Madras High Court provides clarity on taxation of bareboat charter hire charges

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In brief

In a recent decision, the Madras High Court (HC) held that the amount received by the foreign company for use of dredger (bareboat hire charges) was governed by the provisions of Double Taxation Avoidance Agreement (tax treaty) between India and Netherlands and, according to the amended tax treaty, the income earned from hiring of dredging equipment was not taxable in India.

In this ruling, the HC has distinguished its earlier judgment delivered in case of Poompuhar Shipping *[Poompuhar Shipping Corporation Limited & Anr. v. ITO [2014] 360 ITR 257 (Madras)* wherein payment made for taking ship on time charter basis was held to be royalty, and was consequently taxable in India] based on the facts and on the provisions of Article 12 of the tax treaties under consideration in the respective judgments.

Further, the HC also held that mere presence of equipment in India on a bareboat basis, i.e. without Master and Crew, would not constitute a permanent establishment (PE) of the foreign company in India.

In detail

Facts

- Van Oord ACZ Equipment BV (the taxpayer)[1], incorporated in Netherlands, had let out dredging equipment to an Indian company, Van Oord ACZ India Private Limited. The equipment was let out on a bareboat charter basis, i.e., without the Master or the Crew.
- The Indian company had withheld taxes on the payments made to the taxpayer for use of equipment. In its return of income, the taxpayer took the stand that the income earned from chartering the dredging equipment was not taxable in India, and accordingly claimed refund of the entire amount of taxes withheld by the Indian company.
- The taxpayer was taxed on the income in the Netherlands.
- The assessing officer, in his order, treated the income as royalty under section 9(1)(vi) of the Income-tax Act, 1961 (the Act), being consideration for use of industrial, commercial or scientific equipment.
- The Commissioner of Income-tax (Appeals) [CIT(A)] ruled in favor of the taxpayer by noting that the income had been offered to tax in Netherlands and holding that, in the light of modified provisions of Article 12 of the tax treaty with Netherlands, the sum was not taxable in India.
- The Income-tax Appellate Tribunal (Tribunal) confirmed the CIT(A)'s order, and further held that the taxpayer did not have a PE in India, and thus could not be taxed in India.
- Aggrieved by the Tribunal's order, the Revenue filed an appeal before the Madras HC.

Issue before the High Court

Whether the Tribunal was right in holding that the income received by the taxpayer for hiring out dredgers for use in India was not taxable in India in terms

[1] CIT *v.* Van Oord ACZ Equipment BV [TS-695-HC-2014(Madras)]

of the tax treaty with Netherlands?

Revenue's contentions

- The primary contention of the Revenue was that the consideration received for use of or right to use equipment was in the nature of royalty[2], covered under section 9(1)(vi) of the Act.
- The other contention was that Article 12(1) of the tax treaty with Netherlands allowed royalty to be taxed in both the contracting states, and thereby, the Revenue could not be precluded from imposing tax on the same in India.
- Furthermore, it was contended that consideration from chartering of ship should be business income taxable as per Article 7 of the tax treaty read with Article 5, as the presence of equipment in India would constitute a PE under Article 5(2)(i) of the tax treaty[3].

Taxpayer's contentions

- The taxpayer was governed by the provisions of the tax treaty and, according to the amended tax treaty with the Netherlands, the income earned from hiring of dredging equipment was not taxable in India.
- The provisions of the tax treaty would prevail over the provisions of the Act, and therefore, Explanation 2 to clause (iva) of section 9(1)(vi) of the Act was not applicable to the taxpayer's case. Thus, there was no tax liability on the taxpayer.
- The judgment of the HC in the case of Poompuhar Shipping[2] was distinguishable on facts from the taxpayer's case, and hence not applicable.
- The taxpayer did not have a PE in India, and thus was not liable to tax in India[4].

HC's ruling:

The HC, while affirming the Tribunal's decision, held that the taxpayer was not liable to tax in India in respect of income earned from hiring of dredger on bareboat charter basis on the following grounds:

- The definition of the term, 'royalty' under Article 12 of the tax treaty with the Netherlands originally included "payments for the use of equipment", and subsequently, the same was deleted (with effect from April 1, 1998). Thus, the payment for use of equipment could no longer be taxed in India as per the modified tax treaty.
- As per section 90 of the Act, the provisions of the tax treaty would prevail over the Act. Section 9(1) of the Act had no applicability in the present case as the provisions of the tax treaty were more favourable to the taxpayer[5].
- The tax treaties referred to in the judgment of Poompuhar Shipping[2] included 'payments for equipment' in some form or the other. The tax treaty under consideration in the present case had specifically excluded them by an amendment with effect from April 1, 1998. Also, in the present case, as distinguished from Poompuhar Shipping[2], the equipment had been leased out on bareboat charter basis, while in the latter, it was hiring of ship on time-charter basis. Thus, the Poompuhar Shipping's case was distinguishable, and the ratio of that case was not applicable.
- In the present case, since the hiring out was on a bareboat charter basis, no PE could be claimed to have been established, as the entire control of the equipment was not with the taxpayer, a foreign company, but with the Indian Company.

The takeaway

- The Madras HC has rightfully distinguished its prior ruling in the case of Poompuhar Shipping[2], now admitted under an SLP before the Supreme Court.
- The ratio laid down by the HC under this judgment will also be useful for interpretation under tax treaties with other countries (like Belgium, France, Israel, Kazakhstan, Netherlands, Spain, Greece, and Sweden) where the definition of 'royalty' does not cover payments for use of industrial, commercial or scientific equipment. It would be imperative for taxpayers to maintain robust documentation to demonstrate the beneficial ownership of the income and the substance of the transaction, to claim benefits under Article 12 of the respective tax treaties.
- Further, the HC's observation that mere presence of an equipment in India, without the exercise of actual control over it, would not constitute a PE of the foreign company, will serve as a useful precedent for all foreign companies undertaking similar cross-border leasing transactions.

[2] Reliance was placed on Madras HC ruling in the case of Poompuhar Shipping Corporation Ltd. & Anr. *v.* ITO [2014] 360 ITR 257 (Madras).
[3] Article 5(2)(i) states that an installation or structure used for exploration of natural resources is a permanent establishment, provided the activities continue for more than 183 days.
[4] Reliance was placed on ABN Amro Bank, N.V. *v.* CIT [2012] 343 ITR 81 and CIT *v.* BKI/HAM v.o.f. [2012] 347 ITR 570.
[5] Reliance was placed on Apex Court ruling in UOI & Anr. *v.* Azadi Bachao Andolan [2003] 263 ITR 706 (SC)

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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