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Time charter and bare boat charter-cum-demise hire charges held as payment for ‘use of ship’ covered within meaning of ‘royalty’ – term ‘equipment’ includes ship

In brief

The Madras High Court (HC) recently delivered a combined judgment in the appeals of Poompuhar Shipping Corporation Ltd., West Asia Maritime Ltd. and of the Revenue¹ in which it held, after considering various decisions and commentaries, that payments made by the Indian charterer under a time charter agreement constituted ‘royalty’ within the meaning of Explanation 2 below section 9(1)(vi) of the Income-tax Act, 1961 (the Act). The HC also held that hire charges paid under a bare boat charter-cum-demise (BBCD) similarly amounted to royalty. The HC clarified that ship being ‘equipment’ with which the ship-owner operates the business and which the ship-owner commercially exploits, the income arising

from chartering of ship is assessable as royalty. Accordingly, it held that tax should have been withheld by the Indian companies under section 195 of the Act on such payments to foreign ship-owners.

Facts

In the appeals involving Poompuhar Shipping Corporation Ltd.

- The taxpayer, Poompuhar Shipping Corporation Ltd. (PSC), was a state-owned company engaged in the business of moving coal from various parts in India to Tamil Nadu for the Tamil Nadu Electricity Board, Chennai. For this purpose, PSC time-chartered in ships registered in various foreign countries by entering into agreements in standard time charter form.

¹ Poompuhar Shipping Corporation Ltd. v. ITO; West Asia Maritime Ltd. v. ITO; and Asst Director of Income-Tax v. Poompuhar Shipping Corporation [TS-528-HC-2013(Mad)]

- This decision covered cross-appeals by PSC and the Revenue arising from contradictory Income-tax Appellate Tribunal (Tribunal) orders for the years under appeal.
- In one set of appeals, the Tribunal had held that the charges paid by PSC under the time charter agreement were for use and hire of ship, which constituted royalty within the meaning of Explanation 2 below section 9(1)(vi) of the Act (royalty under the Act). Accordingly, it held that the taxpayer needed to withhold tax under section 195 of the Act. Consequently, the taxpayer was liable to be treated as a taxpayer-in-default and to suffer proceedings under section 201 of the Act for not withholding tax on the payments. Following the decision in *Transmission Corporation of AP Ltd.*², the Tribunal held that deduction of tax at source was only a method of tax collection and acted as a check on tax evasion. This order was appealed by the taxpayer before the HC.
- The tax officer (TO) had also observed that the foreign companies that had hired out the ships had not submitted their tax return or paid tax on the amount received on hire charges. Therefore, the TO also proceeded to assess the taxpayer in representative capacity under section 163 of the Act as agent of the foreign shipping companies. The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the TO's contentions. The Tribunal held in these proceedings that the transportation of coal from one port to another on hire basis did not partake the character of royalty and therefore did not attract section 9(1)(vi) of the Act. Though PSC could not be assessed as representative assessee, it was still liable to deduct tax under section 195 of the Act, and consequent to non-withholding of tax, proceedings under section 201 of the Act could be initiated. This case was remitted back to the TO, against which both the parties filed appeals before the HC.

In the case of West Asia Maritime Ltd.

- The second taxpayer, West Asia Maritime Ltd. (WAM), was a public limited company engaged in shipping business. During the relevant year, it made payments to M/s. Dolphin Maritime Co. Ltd. (DMCL), an associated enterprise in Cyprus, towards hire charges under a bare boat charter-cum-demise (BBCD) for use of its ship.

- The TO held that hire charges paid by WAM amounted to royalty for the use of equipment, i.e. the ship. WAM had the option to purchase the ship on making a balloon payment, which it did not exercise. Since these payments were in the nature of hire charges and not towards a purchase transaction, they amounted to royalty for use of equipment paid without withholding tax under section 195 of the Act.
- For the meaning of the term, equipment in Explanation 2(iva) to section 9(1)(vi) of the Act, the CIT(A) referred to the dictionary meaning and the commentary on Double Taxation Conventions by Klaus Vogel to reject WAM's appeal. The CIT(A) held that payments made to DMCL for hire charges would also be covered by Article 12 of the India-Cyprus tax treaty being royalty. This was confirmed by the Tribunal. WAM appealed to the HC against this order.

Issues before the HC

Issues raised in the appeals involving Poompuhar Shipping Corporation Ltd.

- Whether payment made for taking ship on time charter basis constituted royalty under the Act and tax treaties? Consequently, whether tax should have been withheld on such payment?
- Whether payments made by PSC to the foreign shipping companies for transporting goods between Indian ports would be covered as being paid for international traffic under the tax treaty?
- Whether a permanent establishment (PE) existed for the foreign shipping companies in India with whom PSC entered into a time charter agreement?
- Whether proceedings could be initiated simultaneously under sections 163 and 201 of the Act?

Issues raised in the case of West Asia Maritime Ltd.

- Whether a ship is equipment for the purpose of royalty?

² *Transmission Corporation of A. P. Ltd, and another v. CIT* [1999] 239 ITR 587 (SC)

- Whether payments made by WAM under the BBCD constituted capital expenditure based on the fact that BBCD was an approved method of acquiring ships?
- Whether the payments made constituted royalty under the Act and the India-Cyprus tax treaty? Consequently, whether tax should have been withheld on such payments?

Taxpayer's contentions

Contentions of Poompuhar Shipping Corporation Ltd.

- The ship could not be construed as equipment as defined in the Merchant Shipping Act. PSC cited Essar Shipping Ltd.³ to contend that since possession was not transferred to the hirer, payments under the time charter could not be treated as use or right to use the ship.
- Payments under time or voyage charter party or for liner services were payment for services and hence could not be construed as royalty. Time charter was not a contract for hire of ship, but for provision of standard services that the ship-owner provided through the ship, its crew and the master.

Contentions of West Asia Maritime Ltd.

- On reading the other clauses of Explanation 2 *ejusdem generis*, equipment referred to in clause (iva) of the Explanation must be read as having relevance to those special equipment relating to intellectual property rights that are of industrial, commercial and scientific nature. Hence, not every kind of transaction involving equipment for use or right to use is covered by clause (iva) of Explanation 2. Further, its case was covered under Article 8 of the India-Cyprus tax treaty and not under Article 12 thereof relating to royalty.
- The policies of the Ministry of Finance and Ministry of Surface Transport govern the purchase of a ship under BBCD. The agreement was a means for acquiring the ship and not for hiring the ship *simpliciter*.

³ State of Tamil Nadu v. Essar Shipping Ltd. [2012] 47 VST 209 (Mad)

Contentions of the Revenue

In the case of Poompuhar Shipping Corporation Ltd.

- Based on the decision in Gosalia Shipping Pvt. Ltd.⁴ it was contended that the payments made to the foreign shipping companies in respect of ships which were put to use between ports along the Indian coast (ie, not 'international traffic') were assessable as royalty under the Act. Accordingly, hire charges were liable to tax under section 115A read with section 44D of the Act or at the rates specified by the tax treaty⁵, whichever was beneficial.
- Referring to the authoritative commentary on Double Taxation Conventions by Klaus Vogel, the Revenue contended that payments for right to use of industrial, commercial and scientific equipment had to be treated as royalty. Therefore, there was no difference between the treaty treatment and the treatment under the Act.
- The Revenue also relied on judgments under the Tamil Nadu General Sales Tax Act and Service Tax under the Finance Act, 1996 to contend that transfer of right to use and supply of tangible goods for use without transferring the right of possession and effective control respectively could be treated as royalty.
- The taxpayer was a representative assessee under section 163(1)(c) of the Act as it was in receipt of income from non-residents. If such income was not covered by section 9(1)(vi), applicability of section 9(1)(i) became relevant. When the relationship was not occasional but continuous, evidenced by the time charter agreement that showed regularity and intimate connection resulting in profit in India, such a relationship clearly indicated business connection in India.
- Two berths leased exclusively for the ships chartered by the taxpayer at the port tantamounts to a PE for the foreign shipping company. For a PE to exist,

⁴ Union of India v. Gosalia Shipping Pvt. Ltd. [1978] 113 ITR 307 (SC)

⁵ This judgment has referred to various Double Taxation Avoidance Agreements (tax treaties) to interpret the terms, royalty, international traffic, business profits, permanent establishment, and profits from the operations of ships and aircraft. In the judgment, the aforementioned terms have been reproduced from, and discussed under, the India-Australia tax treaty.

the place of business need not be at a fixed geographical location. The only requirement was that there must be a close connection between the business needs and geographical points.

In the case of West Asia Maritime Ltd.

- Contentions similar to the ones in PSC were made. In addition, it was contended that WAM's claim of hire charges as capital expenditure was clearly an afterthought, while the accounting treatment given clearly showed its treatment as revenue expenditure.

High Court's Ruling

Whether ship is an equipment?

- The term equipment has not been defined under the Act or in the tax treaties. However, 'plant' has been defined under the Act to embrace within its fold ships along with 'vehicles, books, scientific apparatus and surgical equipment used for the purposes of the business of profession'. Thus, a ship is equipment forming part of a ship-owner's business.
- Equipment construed in the light of section 9(1)(vi) of the Act extends the normal meaning of the word to cover even machinery or plant that would not be construed as equipment within its plain and ordinary meaning. As rightly pointed out by the Revenue, the only limitation that one could read into the word equipment would be that which is specifically excluded.
- Further, the presence of the word 'any' preceding the word 'equipment' in Section 9(1)(vi)(b) of the Act clearly points out the need for construing equipment widely to embrace every article employed by the employer for the purposes of his business. Therefore, ship is to be treated as a plant – equipment with which the ship-owner operated its business and commercially exploited it for earning income from ship chartering.

Whether payment under time charter amounted to royalty?

- Under the Act and the tax treaties, royalty means consideration that is paid for use or right to use. In *Rashtriya Ispat Nigam Ltd.*⁶, the Supreme Court had held that by giving possession to the lessee who has control and custody of the vessel, the condition of use or right to use was satisfied. So long as the lessee had access to the vessel for its economic advantage, the expression, 'use or right to use' could not be read restrictively to hold that the consideration paid for the same would not be royalty.
- Thus, when the use or right to use the ship for an economic benefit was provided, the consideration for use of industrial, commercial and scientific equipment was royalty under the Act. Payments under the time charter being for use of the ship, were therefore covered within the meaning of royalty under the Act.

Whether hire charges under BBCD amounted to royalty?

- Under the BBCD, until the ship's sale, it was a bare boat charter which as per section 115V(a) of the Act, means hiring of ship for a stipulated period on terms which give the charterer possession and control of the ship, including the right to appoint the master and crew. The consideration paid periodically by the taxpayer was in the nature of hire charges for use of the vessel as per the agreement, and not sale consideration as contended by the taxpayer. The taxpayer had also treated the hire charges as revenue expenditure in its tax return. Therefore, as possession and custody was with the hirer, the payment was liable to be treated as royalty.

Whether test of international traffic is met?

- As per Article 8 of the India-Cyprus tax treaty, only payments to foreign shipping companies that operated in international traffic were taxable in the country in which foreign shipping companies had a 'place of effective management'. In this case, the ships operated only along the coastline of India. Hence the test of international traffic was not met. Therefore, Article 8 could not be invoked to determine withholding tax on payments to foreign shipping companies.

⁶ *Rashtriya Ispat Nigam Ltd. v. Commercial Tax Officer* [1990] 77 STC 182 (SC)

Whether the foreign shipping companies had a Permanent Establishment in India?

- The ship had a place of business at the place where the ship was docked. Since the ship moved from one point to another due to the nature of business contract, and the movement was integrated having business and geographical coherence, one could infer that the foreign enterprise had a PE in India.
- However, the payment was made for hire charges, which were not attributable to the PE but to the use of the ship. The payment was therefore taxable as royalty and not as business profits.

Simultaneous proceedings initiated for sections 163 and 201 of the Act

- An agent was a person who had a business connection with a non-resident in India, or where the non-resident earned income directly or indirectly through or from him. Only under such circumstances could an agent be used to recover taxes payable by the non-resident. When the payer failed to withhold tax or,

after withholding tax, failed to deposit the same, the payer would be treated as a payer-in-default.

- PSC's being an agent had no correlation with its status as payer-in-default. Section 195 of the Act casts a responsibility on a person to withhold tax, while section 163 of the Act was for the purpose of assessment only. As both proceedings operated in different spheres, they could be initiated simultaneously.

Conclusion

- In this ruling, the HC has taken the view that ship was equipment hired by the taxpayers, who had control and custody of the same, and from which it derived economic benefits for its business. The HC further held that even a time charter of a ship was royalty, which is not in line with the globally accepted industry practice. By holding so, in effect, the HC has held that there is no difference between a time charter and a bare boat charter of a ship for the purpose of taxability in India.

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