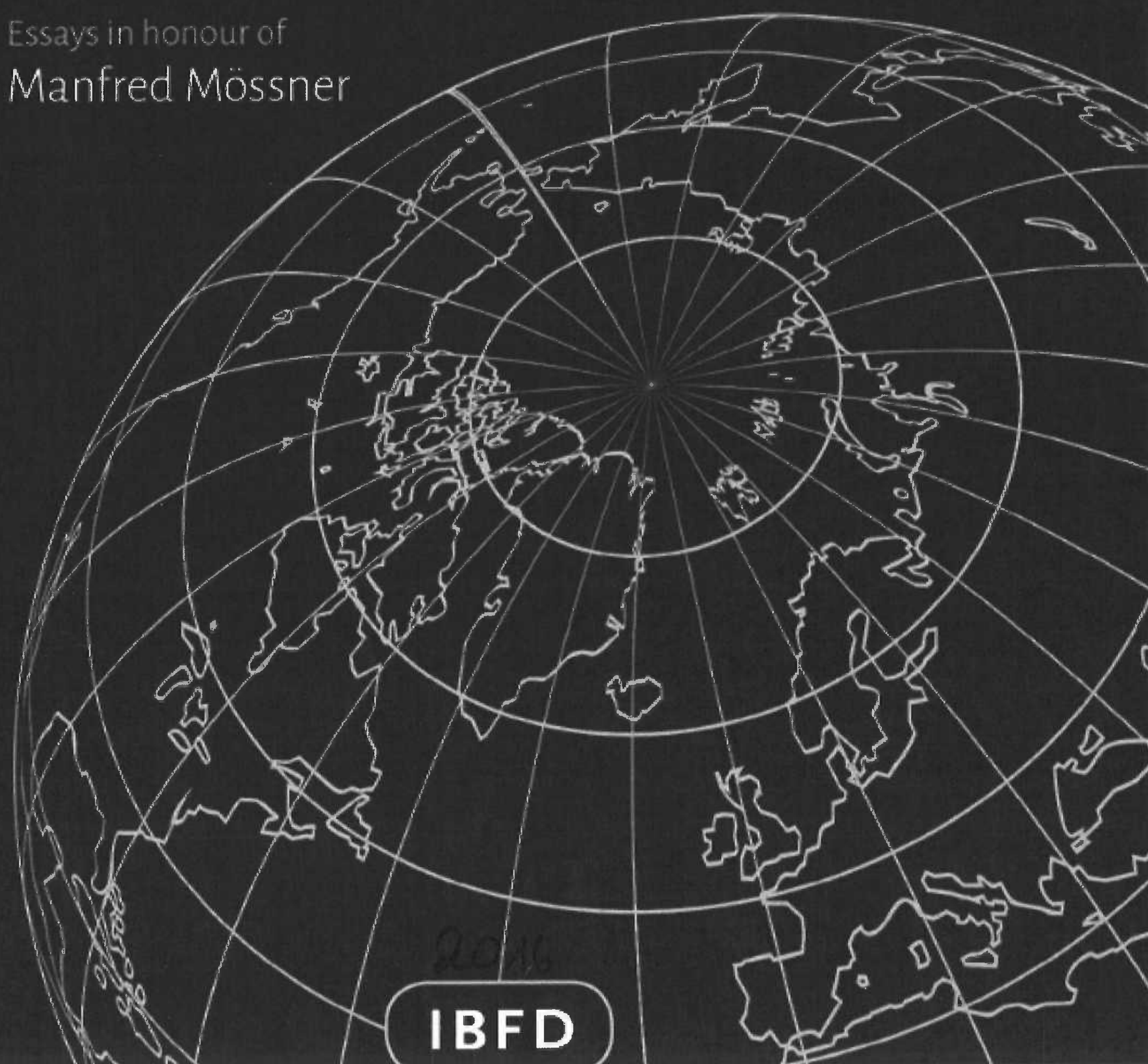
Editors

Heike Jochum, Peter Essers, Michael Lang, Norbert Winkeljohann and Bertil Wiman

Practical Problems in European and International Tax Law

Essays in honour of

Manfred Mössner



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Chapter 12

The Definition of International Traffic under Article 3(1)(e) of the OECD Model Convention

Michael Lang[1]

12.1. Special provisions for ships and aircraft in international traffic

J. Manfred Mössner is a well-travelled man. He has been a visiting professor in various countries, and one of his assignments as a visiting professor was WU (Vienna University of Economics and Business). His great merits include being one of the founding fathers of the European Association of Tax Law Professors (EATLP). He was also a member of the Permanent Scientific Committee of the International Fiscal Association (IFA) for several years. He has always participated in academic congresses on different continents. This of course requires a lot of travelling. I therefore hope I will attract the interest of our friend with my contribution, which deals with the content of the definition of "international traffic" in article 3(1)(e) of the OECD Model Convention (OECD MC) and the importance of that definition for a few other provisions of the OECD MC. This topic is well-suited as an example to illustrate the impressive depth and breadth of J. Manfred Mössner's academic work. He has not only dealt with the provisions of the OECD MC on international maritime shipping and aviation,[2] but he has also published papers on issues of espionage and the immunity of warships, in which he addressed fundamental international law issues.[3] He is an expert both in tax law and international law. When dealing with issues of double taxation convention law, he never neglects to consider the international law character of this field.

1. Director of the Institute for Austrian and International Tax Law of the Vienna University of Economics and Business (WU), scientific director of the post-graduate LLM Studies in International Tax Law and spokesman of the Doctoral Program in International Business Taxation (DIBT) at the same university. The author wishes to thank Ms Anna Binder for her support in literature research and her valuable suggestions.
2. *See*, for instance, J.M. Mössner, in *Steuerrecht international tätiger Unternehmen* mn. 2.232 (J.M. Mössner ed., Otto Schmidt 2012).
3. J.M. Mössner, *Spionage und Immunität von Kriegsschiffen*, 35 NJW 22, 1196 et seq. (1982).

According to the provision of article 8(1) of the OECD MC, on which the present chapter will focus, "profits from the operation of ships or aircraft in international traffic" are exempt from the regime of article 7 of the OECD MC. These are "taxable only in the Contracting State in which the place of effective management of the enterprise is situated". This provision prevents profits from having to be attributed to permanent establishments (PEs) probably situated in different states.[4] The taxation right lies with a single state.[5]

Article 8(1) of the OECD MC contains a few parallel provisions. Pursuant to article 13(3), "[g]ains from the alienation of ships or aircraft operated in international traffic ... or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated". Just as the PE state, which has the taxation right for current income under article 7 of the OECD MC, can also tax gains from the alienation of PEs or their movable property under article 13(2) of the OECD MC, this right is also given under article 13(3) to the state of effective management responsible for the taxation of current profits under article 8 of the Model. Since the structure of article 22 resembles that of article 13, it is not surprising that article 22(3) contains a similar provision:

> Capital represented by ships and aircraft operated in international traffic ... and by movable property pertaining to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

The fact, however, that a similar provision can also be found in article 15(3) of the OECD MC is less evident:

> Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic ... may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

This deviates from the regime of article 15(1) and (2) of the OECD MC, which divides the taxation rights between the employee's state of residence and the state where the activity is performed. As a result, it is possible to avoid difficulties resulting from attributing the activity of ship and aircraft crews to different states.[6] An additional effect is that the state of effective management, in which these remunerations will be regularly deductible as

4. *See* Mössner, *supra* n. 2, at mn. 2.232.
5. *See* OECD Commentary 2014, art. 8(1).
6. *See* R. Prokisch, *Art. 15*, in *Doppelbesteuerungsabkommen6* mn. 103 (K. Vogel & M. Lehner eds., Beck 2015).

expenses under its national tax law and therefore often only have access to a reduced assessment basis, will at least have the taxation right for the remuneration paid to the employee. As opposed to the other provisions mentioned on the operation of ships and aircraft in international traffic, however, the state of effective management does not have an exclusive taxation right under article 15(3) of the OECD MC.

According to all these provisions, the requirement for a taxable event is the existence of international traffic. There is a specific definition for this in article 3(1)(e) of the OECD MC: the term "international traffic" means "any transport by a ship or aircraft operated by an enterprise which has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places situated in the other Contracting State".

12.2. The taxation right for the operation of ships and aircraft in international traffic

At first glance, the above-mentioned definition may seem somewhat odd: apart from one single exception – when "the ship or aircraft is operated solely between places situated in the other Contracting State" – the operation of a ship or aircraft is always considered as taking place in international traffic. This definition, however, does not fully correlate with ordinary language. Against this background, some opinions voiced in the literature are obviously trying to narrow this definition:

> Although the requirement of Article 3 paragraph 1(e) is met, international traffic does not take place either where a ship or aircraft is operated solely between places situated in the other Contracting State, in which the place of effective management of the enterprise is also situated. These cases lack any international reference.[7]

Yet the wording of article 3(1)(e) of the OECD MC is more than clear: "international traffic" also means when a ship or aircraft is operated solely between places in the state of effective management of the enterprise. The exception applies only when the ship or aircraft is operated solely between places in the *other* contracting state. Therefore, article 8(1) of the OECD MC is also applicable when the ship or aircraft has never left the territory

7. *See* C. Pohl, *Art. 3*, in *DBA* mn. 46 (J. Schönfeld & X. Ditz eds., Otto Schmidt 2013) (translation by the author).

of the state of effective management.[8] Although it is surprising that this entrepreneurial activity is considered *international* traffic, the foreseen legal consequence does make sense: the profits may only be taxed in the state of effective management. If, by contrast, the provision of article 7 of the OECD MC were to apply instead of article 8 when tickets for boat trips or flight tickets are sold by the enterprise in the other contracting state for such trips taking place in the state of management, one would have to examine whether PEs exist in the other contracting state and, if any, determine the share of profits attributed to these PEs from the sale of tickets for boat trips or flight tickets.[9] This is not necessary, however, due to the applicability of article 8 of the OECD MC. Therefore, the legal advice provided by the Austrian Federal Ministry of Finance on 7 January 2003, EAS 2203, deserves our full support:

> Where an Austrian air carrier operates both cross-border flights between Austria and Italy as well as internal Austrian flights and internal Italian flights, the profits from all flights shall be subject to taxation in Austria; this results from Article 23 paragraph. 3 of the DTC Italy (credit method). When assessing whether and to which extent Italy can also assert taxation rights (which would then lead to taxes creditable in Austria) in view of the permanent establishments operated in Rome and Bolzano, it must be considered that all income covered by Article 8 of the DTC is beyond Italy's tax reach, although it was generated through Italian permanent establishments. Article 8 DTC Italy, however, only covers profits from the operation of aircraft in "international traffic". Provided that the aircraft are used on a purely internal route in Italy (start and destination of the respective flight lie in Italy), the profits obtained no longer fall under Article 8 DTC Italy, and are subject to the Italian taxation jurisdiction in accordance with Article 7 DTC Italy (thus not entirely, only to the extent that they are functionally attributable to the Italian permanent establishment). Passenger and goods transport between two Italian destinations, however, would again fall under Article 8 DTC Italy if the Italian route is used as part of a cross-border flight.[10]

According to the definition of article 3(1)(e) of the OECD MC, "international traffic" also means any transport by a ship or aircraft operated solely between places *in a third country*. The exception of article 3(1)(e) of the OECD MC applies only when these ships or aircraft are operated solely between two places *in the other contracting state*. Article 8(1) of the OECD MC must then be applied to ships or aircraft operated exclusively in the third country. The resulting consequence is that the other contracting state does

8. *See* OECD Commentary 2014, art. 3(6).
9. Same as in the example in OECD Commentary 2014, art. 3(6); *see* H. Loukota & H. Jirousek, *Internationales Steuerrecht* I/1 Z 3 para. 6 (Manz 2013).
10. Translation by the author.

not have a taxation right, not even if tickets for these boat trips or flights within the third country are sold in PEs of the enterprise that are located in the other contracting state. In contrast, the provision in the DTC between the state of management and the third country modelled on article 8 of the OECD MC is not applicable. For the purposes of this DTC, the third country becomes the other contracting state and the exception of "international traffic" – and thus also of article 8(1) of the OECD MC – applies. In this case, the provision in the DTC between the state of effective management and the third country modelled on article 7 of the OECD MC shall apply and the taxation right of the third country shall depend upon whether and which PEs exist there and which profits must be allocated to these. The justification for this consequence lies in the fact that, in this case, the relationship with the third country is so strong that it would be inappropriate to completely deprive the latter of its taxation right.

12.3. Income from employment exercised aboard a ship or aircraft operated in international traffic

Article 15(3) of the OECD MC was designed on the basis of article 8 of the OECD MC. This provision also allocates the taxation right for "remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic" to the state of effective management of the enterprise for which the employee works. This special provision for employment requires that the employee is resident in a contracting state – otherwise the individual would not be subject to the treaty pursuant to article 1 of the OECD MC – and that the management of the enterprise is situated either in this state or in the other contracting state. If the management is situated in a third country, article 15(3) of the OECD MC no longer applies, so that the general provisions of article 15(1) and (2) of the OECD MC must be used instead. Therefore, if an employee resident in Germany works aboard an aircraft operated solely between two places in Austria, and the enterprise operating this route has its place of management in Slovakia, the provision of the DTC Germany-Austria modelled on article 15(3) of the OECD MC cannot be applied due to fact that the place of effective management is situated in a third country. According to the provisions of the DTC corresponding to article 15(1) of the OECD MC, Austria has the taxation right as the state where the activity is performed, unless the limitation contained in article 15(2) of the OECD MC applies: if the Slovakian enterprise does not have a PE in Austria which can pay the remunerations, the state where the activity is performed loses the taxation right if the recipient of the income is not present in Austria for more than 183 days.

The definition of article 3(1)(e) of the OECD MC is also relevant for the interpretation of the term "international traffic" under article 15(3) of the OECD MC. Therefore, when an employee works aboard ships or aircraft which are operated exclusively between places of his own state of residence and the latter is also the state in which the management of the enterprise that employs him is situated, article 15(3) of the OECD MC applies. Consequently, this state has the taxation right.

This assessment does not change even if the employee is not resident in this state but in the other contracting state. As long as the place of effective management is situated in the same state in which the employer works aboard a ship or aircraft operated exclusively between two places of the same state, it constitutes "international traffic". This state can then tax the remunerations of the employee under article 15(3) of the OECD MC and, depending on the method article, his state of residence must exempt the income or credit the foreign tax.

If, however, the management of the enterprise is situated in the other contracting state and not in the one that the employee works aboard a ship or aircraft operated exclusively between two places of the same state, the conditions laid down in the definition of "international traffic" are no longer met. As a result, the exception of the last phrase of article 3(1)(e) of the OECD MC shall apply. Consequently, it will depend on whether the employee is resident in the state of effective management of the enterprise or in the state in the territory of which he performs the activity. Under article 15(1) of the OECD MC, the employee's state of residence shall have the taxation right. Only when the activity is performed in the other state may the latter tax the employee. When the three requirements set out in article 15(2) of the OECD MC are met, the state of residence shall have the exclusive right of taxation.

The above-mentioned legal advice of the Federal Ministry of Finance also deals with the taxation of employees of an Austrian air carrier:

> If a crew resident in Italy works aboard an aircraft flying across borders (start and destination of the flight lie in different states), pursuant to Article 15 paragraph 3 of the OECD MC their remuneration is subject to taxation in Austria; this is also true even if the crew leaves the machine during a stopover in an Italian airport and is replaced by an Austrian crew.[11]

11. AT: Austrian Federal Ministry of Finance, 7.1.2003, EAS 2203 (translation by the author).

This opinion is correct, since the case involves "international traffic" and Austria has the taxation right according to the provision modelled on article 15(3) of the OECD MC.

The legal advice continues:

> Only where the crew resident in Italy is used in purely domestic flights within Italy (start and destination of the flight lie in Italy) will their remuneration have to be exempt from taxation in Austria.[12]

This constellation triggers the exemption of the DTC provision modelled on article 3(1)(e) of the OECD MC. Although the state, on the territory of which the flights are operated, and the state of management are both contracting states, they are simply different states. Consequently, no "international traffic" is involved. Therefore, according to the provision modelled on article 15(1) of the OECD MC, Italy, being the state of residence of the employees, has the exclusive right of taxation for work performed in Italy.

A more critical approach must be taken toward the other explanations of the legal advice:

> An obligation to exempt from taxes does not apply to the use of the Italian crew on the Austrian domestic flights (Article 15 paragraph 1 DTC Italy; the exemption obligation under paragraph 2 does not apply because of employment with a domestic employer.) Although it is true that Austria may exercise a taxation right in these cases, this does not result from the convention provision modelled on Article 15 paragraph 1 of the OECD MC, but from the provision corresponding to Article 15 paragraph 3 of the OECD MC. Since the state of effective management and the state on the territory of which the flights are operated are identical, this constitutes "international traffic".[13]

The decision 13 K 2730/11 of 3 June 2014 of the Tax Court Munich is similarly inconclusive:[14] the court was asked to decide on the case of a pilot resident in Germany working for an Austrian airline that has its place of effective management in Austria. The court assumed that, where the activity was performed on domestic flights in Austria, Austria may tax the pilot's wages according to article 15(1)(2) of the DTC Austria-Germany.[15]

12. Id. (translation by the author).
13. Id. (translation by the author).
14. *See* S. Schmidjell-Dommes, *FG München zur Besteuerung von sowohl im nationalen als auch im internationalen Luftverkehr tätigen Piloten nach dem DBA Österreich – Deutschland*, 25 SWI 2, 97 et seq. (2015).
15. The pilot had also worked on flights between Austria and Germany. The court applied article 15(5) of the DTC Austria-Germany on the pilot's wages for the operation of these flights. However, the taxpayer appealed, claiming that the wages attributable to

Since, however, these are domestic flights operated in the state of effective management, the requirements for "international traffic" under the definition of article 3(1)(g) of the DTC Austria-Germany are met. Consequently, Austria has the taxation right not according to article 15(1), but according to article 15(5) of the DTC (equivalent to article 15(3) of the OECD MC) instead. This makes a difference for the taxpayer in so far as the exemption method applies to income under article 15(1), but the credit method is foreseen for income under article 15(5). Contrary to the opinion of the Tax Court Munich, Germany also has the taxation right for the income attributable to the Austrian domestic flights and would have to credit an Austrian tax.[16]

Yet the provision of article 15(3) of the OECD MC occasionally gives rise to conflicts even if applied correctly. Especially in triangular situations, it does not always lead to satisfactory results. This can be shown on the basis of the following case, where it is assumed that DTCs modelled on the OECD MC are in place between the three states. A pilot, resident in state A, is an employee of a carrier that has its place of effective management in state B and carries out her activities exclusively on domestic flights in state C. The DTCs concluded by state A with states B and C are applicable to her because she is resident in state A. Pursuant to the convention provision of the DTC A-B modelled on article 3(1)(e) of the OECD MC, the case involves "international traffic". According to this definition, the fact that the flights take place in a third country does not constitute grounds for exclusion. Consequently, state B has the taxation right and state A – depending on the method applied in this DTC for the avoidance of double taxation – must either exempt the income from tax or credit the tax levied in state B. Pursuant to the DTC State A-State C, article 15(3) of the OECD MC is not applicable simply because neither of the two states is the state of effective management. If the pilot carries out her activity in state C for more than 183 days within a period of 12 months, state C has the taxation right for her remunerations pursuant to article 15(1) of the DTC State A-State C. Whether the income should be exempt in state A or a tax levied in state C should be credited will depend on the method article of the DTC State

the part of the activity performed over Austrian territory should still be taxed according to article 15(1) of the DTC Austria-Germany. The case was brought before the German Federal Tax Court (I R 47/14 of 20 May 2015). The Federal Tax Court did not share the taxpayer's opinion but agreed with the Tax Court Munich's decision. Interestingly, the Federal Tax Court did not challenge the Tax Court's assessment according to which the income derived from operating domestic flights in Austria does not constitute "international traffic" either. Its decision only concerns the part of the salary earned from the operation of flights between Austria and Germany.

16. Critical comments also by Schmidjell-Dommes, *supra* n. 14, at 99 et seq.

A-State C. If only one of the two applicable DTCs provides for the exemption method, double taxation shall remain in state B and state C. But even when both conventions provide for the application of the credit method, there is only enough credit substrate in state A for the crediting of the taxes levied in the other two states if the tax in state A is accordingly high. As a rule, double taxation also remains in this case.

12.4. Assessment

The definition of international traffic in article 3(1)(e) of the OECD MC may seem confusing at first, since it also treats situations as "international" that absolutely lack any cross-border elements and would not necessarily be regarded as international in common usage. The authors of the OECD MC and convention negotiators, however, are not bound to common language usage. It is at the discretion of legislators to work with fictions. Just as legislators may declare a cat to be a dog for the purposes of the dog tax, national air traffic may also be treated as international traffic for the purposes of DTCs. The considerations presented here have definitely shown that, despite the unusual law-making methodology, as a rule, the application of article 8 of the OECD MC leads to meaningful results.

One may rightly ask oneself, however, whether a special provision for the operation of ships and aircraft in international traffic is justified from a legal policy point of view.[17] The reason for the exception from the PE principle of article 7 of the OECD MC prescribed under article 8 of the OECD MC can be found in the particular difficulties encountered in attributing the income of these enterprises to different states. Were one to redraft the OECD MC today and take into account situations in which the application of the PE principle proves especially difficult, one would certainly not first and foremost think of the operation of ships and aircraft in international traffic, but would instead consider issues which emerge, for instance, as a result of e-commerce.[18]

The special provision of article 15(3) of the OECD MC deserves an even more critical approach.[19] The present chapter has already pointed out the practical difficulties. The provision also privileges maritime shipping and

17. *See* M. Lang, *Möglichkeiten zur Vereinfachung der Doppelbesteuerungsabkommen*, in *Steuerwissenschaften und betriebliches Rechnungswesen, FS Kofler* p. 132 et seq. (S. Urnik et al. eds., Linde 2009).
18. Id., at 133.
19. Id., at 134 et seq.

aviation enterprises that have their place of management in states with a dense network of DTCs and only have a low level of taxation – especially for income from employment. The crews of these enterprises are then subject to taxation in these states with low rates of taxation and subsequently these benefits remain – except for the progression provision – where the scope of the exemption method applies, without any additional tax burden in the state of residence.

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