each other on the basis of their share contribution (the ratio between each individual operator's capacity contribution and the joint service total capacity).

Take the example of three carriers cooperating to provide a service between 'Country A' and 'Country B', with each carrier supplying two of the six vessels necessary to provide a weekly service. Under that arrangement, each carrier has the right to use one third of the space on each vessel in the service, regardless of which VSA partner actually operates that particular vessel. Each individual carrier maintains its direct, independent relationship with its shipper customer, and the shipper looks to the carrier issuing the bill of lading to move the goods from origin to destination, regardless of who operates the ship on

[16] We use the term "vessel sharing agreement" here in an inclusive sense, to encompass the full range of arrangements through which vessel operators share space. Such arrangements range from simple sales or exchanges of container slots on vessels to highly integrated operational alliances. The differences in the specifics of the various types of agreements are irrelevant for tax policy purposes.

which the goods are transported. It is immaterial to the carrier and to the shipper – and it should be immaterial to the taxing authorities – which vessel is used for any given shipment. Each of the three VSA partners is a vessel operating ocean carrier providing international transportation under the arrangement described just as surely as it would be if it operated the service using only its own assets. The only difference between the two situations is that the assets are used more efficiently, and the shippers have more choices and better coverage and benefit from an optimised use of vessel resources.

If the application of Article 8 were dependent on whether the goods were moved on a vessel actually operated by the carrier issuing the bill of lading, then the operation of VSAs would be greatly complicated, and their use would be discouraged by tax policy. That, in turn, could have very negative implications for service quality and frequency, and therefore on the smooth flow of international trade. That would, in the view of the shipping industry, constitute a most unfortunate policy choice for everyone engaged – directly or indirectly – in international trade.

For these reasons, the shipping industry believes that any revised commentary should reaffirm the current understanding that any entity that is engaged in the international shipping business of transporting cargo for hire should qualify for exemption under Article 8 whether it is a shipowner, a vessel operator, a time or bareboat charterer, a space or slot charterer, or a lessor or a lessee for the voyage generating the revenue. These various arrangements merely characterize the financial and operational details of how the vessel comes to be made available for service; they have no significance to the policy considerations that underlie Article 8.

Inland transportation legs of international transport

31. The 2005 OECD Model Commentary notes that a further example of an ancillary activity 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."[17] As noted above, the UN Model Commentary, drawing upon the pre-2005 OECD Model Commentary, instead merely lists as one of the examples: "transportation of goods by truck connecting a depot with a port or airport" and does not address inland transportation legs more comprehensively.

32. Possibly the operation of the bus service, trucking and all other inland transportation legs could be dealt with in a single, more comprehensive paragraph, while acknowledging the distinctions between the various enterprises involved in international and domestic legs of a journey, especially since, as noted above, most aircraft bus services are likely to be provided by third party operators, rather than the airlines themselves and the same would apply for car

[17] At paragraph 7. The OECD Model Commentary goes on to note: "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."

services to a port for cruise passengers. The OECD Model Commentary might be usefully drawn upon in any discussion on this topic.

33. Members should note the discussion of inland transportation legs in the submission of the International Chamber of Shipping (ICS) and the World Shipping Council (WSC) included at Attachment B. The submission notes for example:

> At the UN meeting in October, ICS pointed out that inland transport is only included in the scope of taxable activity by the OECD commentary to the extent that the local leg is carried out by a domestic carrier, which would be taxed on its income. The international carrier providing through transportation is taxed for the revenue derived from that inland leg only in the "home country". Furthermore, ICS noted that it is not the practice of the industry to carry large volumes of containers on third party vessels outside a formal time charter, slot charter or vessel sharing arrangement. This latter point is relevant to the issue of prohibition of double taxation on the inland transportation leg of through international movements. It is also relevant to the point that the nature of the commercial arrangement under which an ocean carrier provides or obtains space on a ship should not affect that carrier's tax status.

34. Members should also note the discussion of inland transportation legs in the submission of the International Air Transport Association (IATA) included at Attachment D to this paper:

> 20. IATA also urges the UN to confirm the application of Article 8 to income attributable to the "inland leg" of international transportation sold to the customer by the airline.
>
> 21. Paragraphs 6-8 of the OECD Commentary on Article 8 provide helpful examples of the types of situations that are covered by this principle, and IATA urges adoption of these by the UN:
>
> - Airline that operates a bus service primarily to transport its passengers between town and airport;
>
> - Airline which transports passengers or cargo in international traffic which undertakes to have those passengers or 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 another enterprise;
>
> - Income from sale of a ticket issued by another enterprise for the domestic leg of an international voyage offered by the airline.

Ticket selling

35. The 2005 OECD Model Commentary addresses instances of an enterprise frequently selling tickets on behalf of other transport enterprises at a location that it maintains primarily for purposes of selling tickets for transportation on the ships or aircraft that it operates in international traffic.[18] It notes that such sales of tickets on behalf of other enterprises will either be directly connected with voyages aboard ships or aircraft that the enterprise operates (such as sale of a ticket issued by another enterprise for the domestic leg of an international voyage offered by the first enterprise) or else will be ancillary to its own sales. It concludes that profits derived by the first enterprise from selling such tickets are therefore covered by the paragraph.

36. The UN Model Commentary only deals with the "auxiliary"/ "ancillary" nature of the sale of tickets on behalf of other enterprises and Members should consider whether this elaboration of cases that are considered in the OECD Model Commentary as "directly connected" with voyages operated by the enterprise[19] is a useful clarification in the Commentary or else is unnecessary. Members should consider whether, in modern business conditions, profits made from tie-ins with third party providers of buses, hire cars, limousine services or the like are ancillary services best dealt with under this head of consideration, rather than under the present examples of dedicated bus services and inland transportation legs of international transport. If so, the paragraph may need more elaboration.

Advertising

37. The 2005 OECD Model Commentary notes that: "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.[20] This goes further than the UN Model Commentary (which follows the pre-2005 OECD Model Commentary formulation that "[t]he provision applies, inter alia, to the following activities: … *c*) advertising and commercial propaganda")

38. Consideration should be given to whether addressing in more detail the increasingly diverse modern means of airlines, in particular, earning advertising revenue is warranted, on the one hand, or whether, on the other, profits from such activities are unlikely to sufficiently support source country taxation under Article 7 even if they are *not* considered to be "auxiliary activities" and are therefore not covered by Article 8. The reference to "propaganda" represents an outdated usage in the context of advertising which the Oxford Dictionary describes as "derogatory"[21] and this term should in any case clearly be updated.

Containers

39. The 2005 OECD Model Commentary used new wording to address the use of containers in inland as well as international transport. It noted that: "Profits derived by an

[18] At paragraph 8.

[19] That is, in the words of the OECD Model Commentary since 2005, are: "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" since these "should be considered to be directly connected with such transportation". Whether this is a useful clarification might also be considered by Members.

[20] At paragraph 8.1.

[21] http://www.oxforddictionaries.com/us/definition/american_english/propaganda

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."[22] The UN Model Commentary follows the earlier (pre-2005) formulation of the OECD Model that:

> Recently, "containerisation" has come to play an increasing role in the field of 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 which is supplementary or incidental to its international operation of ships or aircraft fall within the scope of this Article.[23]

40. The main differences between the relevant UN and OECD Model Commentaries are that:

- the OECD has deleted the reference to containerisation as a "recent" phenomenon. It is a reference that is now very dated (containerisation began in earnest in the late 1950's) and should clearly be removed;

- as compared to the UN Model Commentary, which is neutral on this point (i.e. it does not include container fees in the paragraph 8 indicative list of auxiliary activities), the OECD Model Commentary takes the view that "[p]rofits 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." [emphasis added]. Members will need to consider whether they agree with a stronger presumption of inclusion than currently exists in the UN Model Commentary, and the relationship with Article 12 Royalties (which covers equipment – such as container – leasing under the UN Model, unlike the OECD Model) will need to be considered; and

- the OECD Model Commentary adds a clarification that: "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." If Members of the Committee agree with the conclusion as to other aspects of the treatment of containers, this seems a reasonable elaboration.

[22] At paragraph 9.
[23] At paragraph 10.

Providing goods or services to other enterprises

41. The OECD Model Commentary as amended in 2005 notes that:

> 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.[24]

42. Of itself, that analysis does not take us far; in effect it is saying that such activities will be directly connected or ancillary (which we assume for the moment to mean the same as the term "auxiliary" used in the UN Model Commentary, an issue noted above) if they are directly connected or ancillary . However paragraph 10.1 of the OECD Model Commentary takes the analysis a little further when it says:

> 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 that wants to reduce the costs of maintaining facilities for the operation of its aircraft in other countries 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.

43. This is no doubt intended to give a level of certainty to such arrangements, and it will fall for consideration by Members whether this is reasonable in view of the purpose of the Article and the general business/commercial models of airlines in particular. Such pooling arrangements include "engine pooling", where airlines, lessors or manufacturers create a pool of spare engines which any member of the pool can use. Other spare parts are also "pooled". Leasing companies may manage such arrangements.[25]

44. As a specific example mentioned in the OECD Model Commentary, the International Airlines Technical Pool (IATP) is a convention of airlines made up of over 100 member airlines. Members of the IATP gather twice yearly to discuss sharing of resources, reducing costs, and improving operating efficiency. Under its auspices, members share aircraft recovery kits[26], aircraft parts and tooling, ground handling equipment and

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[24] At paragraph 10.

[25] See, for example: https://www.willislease.com/pooling.aspx . A useful summary of how pooling operations work is: Trebilcock B, "Right Part, Right Time, Right Places", *Aviation Week*, 1 June 2012, available at http://aviationweek.com/awin/right-part-right-time-right-places

[26] The secretariat understands that there are only 11 complete aircraft recovery kits globally, and that parts within each kit are generally owned separately by individual airlines and airports worldwide. It understands that only one airline has acquired the full equipment. The equipment is needed because the usual practice in the aviation industry calls for airline

manpower/facilities. It is understood that when the IATP was first formed, this co-operation, although covered by a contract, was entirely reciprocal without financial settlement. By 1950, more international airlines had joined, making it difficult to maintain a reciprocal balance of pooled resources. Formulas were then introduced to provide for financial settlements. Members include aircraft manufacturers, parts providers, parts manufactures and those involved with maintenance, repair and overhaul of aircraft.

45. Members should note that the submission of the International Air Transport Association (IATA) included at Attachment D to this paper addresses this issue as follows:

> 22. IATA likewise urges the UN to adopt clarifications relating to the application of Article 8 to income from an airline's provision of goods or services to other carriers.
>
> 23. Examples of this can be found at paragraphs 10 and 10.1 of the OECD Commentary on Article 8, which address, respectively, income a foreign airline earns from providing ground services to other airlines and income an international airline earns from its participation in pooling arrangements, such as the International Airlines Technical Pool (IATP) (e.g. by providing spare parts or maintenance services to other airlines landing at a particular location).

Some exclusions

46. The UN Model Commentary quotes the pre-2005 OECD Model Commentary to the effect that while the keeping of a hotel for no other purpose than to provide transit passengers with night accommodation (the cost of such a service being included in the price of the passage ticket) would fall within the provision (presumably as an auxiliary/ ancillary activity) the keeping of a hotel as a separate business would not.[27] This was deleted in the 2005 OECD Model Commentary, so the issue for the Committee is whether this is a worthwhile practical elaboration (including the issue of whether such single use hotels operated by transport operators themselves actually exist in modern practice).

47. The current and pre-2005 OECD Commentaries[28] both note that paragraph 1 does not apply to a shipbuilding yard operated in one country by a shipping enterprise having its place of effective management in another country.[29] The UN Model Commentary picks up different wording from the pre-2005 OECD Model Commentary, but there appears no difference in substance between the formulations.

Investment income

48. The OECD Model Commentary has slightly changed since 2005 in relation to investment income. It reads as follows (with the changes from the pre-2005 version relied on in the current UN Model Commentary noted by strikethrough of words deleted and bold lettering for new wording):

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and airport operators to complete due diligence in removing an aircraft from a location where it has been damaged as a result of an accident.

27 At paragraph 11.

28 At paragraph 12 in both Commentaries.

29 At paragraph 12.

> 14. Investment income of shipping~~, inland waterways~~ 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 ~~Article~~ **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~~; it~~**: 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.

49. The UN Model Commentary only picks up the first part of even the pre-2005 OECD Model Commentary when it simply notes:

> Investment income of shipping, inland waterways 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[30] […]

50. The exceptions noted in the current OECD Model Commentary are not addressed in the UN Model Commentary. While this does not necessarily imply disagreement with those conclusions[31] it does leave the issue "hanging in the air", as the very thing it does not address is whether and when there are exceptions whereby the investment income will be dealt with under Article 8 – in fact it may be read by some as denying that there will be such cases. Members will need to discuss these issues and to decide whether they agree with the conclusions in at least the pre-2005 version of the OECD Model Commentary and whether they consider these enhance the certainty of the Article's application, while remaining consistent with the Article's meaning. The changes made to the OECD Model Commentary in 2005 do not appear to be major ones

[30] At paragraph 14.
[31] Introduction to the Model, paragraph 21.

Emissions trading

51. The 2014 version of the OECD Model Commentary provides a new paragraph 14.1

> 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). 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.

52. Members might wish to consider whether they agree with this conclusion, although whether a change is made in the next version of the UN Model Commentary might depend on whether changes to other commentaries, such as that on Article 7, are made to address such emission permits and credits.

General approach of the UN Model Commentary and other sources of revenue

53. "Non-ticket" (or, perhaps more accurately, "non-traditional") revenue is an increasingly important component of airline revenues, particularly for budget airlines and cruise shipping companies.[32] There is a useful note by Patrick Murphy on additional profit earning items for airlines[33] which can be broadly summarised, with some additions[34], as follows:

> **Unbundling Air Fares**
> With the fare paid solely for a passenger's transport. The passenger had to pay extra for such things as changes to bookings, checked baggage, seat assignment, in-flight meals, snacks or beverages, credit card fees etc.
>
> **À la Carte Pricing**
> This can include charges for meals, snacks and drinks on board, changes to bookings, extra fees for checked baggage, printing boarding passes at airports, excess baggage, particular seats or types of seats (such as a window or aisle), buying frequent-flyer miles, lounge access, travel by unaccompanied minors, priority boarding and even fast track through security.

[32] See, for example: Luke Barras Hill, *Global Airline Ancillary Revenues Smash US$30 Billion in 2013*, 17 July 2014, *http://www.frontiermagazine.co.uk/business-insight/global-airline-ancillary-revenues-smash-us30/ ;* Karen Jacobs, *Delta CEO Says 20% of Revenue Now Comes From 'Non-Traditional' Sources*, Reuters, 7 May 2014.

[33] Patrick Murphy, *Aircraft Ancillary Revenues*, http://www.aviation-performance.com/pdf/Airline_ancillary.pdf See also the Wikipedia entry at: http://en.wikipedia.org/wiki/Ancillary_revenue as accessed on 14 September 2014.

[34] See for example the Spirit Airline Optional Services at http://www.spirit.com/OptionalServices and the media kit at http://marketing.spirit.com/mediakit.pdf . Spirit is said to have had the highest percentage of ancillary (i.e. non-bare fare) income as a percentage of income at 38.4% See http://www.ideaworkscompany.com/wp-content/uploads/2014/09/2014-Ancillary-Revenue-Yearbook.pdf (IdeaWorks is a company involved in developing ideas for new sources of revenue). See also Jay Sorensen, *Profit From Innovation: Benefits of Ancillary Revenue Reach All Over the World*, an Amadeus and IdeaWorks sponsored 2012 Report: http://www.amadeus.com/airlineit/docs/2012_ideaworks_report_airlines_profit_from_innovation.pdf

Travel Add-Ons
Hotels, car hire, bus transport, excursions and insurance may be booked as part of the flight booking process, earning commissions. As one author notes: "And the options just keep growing. Airlines are offering airport parking, airport-city transport, lounge access, currency exchange, telephone cards, city tours, tickets for events, and even ski rentals. Innovative airlines are coming up with new add-ons every day."

On-Board Sales
This includes duty-free items, which can be ordered and delivered in more convenient ways to travelers than in the past. This is extending to cover items such as headsets, and discount cards. Sale of Wi-Fi usage on board is becoming more common, as is sale of entertainment options.

Advertising Sales
With a captive audience, advertising can be found in the in-flight magazines, but also now on meal trays, cups, serviettes and other meal-related items, flight attendant aprons, overhead bins, window blinds and surrounds, seatbacks, bulkheads in entertainment programs and, especially, through the booking websites. Many airlines are now offering advertising space in lounge facilities and on the exterior of the aircraft, such as with advertising "wraps".

Customer Loyalty Programs
These programs are a source of new revenue by facilitating partners such as hotels or car-rental companies to offer airline miles, wherein the partner acquires the miles issued - for a charge. Purchase of additional miles to achieve a higher frequent flyer "status", achieve a redemption for a particular journey or an upgrade is increasingly important. Payments are sought to gift, share or even re-activate expired miles[35]. Many of the costs of running such programs are outsourced, and hence deductible. Some airlines have annual fees payable to reduce baggage charges and gain access to some special deals.

Co-Branded Credit Cards
Co-branding offers another source of revenue from joining and annual fees as well as sale of miles to the credit card companies

Other Revenue Sources
One author has noted: "Many airlines actively pursue revenue from sale of services to others which they already provide for themselves. Ground-handling services, engineering and maintenance services are traditional sources. But airlines can also offer short-term aircraft leases and the operation of sub-services and charter flights. Some low-cost airlines have even chosen to sell all their belly-hold cargo space to specialist freight- forwarder companies, rather than use it themselves."

[35] http://www.aa.com/viewPromotionDetails.do?fN=A0605_reaactivate.xml

54. Most of these are clearly either part of the primary activity or are “auxiliary”/ “ancillary” services in the context of Article 8, and aspects of commission based products and advertising are already dealt with in the UN and OECD Commentaries to some degree. A more systemic categorisation of these services and how they can be evaluated might be an advance on both the current UN and OECD Commentaries however. The new uses of frequent flyer programs and co-branded credit cards linked to such programs and offering other benefits to holders when travelling is, on the other hand, something that has passed both the UN and Commentaries by and should perhaps be addressed in the next update. Industry input into any such evaluation would, of course, be very important.

55. There are similar developments in the cruise line industry, which are addressed in the separate note on cruise shipping (E.C18/2014/CRP.2)

ATTACHMENT A:

ARTICLE 8 COMMENTARY AS IT APPEARS IN THE 2011 UN MODEL UPDATE

Article 8

SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

A. General considerations

1. Two alternative versions are given for Article 8 of the United Nations Model Convention, namely Article 8 (alternative A) and Article 8 (alternative B). Article 8 (alternative A) reproduces Article 8 of the OECD Model Convention. Article 8 (alternative B) 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. The remaining paragraphs (3, 4 and 5) reproduce paragraphs 2, 3 and 4 of Article 8 (alternative A) with a minor adjustment in paragraph 5.

2. With regard to the taxation of profits from the operation of ships in international traffic, many countries support the position taken in Article 8 (alternative A). In their view, shipping enterprises should not be exposed to the tax laws of the numerous countries to which their operations extend; taxation at the place of effective management was also preferable from the viewpoint of the various tax administrations. 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, and the total profits of shipping enterprises were frequently quite modest.

3. Other countries asserted that they 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, the use of two alternatives in the Model Convention is proposed and the question of such taxation should be left to bilateral negotiations.

5. Although the texts of Article 8 (alternatives A and B) both refer to the “place of effective management of the enterprise”, some countries may wish to refer instead to the “State of residence of the enterprise”.

6. Although there was a consensus to recommend Articles 8 (alternatives A and B) as

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 acceptance of Article 8 (alternative B) might thus lead to a revenue loss, considering the limited number of shipping companies or airlines whose effective management was situated in those countries. Again, in such cases taxation should be left to bilateral negotiations.

7. 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.

8. Some countries consider that the activity of transport carried out in inland waters, by definition, cannot be considered international transport and, by virtue of that, the fiscal or tax power should be attributed exclusively to the source country in which the activities are carried out. Since Article 8 deals with "Shipping, inland waterways transport and air transport", obviously all three modes of transport dealt with in this Article involve problems of double taxation. Income derived from inland waterways transport is also subject to double taxation if a river or lake used for commercial transportation flows from more than one country with the headquarters of the establishment in one country and traffic originating in more than one country. Hence, it is possible that inland waterways transport would give rise to problems of double taxation.

B. Commentary on the paragraphs of article 8 (alternatives A and B)

Paragraph 1 *of Article* 8 *(alternative A)*

9. This paragraph, which reproduces Article 8, paragraph 1, 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 State in which the place of effective management of the enterprise engaged in international traffic is situated. 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. The exemption from tax in the source country is predicated largely on the premise that the income of these 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.

10. The Commentary on the OECD Model Convention notes that the place of effective management may be situated in a country different from the country of residence of an enterprise operating ships or aircraft and that "[…] some States therefore prefer to confer the

exclusive taxing right on the State of residence". The Commentary suggests that States may, in bilateral negotiations, substitute a rule on the following lines: "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." The Commentary continues:

> 3. Some other States, on the other hand, prefer to use a combination of the residence criterion and the place of effective management criterion by giving the primary right to tax to the State in which the place of effective management is situated while the State of residence eliminates double taxation in accordance with Article 23, so long as the former State is able to tax the total profits of the enterprise, and by giving the primary right to tax to the State of residence when the State of effective management is not able to tax total profits. States wishing to follow that principle are free to substitute a rule on the following lines:
>
> Profits of an enterprise of a Contracting State from the operation of ships or aircraft, other than those from transport by ships or aircraft operated solely between places in the other Contracting State, shall be taxable only in the first-mentioned State. However, where the place of effective management of the enterprise is situated in the other State and that other State imposes tax on the whole of the profits of the enterprise from the operation of ships or aircraft, the profits from the operation of ships or aircraft, other than those from transport by ships or aircraft operated solely between places in the first-mentioned State, may be taxed in that other State.
>
> 4. The profits covered consist in the first place of the profits obtained by the enterprise from the carriage of passengers or cargo. With this definition, however, the provision would be unduly restrictive, in view of the development of shipping and air transport, and for practical considerations also. The provision therefore covers other classes of profits as well, i.e. those which by reason of their nature or their close relationship with the profits directly obtained from transport may all be placed in a single category. Some of these classes of profits are mentioned in the following paragraphs [quoted paragraph 4 is taken from the Commentary on Article 8 as it read in the 2003 version of the OECD Model Convention].

11. Applying the principles set out above, the Commentary on the 2003 OECD Model Convention deals with a number of activities and addresses 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 Commentary notes as follows:

> 5. Profits obtained by leasing a ship or aircraft on charter fully equipped, manned 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 occasional source of income for an enterprise engaged in the international operation of ships or aircraft.
>
> 6. The principle that the taxing right should be left to one Contracting State alone

makes it unnecessary to devise detailed rules, *e.g.* for defining the profits covered, this being rather a question of applying general principles of interpretation.

7. Shipping and air transport enterprises — particularly the latter — often engage in additional activities more or less closely connected with the direct operation of ships and aircraft. Although it would be out of the question to list here all the auxiliary activities which could properly be brought under the provision, nevertheless a few examples may usefully be given.

8. The provision applies, inter alia, to the following activities:
a) the sale of passage tickets on behalf of other enterprises;
b) the operation of a bus service connecting a town with its airport;
c) advertising and commercial propaganda;
d) transportation of goods by truck connecting a depot with a port or airport.

9. If an enterprise engaged in international transport undertakes to see to it that, in connection with such transport, goods are delivered directly to the consignee in the other Contracting State, such inland transportation is considered to fall within the scope of the international operation of ships or aircraft and, therefore, is covered by the provisions of this Article.

10. Recently, "containerisation" has come to play an increasing role in the field of 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 which is supplementary or incidental to its international operation of ships or aircraft fall within the scope of this Article.

11. On the other hand, the provision does not cover a clearly separate activity such as the keeping of a hotel as a separate business; the profits from such an establishment are in any case easily determinable. In certain cases, however, circumstances are such that the provision must apply even to a hotel business *e.g.* the keeping of a hotel for no other purpose than to provide transit passengers with night accommodation, the cost of such a service being included in the price of the passage ticket. In such a case, the hotel can be regarded as a kind of waiting room.

12. There is another activity which is excluded from the field of application of the provision, namely a shipbuilding yard operated in one country by a shipping enterprise having its place of effective management in another country.

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

14. Investment income of shipping, inland waterways 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 […].

Paragraph 1 *of Article* 8 *(alternative B)*

12. This paragraph reproduces Article 8, paragraph 1, of the OECD Model 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 in so far as aircraft are concerned.

Paragraph 2 *of Article* 8 *(alternative B)*

13. This paragraph allows profits from the operation of ships 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 the shipping business and 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 irregular or isolated visits, provided the latter were planned and 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.

14. The overall net profits should, in general, be determined by the authorities of the country in which the place of effective management of the enterprise is situated (or country of residence). 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 percentage
reduction in the tax computed on the basis of the allocated profits is intended to achieve a sharing of revenues that would reflect the managerial and capital inputs originating in the country of residence.

Paragraph 2 *of Article* 8 (*alternative A*) and *Paragraph* 3 *of Article* 8 *(alternative B)*

15. Each of these paragraphs reproduces Article 8, paragraph 2, of the OECD Model Convention. The paragraphs apply not only to inland waterways transport between two or more countries but also to inland waterways transport effected by an enterprise of one country between two points in another country. Countries are free to settle any specific tax problem which may occur with regard to inland waterways transport, particularly between adjacent countries, through bilateral negotiations.

16. The rules set out in paragraphs 8 to 10 above relating to taxing rights and profits covered apply equally to this paragraph.

Enterprises not exclusively engaged in shipping, inland waterways transport and air transport.

17. With regard to enterprises not exclusively engaged in shipping, inland waterways transport or air transport, the Commentary on Article 8, paragraph 2, of the OECD Model Convention observes:

> 18. It follows from the wording of paragraphs 1 and 2 that enterprises not exclusively engaged in shipping, inland waterways transport or air transport nevertheless come within the provisions of these paragraphs as regards profits arising to them from the operation of ships, boats or aircraft belonging to them.
>
> 19. 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, inland waterways transport or air transport.
>
> 20. Nor does any difficulty arise in applying the provisions of paragraphs 1 and 2 if the enterprise has in another State a permanent establishment which is not exclusively engaged in shipping, inland waterways transport 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 where the place of effective management of the enterprise is situated. 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. 21. Where ships or aircraft are operated in international traffic, the application of the Article 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 […].

Paragraph 3 *of Article* 8 (*alternative A*) and *Paragraph* 4 *of Article* 8 *(alternative B)*

18. Each of these paragraphs, which reproduce Article 8, paragraph 3, of the OECD Model Convention, refers to the case in which the place of effective management of the enterprise concerned is aboard a ship or a boat. As noted in the Commentary on the OECD Model Convention:

> 22. […] In this case tax will only be charged by the State where the home harbour of the ship or boat is situated. It is provided that if the home harbour cannot be determined, tax will be charged only in the Contracting State of which the operator of the ship or boat is a resident.

Paragraph 4 *of Article* 8 (*alternative A*) and *Paragraph* 5 *of Article* 8 *(alternative B)*

19. Paragraph 4 of Article 8 (alternative A) reproduces Article 8, paragraph 4, of the OECD Model Convention. Paragraph 5 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". As the Commentary on the OECD Model Convention observes:

> 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.

ATTACHMENT B:

SUBMISSION OF INTERNATIONAL CHAMBER OF SHIPPING AND WORLD SHIPPING COUNCIL

TREATMENT OF SHIPPING IN THE UN MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

Comments by the International Chamber of Shipping (ICS) and the World Shipping Council (WSC)

The International Chamber of Shipping (ICS) is the principal international trade association for merchant shipowners and operators, representing all sectors and trades (including *inter alia* tankers, dry bulk carriers, general cargo and specialised ships, as well as containerships) with the various intergovernmental bodies that impact on shipping. Its membership comprises national shipowners' associations in 36 countries representing over 80% of the world merchant fleet.

The World Shipping Council (WSC) is a membership organization representing the liner shipping industry on public policy issues of interest to its members before national, regional, and international governmental bodies. The Council has offices in Washington D.C. and Brussels. Taken together, the 29 World Shipping Council members provide approximately 90% of the world's containerized shipping capacity.

At the eighth session of the Committee of Experts on International Cooperation on Tax Matters, the shipping industry and other interested parties were invited to comment on the discussions about taxation of international transport. We appreciate this opportunity to provide the following remarks about the treatment of international shipping in the UN Model Double Taxation Convention.

About 90% of global trade is carried by sea. The efficiency of ship operations, and the global economy which they serve, is very much dependent upon the existence of a uniform and common understanding of how national rules apply to what is an international industry regulated by multilateral international treaties. If different national rules were to apply during different parts of a voyage then the result would

be chaos and serious inefficiency in the movement of the world's energy, raw materials, food and manufactured products.

Shipping is an inherently globalised business with over 60,000 vessels engaged in international trade calling at numerous different countries during a year. This is true of most ships engaged in bulk and specialist trades, as well as those carrying containerized cargoes. In the case of container vessels, they nearly always carry cargo from a number of different countries during a specific journey voyage. It is therefore paramount that the present and long established principle of taxing international shipping in the 'home country' only (as may be defined by the authorities in that country) is maintained. For the same reason and in order to ensure that there remains a common understanding of the international principles for taxation of shipping, the UN and the OECD model treaties should as far as possible be aligned with respect to their treatment of international shipping. The OECD commentary was revised in 2005 after an extensive analysis of the functioning and operation of modern day international shipping activities. It is the opinion of the global shipping industry that the OECD model should serve as the inspiration for the discussions at the UN level.

General Principles

At the meeting of the Committee of Experts, the question of auxiliary/ancillary income was discussed. ICS commented on the development of the industry – in particular container shipping – where the containers can continue their journey after the vessel reaches port. ICS commented on the practical issues of allocating income between the primary and auxiliary activities, since they are often not separately invoiced. ICS also mentioned that the industry places great value in the importance of having an absolutely consistent interpretation of the scope of the Shipping Article in the UN Convention and its wish to avoid disputes in the large number of countries in which individual vessels call.

These views are fully supported by WSC.

ICS and WSC therefore welcome the efforts of the UN Committee to reach a consensus on the scope of Article 8. However, it is important to understand that any inconsistency with the OECD approach, or any new restriction on the scope of the current Shipping Article, would be extremely problematic for the industry since this could lead to different treatment by local authorities in the various ports of call on a voyage. Given the large number of ships and cargoes involved in international trade this would be chaotic, for tax authorities as well as shipping companies. This could seriously distort international trade which very much depends on common rules and an interpretation of such rules which allows market participants to offer cost-effective and efficient services.

At the UN meeting in October, ICS pointed out that inland transport is only included in the scope of taxable activity by the OECD commentary to the extent that the local leg is carried out by a domestic carrier, which would be taxed on its income. The international carrier providing through transportation is taxed for the revenue derived

from that inland leg only in the “home country”. Furthermore, ICS noted that it is not the practice of the industry to carry large volumes of containers on third party vessels outside a formal time charter, slot charter or vessel sharing arrangement. This latter point is relevant to the issue of prohibition of double taxation on the inland transportation leg of through international movements. It is also relevant to the point that the nature of the commercial arrangement under which an ocean carrier provides or obtains space on a ship should not affect that carrier’s tax status.

Key Features of International Shipping

‘Tramp’ shipping (as opposed to liner shipping) is the maritime transportation of bulk materials (dry and wet) that does not adhere to published schedules and which often responds to instructions from a single charterer (customer) who in many cases takes effective control of the vessel, either for a single voyage or for several multiple voyages. The industry understands that tramp shipping has not developed from a tax point of view since the present UN texts were developed. However, some bulk trades, such as the shipping of oil and chemical products, exhibit similarities to containerised trades in that product tankers often carry cargoes in ‘parcels’ that belong to several different customers located in many different countries which the ship will visit during the course of a voyage.

For the purpose of this paper, however, ICS and WSC would like to focus on modern day liner shipping since it is this activity that is potentially most prone to give rise to double taxation issues.

An ocean carrier’s service involves multiple ports of call and a plethora of international cargo origins and destinations on every single voyage. The maps below show the actual ports called by an ocean carrier on one of its many services. The upper map is the westbound service; the lower map is the eastbound service.

Port calls in a carrier's westbound service

Port calls in the same carrier's eastbound service

In the westbound service, for example, when the ship leaves Los Angeles, United States, it may have been loaded with cargo originating in Canada, the United States and various South American countries which will be unloaded from the ship at ports in Japan, Republic of Korea, Chinese Taipei, Hong Kong (China), Thailand, Sri Lanka, France, Netherlands, Germany, Belgium and the United Kingdom.
At each such port, some of the cargo will:

- be destined for that port and the ocean carrier's responsibilities will end at that port;
- be destined for inland points within the country of the port of call and the ocean carrier has the responsibility to deliver the cargo there;
- be destined for inland points within a country different from the country of the port of call and the ocean carrier has the responsibility to deliver the cargo there (e.g.

cargo is discharged in Rotterdam, Netherlands and barged, railed or trucked to Germany); or

- be trans-shipped in this port onto different vessels used by the carrier to transport the cargo to other ports not on the first vessel's itinerary (e.g. cargo discharged in Colombo, Sri Lanka may be relayed to a different vessel that will call at Mumbai, India), which may then be further transported to the various destination possibilities outlined above.

Most ocean carriers have numerous vessel strings operating simultaneously, which are integrated into networks that enable the carrier to serve the needs of international exporters and importers by literally moving goods from virtually any point in the world to any other point in the world. These can be intricate and very complex networks.

The Entire End-To-End Movement – Including Inland Transportation – Must Be Exempt From Double Taxation as International Traffic

When a ship sails on an itinerary such as the one shown above, the ocean carrier will be required to take into account revenue for the entire promised through transportation that the shipper has negotiated and agreed to pay for, not for portions of the revenue broken into component parts. There will be literally thousands of possible origin and destination combinations across different national boundaries on every single voyage. In addition, payment for a shipment may be from the shipper or from the consignee, in the country of origin or destination or a third country, depending on the commercial factors involved in the sale of the goods.

According the Drewry Shipping Consultants, approximately 163 million TEU[36] of loaded shipping containers moved worldwide in 2011. It is an inherent and unavoidable aspect of the business that each vessel string used in a service, like the one described above, will have literally thousands of origins and destination pair combinations. To apply a varied, differing set of tax treatments to various portions of these thousands of cargo shipments would create immense difficulty. It would artificially sever the international transportation of cargo into components that neither the carrier nor its customer contracted for. If a shipper contracts with an ocean carrier to transport goods to a port and no further, the carrier's international transportation service stops there. But if a shipper contracts with an ocean carrier to transport a container of goods from say Frankfurt, Germany, to Chicago, United States, that is the international transportation service and the "international traffic".

Thus, while an "international journey of a ship" approach may have aptly covered the typical port-to-port movement before the advent of containerization, it does not reflect the reality of modern transportation for the international movement of cargo, where the sea-leg constitutes but one part, albeit an essential part. Thus, the

[36] Source: Drewry Container Market Review and Forecaster, Quarter 3, 2012. A "twenty foot equivalent unit" or "TEU" is a common unit of measure for containerships and containerized cargo. Many containers are 40 feet long. A forty foot container would represent 2 TEU.

shipping industry recommends that it be made very clear that the inland portion of international transportation of cargo is covered under the definition of "international traffic," which the existing UN and OECD Commentary to Article 8 clearly declares as the intention.

For the sake of clarity we would like to point out that an ocean carrier uses the services of third parties to offer inland transportation. Thereby the carrier neither competes with domestic companies nor profits from a beneficial tax treatment of such service.

Vessel Operating Ocean Carriers Should Qualify for Article 8 Regardless of the Commercial Arrangements Under Which They Provide or Obtain Vessel Capacity Used to Transport International Traffic

In addition to the inland transportation issue addressed above, there was also discussion at the most recent Committee of Experts meeting of the application of Article 8 to vessel space provided through vessel sharing arrangements. Specifically, there was a suggestion that Article 8 should not protect from double taxation revenues derived by an ocean carrier that transports a particular shipment using vessel space obtained from another carrier under a Vessel Sharing Agreement[37] or "VSA". The shipping industry believes that this suggestion is unworkable as a practical matter and could have serious implications for the level of service available to cargo interests if it were adopted.

Vessel sharing arrangements have become one of the most common features of the liner shipping industry, with over half of the containerized liner services offered worldwide being offered through such alliances. Because of the capital intensive nature of the shipping business, and because economies of scale have driven the industry towards the use of larger vessels in order to optimize fuel efficiency, it is cost-prohibitive for carriers to offer stand-alone services in many markets. By sharing vessel space, however, multiple carriers can maintain geographic coverage, vessel call frequency, and overall system capacity at levels beyond what they could provide individually, while at the same time those carriers continue to compete commercially for business. These arrangements provide more options, better service and thereby more competition for the carriers' shipper customers.

Within a VSA each of the carriers typically participates in the joint service with a certain number of their own (or chartered) vessels. Each carrier has the right to use a specified amount of the container carrying capacity (TEU capacity / deadweight, whichever is reached first) on board of each of the vessels included in the joint service. The carriers share the capacity with each other on the basis of their share contribution (the ratio between each individual operator's capacity contribution and the joint service total capacity).

[37] We use the term "vessel sharing agreement" here in an inclusive sense, to encompass the full range of arrangements through which vessel operators share space. Such arrangements range from simple sales or exchanges of container slots on vessels to highly integrated operational alliances. The differences in the specifics of the various types of agreements are irrelevant for tax policy purposes.

Take the example of three carriers cooperating to provide a service between 'Country A' and 'Country B', with each carrier supplying two of the six vessels necessary to provide a weekly service. Under that arrangement, each carrier has the right to use one third of the space on each vessel in the service, regardless of which VSA partner actually operates that particular vessel. Each individual carrier maintains its direct, independent relationship with its shipper customer, and the shipper looks to the carrier issuing the bill of lading to move the goods from origin to destination, regardless of who operates the ship on which the goods are transported. It is immaterial to the carrier and to the shipper – and it should be immaterial to the taxing authorities – which vessel is used for any given shipment. Each of the three VSA partners is a vessel operating ocean carrier providing international transportation under the arrangement described just as surely as it would be if it operated the service using only its own assets. The only difference between the two situations is that the assets are used more efficiently, and the shippers have more choices and better coverage and benefit from an optimised use of vessel resources.

If the application of Article 8 were dependent on whether the goods were moved on a vessel actually operated by the carrier issuing the bill of lading, then the operation of VSAs would be greatly complicated, and their use would be discouraged by tax policy. That, in turn, could have very negative implications for service quality and frequency, and therefore on the smooth flow of international trade. That would, in the view of the shipping industry, constitute a most unfortunate policy choice for everyone engaged – directly or indirectly – in international trade.

For these reasons, the shipping industry believes that any revised commentary should reaffirm the current understanding that any entity that is engaged in the international shipping business of transporting cargo for hire should qualify for exemption under Article 8 whether it is a shipowner, a vessel operator, a time or bareboat charterer, a space or slot charterer, or a lessor or a lessee for the voyage generating the revenue. These various arrangements merely characterize the financial and operational details of how the vessel comes to be made available for service; they have no significance to the policy considerations that underlie Article 8.

Auxiliary Services

At the meeting in October 2012 a discussion took place about the terms ancillary vs. auxiliary. As ship owners we are not concerned with the term as such but find that the latest elaboration from the OECD provides a pragmatic understanding of the activities that are clearly related to international transport without constituting a separate business for the shipping company. It is for example customary for shipping companies to charge shippers for late redelivery of containers, cargo storage etc. to ensure the smooth flow of cargo and equipment. Similarly, the income from the use, maintenance or rental of containers, including equipment for the transport of containers such as trailers and chassis, should be taxed only in the country of residence, provided that the containers are used for the international transport of cargo.

# # #

Current practice under the OECD Model Treaty and its commentary has generally resulted in a manageable system for the shipping industry that does not impose unreasonable administrative burdens or discourage service-enhancing arrangements such as vessel sharing agreements. Any proposed changes to that stable and workable regime should be considered with substantial caution. As mentioned, ICS and WSC greatly appreciate the opportunity to participate in the UN discussions of this important topic and would welcome any questions or comments from Committee members.

Contact:

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World Shipping Council
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International Chamber of Shipping
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ATTACHMENT C

DEFINITIONS OF "ANCILLARY" AND "AUXILIARY"

Oxford English Dictionary (3rd) 2010

ancillary /anˈsɪləri/

adjective

providing necessary support to the primary activities or operation of an organization, system, etc.: *ancillary staff*.

- in addition to something else, but not as important: *paragraph 19 was merely* ***ancillary to*** *paragraph 16*.

noun (pl.** ancillaries**)

a person whose work provides necessary support to the primary activities of an organization, system, etc.: *the employment of specialist teachers and ancillaries*.

- something which functions in a supplementary or supporting role: *undergraduate courses of three main subjects with related ancillaries* | *the system measures engine power at the flywheel with all ancillaries (fan, standard exhaust, etc.) connected*.

– ORIGIN mid 17th cent.: from Latin *ancillaris*, from *ancilla* ' maidservant' '.

auxiliary /ɔːgˈzɪlɪəri, , ɒg-/

adjective

providing supplementary or additional help and support: *auxiliary airport staff* | *the ship has an auxiliary power source*.

- (of troops) engaged in the service of a nation at war but not part of the regular army.
- (of a sailing vessel) equipped with a supplementary engine: *an auxiliary schooner*.

noun (pl.** auxiliaries**)

an auxiliary person or thing: *a nursing auxiliary* | *there are two main fuel tanks and two auxiliaries*.

- *N. Amer.* a group of volunteers giving supplementary support to an organization or institution: *members of the Volunteer Fire Department's women's auxiliary*.
- *(Grammar)* an auxiliary verb.
- a naval vessel with a supporting role, not armed for combat.

– ORIGIN late Middle English: from Latin *auxiliarius*, from *auxilium* '' help'.

Merriam Webster Online:

an·cil·lary

adjective \ˈan(t)-sə-ˌler-ē, -ˌle-rē, ***especially British*** an-ˈsi-lə-rē\

- : providing something additional to a main part or function

Full Definition of ANCILLARY

1: SUBORDINATE, SUBSIDIARY <the main factory and its *ancillary* plants>

2: AUXILIARY, SUPPLEMENTARY <the need for *ancillary* evidence>

— **ancillary** *noun*

Examples of ANCILLARY

1. The company hopes to boost its sales by releasing *ancillary* products.
2. The lockout rocked the NHL, but among the *ancillary* benefits has been the emergence of young players who apprenticed for an additional season in the minors … —Michael Farber, *Sports Illustrated*, 21 Nov. 2005

aux·il·ia·ry

adjective \òg-ˈzil-yə-rē, -ˈzil-rē, -ˈzi-lə-\

: available to provide extra help, power, etc., when it is needed

Full Definition of AUXILIARY

1 a: offering or providing help

b: functioning in a subsidiary capacity <an *auxiliary* branch of the state university>

2: *of a verb* **:** accompanying another verb and typically expressing person, number, mood, or tense

3 a: SUPPLEMENTARY

b: constituting a reserve <an *auxiliary* power plant>

4: equipped with sails and a supplementary inboard engine<an *auxiliary* sloop>

AWE reference source for academic writing (University of Hull) http://slb-ltsu.hull.ac.uk/awe/index.php?title=Ancillary_-_auxiliary:

Ancillary - auxiliary

These two words have similar meanings, and can be found in similar contexts. However, their meanings are distinct. So is their spelling. The first **ancillary** has two '-l-s'. The second, **auxiliary**, has only one.

- **ancillary** (with two '-l-'s) is derived from the Latin word for a maidservant - *ancilla*. So it is used in the sense 'supporting' or 'not important', or 'secondary'.
- **auxiliary** (with one '-l-') derives from the Latin word for 'help' or 'assistance' - *auxilium*. In military terms, it denoted - and still denotes - soldiers who are not central to the action, although they may have an important role: in the Roman army, these were those non-citizen or mercenary forces fighting beside the Roman citizens in the Legions (regular troops|). For example: "the **auxiliary** forces [or **auxiliaries**] guarded the wings while the army marched", or "**Auxiliary** vessels scouted the sea for any sign of the enemy". In general use, it means 'helping', or 'second rank'. Auxiliary nurses are usually less highly trained, and do less skilled jobs, than full nurses.
- It is in technical areas that the words are most distinct. Sailing boats may have an **auxiliary** engine, for use when there is no wind; they do not have ~~ancillary~~ engines. In English grammar, main verbs are helped to express their tenses, moods and voices by auxiliary verbs.

See also the discussions at:

http://english.stackexchange.com/questions/15955/auxiliary-or-ancillary
http://www.languageusage.com/q/answers-auxiliary-or-ancillary-15955.html

ATTACHMENT D

SUBMISSION OF INTERNATIONAL AIR TRANSPORT ASSOCIATION

14 October 2013

VIA E-MAIL

Mr. Michael Lennard
Chief, International Tax Cooperation Section
Financing for Development Office
UN Department of Economic and Social Affairs
2 UN Plaza, Room DC2-2172
United Nations
New York, NY 10017
USA
lennard@un.org

Re: United Nations Model Double Taxation Convention, Article 8

Dear Mr. Lennard :

On behalf of the International Air Transport Association (IATA), I am writing to express our interest in the work to be undertaken by the United Nations Committee of Experts on International Cooperation in Tax Matters (the Committee) on Article 8 (Shipping, inland waterways transport and air transport) of the UN Model Double Taxation Convention.

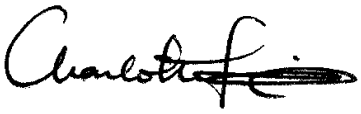
IATA is the trade association for the world's airlines, representing some 240 airlines or 84% of total air traffic. We will be represented at the Committee's Ninth Session in Geneva on 21-25 October 2013 by Messrs. Dane Clapson and Auguste Hocking from IATA's legal department and Mr. Frédéric Roch of Air France (Chairman of IATA's Industry Taxation Working Group), and they look forward to the opportunity to meet you and speak with you there.

In connection with the discussion to take place at the Geneva meeting, we have prepared the attached preliminary comments on Article 8 and its Commentary under the UN Model. I would be very grateful if you could make a copy of these comments available to the Committee members in advance of the meeting.

I would also like to take this opportunity to express IATA's interest in contributing further to any ongoing work the Committee may undertake with respect to Article 8 after this month's meeting. The outcome of the Committee's discussion on Article 8 is extremely important to the IATA membership, and we believe we could contribute very constructively to the Committee's analysis of the policy considerations relevant to Article 8. Please do not hesitate to contact me and/or IATA's tax counsel, Mary Bennett of Baker & McKenzie LLP (mary.bennett@bakermckenzie.com), if you would like to pursue this offer of further dialogue.

Thank you very much for your kind consideration of this letter.

Sincerely,



Charlotte Fantoli
Manager, Industry Taxation
fantolic@iata.org

Attachment: Appendix, IATA Preliminary Comments on Article 8

INTERNATIONAL AIR TRANSPORT ASSOCIATION (IATA) :

PRELIMINARY COMMENTS ON ARTICLE 8 OF THE UN MODEL TAX CONVENTION

MEETING OF THE COMMITTEE OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS

GENEVA, 21-25 OCTOBER 2013

Introduction

1. IATA is the trade association for the world's airlines, representing some 240 airlines or 84% of total air traffic. Our member companies are based in over 125 countries and engage in air transport operations in virtually every country around the globe.

2. Our member companies' ability to conduct their air transport operations without facing crippling compliance burdens and multiple taxation risks depends almost entirely upon the consensus in favor of exclusively residence-based taxation of airlines' income from international traffic, as reflected in Article 8 (Shipping, inland waterways transport and air transport) of the UN Model Tax Convention and in the identical language of Article 8 of the OECD Model Tax Convention.

3. Accordingly, IATA has a strong interest in the manner in which Article 8 is interpreted and applied.

4. The UN Model is an important manifestation of the UN's policy to contribute to the development aims of developing countries by eliminating, on politically and economically acceptable terms, the international double taxation that would otherwise inhibit the growth of investment flows from developed to developing countries.

5. The UN's International Civil Aviation Organization (ICAO) has long recognized the fundamental importance of international air transport services to the development of the economies of developing States, and it has strongly endorsed the Article 8 exemption as a key factor in fostering sustainable economic development by removing the threat of double taxation of international civil aviation.[38] The 38th session of the ICAO Assembly earlier this month endorsed the reinforcement of its policies on taxation in the field of international air transport with ICAO contracting states.[39]

6. We understand that in connection with the preparation of the 2011 update to the UN Model, the Committee discussed the question of whether the Commentary on Article 8 of the UN Model should be revised to align more closely with the Commentary on Article 8 of the OECD Model, including the amendments made to the latter in 2005 to refer to income directly connected with the operation of aircraft in international traffic and income from activities "ancillary" to such operation.

7. The Committee declined to adopt the OECD changes as part of the 2011 update, with members noting that the changes needed to be discussed in more detail to assess their implications.

8. The Committee decided to add the issue of revising the Article 8 Commentary to the catalogue of issues and to consider the issue further at its 2013 meeting.

9. IATA strongly supports the idea of aligning the Commentary on Article 8 of the UN Model with the Commentary on the identical language of Article 8 of the OECD Model, and we are pleased to present the preliminary comments below to explain our reasons for that view.

10. IATA also wishes to confirm to the Committee its interest in contributing constructively to the Committee's ongoing examination of the policy considerations relevant to this decision, and we would be grateful for the opportunity to provide a more thorough analysis after the Committee's October 2013 meeting. We are prepared to engage with the Committee in any way you would find helpful as you pursue this work.

Article 8 -- General

11. The policy of including in treaties a reciprocal exemption for income from the operation of aircraft in international traffic dates back as far as the 1928 League of

[38] See ICAO Assembly Resolution A37-20, Appendix E, and ICAO's Policies on Taxation in the Field of International Air Transport (Third Edition – 2000), Doc 8632.

[39] See http://www.icao.int/Meetings/a38/Documents/WP/wp055_en.pdf.

Nations Model Tax Convention. The rationale then was the same as it is today, namely a recognition that for businesses operating in this sector, "lack of implementation of this rule of reciprocal exemption involves either multiple taxation or considerable difficulties of income allocation in a very large number of taxing jurisdictions."[40]

12. As the ICAO has further noted, decisions in favor of reciprocal exemptions were made because "multiple taxation on the … income of international air transport, as well as taxes on its sale and use, were considered as major obstacles to further development of international air transport. Non-observance of the principle of reciprocal exemption envisaged in these policies was also seen as risking retaliatory action with adverse repercussions on international air transport, which plays a major role in the development and expansion of international trade and travel."

13. IATA worked closely with the OECD in analyzing issues relevant to the scope of the Article 8 exemption during the period leading up to the 2005 changes to the Commentary on Article 8 of the OECD Model. We would be glad to provide the Committee with a detailed review of the considerations that led to the adoption of those clarifications, but for present purposes let us highlight the major points.

Treatment of "ancillary"/ "auxiliary" income

14. Much of the discussion leading to the changes to the OECD Commentary related to the application of the Article 8 exemption to income that was not from the direct operation of aircraft in international traffic but was from activities sufficiently closely connected to that operation to be considered to fall within the scope of the exemption.

15. Prior to 2005, paragraph 7 of the OECD Commentary used the term "auxiliary" to refer to such activities. The 2005 OECD Commentary changed the terminology for that concept to "ancillary". It was IATA's understanding that the primary reason for this change was to avoid confusion with the concept of "preparatory or auxiliary" under Article 5, particularly since the latter is interpreted as referring to activities that are "remote from the actual realisation of profits".[41] It was clear that the examples of so-called "auxiliary" activities described at paragraph 8 of the pre-2005 OECD Commentary on Article 8 (e.g., the sale of passage tickets on behalf of other enterprises, the operation of a bus service connecting a town with its airport, etc.) did not meet the description of being remote from the actual realization of profits. The term "ancillary" to the operation of aircraft in international traffic, adopted at paragraph 4.2 of the 2005 OECD Commentary, was considered a more appropriate description of the activities intended to be covered by Article 8.

16. The 2005 OECD Commentary included elaborations on the types of income that would be considered directly related or ancillary to the operation of aircraft in international traffic.[42] This was done to update the Commentary to reflect more usefully the actual state of cooperation among airlines. IATA had provided

[40] ICAO's Policies on Taxation in the Field of International Air Transport (Third Edition – 2000), Doc 8632.
[41] See paragraph 23 of the Commentary on Article 5 of the OECD Model, reproduced at paragraph 18 of the Commentary on Article 5 of the UN Model.
[42] See, e.g., paragraph 10 of the OECD Commentary on Article 8.

background information to the OECD to explain the need for this greater clarity, including the following:

> The practice of airlines to perform various ancillary activities for one another at airports around the world has existed for many decades and has intensified with the growing development of strategic alliances. The reasons for this practice are basically economic. Everywhere a foreign airline flies it must operate, or otherwise provide for, terminal facilities, baggage and ground handling, load control and communications, ramp services, security services, catering, aircraft servicing and maintenance, hangars, and other capital-intensive functions and equipment. These functions must be performed and equipment provided even where the airline's service of a particular airport is minimal. Similarly, pilots, flight attendants, mechanics, baggage handlers, reservation agents, gate agents, security guards, cooks, cleaners, and other personnel, usually highly unionized, must be provided in each location notwithstanding thin traffic. The evolving demands of modern travelers also require the airlines to provide other amenities, including in-terminal lounges, eating facilities, business facilities, and in-flight entertainment. Almost from the beginning of commercial aviation, airlines have entered into cooperative arrangements to perform these activities for one another in order to maximize the efficient use of available resources. This practice, which has been recognized and encouraged by governments for decades, improves the economic situation of the airlines and their customers alike.

17. IATA urges the UN similarly to recognize that income attributable to these types of activities carried out by airlines on behalf of their passengers and on behalf of one another falls within the scope of the Article 8 exemption for income from operation of aircraft in international traffic.

18. Another important issue addressed by the OECD's 2005 Commentary relates to the income earned by airlines from the extraordinarily common cooperative arrangements that have grown up with respect to the actual provision of transport, including code-sharing arrangements. Code-sharing is a form of marketing arrangement in which airlines agree to allow each other to put their own designator code on flights operated by the other airline in order to be able to sell itineraries they otherwise could not offer to their customers. For example, if a European airline ("EuroAir") and a US airline ("StatesAir") had a code-sharing arrangement, they might both be able to market themselves as offering a Paris-Chicago-Detroit itinerary without regard to which airline was going to operate the individual legs. Thus, a customer purchasing the trip from EuroAir might receive a ticket showing Flight EU123 from Paris to Chicago and Flight EU456 from Chicago to Detroit, and a customer purchasing the same trip from StatesAir might receive a ticket showing Flight ST123 from Paris to Chicago and Flight ST456 from Chicago to Detroit. Airlines that enter into these kinds of code-sharing arrangements typically negotiate a split of revenues and/or profits from the code-shared flights that could take into account various factors, such as which airline operates the actual flights, which airline sells the tickets, relative contributions to marketing expenses, increased revenue and profitability due to code-share, etc.

19. The OECD's 2005 Commentary recognizes the application of Article 8 to income realized by an airline from a code-sharing arrangement in which its passengers are transported internationally on aircraft operated by another enterprise where that arrangement is directly connected or ancillary to the airline's operation of aircraft in international traffic,[43] and IATA likewise urges the UN to adopt this clarification.

Treatment of "inland legs" of international transport

20. IATA also urges the UN to confirm the application of Article 8 to income attributable to the "inland leg" of international transportation sold to the customer by the airline.

21. Paragraphs 6-8 of the OECD Commentary on Article 8 provide helpful examples of the types of situations that are covered by this principle, and IATA urges adoption of these by the UN:

- Airline that operates a bus service primarily to transport its passengers between town and airport;
- Airline which transports passengers or cargo in international traffic which undertakes to have those passengers or 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 another enterprise;
- Income from sale of a ticket issued by another enterprise for the domestic leg of an international voyage offered by the airline.

Income from the provision of goods or services to other carriers

22. IATA likewise urges the UN to adopt clarifications relating to the application of Article 8 to income from an airline's provision of goods or services to other carriers.

23. Examples of this can be found at paragraphs 10 and 10.1 of the OECD Commentary on Article 8, which address, respectively, income a foreign airline earns from providing ground services to other airlines and income an international airline earns from its participation in pooling arrangements, such as the International Airlines Technical Pool (IATP) (e.g. by providing spare parts or maintenance services to other airlines landing at a particular location).

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24. IATA appreciates the opportunity to provide these comments and looks forward to working with the Committee on possible amendments to the Commentary on Article 8.

[43] See paragraph 6 of the OECD Commentary on Article 8.