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# UPDATE ON TAX CHALLENGES FOR FOREIGN AIRLINES IN CAMBODIA



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## INTRODUCTION

Siem Reap and Phnom Penh's success as a tourist destination, as well as a fairly robust economic development, has among other things resulted in a significant boost in connectivity by air for Cambodia. Just before COVID, international arrivals amounted to more than 6 million persons per year, roughly 2 million each from ASEAN and China, and the remainder shared by Japan, Korea, Europe, India and other countries. Direct flights exist with many Asian countries, serviced by more than 50 internationally or regionally renowned airlines. Add to that the significant volume of cargo airfreight (around 100,000 tons cargo airfreight annually, post-COVID) and the true importance of the air transportation sector becomes apparent.

The significant volume of passengers and cargo in the aviation sector is in sharp contrast with the lack of specific tax regulations for the industry. International airlines are merely subject to the same general rules as all other industries such as manufacturing, construction or hospitality while their industry is radically different. Most of their expenses airlines incur in international airspace. Costs for airlines are never incurred in only one country. Passengers and cargo most often use various aircraft and even various airlines in a journey, and assigning a profit to one single branch is very difficult to do. One can see right from the outset how having the same tax rules for a simple manufacturer in Cambodia and for an international airline that sells tickets online and has departures from Cambodia for global air travel, is going to be challenging.

The tax problems international airlines face in Cambodia were highlighted at a recently held industry event facilitated by the Department of Civil Aviation and the airports of Cambodia, based on a survey held among airlines servicing the country.

In this analysis we set out and examine some of the Cambodia tax problems of international (non-Cambodian) airlines contrasting them with the prevailing international rules and practices. We put this in the perspective of both direct and indirect taxes applicable to airlines in Cambodia.

The interesting backdrop is that internationally, and historically, source states (states where airlines fly and derive income, but are not based) have moved strongly toward the exemption of income from international air traffic. That is, as is provided in the OECD and UN Model Double Tax Agreement (DTA) international airlines are only taxed in the state where the airline is a resident, and its overseas branches are exempt from income tax in the states where they are located. But, the source exemption for airline income is not yet universal. It is nearly always created by a DTA between the state where the airline is a resident and the state of the branch (or, in tax terms, a permanent establishment (PE)), and there are plenty of states in Asia that do not (yet) have a DTA between them. Particularly Cambodia, which started concluding tax treaties only from 2017, has several important (air) trade partners without a DTA.



## THE INTERNATIONAL PRACTICE OF TAXING THE BRANCHES OF INTERNATIONAL AIRLINES

There are several ways how states approach the income tax of airlines that are somehow connected to their territory .

1. Probably the most wide spread and simplest way to approach the income taxation of non-resident airlines is to subject their profit only to income tax in the state where they are a resident and to exempt them from tax everywhere else. So, all local branches are exempt from income tax, at least on qualifying income. This is the "**exemption-approach**" propagated by the OECD and UN Model DTAs, and the method of choice recommended by the International Air Transport Association (IATA).

In Cambodia, this method is required under art. 8 of Cambodia's DTAs, which prescribes that any airline resident in another DTA state is taxed only in that other state, and not in Cambodia, even if it has a branch or permanent establishment in Cambodia.

2. Only slightly more complex is **tax on a gross revenue** basis. This is levying income tax at a reduced rate on gross revenue of the branch, or, which very much results in the same end result, levying a deemed net profit margin for airlines based on revenue and taxing it at the normal rate. For this and all other below methods the locally sourced gross revenue needs to be determined, which is a another problem in itself. But the expenses do not come into play under this approach, so one could say the method is easier than some of the following ones. For example, Vietnam and India follow this approach for their non-DTA airlines.

The disadvantages of this approach are obvious: an airline might be taxed on income it actually does not locally or even internationally realize because net profit is determined on a deemed basis, without checking actual profit. This problem is made worse if loss carry forward is inapplicable, resulting in an airline paying profit tax while it incurs loss after loss.

3. Taxing *the branch on its own net income* is the somewhat more complicated but arguably fairer method. Complicated, because one needs to come up with rules to determine not only which revenue must be assigned to the branch, but also which expenses are acceptable. This is the "**Calcutta method**", which allows the branch to deduct local and apportioned expenses from its gross revenue to thus way determine the taxable net profit of the branch .
4. Finally, one could instead of trying to determine the local net income of a branch simply abandon



that pursuit and instead focus on the *worldwide net profit of the airline*. If the airline has realized a profit globally, how much of that net profit should be assigned to one particular branch? There are variations how to do this allocation of net profit. The “**Maritime method**” provides that the percentage of the branch in the global revenue can be used to determine the branch’s portion in the global net profit. The “**Massachusetts method**” calculates that percentage by taking the average percentages in terms of not only revenue but also employee costs and cost of assets used. In both these options, some percentage of the global net profit is deemed to be the branch’s profit and taxed accordingly by the state of the branch.

All these approaches and methods have pros and cons. Some states use more than one, e.g. Australia allows branches of foreign non-DTA airlines to declare local profit based on the Maritime or the Calcutta method.

The administrative difficulties with the exemption approach such as in Art. 8 DTA are very limited. Mostly there could be debates if there is any non-aviation, “normal local income” that is carved out from the income tax exemption. One feature, however, is that the exemption method can result in an unbalance of tax revenue between states that have significant differences as a home base for international airlines. That is to say, this is typically a problem between least developed countries, which may have just one or two airlines of their own, and advanced developed nations with a long list of airlines based on their state. On the other hand, there seems to be ample evidence that international airlines greatly contribute to the economic development of developing nations, and there is no arguing with the success of the exemption method, which is included in both the OECD and the UN Model Tax Convention.

Taxing gross revenue is clearly not the IATA’s favorite approach, and it is easy to see why. The aviation business is notoriously cyclical, with high peaks and periods of significant losses. Airline branches taxed on gross do not have loss carry forward and are thus, by definition,

double taxed on many occasions. Furthermore, taxes on the gross mean that even loss generating branches or routes are paying income tax, while the head office may also be taxed on global income.

Approaches based on the global net profit might be seen as inadequate for very lucrative individual branches, while the Calcutta method may invite more local scrutiny as the tax authorities might feel they need to go through all apportioned expenses, one by one.

## THE CAMBODIAN TAXABLE PRESENCE OF NON-DTA AIRLINES

Cambodia’s Law on Taxation featured a definition of “**permanent establishment**” (the Cambodian PE) from its first draft in 1997. The Cambodian PE functions much like in other countries as a source nexus for the Cambodian income taxation of business income derived from Cambodia by non-residents.

After various (and recent) changes to the definition of “permanent establishment” (PE) in Cambodian tax law and regulations, presently the definition of PE in the LOT reads as follows:

*The term “permanent establishment” means a fixed place of business in the Kingdom of Cambodia, the branch of a foreign company or an agent resident in the Kingdom of Cambodia, through which the non-resident person carries on their business. The term “permanent establishment” also includes any network or connection through which a non-resident person engages in economic activity in the Kingdom of Cambodia. Any person in Cambodia may be considered as a PE of a non-resident if the person has and regularly uses the right to enter into a contract on behalf of the non-resident person or to play a primary role in facilitating reaching the contract. A PE is considered as a resident legal person only for the income from Cambodian sources”.*



Foreign airlines that want to carry goods or passengers to or from Cambodia are often pulled into the Cambodian income tax jurisdiction through the operation of regulatory requirements. To receive permission from Cambodia's Civil Aviation Authority, a foreign airline needs to fulfill various local requirements, which sometimes includes registering a type of commercial presence in Cambodia. As a result, there is for that standard situation little doubt if the foreign airline has a taxable presence in Cambodia, because that commercial presence will constitute a PE for tax purposes, at least under the Cambodian LOT . A non-resident non-DTA airline which opens a commercial presence in Cambodia will automatically be drawn into the income tax jurisdiction because the GDT regards every commercial presence as a taxable branch or PE. So, there is little uncertainty in this situation for the GDT or for the taxpayer.

But there may be many less obvious cases where no formal branch is created by the airline. Under the LOT definition, which was expanded as recently as 2023, the following situations would also give rise to a Cambodian taxable presence for a non-resident airline:

1. The non-resident airline has no formal branch in Cambodia but it has a "network or connection" through which it engages in air transportation business in Cambodia; or
2. The non-resident airline has no formal branch in Cambodia but there is a (legal or individual) person or company in Cambodia which:
  - a. Has and habitually uses the right to sell carriage on behalf of the non-resident airline to customers in Cambodia; or
  - b. That person does not have the right to itself sell carriage but plays "a primary role in facilitating reaching" such sales .

Particularly the "network or connection" and the "person with primary role in facilitating" are perhaps vague concepts that raise questions and uncertainties for both the GDT and the taxpayers. What is more, there is presently no administrative path for a non-resident non-DTA airline to self-declare an agency PE distinct and separate from its agent proper unless it has a commercial presence as well. In other words, an airline with a dependent agent in Cambodia cannot really declare its own Cambodia source income separate from that agent's own income, short of registering a commercial branch which it may not be in a position to do. Typically, for these situations, which we also encounter in the Cambodian taxation of carriage of goods by the sea, the GDT may on occasion add the liner's income to that of the agent, particularly if they are group entities. This is practically troublesome and theoretically unsound . If the LOT calls for certain situations to be taxable, the GDT needs to create the proper administrative possibilities for taxpayers to comply with that tax obligation.

When considering the above situations of a non-branch non-DTA airline, one area of uncertainty is the business models of **code-sharing, agency** and similar arrangements. In a very general sense, under the code sharing model passengers or freight may purchase a ticket from one airline but are actually transported over another airline or airlines. This typically involves an "operating carrier", which actually operates the aircraft, and the "marketing carrier", which purchases seats from the operating carrier for re-sale to the market. The airlines may alternatively swap seats with each other. In the agency model, the marketing airline merely represents the operating airline. The contract concluded or the ticket issued only binds the operating airline, not the marketing airline.

It is clear that the Cambodia branch of a non-resident non-DTA marketing airline that acts as an agent on behalf of other airlines which do not have



a branch in Cambodia, may squarely fall within the Cambodian definition of a PE, if the above conditions for PE are met. That is to say, if the marketing airline has the authority to fully conclude the contract for the carriage or plays the primary role in getting to the end result, can it be said that the marketing airline is the agency-PE for the operating airline? Again, however, the operating airline might decide not to comply with its (alleged) tax liability as there is no administrative way for him to declare income separately from the marketing airline, except to register a commercial branch (which may not be feasible for regulatory reasons).

## **WHAT IS “CAMBODIA SOURCED INCOME” AND “DOMESTIC TICKET SALES” FOR NON-DTA AIRLINES?**

### **Cambodia source income in general**

Cambodia’s Law on Taxation sets out a list of source rules, determining which income derived by non-residents is taxable in Cambodia . The source rules are somewhat different per class of income, as is the case in most countries. Two heads of jurisdiction as Cambodia source income may -conceivably- come into play for international air transport: art. 33 (3) “income from services performed in the Kingdom of Cambodia” and the general art. 33(10) “income from business activities carried on by a non-resident”.

It is difficult to argue that “income from services performed in Cambodia” is an appropriate category of income for international air transport. The plain reading of the text seems to refer to just the opposite, in fact. In addition, there is no official general guidance from the GDT to indicate that this class of income could comprise income from international air transport, in fact quite the opposite. In actual cases, payments for international transport, including those for passengers and goods departing from or arriving in Cambodia, have by the GDT consistently been treated as not subject to withholding tax. At the very least, we cannot equate the purely temporary physical presence of an aircraft on Cambodia territory, including its airspace, as “performance in Cambodia”, as such an interpretation would result in any aircraft touching or crossing the airspace (not only arriving in or departing from it) triggering taxability. This is entirely unfeasible practically, and internationally unprecedented. At the most, international airlines departing from and arriving in Cambodia “perform” only a very short part of their trajectory within national boundaries.

When considering income realized from the transportation of passengers and goods by non-DTA airlines, the class “income from business activities” seems the more appropriate one . Business income derived by a non-resident taxpayer is only taxable in Cambodia if it is realized through a Cambodian PE .

Cambodian tax law does not provide much detail on how to determine which income that is derived from Cambodia should be included in the income of a Cambodian PE. The LOT merely provides that “business income from a non-resident **through** a PE in Cambodia” is considered Cambodia sourced income . “Through a PE” was the original language of the draft law in 1997, prepared by consultants who were well aware of the internationally customary attribution of income to PE’s, as per the OECD Model DTA. In Cambodian language this was translated into “tam royak” which means “by means of” or “through” . The main regulation on income tax, the Prakas on Income Tax, remarkably, merely repeats the LOT’s statutory rule, without adding any clarification or detail.

In our view, the use of the word “through” a PE (or, in Cambodian language “tam royak”) in the LOT before 2023 at least meant that the PE must have been the link between the income and the non-resident. Not only must the PE have been involved, it must have been in the middle between the income and the non-resident. This seems to be the equivalent of the OECD’s approach in art. 7 OECD Model DTA.



Cambodia's transfer pricing regulation does offer some more color on determining a PE's income. Prakas 986 provides in rules to determine the arm's length price for transactions between related enterprises and follows, by and large, the OECD's main concepts in the matter such as functional analysis, comparability, CUP and other methods, etc. In the 2023 amendment of the LOT, it is emphasized that the relationship between a PE and its head office is also a related party relationship for transfer pricing purposes. The arm's length principle is not a source rule per se, but it will operate with much the same result under the circumstances.

In 2023, the allocation of income to a PE was amended and enlarged. A new sub-paragraph was added reading:

*"The allocation of income to the PE of a non-resident in Cambodia must also include income from the same or similar supply of goods or services to the business activity of the PE supplied by the non-resident in Cambodia".*

There is a similarity here with the UN Model DTA's "limited force of attraction", but both concepts are not the same.

The UN Model's provision reads:

*"[...] may be taxed in the [source] state ... (b) sales in the [source] state of goods or merchandise of the same or similar kind as those sold through that PE or (c) other business activities carried on in that [source] state of the same or similar kind as those effected through that ME".*

The idea that all income from a source country should end up in a PE's tax calculation is not uniformly considered workable, even by the developing countries in the UN Committee of Experts:

*"Some members from developing countries pointed out that the force of attraction rule had been found unsatisfactory and abandoned*

*in recent tax treaties concluded by them because of the undesirability of taxing income from an activity that was totally unrelated to the establishment and that was in itself not extensive enough to constitute a PE. They also stressed the uncertainty that such an approach would create for taxpayers"*

### **Income from international traffic specifically**

Internationally, there are two alternative approaches to determining the source revenue of an international airline: the **Point of Uplift Method** and the **Point of Sale Method**. A 2008 "Practice Statement" of the Australian Tax Office (ATO) in the matter of non-treaty airlines provides a well written illustration of this. First of all, the ATO's Practice Statement sets out that non-DTA airlines may in Australia choose between the Maritime or the Calcutta method. Then, to determine the "gross Australian revenue" of the branch under each method, the taxpayer may use, and the ATO will generally accept, one of two rules:

- A. **Point of Uplift:** the Practice Statement states that "in most cases the place of performance, being where the actual provision of the transportation service takes the place will be the vital factor leading to the derivation of the income. [...] The Commissioner considers that where the carriage commences, otherwise known as the point of uplift- is a reasonable approximation of the place of performance source rule". Under this rule, income will be regarded as locally sourced income for flights where the carriage commences in the source country. For this rule, transit stops to transfer to a different aircraft, change aircraft or take fuel are disregarded. The income for the entire trip from the source country to the destination is counted, including transfers. The ATO makes an exception for flights that have a stopover, i.e. the passenger or goods leave the airport and move into the state, stay in a hotel outside the airport and continue their voyage after some time.





This means that the return trip is not counted as Australian source income, as the point of uplift is overseas. Practically, the income of a return ticket is divided in two to count only the Australian uplift income.

- B. **Point of Sale:** This rule looks at all the carriage of goods and passengers sold in the source state, irrespective of whether the transport is to or from the state where the carriage was sold. In this case, the revenue from an entire flight, go and back is included in the branch's gross income of the branch that sold the ticket.

From the ATO's point of view, taxpayers might propose either the Uplift rule or the Point of Sale rule to determine gross revenue. But for a non-DTA airline with "significant operations in Australia as evidenced by the existence of an operational or sales office or with specific and strategic marketing and advertising in Australia" the Point of Sale rule is the more appropriate one, the Practice Statement provides .

How do e-commerce sales affect this source issue? The fact that carriage is sold to customers does not have much impact under the Uplift method. Regardless where the sale has been concluded, passengers and freight departing from the branch state will be included in that state's revenue. For the Point of Sale rule, this is less clear. The ATO Practice Statement seems to take the view that it suffices that the carriage is sold "in Australia" and not necessarily by the Australian branch.

With respect to Cambodia, there is no actual law or regulation to clarify which part of the revenue of a non-resident non-DTA airline should be allocated to the Cambodian branch or PE (if any) of such airline for income tax purposes. At the higher referred event of 27 September 2023, the GDT as far as we are aware for the first time publicly stated its view that "[airlines] shall recognize income from the sale of tickets based on the total number of passengers departing from Cambodia (passenger Uplift from Cambodia) and regardless of the number of the tickets at the point of sale. The airfare shall be calculated based on one way ticket which departs from Cambodia or half of the round way fare" .

Following general Cambodian tax principles, it seems fairly uncontroversial that tickets or cargo sold by and paid to the Cambodian branch itself (as the Point of Sale) should be included in its gross revenue. But the GDT seems to have chosen for the Uplift method instead, in all situations, which is not in line with for example the recommended method in Australia in case the airline has a full blown local sales office. Accordingly, the GDT suggests that the income related to passengers living abroad who buy tickets and depart from overseas, is also included in Cambodian source income for the round trip when they are uplifted from Cambodia. For example, if they take a round trip from France to Cambodia, then half of the return trip fare should be

deemed Cambodian source income. Furthermore, along the same lines, passengers or cargo leaving Cambodia booked and paid for at the airline's head office, for example by the passenger's employer, or by the overseas buyer of the cargo, may according to the GDT be deemed Cambodia source income. The GDT also takes the view that tickets sold online, and for example recognized at the head office should be included in Cambodia source income (half if a return trip) provided the passenger who booked this trip is uplifted from Cambodia at some point.

### **"Domestic sale" in Cambodia's indirect tax system**

The Cambodian indirect tax system for airline tickets offers little comparative guidance, as the nature and structure of an indirect tax cannot be compared in any way with an income tax. Cambodia provides in a -presently- 10% **"Specific Tax"** on the gross value of the "domestic sale of passenger airfare for domestic and international routes". There has been a Specific Tax on airline tickets for passengers in some form or another since 1997 in Cambodia, with various rates and taxable bases.

According to the GDT, the scope of "domestic sale" for the purposes of Specific Tax was provided in a regulation issued in 1997:"

*"Any air ticket shall be considered as departing or sale to passengers in Cambodia if those air tickets have been given to the passenger before departing from Cambodia".*

Th GDT recently added that "this means the local air ticket sold includes the direct sale through the Branch, sale through agency using air ticket system and sale through the internet. The Branch shall calculate Specific Tax based on the number of passengers who have their first departure originated from Cambodia".

It is not entirely certain how the definition of Prakas 341 from 1997 is useful to clarify the application of Specific Tax in the age of e-commerce. The reference to "delivery" or "giving a ticket to the passenger" in Prakas 341 is difficult to understand now that physical

tickets are rarely used. The same Prakas continues in par. 4 that:

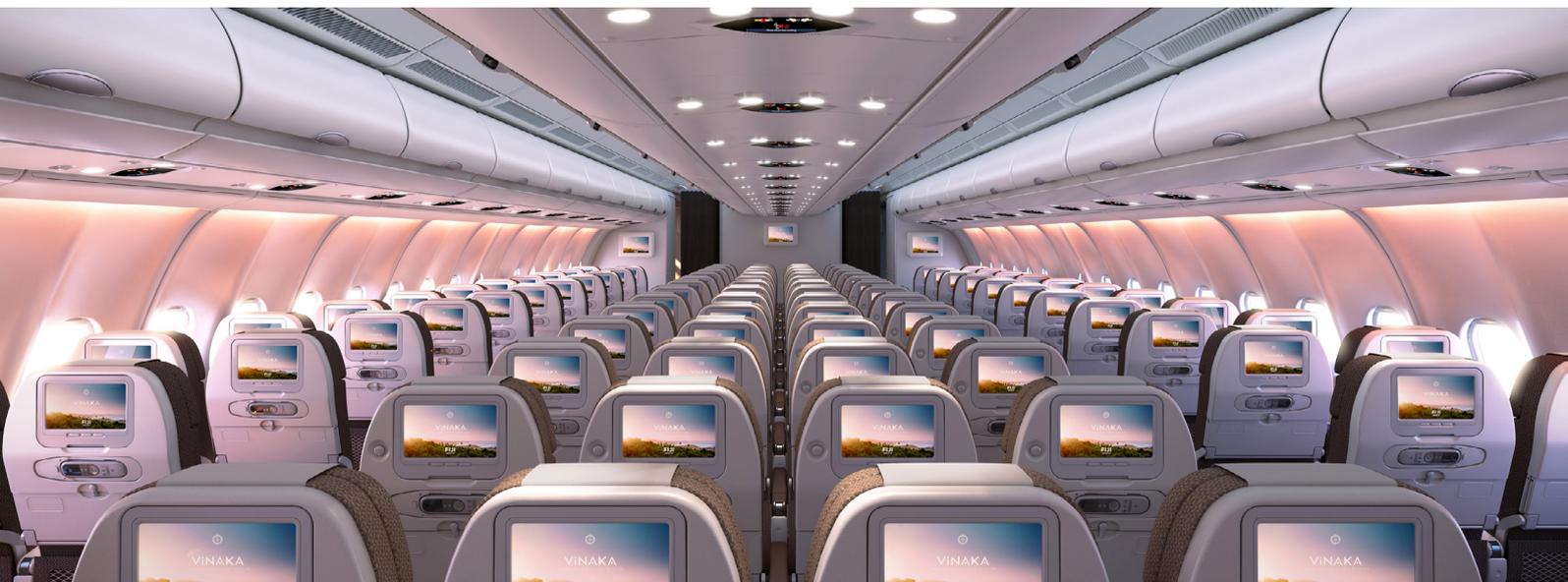
*"[T]he person liable to charge [Specific Tax] is the issuer of tickets if issued in Cambodia. For any air carrier which issues tickets abroad and sends them to Cambodia, it must carry our business through an authorized agent [ and] who is liable to pay this [tax]".*

Again, it is difficult to understand if a non-resident airline is "sending a ticket to Cambodia" by allowing, for example, a corporate customer in the same country as the airline to book a ticket online for its employee departing Cambodia. Furthermore, the definition of Prakas 341 referred to a taxable basis that has since gone through several reforms. It is a little counter-intuitive that the concept "domestic sale" which was introduced since the tax was created in 1997, actually according to the GDT regulation has very little to do with selling something in Cambodia.

### **HOW TO DETERMINE THE CAMBODIAN BRANCH PROFIT OF A NON-DTA AIRLINE?**

As with the revenue determination, Cambodia's tax laws and regulations itself have no explicit guidance for determining the net profit of the Cambodian branch or PE of a non-resident non-DTA airline. There are no specific rules for the airline industry on the recognition or allocation of expenses to such a branch, either with regard to local expenses or allocated global expenses. Taxpayers and GDT officials will have to make do with the general, all-purpose expense rules which were not written for the industry or even for cross-border situations.

From the internationally recognized formulas discussed above, it seems that the Calcutta formula is most readily in line with general Cambodian tax principles, as it involves determining a net profit for the branch based on the deduction of local and allocated expenses. These are all elements known to the tax determination of ordinary Cambodian subsidiaries and branches.



It is a bit more complicated, theoretically at least, for the Maritime and Massachusetts formulas, which would result in a branch declaring a net profit based on a percentage of its global profit, if any. Cambodian tax law prescribes that the Tax on Income charges "taxable income" which is, including for a branch, derived from business activities and is the excess over expenses made to acquiring a profit. The branch is required to apply Cambodian Accounting Standards as a starting point to derive taxable income. There is no basis in the LOT itself to replace the net profit calculation of a branch with a percentage of a global result. On the other hand, intercompany arrangements on allocating profit can have exactly the same effect, and these are commonly found and tested by the GDT on their arm's length character under Cambodia's transfer pricing regulations. The GDT has practically speaking the final say, as it can decide whether or not the accounting records of the taxpayer are "proper" in the sense of the LOT. Deciding the accounting records are not proper opens the way for the GDT to issue a reassessment. No reassessment can be issued if the GDT is of the view that the accounting records (based on the Maritime or Massachusetts formula) are proper and the correct amount of taxes has been paid.

The Cambodian GDT typically accepts the allocation of foreign shared services or general and administrative expenses by the head office or group companies to its Cambodian subsidiaries or branches. However, a common area of disputes is whether such shared services or costs trigger any Cambodian tax liabilities such as withholding taxes.

This problem is exasperated when it comes to expenses that can be specifically allocated to routes involving Cambodia such as interest, fuel hedging fees, expenses for the lease or use of aircraft, depreciation of aircraft, insurance, and the like. There is a question whether one or more of these payments might trigger withholding taxes in certain scenarios, and disclosing their details might open up the taxpayer to a whole new group of tax reassessments.

For example, lease payments of an aircraft. Let us take the example of a non-resident leasing company in a DTA or even a non-DTA country which leases an aircraft to a non-resident and non-DTA airline. This aircraft is sometimes or even always used on the route to and from Cambodia by the lessee/airline.





Is this lease income a Cambodia source income? I would argue it certainly is not. First of all, the lessor derives income from the country of the airline, not from Cambodia. The airline, not the branch is the lessee. Secondly, even if we would deem that the lessor derives (some) income from Cambodia, it does so without having a Cambodian PE. So, under art. 33 (10) LOT the lessor is not taxable in Cambodia, and the lease income is not Cambodia source income. In my view, the fact that the branch would have included the allocation of the lease costs in its financial statements does not change the tax analysis in the slightest. Compare it to the situation where the branch would record a service payment to an overseas transporter for bringing a computer used by the branch from Cambodia to an overseas destination. Clearly an international transport which is accepted by the GDT for many years as not a Cambodia source income and not subject to withholding tax, even though it is recorded as an expense by the branch. Incurring expenses does trigger taxability of an income which has a Cambodia source, but not the other way around. In other words, just by incurring an expense which is not a Cambodia source income, it does not become Cambodia sourced.

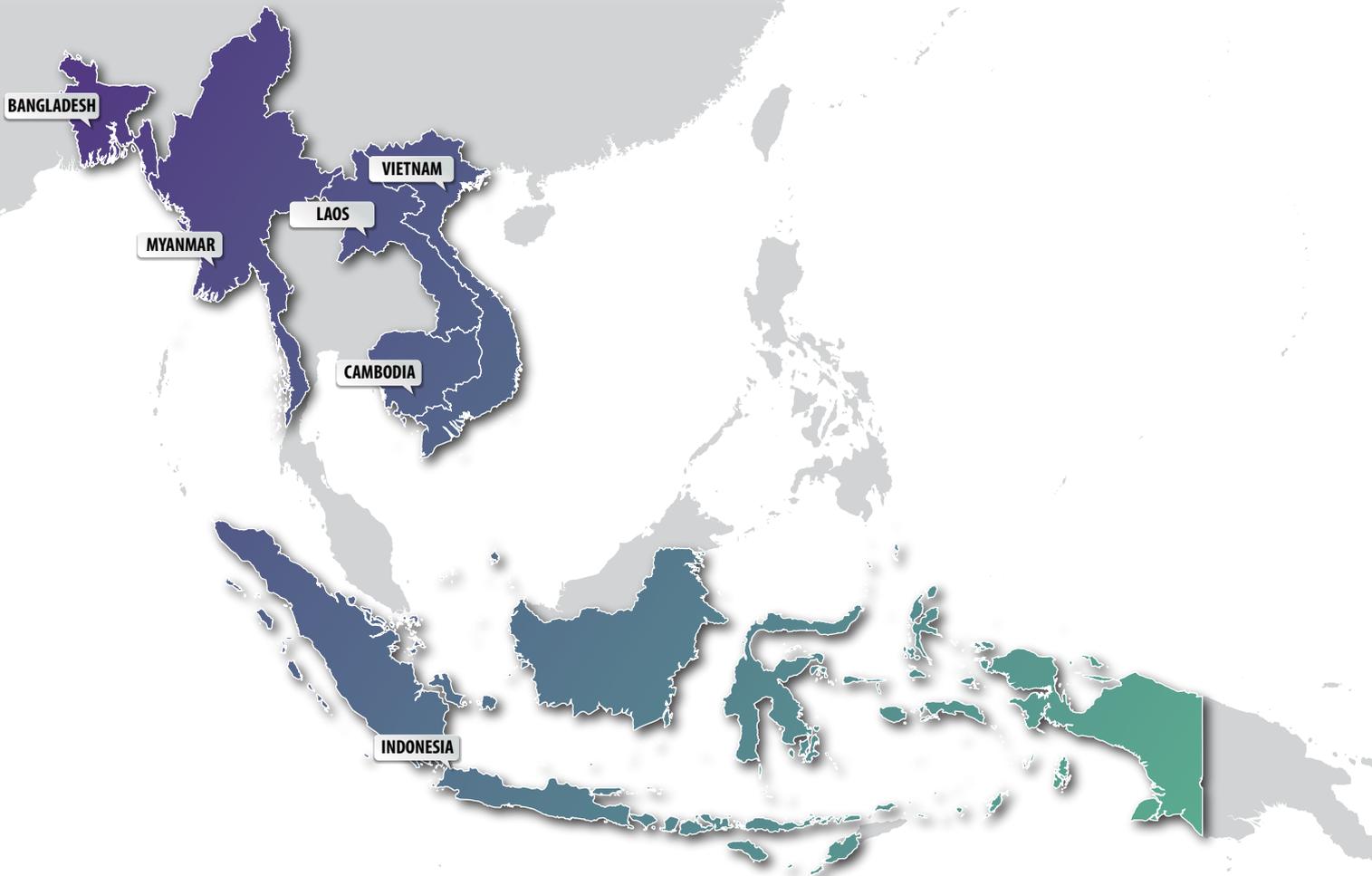
#### **CONCLUSIONS: SIGNIFICANT UNCERTAINTY**

A combination of factors have resulted in significant uncertainty for international airlines and their agents and partners when it comes to predicting the tax consequences of their Cambodian routes. One such factor is the rise of e-commerce, which allows passengers regardless of their location to purchase tickets wherever they like online, with unpredictable impact on the notion of “domestic sale of tickets” as a taxable trigger in Cambodian Specific Tax regulation.

Another such factor is the repeated enlargement of the Cambodian PE-concept, possibly casting a wider and deeper net while very few taxpayers in the industry are aware of the development.

At the core lies the lack of industry specific detailed regulation or guidance on the determination of direct and indirect tax imposts for airlines and aircraft lessors. Certainly in non-DTA situations but also when a DTA applies, industry actors need a predictable enforcement and calculation of their liabilities and exemptions. In that sense it is not useful to try and “re-invent the wheel”: all market participants, including the Government, have much to gain by choosing well established and familiar international concepts such as an incremental use of the source tax exemption for airlines, the Maritime or Calcutta formula, and the Uplift or Point of Sale method of determining income.

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