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PROPOSED CHANGES TO THE OECD MODEL TAX CONVENTION DEALING WITH THE OPERATION OF SHIPS AND AIRCRAFT IN INTERNATIONAL TRAFFIC

To Whom it May Concern,

On November 15, 2013 the OECD invited interested parties to comment proposed changes to Articles 8 and 15(3) of the OECD Model Tax Convention and the related Commentary, concerning the application of the Convention to ships and aircraft engaged in international traffic and their employees. We would like to respond to that request.

Background of Rödl & Bartling GmbH:

We are an audit and tax consulting firm in Hamburg (Germany) consulting shipping enterprises, ship management enterprises and crewing enterprises with more than 700 commercial ships, tankers and cruise ships and more than 100,000 crewmembers.

In our daily work we are confronted with all issues related to the application of the regulation in the Conventions between different states. Very often fiscal courts had to decide cases of different interpretations of the provisions in Art. 8 and Art. 15 (3) of a Convention.

In our opinion any change in the Model Convention should take into account the changes in the international economic environment.

In our attached comment we explain those changes and the problems of application of the conventions and try to find solutions.

Yours sincerely

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Comment to

PROPOSED CHANGES TO THE OECD MODEL TAX CONVENTION DEALING WITH THE OPERATION OF SHIPS AND AIRCRAFT IN INTERNATIONAL TRAFFIC

(Public discussion draft of OECD November 11, 2013)

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1 Article 8

A deep analysis of art. 8 should precede any change of the article.

1.1 International shipping today

Since more than 25 years more and more ship operating enterprises source out operational functions to specialized enterprises. Those functions are technical management, commercial management and the crewing of the ships. At the time when art. 8 was introduced, those functions had been performed only by the shipping enterprises itself. There are more and more smaller shipping enterprises especially one ship enterprises, which do not have an own operation at all.

1.2 Avoidance of double taxation

To avoid taxation from worldwide shipping in different countries worldwide art. 8 was introduced giving one state the right to tax.

By splitting the operation of a ship into several operational functions performed by different enterprises those enterprises suffer the same international taxation problem as the shipping enterprise doing the functions itself: Performing functions of international shipping requires PEs and dependent agents in different countries worldwide in the same way as for the shipping enterprises.

The convention Germany/Cyprus is the first convention, which qualifies the income of those specialized enterprises as shipping income under art. 8.

Proposal: Profits from the operation of ships include profits of enterprises which perform the different tasks of operating a ship for the shipping enterprises, such as crewing, technical and commercial management.

1.3 "Enterprise of a Contracting State"- Fragmentation in case of Partnerships

The terminology "enterprise of a Contracting State" creates serious problems in case the enterprise is carried on by "**residents**" (definition in Art. 3 (1d)) in different countries. That is the case, if the enterprise is carried on by a transparent partnership, which itself is not considered as a resident under Art. 4. Giving the right to tax the profit of the enterprise to the contracting state, each state of residence of a partner of the partnership would have the right to tax the respective profit share, though the partnership running the enterprise is registered and/or established only in one contracting state. Under the usual definition structure of art. 3 and art. 4 the enterprise of the partnership is split into enterprises of each partner.

Taking into account that more and more shipping enterprises are carried on by partnerships the fragmentation of the enterprise of the partnership into enterprises of each partner subject to regulations of different Tax Conventions with the respective resident partner will cause serious problems, because each state has its own rules to determine and control the tax base.

To avoid those problems of partnerships under the conventions the only solution is to apply art. 8 on the "profit of an enterprise carried on in a contracting state" by a "person, which may not be a resident of a contracting state" and not on an "enterprise of the Contracting state". That is a derogation from the requirement of Art. 1 under which the convention can be applied only on persons being residents of one or both contracting states. That derogation from the general rule is justified by the world wide activity of shipping enterprises.

As an enterprise can be performed anywhere one location must be determined to reach the target of art. 8:

Proposal:

a) Either**:" Profits from the operation of ships or aircraft in international traffic by an enterprise carried on by a person resident or not in a contracting state**

shall be taxable only in the Contracting state where the person carrying on the enterprise is registered or if not registered, established under its law",

b) or: **"Profits from the operation of ships or aircraft in international traffic by an enterprise carried on by a person resident or not in a contracting state shall be taxable only in the Contracting State in which the place of effective management of the person carrying on the enterprise is situated."**

Both possibilities cover any kind of organizational form of the shipping enterprise giving one contracting state the right to tax. As the person does not have to be resident in a contracting state, it will sufficient that the person is registered or established in a contracting state (lit a) or the place of effective management is situated in a contracting state (lit b).

1.4 Proposals of the OECD

The proposals of the OECD do not solve the existing problems applying art. 8.

2 Taxation of Crewmembers

The OECD is proposing to amend art. 15 (3) in a way that the contracting state of the residence of the crewmember shall have the exclusive right to tax.

2.1 UNCLOS

The "United Nations Convention on the Law of the Sea of 10 December 1982" ("UNCLOS")

The Convention was ratified by 166 parties including the European Union, but not the USA.

Both the right of free navigation granted vessels and aircrafts (Art. 87 UNCLOS) which is identified and the ability of Contracting States to impose taxes territorially are restricted within this convention:
It is regulated in UNCLOS:

- Art. 87: Freedom of navigation of vessels and aircrafts and of performing any activity on highs seas.
- Art. 89 UNCLOS: No state may impose sovereignty rights on high seas

- Art. 91: A ship has the nationality of the flag state; sovereignty over the ship of the flag state on high seas.
- Art. 92; Only the flag state can impose its law on the ship on high seas; only the flag state can impose tax on the income for services of crewmembers performed on high seas. (sovereignty of the flag state over the ship; nationality of the ship)
- Art. 17: Innocent passage i.e. passing through territorial waters and proceeding to and from an internal water's port, but not domestic proceedings. The coastal state has only rights regarding safety manners and other regulations but not sovereignty rights regarding manning and tax rights for services on board.

Any other state than the flag state imposing income tax for the service of crewmembers performed on high seas and during innocent passage violates the free navigation right of the respective vessel and and the sovereignty right over the vessel under UNCLOS. Consequently Art. 15 (3) should contain the obligation for the contracting states to leave the tax right on high seas including "innocent passage" to the flag state. As only "international traffic" is regulated under Art. 15(3) no regulation for the remaining domestic traffic is necessary.

By ratifying UNCLOS the resident state has agreed not to restrain the free navigation of the flag states ship. By imposing income tax the on the crewmembers' salaries the non flag state increases the cost of navigation of the flag state's ship on highs sea and innocent passage.

It remains the problem that in many cases the flag state is not a contracting state. Taking into account the binding rules of UNCLOS not to impose tax on income for services of crewmembers on ships under the flag of another state the contracting states should agree not to tax the income of crewmembers for services exercised on ships not operating under the flag of a contracting state. That would bind also states, which haven't ratified UNCLOS like the USA.

In case no contracting state is the flag state the application Art. 15 (3) of the convention is nevertheless secured, if one state is the state of residence and the other state the place where the enterprise of the employer is registered or if not registered estab-

lished under the law of that other state, no matter if the employer is tax a resident person or not. That wording secures the application of Art. 15 (3) even if the person of the employer is a partnership.
(please see our comments to Art. 8 regarding the extension to the enterprise of partnerships)

We suggest the following wording for Art. 15 (3):
Proposal:
3. Notwithstanding the preceding provisions of this Article, remuneration derived by a resident in a contracting state employed by a person registered in the other contracting state or if not registered established under the law of the other contracting state, and no matter if that person is resident or not in the other contracting state, in respect of an employment exercised aboard a ship or aircraft operated in international traffic, may be taxed only in the state under whose flag the ship or aircraft is operating whether the flag's state is a contracting state or not and in case exercised aboard a boat in inland waterways where that employer is registered or established.

In our opinion it would not be appropriate that the OECD would draft a tax right, which would violate an international convention (UNCLOS) if exercised by the contracting state.

The suggested provision will lead to a non taxation in case the flag state does not tax the income of the crewmember. Such a non taxation would not be caused by the convention but by the fact, that only the flag state has the sovereignty and authority to impose its tax law on income generated on the ship under its flag on high seas including innocent passage.

States which haven't ratified UNCLOS and do not agree the free navigation principles of UNCLOS as common law could adopt the following rule:

Proposal
3. Notwithstanding the preceding provisions of this Article, remuneration derived by a resident in a contracting state employed by a person (employer) registered in the other contracting state or if not registered established under the law of the other

contracting state, and no matter if that person is resident or not in the other contracting state, in respect of an employment exercised aboard a ship or aircraft operated in international traffic or exercised aboard a boat in inland waterways, may be taxed only in the state where the enterprise of the employer is registered or established.

Or as an alternative:

may be taxed only in the state where the place of effective management of the enterprise of the employer is situated.

2.2 Employment Effect, Protection of Crewmembers

Crewmembers must offer their work on ships worldwide. They take part in the international market of labor. Internationally salaries are agreed on a net basis (before income tax). Leaving the right to tax the salaries of crewmembers to their state of residence will have an impact according the rate of income tax.

Countries, for which employment in international transport is not important, are not making any concessions regarding the taxation of salaries of their resident crewmembers. Crewmembers of those states are in competition with crewmembers resident in counties, which reduce the income tax on their resident crewmembers significantly, even down to zero. The salary after deduction of normal income tax would be so low that those crewmembers could not continue to work in their profession.

As the individual crewmembers cannot influence the tax rules of their countries, their existence could be endangered by the tax right given to the state of residence.

It can be estimated that at least half of crewmembers employed in international shipping are employed by enterprises specialized in crewing (crewing companies). Those crewing companies are mainly located in countries which do tax salaries of crewmembers in international traffic very low or not at all.

To secure the employment for all crewmembers at similar conditions, the tax right should have only the state of the employer. That is regulated at present in art. 15 (3)

of the model convention, if the exemption method will be applied on that income or if it can be taxed "only" that state.

To protect the crewmembers art. 15 (3) should give the right to tax the salaries only to the employers with place of effective management in the contracting state.

2.3 Employment in International Shipping, Clarifying of "Enterprise" in Art. 15(3)

The employment of crewmembers by crewing companies is since long a normal employment in international shipping. The regulation of art. 15 (3) should regard **all** crewmembers employed on ships in international traffic. A restriction to crewmembers employed by the enterprise, which is operating the ship, on which the crewmember is performing his/her work, would exclude more and more crewmembers from the application of art. 15 (3). Only if the "enterprise" in art. 15(3) means the employer of the crewmember art. 15 (3) would regard **all** crewmembers.

Under changes of the commentary to art. 15 (3) proposed by the OECD it is mentioned that "enterprise" shall mean the enterprise which operates the ship. That contradicts the target of art. 15 (3): if all crewmembers would be employed by crewing enterprises, art. 15 (3) could not be applied at all and there would be no regulation for the income of crewmembers.

Being forced to assume that logic states are trying to be able to impose tax by arguing that "employer" means the "economic employer" and the enterprise operating the ship on which the crewmember exercises his work would be the economic employer and not the crewing enterprise employing the crewmember.

The Commentary should explain that the criteria for economic employer under Art. 15 (2) cannot be applied on employment of crewmembers employed by a crewing enterprise for the work on a ship of the ship operating enterprise. In international shipping the crewmembers exercise their work worldwide in an environment of different international conventions and national rules. For small and medium shipping enterprises is not economic to care about those rules and regulations regarding the crew working on their ships and are able to replace missing crewmembers immediatlely. Therefore the manning function is outsourced by more and more shipping enterprises to specialized crewing enterprises, which care not only about those regulations but also replace

missing crewmembers without delay etc. Under normal conditions the employment of crewmembers by crewing enterprises cannot lead to a separation into legal employer and economic employer under the taxation rules of the Convention.

It is important to give clear interpretation in the commentary to avoid in the future proceedings at fiscal courts about the interpretations.

2.4 Relation between Art. 15 (3) and Art. 8

The commentary says to Art. 15 (3): *" a rule which follows up to a certain extent the rule applied to the income from shipping, inland waterways transport and air transport, that is, to tax them in the Contracting State in which the place of effective management of the enterprise concerned is situated."*

That shall be changed as follows

9.2 [the following is partly based on existing paragraph 9] ***The provisions of paragraph 3 of Article 15 are based*** ~~a rule which follows up~~ to a certain extent ***on*** the rule appli***cable***~~ed~~***, under Article 8,*** to ***profits*** ~~the income~~ from shipping~~, inland waterways transport~~ and air transport***. The paragraph, however, focuses on remuneration of employees rather than profits of enterprises, which explains why the paragraph gives the right to tax to the State of residence of the employees.***

The remark "to a certain extent" had been used by highest fiscal courts to justify their interpretation that "enterprise" in art. 15(3) meant only the employer, who is operating the ship, with the effect that art. 15(3) could not be applied on crewmembers employed by crewing companies.

In fact the only relation of the present art. 15 (3) with art. 8 is the taxation right of the contracting state in which the effective management of the enterprise is situated.

To avoid any misinterpretation it should be formulated:
" a rule which follows up to a certain extent the rule applied to the income from shipping, inland waterways transport and air transport, that is, to tax them in the Contracting State in which the place of effective management of the enterprise ***of the employer of the crewmember (art. 15 (3) or the shipping enterprise (art. 8 (1))*** ~~***concerned***~~ *is situated or where the enterprise of the employer is registered or established.*

2.5 "Risk" of Non-Taxation of the Income

The proposed OECD commentary highlights the risk of non taxation as a reason to give the contracting state of residence right to tax the salary of the crewmember, and mentions the possibility for a crewmember to move the residence into a state, which taxes the salaries of crewmembers very low or not at all.

Those remarks might be conform with the system of tax conventions, but they do not solve the situation of the individual crewmember being resident in a state, which taxes the salary already paid internationally on a net basis.

The exclusive right of the flag state to tax in the income of the crewmembers on high seas and innocent passage under UNCLOS adopted in Art. 15 (3) of the Model Convention could lead to a non taxation, if the flag state doesn't tax. That non taxation is the consequence of international law, which cannot be abrogated by contracting states to the detriment of the flag state of the ship and the crewmember working on that ship.

A state, which hasn't ratified UNCLOS (like USA), may not adopt the flag state's right to tax, because it fears an impact on its sovereignty. Then only by giving the exclusive right to tax to the contracting state, where the enterprise of the **employer** is situated, either by its place of registration or establishment or of effective management, the conditions to work, to be paid and to be taxed could be adjusted to similar level for all crewmembers internationally. The crewing enterprises would have the function of a catalyzer, by having the place of effective management in a state, whose tax on income of crewmembers is low or zero.

In any case it will be easier for the residence state to accept not having the right to tax under the convention (following UNCLOS or not), than to justify a national reduction of income tax for seafarers as a minority group of all resident taxpayers.

3 Final Remarks

The present regulation of Art. 8 (1) gives in the Commentary the contracting states already the possibility to chose the tax right of the contracting state of the shipping enterprise:

> 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.

In our opinion there is no need to put that rule into Art. 8 (1) transferring the present rule as a possibility into the commentary. A vice versa replacement Convention Commentary would be possible.

In addition to that change the OECD proposes some other possibilities to be mentioned in the Commentary. The more possibilities are given the less is the "binding" effect of the Article in the Model Convention on the contracting parties.

In that way none of the problems with the present rules are solved.

We propose to adjust the existing rules to include "body of persons" – mainly partnerships – for which the persons do not have to be residents of the contracting states. That can be done by amending the present text in Art. 8 (1) taking into account the opinion expressed by the majority of states:

" Profits from the operation of ships or aircraft in international traffic by an enterprise carried on by a person resident or not in a contracting state shall be taxable only in the Contracting state where the person carrying on the enterprise is registered or if not registered, established under its law",

And the option in the Commentary nr. 2:

"Profits from the operation of ships or aircraft in international traffic by an enterprise carried on by a person resident or not in a contracting state shall be taxable only in the Contracting State in which the place of effective management of the person carrying on the enterprise is situated."

The outsourcing of functions of the operating of seaships in international traffic to specialized enterprises imposes on those enterprises the same international tax problems the shipping enterprises suffer internationally. An extension of art. 8 to the profit of those enterprises is strongly advisable:

"Profits from the operation of ships include profits of enterprises which perform the different tasks of operating a ship for the shipping enterprises, such as crewing, technical and commercial management."

Regarding the taxation of the income of crewmembers the proposed change to the exclusive right to tax given to the residence state would contradict the free navigation right under UNCLOS and trigger serious employment problems for crewmembers resident in countries with high taxation in an international environment, where many states reduce the tax on salaries of seafaring crewmembers significantly and sometimes to zero.

The protection requires the exclusive right to tax of the contracting state in which the enterprise of the employer is registered or if not registered established under its law or where the effective management of the employer of the crewmember is situated.

Not to exclude all those crewmembers – probably today more than 50% worldwide – which are employed not by the enterprise, which operates the ship, but by specialized crewing enterprises from the application of Art. 15 (3), the word "enterprise" should be replaced by " employer".

Art, 15 (3) should read:
3. Notwithstanding the preceding provisions of this Article, remuneration derived by a resident in a contracting state employed by a person registered in the other contracting state or if not registered established under the law of the other contracting state, and no matter if that person is resident or not in the other contracting state, in respect of an employment exercised aboard a ship or aircraft operated in international traffic, may be taxed only in the state under whose flag the ship or aircraft is operating whether the flag's state is a contracting state or not and in case exercised aboard a boat in inland waterways where that employer is registered or established.

Taking into account all the tasks related to the employment of crewmembers working worldwide and being performed by crewing enterprises the “employer” of the crew-member cannot be divided into “legal employer” and “economic employer” for the taxation under the criteria of Art. 15 (2).

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