

The Fiscal Landscape of International Air Transport

Background

The global and interconnected air transport industry features complex and highly regulated operations across multiple countries and jurisdictions. As airline networks expand and tax systems become more intricate, with an increase in the number and types of taxes and reporting requirements impacting international airlines, complexity is on the rise.

This brief aims to provide an overview of the legal framework underpinning the taxation of international air transport enterprises and the resulting complexities.

The international framework underpinning air transport

The Chicago Convention and the air service agreements

The Convention on International Civil Aviation (also known as the Chicago Convention)¹ established the International Civil Aviation Organization (ICAO), the specialized agency of the United Nations responsible for coordinating and regulating international civil aviation. It establishes rules covering airspace, aircraft registration and safety, and details the rights and obligations of the signatories in relation to air transport over and into their territories. Above all, it embodies the principle that legislative and regulatory harmonization across jurisdictions is paramount for international civil aviation to function optimally and to provide equal opportunities across the industry and the global economy.

The General Assembly of ICAO has, by resolution, “urged Member States to avoid adopting unilateral and extraterritorial measures that may affect the orderly, sustainable and harmonious development of international air transport and to ensure that domestic policies and legislation are not applied to international air transport without taking due account of its special characteristics”.² Hence, the Chicago Convention facilitates harmonization by exempting international civil aviation from certain forms of taxation. However, the industry is more specifically organized through bilateral air service agreements (ASAs) and double taxation treaties.

Under the international air transport legal framework (ASAs), foreign airlines can exercise their home government’s traffic rights if:

- they are designated for this purpose by the relevant partner - contracting government, and
- they operate as a foreign legal entity of their Head Office (as stipulated in the “Substantial ownership and Effective Control” provision of the bilateral ASAs).

Most nations impose limits on foreign ownership and control of their airlines and require comparable restrictions for foreign airlines under their ASAs. Consequently, it is generally not possible for an airline to

¹ Convention on International Civil Aviation done in Chicago on 7 December 1944. URL: https://www.icao.int/publications/Documents/7300_orig.pdf

² ICAO Assembly Resolution A41-27. URL: https://www.icao.int/sites/default/files/sp-files/Meetings/a41/Documents/Resolutions/a41_res_prov_en.pdf

operate in a foreign country (i.e., exercise traffic rights) using a locally incorporated subsidiary or a subsidiary incorporated in a third-party jurisdiction.

Therefore, unlike many other types of global business, foreign airlines often operate via simplified legal structures that constitute a direct extension of their foreign Head Office and that may not even require a formal branch registration or permanent establishment (PE)³ abroad. Such branches, if any, have no operational decision-making power and are not distinct or separate entities for the purposes of the ASAs. This organizational structure is a requirement arising from the regulatory framework rather than a corporate choice.

The fiscal principle for airlines' profits

International airlines operate within specific fiscal frameworks. While ICAO has developed Policies on Taxation in the Field of International Air Transport (ICAO Doc. 8632),⁴ which acknowledges the unique taxation challenges of international air transport, these policies and recommendations are generally not legally binding on ICAO member States. ICAO Doc. 8632 affirms that States shall grant reciprocal exemption from taxation on the income of air transport enterprises of other Contracting States derived in that Contracting State. However, the actual implementation of reciprocal tax exemptions is traditionally achieved through bilateral ASAs and Double Taxation Avoidance Agreements (DTAAs), which may incorporate principles from ICAO's policies.

The ICAO General Assembly resolutions represent the collective will and policy direction of the 193 ICAO member States. The resolutions carry significant weight as expressions of international consensus and seek to influence how States develop their national policies and legislation, including those relating to taxation.

This principle, crucial for avoiding double taxation and a fragmented system, both essential for the optimization of global air connectivity, is also reflected in Article 8 of the OECD Model Tax Convention on Income and on Capital ("OECD Model Convention") and it is widely adopted in DTAAs. Article 8 provides that profits derived by an enterprise from the operation of aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated. This generally means that the income from international air transport services provided by a foreign airline is taxable exclusively in its country of tax residence, which is where the Head Office is located and where its effective management is exercised. This globally recognized fiscal principle acknowledges the unique challenges associated with taxing a worldwide network.

Negotiating DTAAs is a complex process, involving balancing numerous factors and requiring ratification by both governments. Therefore, the income tax legislation of many States often opts to exempt profits from foreign aircraft operations, provided the foreign State offers a reciprocal exemption, in some cases through processes that can be formalized by the responsible Minister or the Commissioner of taxation requiring only a simple exchange of letters.

This fiscal treatment of airlines' income and profits is a deliberate policy decision, as evidenced by the 3,500+ DTAAs⁵ and ASAs⁶ all containing specific rules in this domain.

³ Generally, a PE is a fixed place of business entailing a certain level of business presence that could give rise to income or value-added tax liability in a particular foreign jurisdiction.

⁴ ICAO's Policies on Taxation in the Field of International Air Transport, 2000. URL: https://www.icao.int/publications/Documents/8632_3ed_en.pdf

⁵ OECD source. URL: <https://www.oecd.org/en/topics/tax-treaties.html>

⁶ ICAO source. URL: <https://www.icao.int/database-worlds-air-services-agreements>

The unique features of international air transport and its taxation

The limited activity of local branches

As already noted, foreign airlines often operate via simplified legal structures, which in some countries can take the form of:

- A registered branch office that is only allowed to represent the foreign airline company. The setup and functions of the branch regarding the international air transport services⁷ are akin to a liaison office, tasked with representing the parent company. Typically, a branch office gives rise to a PE under the DTAA's or the domestic legislation of the foreign country.
- An acknowledged PE, without a registered branch office, under the domestic legislation of the foreign country.
- Appointing a local agent, also known as General Sales Agent (GSA), without opening a branch office in the served country. In most cases, a GSA does not give rise to a PE under the DTAA's and/or the domestic legislation of the foreign country.

In jurisdictions where airlines have foreign branches or PEs, the registration of a branch office or the acknowledgement of a PE is usually a consequence of compliance with legal requirements rather than a corporate choice. In this regard, it does not alter the nature of the activity undertaken in the country.

As a representative office, a local branch has limited commitment powers and only those necessary for its normal functioning, and it acts on the direction of the Head Office. It has no independent revenue-generating air transport activity. While ticket sales may occur through various channels, the delivery, fulfilment, and related risks and responsibilities under the contract of carriage⁸ rest with the Head Office and is circumscribed by the traffic rights exchanged between the two countries under the international air transport legal framework (Chicago Convention system and ASAs).

In countries where international air transport tickets may be subject to VAT or GST, the branch of the foreign airline usually supports the collection and discharge of the relevant VAT/GST liabilities to the government authorities,⁹ and remits surplus funds to the airline Head Office. However, the prices of air travel tickets or cargo and freight fees, including which routes to operate, are decided by the Head Office.

The various expenses incurred by an international airline for its worldwide operations, such as aircraft rentals, repair and maintenance costs, and flight crew salaries, are incurred by the Head Office and are not specific to the local branches. The contracts for such services are also executed by the Head Office.

In scenarios where the local branch has contracts with local vendors (for instance, fuel procurement and line maintenance service in the country, ground handling services, or catering from the local destinations), such contracts are executed under the corporate governance, procurement policy, guidance and complete approval of the Head Office. In those cases, the local vendors charge VAT/GST, where applicable, and raise invoices.

⁷ A branch could engage in different business activities outside of air transport services in accordance with the fiscal principle of assets, functions, and risks allocated to the given branch. Such other business activities are not in the scope of this brief.

⁸ For instance, the Head Office is financially responsible for claims against flight cancellations, lost baggage, and unfortunate air accidents, and it takes out insurance coverage against these risks.

⁹ Such VAT or GST collections and payments have no relation to the presence or absence of the local branch. The tickets could be sold, and the proceeds from the sales could be collected, anywhere in the world for passengers embarking from the given foreign country for their international journey. Accordingly, the VAT/GST liability, if any, is usually deposited for tickets with origin locally and is not restricted only to the collections done by the local branch.

Payments to such local vendors are either performed directly by the Head Office or through the local branch bank account which receives funds remitted from the Head Office for such purposes.¹⁰

There is neither an internal arrangement nor a contract between the Head Office and the local branch to provide or receive support for the performance of the air transport services. The local branch does not receive services from the Head Office arising from any cost incurred by the Head Office in furtherance of its business, and there is no contractual relationship aimed at supplying services by the Head Office to the local branch.

Importantly, the local branch of a foreign airline does not have any substantive entrepreneurial risk of its own regarding international air transport services – the entire business risk and reward associated with these operations is borne by the Head Office itself.

Therefore, there is a complete absence of local revenue and expenses pertaining to the fulfilment of the air transport services, and correspondingly no basis for any compliance with local reporting obligations applicable to such activities.

Lack of local financial statements

As the local branch is not responsible for the delivery of air transport services, in most countries, airlines do not face any statutory or regulatory requirement to prepare separate accounts or local financial statements in the countries where they operate international air transport services outside of their State of effective management (i.e. home State).¹¹

In countries where an international airline has established a local branch, the airline is not and should not be required to maintain books of accounts and it is typically exempt from preparing audited financial statements, balance sheets, profit and loss accounts, trial balances, and other such financial reporting obligations.

There are significant differences between the accounting for the activities of the local branch or PE of an international airline and the local branch or PE of a foreign manufacturer or distribution company, for example. Having no air transport activities, any financial statements prepared by a branch or PE of an international airline will contain information that is unrelated to the financial information required by tax authorities in the context of an airline's existing tax obligations.¹² Overlooking these differences can give rise to extraordinary difficulties regarding the fair and consistent attribution of revenue and costs associated with the operation of aircraft in international air transport. The approach taken in such cases is often based on observations and formulas, as detailed below.

Determination of local net income

Despite the ICAO recommendations, some States still do not provide for the reciprocal exemption of profits derived from the operation of foreign aircraft either pursuant to statutory provisions in the tax laws of the two States or by negotiation of DTAAs and other bilateral agreements. Airlines from such States may subsequently be subject to local income tax in other States when they come within the jurisdictional reach of those tax administrations.

Where there is no tax exemption on airlines' income, the State should allow for the taxation to be imposed on a local net-income basis,¹³ which considers the profitability of the airline operations in that State. Foreign airlines

¹⁰ Liaison offices are usually allowed to open a local bank account for receiving remittances from the Head Office to cover its expenses.

¹¹ In the limited jurisdictions where separate accounts or financial statements are prepared for an international airline's PE to meet local obligations, these separate accounts or financial statements are not aligned with an Acceptable Financial Accounting Standard.

¹² For instance, many countries have prescribed expense deduction rules for tax purposes that apply specifically to the airline industry, which is a further departure from any conceptual local financial statements.

¹³ As opposed to income taxes on deemed profit, gross receipts or turnover, which have no relationship to operating profit and could result in double taxation and are discriminatory and regressive.

do not typically operate domestic flights outside of their home State. Considering the uniqueness of foreign airline operations internationally, the process of determining a local net income may be very burdensome and may not reflect the economic reality of the airline activity.

The operations of an airline to and from one State in its global network have an economic effect on its operations in every other State of its network and vice versa. It has therefore been considered by most tax administrations and by the airlines themselves that apportionment formulas provide a reasonable base on which to levy net income tax in States other than the State of fiscal domicile in the absence of the recommended reciprocal exemption. [IATA's Guidelines for Taxation of International Air Transport Profits](#) provide a brief outline of several generally accepted net income apportionment formulas.

To determine such apportioned local net profit, the recommendation is to consider the global net air transportation profit as published by the Head Office in the financial statements of the international airline, which are available in the public domain (or deposited in official registries) and are subject to audits by independent auditors on a regular basis. Such published statements can universally be accepted as accurate, fair, and systematic reflections of the operating results of the airline concerned.

On the contrary, any attempt to apply a conventional method of preparing branch profit and loss accounts comprising identifiable local income and expenditure will not produce an accurate result when applied to the branch/PE of an international airline. The local branch or PE of an international airline cannot prepare accurate separate statements, as the revenue and expenses potentially attributable to that branch are not accrued or incurred/paid locally, but they pertain to global operations executed by the Head Office.¹⁴

Definition of local revenue

Air transport tickets can be sold up to one year before travel. Airlines collect payments from the customer at the time of ticket issuance and record the funds collected as a liability (deferred revenue) on their balance sheet. It is only once the service is provided (i.e., the passenger or cargo is transported) that the respective carrier records the amount as revenue in its financial accounts. Therefore, gross revenue, as reflected in the airlines' financial accounts, is "flown revenue", meaning the revenue earned is recognised when the carriage purchased by the customer is actually performed, and not sales revenue.

For this reason, in countries where international air transport tickets may be subject to VAT/GST, turnover established for such purposes (i.e., sales revenue) does not match any related gross revenue (i.e., flown or accrued revenue). Furthermore, such sales revenues usually comprise taxes and charges included in the air passenger tickets. These taxes and charges are collected by the airline at the time of issuance on behalf of the relevant authorities and then remitted to the relevant charging authority, as stipulated by accounting standards such as IFRS 15.¹⁵ These do not form part of airline revenue. Indeed, since these amounts are considered as liabilities,¹⁶ such taxes and charges in the air transport tickets are not reflected in airline income statements, making it difficult to reconcile any turnover.

Additionally, due to "interline" agreements that allow passengers to purchase an itinerary with segments provided by multiple airlines, the total local receipts for sales of tickets rarely equal the actual local revenue of

¹⁴ The airline industry incurs a multitude of significant expenses related to the provision of air transport services that are not necessarily incurred or paid at the operational country level. Several substantial operation costs are typically centralized and managed at the Head Office level, including fuel, navigation fees, training, and costs related to reservation systems and distribution. This complexity adds considerably more difficult tasks to the financial management of airline operations to the various jurisdictions they do business in.

¹⁵ IATA, Industry Accounting Working Group Guidance IFRS 15, Revenue from Contracts with Customers, 2022. URL: <https://www.iata.org/contentassets/4a4b100c43794398baf73dcea6b5ad42/iawg-guidance-ifs-15.pdf>

¹⁶ In general, VAT/GST/sales taxes are due at the time of the airline ticket's sale, while other specific taxes and airport charges included in the ticket are deferred until the passenger flies, with the payment being due to the charging authorities after the provision of transport.

the airline issuing the ticket in any State.¹⁷ As such, revenue sourced to a State, if any, should include only revenue accruing to the operating airline,¹⁸ excluding revenue claimed and remitted to other airlines.¹⁹

In this context, one of the many complexities and challenges in subjecting a foreign international airline to local income tax is exactly the non-standard definition of “revenue” in the legislation (or even a lack of definition) and the different existing touchpoints to each sale²⁰, as well as the specific accounting rules for revenue recognition. As a result, the taxation of airlines in the absence of reciprocal exemptions tends to be both highly complex and unfair.

Off-line carriers

An international airline that does not have flight operations to and from a foreign country but does have ticket sales there is known as an off-line carrier.

Such airlines selling tickets through their own office perform functions similar to those of a ticket broker. Therefore, the off-line carrier could be subject to tax liability as a foreign resident business entity for the non-transport activities carried out there.²¹

However, where an airline does not have direct sales by its own office in a foreign country but sells its tickets through a GSA or other air transportation enterprises, the standard form of agreement for ticket sales excludes “any business carried out through an independent broker acting in the usual course of its business” from the definition of a PE. Therefore, no income taxes or similar taxes in such a foreign country should be imposed on the off-line carrier.

Concluding remarks

Airlines provide air transport services in foreign countries under the bilateral ASAs exchanged by their home jurisdictions and the relevant contracting ICAO State. Unlike many other types of global business, international airlines have a specific income tax treatment under Article 8 of the OECD Model Convention, and they often operate via simplified legal structures that may not even require a formal branch registration. Although they may establish local branches in those countries for representation purposes, the execution of their contracts and the associated risks and costs are incurred by the Head Office in their home jurisdictions. It is the organizational structure of airlines under the international air transport framework which makes their fiscal landscape very unique and complex. Airlines’ corporate structure is a consequence of compliance rather than a deliberate corporate choice.

The ICAO Resolutions urge member countries to avoid discriminatory taxes and double taxation, and provide a framework for harmonized practices, promoting fair competition, and ensuring the efficient functioning of international air transport while respecting the sovereignty of individual countries. However, challenges in the implementation in individual signatory States have persisted and might even be escalating. Fragmentation in the global civil aviation system is an acute threat to the provision of the service and its affordability, and therefore to its ability to help improve productivity and living standards in the global economy.

¹⁷ If revenue derived from the issue value of tickets is the basis of taxation it is impossible to apportion the tax to all airlines involved as these are not known for certain until after the passenger travels, and it is completely inequitable for the issuing airline to bear the whole burden of any income tax.

¹⁸ As per the industry definition in the IATA Glossary of Commonly Used Air Passenger Terms, the ‘operating carrier’ is the airline actually providing carriage or other services incidental to such air carriage, which bears the responsibility against the passengers for providing the air transport services.

¹⁹ Interline agreements necessarily impose on each airline a high degree of standardisation of accounting processes, allowing airlines to produce this information on a consistent and accurate basis, although not all use precisely the same accounting methods.

²⁰ For instance, some countries consider the local revenues either based on where the tickets have been sold (point of sale) or where the services are delivered (point of origin of the itinerary/flight).

²¹ One method to determine its taxable results could be by deducting from the commission earned on the sale of tickets, including deemed commission on its own sales, the amount of local costs incurred in earning that commission.