

Indian tax hawks circle shipping

Foreign shipping operators calling in Indian ports have been stunned by a sudden aggressiveness on the part of tax authorities, as **Greg Miller** reports

Shipping now faces new tax threats on multiple fronts in India, according to Samir Kanabar, global tax and advisory services partner at Ernst & Young Pvt Ltd (India).

Traditionally, foreign companies have enjoyed a tax exemption if they are residents of countries that signed a tax treaty with India.

Shipping companies residing in tax havens that do not have a treaty with India must pay under domestic law: 7.5% of revenues derived from shipping operations in India are deemed profit and subject to a 42.23% tax.

The environment for companies claiming tax-treaty exemptions has deteriorated over the past two years. According to Kanabar, Indian authorities are now “examining in depth whether foreign shipping companies are eligible for a tax-treaty exemption” by “challenging whether the foreign shipping company is really a tax resident that has effective management in that country [with the treaty]”.

Specifically, authorities are asking where board meetings and annual meetings are held and how much time executives spend in that country.

“We are facing this challenge on a

day-in and day-out basis,” reported Kanabar. He explained that it is difficult to produce the documentation requested “because in an age of teleconferencing and videoconferencing, it’s not necessary to hold meetings in the country where you are a tax resident”.

One solution is to secure documentation from authorities in the shipping company’s tax residence proving that the firm is eligible for a treaty exemption.

Kanabar speculated that India’s newfound aggressiveness arose from a case involving a Middle Eastern company that had shipping as well as other interests.

He explained that India has a particularly favourable tax treaty with Mauritius and this Middle Eastern company was doing business in India and claiming a Mauritius tax residence.

It was then discovered that the company’s effective management was Middle East-based. Two years ago, this company’s tax-treaty status was revoked and ever since, Indian authorities’ interest in foreign shipping companies has “awakened”, said Kanabar.

The second new tax challenge faced by shipping involves inland Indian transport. When a foreign shipping company must lift cargo inland and move it to a

port, Indian authorities are now arguing that this inland portion of the income should be taxed as domestic activity.

Shipping’s stance is that inland transportation is incidental to international traffic and should not be taxed, given tax-treaty status.

Last month, a pivotal case in this disagreement was decided by a tribunal in favour of shipping. “But it’s not over yet,” said Kanabar, noting that Indian tax authorities are appealing.

Beyond these two new issues, yet another aspect differentiates India’s shipping taxation from most other jurisdictions. For a vessel to leave an Indian port, it must either pay tax under the domestic regime or provide the port authority with a tax certificate proving tax-treaty status.

This certificate must be pre-emptively obtained from Indian tax authorities.

Kanabar is not aware of a vessel actually being forced to remain in port over a tax dispute. In cases of disagreement, he said the shipping operator pays a provisional tax and files a claim for a refund.

Taken together, all of these issues have transformed India into one of the world’s most challenging jurisdictions for shipping taxation. The looming question is whether other shipping jurisdictions will follow suit. **■**

Indian officials are intensely questioning the tax-treaty status of foreign ships that call at their ports



Photo: Jochen A. Heide

Ernst & Young's Tamara Moravia-Israel warns that new tax-liability disclosure hurdles could be on the horizon

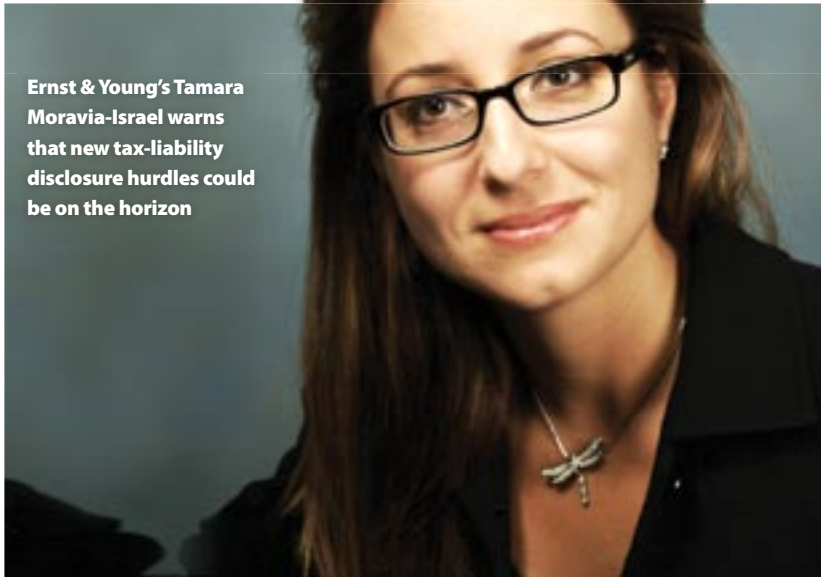


Photo: Ernst & Young

Tax unknowns.

Is shipping taking account?

A US disclosure rule on tax liabilities could be adopted into future international standards. Shipping must step up, **Greg Miller** discovers

Financial Interpretation Number 48 (FIN 48) became effective in 2006, mandating heightened disclosure of global tax liabilities by companies filing under US Generally Accepted Accounting Principles (US GAAP). This includes foreign shipping companies publicly listed in the US.

With America preparing for a shift from US GAAP to International Financial Reporting Standards (IFRS), there is a possibility that a disclosure rule similar to FIN 48 will be adopted worldwide as part of the 'convergence' between the two systems. If that happens, the broader shipping industry will need to adjust to this higher standard.

While it is generally assumed – rightly so – that shipping operates tax-free in global trades, that too is changing. India in particular is becoming more aggressive in levying taxes on international shipping companies (see p24).

Shipping could have more potential

tax liabilities ahead, which could require more disclosures and reserves under FIN 48 – and possibly under IFRS in future. *Fairplay* spoke with experts at Ernst & Young on the implications.

According to E&Y tax services partner Chris Kealy, FIN 48 requires a two-step process. In the 'recognition threshold phase', a company must examine its uncertain tax positions and gauge whether they're acceptable to the Internal Revenue Service.

If the company's chance of having its tax position sustained upon audit is deemed greater than 50%, it must then decide in the 'measurement phase' on how much reserve, if any, to put up to cover that potential liability – and whether to include a footnote to financial statements describing that liability.

If the chance of having the tax position sustained is less than 50%, the company must reserve 100% of the benefit of that tax position and must include

a footnote to its statements. Many companies are uncomfortable with this footnote rule "because it asks taxpayers to lay out all of their uncertain tax positions and the concern is that revenue agents will have a roadmap to where all their risks are", said Kealy.

Asked whether any shipping company has a FIN 48 footnote on its financial statement or has set aside a related reserve, E&Y international tax services principal Tamara Moravia-Israel responded: "I have not seen any shipping company put up reserves. However, many firms go through the [FIN 48] analysis and appropriately find that no reserve is needed."

She explained that a common way to prove no reserve or disclosure is required is via an 'administrative practice' determination. If a shipping company determines that under 'administrative practice', a particular country has never enforced and will not enforce tax rules against shipping companies calling in its ports, this essentially serves as a 'free pass' under FIN 48.

"The problem is when you have a jurisdiction like India that's sending out notices to shipping companies and starting to enforce tax laws at all of its ports," warned Moravia-Israel. "India is the first out of the gate in taking a hard stance."

Future liabilities could eventually spread. "Every country wants to get their piece of the pie and one way to do that is to look at the laws on the books and enforce them, even though they haven't done so in the past through 'administrative practice'," said Kealy.

Currently, the disclosure and reserve mandate only applies to US-listed shipping companies with US GAAP statements. But it could spread worldwide as soon as 2012 if the IFRS adopts a FIN 48-like rule.

The current rule under IFRS "is more of a principle-based than a rule-based standard and companies don't have to disclose as much as under FIN 48", explained Kealy.

It's too early to tell which way convergence of IFRS and US GAAP will lean on the FIN 48 issue. According to Kealy, it would be more favourable for shipping if the final convergence rule retained today's less stringent IFRS regime. **F**



Drydock accounting on the move

DryShips, Paragon, Star Bulk, and Top Ships have all recently changed their accounting of drydockings. **Barry Parker** asks what's driving this trend

Shipping accountants have taken their cue from the airline industry, according to Ernst & Young assurance and business advisory services partner Bruce Baylson.

The impetus is the Financial Accounting Standards Board, the standard-setter for US Generally Accepted Accounting Principles (US GAAP). In 2006, the FASB set accounting guidance initially for airlines, but the implications have extended to maritime.

At issue are expenses for 'planned major maintenance activities', which are carried out during routine vessel drydockings.

"Historically, the shipping companies have capitalised many items," Baylson

explained to *Fairplay*. "The Securities & Exchange Commission, in their review of shipping company filings, have commented that they consider deferred drydock costs as those direct costs you incur solely as a result of the regulatory

Accounting of routine drydockings is moving from the deferral to direct expense method

requirement that a vessel be inspected, as opposed to costs you elect to incur at the time of drydocking out of convenience to your business operations."

"If the expenditure is not adding value to the vessel, or is not extending the life of the vessel, it should be expensed – decreasing income in that month or quarter," Baylson explained.

There are three basic ways to account for these expenses: 'accrual in advance', 'deferral' and 'direct expense' (see table below). The recent shift has been away from deferral in favour of direct expense.

The direct expense method for all expenditures incurred at the time of drydocking simplifies matters because it removes the sometimes tricky judgmental element from decisions on the proper treatment of costs.

Where owners are capitalising drydock costs, they follow the deferral method, amortising costs of a just-completed docking over time, until the next drydocking.

Baylson explained that the third methodology, the accrue in advance method, has not been acceptable under US GAAP since 2006. With this method, anticipated drydocking costs are estimated in advance and expensed over the time until the actual docking.

Irrespective of the accounting treat-

Drydocking accounting methods

How it Works	Accrue in advance	Deferral	Direct expense
	Estimated cost that will be incurred in the future	Actual cost of drydocking, after the fact	Actual cost of drydocking, after the fact
Numerical example	In 1Q06, owner estimates cost for 3Q08 drydocking at \$750,000. Expense spread at \$75,000 over each of next 10 quarters	Vessel drydocked in 3Q08 at a cost of \$1M. Expense spread at \$100,000 over each of next 10 quarters	Vessel drydocked in 3Q08 at a cost of \$1M. Expense of \$1M accounted for in 3Q08
Income statement impact	Expense the estimate, over 30 months, as the reserve is created	Expense item over 30 months from the time of drydocking	Expense item aligns with cash. Expense in the quarter of the actual drydocking
Cash flow impact	Cash outflow at time of drydocking of \$1M – \$250,000 above the original \$750,000 estimate	Cash outflow at time of drydocking of \$1M	Cash outflow at time of drydocking of \$1M
Balance sheet impact	Creates a liability that is built up over drydock cycle	Creates an asset that is amortised down over drydock cycle	No asset or liability related to drydocking

Table: right

The three accounting methods for planned major maintenance are shown here using a 30-month drydocking cycle and \$1M drydocking expense. The accrue in advance method has been unacceptable under US GAAP since 2006. The example given shows how the accrue in advance method commonly underestimated actual costs.

ment, the actual cash flows of drydockings are unchanged: a \$1M dry-docking of a ship means that \$1M of cash will be flowing out of the owner's coffers at the time of the docking.

"If you look at major airlines with big fleets, most of them use the direct expense method for their planned major maintenance activities. When you have large fleets, the direct expense method would typically smooth out the profit-and-loss charges, because in each period, they will be conducting major maintenance activities," said Baylson.

Most shipping companies normally space out their drydockings, a consideration based on regulatory timing, but also a sensible commercial practice.

Shipping's financial statements will show the impact of changes in the method of accounting for planned major maintenance activities. Baylson noted that companies changing their accounting method restate all prior periods to account for drydocking in accordance with the newly adopted method.

According to Baylson, US-based companies listed on the NYSE or NASDAQ would be following US GAAP, while foreign-based companies can choose to follow international rules (IFRS).

US GAAP and IFRS diverge on drydock accounting. For example, under the 'component depreciation' principle of IFRS, the accounting for a second-hand vessel acquired in the midst of a drydock cycle would differ from US GAAP.

Under US standards, a vessel purchased for \$20M would be depreciated over the remainder of its useful life. In contrast, under the IFRS' component approach, the portion of the purchase price representing drydocking costs – for example, \$1M – would be accounted for separately from the cost of the ship.

Therefore, the value assigned to the vessel under IFRS of \$19M will be depreciated over the vessel's remaining useful life, while the \$1M assigned to the value of the drydocking would be amortised over the period to the next drydocking. **F**

How IT keeps shipping's books in order

By embracing information technology, shipping has tapped greater efficiencies in its accounting and tax procedures, **Gregg Miller** reports

FROM accounting software like SAP, to operational software like Veson's IMOS, to web platforms like INTTRA and GT Nexus, e-commerce is making life easier for shipping accountants. Speaking to *Fairplay*, Veson Nautical president John Veson offered numerous examples of IT benefits.

"One issue where there's more scrutiny under Sarbanes Oxley [Public Company Accounting Reform and Investor Protection Act of 2002] is the enforcement of a clear segregation of duties – making sure the person in your organisation that commits you to a certain vendor or

expense is not the same person who approves it and books it down into your financials," he explained.

Veson's software includes an approval mechanism that both establishes an audit trail and ensures there are different access rights for approvals.

Veson also pointed to manpower efficiencies offered by IT and how resources can be reallocated. People who'd previously been focused on laboriously closing their monthly books have more time to "find money" and "catch errors" because software can allow books to be closed within hours.

There's also an accounts receivable benefit to e-commerce solutions, according to John DeBenedette, commercial vp for portal company INTTRA. "If your e-channel includes electronic invoice presentation and payment, you know when your customer received an invoice," DeBenedette told *Fairplay*.

"Simply getting that invoice into the payment stream reliably and predictably can have a huge impact, because some carrier customers are mom-and-pop consolidators and forwarders, while others are giant corporations with their own accounts payable bureaucracies," he continued.

According to DeBenedette, it's more difficult with electronic processing for a customer to respond: "I didn't get the invoice yet" or "I can't find it".

On the taxation front, Veson explained: "There are different tax rules based on different customers and different countries. With technology systems, you can set up specific rules based on what country the counterparty is from, where the vessel is trading, what kind of commodity is being carried. The system can also pull out the information you need to examine tax implications and make sure you're in line from a reporting standpoint."

Looking forward, Veson foresees future applications tied to the burgeoning use of forward freight agreements. Technology will allow shipping companies that hedge freight or bunkers to conduct risk analysis earlier in the process. "This allows better planning decisions and for your cash position to be updated automatically. That's where we're heading and where we will continue to deliver enhancements," affirmed Veson. **F**

John Veson explains how IT solutions allow personnel more time to 'find money'

