Code-Share Income and Article 8: Rethinking Treaty Protections

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A recent decision of the Income Tax Appellate Tribunal in Delta Airlines Inc's case [TS-833ITAT-2024(Mum)] has reignited a debate on the scope of the treaty protection, under Article 8, for the source taxability of airlines' code-sharing income. This analysis proposes to primarily deal with an alternative approach, other than the one taken in this decision, to address this treaty protection controversy. While the subject matter of this analysis is treaty protection for the same income, it traverses a different path.

In the world of air transportation, code sharing is a business arrangement between two or more airlines that market and publish the same flight under their own designator and flight number. The same flight operated by the same airlines thus has two or more different flight numbers, though for different airlines, in the code-sharing arrangements, and both airlines derive income from these arrangements. It can be for a complete route or part thereof. For example, when someone books AI 7569 from New Delhi to Addis Ababa, he actually flies on the Ethiopian Airlines' ET 689. Similarly, when a passenger is booked to travel from Delhi to Lyon on AI 2025 (DEL-FRA) and AI 8582 (FRA-LYS), he actually travels on Lufthansa's LH 1082 on Frankfurt- Lyon sector. As the same airline has code-sharing arrangements with different airlines as well, the same flight is known by several other designators and flight numbers also. For example, Lufthansa's LH 1082, besides being booked as Air India's AI 8582, is also booked as Singapore Airlines' SQ 2182, All Nippon Airlines NH 6131 and Lot Polish Airlines' LO 4857.

The revenues from these code-sharing flights are shared between the airline issuing the ticket and the airline operating the flight in the agreed mechanism. Resultantly, based on the hypothetical assumption of the sale of such tickets by Air India, there may be some income in the hands of Air India on account of code sharing without any operation of aircraft in international traffic in respect of the same. To that extent, there is no issue, as the worldwide income of Air India is taxable in India anyway. There can, however, also be situations in which a foreign airline earns some income from such code sharing and without any operation of aircraft in) international traffic to that extent, and a bit of effort on a web search can demonstrate several such possibilities to you. To give you one example, when I was booking a return flight from Delhi to a major international destination, on a foreign airline, I found my return flight, though with a flight originator and code belonging to that airline, was actually on a domestic airline. The ticket is thus sold by that foreign airline on its flight number, but the travel is on a domestic airline, and the airline's income on this ticket is purely a code-sharing revenue- not from their operation of aircraft in international traffic.

The question that arises for consideration is whether such a code-sharing income can be treaty-protected from source taxation, under Article 8 of the OECD Model Convention, which provides as follows and which is the lowest common factor in most Indian tax treaties:

1. **Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.**
2. **The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.**

In simple words, and reading Article 8(1) and Article 8(2) together, **"the profits of an enterprise of a contracting state from the operations of ships of aircraft in the international traffic, and from the participation in a pool, a joint business or an international agency (in respect thereof), shall be taxable only in the contracting state of which the enterprise is resident".**

It is in this backdrop that one of the questions arising for consideration, apart from the fundamental question of whether the income from code-sharing pooling is an integral part of the profits from the operations of aircraft in international traffic, is whether an airline's codesharing income is an income from the participation in a 'pool' and, as such, treaty-protected under Article 8(2). I will take up this question first, and I must, therefore, begin by examining the legal connotations of the expression 'pool' in the context of Article 8.

While examining the connotations of a legal expression, be that in law or a legal document, it is useful to bear in mind the fact that the principles of legal interpretation, rather than being a brooding omnipotence in the sky, are pragmatic tools of social order and have evolved over the centuries based on pragmatism and a common-sense approach. It is well settled, as noted by Maxwell in Interpretation of Statutes and while elaborating on the principle of noscitur a sociis, that when two or more words which are susceptible to analogous meaning are used together, they are deemed to be used in their cognate sense. Similarly, Broom's Legal Maxims (10th Edn.) observes that "It is a rule laid down by Lord Bacon, that copulatio verborum indicat acceptationem in eodem sensu , i.e. the coupling of words together shows that they are to be understood in the same sense." They take, as it were, their colours from each other, the meaning of more general being restricted to a sense analogous to that of less general. Noscitur a sociis is a broader version of the maxim ejusdem generis. Just as a man is known by the company he keeps, a word may be interpreted with reference to the accompanying words. Words derive colour from the surrounding words, and that is a globally well-accepted approach to legal interpretation.

To understand the connotations of the expression profits from participation in a 'pool', therefore, one has to look at the meaning and the genus of participation in a 'joint business' or participation in 'an international operating agency' in the context of airlines. The highest common factor in these three forms of business is commercial collaboration concerning the line of business of airlines and shipping companies, i.e. operations of ships or aircraft in international traffic. In my humble understanding, every form of commercial collaboration regarding the core business of 'operation of ships and aircraft in international traffic' is covered by the broad scope of 'participation in a pool, a joint business or an international operating agency'. The OECD Model Convention Commentary, which has also been quoted with approval in the UN Model Convention Commentary as well, also highlight this broad coverage of the pool, and that is evident from its observations to the effect that "Various forms of international co-operation exist in shipping or air transport. In this field, international cooperation is secured through pooling agreements or other conventions of a similar kind which lay down certain rules for apportioning the receipts (or profits) from the joint business". The oft referred treaties 'Klaus Vogel on Double Taxation Convention', at page 655, notes, and rightly so, that "The notions of 'pool', 'joint business' and 'international agency', however, cover all forms of cooperation and their enumeration is not exhaustive'. The expression 'pool', thus, is indeed an expression of wide scope and extension beyond the enumerated forms of cooperation.

Viewed from this perspective, code-sharing income is out of a form of international cooperation, it is a form of pooling arrangement, and it is earned based on certain rules of apportioning the receipt in connection with a business operation wherein the airline and its relevant partners jointly play the defined roles in joint furtherance of their business.

While on the subject, it is also important to note that rejecting a narrow approach to the expression 'pool' appearing in Article 8, the Hon'ble Delhi High Court has, in the case of **DIT Vs KLM Royal Dutch Airlines [**TS-5072-HC-2017(Delhi)-O**],** has observed that, **"This Court is of the opinion that a "pool" cannot be stereotyped as the Revenue advocates. The international airline business is a mammoth one; its size is assessed through operations of international airlines in several ways: fleet; cargo handled; passengers handled; countries served; scheduled freight tonne-kilometres (millions) served; profits; market capitalization and employees serving".** There is thus no justification for giving the expression 'pool' a narrow approach. The only thing that must restrict the connotation of 'pool' is the genus to which the expressions 'joint business' and 'international agency' belong, and that is a form of business collaboration – the genus to which these expressions belong.

In **ADIT Vs Delta Airlines Inc [TS-5706-ITAT-2008(Mumbai)-O]**'s case, the treaty protection of codeshare income did come up for consideration, but the treaty protection by the 'pool' clause was not even taken up by the airline. The assessee claimed that the code-sharing income was exempt from source taxation because it was in the nature of 'profits derived' by the airline from**"the operation of ….aircraft in international traffic."** The Tribunal rejected this plea. In a subsequent case of the same assessee [reported as **Delta Airlines Vs ADIT [(2015) 57** [TS-239-ITAT-2015(Mum)-O], the plea of codesharing income being an income from a 'pool' was also taken up before the Tribunal, but rejected by holding that "arrangement does not meet principles of pool arrangement' on the ground that (a) the concept of pool requires more than two persons coming together and combining their resources for a large business; (b) no common funds or resources were contributed to the pool; and (c) the parties have not contributed aircraft to the pool. A very narrow view of the connotations of 'pool' was thus taken.

However, the correctness of these views does not seem to be free from doubts.

Clearly, even two airlines are good enough to form a pool as a form of commercial collaboration, as the concept of pooling, as the Cambridge Dictionary aptly puts it, implies "the act of sharing or combining two or more things", and the proposition that 'pooling requires several (more than two) persons' coming together lacks sound reasons. It is one of the fundamental treaty interpretations that a treaty needs to be liberally interpreted vis-à-vis its objects, and thus, there is no reason to curtail normal meanings of 'pool' in this context. The bilateral code-sharing arrangements will thus also be covered by a pool arrangement, and any restrictive definition thereof will be devoid of any conceptual justification.

Equally un-understandable are the "principles of pool arrangement" propounded in this judgment and the conceptual justification thereof. Contributing funds and resources in a common pool for the use of all the pool members could indeed be one format of pooling the resources, but that is undoubtedly not the only mode of pooling, and as Klaus Vogel quite rightly notes, "the notions of 'pool', 'joint business' and 'international agency', however, cover all forms of cooperation and their enumeration is not exhaustive". If pooling of resources and joint business was the only permissible mode for the protection of Article 8(2), there was no need of additional terms 'pool' and 'international operating agency'. The form of pooling recognised by the Tribunal was only in the nature of joint business, but then clearly, the broad scope of the terminology employed indicates other kinds of pools as well.

It is also not necessary for both or all the parties in an airline pool to contribute aircraft to the pool; even pooling the reciprocal codesharing privileges is a valid contribution to an airline pool. Under the codeshare arrangements, both or all of the airline's parties to such an arrangement allow codeshare flight privileges to each other; it is not one-way traffic. The contribution is thus materially similar and it has a commercial rationale.

As for the interplay between Article 8(1) and Article 8(2), it is essential to remember that the treaty protection is not for the "pool's profits" but for "profit from participation in the pool", and, therefore, while the operation of aircraft in international traffic by the assessee is necessary for treaty protection under Article 8(1), there is no such requirement for treaty protection under Article 8(2). When you are looking at profits from the operation of a pool, which is essentially in respect of the business of operation of aircraft in international traffic- as a code-sharing arrangement inherently is, it is not necessary that the aircraft must be operated by the assessee airline. It is so for the simple reason that what qualifies for treaty protection is a profit from participation in a pool in respect of the business of operating aircraft in international traffic, which essentially has more than one participant, whereas there can only be one airline operating the aircraft. In every airline pool, while the actual aircraft operation can be done by only one airline concerning a flight, what will be eligible for treaty protection will be the profits in the hands of the pool members- which, by definition, are essentially more than one airline.

What emerges from these discussions is that the profits from code-sharing receipts are, on the first principles, covered by the scope of "profit from participation in a pool, a joint business or an international agency" in respect of the operation of aircraft in international traffic, and thus duly treaty-protected against source taxation. One cannot, however, be oblivious to the fact that, as of now, this aspect of the matter is covered against the assessee by a decision of the Income Tax Appellate Tribunal, and unless a Special Bench of the Tribunal or the Hon'ble High Court reverses or overrules it, this decision holds the field. The amounts involved in this dispute may be relatively small, but it involves fascinating issues relating to the treaty interpretation.

In this analysis, for the sake of brevity, I must stand confined to the 'pool' aspect only, rather than extending the analysis to examining the scope of Article 8(1) and the principles governing the treaty interpretation. Let these issues, howsoever critical, be the subject matter of a separate analysis.

However, as is noted earlier in this analysis, the Income Tax Appellate Tribunal, in the judgments reported as **ADIT Vs Delta Airlines Inc** [TS-5706-ITAT-2008(Mumbai)-O] and **Delta Airlines Vs ADIT** [TS-239-ITAT-2015(Mum)-O] had declined treaty protection under Article 8. In a recent judgment of the same assessee for a subsequent assessment year, the Tribunal has reached a different conclusion. The Tribunal did take note of the earlier judgment; it was not even the case of the Tribunal, and rightly so, that this decision was per incuriam, yet the Tribunal proceeded to decide the matter on merits in the light of the principles emerging from some other judicial precedents, including from the Hon'ble jurisdictional High Court. To what extent such decisions may constitute binding judicial precedents is also not free from doubt. As observed by the Hon'ble Bombay High Court, in the case of **CIT v. Sudhir Jayantilal Mulji** [TS-5577-HC-1994(Bombay)-O], a judicial precedent is only **"an authority for what it actually decides and not what may come to follow from some observations which find place therein"** . A view is thus indeed possible that the binding nature of a judicial precedent in the assessee's own case directly on an issue and for the preceding years can hardly be disregarded based on principles emerging from other judicial precedents. A fivejudge bench of the Hon'ble Supreme Court has, as recently as on 6th November 2024 and in the case of **Bajaj Alliance General Insurance Co Ltd** [TS-5256-SC-2023-O]**,** observed that **"If a court doubts the correctness of a precedent, the appropriate step is to either follow the decision or refer it to a larger Bench for reconsideration"** . It is hardly open to a coordinate bench to deviate from a coordinate bench decision except when it is overruled directly or, at least, implicitly. The binding value of a judicial precedent that does not itself follow a binding judicial precedent is rather doubtful, and the Tribunal did decline that in the case of**Mehratex India Ltd vs DCIT** [(2005) 3 SOT 539 (Mum)] and many such other cases. While the recent Tribunal decision in Delta Airlines' case, and very erudite and profound judicial analysis therein, must be a welcome relief to the airlines in question, finding legally sustainable merits in deviating from the coordinate bench decision is quite challenging and walking on thin ice.

To summarise, the source taxation of a foreign airline's codesharing income, though insignificant in quantum, is quite contentious, and it will be fascinating to see how related legal developments, particularly on the treaty interpretation principles- certainly an issue of wide ramifications, unfold in the times to come.