Taxation of Shipping Income under Tax Treaties – Development of Case Law in India

Dr Amar Mehta[*]

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About 90% of India's sea-bound cargo is handled by foreign carriers. Hence, shipping income provisions under various Indian tax treaties have gained significant importance in recent years and India is one of the few jurisdictions with a substantial number of court decisions on the subject matter. Article 8 of the OECD MC attributes the exclusive right to tax shipping profits to the state in which the effective management of the enterprise is situated. Article 8 of the UN MC leaves the matter open. Some important Indian tax treaties deviate from the OECD MC and permit India (as a source state) to tax to a certain extent a foreign shipping enterprise's income from operation of ships in international traffic. The most prominent decisions of the Indian Income Tax Appellate Tribunal (ITAT) dealing with interpretation shipping provisions in various Indian tax treaties are discussed in this article.

1. Introduction

India has 13 major ports and over a couple of hundred non-major ports. About 95% of India's foreign trade by volume, and about 70% by value, occurs through international shipping. Between April 2014 and February 2015, container handling activities in India grew by 7.15% on a year-on-year basis.[1]

As in so many other countries, the Indian tax law[2] provides for taxation of international shipping income of foreign enterprises.[3] However, the standing policy of most countries in the world is to exempt this income on a reciprocal basis under their tax treaties. There are even countries that provide for such exemption without a tax treaty on a factual reciprocal basis.[4] The OECD Model reflects this *communis opinio* in article 8 whereas in the UN Model it is one of the two options (*see* under section 2.).

About 90% of India's sea-bound cargo is handled by foreign carriers, and Indian exporters and importers paid freight of about USD 50 billion to foreign shipping companies during 2013 fiscal year.[5] Hence, it is no surprise that the shipping income provisions under various Indian tax treaties have gained significant importance in recent years. Also, as a consequence, India is one of the few jurisdictions with a substantial number of court decisions on the subject matter.

This article discusses Indian judicial developments with respect to the shipping income provisions in various Indian tax treaties.

2. Shipping Income Provisions in the Model Conventions and Important Indian Tax Treaties

Article 8 of the OECD MC attributes the exclusive right to tax shipping profits to the state in which the effective management of the enterprise is situated. Article 8 of the UN MC leaves the matter open. As a first option the UN MC follows the OECD MC in alternative A. However, in alternative B the UN MC provides for a shared right to tax in that the source country may tax foreign shipping income under certain conditions. These articles in the OECD and UN Models provide to the extent relevant for the purpose of this article as follows:

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* **Dr Amar Mehta has advised numerous multinational companies on international business transactions with India. Formerly, he was tax partner at Ernst & Young in India, international tax senior manager at Ernst & Young in Toronto (Canada) and research associate with IBFD. He can be contacted at amarmehta@indi-genius.com.**

1 *Source*: India Brand Equity Foundation.
2 The Income Tax Act, 1961.
3 A discussion on those provisions is beyond the scope of the present article.
4 E.g.: art. 19 Netherlands Corporate Income Tax Act.
5 *Indian cargo making foreign lines rich*, Business Line (27 Sept. 2013).

OECD MC 2014 **Article 8**	UN MC 2011 **Article 8**
“1. Profits 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.” … … “4. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.”	**Alternative A:** “1. Profits 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.” **Alternative B:** “2. Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by ___ per cent. (The percentage is to be established through bilateral negotiations.) … … 5. The provisions of paragraphs 1 and 2 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.”

As may be observed from the matrix at the end of this article, the shipping income provisions in the majority of the key Indian tax treaties are similar to the shipping article in the OECD MC. But, some important Indian tax treaties deviate from the OECD MC and permit India (as a source state) to tax to a certain extent a foreign shipping enterprise’s income from operation of ships in international traffic. Article 9(2) of the Income and Capital Tax Treaty between India and Denmark is one such example, which provides as follows:

> 1. Profits derived from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
>
> 2. Notwithstanding the provisions of paragraph 1, such profits may be taxed in the other Contracting State from which they are derived provided that the tax so charged shall not exceed:
>
> (a) during the first five fiscal years after the entry into force of this Convention, 50%, and
>
> (b) during the subsequent five fiscal years, 25%, of the tax otherwise imposed by the internal law of that State. Subsequently, only the provisions of paragraph 1 shall be applicable.

Shipping income articles in India’s tax treaties with France and Japan include similar provisions.

Article 9(2) of the Income Tax Treaty between India and Korea (Rep.) is another deviation from the OECD MC. It permits India to tax a Korean shipping enterprise’s income from operation of ships in India (in course of international traffic). That provision, however, stipulates that the Indian tax on such income shall not exceed 50% of the tax that may be otherwise imposed under the Indian tax law, i.e. the Income Tax Act 1961 (“the Act”).

Interestingly, the above-mentioned shipping articles deviate from article 8B(2) of the UN MC as well. Unlike the UN MC, the shipping articles in the above-mentioned Indian tax treaties permit the source state to tax (to a certain extent) a foreign enterprise's income from operation of ships in international traffic, regardless of whether such operation in the source state is of a "*more than casual"* nature.

3. Indian Case Law Concerning Shipping Profits Article in Tax

There are many decisions of the Indian Income Tax Appellate Tribunal (ITAT) dealing with interpretation shipping provisions in various Indian tax treaties. As we will see in this article, they cover an interesting variety of issues. The most prominent decisions are discussed in this article.

3.1. Income from international transportation of passengers or cargo

The shipping article applies to an enterprise's income from transportation of passengers or cargo by ships in international traffic. Often, shipping enterprises perform activities that may not strictly pertain to transportation per se. Then too, the shipping article should apply to the shipping company's income that is directly or indirectly connected with operation of ships in international transportation of passengers or cargo.

Many shipping companies provide vessels for offshore operations in oil and gas exploration/extraction projects. In *ACIT v. Interocean Shipping (I.) (P.) Ltd.*,[6] the ITAT concurred with the Indian tax authorities that the shipping article in the Income Tax Treaty between India and the United Kingdom did not apply in respect of a UK shipping company's income from provision of a vessel for construction of platforms for an oil and project in the Bombay High offshore area in India.[7]

In *Aktieselskabet Dampskibsselskabet Svendborg v. ADIT*,[8] a Danish shipping company had recovered "telecommunication costs" from its Indian group companies. The ITAT rejected the Indian tax authorities' view that the said receipts amounted to fees for technical services taxable in India. Those communication costs were incurred for facilitation of international transportation and, therefore, were directly connected with such operations. Accordingly, the ITAT concurred with the Danish company that the amounts recovered from the Indian group companies formed part of the shipping revenue.

3.2. Special v. general provisions

As per the maxim *generalia specialibus non derogant*, a special provision would normally exclude operation of a general provision. Therefore, in a situation where a general treaty provision (for instance, the business profits article) as well as a special provision (such as the shipping income article) may apply, the latter should prevail over the former.

In *Mathewsons Exports & Imports Pvt. Ltd. v. ACIT*,[9] the ITAT treated article 8 (Shipping) as a more specific provision compared to article 12 (Royalties and fees for technical services). In that case, an Indian company had hired a ship from a UAE shipping company (on time charter basis) for transporting goods to Maldives. The Indian tax authorities rejected the Indian company's claim that the consideration payable to the UAE shipping company was exempt from Indian taxation in view of the shipping article contained in the Income and Capital Tax Treaty between India and the United Arab Emirates. The Indian tax authorities interpreted the UAE shipping company's income as "royalty" taxable in India in accordance with article 12 of the treaty. The ITAT's conclusion – that article 8 of the tax treaty between India and the United Arab Emirates was a more specific provision (compared to article 12) – seems to be based on the fact that article 8(2) of the treaty specifically stipulated that "profits from operation of the ship in international traffic" included income from charter or rental of ships incidental to such transportation.

The ITAT acknowledged in *A.P. Moller, Maersk Agency India (P.) Ltd.* that article 9 (Shipping) of the Income and Capital Tax Treaty between India and Denmark was a special provision vis-à-vis article 7 (Business profits) of the tax treaty.[10] But, unfortunately, the ITAT carried that interpretation too far.

In the above-mentioned decision, a Danish shipping company had earned certain income, including "slot fees",[11] from India. The Indian tax authorities rejected the Danish company's claim that the income on account of slot fees was exempt

6 ITA No. 4782/Del/1993, dated 30 September 1994.
7 But, the ITAT (correctly) concluded that the UK company's income was in the nature of business profits that were exempt from Indian taxation because they were not attributable to a permanent establishment in India.
8 ITA Nos. 2080 to 2082/Mum/2009, dated 31 August 2012.
9 ITA No. 39/Coch/2014, dated 21 October 2014.
10 ITA No. 4372/Mum/1992, dated 27 January 2003.
11 A "slot" is space, on a vessel, that can hold a 20-foot container.

from Indian taxation in accordance with article 9 of the tax treaty between India and Denmark. The ITAT concurred with the Indian tax authorities. Thereafter, the ITAT opined that article 9 was the only tax treaty provision dealing with the treatment of a shipping enterprise's income. And, in the ITAT's view, article 7 (Business profits) of the tax treaty did not apply in the present case even if the income on account of slot fees was beyond the purview of article 9 of the tax treaty. As a result, the ITAT concluded that such income was taxable in India in accordance with the relevant provisions of the Indian Income Tax Act 1961. With due respect to the ITAT, its approach seems erroneous. It is submitted that if article 9 (Shipping) of the tax treaty between India and Denmark did not apply in respect of income on account of slot fees, then article 7 (Business profits) applied because the Danish shipping company had derived that income in course of its business.

3.3. Income through feeder vessels and slot charter and pooling arrangements

Shipping companies frequently charter "slots" on "feeder vessels" of other companies for transporting cargo from the point of origin to a "hub port" or from the hub port to the destination. In common parlance, a "slot" may be referred to as space (on a vessel) that can hold a 20-foot container. "Feeder vessels" collect cargo from various ports and bring the same to a hub port/central port (or transport the cargo in the opposite direction).

The ITAT's decision in *MISC Berhad v. Asst. Director of Income Tax* (ITA No. 6499/Mum.2012 dated 16 July 2014) dealt with an important question as to whether the shipping article in a tax treaty could apply to income earned through slot charter and feeder vessels. In that case, a Malaysian shipping company had transported cargo to/from India. The Malaysian shipping company claimed that its income from the said activity was exempt from Indian taxation in accordance with article 8(1) of the Income Tax Treaty between India and Malaysia.[12] The Indian tax authorities, however, rejected that claim on the grounds that although the Malaysian shipping company had used owned/leased vessels between an overseas place of origin/destination and a hub port, it had used feeder vessels on slot charter basis between the hub port and a port in India.

The Malaysian shipping company successfully argued before the ITAT that the voyages through the above-mentioned feeder vessels were inextricably linked to the voyages through the owned/leased vessels.

The ITAT acknowledged that the expression "operation of ships" had to be interpreted in a broader sense of *"carrying on of shipping activity"*. A shipping company may carry on such activities qua owner/lessee of a ship, or qua charterer of a ship. Further, the ITAT explained, the term "charterer" had to be understood as "a person who charters or hires a ship for voyage". That term was distinguishable from the concept of ownership, and even a portion of a space on a vessel for a journey could be regarded as "charter of ship". And, such a charter included a voyage charter or a slot charter.

Thereafter, the ITAT explained that the shipping article in the tax treaty between India and Malaysia applied if the following two conditions were satisfied:

(1) the transportation (between India and a hub port) of cargo through a feeder vessel was part of the main voyage between India and an overseas place of origin/destination; and

(2) there was a linkage between the journey through the feeder vessel and the journey through the vessel owned/leased by the Malaysian shipping company.

The above-mentioned two prerequisites were satisfied in the present case. Accordingly, the Malaysian shipping company's income was exempt from taxation in India in accordance with article 8(1) of the tax treaty between India and Malaysia.

In *APL Co. Pte. Ltd. v. DCIT* (ITA No. 1587/Mum/2008 dated 20 March 2013) the ITAT confirmed that a "slot charter" arrangement had to be construed as "charter" per se. As a result, the shipping article in a treaty applied to income from international transportation of cargo through slot charter.

The Bombay High Court has examined the concept of "'slot charter" in *DIT v. Balaji Shipping UK Ltd.*,[13] which was concerned with article 9 (Shipping) of the 1993 Income Tax Treaty between India and the United Kingdom. The High Court acknowledged that slot charter was a regular and well-established feature of the shipping industry. Therefore, article 9 of the tax treaty between India and the United Kingdom applied in respect of a UK shipping company's income through slot charter arrangements.

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12 That provision was similar to article 8(1) of the OECD MC.
13 Income Tax Appeal Nos. 3024 and 3215 of 2009, dated 6 August 2012.

The ITAT, however, subsequently distinguished its earlier decision – in *DDIT v. Balaji Shipping UK Ltd.* [14] (which was approved by the Bombay High Court in the above-mentioned decision) – in *ADIT v. Simatech Shipping Forwarding LLC.* [15] In that case, a UAE shipping company had derived certain income from India through "joint pool agreements" with other shipping companies. The UAE company claimed that article 8(4) of the Income and Capital Tax Treaty between India and the United Arab Emirates clearly provided that article 8(1) of the treaty applied in case of income from participation in a pool, a joint business, or and international operating agency. The Indian tax authorities rejected the UAE shipping company's claim that the said income was exempt from tax in India in view of article 8(1) of the India-UAE treaty. In first appeal, the Commissioner of Income Tax (Appeals) ("the CIT(A)") had upheld the UAE shipping company's claim. But, the CIT(A) had held in the UAE shipping company's favour on the basis of the ITAT's earlier decision in *DDIT v. Balaji Shipping UK Ltd.*, which was based on article 9(1) of the Income Tax Treaty between India and the United Kingdom. The relevant shipping provisions in India's tax treaties with the United Arab Emirates and the United Kingdom were differently worded. Therefore, the CIT(A) had committed an error by relying on the ITAT's earlier decision in *DDIT v. Balaji Shipping UK Ltd.*

The relevant provisions of India's tax treaties with the United Kingdom and the United Arab Emirates stipulated as follows:

Article 9(1) of India-UK Income Tax Treaty	**Article 8(1) of India-UAE Income and Capital Tax Treaty**
"Income of an enterprise of a Contracting State from the *operation of ships in international traffic* shall be taxable only in that state." [Emphasis supplied.]	"Profits derived by an enterprise of a contracting state *from the operation by that enterprise of ships* in international traffic shall be taxable only in that state." [Emphasis supplied.]

The ITAT considered it necessary to restore the matter to the tax authorities to examine as to whether the UAE shipping company's income derived through "'joint pool agreements" with other shipping companies satisfied the requirement for applicability of article 8(4) of the tax treaty between India and the United Arab Emirates. Thus, the ITAT did not reach any conclusion on the issue.

3.4. UN MC and "casual shipping"

As mentioned earlier, article 8B(2) of the UN MC permits the source state to tax income from operation of ships in international traffic, if such income is derived through "'more than casual" activities. Undoubtedly, regular or frequent visits of a shipping enterprise's ships to a contracting state should tantamount to more than casual operations. The UN Commentary on Alternative B of Article 8 of the UN MC 2011, however, clarifies that the said expression equally applies in case of irregular or isolated visits for picking up passengers or freight, if such visits are planned and not merely fortuitous.

Article 8A(2) of the Income and Capital Tax Treaty between India and the Netherlands contains a provision similar to Alternative B of article 8 of the UN MC. That provision was the subject matter of the ITAT's decision in *James Mackintosh & Co. (P.) Ltd. v. ACIT*.[16]

In the above-mentioned decision, a Netherlands company was engaged in the business of *tramp shipping*.[17] It owned three ships, hereafter referred to as Ship A, Ship B and Ship C. During the relevant tax year (1996/97), Ship A had visited Indian ports once, whereas the other two ships had visited the Indian ports six times. The Indian tax authorities rejected the Netherlands shipping company's claim that its shipping operations in India were of a casual nature.

The ITAT confirmed that article 8A(2) of the tax treaty between India and the Netherlands applied in respect of the Netherlands shipping company's income from visit of ships B and C to the Indian ports. The Netherlands shipping company could not persuade the ITAT that the term "casual" implied "resulting from or accruing by chance, occurring without regularity, occasionally, employed for irregular period".

Because article 8A of the tax treaty between India and the Netherlands was similar to article 8B of the UN MC, the ITAT found it appropriate to take into account the UN Commentary on the UN MC, as per which the expression "more than casual" meant scheduled or planned visits to a particular country, and such visits included "irregular and isolated visits" as long as they were planned and not merely fortuitous or not something that happened completely by chance. Accordingly, the Netherlands shipping company's activities through ships B and C could not be regarded as casual merely because

14 117 TTJ 865.
15 ITA No. 3819/Mum/2011, dated 17 July 2013.
16 ITA No. 4549/Mum/1999, dated 28 May 2004.
17 A ship engaged in *tramp shipping* does not have a fixed schedule or published ports of call.

those ships visited Indian ports at irregular intervals. Hence, the Netherlands shipping company's income through Ships B and C was taxable in India in accordance with article 8A(2) of the tax treaty between India and the Netherlands.

4. Concluding Remarks

This article discusses only the more prominent of the numerous Indian decisions dealing with issues concerning the shipping income articles under various tax treaties. It is evident that the Indian case law on the subject matter is well developed with impressive depth and breadth, and it is fairly complex.

Perhaps, India is the only jurisdiction with such an extensive case law concerning shipping articles in tax treaties. And, the case law on the subject matter is still growing at a rather fast pace.

Provisions for taxation of income from international shipping in key Indian tax treaties

India's Treaty with	Based on/Result similar to		Remarks
	OECD MC Article 8(1)	UN MC Article 8, Alternative B	
Australia (1991)	√	–	–
Belgium (1993)	√	–	–
Canada (1996)	√	–	–
China (People's Rep.) (1994)	√	–	–
Denmark (1989)	–	–	Note 1
Finland (2010)	√	–	–
France (1992)	–	–	Note 2
Germany (1995)	√	–	–
Italy (1993)	√	–	–
Japan (1989)	–	–	Note 3
Korea (Rep.) (1985)	–	–	Note 4
Malaysia (2012)	√	–	–
Mexico (2007)	√	–	–
Netherlands (1988)	–	√	Note 5
New Zealand (1986)	–	–	Note 6
Norway (2011)	√	–	–
Portugal (1998)	√	–	–
Russia (1997)	√	–	–
Singapore (1994)	√	–	–
South Africa (1996)	√	–	–
Spain (1993)	√	–	–
Sweden (1997)	√	–	–
United Arab Emirates (1992)	√	–	–
United Kingdom (1993)	√	–	–
United States (1989)	√	–	–

For the sake of simplicity, for the purpose of this matrix, it is presumed that the international shipping enterprise's effective management is situated in the country of residence. This matrix does not deal with income from transportation of cargo and passengers between two ports within the source state.

Note 1: Denmark (1989)

Article 9(1) and 9(2) of India's Income and Capital Tax Treaty with Denmark provide as follows:

> 1. Profits derived from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
>
> 2. Notwithstanding the provisions of paragraph 1, such profits may be taxed in the other Contracting State from which they are derived provided that the tax so charged shall not exceed:
>
> (a) during the first five fiscal years after the entry into force of this Convention, 50%, and
>
> (b) during the subsequent five fiscal years, 25%, of the tax otherwise imposed by the internal law of that State. Subsequently, only the provisions of paragraph 1 shall be applicable.

Note 2: France (1992)

Article 9(1) and 9(2) of India's Income and Capital Tax Treaty with France provide as follows:

> 1. Profits derived by an enterprise of a Contracting State from the operation of ships in international traffic shall be taxable only in that Contracting State.
>
> 2. Notwithstanding the provisions of paragraph 1, such profits may be taxed in the other Contracting State from which they are derived, provided the tax so charged shall not exceed:
>
> (a) during the first five fiscal years after the entry into force of this Convention, 50%, and
>
> (b) during the subsequent five fiscal years, 25%,
>
> of the tax otherwise imposed by the internal law of that Contracting State. Subsequently, only the provisions of paragraph 1 shall be applicable.

Note 3: Japan (1989)

Article 8(2) and 8(3) of India's Income Tax Treaty with Japan provide as follows:

> 2. Profits from the operation of ships in international traffic carried on by an enterprise of a Contracting State shall be taxable only in that Contracting State.
>
> 3. Notwithstanding the provisions of paragraph 2, such profits may be taxed in the other Contracting State from which they are derived during a period of first ten taxable years of "previous years", as the case may be, for which this Convention shall have effect provided that the tax so charged shall not exceed:
>
> (a) during the first five years, 50%;
>
> (b) during the remaining five years, 25% of the tax otherwise imposed by the taxation law of that other Contracting State.

Note 4: Korea (Rep.) (1985)

Article 9(1) and 9(2) of India's Income Tax Treaty with Korea (Rep.) provide as follows:

> 1. Profits derived by an enterprise of a Contracting State from the operation of ships in international traffic shall be taxable only in that State.

2. Notwithstanding the provisions of paragraph 1 of this Article, profits derived from the operation of ships in international traffic may be taxed in the Contracting State in which such operation is carried on; but the tax so charged shall not exceed 50% of the tax otherwise imposed by the internal law of that State.

Note 5: The Netherlands (1988)

Article 8A(1) and article 8A(2) of India's Income and Capital Tax Treaty with the Netherlands provide as follows:

1. Profits from the operation of ships in international traffic shall be taxable only in the State in which the place of effective management of the enterprise is situated.

2. However, if the operation of a ship in the other State is more than casual, such profits may also be taxed in that other State and according to the laws of that State, but only so much of them as is derived from that other State and provided that the profits are in respect of any one or more of the first ten fiscal years for which the Convention has effect.

For the purposes of this paragraph:

(a) profits derived from the other State mean profits from the carriage of passengers or freight embarked in that other State;

(b) the amount of such profits shall not exceed 5 per cent of the sums receivable in respect of such carriage;

(c) the rate of tax chargeable on such profits shall be 50 per cent of the rate of tax on that profits which would have been chargeable in the absence of this Convention.

Note 6: New Zealand (1986)

Article 8A(1) and 8A(2) of India's Income Tax Treaty with New Zealand provide as follows:

1. Profits of an enterprise of a Contracting State derived from the operation of ships in international traffic shall be taxed only in that Contracting State.

2. Notwithstanding the provisions of paragraph 1, such profits to the extent that they are derived from the other Contracting State may also be taxed in that Contracting State but the tax so imposed shall not exceed 50% of the tax which would have been chargeable on those profits in the absence of this Convention.