TR 2008/8EC - Compendium

Ruling Compendium – TR 2008/8

This is a compendium of responses to the issues raised by external parties to draft TR 2008/D3 – Income tax: the taxation treatment of ship and aircraft leasing profits under the ships and aircraft articles of Australia's tax treaties

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

Summary of issues raised and responses

Issue No.	Issue raised	Tax Office Response/Action taken
General comments		
1.	Clarification is sought on the application of the PAYG provisions contained in 12-190(1) of the *Taxation Administration Act 1953* to payments made to a non-resident owner of a ship providing shipping services in Australia on a time charter basis.	This Ruling deals with the allocation of taxing right principles for leasing profits derived by a non-resident lessor for the ships and aircraft article and the method of taxation where Australia may tax. It does not deal with the broader administrative obligations which may arise. The matter has been referred to the relevant area within the Tax Office for consideration.
2.	Restrict the application of the Ruling to leasing profits, rather than also providing analysis of the position of non-leasing profits, such as the ordinary international aircraft operations.	The taxing position on leasing profits flows from the broader framework of the ships and aircraft article's allocation of taxing rights. Therefore the two issues are closely linked. It follows that in order to understand how you treat leasing profits under the treaty you first must understand how the ships and aircraft article allocates taxing rights over profits falling within its scope. Therefore the Ruling has not been amended.
3.	Clarification of the meaning of the undefined term 'ship' would be useful.	Given the range of issues already required to be dealt with by this Ruling and this Office's understanding that the meaning of 'ship' is generally understood by the broader shipping sector, clarification of specialist vessels used by the oil and gas sector may be more appropriately dealt with in their own product. The Tax Office will provide consideration to the development of a separate public ruling or determination on this matter.
4.	There is a lack of practical guidance on what is meant by the term 'ancillary'.	The main focus of this Ruling is to set out the broad principles which apply to leasing profits and not to deal with specific issues such as 'ancillary activities'.

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		The Ruling provides an explanation of the meaning of ancillary at paragraph 24 (repeated at paragraph 105) via a principle approach. This principle is supported by details of factors that the Commissioner considers relevant in determining whether the leasing activity is 'ancillary' to the operation of ships or aircraft at paragraph 145. In light of the submissions the Tax Office will examine whether there are appropriate examples to warrant further guidance.
SPECIFIC COMMENTS TO THE BINDING SECTION		
Background		
5.	Paragraph 9 of the draft Ruling makes an inaccurately broad statement in relation to the position supposedly adopted by Australia to 'treat as internal traffic the operation of ships or aircraft even if they are part of a broader international voyage.	The Ruling has not been amended as the submission dismisses Australia's long standing treaty practice to preserve Australia's right to tax the profits from the operation of ships and aircraft confined solely to places in Australia (which includes coastal and continental shelf operations). The 1967 UK agreement was the first treaty to reflect this practice as indicated by the then Treasurer's second reading speech: Under the 1946 agreement - as indeed under our other three agreements with the United States, Canada and New Zealand - the basic principle is that the country of residence of a shipowner, or of an airline company, has the sole right to tax shipping and airline profits. **The new agreement with the United Kingdom continues this as regards profits derived in the course of international traffic but concedes taxing rights to the other country as regards profits from voyages or flights solely between places in that country.** The accompanying explanatory memorandum provides that: A United Kingdom resident, for example, will be exempt from Australian tax on profits that relate to a voyage of a ship between the United Kingdom and Australia. But if a United Kingdom-owned ship makes a voyage solely between Australian ports Australia will be entitled to tax the income arising from that voyage.

		Furthermore Australia's policy to retain its taxing rights over internal traffic is reflected in Australia's reservation to article 8 first lodged to the 1977 OECD Model.[1] To give effect to this policy the Commissioner's interpretive approach has always been to follow the goods or passengers being transported (the 'meat') rather than the ships or aircraft transporting them (the 'metal'). The long standing practice to include paragraph 4 of article 8 to clarify the treatment with respect to carriage is further evidence of the Government's policy position. Therefore Australia's intention has always been to treat as internal traffic the operation of ships or aircraft even if they are part of a broader international voyage.
Standard article		
Bareboat charters		
6.	Brevity of the binding part of the Ruling has compromised clarity of the Ruling at: 6.1) Paragraph 23, with respect to why a bareboat lease is not an 'operation of a ship'. 6.2) Paragraph 24, with respect to the meaning of 'ancillary activities'. The second bulleted point uses the word 'operation' in an inconsistent manner with bareboat lease profits. 6.3) Insert paragraph 108 after paragraph 25 to summarise the view of the ATO. 6.4) Paragraphs 31 and 35, with respect to the treatment of bareboat leases not subject to article 8.	6.1) Paragraph 23 of the Ruling has been redrafted to explain why a bareboat lease is not an 'operation of a ship' and that such leasing profits do not fall within the article 8 unless they are 'ancillary' to the lessor's activities. 6.2) The Ruling has been amended at paragraph 24 by inserting a footnote cross-referencing to paragraph 145 which provides further clarification on the meaning of 'ancillary activities'. The second bullet point to paragraph 24 and paragraph 105 of the Ruling were amended as suggested. 6.3) The Ruling has not been extended as the Commissioner considers that repeating paragraph 108 did not provide additional clarity to the Ruling. 6.4) Paragraphs 31 and 35 of the Ruling provide positive statements that only those bareboat leases which are 'ancillary' to the lessor's ship or aircraft 'operations' fall within the scope of article 8. The Commissioner considers that the inclusion of a statement that 'bareboat activities that are not ancillary are not subject to article 8' did not provide additional clarity to the Ruling.

[1] Reservations to the OECD Model Convention were required to be lodged for the first time with the publication of the 1977 OECD Model Convention. Prior to the publication of the 1977 Model most treaties were based on the 1963 OECD Draft Model Convention which due to its draft form countries were not required to lodge reservations to signify policy departures.

Paragraph 1 – application to transport activities only		
7.	The origin of the Ruling's position that paragraph 1 of the standard article only applies to 'transport operations' should be made clear.	The Ruling has been amended by inserting an additional footnote to paragraph 20 to clarify the link.
Paragraph 2		
Internal leg of an international voyage		
8.	The internal leg of an international voyage should not fall within the scope of paragraph 2 of the 'standard article' (standard article, as outlined in paragraph 12 of the draft Ruling). The reasons provided in submissions include: 8.1) Paragraphs 1 and 2 of the standard article are mutually exclusive in their application to transport-related activities. 8.1) Inconsistent with the ordinary meaning of the phrase 'confined solely'. 8.1) The TR relies upon distinguishing the word 'operations' in paragraph 2 from the word 'operated' in the definition of 'international traffic'. The submission maintains there is no substantive difference in the meaning of either word. 8.1) The TR's view of the scope of paragraph 2 of the standard article is inconsistent with the context of the scope of paragraphs 1 and 4. 8.1) The need for apportionment of expenses (employee costs, fuel etcetera) undermines the characterisation of the internal leg as a 'sole' operation.	These comments are based on misunderstandings as to the interpretive approach taken and the interaction of the respective paragraphs. The positions taken in the Ruling are based on the ordinary meaning of the words and the phrases used in paragraph 2 of the standard article, taking into account the context of the paragraph in terms of the rest of the article and the rest of the tax treaty. In response to the issues raised in the submission's supporting arguments it is noted that: Points 8.1), 8.2) and 8.3) Paragraphs 1 and 2 of the standard article are not mutually exclusive as differences in the use of words between the two paragraphs provide for a difference in the interpretive focus of the paragraph. This difference is explained in paragraph 118 of the Ruling. The reference in paragraph 2 of the standard article to 'confined solely' is in respect of the 'operations', not the 'ship or aircraft' as occurs in respect of paragraph 1 of that article. Therefore the distinction is between where 'a ship or aircraft' is operated solely between places and where 'ship or aircraft operations' are confined solely to places. There is a substantive difference between the two. The first reference focuses on the ship or aircraft (that is, the 'metal') while the second focuses on the operations (the transport of goods, people or non-transport activity etcetera, that is, the 'meat'). The fact that there is a substantial difference between the two is reflected in Australia's reservation to Article 8 of the OECD Model. Point 8.4) As indicated under item 1 above, paragraphs 1 and 2 of the standard article have a different focus and therefore paragraph 2 is not

		inconsistent with paragraph 1. Paragraph 4 of the standard article is included to inform the scope of paragraph 2 to the extent that the relevant profits are from transport, so it cannot be inconsistent with the scope of either paragraph 1 or 2. The role of paragraph 4 is discussed further at issues 23 and 24 of the Compendium. Point 8.5) The requirement is that the activities be sufficient to constitute an identifiable and separate operation in that State. Apportionment recognises the business reality that expenses can be incurred for a variety of purposes; including for domestic and international purposes.
9.	The draft Ruling incorrectly focuses on 'operations' of the lessee rather than those separate activities of the lessor. In doing so it adopts an unreasonably narrow interpretation of 'operations'. Submit that the term should be interpreted widely to include such matters including but not limited to (i) negotiation of the lease (ii) aircraft ownership/financing (iii) aircraft maintenance (iv) cabin crew and technical crew employment and management (v) aircraft scheduling and network management (vi) fuelling (vii) insurance and (viii) potentially catering. Consequently the leasing profits of a non-resident lessor should not be subject to source taxation in Australia unless all these relevant operational activities take place in Australia.	Consistent with the Commissioner's view that the full basis lease involves the provision of a service, the predominant activities to be considered in determining whether the profits of the lessor are derived from ship or aircraft operations confined solely to places in that State are those activities relating to the actual provision of the service, rather than activities concerning the leasing contracts themselves. See paragraphs 115 and 139 of the Ruling.
10.	Where the relevant 'operations' of the non-resident lessor are interpreted primarily on the actual flight activities and passenger/cargo movements, it cannot be said that the domestic leg relates to 'operations confined solely to places in Australia' where there are continuing international passengers and cargo.	The view expressed in the submission is consistent with the alternative view contained in the Ruling. The Commissioner has not adopted such a view because it is inconsistent with the interpretation of the specific words of paragraph 2 of the standard article (see paragraph 118 of the Ruling).
Non-transport operations (generally)		
11.	Paragraph 2 of the standard article should not apply to non-transport operations.	This is a policy matter.

12.	The Ruling should clarify the scope of 'non-transport operations' in respect of aircraft operations by describing the type of operations that may constitute non-transport activities.	The Ruling has been amended to include additional examples of non-transport activities (aerial advertising and aerial spotting) at paragraph 123. Note the Ruling provides explanation of the scope of non-transport operations in respect of non-transport aircraft activities through the examples at paragraph 123 of the Ruling of crop dusting and surveying when read in conjunction with paragraphs 124 to 129 of this Ruling.
13.	Amend the comments to paragraph 2 such that the paragraph only applies to non-transport activities where explicitly included in the specific treaty being considered rather than interpreting treaties on a generic or general basis. The draft Ruling inappropriately ignores the reference to 'transport' in the heading of the article in extending its application to non-transport activities. The submission compares the UK treaty to the 1976 Netherlands treaty and argues that the article heading to the Netherlands treaty limits the scope of the article to 'transport' activities.	The Commissioner considers that the inclusion of the word 'transport' in the article heading does not set boundaries around the scope of activities which will fall under the article. Normal treaty interpretive principles apply which require a 'holistic' approach to the interpretation of the relevant treaty. It is necessary to examine the other things that the article does. In this case, regard must be had to Australia's long standing practice to preserve source taxation rights over the profits from internal ship and aircraft operations, which include not just transport activities but also non-transport activities. This practice is reflected in Australia's reservation to Article 8 of the OECD Model. In contrast to Australia's reservation (supported by the words of the treaty), the heading is a very short description of the article which may change from treaty to treaty to accommodate other countries practices. In addition, other provisions of the relevant treaty need to be considered. For example, the application of paragraph 6 of article 8 (ships and air transport) of the 1976 Netherlands agreement to restrict the limitation of the rate of tax charged for internal profits to 'internal transport activities' provides clear evidence of the intention of the article to deal with both transport and non-transport ships and aircraft activities. The explanatory memoranda to the 1976 Netherlands, 1977 Belgium and 1980 Swiss article 8 treaty arrangements refer to 'traffic' rather than 'transport'. In the absence of an express inclusion in these treaties to limit the term 'international traffic' to transport it is considered that the intended scope of the article is to cover any 'movements by ship or aircraft'. Therefore the Commissioner considers that both transport and non-transport activities are within the scope of article 8 in the respective treaties.

		The following is an extract from the 1976 Netherlands tax treaty explanatory memorandum: Under this article the right to tax profits from the operation of ships or aircraft in international traffic, including profits received through participation in a pool service, in a joint transport operating organisation or in an international operating agency, is reserved to the country of residence of the operator. However, any profits derived by a resident of one country from internal traffic in the other country may be taxed in that other country. In such cases, the tax shall not exceed 5 per cent of the net amount paid or payable in respect of carriage in internal operations. By reason of the definition of "Australia" in article 3 and the terms of paragraph (4) of article 8, any shipments by air or sea from a place in Australia to another place in Australia, its continental shelf or external territories are to be treated as forming part of internal traffic.
Ancillary operations		
14.	The treatment of 'ancillary' activities that fall under both paragraphs 1 and 2 should be clarified, to provide guidance on which paragraph should prevail.	The Ruling provides guidance on which paragraph should prevail at paragraph 147.
Relationship with domestic law – source of income		
15.	Clarify the relationship between the article and the domestic law and express the paramount effect of the domestic law in particular while the treaty may allocate a taxing right the income may not be taxable under domestic law.	The submission has not considered the application of the treaty source rules. These special source rules (included in most of Australia's treaties) deem income to be sourced in Australia (for treaty and domestic tax law purposes) where the treaty permits Australia to tax such income as the country of source. Further explanation of the treaty source rules is not necessary as their application is relatively straight forward. However, a number of the explanations of the Examples in the Ruling have been amended to provide further guidance on the application of these treaty source rules.

Part D: method of taxation in Australia		
16.	The Ruling should clarify that the mere application of the standard article does not mean that a foreign enterprise would necessarily be taxed on Australian-sourced leasing profits as ordinary income, particularly where there are a chain of leases.	This Ruling deals with the allocation of taxing right principles for the ships and aircraft article. It does not deal with the question of who is in and who is out in respect of chains of leases. These issues are dealt with in other Rulings (that is, TR 2006/1 at paragraphs 68 to 71 and TR 2007/10 at paragraphs 28 and 129 to 132).
17.	The Ruling should provide more guidance on how to calculate assessable income particularly where the voyage is partly in Australia. For example it was suggested that a statement could be inserted that a time basis of apportionment is acceptable and be consistent with paragraphs 105 and 106 of TR 2006/1.	New paragraph 211 has been inserted in the Ruling to provide further guidance.
Examples		
18.	Provide an example (similar to example 4) to contrast between bare boat and ancillary bareboat charters.	Such an example is outside the scope of the Ruling. Also see comments to issue 4.
19.	Provide a further example of the priority of the ships and aircraft article over the royalties article where Australia is prevented from taxing the bareboat leasing profits of the non-resident.	The Ruling has not been extended because the inclusion of such an example is unlikely to provide further clarification. This issue is dealt with by paragraphs 54 and 202 of the Ruling which make it clear that the ships and aircraft article should take priority over the royalties article unless there are clear words to the contrary in the relevant treaty.
20.	The Ruling needs to be extended to deal with more complex (non-transport) shipping leasing arrangements commonly encountered in the oil and gas industry. For example: • ships to conduct seismic operations or geological data processing • ships to perform sub sea operations such as pipe laying, ROV operation, inspections and maintenance • converted tankers which perform production, storage and offloading, and • ships that mobilise and demobilise drilling rigs and	The scope of the Ruling is to deal with leasing profits, so to the extent that such specialised services are provided as part of a wet lease of the vessel, the Ruling provides guidance as to whether Article 8 applied to leased ships that are used for transport or non-transport activities. However, the complex nature of bundled specialised service arrangements using ships in the oil and gas sector are beyond the scope of this Ruling and may be more appropriately dealt with by private ruling or tax determination. In light of these comments and those at issue 15 of the Compendium changes have been made to relevant examples in the Ruling to provide greater clarity through the distinction between the lessor profits and the profits of the lessee.

	other forms of equipment.	
Date of effect		
21.	The Ruling should apply prospectively from the date of issue on the basis that some of the views, in particular including non-transport activities within the scope of paragraph 2, represent a shift in previous interpretation and application of the article.	There has been no change in the Commissioner's view on the application of the ships and aircraft article to non-transport activities. Refer to the comments to issue 11 of the Compendium.
NON-BINDING SECTION		
Ancillary activities – benchmarks		
22.	The provision of 'safe harbour' benchmarks similar to the example at paragraph 59 throughout the Ruling will improve practical compliance especially by small to medium sized enterprises. Regard should also be had to the volatility of the airline industry such that short term leases for excess capacity is often required and a normal part of airline operations.	The Ruling has already identified a number of areas where it was appropriate to provide 'safe harbour' benchmarks, that is, paragraph 127 and the examples at paragraphs 59 and 62 (ancillary), paragraph 145 (operations) and paragraph 147 (ancillary to an internal leg). However, because of the broad nature of ship and aircraft operations and related activities it was considered that other issues needed to be dealt with on a case by case basis according to their particular facts and circumstances. Accordingly, it is not considered feasible to provide further 'safe harbour' benchmarks in this Ruling particularly of a single metrics nature. Volatility of an industry does not, of itself, determine whether a particular activity is ancillary to the main activity of an enterprise. An activity will be an ancillary activity if it satisfies the tests stated in paragraph 24 of the Ruling having regard to the factors considered relevant to this question listed at paragraph 145.

Paragraph 4 – application to internal leg of an international voyage		
23.	Paragraph 4 may apply to a 'voyage to nowhere', but not necessarily to the internal leg of an international voyage. The draft Ruling is consistent with the views contained in the submission. However, the draft Ruling should: a) more clearly state the requirements of paragraph 4 b) discuss circumstances when paragraph 4 doesn't apply (passengers transiting through Australia or uploaded o/s or discharged o/s), and c) provide further examples or examples 3-5 consider the application of paragraph 4.	This Ruling deals with the allocation of taxing right principles for leasing profits derived by a non-resident lessor for the ships and aircraft profits article and the method of taxation where Australia may tax. The Ruling provides that paragraph 4 of the standard article does not apply to leasing arrangements as they are a provision of a service and not carriage. Therefore a fuller explanation of paragraph 4 and further examples is beyond the scope of this Ruling. The Ruling's discussion on the broader framework of the ship and aircraft article's allocation of taxing rights, including the application of paragraph 4, is to assist in understanding the treatment of leasing profits under the treaty. However, in most cases the application of paragraph 4 of the standard article is clear. It is likely that any need for further elaboration would be driven in part by unique facts. Such cases are more appropriately addressed by private ruling.
Application to paragraph 4 and its interaction with paragraph 2 – broader application of Article 8 to profits from transport		
24.	Paragraph 121 suggests that all profits attributable to a domestic leg of an international flight are subject to source country taxation. The profits falling within paragraph 2 should be those 'domestic only' passengers who both board and disembark in the same country.	Paragraph 121 of the Ruling has been substantially amended to address this matter in order to provide greater clarification.

Part C: priority of ships and aircraft article over:		
Business profits		
25.	Further clarification of the application of the priority and the authority on which the ATO bases its conclusions. Explain what is meant by the term 'dealt with'. The submission states: Where two treaty Articles give two different results, it is necessary to determine which has precedence. As the Business Profits Article is not at odds with paragraph 2 of the Ships and Aircraft Article (because it simply says a country 'may' tax certain profits), it is not clear why the Business Profits Article should not apply.	It is noted that paragraphs 52 and 193 of the Ruling provide an explanation of the term 'dealt with'. The Commissioner considers that there is no need to provide further explanation of the priority rules. The submission's statement is based on an incorrect understanding of how the priority rule in the Business Profits Article applies (usually Article 7(6)). The rule is not based on an inconsistency existing between Article 7 and Article 8, but rather is based on whether Article 8 'deals with' the income, and if it does, Article 7 has no application. The Ruling's position is supported by paragraph 35 of the OECD Commentary to article 7 which provides that where profits fall within the scope of both the business profits article and another specific article of the treaty the priority rule gives first preference to the specific article. It also makes it clear that those profits may be taxed either separately or as business profits under either article in conformity with domestic laws. This is because at a practical level it makes no difference which article it is taxed under.
Royalties		
26.	While supporting the Ruling's conclusion that the standard article should prevail over the royalties article the submission suggests the reasoning should be made clearer. The submission considers that the Vienna Convention may offer support to the approach taken in the Ruling. In particular, article 31(1) of the Vienna Convention requires a treaty to be interpreted in accordance with its context, purpose and objects, and therefore justifies an approach to treaty interpretation whereby the scope of each provision is ascertained by reference to the context of that provision in light of the treaty as a whole.	Given the range of issues already required to be dealt with by this Ruling the Commissioner considers that including a reference to TR 2001/13 which sets out this Office's treaty interpretation principles is the best way to address this issue. However, the reference at paragraph 197 of the Ruling has been amended to assist users of this Ruling.

Areas of the Ruling receiving no substantive comments		
		No substantive comments were received in respect of 'Part B: the treatment of leasing profits under non-standard ships and aircraft articles' to the Ruling.