Centre for Tax Laws (CTL)
Directorate of Distance Education
NALSAR University of Law, Hyderabad
In collaboration with
TAXMANN

Course Material

M.A. (INTERNATIONAL TAXATION)

1.2.6. BUSINESS PROFITS AND ASSOCIATED ENTERPRISES

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1. Introduction

Tax treaties are based on Model Conventions like OECD/UN/US Model Conventions and are exhaustive in nature. They are composed of 32 Articles, of which Article 7 and Article 9 extensively cover treatment of Business Profits and Associated Enterprise respectively.

2. Meaning & Scope of Business Profits

In common parlance, 'Profit' is the outcome of carrying on trade viz. aggregate receipts minus aggregate expenses. Further, the term 'Business' has been interpreted by various courts of law in order to establish as to what activity will qualify as business. It shall also tend to include an organized activity carried on by a professional.

The term 'Business Profit' in the context of treaty law shall be interpreted in the same way as in the Income Tax Act, 1961. However, Article 7 on Business Profits shall not include services rendered by a professional in his/her individual capacity. For instance, a teacher providing services to individual students by way of conducting tuition classes shall not be covered under this article; however, if the teacher brings another teacher and run a coaching class, then the same shall be classified as a business activity and shall be covered under the said Article.

2.1. Article 7 on Business Profits of the UN Model Convention

Article 7 on Business Profits of the UN Model Convention reads as under:

Paragraph 1: *"The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment."*

Brief: According to Paragraph 1, the profits can be taxed in the country of residence only unless it operates through a Permanent Establishment (hereinafter called as PE) in the other state. The State wherein the business is conducted can only tax the profits if the said business is carried on through a PE. The profits that are attributable to such PE are only subject to tax. Hence, there are two basic parameters for taxability of foreign enterprise which need to be fulfilled; first, whether the enterprise has a PE in the source state and if yes, what are the profits attributable to such PE.

Paragraph 2: "*Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent* *establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."*

Brief: According to Paragraph 2, a PE should be considered as a separate and independent unit for its transactions with the companies in its State and also with its foreign parent company. This shall also have transfer pricing implications since accordingly the markup or cost of transfer of goods to the parent shall be at the same price, as it would be to any other entity.

Paragraph 3: "*In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices."*

Brief: This paragraph limits the deductions that are allowed to a PE while computing its income. All the expenses that are incurred by the PE in that State or in another State, which are in relation to its business, shall be allowed as deduction. However, any kind of payments made to head office or any other group company shall not be allowed as deduction except for reimbursement of actual expenses. In case of banking companies, interest paid on moneys borrowed from head office or other group companies shall be allowed as deduction. Such restrictions are in place in order to ensure that the profits of the PE are not suppressed. Generally, profits of a PE is computed basis the domestic tax laws however, UN model convention specifically lays down the manner in which the profits that are attributable to a PE are computed.

Paragraph 4: "*In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.*"

Brief: This paragraph allows the source State to determine the profits of the enterprise by allocating its total profit to its various parts of the same is customary for the State to determine profits in such manner.

Paragraph 5: "*For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.*"

Brief: This paragraph determines that a consistent method shall be used from year to year in order to compute the profits of the PE.

Paragraph 6: "*Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.*"

Brief: According to Paragraph 6, a special article shall override a general article and hence, items of income such as royalties, interest, dividends, which are dealt with independently by other Articles shall not be affected by this Article.

2.2. Comparison with OECD Model and US Model Convention

OECD Model Convention	US Model Convention
Paragraph 1 and 2 are similar when both are read conjointly.	Paragraph 1 and 2 are similar when both are read conjointly.
Paragraph 3, 4, and 5 are absent.	Paragraph 3, 4, and 5 are absent.
Paragraph 6 is similar.	Paragraph 6 is similar.
	Additional Paragraph: In applying this Article, paragraph 8 of Article 10 (Dividends), paragraph 5 of Article 11 (Interest), paragraph 5 of Article 12 (Royalties), paragraph 3 of Article 13 (Gains) and paragraph 3 of Article 21 (Other Income), any income, profit or gain attributable to a permanent establishment during its existence is taxable in the Contracting State where such permanent

	establishment is situated even if the payments are deferred until such permanent establishment has ceased to exist.

3. <u>Business Profits and PE</u>

As has been discussed above, the important element of this Article is PE. The crux of Article 7 is that the profits of an enterprise of a Contracting State are not taxable in any other Contracting State unless the enterprise carries on a business in that other state through a PE. Hence, this article has to be read conjointly with Article 5 since a PE is defined in Article 5 and business profits are taxable only if the PE exists in the State and only to that extent. This rule is generally called as "Attribution Rule". Its main purpose is to limit the taxable income to what is derived from that State. Both UN and OECD Model Convention follows this rule however, UN Model extends its scope by what is called as the "Force of Attraction Rule", discussed further.

There must be a business connection or PE that gives rise to income for the non-resident in the source State. This has also been observed in the case of ***Ishikawajma-Harima Heavy Industries Ltd. V. DIT (2007) (158 Taxman 259) (SC)*** as:

"Whereas business connection is relevant for the purpose of application of section 9 under the Act, the concept of PE is relevant for assessing the income of non-resident under DTAA".

If the source of income is that from any activity or any asset of a PE, then the said income shall be taxable as business profit. However, incomes such as royalty, dividend, etc. if not connected with the activity or asset of PE, the same shall be taxed under different articles. Generally, it is easy to identify whether incomes such as royalty, dividends, etc. is attributable to a PE or not, however, this becomes difficult in cases such as income generated from composite contracts. For instance, income generated from supply and erection of a machine where incomes have to be split up as business income or fees for technical services.

3.1. Attribution Rule

The basic requirement to tax a business income is that it must be attributable to the PE. Basically, the tax treaties and model conventions do not prescribe as to what are the profits that can be termed as the profits attributable to the PE. In such cases, it is important to observe the following extract from Klaus Vogel on Double Tax Conventions which was quoted by the Supreme Court in the case of Ishikawajma-Harima Heavy Industries Ltd.:

In contrast, the second sentence of Article 7(1) MC allows the State of the permanent establishment to tax only those profits which are economically attributable to the permanent establishment, i.e. those which result from the permanent establishment's *activities, which arise economically from the business carried on by the permanent establishment.*

As regards the profits made by the enterprise in the State of the permanent establishment, a distinction must always be made between those profits which result from the permanent establishment's activities and those made, without any inter- position of the permanent establishment, by the head office or any other part of the enterprise.

It is only when there is a connection with the permanent establishment that the State of the permanent establishment is entitled to impose tax.

As given above, profits that are to be treated as profits attributable to PE, must arise economically from the business carried out by the PE and must have a proximate and direct connection with the PE.

The SC in above case has further elaborated on the territorial nexus doctrine by stating that the income arising as a result of operations carried out in more than one jurisdiction would have territorial nexus with each of the jurisdiction on actual basis. In such cases, it is not correct to say that the entire income arises in each of the jurisdictions however, following observations have been made by the SC which stands different:

In case, where different severable parts of the composite contract are performed in different places, the principle of apportionment can be applied, to determine which fiscal jurisdiction can tax that particular part of the transaction. This principle helps determine, where the territorial jurisdiction of a particular state lies, to determine its capacity to tax an event. Applying it to composite transactions which have some operations in one territory and some in others, is essential to determine the taxability of various operations.

Further, attribution of profits in case of composite contracts and turnkey projects was dealt in case of ***CIT vs Hyundai Heavy Industries Co. Ltd. (2007) (161 Taxman) (SC)***. In the given case, a Korean based taxpayer supplied its goods to an Indian based taxpayer along with its installation and commissioning services in India under a different contract. The tax authorities in this case sought to tax the profits earned by the Korean company on its supplies which was later rejected by SC ruling that the profits earned by the company on its supplies cannot be attributed to the installation and commissioning services as the same came into existence only after the completion of the sale transaction of supplies.

3.2. Force of Attraction Rule

The 'Force of Attraction Rule' is an extension of the attribution rule and it means all the incomes arising from all the sources in a country where the foreign enterprise maintains a PE is subject to tax in that country irrespective of the fact that the income so accrued is attributable to PE or not. Hence, profits arising from transactions outside PE are also subject to tax. Therefore, if a foreign enterprise has a PE in a particular State, the State should get the right to tax all the income arising therein to the PE whether the same has any connection with the business activity or not.

Mostly, all the DTAAs entered into by India with other countries provide for taxation of business profits only attributable to the PE however, there are eight DTAAs entered into by India with countries such as UK, Japan, Singapore, China, Uzbekistan, Ukraine, Oman and Vietnam, which provides that the profits attributable to the PE have to direct as well as indirect and hence contains the force of attraction rule.

The term ‘indirectly attributable to the PE’ as used in Article 7 of India-UK DTAA was dealt by the Mumbai Bench of the Tribunal in the case of Linklaters LLP. In the said case, the Tribunal observed that the principle underlying the force of attraction rule is that when a PE is set up by an enterprise in another country, the enterprise brings itself under the fiscal jurisdiction of that other country in a manner that such other country can properly tax all the profits earned from the country, whether the transactions are routed and performed through the PE or not. The Tribunal later concluded that the term ‘profits indirectly attributable to PE’ incorporate the force of attraction rule in the India-UK DTAA. Hence, it was held that the entire profits relating to services rendered by the taxpayer whether in India or outside India, in respect to Indian projects are subject to tax in India.

Along with the above conclusion of the Tribunal, it is also important to consider the provisions of clause (3) of the Article 7 of the India-UK DTAA which clarifies that where a PE takes active part in negotiating, concluding or fulfilling contracts entered into by the enterprise, then, notwithstanding that other parts of the enterprise have also participated in those transactions, the portion of profits of the enterprise arising out of those contracts which the contribution of the PE to those transactions bears to that of the enterprise as a whole, shall be treated as profits indirectly attributable to PE.

Moreover, it must be noted that the similar phrase of ‘profits indirectly attributable to PE’ used in India-Japan treaty was considered in the case of Ishikhwajima Harima Heavy Industries Ltd. where the SC observed that the PE must be involved in the activity that gives rise to the profits that are directly or indirectly attributable to the PE.

The developed countries would usually be in favour of adoption the said rule of ‘force of attraction’ however, the developing countries would generally not favour the adoption. Most countries would like to limit the application of the said rule to business profits covered by Article 7 and not extend it to incomes such as royalties, interest, etc. that are covered by separate Articles. Moreover, the countries would not want to extend the rule to the profits that arise from activities carried through an independent agent. A compromise, between the countries on acceptance of such rules while framing DTAA, is generally reached by providing that only similar activities or sale of similar goods even if not carried out through the PE shall be taxable.

Business profits do not include royalty, interest, etc. unless they are attributable to the PE. Moreover, this also affects the tax planning and it also leads to uncertainty regarding obligation and liability to tax in the other State of the foreign enterprise. Thus, while negotiating DTAA, a compromise is reached as to what can be considered attributable to PE in order to restrict taxability to income, other than business income, to the extent such other income can be attributed to PE.

4. Arm's Length Principle

PE is considered as a standalone entity since Paragraph 2 of the Article 7 provides that the profits that are attributable to the PE would be the profit that it would have made even if did not have any connection with the Head Office.

Since, the PE is considered as a standalone entity, the profits are computed at an arm's length as if it were an independent entity. By doing this, the authorities try to arrive at a market price and prevent the foreign companies from artificially suppressing its profit by charging a higher mark-up on transfer of goods or a higher amount of royalty than the normal practice.

The said principle is required in order to bring the non-resident taxpayers at par with the resident taxpayers.

In case of Linklaters LLP (supra), it was held that for the purpose of computing income of the PE in respect of services rendered to the Indian Clients, the value of services is not to be considered at the market value of such services in India but the price at which the UK firm has billed the Indian Clients. As can be observed in the said case, the independence of the PE as a standalone entity under Article 7 (2) of the DTAA does not go beyond the transactions with entities other than general enterprise and the PEs belonging to the same general enterprise.

5. Meaning and Scope of Associated Enterprises

In order to prevent misuse of treaty provisions by conducting business in the State not directly but through a chain of enterprises, the concept of Associated Enterprise (hereinafter called as AE) was introduced. The Article provides that in cases where an enterprise controls another enterprise directly or indirectly through capital or management of that enterprise and the transactions between such enterprises are not at market rates, then the profit which would have accrued at arm's length to the enterprise supplying such goods or services shall be deemed to be the income of that enterprise. The motive behind this Article is to ensure that profits are computed on an arm's length basis and are not enhanced or suppressed artificially in order to enhance relief and reduce liability. The Article also allows the authorities to compute fair profit on a transaction between two AEs, only where there is a reason to believe that the profits have been tampered with.

Whether the enterprises are associated with each other would be considered basis the connection between the enterprises and the commonality of the capital and management of the enterprises. If the enterprises are acting in their independent capacity and do not influence each other, they cannot be considered as an AE, however, the commonality of management may lend a presumption that there is a scope to misrepresent the facts and, in such cases, the enterprise has to prove otherwise.

5.1. Article 9 of the UN Model for AE

Article 9 of the UN Model comprises provisions related to Associated Enterprises and it reads as under:

Paragraph 1: *"Where: (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."*

Paragraph 2: *"Where a Contracting State includes in the profits of an enterprise of that State— and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other."*

Paragraph 3: *"The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default."*

5.2. Comparison with OECD Model and US Model Convention:

OECD Model Convention	US Model Convention
Paragraph 1 is similar	Paragraph 1 is similar
Paragraph 2 is similar	Paragraph 2 is similar
Paragraph 3 is absent	Paragraph 3 is absent

6. Applicability of Article 9 Basis Domestic Laws

The principle of avoidance or reduction of tax liability by the help of AE must be avoided and the same principle is also recognised in the transfer pricing provisions introduced in the Act by the Finance Act, 2001 and covered in sections 92-92F. The main crux of the provisions is the arm's length principle that requires charging arm's length price for all international transactions between AEs which shall be supported by appropriate documentation.

The term "international transaction" is defined under section 92B which means a transaction, between two or more AEs where either or both of whom are non-residents. The transaction can be in nature of sale, purchase or lease of tangible or intangible property, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises and shall include a mutual agreement between two or more AEs for allocation of or any contribution to any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

Whereas the term "transaction" is defined under section 92F(5) to include an arrangement, understanding or action in concert-

a) whether or not such arrangement, understanding or action is formal or in writing; or
b) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding.

The Finance Act, 2015 has also amended the concept of "deemed international transaction" where a transaction between two independent local entities may also be considered as an international transaction, subject to fulfilment of certain conditions and hence would be subject to transfer pricing regulations in India. The Finance Act, 2012 introduced the concept of Advance Pricing Agreement (APA) which is an agreement between the CBDT and the taxpayer that determines, in advance, the arm's length price or that specifies the manner of determination of the arm's length price in relation to an international transaction.

The term Associated Enterprise has been defined in section 92A(1) of the Act and emphasis has been laid on the inter-dependence of the enterprises. Such dependence may be for supply of raw materials or provision of services or marketing dependence. Any transaction between such enterprises to be at an "arm's length price".

Test Your Knowledge

QUESTIONS	
1.	Explain the term ‘Business Profit’.
2.	When are the profits considered to be attributable to the PE? How is such attribution dealt in with composite contracts?
3.	What is the ‘Force of Attraction Rule’?
4.	State the importance of Arm’s Length Principle in relation to Associated Enterprises.
5.	Compare the applicability of Article 9 on Associated Enterprises with Domestic Indian Laws.

SOLUTIONS	
1.	In common parlance, 'Profit' is the outcome of carrying on trade viz. aggregate receipts minus aggregate expenses. Further, the term 'Business' has been interpreted by various courts of law in order to establish as to what activity will qualify as business and shall include an organized activity carried on by a professional. In the context of treaty law, the term "Business Profit" shall be interpreted in the same way as in the Income Tax Act, 1961. However, as per Article 7, business profits shall not include services rendered by a professional in his/her individual capacity. For instance, a teacher providing services to individual students by way of conducting tuition classes shall not be covered under this article; however, if the teacher brings another teacher and run a coaching class, then the same shall be classified as a business activity and shall be covered under the said Article.
2.	According to the "Attribution Rule", a business income that is liable to be taxed must be attributable to the Permanent Establishment (PE). As has been observed in the case of Ishikawajma-Harima Heavy Industries Ltd., profits that are considered to be attributable to PE shall arise economically from the business that has been carried out by the PE. Moreover, it must have a proximate and direct connection with the PE. For composite contracts, case of CIT vs. Hyundai Heavy Industries Co. Ltd. is to referred wherein the SC ruled out that the profits that are earned by company on the supplies cannot be attributed to the installation services provided since the same came into existence only after the completion of the sale transaction of supplies.
3.	The 'Force of Attraction Rule' is an extension of the attribution rule and it means all the incomes arising from all the sources in a country where the foreign enterprise maintains a PE is subject to tax in that country irrespective of the fact that the income so accrued is attributable to PE or not. Hence, profits arising from transactions outside PE are also subject to tax. Therefore, if a foreign enterprise has a PE in a particular State, the State should get the right to tax all the income arising therein to the PE whether the same has any connection with the business activity or not.
4.	In case of Associated Enterprises, where an enterprise controls another enterprise directly or indirectly through capital or management of that enterprise and the transactions between such enterprises are not at market rates, then the profit which would have accrued at arm's length to the enterprise supplying such goods or services shall be deemed to be the income of that enterprise. Hence, it becomes important that profits are computed on an arm's length basis and are not enhanced or suppressed artificially in order to enhance relief and reduce liability. The main crux of the provisions is the arm's length principle that requires charging arm's length price for all international transactions between AEs which shall be supported by appropriate documentation.
5.	The principle of avoidance or reduction of tax liability by the help of AE must be avoided and the same principle is also recognised in the transfer pricing provisions introduced in the Act by the Finance Act, 2001 and covered in sections 92-92F. The term "international transaction" is defined under section 92B which means a transaction, between two or more AEs where either or both of whom are non-residents.

	The transaction can be in nature of sale, purchase or lease of tangible or intangible property, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises and shall include a mutual agreement between two or more AEs for allocation of or any contribution to any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises. Whereas the term “transaction” is defined under section 92F(5) to include an arrangement, understanding or action in concert- a) whether or not such arrangement, understanding or action is formal or in writing; or b) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding. The Finance Act, 2015 has also amended the concept of “deemed international transaction” where a transaction between two independent local entities may also be considered as an international transaction, subject to fulfilment of certain conditions and hence would be subject to transfer pricing regulations in India. The Finance Act, 2012 introduced the concept of Advance Pricing Agreement (APA) which is an agreement between the CBDT and the taxpayer that determines, in advance, the arm’s length price or that specifies the manner of determination of the arm’s length price in relation to an international transaction. The term ‘Associated Enterprise’ has been defined in section 92A(1) of the Act and emphasis has been laid on the inter-dependence of the enterprises. Such dependence may be for supply of raw materials or provision of services or marketing dependence. Any transaction between such enterprises to be at an “arm’s length price”.

Module II – Shipping, Inland Transport and Waterways

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1. Introduction

Tax treaties are based on Model Conventions like OECD/ UN/ US Model Conventions and are exhaustive in nature. They are composed of 32 Articles, of which Article 8 extensively covers treatment of profits arising from operation of Ships, Inland Waterways Transport and Air Transport.

2. Contents of Article 8

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

Paragraph 2 *Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.*

Paragraph 3 *If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbor of the ship or boat is situated, or, if there is no such home harbor, in the Contracting State of which the operator of the ship or boat is a resident.*

Paragraph 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.*

3. International Traffic

The term 'international traffic' is defined in Article 3 as "*any transport by a ship or aircraft operated by an enterprise of a Contracting State except when the ship or aircraft is solely operated between the places in the other Contracting State*."

The above definition is important as it indicates the entitlement of benefit of exemption of shipping income and also limits what is included. Generally, transport within the State and coastal traffic is excluded.

The UN and OECD Model Convention provides the taxation rights in case of operation of ships or aircrafts to the state where the enterprise's place of effective management lies.

The profits arising from the operation of ships or aircraft in international traffic shall be taxed in one State alone and the profits shall be exempt from tax at source and shall be taxed exclusively in the Contracting State of the enterprise that is engaged in international traffic. Article 8 provides an independent operative rule for such activities and is not covered by Article 5 and 7 where business profits are governed by the permanent establishment rules.

Exemption from tax in the source country is based on the premise that the income arising from these activities is earned by the enterprises on the high seas and that the exposure to the tax laws of various other countries would result in double taxation or allocation problems. Moreover, the exemption also ensures that the enterprises shall not be taxed in foreign countries in case if the enterprises have unprofitable operations.

4. <u>Profits from the Operation of Ships or Aircraft in International Traffic</u>

With respect to the term *"profits from the operation of ships or aircraft in international traffic"*, the Model Convention lays down two categories of profits which should fall within the scope of this Article.

a) Profits directly obtained by the enterprise from the carriage of passengers or cargo in international traffic;
b) Profits from activities to permit, facilitate or support international traffic operations which is further divided into two categories:
    a. *Those directly connected with such operations*: Any activity that is carried on by the enterprise, primarily, in connection with transportation of passengers or cargo by ships or aircraft that the enterprise operates in international traffic shall be considered to be directly connected with such transportation.
    b. *Those not directly connected but ancillary to such operations:* Any activity, that the enterprise need not carry on for the purpose of its own operation of ships or aircrafts however makes minor contribution to such operation and are so closely related to such operation that it cannot be regarded as a different business of the enterprise, shall be considered to be ancillary to the operation of ships and aircraft in international traffic.

Profits generated by leasing a ship or an aircraft on charter that is fully equipped, supplied and crewed must be treated as profits arising from the carriage of passenger or cargo. Article 12 covers the treatment of profits arising from leasing a ship or aircraft on a bare boat charter basis except in cases when it is an ancillary activity of an enterprise which is engaged in the international operations of ships or aircrafts.

Profits arising from the transportation of passengers or cargo otherwise than by ships or aircraft that the enterprise operates in the international traffic are also covered by the Article to an extent that such transportation is directly connected or is ancillary to the operation of ships or aircrafts in international traffic. For instance, an airline company operating a bus service connecting a town with the airport in order to provide access to and from that airport to the passengers of its international flights.

There are instances where the enterprises engaged in international transport may enter into pooling arrangements in order to reduce the cost of maintaining facilities that are needed for the operation of their ships or aircrafts in other countries. Such arrangements shall also be considered as activities ancillary to the operation of aircraft in international traffic. For instance, under an International Airlines Technical Pool agreement, an airline agrees to provide spare parts or maintenance services to other airlines landing at a defined location, such activities shall be treated as activities ancillary to the operation of aircraft in international traffic.

Investment income such as income from stocks, bonds, shares or loans earned from shipping, inland waterways or air transports shall be subject to the treatment that is ordinarily applied to this class of income except where such incomes are an integral part of carrying on the business of operating the ships or aircrafts in the international traffic in the Contracting State in such a way that the investment is considered to be directly connected with such operation. It shall not include incomes generated from short term investments of the profits generated by local operation of the business where such investment is not required for that operation.

5. Profits from Operation of Boats Engaged in Inland Waterways Transport

Profits arising to an enterprise of a Contracting State from inland waterways transport fall within the purview of this Article only to the extent that such transport constitutes international traffic as defined in Article 3.

Some countries might wish to extend the treatment provided in paragraph 1 to the profits derived from any transport on rivers, canals and lakes. Such countries can do so by including the provision as below mentioned in their bilateral treaties:

"Profits of an enterprise of a Contracting State from the operation of boats engaged in inland waterways transport shall be taxable only in that State."

While the other countries consider that inland waterways transport that does not constitute international traffic should not be treated differently from other businesses. Such countries, in order to avoid double taxation, can treat the profits according to the provisions of the Article 7 and 23A or 23B in cases where foreign enterprises are allowed to carry on such transportation activities.

6. Enterprise Not Exclusively Engaged in Shipping or Air Transport

As per paragraph 1 of Article 8, enterprise that are not exclusively engaged in shipping or air transport shall also be covered under the provisions of the paragraph with regards to the profits arising to such enterprises from the operation of ships or aircraft belonging to them.

If such enterprises have a PE in a foreign country that is exclusively concerned with the operation of its ships or aircrafts, such enterprises shall be treated as the enterprise exclusively engaged in shipping or air transport.

If the enterprise has a permanent establishment in another State and if its goods are carried in its own ships to such permanent establishment, then none of the profits obtained by the enterprise through acting as its own carrier can be properly taxed in the State where the PE is situated. This is also applicable in cases where the PE maintains installations for operating the ships or aircrafts or incurs other costs in connection with the carriage of enterprise's goods. In such cases, despite of the fact that certain functions related to the operation of ships and aircraft in international traffic is performed by the PE, the profits attributable to these functions are taxable in the State to which the enterprise belongs.

7. Taxation of Foreign Shipping Companies under Income Tax Act, 1961

Taxation of shipping companies is governed mainly by two sections under the Act viz., Section 44B and Section 172.

7.1. Section 44B

Section 44B deals with the provision for computing profits and gains of shipping business in case of non-residents. It was introduced by the Finance Act, 1975.

Section 44B is a non-obstante clause. Accordingly, sections 28 to 43A are not applicable in the case of a non-resident engaged in the business of operation of ships.

According to the provisions of the said section, for a non-resident assessee, engaged in the business of operation of ships, a sum equal to 7.5% of the aggregate amounts as specified shall be deemed to the profit of such enterprises and shall be chargeable to tax under the head “Profits and Gains of Business or Profession”.

For the purposes of the said section, specified amount shall be-

a. The amount paid or payable (whether in or outside India) to the assessee or to any person acting on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods shipped at any port in India and;
b. The amount received or deemed to be received in India by the assessee or by any person acting on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India.

Note:

The amounts paid or payable or the amounts received or deemed to be received will also include the amount paid or payable or received or deemed to be received by way of demurrage charges or handling charges or any other amount of similar nature **[CIT v. Japan Lines Ltd. 260 ITR 656(Mad)]**. Thus 7.5% of the gross amounts mentioned above would be liable to tax and no deduction would be allowed for any expenditure, (i.e. the provisions of section 28 to 43A are not to be taken into account) however carried forward losses would be allowed to be set off from such income.

Illustration:

A company based in Switzerland operates its ships to and fro Vishakhapatnam port, collected freight of Rs. 85 Lakhs, demurrage of Rs. 5 Lakhs and handling charges of Rs. 2 Lakhs in respect of goods shipped at Vishakapatnam port. It incurred expenses of Rs. 35 Lakhs during the year for operating its fleet. In respect of goods shipped at Switzerland, it received Rs. 50 Lakhs in India.

What shall be the tax liability of the company for the A.Y. 2022-23 applying the presumptive provisions under section 44B?

Solution:

Section 44B provides that in the case of an assessee, being a non-resident, engaged in the business of operation of ships, a sum equal to 7.5% of the aggregate of the following amounts would be deemed to be the profits and gains of such business chargeable to tax under the head “Profits and gains of business or profession”.

i) The amount paid or payable, whether within India or outside, to the assessee or to any person on his behalf on account of the carriage of passengers, livestock, mail or goods shipped at any port in India; and
ii) The amount received or deemed to be received in India by the assessee himself or by any other person on behalf of or on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India.

The above amounts will include demurrage charges and handling charges.

Therefore, in this case, company is required to pay tax on deemed profit of Rs. 10.65 lakhs (7.50% on the total receipts of Rs. 142 lakhs). The expenses incurred for earning of such income shall not be allowed to be set off.

Tax liability of company = Rs. 10.65 x 41.6% (40% + cess @ 4%) = Rs. 4.4304 lakhs.

7.2. Section 172

The provisions of Section 172 deals with levy and recovery tax from foreign shipping companies. It provides that every foreign shipping company shall declare a certain percentage of profit on its freight income for taxation. This section overrides all other sections except section 90 of the Act since the Central Government has signed agreements with other countries for giving relief to residents of contracting state.

The section shall apply to any ship that belongs to or is chartered by a non-resident and which carries passengers, livestock, mail or goods shipped at a port in India.

Deemed income for shipping business: A sum equal to 7.5% of the amount paid or payable to the owner or the charterer or to any person on his behalf, whether that amount is paid or payable in or out of India, shall be deemed to be income accruing in India to the owner or charterer on account of such carriage.

Assessment: Under the said section, a summary assessment is made and clearance certificate is only granted by the clearing officer when all the taxes are paid under this section.

Master of the ship to submit Voyage Return to the Assessing Officer (AO) having jurisdiction over the port of departure before departure of the ship. In case if the master of the ship is unable to furnish such return, then he shall make satisfactory arrangement for filing voyage return within 30 days of the departure of the ship. Assessment of income for determination of tax payable, if any, shall be made within 9 months from the end of relevant financial year in which the return is furnished.

A circular was issued by CBDT wherein it was provided that annual NOC should be issued in cases where no tax is leviable on foreign shipping business due to the DTAA. NOC must include details such as the name of ships owned, name of shipping company and name of members of the pool.

As per section 172 (7), if a foreign shipping company files an intimation to the AO expressing its willingness to be assessed on the annual basis instead of voyage basis, the assessment before Port AO shall cease and he/she shall intimate the concerned AO to issue annual NOC.

7.3. Section 44B vis-à-vis Section 172

The analysis with differences between Section 44B and Section 172 is presented below:

Sr. No.	Point of Difference	Section 44B	Section 172
1.	About the Section	Presumptive tax provisions for non-residents engaged in shipping business. It does not, however, contain any procedure for assessment and collection of tax.	Complete code for taxation of occasional shipping business of non-residents, including assessment and collection of tax.
2.	Manner of computation of presumptive income	Notwithstanding anything to the contrary contained in sections 28 to 43A, in the case of an assessee, being a non-resident, engaged in the business of operation of ships, a sum equal to 7.5% of the aggregate of the - - amount paid or payable (whether in or outside India) to the non-resident or to any other person on his behalf on account of the carriage of passengers, livestock, mail or goods shipped at any Indian port and - the amount received or deemed to be received in India on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India. <u>shall be deemed to be the profits and gains of such business</u> chargeable to tax under the head "Profits and gains of business or profession".	Where a ship carries passengers, livestock, mail, or goods shipped at a port in India, a sum equal to **7.5%** of - the amount paid or payable on account of such carriage to the owner or the charterer or to any person on his behalf, whether that amount is paid or payable in or out of India, <u>shall be deemed to be income accruing in India</u> to the owner or charterer on account of such carriage.

Test Your Knowledge

QUESTIONS	
1.	Define the term 'International Traffic'.
2.	Explain the term 'Profits from the operation of ships or aircraft in international traffic'.
3.	State two activities that can be considered as activities ancillary to the operation of aircraft in international traffic.
4.	Elaborate the taxability of shipping income under section 44B of the Income Tax Act, 1961.
5.	Brief note on Assessment under section 172 of the Income Tax Act, 1961.
6.	Mr. Jackson, a non-resident, (aged 46) operates a ship for the carriage of goods, passengers and livestock between London, Mumbai and Kolkata. He provides you the following particulars for the P.Y. 2021-22: (i) Received Rs. 200 Lakhs in India on account of carriage of livestock from Mumbai to Australia. (ii) Received Rs. 50 Lakhs in India on account of carriage of passengers from London to Colombo. (iii) Received Rs. 65 Lakhs in London on account of carriage of goods from Kolkata to London. (iv) Expenses incurred during the year in respect of operation of such ships Rs. 195 Lakhs. (v) Winning from horse races in India Rs. 25 Lakhs. Compute the total income of Mr. Jackson chargeable to tax in India for the A.Y. 2022-23. Also, calculate the tax payable thereon assuming Mr. Jackson does not opt for the provisions of Section 115BAC of the Act.

	SOLUTIONS
1.	The term ‘international traffic’ is defined in Article 3 as any transport by a ship or aircraft operated by an enterprise of a Contracting State except when the ship or aircraft is solely operated between the places in the other Contracting State.
2.	The term profits from the operation of ships or aircraft in international traffic is covered under the Model Convention and it lays down two categories of profits which should fall within the scope of this Article. a) Profits directly obtained by the enterprise from the carriage of passengers or cargo in international traffic; b) Profits from activities to permit, facilitate or support international traffic operations which is further divided into two categories: a. <u>Those directly connected with such operations:</u> Any activity that is carried on by the enterprise, primarily, in connection with transportation of passengers or cargo by ships or aircraft that the enterprise operates in international traffic shall be considered to be directly connected with such transportation. b. <u>Those not directly connected but ancillary to such operations:</u> Any activity, that the enterprise need not carry on for the purpose of its own operation of ships or aircrafts however makes minor contribution to such operation and are so closely related to such operation that it cannot be regarded as a different business of the enterprise, shall be considered to be ancillary to the operation of ships and aircraft in international traffic.
3.	Examples of activities undertaken by an enterprise that can be considered as activities ancillary to the operation of ships and aircraft in international traffic are as below: 1. An airline company operating a bus service connecting a town with the airport in order to provide access to and from that airport to the passengers of its international flights. 2. Under an International Airlines Technical Pool agreement, an airline agrees to provide spare parts or maintenance services to other airlines landing at a defined location, such activities shall be treated as activities ancillary to the operation of aircraft in international traffic.
4.	Taxability of shipping income under section 44B of the Income Tax Act, 1961 is as under: a. The section deals with the provision for computing profits and gains of shipping business in case of non-residents. It was introduced by the Finance Act, 1975. b. According to the provisions of the said section, for a non-resident assessee, engaged in the business of operation of ships, a sum equal to 7.5% of the aggregate amounts as specified shall be deemed to the profit

	of such enterprises and shall be chargeable to tax under the head "Profits and Gains of Business or Profession". c. For the purposes of the said section, specified amount shall be- - The amount paid or payable (whether in or outside India) to the assessee or to any person acting on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods shipped at any port in India and; - The amount received or deemed to be received in India by the assessee or by any person acting on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India.
5.	Assessment under Section 172 of the Income Tax Act, 1961: a. Under the said section, a summary assessment is made and clearance certificate is only granted by the clearing officer when all the taxes are paid under this section. b. Master of the ship to submit Voyage Return to the Assessing Officer (AO) having jurisdiction over the port of departure before departure of the ship. In case if the master of the ship is unable to furnish such return, then he shall make satisfactory arrangement for filing voyage return within 30 days of the departure of the ship. c. Assessment of income for determination of tax payable, if any, shall be made within 9 months from the end of relevant financial year in which the return is furnished. d. As per section 172 (7), if a foreign shipping company files an intimation to the AO expressing its willingness to be assessed on the annual basis instead of voyage basis, the assessment before Port AO shall cease and he/she shall intimate the concerned AO to issue annual NOC.
6.	• Section 44B provides that profits and gains of a non-resident engaged in the business of operation of ships are to be taken @ 7.5% of the aggregate of the following amounts: (i) paid or payable, whether in or out of India, to the assessee or to any person on his behalf on account of carriage of passengers, livestock, mail or goods shipped at any port in India; and (ii) received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India. • These provisions for computation of the income from the shipping business in case of non-residents would apply notwithstanding anything to the contrary contained in the provisions of Sections 28 to 43A. • Accordingly, profits from shipping business of Mr. Jackson computed as follows: **Computation of total income and tax payable by Mr. Jackson**

	Amount (Rs.)
(i) Amount received in India on account of carriage of livestock from Mumbai to London	200 lakhs
(ii) Amount received in India on account of carriage of passengers from Dubai to Colombo	50 lakhs
(iii) Amount received in Dubai on account of carriage of goods from Chennai to Dubai	65 lakhs
Total amount received	315 lakhs
Profits and gains chargeable under head profits and gains from business or profession @ 7.5% of the total amount received	**23,62,500**
Income from other sources	
Winning from horse races in India [assumed to be the gross amount]	25,00,000
Total Income	**48,62,500**

Tax on winning from horse races @ 30%		7,50,000
Tax on balance income of Rs. 23,62,500		
Upto Rs. 2,50,000	Nil	
Rs. 2,50,001 – Rs. 5,00,000 @ 5%	12,500	
Rs. 5,00,001 – Rs. 10,00,000 @ 20%	1,00,000	
Rs. 10,00,001 – Rs. 23,62,500 @ 30%	4,08,750	5,21,250
		12,71,250
Add: Health and Education cess @ 4%		50,850
Tax liability		13,22,100
Less: Tax deduction at source on winnings from horse races [31.2% of Rs. 25,00,000]		(7,80,000)
Tax payable [Note]		**5,42,100**

Note: The tax payable would get further reduced by the amount of tax paid u/s 172(4). The amount of tax payable u/s 172 would be 41.6% (being the rate applicable to a foreign company) of 7.5% of Rs. 265 lakhs (being the amounts payable for goods shipped at a port in India) = Rs. 8,26,800. After reducing this amount, the tax refundable on total income would be Rs. 2,84,700.