Unrestricted

Source-Based Taxation and International Air Transport: Potential Economic Implications

Introduction

1. The current international framework for the taxation of profits from international air transport, as set out in ICAO Document 8632 and reflected in Article 8 of bilateral tax treaties or relevant provisions of Air Service Agreements (ASA), allocates taxing rights to the country in which an airline is resident. The draft UN Framework Convention on International Tax Cooperation and the proposed Protocol on the Taxation of Income from Cross-Border Services (Protocol I) seek to expand source-based taxation for cross-border services.

2. There is a proposal to keep income from international air transport out of scope of the proposed Protocol 1 of the UN Framework Convention. However, any future extension of source-based taxation to the sector as a result of the ongoing negotiations could significantly increase compliance costs and the risks of double or multiple taxation, with potentially severe consequences for countries' connectivity. These impacts are likely to be particularly pronounced in developing countries, where connectivity is often more limited and the economic benefits of additional air services may be especially significant.

Economic importance of connectivity

3. Air transport facilitates trade, tourism, foreign direct investment and productivity. Previous analysis indicates that aviation generates particularly large spillover effects in developing economies and in certain regions, especially in Africa (Table 1).[1] Furthermore, Africa remains the least connected region globally on both a per-capita and per-GDP basis.[2] Policies that discourage connectivity therefore risk disproportionately affecting economic development in those economies for whom the potential economic benefits are the greatest.

Table 1: Value of aviation as % of GDP and employment (2023)

Region/Country Income Group	Direct (% of GDP)	Total (% of GDP)	Multiplier (Direct/Total)	Employment (m)
Africa	0.42%	2.6%	6.25	8m
Latin America	0.90%	3.6%	4.00	8m

[1] See also Aviation Benefits Beyond Borders 2024 (ATAG) and Value of Air Transport Country Reports (IATA).
[2] See Air Connectivity (IATA)

Asia-Pacific	0.53%	2.5%	4.68	42m
Middle East	0.95%	4.3%	4.53	4m
Europe	1.07%	4.6%	4.29	15m
Least-developed	0.35%	1.7%	4.81	6m
Non-OECD	0.58%	2.8%	4.81	61m
OECD	1.30%	4.6%	3.54	29m

Notes: Direct impact denotes the share of GDP generated by airlines, airports, air navigation service providers and civil aerospace manufacturing. The total impact denotes Direct, indirect, induced and tourism catalytic GDP supported by aviation. The number do not capture impact on sectors outside of aviation value-chain, apart from tourism, hence should be considered a lower-bound estimate. Least-developed countries are those that are designated as such by the UN and are ICAO Member States. Source: ABBB 2024

Potential economic impacts

- Low airline profit margins[3] mean that any source-based taxation based on gross receipts can translate into very high effective tax rates compared with profit-based taxation.
- Additional source-based taxation of international air transport may reduce the commercial viability of marginal routes, affecting flight frequencies and network development.
- In order to avoid loss-making routes, airlines may respond by reallocating capacity towards jurisdictions that do not impose additional source-based taxes.
- Reduced connectivity may have wider effects on trade, tourism, investment and productivity because aviation acts as critical enabling infrastructure.

Connectivity risks for developing markets

4. The effects of source-based taxation may be particularly significant for countries that depend heavily on foreign airlines for international connectivity. African countries, for example, rely substantially on non-African carriers for services to destinations outside the region.[4] However, traffic to and from Africa represents a relatively small share of the worldwide revenues of many of these airlines. If additional source-based taxes impact the profitability of African routes, carriers will have stronger incentives to reduce frequencies or reallocate capacity to other markets. This risk is especially relevant where routes are already marginally profitable.

Implementation considerations

5. The draft Protocol I discusses multiple potential sourcing rules, including where services are performed, where customers or users are located, where payments are made and where data are generated. These concepts are considerably more difficult to apply to international aviation because a single journey frequently spans several jurisdictions and may involve multiple airlines.

[3] The net profit margin is forecast to be 2% in 2026. See: Global Outlook for Air Transport: Energy in Crisis (IATA).
[4] 63.9% of seats on scheduled flights originating in African countries on international flights to non-African countries were provided by non-African airlines in 2025 (Source: DDS data).

6. Even where source-based taxation of international air transport is attempted on a net-income basis, determining the profits attributable to a particular jurisdiction would be inherently approximate. International air services involve shared aircraft, crews, network infrastructure and overhead costs, making it difficult to allocate revenues and expenses accurately across individual routes and countries. Different allocation methods could produce materially different results, increasing uncertainty and compliance costs, while failing to reflect the airline's actual profitability in the jurisdiction and continuing to risk high effective tax rates on certain routes.

7. Interline and codeshare arrangements illustrate these difficulties. Participating airlines often do not observe the passenger's complete itinerary, the total ticket price or payments made to other carriers. Different countries could therefore assert taxing rights over the same journey using different nexus rules, creating overlapping claims and significant compliance complexity.

Foreign tax credits

8. The draft Protocol I includes provisions for foreign tax credits to mitigate double taxation. However, credits are limited to the residence country's tax attributable to the same income and are capped at the amount of residence-State tax attributable to the relevant income. If source-State taxes exceed that amount, or if multiple countries impose source-based taxes, residual double taxation may remain.

Conclusion

9. The economic implications of the extension of source-based taxation to international air transport are not limited to the additional compliance and direct tax burden on airlines but extend to the likely consequences for connectivity and the wider economy. Given aviation's relatively low operating margins and substantial spillover effects, changes to international taxing rights could have implications extending beyond the aviation sector to trade, tourism and economic development. These risks are particularly relevant for developing countries, where air connectivity remains relatively limited and the potential economic gains from additional connectivity are often greatest.