ARTICLE

UN MTC Article 8: Was the Source Rule Surrender on Article 8 a Blunder? The Case Study of Pakistan

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The United Nations Model Tax Convention (UN MTC) Article 8 allocates taxing rights on international traffic to the state of effective management. Article 8 (Alternative B), however, to the extent of shipping, conditionally allows some taxing rights to source state, too. The study posits that by surrendering source rule on Article 8, UN MTC ditched developing countries. This allowed airlines and shiplines stationed in developed countries not only generate large sums of revenues by hitting developing countries' ports but also repatriate them tax free to a sustained disadvantage to the developing countries. The costs of the source rule surrender for the developing countries were realized on account of soft outflow of hard-earned foreign exchange, foregone revenues, and stunted growth of critical communication industries. It is argued that Pakistan's aviation and maritime industries' decent rise through 1950s, 1960s, 1970s and 1980s, and their abject descend into chaos through 1990s, 2000s and 2010s is explainable in terms of double taxation agreements (DTAs) obtaining Article 8 it signed. The insights gleaned are generalizable to other similarly circumstanced developing nations whose aviation and maritime industries failed to keep pace with their overall development. The UN MTC's surrender on Article 8, it is posited, promoted mass-scale injustice at inter-state level, and therefore, needs correction.

Keywords: UN Model Tax Convention, UN MTC Article 8, International Traffic, International Shipping, International Aviation, Reciprocal Exemption, Territoriality, Double Taxation Agreements, DTAs and Developing Countries, Tax Base Erosion

1 Introduction

Primarily, the United Nations Model Tax Convention (UN MTC) vide Article 8 allocates taxing rights on profits from international traffic to the state of effective management of the airlines and shiplines. However, Article 8 (Alternative B) thereof, to the extent of shipping, conditionally allocates some taxing rights to the source state if the activities giving rise to such profits 'are more than casual'. The percentage of sharing of taxing rights, nonetheless, has been left to be determined through negotiations between states. Apart from this meekly worded Article 8 (Alternative B), the UN MTC is materially in harmony with the Organization for Economic Development and Cooperation Model Convention (OECD MTC) on taxation of international traffic.[1] Accordingly, a great majority of double taxation agreements (DTAs) that have been signed over the past century by developing countries purportedly modelled on the UN MTC conveniently abdicate taxing right on international traffic in favour of the state of residence or the state of effective management.

The fact that both aviation and maritime industries are capital-intensive and technology-driven, and that they are majorly domiciled in developed countries, gives rise to a paradoxical situation. This paradox emanates from the fact that the UN MTC is not only meant to serve as a template for negotiations between developed and developing countries, but also to champion and protect fiscal rights of developing countries vis-à-vis developed countries. This position is in sharp contrast to the OECD MTC, which admittedly looks to promote fiscal interests of developed countries. The paradox between the UN MTC's stated position of a protector of developing countries' rights, and a meek capitulation and abdication of the source state's taxing rights on international traffic, may potentially have resulted in substantial fiscal fallouts for the developing world – not identified, focused upon, and worked out so far in a clear-cut fashion.

The paper posits that by surrendering source taxation on international traffic, the UN MTC has not done any good to the cause of developing countries – an extant international consensus on the matter – notwithstanding.

Notes

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[1] The UN MTC Art. 3.1.(d) exclusively defines 'international traffic' as 'any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State'.

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This way airlines and shiplines stationed in developed capital-owning countries were not only allowed to generate large sums of revenues by extensively hitting developing countries' ports but were also permitted to repatriate them tax free. It is premised that the UN MTC, in fact, blundered by surrendering source taxation rights on international traffic on behalf of developing nations as it cost them dearly not only on account of tax revenue lost which essentially was being generated by their own economic agents and on their own soil, but also on account of stunted and stalled development of their own aviation and shipping industries.

This hypothesis is tested through developing a case study in respect of Pakistan. Without being monocausal, it is argued that Pakistan's aviation and maritime industries' decent rise through 1950s, 1960s, 1970s and 1980s, and their descend into chaos through 1990s, 2000s, and 2010s is explainable in terms of the pattern in which Pakistan signed and enforced DTAs (obtaining Article 8) rather recklessly. It is observed that, on the one hand, as more and more DTAs were signed creating tax free business opportunities on Pakistani ports for international lines, on the other, Pakistan's own flag carriers were confronted with severe competition internationally and coercive taxation domestically, which undermined their profitability, deepened their incompetitiveness, and hastened their demise. Plausibly, the vegetative condition in which Pakistan's maritime and aviation sectors have been for the past three decades or so has a causal connection with the UN MTC and surrender of source taxation on international traffic. Apparently, there is a case to generalize the empirically-based conclusions drawn from Pakistan to other similarly-circumstanced developing nations whose aviation and maritime industries failed to grow in line with their overall development trajectories.

The article consists of six sections. After section 1 has introduced the topic, section 2 lays bare the international consensus on vesting taxing rights on international traffic to the residence state by the UN MTC, the OECD MTC, and the US MTC, and traces its roots in history from League of Nations' early years to its latest revision in 2017. Section 3 appraises the source rule surrender by taking stock of adoption by developing countries of the UN MTC Article 8 (Alternative B) and its ramifications. Section 4 reviews Pakistan's shipping industry against its tax treaty landscape in the context of Article 8 to glean requisite empirics and insights. Section 5 does the same to Pakistan's aviation industry and puts it to an identical analysis. Section 6 summarizes the debate by generalizing the summations to other countries whose domestic maritime and aviation industries may be struggling to compete with foreign carriers even on their own ports and meet the transportation needs of their own people and economies. The article concludes with a glum comment on the efficacy of the UN MTC to serve its avowed objectives, as well as its ramifications for the developing world, particularly, if the extant international compact on taxation of international traffic is left unaltered for any further length of time.

2 The UN MTC: source rule surrender

2.1 *International Consensus*

Intriguingly, the UN MTC's source rule surrender does not come in isolation. In fact, the international consensus that prevails as regards the principle of taxation of aviation and maritime industries vesting taxing rights in the residence state or the state of effective management runs across developed/developing country divide. Article 8(1) of the OECD MTC ordains that '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'.[2] The US MTC allocates to residence state outright taxing rights on the incomes of shiplines and airlines. Article 8 of the US MTC stipulates that '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'.[3] It was further amplified that even 'if the enterprise has a permanent establishment in the other state, it is taxable only in the residence state', and that 'place of residence need not be the place of effective management of the enterprise'.[4] Even the Andean Community Model Convention (AC MTC) trails the international consensus by stating that 'The profits obtained by air, land, sea, lake and river transport companies shall be subject to tax liability only in the Member Country in which these companies are domiciled'.[5]

The consensus on vesting taxation rights on international traffic in the state of residence or that of place of effective management amongst the OECD states and US is quite explainable as most shipping and airlines enterprises being highly technical and capital-intensive are based in advanced and developed economies. The OECD MTC admittedly promotes financial and fiscal interests of advanced economies. The US MTC, likewise, is geared to protect economic interests of the US FISC by jealously guarding taxation rights on its established maritime and

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2 OECD, *OECD Model Tax Convention on Income and on Capital* (Paris: OECD Publications 2017).

3 US, 'United States Income Tax Convention' (Washington D.C: US-IRS 1996).

4 R. Rohatgi, *Basic International Taxation*, vol. I: Principles of Taxation, 144 (Richmond, U.K.: Richmond Law & Tax 2005).

5 Andean Community, *Model Convention for the Avoidance of Double Taxation Between Member Countries and Other Countries Outside the Andean Sub-region* (Lima, Peru: Commission of Andean Community 2004).

aviation industries. The AC MTC looks to forge and promote bilateral economic relationship between neighbourly par economies having their shipping and airlines at an almost equal level of development. However, it was the UN MTC's professed position and responsibility to promote fiscal interests of the developing countries (as probably they could not do so on their own), and its brazen capitulation into surrendering source taxation on international traffic was nothing less than a grand failure with far-reaching implications.

2.2 *Pre-League of Nations Period*

The principle of territoriality in international taxation had historically enjoyed near-universal acceptance. In a few instances, however, in respect of shipping, exceptions could be spotted manifesting in unilateral or bilateral arrangements. It was not until early 1910s that UK tax administration started to levy income tax on foreign shipping companies, which booked freight in its territory through designated agents.[6] In 1916, US followed the suit and 'introduced tax rules on taxation on non-residents on income arising from US sources'.[7] This led Scandinavian governments to protest the matter with US and UK threatening retaliatory measures. In consequence, both US and UK brought in legislations exempting profits of foreign shipping corporations provided other countries also reciprocated. Sasseville is of the opinion that the 'end of the First World War, which made it possible to eliminate unpopular or inefficient taxes, led the United States and the United Kingdom to reconsider the taxation of shipping profits of foreign shipowners', and that since 'tax practices of both countries had been criticized by other countries' it is plausible that they 'gave due regard to the fact that their attempts at taxing foreign shipowners would logically lead other countries to tax British and American shippers'.[8]

It has been remarked that the 'reciprocity test laid down by British and US internal laws was therefore the driving factor, which activated moves of other legislatures'.[9] In a flurry of reciprocal exemptions, major maritime powers like Norway, Japan, Italy and France introduced requisite legislations in 1924, 1924, 1925, and 1926, respectively.

At inter-state level, instances of exception to the principle of territoriality are found in treaties on taxes, on commerce and on navigation. The agreement between Austria and Hungary signed in 1867, sought to allocate taxing rights on the profits of First Danube Steam Navigation Company to the country of centre of management. Likewise, a few treaties on commerce and navigation carried provisions to exempt income from shipping activities conducted by nationals of the other contracting state. Article 2 of the Italy-Austria Treaty on Commerce and Navigation, 1878, states: 'The income of the nationals of one of the contracting States who conduct the activity of caterers, or the maritime or river navigation between places of the two States shall not be subject for the conduct of such activities or business to any industrial tax in the country of the other State'. Similarly, Article 13 of the Hungary-Czechoslovakia Convention, 1923, stipulates that '[s]hipping undertakings on the Danube are only subject to taxes on the profits derived from their shipping business in the State in which the centers of management and control of the undertakings are established'.

2.3 *The League of Nations MTC*

The pre-existing culture of reciprocal exemption under unilateral or multilateral arrangements must have influenced the League of Nations perceptions on the matter, which started its work on international double taxation in 1920. Article 5 of the League of Nations' 'Model Bilateral Convention for the Prevention of Double Taxation in the Special Matters of Direct Taxes, 1928' (1928 Draft) created a significant exception by delinking the principle on taxation of international traffic from that of general principle of taxation of business income on the basis of permanent establishment. The final paragraph of Article 5 of 1928 Draft reads: 'Nevertheless, income from maritime shipping and air navigation concerns shall be taxable only in the State in which the real centre of management is situated'.[10] The Commentary on the 1928 Draft explicated the principle by arguing that through 'an express exception to the principle laid down … income from maritime shipping or air-navigation concerns shall be taxable only in the State in which the real centre of management is situated'.[11] In 1935, the League of Nations produced their 'Convention for the Allocation of Business Income between States for the Purposes of Taxation' (1935 Draft), assigned international traffic a separate article, and slightly altered its language, but essentially retained the principle stating that 'Income

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6 Guglielmo Maisto, *The History of Article 8 of the OECD Model Treaty on Taxation of Shipping and Air Transport*, 31(6/7) Intertax (2003).

7 *Ibid.*

8 Jacques Sasseville, *Historical Background of Proposed Changes to Articles 8 and 15(3) OECD Model*, in *Taxation of Shipping and Air Transport in Domestic Law, EU Law and Tax Treaties* 75 (Guglielmo Maisto ed., Amsterdam: IBFD 2017).

9 Maisto, *supra* n. 6.

10 League of Nations, *Model Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Direct Taxes*, in *(1928 Draft)* (New York: League of Nations 1928).

11 *Commentary on the Model Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Direct Taxes* (New York: League of Nations 1928).

from maritime shipping and air navigation enterprises shall be taxable only in the State in which the real center of management is situate'.[12]

The League of Nations reiterated their preference in favour of extra-territorial taxation on international traffic yet once again through 'Model Bilateral Convention for the Prevention of the Double Taxation Income, 1943' (Mexico Draft). Article V of Mexico Draft unequivocally promotes residence-based taxation as it stipulates that 'Income which an enterprise of one of the Contracting State derives from the operation of ships or aircraft registered in such State is taxable only in that State'.[13] The League of Nations' final effort to further refine and cement the residence state right comes in the shape of 'Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property, 1946' (London Draft), wherein the principle was enshrined that 'Income which an enterprise in one of the Contracting State derives from the operation of ships or aircraft engaged in international transport is taxable only in the State in which the enterprise has its fiscal domicile'.[14] Although, the formulation of the article on international traffic is different in both Drafts, yet it was explained that the 'difference in wording of that article in the Mexican and London drafts is due to the fact that an attempt has been made to state this rule more precisely in the latter draft'.[15] Maisto has disagreed with the League of Nations' own interpretation of the provision citing material differences between the two drafts.[16] In the main, the principle on allocation of taxing rights was left unaltered. Jogranjan reports that 'more than a hundred double taxation agreements, based on the 1928 Models, were concluded in the 1930s'.[17] She also provides invaluable peek into 'why the model conventions on tax evasion were not successful', and goes on to imply that at 'every stage of their work, the League's Experts recognized the practical difficulties in their proposals, particularly with regard to exchange of information, but were ultimately unable or unwilling to resolve these differences'.[18]

The Organization for European Economic Cooperation (OEEC) – a prequel to the OECD – soon after its establishment in 1948, established the Fiscal Committee to study matters pertaining to international double taxation. The Committee published two reports in 1958, and 1959. Article V of the reports dealing with shipping, inland waterways and air traffic, fundamentally resonating the London Draft, reads: 'Income 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'. The end of World War II heralded the demise of League of Nations, and simultaneously the independence of a large number of nation states in Africa and Asia. From the ashes of the League of Nations rose the UN, inter alia, to voice the concerns and interests of poor and developing countries. It has been posited that the UN espoused unto itself the role of a collective bargaining agent on behalf of developing nations as against developed ones. However, in the field of international taxation, as proven by subsequent events, it would not be irrelevant to mention that the League of Nations being an exclusive club of the rich countries, its legacy whatever it stood for, was well-deservedly inherited by the OECD, rather than the UN as is generally believed.

2.4 *The UN MTC*

In the post-World War period, developing countries continued to use the London Draft (or even the OECD MTC, 1963) until the 'United Nations Model Double Taxation Convention between Developed and Developing Countries' was published in 1980. It has been emphatically argued that 'the UN Model grants more taxation rights to the source state or capital-importing country than the OECD Model'.[19] It was during the formative phase of the UN MTC 1980 that allocation of taxing rights on international traffic were seriously deliberated upon as some of the developing countries dragged their feet on outright surrendering of the taxation rights out of the source state. It, however, appears that the voicing of the dissent was neither formidable nor pronounced enough to alter the course or outcome of deliberations. Eventually, it was decided to introduce Alternative B to Article 8 but only to the extent of shipping and there too

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12 *Convention for the Allocation of Business Income Between States for the Purposes of Taxation* (Geneva: League of Nations 1935).

13 *Model Bilateral Convention for the Prevention of the Double Taxation of Income* (Mexico: League of Nations 1943).

14 *Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property* (London: League of Nations 1946).

15 *Commentaries on Mexico and London Draft* (Geneva: League of Nations 1946).

16 Guglielmo Maisto argues that the differences between Mexico and London Drafts are of 'a substantive nature in that the Mexico Model Convention excludes from the source State exemption income derived from the operation of ships which are registered under the flag of a State other than the State of residence. Moreover, under both model conventions the taxing power is granted to the State where the fiscal domicile of the enterprise is located (with no consideration for the further requirement of registration included in the Mexico model Convention); in the Mexico model Convention, however, such State is the one under the laws of which the shipping company was incorporated, while in the London model Convention such State is the one where the real centre of management of the shipping company is located'. *See* for a detailed discussion, Maisto, *supra* n. 6.

17 Sunita Jogaranjan, *The Drafting of the First Model Treaties on Tax Evasion*, Tax Law History Conference IX (2018).

18 *Ibid.*

19 Bart Kosters, *The United Nations Model Tax Convention and Its Recent Developments*, 4 Asia-Pacific Tax Bull. (Jan./Feb. 2004).

only if it was 'more than casual in nature'. The UN MTC continued to be in vogue throughout 1980s and 1990s. In order to accommodate the 'increasing focus on tax impacts of new financial instruments, transfer pricing, the growth of tax havens and globalization affecting international economic relations', the UN MTC was revised in 1999, and published in 2001.[20] The principle on international taxation was retained without any substantive alterations. In more recent past, the UN MTC was revised in 2011, and again in 2017, but essentially the allocation of taxing rights between the source state and residence state (or the state of effective management) remain unaltered reinforcing the international consensus in this area of international taxation. Thus, while developing nations may not have the requisite capacity and wherewithal to change the century-old consensus on this count, the developed nations have no incentive to alter it.

3 Source rule surrender: appraisal

3.1 *Evaluation of Defence*

Under an overarching internationally accepted principle of domestic taxation 'any income derived from the activities carried on within a country is sourced in that country'.[21] A corollary to this canon comes from the public international law, under which 'every country has the primary right to tax the income arising or derived from an economic attachment or territorial link with that country (i.e. domestic source income)', and it is wherefore that 'a nonresident person is liable to pay a tax for the privilege of earning the income from a source in the host country'.[22] Against the backdrop of such a canonical position vesting taxing rights in the source state, the UN MTC's source rule surrender can be appraised on the broader principles of international taxation. In this connection, an unequivocal stipulation comes from the UN MTC itself, claiming that in essence it 'seeks to be balanced in its approach'.[23] Broadly speaking, five principles determine and govern allocation of taxing rights at inter-state level out of which the first three are espoused by the UN MTC, too. Firstly, the 'taxation of income from foreign capital should take into account expenses allocable to the earnings of the income so that such income is taxed on a net basis'.[24] Secondly, taxation in the source state 'should not be so high as to discourage investment'.[25] Thirdly, the source state while asserting its territorial taxation ought to 'take into account the appropriateness of the sharing of revenue with the country providing the capital'.[26] Fourthly, as Rohatgi also pointed out, the right to tax on part of source state can legitimately be claimed 'only if there is an economic connection between a particular item of income and the country as a taxing jurisdiction'.[27] Lastly, the country asserting territoriality must be in a position 'to identify the income and its recipient, to quantify it and to enforce its taxing rights'.[28] It has also been argued that, for tax purposes, source rules provide connecting factors in that they help identify as to where a certain chunk of income arise, and which jurisdiction has a predominant taxing rights over it.[29]

When the nature and source of income from international traffic is evaluated on the touchstone of these principles, interesting insights are derived. One finds that on all five counts, income from international traffic cannot be shifted out of the source state. In fact, first three principles are normative in nature and it is, in fact, in developing countries' own interest to actually implement and honour them so as to continue deriving benefits of economic coupling with developed countries. Now against such an unequivocal case of developing countries to assert the source taxation right, the League of Nations, which had been guilty of the First Sin of surrendering the source rule at multilateral level lamely defended its capitulation by stating that it was 'intended to facilitate the operation of international transport enterprises', and that it would avoid 'numerous difficulties which experience has shown to be involved in the taxation of profits from international navigation outside the home-country of the operating enterprise'.[30] Astonishingly, this defence for the source rule surrender does not justify itself on any of the aforementioned principles of taxation and allocation of taxing rights between states. In fact, this is precisely the OECD position on the issue, too. It has been remarked that the 'OECD tax treaty approach for

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[20] UN, *Commentary on the United Nations Model Double Taxation Convention Between Developed and Developing Countries*, viii (New York: UN-DESA, 2011).

[21] Rohatgi, *supra* n. 4, at 222.

[22] *Ibid.*

[23] UN, *supra* n. 20, at ix.

[24] *Ibid.*

[25] *Ibid.*

[26] *Ibid.*

[27] Rohatgi, *supra* n. 4, at 222.

[28] *Ibid.*

[29] *Ibid.*

[30] Nations, *Commentaries on Mexico and London Draft.*

international transport income is premised on the view that the income will be equally balanced between the two countries, so that it is simpler from an administrative point of view to confine taxation to the country of residence of the company carrying out the international transport'.[31]

The OEEC's Fiscal Committee while deliberating upon Article 8 and its historical build up 'was unable either to justify the reference to "place of effective management" or to reject it in favour of residence or domicile on any principled basis'.[32] In a nutshell, the most weighty argument advanced in favour of vesting taxation rights in residence state is the administrative convenience of shiplines or airlines so they do not have to go through rigors of filing of tax declarations in multiple jurisdiction, but then this argument is equally applicable to all multinational corporations (MNCs) and their business models that are spread over from a few to hundreds of jurisdictions. The argument has further lost its lustre in view of the hyper exchange of information and administrative assistance in collection of taxes regimes being in vogue of late. This lack of moral moorings to any of the formulations in the administrative convenience domain has failed to impel multilateral organizations, developing country governments, or even the academics fraternity to project the source taxation principle in any systematic or forceful manner. In fact, the administrative convenience argument has had such a sway so as to be tantamount to semantic occupation of developing countries consciousness.

3.2 *Adoption of UN MTC Article 8 (Alternative B)*

The UN MTC's position taken through Article 8 (Alternative A) is the primary position which reinforces the international consensus on this matter, and the position taken through (Alternative B) is a subaltern one. This subalternity of Alternative B appears to have influenced the perceptions of the developed and developing countries alike in their negotiations in that it has not been signed into a large number of DTAs. It was reported in 2004 that out of a total of about 3,500 DTAs in force involving, at least, one developing country, only a little over hundred had incorporated Alternative B or an equivalent of it.[33] What may be further embarrassing for UN MTC was the fact that 'the condition that the activities must be "more than casual" had been waived in almost all of these treaties'.[34] Likewise, the UN prescription that profits on international traffic be taxed on net basis has widely been disregarded and 'gross revenue would be the basis' of enforcement of source taxation rights in most of the treaties that have incorporated Alternative B. It may partly be because the developed countries have been taking hard and arrogant position on asserting their taxing rights based on residence or place of effective management rule,[35] except perhaps the Netherlands which 'has accepted the alternative prescribed in Article 8B in its treaties with a number of developing countries (especially … with Asian countries)'.[36] Like in all international transactions in the realist world, DTAs negotiations among unequals, coercion is used as a tool to drive home maximum benefits. Pressure defined as 'continuation of negotiations through other means' is continuously applied to optimize on economic gains by a stronger partner in the negotiations. Vann has posited that when it comes to 'international transport, source taxation is generally excluded (although the UN Model has a little-used variant for shipping)'.[37]

Illustratively, in the original Pakistan-China DTA, the Article on international traffic did not cover incomes from containerization and other ancillary sources; it was got included through Mutual Agreement Procedure in 1999 – a decade after the signing of the agreement itself. Likewise, China-Pakistan DTA was amended years after its enforcement through a protocol expanding the scope of residence rule to 'wages, salaries or other similar remuneration derived by employees of airlines or shipping company of a Contracting State stationed in the other Contracting State'.[38] This belated interpolation essentially meant that even the right to tax salaries and wages of Chinese employees working in Pakistan for their shipping and airlines active in Pakistan was allocated to China on

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[31] Richard J. Vann, *International Aspects of Income Tax*, in *Tax Law Design and Drafting* 21 (Victor Thuronyi ed., Washington D.C.: IMF 1998).

[32] Lara Friedlander & Scott Wilkie, *Policy Forum: The History of Tax Treaty Provisions – And Why It Is Important to Know About It*, 4 Canadian Tax J. 54 (2006).

[33] Kosters, *supra* n. 19.

[34] *Ibid.*

[35] The UK Inland Revenue had been looking to sign an DTA with Thailand since early 1930s. It was majorly because Thailand would impose a tax on gross-basis on shiplines hitting its ports. Mindful of the fact that the UK would not be able to assert its traditional policy of residence-based taxation rights, the negotiations effectively could not go ahead until mid-1970s. During the protracted talks both states asserted taxation rights based on diametrically opposite principles. Eventually, hardened positions on both sides resulted in dropping off the very Art. 8 from the DTA allowing Thailand to retain its taxing rights over British shipping, without setting a precedent through a clause specifically permitting it. *See* for further details, Martin Hearson, *The U.K's Tax Treaties with Developing Countries During the 1970s*, in *Studies in the History of Tax Law* (Peter Harris & Domnic de Cogan eds, Oxford, U.K: Hart Publishing 2017).

[36] Kosters, *supra* n. 19.

[37] Vann, *supra* n. 31, at 44.

[38] DTA, *First Protocol to the Pakistan-China Avoidance of Double Taxation Agreement* 1989 (Federal Board of Revenue ed., Islamabad: FBR 2000).

the lines of Article 8 source taxation rights.[39] It has been argued that DTAs 'signed between developed and developing countries mainly reflect the interest of the developed partners', which scenario demonstrates the fact that 'developing countries are still at the mercy of developed countries as regards their taxation rights in an international setting'.[40] Steenkamp believes that the acceptance of the OECD MTC over competing MTCs is explainable in terms that 'most developed countries of the world, which are, not coincidentally, also the major capital exporting countries'.[41] In a nutshell, the strong preference exhibited by developed countries in favour of Alternative A, and developing countries' acceptance of the same in DTA negotiations, in a way, is indicative of failure of collective action and bargaining under the UN MTC and all what it aspired to achieve.

3.3 *Source Rule Surrender: Implications*

The source rule surrender on international traffic earlier by the League of Nations Model Tax Convention (LN MTC) and then by the UN MTC streaming into the international consensus on allocative principle of taxing rights and cementing it, may actually have had significant implications for the developing countries' economies and their untapped development potential. In the absence of a dedicated study focusing only on estimation of revenue loss by developing countries, it can still be conjectured that the figure could be a staggering one. Section IV and V map erosion of Pakistan's fiscal base on this score which could then be extrapolated to have some broad approximation of tax and other losses incurred by various developing countries over the past century.

The coercive implications of source rule surrender get amplified broadly on five counts. Firstly, the definition of 'profits' is constantly expanding whereby taxing rights on more and more genuine economic activities taking place on developing countries' soil are getting shifted to the capital-owning residence states. Although, primarily it covered 'the profits directly obtained by an enterprise from the transportation of passengers or cargo by ships or aircraft that it operates in international traffic', yet, over time, it has expanded into 'shipping and air transport enterprises invariably carry(ing) on a large variety of activities to permit, facilitate or support their international operations'.[42] The definition of the word 'ship' itself has widened in due course to cover 'any vessel used for water navigation'.[43] In due course, the scope of Article 8 has broadened to envelop 'profits from activities *directly* connected with such operations as well as profits from activities which are not directly connected with the operation of the enterprise's ships or aircraft in international traffic as long as they are *ancillary* to such operation'[44] – including but not limited to profits derived by an enterprise from (1) leasing of ships or aircrafts on charter; (2) sale of tickets or booking of load on behalf of other enterprises[45]; (3) operation of a link passenger transport service[46]; (4) marketing, advertising or commercial publicity[47]; (5) transportation of goods by trucks to and from a port or airport to a depot[48]; (6) containerization as well as 'from detention charges for the late return of containers'[49]; (7) operation of boats and vessels 'engaged in fishing, dredging or hauling activities on the high seas'[50]; (8) debt that is earned as a by-product of the main or ancillary business operations; (9) provision of technical expertise (engineers) and goods (spare-parts) to other enterprises; and (10) maintenance services extended to other enterprises under a 'pool agreement'. In the same vein, the UN MTC vests taxing rights on capital gains arising out of 'the alienation of ships or aircraft operation in international traffic, boats engaged in inland waterways transport or moveable property pertaining to the operation of such ships, aircrafts or boats', in the state of effective management rendering costs of the source rule surrender further expensive for the source state.[51]

Secondly, the allocation of taxing rights to developed countries on international traffic on incomes earned in developing countries, impacts the latter's balance of payments and foreign exchange reserves rather severely. The developing countries which continually face balance of payments crisis hardly afford to let go of even a

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[39] Muhammad Ashfaq Ahmed, Na Li & Peter Mellor, *China-Pakistan Double Taxation Agreement and China-Pakistan Economic Corridor*, 8 Bull. Int'l Tax'n 72 (2018).

[40] Fernando Souza de Man, *Taxation of Services in Treaties Between Developed and Developing Countries: A Proposal for New Guidelines* 153 (Amsterdam: IBFD 2017).

[41] Lee-Ann Steenkamp, *An Analysis of the Applicability of the O.E.C.D Model Tax Convention to Non-O.E.C.D Member Countries: The South African Case*, 10(1) J. Econ. & Fin. Sci. 85 (2016).

[42] OECD, *Commentary on the Model Tax Convention on Income & on Capital* 174 (Paris: OECD Publishing 2012).

[43] OECD, *Commentary on the Model Tax Convention on Income & on Capital* 223 (Paris: OECD Publishing 2017).

[44] OECD, *Commentary on the Model Tax Convention on Income & on Capital* 175.

[45] Ahmad Khan, *Cross Border Transactions and Tax Treaties Theory and Practice* 175 (Singapore: Petrosin 2000).

[46] *Ibid.*

[47] *Ibid.*

[48] *Ibid.*

[49] OECD, *Commentary on the Model Tax Convention on Income & on Capital* 176.

[50] *Ibid.*

[51] Art. 8 of the UN, *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (New York: United Nations 2011).

few millions of dollars in soft outflow; this causes serious haemorrhage in their hard-earned meagre foreign exchange reserves. Thirdly, the source rule surrender may have stunted maritime and aviation industries of the developing countries by providing tax-free opportunities to financially stronger and technologically advanced and equipped foreign lines. Fourthly, source rule surrender may have had implications for the defence of many developing countries as their own maritime and aviation industries – so very vital to the integrity and security of a state – could not develop into stable and reliable means of communications. Lastly, stunted maritime and aviation sectors hurt developing nations in terms of their lost pride that is generally associated with national flag carriers.

The UN MTC's source rule surrender on Article 8 creates a default position. It creates extraordinary situation where a developing country at the start of negotiations comes out with the UN MTC as *its own* (draft) considering it is favourable to developing countries. Although, originally residence state rights on international traffic was to be brought in as a bargaining chip. It was posited, with reference to the LN MTC, 'that taxation of shipping had to be dealt with within the context of a more comprehensive double taxation agreement so that the exclusive right to tax shipping profits to be country of residence could be balanced by counter-benefits'.[52] Over time, this has become given position – almost non-negotiable on part of certain developed countries. It has been observed that in view of some 'obvious disadvantages tax treaties have for developing countries, civil society organizations are starting to demand a change in developing and developed countries' tax treaty strategy', in that 'Governments in the global North and South should change their treaty system so as to protect revenue bases and policy space'.[53] Recently, the Kenyan High Court, in a landmark judgement, struck down a tax treaty between Mauritius and Kenya, in which context it was remarked that there is a need 'to rethink the costs, benefits and motivations around signing DTAs in the first place', and that there might also be a need to 'set up a DTA policy framework – which sets out the basic minimums the country should consider while signing bilateral tax agreements'.[54]

4 Pakistan DTAs & maritime sector

4.1 *Pakistan's Maritime Sector*

Pakistan, at independence in 1947, inherited a modest fleet of four privately-owned ships; it grew to fifty-three by 1965, and to seventy-one by the end of 1970s. In 1971, when its eastern part emerged as Bangladesh, Pakistan's fleet was reduced to fifty-seven, which was still good enough to cargo up to about half of its total international trade. In 1974, shipping industry was nationalized and fourteen new ships were added to the fleet in the public sector over the next five years. The shipping industry did reasonably well up until 1980s, which is evident from the fact that it was catering to Pakistan's cargo transportation needs up to around 40%. It was towards late 1980s that the rot started to set in and has since continued to permeate deeper and wider. Currently, Pakistan with a population of over 200 million and international trade in the vicinity of USD 100 billion per annum, has a shipping capacity of meagre five ships that renders Pakistan a perpetual net importer of shipping services. While sea being the cheapest and most efficient means of transportation, sustains about 90% of all international trade, in Pakistan's context, it caters about 95%, out of which 96.5% is transported by foreign lines.[55] Thus, Pakistani ships transport less than 4% of its total trade as against international standard of 40% as prescribed by the UN Commission on Trade & Development (UNCTAD) for national carriers.[56] Thus, currently Pakistan's shipping industry is as good as non-existent.

4.2 *Pakistan DTAs & Article 8*

Out of sixty-three DTAs that Pakistan has signed and enforced so far which contain Article 8,[57] forty-one carry the UN MTC Article 8 (Alternative A) – essentially the OECD MTC Article 8,[58] and remaining twenty-two, the UN MTC Article 8 (Alternative B) though couched in varying formulations. Pakistan's DTAs adopting the UN MTC Article 8 (Alternative B) are listed in Table 1.

Notes

52 Maisto, *supra* n. 6.

53 Katrin McGauran, *Should the Netherlands Sign Tax Treaties with Developing Countries?* (Amsterdam: Centre for Research on Multinational Corporations 2013).

54 Victor Amadala, *Kenya-Mauritius Double Tax Avoidance Void, High Court Rules*, Tax Justice (19 Mar. 2019).

55 Sajid Hussain, Muhammad Ayaz Khan & Abdul Rahman, *Role of Maritime Sector in Pakistan's Economic and Security Development*, 50(1) Pak. Ann. Res. J. 72 (2014).

56 *Ibid.*, at 73.

57 In fact, Pakistan has signed sixty-five DTAs so far; its DTAs with US and Egypt do not carry Art. 8.

58 Pakistan's DTAs obtaining UN MTC Art. 8 (Alternative A) include Azerbaijan, Bahrain, Belarus, Belgium, Bosnia, Brunei, Canada, Czech Republic, China, Denmark, Germany, Iran, Ireland, Japan, Kazakhstan, Kuwait, Kyrgyz Republic, Lebanon, Libya, Malaysia, Malta, Mauritius, Morocco, Netherlands, Oman, Poland, Portugal, Qatar, Romania, Saudi Arabia, Serbia, Spain, Syria, Tajikistan, Tunisia, Turkey, Turkmenistan, Ukraine, United Arab Emirates, United Kingdom, Uzbekistan, and Vietnam.

Table 1 Pakistan's DTAs: UN MTC Article 8 (Alternative B)[59]

#	*Pakistan's DTA Partners*	*Year of Enforcement*	*Source Taxation Rights Preserved*
1	Austria	2005	50%
2	Bangladesh	1980	50%
3	Finland	1996	50%
4	France	1996	100%[60]
5	Hong Kong	2017	50%
6	Hungary	1992	50%
7	Indonesia	1990	100%[61]
8	Italy	1984	50%
9	Jordan	2006	50%
10	Korea	1987	50%
11	Nepal	2001	50%
12	Nigeria	1989	01%[62]
13	Norway	1986	50%[63]
14	Philippines	1980	60%[64]
15	Singapore	1993	50%
16	South Africa	1998	50%
17	Sri Lanka	1981	50%
18	Sweden	1985	100%
19	Switzerland	2005	50%
20	Thailand	1980	50%
21	Yemen	2004	04%[65]

This is quite an impressive performance given most developed countries' intransigence to let go of taxing rights on shipping based on the residence rule – the predominant trend in this connection.[66] Pakistan may be the country that has signed largest number of the UN MTC Article 8 (Alternative B) in its DTAs. Nonetheless, the signing of DTAs may have causal links with the state of maritime industry in Pakistan. It is intriguing to note that Pakistan's maritime industry and its descend into desolation has a positive correlation with the pattern of signing of DTAs. Table 2 contains decade-wise details of DTAs signed and operative.

Table 2 Pakistan's DTAs Signed & Operative: Decade-Wise Details (UN MTC Article 8 (Alternative A) & (Alternative B))

	Total DTAs		*UN MTC Article 8 (Alternative A)*		*UN MTC Article 8 (Alternative B)*	
Decade	*Signed*	*Operative*	*Signed*	*Operative*	*Signed*	*Operative*
1950s	1	1	0	0	0	0
1960s	0	1	0	0	0	0
1970s	4	5	4	4	0	0
1980s	16	21	6	10	10	10
1990s	20	41	13	23	6	16
2000s	19	60	14	37	5	21
2010s	5	65	4	42	1	22
Total	**65**	**65**	**41**	**41**	**22**	**22**

It would be seen that during 1950s, 1960s, and 1970s, when there were only a scant number of DTAs signed and operative, Pakistan's maritime sector was doing reasonably well. In 1980s, however, as the frantic efforts added more and more DTAs to the tally, not only that its fiscal base started to get eroded beyond repair but also that its shipping industry began to lose its foothold against the challenge posed by foreign flag-carriers that were far better financed and technologically equipped. In fact, Pakistan became so generous in granting exemptions to international shiplines and airlines, that a reciprocal exemption on this count was incorporated in the substantive law.[67] It may be

Notes

[59] It means Art. 8 is based on or is identical in formulation or outcomes to UN MTC Art. 8 (Alternative B).

[60] The source state has been extended full taxing jurisdiction subject to the condition that it is done 'in accordance with its domestic law'.

[61] Pakistan-Indonesia DTA Art. 8(2) vests taxing rights in the source state but only 'on account of carriage of passengers, livestock, mail or goods shipped' at any of its ports.

[62] Pakistan-Nigeria DTA Art. 8(2) envisages reciprocal exemption on account of international traffic. However, this reciprocal exemption becomes ineffective if 'operations in international traffic are carried on by an enterprise of only one of the contracting state'; in which scenario, 'the tax charged shall not exceed 1 percent of the earnings of the enterprise derived from the other Contracting State'.

[63] Pakistan-Norway DTA Art. 8(3) allocates full taxing rights to source state subject to the condition that 'for the first ten years for which the convention is effective, the tax so charged … shall be reduced by fifty percent'.

[64] Pakistan-Phillippines DTA Art. 8(2) further stipulates that, in no case, 'shall the tax so charged exceed the lowest rate Philippines tax that may be imposed on profits of the same kind derived under similar circumstances by a resident of a third state'.

[65] Pakistan-Yemen DTA Art. 8(2), after vesting primary right to tax profits of shipping and airlines business in the state of effective management of the enterprise, stipulates that 'such profits derived from sources within the other Contracting State may also be taxed in that other state in accordance with its domestic law, provided that tax so charged in that other State shall be 4 per cent'.

[66] In contrast, out of the total of seventy-five DTAs that it has signed so far, India has been able to assert partial source taxation right in only six DTAs, i.e. with Denmark, France, Japan, Korea, Netherlands, and New Zealand.

[67] S. 52 of the Income Tax Ordinance, 2001, which reads: '52. Non-resident shipping and airline enterprises – (1) Subject to sub-section (2), any income of a non-resident person, for the time being approved by the Federal Government for the purpose of this section, from the operation of ships and aircraft in international traffic shall be exempt from tax under this Ordinance, other than income from ships and aircraft operated principally to transport passengers, livestock, mail or goods between places in Pakistan.

added that despite the fact that Pakistan has done reasonably well by signing the UN MTC Article 8 (Alternative B) into a substantial number of its DTAs, yet even those DTAs are costing it dearly – nearly 50% of the taxing rights. It may, therefore, be not completely illogical to deduce that Pakistan would have been far better off without a large of number of DTAs obtaining even the UN MTC Article 8 (Alternative B).

4.3 *Pakistan: Interplay of DTAs & Port Activity*

When Pakistan's DTAs bearing Article 8 are juxtaposed against the port activity that took place on its ports, interesting insights are derived. Table 3 presents the data of non-DTA partner countries' ships that hit Pakistani ports during T/Ys 2012 to 2016.

The total number of ships that hit Pakistani ports during the period covered comes to 18,492. The number of ships from non-DTA countries at 9,527, being slightly greater than that from DTA countries at 8,965, tempts one to drag into an overly simplified analysis and discount the importance of taxation in shipping decision-making equation. The fact remains that to the former tally the contributory jurisdictions are mostly well-known tax havens – particularly for maritime industry e.g. Panama, Liberia, Marshal Islands, Antigua and Barbuda, Greece, Bahamas, Monrovia, and St. Vincent etc. It was widely insinuated, with reference to Paradise Leaks, that a lot of black money has gone into shipping industry worldwide. When the focus of analysis is further reduced to a comparison between Pakistan's DTAs on the OECD MTC Article 8/UN MTC Article 8 (Alternative A) and (Alternative B), one again gets to glean some interesting perspectives. Table 4 contains the data of ships hitting Pakistani ports during T/Y 2012 to 2017 from countries with which Pakistan has signed the UN MTC Article 8 (Alternative A), and Table 5 obtains the data of those countries ships with which

Table 3 Pakistan's Top 10 Non-DTA Partners (Number of Ships Hitting Pakistani Ports)

#	*Country*	*2012*	*2013*	*2014*	*2015*	*2016*	*2017*	*Total*
1	Panama	534	484	517	529	719	752	3,535
2	Liberia	404	367	389	496	442	439	2,537
3	Marshall Islands	133	222	196	212	228	272	1,263
4	Antigua & Barbuda	76	71	38	76	58	64	383
5	Greece	69	58	46	45	26	51	295
6	Bahamas	58	72	49	33	24	31	267
7	India	47	34	26	46	28	18	199
8	Monrovia	49	60	26	19	29	2	185
9	Tanzania	42	22	17	8	18	7	112
10	Saint Vincent	20	24	12	11	19	12	100
	Miscellaneous[68]	111	125	81	73	138	123	651
	Total	1,543	1,539	1,397	1,548	1,729	1,771	9,527

Source: (1) Karachi Port Trust vide No.S.20/36, dated 4 January 2018 vis-à-vis the port activity taking place at Karachi Port, Karachi. (2) Port Qasim Authority vide email dated 10 March 2018, vis-à-vis the port activity taking place at Port Qasim, Karachi. Data of both ports have been clubbed together.

Table 4 Pakistan's Top 10 DTA Partners – UN MTC Article 8 (Alternative A) (Number of Ships Hitting Pakistani Ports)

#	*Country*	*2012*	*2013*	*2014*	*2015*	*2016*	*2017*	*Total*
1	Malta	100	65	91	168	208	200	**832**
2	USA	141	65	123	100	86	71	**586**
3	Kuwait	74	65	53	47	42	41	**322**
4	China	18	28	43	65	72	58	**284**
5	Saudi Arabia	27	15	38	63	62	47	**252**
6	Germany	73	37	51	19	31	24	**235**
7	United Kingdom	36	46	29	43	32	39	**225**
8	Philippines	12	17	20	51	36	11	**147**
9	Malaysia	16	17	22	20	24	32	**131**
10	Portugal	7	4	19	13	28	35	**106**
	Miscellaneous[69]	62	90	57	120	74	9	**713**
	Total	**567**	**446**	**545**	**664**	**695**	**615**	**3,532**

Source: (1) Karachi Port Trust vide No.S.20/36, dated 4 January 2018 vis-à-vis the port activity taking place at Karachi Port, Karachi. (2) Port Qasim Authority vide email dated 10 March 2018, vis-à-vis the port activity taking place at Port Qasim Karachi. Data of both ports have been clubbed together.

Notes

(2) Sub-section shall not apply to a non-resident person where the person's country of residence does not allow a similar exemption to a resident of Pakistan'. This provision of law was omitted vide Finance Act, 2002.

[68] Pakistan's non-treaty partners in shipping business with less than hundred ships – Cambodia, Gabon, Cayman Islands, Kingston, Mali, Niger, Seychelles, Venezuela, Bolivia, Georgia, Cypress, Dominican Republic, Croatia, Barbados, Angola, Cook Islands, Moldova, Sierra Leone, Luxembourg, Russia, Belize, North Korea, Monrovia, Mongolia, Comoros, Isle of Man, Gibraltor, Togo, Bermuda, Taiwan, and Saint Vincent – have been clubbed together.

[69] Pakistan's DTA partners on the UN MTC Art. 8 (Alternative A) with less than fifty ships – Belgium, Bulgaria, Bahrain, Libya, Vietnam, UAE, Iran, Turkey, Netherlands, Qatar, Canada, Japan, Lebanon, Mauritius, Morocco, Tunisia, and Ukraine – have been clubbed together.

Table 5 Pakistan's Top 10 DTA Partners: UN MTC Article 8 (Alternative B) (Number of Ships Hitting Pakistani Ports)

#	*Country*	*2012*	*2013*	*2014*	*2015*	*2016*	*2017*	*Total*
1	Singapore	233	224	337	341	382	332	**1,849**
2	Hong Kong	144	158	200	240	220	273	**1,235**
3	South Korea	40	31	28	29	35	23	**186**
4	Denmark	43	17	32	9	21	35	**157**
5	Philippines	12	17	20	51	36	11	**147**
6	France	30	27	23	9	8	7	**104**
7	Italy	13	22	16	12	15	16	**94**
8	Norway	13	12	10	10	19	26	**90**
9	Sri Lanka	8	11	6	5	7	6	**43**
10	Thailand	16	4	2	2	3	2	**29**
	Miscellaneous[70]	5	7	10	9	15	12	**58**
	Total	**557**	**530**	**684**	**717**	**761**	**743**	**3,992**

Source: (1) Karachi Port Trust vide No.S.20/36, dated 4 January 2018 vis-à-vis the port activity taking place at Karachi Port, Karachi. (2) Port Qasim Authority vide email dated 10 March 2018, vis-à-vis the port activity taking place at Port Qasim Karachi. Data of both ports have been clubbed together.

Pakistan has signed the UN MTC Article 8 (Alternative B) or a close variant of it.

A complete surrender of source taxation rights on shipping to tax havens like Malta and maritime powers like Kuwait, China, Saudi Arabia, Germany and UK hardly make a sense in Pakistan's particular context. The number of Pakistan's DTA partner ships hitting its ports during the period covered when segregated under the UN MTC Article 8 (Alternative A) at 3532 and the UN MTC Article 8 (Alternative B) at 3992 produces a differential of 460 ships. At some level, this may again be indicative of the fact that tax exemption at destination port may not be the only deciding factor in favour of or against a decision to undertake a particular voyage. However, it is obvious that a shipping expedition to a taxing port is hardly launched by a shipping enterprise of a fully functional state until there is some kind of tax treaty in place allowing tax exemption – India being a significant exemption, but then India is a neighbouring state. Even a cursory look at Table 5 reveals that Pakistan would have been much better off had it not signed any DTAs or DTAs sans Article 8 therein with a few low tax jurisdictions e.g. Singapore, Hong Kong, and Malta.

4.4 *Pakistan: Domestic Tax Regime on Shipping*

It may not be out of place to mention that Pakistan's own taxation regime as applicable to non-resident shipping lines is aggressive and effective. The Income Tax Ordinance, 2001, *imposes* a tax on gross basis 'on every non-resident person carrying on the business of operating ships or aircraft as the owner or charterer thereof in respect of – (1) the gross amount received or receivable (whether in or out of Pakistan) for the carriage of passengers, livestock, mail or goods embarked in Pakistan; and (2) the gross amount received or receivable in Pakistan for the carriage of passengers, livestock, mail or goods embarked outside Pakistan'.[71] It has been argued that the 'approach was adopted by Pakistan in the 1980s as a result of presumptive taxation of these activities by competitors, like … Thailand and the Philippines'.[72] India also adopted an identically aggressive taxation regime on shipping and air transport in 1976, when section 44B was inserted into the Indian Income Tax Act, 1961.[73]

The taxability of freight incomes arising from inward cargo has been subject of some debate in Pakistan, like in some other countries, too. The Central Board of Revenue (CBR)'s instructions issued with reference to section 80 of

Notes

[70] Pakistan's DTA partners on the UN MTC Art. 8 (Alternative B) having less than twenty ships – Bangladesh, Switzerland, Indonesia, Jordan, Yemen, and South Africa – have been clubbed together.

[71] S. 7(1) of Pakistan, 'The Income Tax Ordinance, 2001' (Islamabad: FBR 2001).

[72] Geerten M. Michielse, *Tax Provisions and the Global Economy*, in *The Role of Taxation in Pakistan's Revival* 228 (Jorge Martinez-Vazquez & Musharraf Rasool Cyan eds, Karachi: Oxford University Press 2015).

[73] Amar Mehta, *Taxation of Shipping Income Under Tax Treaties – Development of Case Law in India*, 3 Asia-Pacific Tax Bull. 21 (2015).

the Income Tax Ordinance, 1979, expressly waived chargeability in respect of passengers, livestock, mail or goods embarked outside Pakistan.[74] The issue came up under judicial scrutiny before Sindh High Court in 2011. The facts of the case were that cargo was brought into Pakistan on ships operated by non-resident shiplines. The cargo consisted of goods sold to Pakistani buyers by foreign sellers on free on board (FOB) basis, and the freight (and other charges, if any) in respect of the carriage were paid in Pakistan by the resident buyers. The Commissioner took the position that the amounts received by the foreign shiplines were taxable under section 7(1)(b) of the Income Tax Ordinance, 2001. The petitioners, on the other hand, contended that the provision did not apply to the case, and that even if it did, the amounts paid were not taxable in Pakistan on account of the relevant DTA provisions. The amounts were nonetheless taxed. At first appeal stage the chargeability was upheld, and at second appeal i.e. the tribunal, it met the same fate. The High Court affirmed the tribunal's order and the matter ended up being in the Supreme Court of Pakistan. The apex court agreeing with the High Court held that 'we don't agree with the learned counsel for the petitioner that freight charges on inbound cargo cannot be taxed', in Pakistan.[75] More importantly, Supreme Court struck down CBR's clarification dated 1 August 1995, stipulating that 'the interpretation made in the circular is not in conformity with the provisions' of the law.[76]

Pakistan's domestic tax regime as applicable to resident shipping companies though prescribes nominal tax rates yet it seeks to presumptivize gross receipts as income. The rates prescribed are (1) one US dollar per gross registered tonnage per annum in respect of all ships and floating crafts 'purchased or bare-boat chartered and flying Pakistan'; and (2) 15 US cents per ton of gross registered tonnage per chartered voyage in respect of all ships, vessels, and floating crafts 'not registered in Pakistan and hired under any charter other than bare-boat charter'.[77] Under the arrangement, which is to continue till 30 June 2020, resident shipping companies have also been exempted from payment of minimum turnover tax.[78] It is believed that Pakistan's shipping companies not only themselves register in offshore jurisdictions but also register their ships elsewhere; such ships then hit Pakistani ports under foreign flags to avail benefits that are available under the operating DTAs. Pakistan, therefore, is not only net importer of shipping services but also a net exporter of jobs and capital to foreign countries in this industry.

5 Pakistan DTAs Article 8: Aviation Industry

5.1 *Pakistan's Aviation Industry*

The descent of Pakistan's aviation industry into darkness has significant similarities with that of its shipping industry. Pakistan's aviation history dates back to the establishment of Orient Airways on 23 October 1946. Orient Airways commenced its operations on 4 June 1947, with four aircrafts, but ceased to operate on 11 March 1955, after being merged into Pakistan International Airlines (PIA) – Pakistan's national flag carrier. PIA soon rose to glory and was reckoned amongst top airlines of the world through 1960s, 1970s, and 1980s. At its peak, PIA boasted of fifty decent aircrafts, top-class cabin service, high safety standards, and punctual flight schedule. It was also credited for its role towards establishment of regional airlines like Emirates and Gulf, and the training of crew, engineers, and pilots of quite a few other airlines. Then the degeneration starts to set in towards late 1980s bringing the national flag carrier to near grinding halts a few times since. PIA's fleet after hitting a meagre number of eighteen aircrafts in early 2010s has doubled since though with great difficulty.

This is still not sufficient aviational strength to meet the needs of the country since Turkey, Malaysia, and Thailand have over 1000 aircrafts to cater to a population of 250 million, as against Pakistan's eighty aircrafts to service over 220 million people. While Pakistan's domestic air traffic has grown 10% – six percentage points higher than 4% in international air traffic, whereby its market size has constantly increased, the share of domestic airlines has continually decreased. Now, domestic airlines account for only about 40% of the passenger population, leaving the remaining 60% to be picked up by international carriers. In Pakistan, indirect taxation on the aviation sector is 27% on domestic routes, and 41% on international routes. When it comes to direct taxes all international airlines do business on Pakistani ports tax free, leaving domestic airlines to fend for themselves against an aggressive tax system, which is extensively withholdingized.[79]

While Pakistan's domestic airlines are taxed on net basis, its tax regime for the air transport income of a non-resident persons as enshrined in section 7 of the Income Tax Ordinance, 2001, is quite aggressive in that it *imposes* a tax 'on every non-resident person carrying on

Notes

[74] The CBR's Circular Letter No.C.2(4)IT.2/95, dated 1 Aug. 1995.

[75] *A.P.Moller (thr.) Maersak Pakistan (Pvt) Ltd v. Commissioner, Income Tax*, 01 P.T.R (2012).

[76] *Ibid.*

[77] S. 7A of the Pakistan, *The Income Tax Ordinance* (2001).

[78] Clause (11A)(xi) of Part IV of Second Schedule to the *ibid.*

[79] Muhammad Ashfaq Ahmed, *Pakistan: Withholdingization of the Economic System: A Source of Revenue, Civil Strife or Dutch Disease+?*, 56(VI) Pak. Dev. Rev. (2019).

the business of operating … aircraft as the owner or charterer thereof in respect of (a) the gross amount received or receivable (whether in or out of Pakistan) for the carriage of passengers, livestock, mail or goods embarked in Pakistan; and (b) the gross amount received or receivable in Pakistan for the carriage of passengers, livestock, mail or goods embarked outside Pakistan'.[80] The prescribed tax rate is '3% of the gross amount received or receivable'.[81]

5.2 *Pakistan's DTAs and Aviation Industry*

In many respects the rise and fall of Pakistan's aviation and shipping industries follow an identical pattern. Likewise, it can reasonably be argued that the aviation sector's decline has also causal connections with the pattern of signing of DTAs rather thoughtlessly. All of the sixty-five DTAs that Pakistan has signed tend to surrender source taxation rights on airlines industry. Additionally, Pakistan has signed a number of limited purpose airlines-specific tax agreements with countries such as Jordan,[82] Kenya,[83] Saudi Arabia,[84] and India,[85] which extend reciprocal exemptions to airlines plying to each other's ports. The coercive implications of the source rule surrender as brought out with reference to maritime industry in Part 3.3 are, mutatis mutandis, also applicable to aviation sector.

5.3 *Pakistan's DTAs and Port Activity*

Out of a total of twenty-one airlines that visited Pakistan, seventeen were from countries that enjoyed reciprocal exemption under bilateral DTAs – contextually the UN MTC Article 8 (Alternative A). Table 6 contains the data

Table 6 Pakistan's DTA Partners (Flights & Revenue): T/Ys 2014 to 2018 (Rupees in Million)

	T/Y 2014		*T/Y 2015*		*T/Y 2016*		*T/Y 2017*		*T/Y2018*	
Country	*Flights*	*Revenue*	*Flights*	*Revenue*	*Flights*	*Revenue*	*Flights*	*Revenue*	*Flights*	*Revenue*
Bahrain	3,067	836	3,164	923	3,268	1,169	3,943	1,259	3,993	1,269
Bangladesh	680	44	377	36	24	27	25	28	21	25
China	840	220	930	240	1,079	388	1,354	507	1,613	674
H. Kong	3,119	372	3,156	243	1,808	149	1,483	128	1,297	118
Iran	52	32	60	30	89	40	70	36	53	30
Kuwait	2,037	371	2,400	442	2,737	513	3,623	599	4,373	703
Germany	770	69	503	44	420	33	529	41	540	43
Oman	5,274	995	5,589	946	6,705	795	7,843	1,469	7,640	1,582
Malaysia	-	-	-	-	75	33	335	163	275	141
Sri Lanka	1,257	217	1,193	244	798	269	719	262	621	294
S. Arabia	7,198	2,837	8,122	3,037	8,172	3,776	9,297	4,842	10,823	6,076
Turkey	6,643	738	8,065	1,022	10,138	1,672	10,653	1,725	10,755	2,063
Thailand	9,410	444	9,001	422	7,932	495	9,033	579	9,883	656
Qatar	17,943	2,781	19,450	3,373	20,657	4,742	21,784	5,268	26,762	5,675
UAE	48,749	10,084	57,332	10,893	60,373	15,570	62,497	16,114	60,546	16,739
Uzbekistan	1,806	101	1,691	70	1,549	74	1,471	76	1,630	119
Total	**108,845**	**20,140**	**121,033**	**21,965**	**125,839**	**29,748**	**134,664**	**33,099**	**140,825**	**36,207**

Source: Civil Aviation Authority vide letter No. HQCAA/1091//067/ATIR/XIV dated 19 October 2018.

Notes

80 S. 7(1) of Pakistan, *The Income Tax Ordinance* (2001).

81 Para. (b) of Division V of Part I of first Schedule to the *ibid.*

82 Pakistan-Jordan Agreement for the 'Avoidance of Double Taxation on income of air enterprises', was enforced on 27 Dec. 1989.

83 Pakistan-Kenya Agreement, 'Concerning the Reciprocal Avoidance of Double Taxation of Air Enterprises from Payment of Income Tax' was enforced on 13 July 1994.

84 Pakistan-Saudi Arabia 'Agreement … for the Avoidance of Double Taxation of Income of Air Transport Enterprises was enforced on 21 June 1981. Later, the reciprocal exemption on both airlines and shipping was preserved in Art. 8 of the DTA signed between the two countries on 2 Feb. 2006.

85 Pakistan-India Agreement for the 'Avoidance of Double Taxation of Income Derived from International Air Transport' was enforced on 1 Aug. 1989.

of Pakistan's DTA partners' airlines and Table 7 those of its non-DTA partners that visited its ports over the past five years.

Even a cursory comparative look at Table 6 reveals that international airlines track DTAs to an extent possible. In comparison, the aircraft activity of Pakistan's non-DTA partner airlines plotted in Table 7 presents only a miniscule picture. In certain cases airlines have even been prompting their states to negotiate DTAs where there is a visible business opportunity available. This has been true in the case of Pakistan. It was remarked that PIA during its heydays would lobby, financially afford, and offer travel to Pakistan's treaty negotiating teams enabling them to aggressively sign reciprocal exemption in the DTAs. A cursory look at Table 6 reveals only six DTAs i.e. with Bahrain, Oman, UAE, Saudi Arabia, Turkey, and Qatar account for 91%, 92%, 93%, 93%, and 92% of total revenue generated by international airlines during 2014, 2015, 2016, 2017, and 2018, respectively. In fact, just one DTA with UAE should have been good enough to pulverize Pakistan's aviation sector as it singly facilitates 289, 497 flights and a corresponding revenue of Rs. 1,458,630 in five years. The data of UAE based airlines flights, and revenues earned in Pakistan are plotted in Table 8.

It can be seen that Pakistan-UAE DTA has covered more than 40% of total international flights to and from Pakistan and 42% of the total revenue earned in Pakistan over the past five years. It appears that in a zero-sum trade-off, on the one hand, PIA kept losing its market share of Pakistani passengers, and on the other, Gulf-based and other airlines kept grabbing it with both hands rendering Pakistan only a customer country.

5.4 *Pakistani Airlines' Port Activity in DTA partners*

In comparison, a look at the Pakistani airlines hitting its DTA partners' ports as plotted in Table 9 paints a revealing picture.

Likewise, if the above framework is expanded and the data of complete aviation activities that Pakistan has undertaken in DTA partner jurisdictions in terms of flights undertaken and revenue earned during the past five years, are analysed, the only conclusion that can be drawn is that the source rule surrender streaming into reciprocal exemption has been unjust at the inter-state level, and this is not only on the fiscal dimension. Other opportunity costs associated with reciprocal exemption on aviation industry must have had in terms of stunting of its development, and other employment opportunities that it must have created in the sub-industrial and related service sectors.

Table 7 Pakistan's Non-DTA Partners (Flights & Revenue): T/Ys 2014 to 2018 (Rupees in Million)

	T/Y 2014		*T/Y 2015*		*T/Y 2016*		*T/Y 2017*		*T/Y 2018*	
Country	*Flights*	*Revenue*	*Flights*	*Revenue*	*Flights*	*Revenue*	*Flights*	*Revenue*	*Flights*	*Revenue*
Afghanistan	1,947	73	3,913	77	2,762	87	2,299	78	1,170	42
Ethiopia	1524	167	1379	153	1450	214	1924	257	1754	271
Eretria	19	10	0	0	0	0	0	0	0	0
Iraq	236	17	400	31	28	2	0	0	38	13
Luxembourg	1398	106	1384	104	1361	112	1510	131	1523	140
Total	**5,124**	**373**	**7,076**	**365**	**5,601**	**415**	**5,733**	**466**	**4,485**	**467**

Source: Civil Aviation Authority vide letter No. HQCAA/1091//067/ATIR/XIV dated 19 October 2018.

Table 8 Pakistan-UAE DTA (UAE Flights & Revenue): T/Ys 2014 to 2018 (Rupees in Million)

	T/Y 2014		*T/Y 2015*		*T/Y 2016*		*T/Y 2017*		*T/Y 2018*	
UAE Airlines	*Flights*	*Revenue*	*Flights*	*Revenue*	*Flights*	*Revenue*	*Flights*	*Revenue*	*Flights*	*Revenue*
Air Arabia	8,100	906	9,341	1,105	10,838	2,101	11,517	2,420	10,483	2,407
Etihad Airways	13,607	2,349	15,761	2,660	16,704	3,144	16,359	3,090	14,843	2,993
Fly Dubai	6,063	708	9,475	834	10,547	2,184	11,581	2,435	11,320	2,621
RAK Airways	572	130	0	0	0	0	0	0	0	0
Emirates Airlines	20,407	5,991	22,755	6,294	22,284	8,141	23,040	8,170	23,900	8,719
Total	**48,749**	**10,084**	**57,332**	**10,893**	**60,373**	**15,570**	**62,497**	**16,114**	**60,546**	**16,739**

Source: Civil Aviation Authority vide letter No. HQCAA/1091//067/ATIR/XIV dated 19 October 2018.

Table 9 Pakistan's Aviation in DTA Partners (Flights & Revenue): T/Ys 2014 to 2018 (Rupees in Million)

	T/Y 2014		*T/Y 2015*		*T/Y 2016*		*T/Y 2017*		*T/Y 2018*	
Country	*Flights*	*Revenue*	*Flights*	*Revenue*	*Flights*	*Revenue*	*Flights*	*Revenue*	*Flights*	*Revenue*
Bahrain	21	6	26	8	85	30	77	25	1	0.318
Bangladesh	197	13	134	13	123	138	107	120	129	154
China	150	39	153	39	186	67	146	55	104	43
Iran	26	16	15	8	-	-	-	-	-	-
Kuwait	241	44	221	41	213	40	225	37	159	26
Germany	9	1	-	-	-	-	-	-	-	-
Oman	374	71	498	84	703	83	740	139	625	129
Malaysia	192	-	229	-	294	129	307	149	216	111
S. Arabia	2,330	918	2,273	850	2,866	1,324	3,092	1,610	3,046	1,710
Turkey	-	-	-	-	1	0.164	1	0.162	-	-
Qatar	88	14	137	24	178	41	162	39	112	24
UAE	1,774	367	1,940	369	2,874	741	2,842	733	2,624	725
Total	**5,402**	**1,488**	**5,626**	**1,435**	**7,523**	**2,595**	**7,699**	**2,907**	**7,017**	**2,922**

Source: Civil Aviation Authority vide letter No. HQCAA/1091//067/ATIR/XIV dated 19 October 2018.

Table 10 Pakistan & DTA-Partners: Reciprocally Exempted Revenue T/Y 2014–2018 (Rupees in Million)

	Bahrain		*Oman*		*S. Arabia*		*Turkey*		*Qatar*		*UAE*	
Year	*Given*	*Got*	*Given*	*Got*	*Given*	*Got*	*Given*	*Got*	*Given*	*Got*	*Given*	*Got*
2014	836	6	997	71	2,837	918	738	-	2,781	14	10,084	367
2015	923	8	946	84	3,037	850	1,022	-	3373	24	10,893	369
2016	1,169	30	795	83	3,776	1,324	1,672	0.16	4,742	41	15,570	741
2017	1,259	25	1469	139	4,842	1,610	1,725	0.16	5,268	39	16,114	733
2018	1,269	.31	1582	129	6,076	1,710	2,063	-	5,675	24	16,739	725
Total	**5,456**	**69**	5789	506	**20,568**	**6,412**	7,220	**0.32**	**21,839**	142	**69,400**	**2,935**

Source: Civil Aviation Authority vide letter No. HQCAA/1091//067/ATIR/XIV dated 19 October 2018.

The data of reciprocal exemption received and allowed by Pakistan under DTAs with Bahrain, Oman, Saudi Arabia, Turkey, Qatar and UAE is plotted in Table 10. It turns out that Pakistan is in net deficit on reciprocal exemption to the tune of Rs. 5,387, 5,283, 14,156, 7,220, 21,697, 66,465 million with Bahrain, Oman, Saudi Arabia, Turkey, Qatar and UAE, respectively. Legally speaking, this may be an exhibition of bilateral reciprocal exemption but, in essence, it is a brute unilateral one. The predatory nature of the reciprocal exemption gets galvanized by the fact that most of the Middle Eastern airlines enjoy a total tax exemption back home. The allocation of taxing rights in the residence state on air transport finds awkward justifications. Vann, with particular reference to the OECD MTC, posits that since 'the income will be equally balanced between the two countries, so that it is simpler from an administrative point of view to confine taxation to the country of residence of the company carrying out the international transport', and that in 'the case of air transport, this assumption will generally be correct because of the restrictions in international airline agreements entered into by governments, which try to share revenues between the airlines of each country'.[86] One only wonders how vesting of taxing rights exclusively in state of residence would 'equally balance' the taxation of income 'between the two countries', and

Notes

[86] Vann, *supra* n. 31.

how 'restrictions in international airline agreements entered into by governments, which try to share revenues between the airlines of each country', would allow full or part taxation in the source state.

6 Conclusion

The argument developed in the article has both theoretical and empirical dimensions. While the empirical dimension may need more cross-country data in order for the premise to be generalizable to other developing nations, the theoretical dimension is robust and convincing on all three counts i.e. fiscal, economic, and non-economic. On fiscal side, it is an open and shut case. On all plausible canons of allocation of taxing rights as analysed in section 3.1 income from international traffic deserves to be taxed where it arises or where its market is located – the source state. The creation of exception on international traffic vis-à-vis taxation of business incomes based on the permanent establishment (PE) principle is tenable only up until developing countries attain full cognition of the matter, and muster enough capacity and courage to raise a voice to change it. On economic front, though the premised causal connection between reciprocal exemption on international traffic and stunted aviation and maritime industries in developing countries may require more rigorous empirical testing, yet in Pakistan's context, the relationship is well made out as explicated in sections 4 and 5. In respect of the non-economic domain – national defence and pride – the premise does not warrant much elaboration. The strength and size of a country's aviation and maritime industries have an inevitable and direct bearing on its defence as well as on the pride that its people take in being its citizen. Notwithstanding, its obvious limitations the study does bring out some important points which may open up new vistas for future research in the field and also prompt UN and other multilateral frameworks to start thinking towards taking out demons that have been implanted in the UN MTC, and dismantling of the prevailing international consensus. Plausibly, the framework developed has a potential to be applied to other developing countries to examine if their international means of communications have stunted over time and that the process may have linkages with their DTA networks.

The paper sums up that the eerie extant consensus on allocation of taxing rights on international traffic out of the source state may have diverse and far-reaching implications for the developing world. It attempts to dissect the international consensus in all its perverse ramifications as much to disturb it. The roots of the prevailing near-universal consensus are traced back in time to the LN MTC connecting it to the UN MTC arguing that it is, in essence, tantamount to a failure on collective bargaining by the UN and ditching down of developing countries. The findings indicate that UN's stance, stature and claim to being protector of developing country rights may have been compromised. It further transpires that the legitimate heir to the LN's legacy in the fiscal domain is the OECD and not the UN. In fact, UN's abject surrender on the matter has left developing countries in a blind alley – a booby trap. Rohatgi has rightly posited that the UN MTC has invited ire for failing to make any substantial impact on the way tax treaties have been negotiated and signed, for which one of the important reasons could be that the UN MTC has subserviently trailed the OECD MTC.[87]

Finally, it gives a new direction to the debate on taxation of international traffic, which has, so far been focused on what should it be based at – 'real centre of management', 'place of effective management', 'place of registration', or 'domicile', etc.; in all situations it was away from the source state – contextually, developing countries. The new direction zeroes in the focus onto the allocative rights between the source state and the residence state. The argument that 'shipping enterprises should not be exposed to the tax laws of the numerous countries to which their operations extend',[88] has been debunked by counter-arguing that it could equally be applicable to all cases of MNCs that operate in hundreds of countries simultaneously. In order to safeguard international traffic against being exposed to multiple taxation systems, and their country-specific filing requirements, the way out is not to strip the weaker partners in the equation of their due share in revenues but developing a multilateral framework for an equitable sharing of revenues proportionately by all countries. The article makes the UN MTC stand in the dock.

Notes

[87] R. Rohatgi, *Basic International Taxation*, vol. II, 60 (London: Kluwer Law International, 2002).

[88] UN, *supra* n. 20, at 162.