KTBA Karachi Tax Bar Association

29th KTBA CASE LAW UPDATE (February 13, 2024)

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Dear Members,

A brief update on a recent judgment by the Supreme Court of Pakistan on **"Income from (i) CDC (ii) CSC and (iii) THC are part of profits of Shipping Company from Operations in International Traffic"** is being shared with you for your knowledge. The order has been attached herewith the update.

This update is in line with the efforts undertaken by our **"CASE LAW UPDATE COMMITTEE"** to apprise our Bar members with important court decisions.

You are equally encouraged to share any important case law, which you feel that should be disseminated for the good of all members.

You may contact the Committee Convener Mr. Shams Ansari or at the Bar's numbers 021-99212222, 99211792 or email at info@karachitaxbar.com&ktba01@gmail.com

(Syed Zafar Ahmed)	**(M. Mehmood Bikiya)**
President	Hon. General Secretary

29th KTBA CASE LAW UPDATE
(February 13, 2024)

INCOME FROM (i) CDC (ii) CSC AND (iii) THC ARE PART OF PROFITS OF SHIPPING COMPANY FROM OPERATIONS IN INTERNATIONAL TRAFFIC

Appellate Authority : Supreme Court of Pakistan.
Petitioner: Commissioner IR, KHI
Section: Section 107 of the Income Tax Ordinance, 2001 & Double Tax Treaty with Denmark.

Detailed judgment in AP Moller case was issued on January, 01 2024 in C.P.560-K/2019 to C.P.589-K/2019.

BACKGROUND: Appeal was filed by the department against the order of the Sindh High Court wherein it was held that income of a Shipping Line from CDC, CSC and THC charges are covered under "profits from the operation of ships in international traffic" and, therefore, are protected under the Double Tax Treaty (DTT) with Denmark. Needless to mention that CDC pertains to charges for container rent when a customer holds a container beyond the stipulated unloading time. CSC refers to charges for container services due to unloading goods at the destination, while THC represents terminal charges at the port of disembarkation.

DECISION OF THE COURT:

First Ruling of the Court:

DTTs TO BE SEEN THROUGH THE LENS OF OECD MODEL & UN MODEL COMMENTARIES

International tax agreements, such as tax treaties, are governed by Vienna Convention on the Law of Treaties, which sets out rules for interpretation. These treaties differ from domestic tax laws in language, application and purpose as their primary aim is to prevent double taxation; in contrast to domestic law that imposes taxes. Tax treaties require a broad and purposive interpretation, often more liberal than domestic law. States involved in bilateral agreements are primarily expected to implement rather than unilaterally interpreting them. Even when it comes to interpreting, their provisions should be interpreted considering international tax language, legal precedences, model treaties, relevant scholarly works and commentaries from organizations like OECD and the UN.

Second Ruling of the Court:

SPECIAL PROVISION FOR INTERNATIONAL SHIPPING OPERATIONS

The rule for international shipping, which deviates from traditional allocation of taxing rights based on PE principle, has Special place in a tax treaty law. This special treatment for shipping and to air transport, recognizes the unique nature of their activities—operating across multiple countries and jurisdictions. Due to the complexity of attributing profits from such operations across various jurisdictions, applying general provisions could lead to fragmented taxation and potential double taxation. Thus, both the OECD and UN Model Conventions introduced provisions specifically addressing taxation or exemption on profits from international shipping and air transport. These provisions supersede general rules on business profits, exempting profits from the operation of ships and aircraft in international traffic from the permanent establishment principle. Moreover, they acknowledge that shipping and air transport enterprises engage in a wide range of activities to support their international operations.

Third Ruling of the Court:

PROFITS FROM THE OPERATION OF SHIPS IN INTERNATIONAL TRAFFIC TO INCLUDE ……

Article 8 of both the OECD Model Convention and the UN Model Convention broadly covers profits related to "profits from the operation of ships in international traffic." This includes not only profits directly from transporting passengers or cargo but also those directly or indirectly connected to such operations. Activities are deemed ancillary if they are not essential for ship operation, make a minor contribution, and are closely linked to the main operation. Therefore, profits under Article 8 encompass various aspects such as transport operations, sales of tickets, leasing of ships, inland transport, interest, code sharing, catering services, and more.

Fourth Ruling of the Court:

CDC, CSC & THC

The issue in question concerns income arising from the above three sources. Notably, two of these sources involve charges imposed for services related to containers, whereas the third one pertains to charges associated with terminal services for cargo handling. In the context of such income sources, Vogel, a recognized authority, emphasizes the widespread use of containers in international transport. Profits arising from short-term storage of containers or from detention charges for the late return of containers, according to Vogel, are covered within the purview of "profits from the operation of ships in international traffic". Further, special remuneration for services ancillary to container operations are covered within the ambit of shipping income from international traffic. Income derived from services provided for cargo handling is also considered part of shipping income from international traffic when directly connected or ancillary to the operation of ships in international traffic.

CONCLUSION: Profits from CDC, CSC, and THC are deemed ancillary to the operation of ships in international traffic, falling within the scope of "profits from the operation of ships in international traffic", therefore, are subject to the provisions outlined in the Pakistan-Denmark and Pakistan-Belgium Double Taxation Conventions. Consequently, the petitions are dismissed, and the judgment of the High Court stands.

COMMENTS: The escalation of international trade has led to a rise in tax disputes among countries. Historically, our judicial system hasn't seen many case laws concerning international taxation and treaties. However, recent times have witnessed a notable increase in such judgments. For instance, the case reported as 2023 SCMR 1055 delved into extensive discussions on treaties. These judgments serve as valuable resources for comprehending treaties and their application within Pakistan.

DISCLAIMER:
This update has been prepared for KTBA members and carries a brief narrative on a detailed Judgment and does not contain an opinion of the Bar, in any manner or sort. It is therefore, suggested that the judgment alone should be relied upon. Any reliance on the summary in any proceedings would not be binding on KTBA.

Dear Members,

A brief update on a recent judgment by the Supreme Court of Pakistan on **"Income from (i) CDC (ii) CSC and (iii) THC are part of profits of Shipping Company from Operations in International Traffic"** is being shared with you for your knowledge. The order has been attached herewith the update.

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Best regards

(Syed Zafar Ahmed)
President

(M. Mehmood Bikiya)
Hon. General Secretary

(Shams M. Ansari)
Convener: Case Law Update Committee

IN THE SUPREME COURT OF PAKISTAN
(Appellate Jurisdiction)

Bench-III:
Mr. Justice Syed Mansoor Ali Shah
Mr. Justice Jamal Khan Mandokhail
Mr. Justice Athar Minallah

C.P.560-K/2019 to C.P.589-K/2019
(Against the consolidated judgment of High Court of Sindh at Karachi dated 31.05.2019, passed in ITRAs No.22 of 2014, etc.)

Commissioner Inland Revenue Zone-IV, Karachi (In all cases)

.... Petitioner(s)

Versus

M/s A.P. Moller Maersk (In CP 560-K to 573-K of 2019)
M/s Safmarine Container Line (In CP 574-K to 589-K of 2019)

....Respondent(s)

For the petitioner(s): (In all cases) — Dr. Shahnawaz, ASC.
Mr. Abdul Wahid, Addl. Commissioner, FBR.

For the respondent(s): (In all cases) — Mr. Khalid Javed Khan, ASC
(Through V.L. Karachi Registry)

Date of hearing: 12.01.2024

ORDER

Syed Mansoor Ali Shah, J.- The question before us is whether income arising from container detention charges (**"CDC"**), container service charges (**"CSC"**) and terminal handling charges (**"THC"**) falls within the category of "profits from the operation of ships in international traffic" in the context of double taxation conventions concluded between Pakistan and Denmark, as well as between Pakistan and Belgium.

2. The respondents are non-resident companies, one incorporated in Denmark and the other in Belgium. They are involved in cargo shipping activities, conducting their business operations within Pakistan through the authorized agent, M/s Maersk Pakistan (Private) Limited. The respondents filed income tax returns, accounting for income derived from freight charges, CDC, CSC and THC. They claimed entitlement to tax benefits under Article 8 of the Convention between the Islamic Republic of Pakistan and the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income

(**"Pakistan-Denmark Convention"**), and similarly, under Article 8 of the Convention between the Kingdom of Belgium and the Islamic Republic of Pakistan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (**"Pakistan-Belgium Convention"**), as the case may be.

3. The Deputy Commissioner Inland Revenue disagreed with the aforementioned assessment, asserting that CDC, CSC, and THC were not eligible under the beneficial provisions of the Pakistan-Denmark Convention and the Pakistan-Belgium Convention. The Deputy Commissioner reasoned that these charges were not explicitly covered under Article 8 of either Convention, which addresses beneficial taxation in relation to "profits from the operation of ships in international traffic". The respondents remained unsuccessful both in the appeal before the Commissioner Inland Revenue (Appeals) and in the subsequent appeal before the Appellate Tribunal Inland Revenue. Nevertheless, the High Court, in its decision given in Income Tax References filed by the respondents, concluded that profits arising from CDC, CSC, and THC fell within the scope of the term "profits from the operation of ships in international traffic" as stipulated in Article 8 of the two Conventions. Consequently, such profits were deemed eligible for the benefit of favourable taxation. The Department is now seeking leave to appeal the High Court's determination, challenging the inclusion of CDC, CSC, and THC under the umbrella of "profits from the operation of ships in international traffic" and their eligibility for beneficial taxation envisaged in Article 8 of the two Conventions.

4. We have heard the arguments of the learned counsel for the parties and have carefully gone through the record.

5. The respondents, being tax residents of Denmark and Belgium, are entitled to the benefits and concessions under the Pakistan-Denmark Convention and the Pakistan-Belgium Convention, as the case may be, in line with the provisions of Section 107 of the Income Tax Ordinance 2001 (**"Ordinance"**). Under subsection 2(c) of Section 107 of the Ordinance, the taxability of the respondents' income is to be determined under the provisions contained in the two Conventions which override the Ordinance. These Conventions provide for allocation of taxing jurisdiction to the

contracting States in respect of different heads of income. With respect to the income falling under the head of "profits from the operation of ships in international traffic" which is dealt with under Article 8 in both the Conventions, the allocation of jurisdiction to the contracting States is not identical. The Pakistan-Belgium Convention assigns the sole right to tax profits from operating ships in international traffic to the residence State. In contrast, the Pakistan-Denmark Convention permits the source State to tax these profits, but only to the extent derived from sources within that State, in accordance with its domestic law. However, this difference is not relevant for the purposes of the dispute before us. The issue before us, common to both the Conventions, relates to the nature of profits arising from CDC, CSC, and THC: whether these profits fall within the scope of the term "profits from the operation of ships in international traffic" or not. If this question is decided in the affirmative, the respondents' profits resulting from CDC, CSC, and THC will be subjected to taxing provisions contained in Article 8 of the respective Conventions. Otherwise, profits resulting from CDC, CSC, and THC will not be considered as shipping income eligible to be dealt with under Article 8 of the two Conventions.

6. Notably, the matter at hand involves the interpretation of international tax conventions. Recently, this Court in *Snamprogetti*[1] emphasized the distinctiveness of international tax treaties, their specific interpretive framework, and the importance of equitable outcomes in cross-border taxation. International tax treaties, conventions or agreements, given their unique nature, as held in *Snamprogetti*, require a distinct interpretive approach compared to the one used while interpreting domestic legislation. These agreements being international treaties are governed by the rules of interpretation outlined in the Vienna Convention on the Law of Treaties. Tax treaties differ from domestic tax laws in language, application, and purpose. These treaties are relieving in nature and seek to avoid double taxation, while domestic tax law imposes tax in specific situations. Tax treaties require a broad purposive interpretation, and their interpretation may be more liberal than domestic law. Treaty interpretation is a separate subject from

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[1] Snamprogetti Engineering B.V. v Commissioner of Inland Revenue, 2023 SCMR 1055.

statutory interpretation, accentuating the need to interpret tax treaties independently of domestic law. The role of a State in a bilateral agreement is more of implementing the terms of such agreement rather than that of interpreting the same and that too in a unilateral manner. Given that the primary purpose of tax treaties is to avoid and relieve double taxation through equitable and acceptable distribution of tax claims between the countries, it is important that the provisions of these treaties are interpreted in a common and workable manner, taking into account international tax language, legal decisions of other countries, model treaties[2], along with their commentaries, developed by the Organization for Economic Cooperation and Development (**"OECD"**)[3] and the United Nations (**"UN"**)[4], and scholarly academic works where appropriate.

7. We see that the operation of ships in international traffic has been given special tax treatment in Pakistan-Denmark Convention and the Pakistan-Belgium Convention in accord with the OECD Model Convention (**"OECD MC"**) and the UN Model Convention (**"UN MC"**). The general policy underlying the special rule for international shipping and the deviation from the allocation of taxing rights based on the permanent establishment principle has its roots at the very beginning of tax treaty law. Maritime shipping was viewed as an activity that warrants a special rule. Having regard to the distinct nature of activities carried on by shipping (air transport was also added to this category later) entities which operate across different routes spread across several countries and the complexity of apportioning profits arising from such business across numerous countries, it was felt that general provisions dealing with business profits would result in taxation of fragmented profits in numerous countries, thereby possibly leading to double taxation. Accordingly, it was considered necessary to introduce a separate provision in the OECD MC, and also in the UN MC, to specifically deal with profits from operations of shipping and air transport business in international traffic. The provision relating to shipping and air transport takes precedence over the general rule relating to business

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[2] Model treaties provide standard frameworks of guidance for treaty negotiation and are of high persuasive value in terms of defining the parameters of double taxation treaties and have world-wide recognition as basic documents of reference in the negotiation, application and interpretation of multilateral or bilateral tax conventions.
[3] OECD Model Tax Convention on Income and on Capital.
[4] United Nations Model Double Taxation Convention between Developed and Developing Countries.

profits and the permanent establishment principle is not applied to profits falling within its scope of application i.e. profits arising from the operation of ships and aircraft in international traffic. More importantly, this provision also takes into account the fact that shipping and air transport enterprises invariably carry on a large variety of activities to permit, facilitate or support their international traffic operations.[5]

8. The issue before us pertains to the characterization of income arising from CDC, CSC, and THC. Let us have a look at the meaning of CDC, CSC, and THC in order to understand the nature of these incomes. The High Court has observed, and there exists no contention between the parties on this point, that CDC is the amount collected on account of rent of container, which is charged if a customer holds the said container beyond the stipulated time required to discharge the goods at the intended port of disembarkation; CSC is collected by shipping lines on account of services in respect of containers which may be required due to discharge of goods at the destination; and THC is collected by shipping lines on account of terminal charges incurred at the port of disembarkation. With this understanding of the aforementioned sources of income viz. CDC, CSC and THC, we proceed to examine whether such income aligns with the expression "profits from the operation of ships in international traffic".

9. The Commentary on Article 8 of the OECD MC provides guidance about qualifying activities and related profits with respect to income falling under the head of "profits from the operation of ships in international traffic". It provides that the profits covered consist in the first place of the profits directly obtained by the enterprise from the transportation of passengers or cargo by ships that it operates in international traffic such as any activity carried on primarily in connection with the transportation, by the enterprise, of passengers or cargo by ships that it operates in international traffic. It is then recognized that with the evolution of international transport, shipping enterprises invariably carry on a large variety of activities to permit,

[5] Georg Kofler, in Reimer & Rust (eds), *Klaus Vogel on Double Taxation Conventions* (5th edn 2021) vol 1, art 8, paras 7, 33. See also Shefali Goradia, 'Taxation of Services' in Guglielmo Maisto (ed), *Current Tax Treaty Issues,* vol 18 (IBFD EC and International Tax Law Series 2020) 535-536; Ola Ostaszewska and Belema Obuoforibo (eds), *Roy Rohatgi on International Taxation,* vol 1 (IBFD 2018) 187.

facilitate or support their international traffic operations. The expression "profits from the operation of ships in international traffic" therefore also covers profits from activities directly connected with such operations as well as profits from activities which are not directly connected with the operation of the enterprise's ship in international traffic as long as they are ancillary to such operation – activities that the enterprise does not need to carry on for the purposes of its own operation of ships in international traffic but which make a minor contribution relative to such operation and are so closely related to such operation that they should not be regarded as a separate business or source of income of the enterprise should be considered to be ancillary to the operation of ships in international traffic.[6] We also note that since 2017, the UN MC Commentary fully reproduces the OECD guidance.

10. The objective scope of Article 8 of the OECD MC and the UN MC with its reference to "profits from the operation of ships in international traffic" covers not only profits directly obtained by the enterprise from the transportation of passengers or cargo by ships that it operates in international traffic, but also, profits from activities directly connected with such operations as well as profits from activities which are not directly connected with the operation of the enterprise's ships in international traffic as long as they are ancillary to such operation. Activities are to be considered ancillary to the operation of ships in international traffic if (i) the enterprise does not need to undertake them for the purposes of its own operation of ships in international traffic but which otherwise (ii) make a minor contribution relative to such operation and (iii) are so closely related to such operation that they should not be regarded as a separate business or source of income. Article 8 OECD and UN MC therefore applies not only to profits directly obtained in international traffic e.g. transport of passengers or cargo, sales of tickets of the enterprise, leasing of ships, but also to profits directly connected with international traffic and to profits ancillary to international traffic e.g. inland transport, interest, code sharing and slot chartering, haulage services and catering services, provision of goods and services to other enterprises, sales of tickets on behalf of other enterprises,

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[6] OECD MC Commentary, art 8.

advertising on behalf of other enterprises, letting of immovable property, rental of containers.[7]

11. The issue in question concerns income arising from three sources: CDC, CSC, and THC. Notably, two of these sources involve charges imposed for services related to containers, whereas the third pertains to charges associated with terminal services for cargo handling. In the context of such income sources, Vogel, a recognized authority, emphasizes the widespread use of containers in international transport. Profits arising from short-term storage of containers or from detention charges for the late return of containers, according to Vogel, are covered within the purview of "profits from the operation of ships in international traffic". Further, special remuneration for services ancillary to container operations are covered within the ambit of shipping income from international traffic. Income derived from services provided for cargo handling is also considered part of shipping income from international traffic when directly connected or ancillary to the operation of ships in international traffic.[8]

12. We thus reach the conclusion that profits arising from CDC, CSC and THC are connected with and ancillary to the operation of ships in international traffic. Consequently, these profits squarely fall within the purview of the expression "profits from the operation of ships in international traffic". Therefore, CDC, CSC, and THC collected by the respondents are part of the revenue earned in shipping in international traffic and are to be dealt with in accordance with the provisions of the Pakistan-Denmark Double Taxation Convention and the Pakistan-Belgium Double Taxation Convention, as the case may be. As a result, we do not feel inclined to interfere with the judgment of the High Court. These petitions are therefore dismissed.

Judge

Judge

[7] Georg Kofler, in Reimer & Rust (eds), *Klaus Vogel on Double Taxation Conventions* (5th edn 2021) vol 1, art 8, paras 33, 35.
[8] ibid, paras 44-46.

Islamabad,
12th January, 2024.
Approved for reporting Judge
Iqbal