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Taxation of employees on aircraft or ship - application of conventions on taxation of income and capital

Airline employees, as well as crew on board ships, are usually citizens of different countries. Conventions for the avoidance of double taxation and the prevention of tax evasion help to understand the principles of taxation of the income of employees, but the provisions of tax conventions are still difficult to apply in practice.

Today aircrafts and ships can work under the registration of one country, be owned by a company in another country, be operationally managed by a company in another nation, and with the crew on board the aircraft or ship being employed from several other nations. As a result it is important to understand the tax liabilities of employees not only for the personal tax compliance, but also consider the tax planning of their employers operating in a highly competitive environment.

The Tax code of Ukraine specifies that residents of Ukraine pay income tax on income received both in Ukraine and abroad, and non-residents only on income received in Ukraine. Residents of Ukraine for tax purposes are natural persons who have a permanent place of residence in Ukraine. If an individual also has a place of permanent residence in another state, he is considered a resident of the country where the center of his life interests is located. If it is impossible to determine the center of life interests, then the natural person is considered a resident of the country in which he stays for at least 183 days. A sufficient, but not exclusive, condition for determining the place of life interests of an individual is the place of residence of his family members or the place of his registration as a subject of entrepreneurial activity. If all the above-mentioned criterions do not make it possible to determine the person's residency, then the person is considered a resident of Ukraine if he has Ukrainian citizenship [1]. Thus, if, in accordance with the above norms of the Tax Code of Ukraine, the member of aircraft or ship crew is a tax non-resident of Ukraine, then income tax in Ukraine is not required to pay.

Taxation of income of regular employee's onboard aircraft of ship in international traffic is covered by the tax conventions on income and capital. To date Ukraine signed and ratified more than 70 tax conventions on income and capital. Recommendations provided in OECD Model Tax Convention play a significant role today [2]. The Article 15 (paragraph 3) of the Model Tax Convention on income and capital (OECD) states that "… remuneration derived by a resident of a Contracting State in respect of an employment, as a member of the regular complement of a ship or aircraft, that is exercised aboard a ship or aircraft operated in international traffic, other than aboard a ship or aircraft operated solely within the other Contracting State, shall be taxable only in the first-mentioned State" [3]. In other words the Model Convention recommends taxing the income of a member of the regular complement of a ship or aircraft in the state of the individual's tax residency. This recommendation was introduced by the OECD in the year 2017. The

purpose of that amendment was to provide a clearer and administratively simpler rule concerning the taxation of the remuneration of these crews.

However, in some counties the taxation of non-resident crew income continues to be exercised by the state in which the place of effective management is situated. Some states prefer to allow the remuneration of an employee who works on board a ship or aircraft operated in international traffic to be taxed both by the State of the enterprise operating such ship or aircraft and by the State of the employee's habitual residence.

For example, paragraph 3 of Article 15 of the Ukraine-Ireland Tax convention on income and capital stipulates the following:

"3. Notwithstanding the preceding provisions of this Article, remuneration derived in connection with employment exercised on board a ship or aircraft operated in international traffic by an enterprise of a Contracting State may be taxed in that Contracting State" [4]. This means that according to the Ukraine-Ireland Tax Convention in respect of income from an employment exercised aboard an aircraft operated in international traffic where the place of effective management of the enterprise operating the aircraft is, for example, in Ireland, the charge to Irish tax is not relieved. Flight crew is chargeable to Irish income tax and will pay their taxes in Ireland according to the Irish national legislation.

In this case, a double taxation situation should not arise but is dependent on the Ukrainian tax legislation. In particular, the Tax code of Ukraine (paragraph 13.3) says that incomes received by a natural person - a resident from sources of origin outside Ukraine are included in the total annual taxable income, except for incomes that are not subject to taxation in Ukraine in accordance with the provisions of this code or an international treaty, the binding consent of which has been granted by the Verkhovna Rada of Ukraine.

According to the paragraph 13.5 of the Tax code of Ukraine, to obtain the right to credit taxes and fees paid outside of Ukraine, the payer must obtain from the state body of the country where such income (profit) is received, authorized to pay such tax, a certificate of the amount of tax and fee paid, as well as the base and /or object of taxation. The specified certificate is subject to legalization in the relevant country, the relevant foreign diplomatic institution of Ukraine, unless otherwise stipulated by the current international treaties of Ukraine [1].

More detailed approach is given in the Ukraine-Poland Tax Convention: *"3. Notwithstanding the preceding provisions of this article, remuneration received in connection with work for hire carried out on board a sea or aircraft operated in international traffic, or on board a river vessel, may be taxed in the Contracting State of which the resident is a resident there is an enterprise that operates a sea, river or aircraft"* [5].

Another wording of paragraph 3 of Article 15 is in the Ukraine-Hungary Tax Convention: *"3. Regardless of the previous provisions of this article, the reward, received in connection with work for hire carried out on board sea or aircraft, or road vehicle, which is operated in international transportation by a resident of a Contracting State, is subject to taxation only in this Contracting State"* [6]. According to this the Ukraine-Hungary Tax Convention grants sole taxing rights to the State in respect of income from an employment exercised aboard an aircraft

operated in international traffic where the place of effective management of the enterprise operating the aircraft is in this State.

For example, if Wizzair Company has Hungary as a place of residence and the Ukrainian tax residents are members of the regular complement of this aircraft, the income of Ukrainian national will be taxed only in Hungary.

Ukraine-Greece Tax Convention says that *"3. Regardless of the previous provisions of this article, remuneration received in connection with work for hire, which is carried out of aboard a sea or aircraft operated in international transportation, may be taxed in the Contracting State in which the profits from the operation of sea or air vessels are taxed in accordance with the provisions of Article 8"* [7]. As we can see, countries agreed that the state where the employer pays tax on profit, has also the right to tax income received from an employment exercised aboard an aircraft or ship operated in international traffic.

In this case employee's income will be taxed by the state where the company pays tax on profit received from the operations with aircrafts or ships. And then the state of employee's tax residency can also tax this income providing the possibility of double taxation relief.

To summarize provisions of paragraph 3 of Article 15 of the Model Tax Convention and effective conventions in Ukraine, three main approaches to taxation of employee's income are defined:

1) The taxing right has only the state of tax residency of employee.

2) The taxing right has only the state of employer's registration, or where the place of effective management is situated, or where the tax on profit is paid by the employer.

3) Remuneration received in connection with employment carried out on board a sea or aircraft operated in international traffic by an enterprise of a Contracting State may be taxed in both Contracting States.

The first and the second approaches are the most convenient from the employee's point of view due to taxation only by one state (e.g. the state of employee's tax residency or by the state of employer's registration). As for the third approach, the employee can be taxed by two states with the possibility of the double tax relief according to the Tax Convention or based on the domestic legislation. The first right to tax has the employer as an economic source of income, and then the personal income can be taxed by the state of his/her tax residency with the application of article 23 of tax convention "Elimination of double taxation"..

Avoidance of double taxation in Ukraine is not straightforward. The Tax code of Ukraine contains very strict requirement for the document confirming the income received and taxed abroad as required for the foreign tax credit in Ukraine. The foreign tax administrations often do not issue the document in the form prescribed by the Ukrainian legislation [8]. In this case, Ukrainian tax residents cannot claim the credit of tax paid abroad against their Ukrainian personal income tax liability.

Even when the taxing right has only the state of tax residency of employee, this approach also must be properly documented. For example, the Ireland-Netherlands Tax Convention in paragraph 3 of Article 14 "Dependent Personal Services" states that "3. … remuneration derived by a resident of one of the States in

respect of an employment exercised aboard a ship or aircraft in international traffic shall be taxable only in that State" [9]. For example, an individual is a tax resident of the Netherland and exercises duties of his/her employment with Irish air company aboard an aircraft which operates between the Netherlands and Germany (international traffic). The individual is taxable in the Netherlands as a tax resident and must submit a personal tax declaration. The Irish employer, in its turn, does not withhold Irish tax from this individual if the individual confirms the tax resident status in the Netherlands and confirms he/she is subject to tax on income in the Netherlands. In addition the employee agrees to notify her employer about any changes in tax resident status or ceasing to be subject to tax on this income in the Netherlands [10].

Another question is how to tax personal income of crew members if there is no effective tax convention signed by the state of employer's effective management (or registration) and by the state of employee's tax residency? It depends on the domestic legislation of these two states. If the first mentioned state prescribes to tax the income of employee, then usually any question concerning relief for double taxation suffered by employee is a matter for tax authorities in the state of employee's tax residency.

Conclusions:

- OECD Model Tax Convention provides that remuneration of crews of aircraft or ships operated in international traffic is taxable only in the state of permanent residence of the employee. The principle of exclusive taxation in the state where the employee resides was included in the paragraph due to changes made in 2017. The purpose of this amendment was to provide a clearer and administratively simplified rule regarding the taxation of the remuneration of these crews.
- In practice countries may prefer to attribute the exclusive right to tax profits from shipping and air transport to the state in which the place of effective management of the enterprise is situated rather than the state of residence.
- Some states prefer to allow taxation of the remuneration of an employee who works aboard a ship or aircraft operated in international traffic both by the state of the enterprise's residence that operates such ship or aircraft, and the state of residence of the employee.

The approach proposed by the OECD as well as allocation of taxing right only to the state of the enterprise that operates such ship or aircraft are the most convenient for employees. At the same time these approaches require the proper documenting of taxpayers tax status and tax situation.

When taxation of the remuneration of an employee who works aboard a ship or aircraft operated in international traffic is applied both by the state of the enterprise that operates such ship or aircraft, and by the employee's state of residence, additional complex procedures must be completed by the employee in order to avoid the double taxation of his/her personal income.

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