TR 2006/D8 - Income tax: the treatment of shipping and aircraft leasing profits of United States and United Kingdom enterprises under the deemed substantial equipment permanent establishment provision of the respective Taxation Conventions

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Draft Taxation Ruling

Income tax: the treatment of shipping and aircraft leasing profits of United States and United Kingdom enterprises under the deemed substantial equipment permanent establishment provision of the respective Taxation Conventions

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This Ruling provides you with the following level of protection:

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What this Ruling is about

Class of entities

1. This Ruling applies to:

   (i) enterprises of the United States (US) for the purposes of the 1982 Tax Convention with the United States[1] as amended by the 2001 Protocol (the US Convention); and

   (ii) enterprises of the United Kingdom (UK) for the purposes of the 2003 Taxation Convention with the United Kingdom[2] (the UK Convention),

that lease out ship(s) or aircraft where the leasing out of the ship(s) or aircraft may result in these enterprises having a substantial equipment permanent establishment in Australia in accordance with Article 5(4)(b) of the US Convention or Article 5.3(b) of the UK Convention.

[1] International Tax Agreements Act 1953 Schedule 2.
[2] International Tax Agreements Act 1953 Schedule 1.

Scheme

2. This Ruling applies in relation to leases under which the paramount purpose is for the hire of a ship or aircraft.

3. This Ruling distinguishes such leases from those leases under which the paramount purpose is for the purchase of the equipment concerned and that contain financing elements as part of the agreement. These latter leases are excluded from the substantial equipment provisions of the Permanent Establishment Article (Article 5) of the respective Conventions.

4. This Ruling applies to leases of ships or aircraft that do not fall for consideration under the Shipping and Aircraft Article (Article 8) of the respective Conventions.[3] These articles apply to certain 'full basis' and 'bareboat basis' leases relating to the operation of ships or aircraft.

5. This Ruling does not apply to voyage charterparties. A voyage charterparty is a carriage, and is not a lease for the purposes of the Business Profits Article (Article 7) and Article 8 of the respective Conventions. The charterer under a voyage charterparty does not obtain possession of the ship or have the ship at its disposal.[4]

Issues discussed in this Ruling

6. In respect of profits derived by a US or UK enterprise from the shipping or aircraft leases to which this Ruling applies, this Ruling explains the circumstances under which those profits will fall outside Article 8 and be considered under Article 7 of the respective US and UK Conventions. For those profits that fall under Article 7, this Ruling explains the circumstances under which Australia will have a taxing right under Article 7 because the US or UK enterprise has a permanent establishment in Australia to which those profits are attributable.

7. The explanation in this Ruling firstly identifies what types of shipping and aircraft leases are the subject of an Australian taxing right under Article 7 of each Convention.

8. The Ruling then addresses a number of issues concerning the relevant permanent establishment provisions of Article 5 of the respective Conventions. The major focus of the Ruling, in relation to the leasing profits that are the subject of this Ruling, is whether:

- the lessor 'maintains substantial equipment for rental or other purposes within the other State (excluding equipment let under a hire–purchase agreement) for a period of more than 12 months' (see Article 5(4)(b) of the US Convention and Article 5.3(b) of the UK Convention); and

[3] Paragraph 6 of Article 7 in both the US and UK Conventions provide an ordering rule that gives Article 8 priority over Article 7.
[4] For further explanations of the character of a voyage charterparty, see paragraphs 13, 22, 34-40 of Taxation Ruling TR 2003/2.

- the lessor is subject to an Australian source country taxing right under Article 7.

9. The Ruling addresses separately any differences between Articles 5(4)(b) and 5.3(b) and their operative effect on Australia's taxing rights under the respective Articles 7.

10. For completeness, other aspects of Article 5 that are relevant are also addressed in the Ruling.

11. The Ruling does not address situations where an enterprise of Australia leases out ships or aircraft and the issue arises as to whether it is deemed to have a substantial equipment permanent establishment in the US or UK.

12. This Ruling has no application to tax treaties concluded by Australia with countries other than the US and the UK.

Background – commercial terms

Meaning of 'full basis' and 'bareboat basis' leases

13. Various commercial arrangements are entered into in the shipping and airline industries and the terminology used to describe the arrangements differs between the industries. The concepts of full basis and bareboat leases in the OECD Model Tax Convention on Income and on Capital (OECD Model) and the US and UK Conventions are more general concepts that provide a broad principle that can be applied to the various industry specific arrangements. The concept of a 'lease' in this context is therefore considered to be a broad one, as opposed to any strict legal or specific domestic tax law meaning of lease.

14. A lease of a ship or aircraft on a *full basis* (also generally referred to as a 'time charterparty' in the shipping industry and as a 'wet lease' in the airline industry) basically refers to the charter of a ship or aircraft with the captain and crew. Consistent with paragraph 5 of the OECD Model Commentary on Article 8, the Explanatory Memorandum to the International Tax Agreements Amendment Bill 2003 (UK Explanatory Memorandum)[5] explains that a full basis lease is one that is 'fully equipped, crewed and supplied'. Conversely, a *bareboat* lease (also generally referred to as a 'demise' or 'bareboat charterparty' in the shipping industry and as a 'dry lease' in the airline industry), basically refers to the charter of a ship or aircraft generally without the captain and crew.[6]

[5] See paragraph 1.99.
[6] See paragraph 2.13 of the Explanatory Memorandum to the 2001 US Protocol which refers to a bareboat lease as being 'generally, without crew'.

15. A full basis lease involves a situation where a lessee wishes to have a ship or aircraft for its use for a given period of time, but has no wish to operate the ship or aircraft itself. The owner of the ship or aircraft provides the captain, crew (who remain its servants) and equipment and the owner is responsible for the technical operation and navigation of the ship or aircraft. The lessee pays hire to the owner in order to have the ship or aircraft at its disposal for the specified period of time. The lessee therefore obtains the right to commercially exploit the carrying capacity of the ship or aircraft for its own purposes.

16. A bareboat lease involves a situation where a lessee wishes to take a ship or aircraft and to treat it as its own for a certain period of time. The ship or aircraft will usually, but not invariably, be leased without captain and crew. The practical effect, however, is the same whether the ship is actually leased with or without captain and crew, because in both situations the lessee obtains control of the captain and crew under the lease (that is they are the servants of the lessee, not the owner). The owner of the ship or aircraft also transfers the possession and navigation of the ship or aircraft to the lessee.

Ruling

Leasing Profits falling within the scope of Article 7 of the US Convention

17. Article 7 of the US Convention applies to profits of US enterprises as lessors from the following ship and aircraft leases:

- a full basis lease where the ship or aircraft is not operated in international traffic by the lessee;
- a full basis lease where the ship or aircraft is operated in international traffic by the lessee, provided that the US lessor:
  - (i) either does not operate ships or aircraft or only operates them solely between places in Australia; and
  - (ii) does not regularly lease ships or aircraft on a full basis; and
- a bareboat lease which is not 'merely incidental' to the US lessor's operation of ships or aircraft in international traffic.

18. Profits of a US enterprise lessor from one of the above types of leases of a ship or aircraft may be taxed in Australia under Article 7 as profits from the carrying on of a business through a permanent establishment situated in Australia where:

- the ship or aircraft is leased through an office, dependent agent or other permanent establishment within the meaning of Article 5, other than subparagraph (4)(b) of that Article, of the enterprise in Australia; or

- subparagraph (4)(b) of Article 5 applies in relation to the enterprise because the lease is essentially for hire of the ship or aircraft, and the ship or aircraft is substantial equipment which the enterprise maintains within Australia for a period of more than 12 months.

Leasing Profits falling within the scope of Article 7 of the UK Convention

19. Article 7 of the UK Convention applies to a bareboat lease of a ship or aircraft where the lease is not 'directly connected or ancillary' to the UK lessor's operation of ships or aircraft in international traffic.

20. Profits derived by a UK enterprise lessor from the above type of lease of a ship or aircraft may be taxed in Australia under Article 7 as profits from the carrying on of a business through a permanent establishment situated in Australia where:

- the ship or aircraft is leased through an office, dependent agent or other permanent establishment within the meaning of Article 5, other than subparagraph 3(b) of that Article, of the enterprise in Australia; or
- subparagraph 3(b) of Article 5 applies in relation to the enterprise because the lease is essentially for hire of the ship or aircraft and the ship or aircraft is substantial equipment which the enterprise maintains within Australia for a period of more than 12 months.

Meaning of 'merely incidental' and 'directly connected or ancillary'

21. The expression 'merely incidental' in Article 8(1)(b) of the US Convention and the expression 'directly connected or ancillary' in Article 8.3 of the UK Convention achieve the same operative effect. The expressions determine whether a bareboat lease falls outside the scope of Article 8 and into Article 7.

22. Article 7 applies to bareboat leases that are not 'merely incidental' (in the case of the US Convention) or that are not 'directly connected or ancillary' (in the case of the UK Convention) to the US or UK lessor enterprise's international traffic operations.

23. Therefore, Article 7 will be the applicable Article where the US or UK enterprise does not operate ships or aircraft in international traffic itself, or if it does undertake such operations, its bareboat leasing activity:

- is not carried on primarily for the purpose of its own shipping or aircraft transportation operations; and
- makes more than a minor contribution to its overall international traffic operations; or

- amounts to a separate source of income or separate business operation.

Meaning of 'maintains …for rental or other purposes'

24. The expression 'maintains … for rental or other purposes' in Article 5(4)(b) of the US Convention and Article 5.3(b) of the UK Convention applies to situations where a US or UK lessor enterprise has a ship or aircraft within Australia for the requisite time period by reason of the lease or for leasing or other commercial purposes, including times during that period when it has the ship or aircraft available for such purposes. See paragraph 30 to 32 of this Ruling for the requisite time period.

Meaning of 'substantial equipment'

25. Whether an item is 'substantial equipment' for the purposes of Article 5(4)(b) of the US Convention and Article 5.3(b) of the UK Convention is a question of fact and degree to be determined on balance, according to the facts and circumstances of each particular case. Equipment can be substantial in either:

- an absolute sense, that is, when viewed independently; not in comparison with something else; or
- a relative sense; that is, by comparing it to something else.

26. The Commissioner considers that it would be extremely rare for a ship or aircraft not to be substantial equipment for the purposes of Article 5(4)(b) of the US Convention and Article 5.3(b) of the UK Convention. By reason of their size alone, ships or aircraft would be expected to constitute substantial equipment in an absolute sense.

The scope of the 'hire-purchase exclusion'

27. The term 'hire-purchase agreement' in Article 5(4)(b) of the US Convention and Article 5.3(b) of the UK Convention is interpreted in a manner consistent with the fundamental distinction between lease agreements under which the paramount purpose is purchase and those under which the paramount purpose is hire. A 'hire-purchase agreement' therefore includes an agreement that:

- has an option to purchase with a financing element and where the purchase of the equipment is paramount;
- is for the effective life of the equipment and there is a financing element present; or
- is a terms purchase or instalment sale with a financing element present.

28. As a result, where a ship or aircraft is leased under the above types of agreements, the leasing profits will not give rise to a deemed permanent establishment under Article 5(4)(b) of the US Convention and Article 5.3(b) of the UK Convention. Unless a permanent establishment otherwise arises, the interest component arising from these types of leases is dealt with under Article 11 of the respective Conventions.

29. Where a US or UK lessor has a permanent establishment in Australia under another provision of Article 5, for example Article 5(1), then Article 11(6) may apply such that the interest component is dealt with under Article 7 of the respective Conventions.

The time threshold test – 'period of more than 12 months'

30. The time threshold test in Article 5(4)(b) of the US Convention and Article 5.3(b) of the UK Convention of maintaining substantial equipment within Australia for a period of more than 12 months will be met where the equipment is physically present within Australia for a 'continual' period in excess of 12 months. Temporary interruptions where the ship or aircraft is taken outside of Australia for repairs, maintenance or other natural incidents of business will not constitute a break in the continuity of the period of the equipment being maintained within Australia. The time in which the ship or aircraft is maintained within Australia, both before and after the temporary interruption, is added together for the purposes of calculating the 12 month period.

31. The calculation of the time period will not be broken where a leased ship or aircraft has to be replaced due to natural incidents of business, such as an accident that damages or destroys the leased ship or aircraft.

32. The time threshold test will also be satisfied where a US or UK lessor enterprise leases a number of different ships or aircraft (as opposed to the exact same single ship or aircraft) within Australia, as long as collectively the different ships or aircraft are physically present in Australia for a continual period of more than 12 months.

The lack of express deeming to 'carry on business through that permanent establishment' in Article 5(4)(b) of the US Convention

33. A US lessor that is deemed to have a permanent establishment in Australia under Article 5(4)(b), must also satisfy the condition in Article 7(1) that it is carrying on a business in Australia through that deemed permanent establishment. Whether this will be the case, is a question of fact and degree to be determined on balance according to the facts and circumstances of each particular case.

34. Based on the indicators identified by Australian courts for determining what constitutes carrying on business, the Commissioner considers that a US enterprise leasing a ship or aircraft will almost always be found to be carrying on business.

35. Under Article 5(4)(b), the permanent establishment is the 'activity' of maintaining a ship or aircraft for rental or other purposes within Australia (as opposed to being 'a fixed place of business' permanent establishment as is the case under Article 5(1)). Therefore a US lessor will be carrying on business 'through' its deemed permanent establishment in Australia for the purposes of Article 7(1) because:

- the business carried on by the US lessor is the leasing of ships or aircraft; and
- this leasing business is carried on 'through' the activity of maintaining ships or aircraft for rental purposes within Australia (the deemed permanent establishment).

Examples

Section A: The US Convention: Full basis leases

Example 1: Full basis lease of a ship by an international ship operator, and lessee uses ship exclusively within Australia

36. Americo is a US enterprise that operates ships for carriage of cargo between the US and Australia. Its shipping operations are controlled from its headquarters in Houston, Texas, and it acts in Australia through independent shipping agents.

37. Whilst one of its ships is docked in Sydney, Americo advertises the ship as available for lease on a full basis. After 3 months of advertising, the ship is leased out on a full basis for a period of 10 months and is used by the lessee for that period exclusively in the Australian coastal trade.

38. Article 7 of the US Convention applies in relation to the profits Americo derives from the lease because the ship is not operated in international traffic by the lessee.

39. Therefore, if Americo has a permanent establishment in Australia under Article 5, Australia will have a taxing right under Article 7(1) in respect of Americo's leasing profits that are attributable to the permanent establishment.

40. The facts indicate that Americo does not have a fixed place of business or dependent agent, within the meaning of Article 5, in Australia. However, Americo is deemed by Article 5(4)(b) to have a permanent establishment in Australia because Americo *maintains* the ship *for rental or other* purposes within Australia for a period of 13 months. The 3 months during which it is advertised for lease in Sydney, as well as the 10 month lease period are considered to be time that the ship is maintained within Australia for rental or other purposes.

41. Americo will satisfy the conditions for Australia to have a taxing right under Article 7(1) because it is carrying on a business in Australia through the deemed permanent establishment. The permanent establishment is the activity of maintaining a ship in Australia for rental purposes. Americo is in the business of maritime transportation and is carrying on that business through the act of leasing the ship in Australia. As Article 7 applies, Australia's taxing rights are preserved in respect of Americo's leasing profits that are attributable to the permanent establishment.

Example 2: Full basis lease of a ship by an international ship operator, and lessee uses ship in international traffic

42. The facts are as in Example 1 except that the ship is used by the lessee exclusively in international traffic.

43. Article 7 does not apply in respect of the profits derived by Americo from the lease because the ship is operated in international traffic by the lessee and Americo operates ships otherwise than solely between places in Australia. Accordingly, the application of Article 8 will need to be considered.

Example 3: Full basis lease of a ship by an enterprise not engaged in shipping operations nor regular full basis leasing activity, and lessee uses ship in international traffic

44. Eagleco is a US enterprise in the business of building and selling ships. Eagleco encounters some difficulty selling one of its ships. As a result, on one particular occasion Eagleco agrees to lease the ship on a full basis instead of selling it. The ship is used by the lessee for voyages between Australia and the US for a period of 18 months.

45. Even though the lessee operates the ship in international traffic, Eagleco's leasing profits fall within the scope of Article 7 because Eagleco is not in the business of operating ships itself and Eagleco does not regularly lease out ships on a full basis.

46. Article 5(4)(b), however, does not deem Eagleco to have a permanent establishment in Australia in respect of the leasing profits because the use of the ship by the lessee exclusively in international traffic means that the ship is not maintained by Eagleco within Australia for rental or other purposes during the period of the lease.

47. Therefore, Australia will not have a taxing right under Article 7 over the profits from the full basis lease of the ship by Eagleco, unless Eagleco has a permanent establishment in Australia by way of a fixed place of business or dependent agent under Article 5 and the leasing profits are attributable to that permanent establishment.

Section B: The US Convention: Bareboat leases

Example 4: International ship operator who regularly leases ships on bareboat basis – whether such leasing activity is merely incidental to its other ship operations

48. Marineco is a US enterprise that operates ships for carriage of cargo between the US and Australia. The ships that Marineco uses for this purpose are leased from another US enterprise under long-term leasing arrangements.

49. Marineco also regularly sub-leases its ships on a bareboat basis to other shipping operators. The extent of this sub-leasing depends on the level of demand from the international shipping operations, but usually represents around 25% of its operations. The ships are berthed at their home port in the US when not being utilised by Marineco for its transport operations or under sub-lease to other operators.

50. Marineco is approached by another company on 1 January 2004 whilst one of its ships is tied up in Sydney seeking to sub-lease the ship. The sub-lease negotiations and formalities take a month to complete, during which time the ship remains tied up in Sydney. It is then sub-leased out on a bareboat basis for a period of 12 months from 1 February 2004.

51. The regularity and extent with which Marineco sub-leases out its ships on a bareboat basis means that the sub-lease is not 'merely incidental' to its international shipping operations. Therefore the profits from the sub-lease are not within the scope of Article 8 and Article 7 applies.

52. Australia will have a taxing right under Article 7 in respect of the sub-lease profits if the ship was sub-leased through a fixed place of business or dependent agent, within the meaning of Article 5, in Australia of Marineco.

53. If that is not the case, Australia will have a taxing right in respect of those profits under Article 7 only if the profits are attributable to a permanent establishment which Marineco is deemed to have in Australia through the operation of Article 5(4)(b). This in turn will be dependent on the use of the ship by the sub-lessee.

54. If the ship is used by the sub-lessee exclusively in international traffic, Marineco will not have a deemed permanent establishment in Australia because it will not satisfy the time threshold requirement in Article 5(4)(b) as it will have only maintained the ship for rental purposes within Australia for the month when the ship was tied up in Sydney. Alternatively, if the ship was used by the sub-lessee exclusively within Australia, Marineco will meet the time threshold in Article 5(4)(b) for the combined 13 month period, being the month in Sydney and the 12 month period of the sub-lease.

Section C: The UK Convention: Full Basis Leases

Example 5: Full basis lease of an aircraft by an international aircraft operator, and lessee uses aircraft in international traffic

55. Royalco is a UK enterprise that operates aircraft for the carriage of passengers and cargo between the UK and Australia. Royalco decides to lease out one of its aircraft that it does not require for its own transport operations. It leases the aeroplane on a full basis to an Australian company for a period of 18 months and it is used by that company exclusively for carriage of passengers and cargo between Australia and Hong Kong.

56. The profit derived by Royalco is from a full basis lease of an aircraft and therefore does not fall within the scope of Article 7. Accordingly, the application of Article 8 will need to be considered.

Section D: The UK Convention: Bareboat Leases

Example 6: International aircraft operator who regularly leases aircraft on bareboat basis – whether such leasing activity is directly connected or ancillary to its other aircraft operations

57. Charterco is a UK enterprise which has a fleet of 100 aircraft. It leases 90 aircraft on a bareboat basis and it operates the remaining 10 aircraft for its own international transport operations.

58. One of Charterco's aircraft is leased by an Australian company for a period of 20 months and is used exclusively for Australian domestic transport.

59. The profits derived by Charterco from the relevant bareboat lease are the subject of Article 7 because the bareboat leasing activity of Charterco is such a significant proportion of its overall shipping activities that it is not considered 'directly connected or ancillary' to its other international shipping transport operations.

60. The facts are insufficient to determine whether Charterco has leased the aircraft through a fixed place of business or dependent agent, within the meaning of Article 5, in Australia. However, there are sufficient facts to conclude that Charterco will have a deemed permanent establishment in Australia under Article 5.3(b) because the lessee uses the aircraft exclusively within Australia for the duration of the 20 month bareboat lease. Therefore, Charterco maintains the aircraft within Australia for rental purposes for more than 12 months and thus has a deemed permanent establishment under Article 5.3(b).

61. Article 5.3(b) then also deems Charterco to be carrying on a business in Australia through that permanent establishment for the purpose of Article 7(1).

62. As a result, Charterco will have an Australian income tax liability for each income year applicable to the 20 month lease period reflecting the profits attributable to its permanent establishment in Australia.

Section E: Time thresholds

Example 7: A temporary interruption

63. The facts are as in Example 6 except that ten months into the lease, the Australian lessee flies the aeroplane to New Zealand for a week of maintenance checks.

64. The more than 12 month threshold in Article 5.3(b) will still be satisfied in this situation because the week that the aircraft is in New Zealand does not amount to more than a mere temporary interruption occurring as a natural incidence of business and therefore does not constitute a break in calculating the period in which the aircraft is maintained for rental or other purposes within Australia. Although the week while the aircraft was in New Zealand is not included in calculating the period, the period the aircraft was in Australia, before and after that week, when added together meets the more than 12 month time threshold test. Therefore, Charterco will continue to have an Australian income tax liability notwithstanding that the aircraft is in New Zealand for one week.

Example 8: More than a mere temporary interruption

65. The facts are as in Example 6 except that during the period of the 20 month lease, the Australian lessee also uses the aeroplane for regular international flights to Singapore and Hong Kong on a rotational basis.

66. In this case, Charterco will not be deemed to have a permanent establishment under Article 5.3(b) because the aeroplane is not maintained in Australia for a continual period of more than 12 months. The international trips are regularly undertaken such that they constitute a break in the period the plane is being maintained in Australia. As a result Australia would not have a taxing right under Article 7 over the leasing profits.

Date of effect

67. It is proposed that when the final Ruling is issued, the Ruling will apply in relation to the shipping and aircraft leasing payments and profits to which:

- the US Convention has effect, being payments made and profits derived both before and after the Ruling's date of effect; and
- the UK Convention has effect, being payments made on or after 1July 2004 and profits derived during the 2004-2005 years of income and subsequent years of income.

68. This Ruling does not apply to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling.

Commissioner of Taxation
24 May 2006

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

Introduction

69. As there is a degree of similarity in the wording of the relevant provisions in both Conventions, many matters governing whether Australia has a taxing right under the respective Articles 7, in respect of the leases to which this Ruling applies, are common to the relevant provisions in both Conventions. However, due to a number of differences in the terms of the respective provisions of the Conventions, certain matters are peculiar to one or other of the Conventions, rather than both.

70. Accordingly, this section of this Ruling is divided into two Parts. Part A addresses the relevant factors and issues in the context of the provisions of the US Convention. Part B addresses those factors and issues in the context of the corresponding provisions of the UK Convention.

Undefined terms

71. Many of the terms that are contained in Articles 5, 7 and 8 of the US and UK Conventions are not defined within those Conventions.

72. Article 3.3 of the UK Convention states:

> As regards the application of this Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the laws of that State for the purposes of the taxes to which this Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

73. Article 3(2) of the US Convention similarly provides that where a term is not defined in the Convention it takes on the meaning it has under the domestic tax law of the country applying the Convention unless the context otherwise requires.

74. Notwithstanding the different wording in Article 3(2) of the US Convention compared with Article 3.3 of the UK Convention, it is considered that there is no substantive difference in the application and operation of the General Definitions Article in both Conventions as it relates to undefined terms.

75. Taxation Ruling 2001/13 Income Tax: Interpreting Australia's Double Tax Agreements, sets out the Commissioner's approach to the interpretation of undefined terms in a treaty (see paragraphs 63 to 76 of TR 2001/13). This approach is relied upon in this Ruling to provide meaning to the undefined terms referred to in this Ruling.

Part A. The US Convention

76. This Part addresses the following factors and issues in relation to the relevant provisions of the US Convention:

a) the shipping and aircraft leases that are the subject of Article 7;

b) the permanent establishment provisions of Articles 5(1), 5(2), 5(4)(a) and 5(5);

c) the permanent establishment deeming provision of Article 5(4)(b):

   (i) the meaning of 'maintains … for rental or other purposes';

   (ii) the application of the expression 'substantial equipment' in relation to ships and aircraft;

   (iii) the relevance of the lessee's residence and place of execution of the lease;

   (iv) the ownership status of the lessor in relation to the leased ship or aircraft;

   (v) the scope of the exclusion for hire-purchase agreements;

   (vi) the more than 12 months threshold period condition; and

d) the requirement in Article 7(1) that the US enterprise carries on business through a permanent establishment in Australia in order to establish an Australian taxing right.

The shipping and aircraft leases that are the subject of Article 7

77. Australia has a taxing right under Article 7(1) in respect of profits derived by an enterprise of the US from certain types of ships and aircraft leases only to the extent the profits are attributable to a permanent establishment, as defined in Article 5, of the enterprise in Australia.

78. In respect of the categories of leases covered by this Ruling, Article 7 deals with profits arising from leases of ships and aircraft that are not dealt with by Article 8[7]. The following leases are not dealt with by Article 8 and thus fall for consideration under Article 7.

[7] The *Royalties Article* (Article 12) no longer plays any role as the 2001 US Protocol removed from the definition of 'royalties' in Article 12 payments for the use of or the right to use industrial, commercial or scientific equipment.

A lease on a full basis of a ship or aircraft:

- where the ship or aircraft is not operated in international traffic by the lessee; or
- where the ship or aircraft is operated in international traffic by the lessee, provided that the US lessor:
  - (i) either does not operate ships or aircraft or only operates them solely between places in Australia, that is, where the lessor does not also operate ships or aircraft in international traffic or between places in the US or another country; and
  - (ii) does not regularly lease ships or aircraft on a full basis.

A lease on a bareboat basis of a ship or aircraft:

- where the lease is not 'merely incidental' to the US lessor's operation of ships or aircraft in international traffic (regardless of whether the ship or aircraft is used in international traffic or otherwise by the lessee).

The meaning of 'merely incidental'

79. The operative effect of the expression 'merely incidental' in Article 8(1)(b) of the US Convention is to restrict the application of Article 8 to those bareboat leases where:

- the primary activity of the lessor is the operation of ships or aircraft in international traffic; and
- the lessor's bareboat leasing activity only makes a minor contribution to, and is so closely related to, this primary activity that it does not amount to a separate business or source of income for the lessor.

80. This could typically be the case, for example, where a ship is leased out to another enterprise to avoid idle capacity. The leasing activity could be expected in those circumstances to only marginally contribute to the overall profits of the lessor enterprise.[8]

[8] See also *Klaus Vogel on Double Taxation Convention*, Third Edition, Kluwer Law International 1997, 485 and 486.

81. The meaning of the undefined term 'merely incidental',[9] in the context of its use in Article 8 in relation to bareboat leasing, is supported by the US Treasury Technical Explanation for the US Protocol.[10] The US Technical Explanation states: 'The Protocol makes coverage of bareboat leasing in Article 8 of the Convention generally consistent with Article 8 of the OECD Model'.

82. Whether a particular bareboat lease of a ship or dry lease of an aircraft is 'merely incidental to the operation in international traffic of ships or aircraft by the lessor' is a matter to be determined on the facts of each case. Factors upon which the Commissioner will have regard include:

- a comparison between the lessor's activities in operating ships or aircraft in international traffic and its bareboat leasing activity;
- the duration of the lease or sub-lease of the ship or aircraft;
- the frequency with which the taxpayer engages in such leasing activities; and
- any other facts and circumstances the Commissioner considers relevant to determining whether such activities are incidental to the business, or are a separate investment or business of the taxpayer.

83. Therefore, in relation to a bareboat lease, Article 7 will be the applicable Article where the enterprise does not operate ships or aircraft in international traffic itself, or if it does undertake such operations, its bareboat leasing activity:

- is not carried on primarily for the purpose of its own shipping or aircraft transportation operations; and
- makes more than a minor contribution to its overall international traffic operations; or
- amounts to a separate source of income or separate business operation.

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[9] The meaning of this term is not specifically addressed in the Explanatory Memorandum to the International Tax Agreements Amendment Bill (No. 1) 2002, or in other relevant extrinsic material from an Australian perspective.

[10] The US Treasury Technical Explanation (CCH Topical Law Reports, Tax Treaties, Volume 1, page 19241, paragraph 513). Note that the reference to the OECD Model in the US Technical Explanation incorporates the Commentary on Article 8 of the OECD Model as at January 2003. This Ruling also takes into account subsequent amendments to paragraphs 4 to 4.3 of the Commentary on Article 8 of the OECD Model published in July 2005.

The permanent establishment provisions of Articles 5(1), 5(2), 5(4)(a) and 5(5)

84. The permanent establishment condition for Australia to have a taxing right under Article 7(1) in relation to profits derived by a US enterprise from a relevant shipping or aircraft lease will be satisfied where the equipment is leased through a fixed place of business of the enterprise in Australia within the meaning of Articles 5(1) and 5(2) such as an office or branch in Australia.[11]

85. That condition is also deemed to be satisfied by Article 5(4)(a) where the equipment is leased through a dependent agent of the US enterprise (including an associated company where the circumstances are such that the associated company does not qualify as an independent agent within the meaning of Article 5(5)).

The permanent establishment deeming provision of Article 5(4)(b)

86. The Commissioner considers that the specific reference in Article 5(4)(b) to an enterprise of one State that maintains substantial equipment for rental purposes within the other State has application to the 'mere leasing' by a US enterprise of a ship or aircraft where the presence of the ship or aircraft satisfies the conditions stated in Article 5(4)(b).[12]

87. The opening words of Article 5(4) deem a US enterprise to have a permanent establishment in Australia for the purposes of the Convention where any of the conditions described in the various subparagraphs of Article 5(4) are applicable to the circumstances of the enterprise.

88. This deeming of the existence of a permanent establishment under Article 5(4) occurs even though the enterprise does not have a fixed place of business in Australia within the meaning of Articles 5(1) and (2). The inclusion of the phrase 'Notwithstanding paragraphs (1) and (2)' at the beginning of Article 5(4) supports this approach.

89. The opening words of Article 5(1), 'for the purposes of the Convention', apply to any deemed permanent establishment arising from provisions in Article 5 including Article 5(4)(b). This ensures the consistent application of each part of Article 5 across the Convention. Furthermore, in considering a tax treaty as a whole, it is appropriate that provisions of a tax treaty apply at least for the purposes of that treaty.[13]

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[11] See paragraph 8 of the Commentary on Article 5 of the OECD Model.

[12] Paragraph 8 of the Commentary on Article 5 of the OECD Model provides that an enterprise is not to be regarded as having a permanent establishment in the other State merely because of the presence of leased equipment in the other State. However, this statement has no relevance for present purposes as the OECD Model has no counterpart to Article 5(4)(b).

[13] Unless a particular provision expressly states that the provision is to apply for other purposes as well. An example would be the Source of Income Articles in many of Australia's tax treaties. In relation to this, see also paragraphs 30 and 34-37 of Taxation Ruling TR 2001/13.

90. Accordingly, the deeming of a permanent establishment in Article 5(4)(b) applies for the purposes of the Convention as a whole. The inter-relationship between Articles 5 and 7 supports this.

91. The issues that arise in relation to the specific terms and operative effect of Article 5(4)(b) are addressed below.

The meaning of 'maintains … for rental or other purposes'

92. The relevant meanings of the term 'maintains' in the Macquarie Dictionary[14] are:

- to keep in existence or continuance, preserve; retain;
- to keep in due condition, operation, or force; keep unimpaired; and
- to keep in a specified state, position etc.

93. The term 'maintains' refers to the act of keeping something.

94. Article 5(4)(b) qualifies the meaning to be given to the term 'maintains' by requiring that the enterprise maintains substantial equipment 'for rental or other purposes'. The ordinary meaning of rental is 'relating to, or available for, rent' and would thus infer that any purpose relating to the actual or future receipt of rent would be covered by the expression. The words 'or other purposes' could potentially be interpreted as broadly as covering any purpose. However, given the context of the provision is to determine a threshold for source country taxing rights under Article 7, this expression is considered to relate to any other business related purpose, that is it would not cover maintaining substantial equipment for private purposes.

95. In relation to the lessor enterprise, the act of leasing out substantial equipment by the enterprise would therefore satisfy the requirement of 'maintains substantial equipment for rental purposes'. In this sense, the lessor keeps the equipment for the purpose of renting it out, without necessarily having to be in physical possession or control of it at any time over the term of the lease in which it is operated in Australia by the lessee.

96. Accordingly, the mere presence of the substantial equipment under lease in Australia for the required time would be sufficient for the lessor enterprise to be considered to be maintaining substantial equipment for rental purposes.

97. This interpretation of the term 'maintains' in Article 5(4)(b) is consistent with the meaning of the similar term 'maintenance' as used in several subparagraphs of Article 5(3) of the US Convention. In Article 5(3) of the US Convention (and the corresponding Article 5.4 of the OECD Model), the word 'maintenance' is used to refer to the act of maintaining stock or a fixed place of business for the particular purposes stated in subparagraphs 5(3)(b) to 5(3)(f).

[14] 5th Edition, 2001.

98. Article 5.3(b), of the UK Convention uses identical wording to that of Article 5(4)(b) of the US Convention. Based on the principle that tax treaty negotiators will, as far as possible, avoid the same wording having different usages across tax treaties, the Commissioner considers that the UK Explanatory Memorandum is also relevant context to determining the meaning of the term 'maintains' in Article 5(4)(b) of the US Convention. Whilst the Commissioner recognises that it is not always possible to follow this principle in all tax treaty negotiations, there is no evidence to suggest that a different meaning was intended in this particular circumstance.

99. Paragraph 1.61 from the UK Explanatory Memorandum states in relation to Article 5.3(b) of the UK Convention:

> … an enterprise shall be deemed to have a permanent establishment if it has substantial equipment in a country for rental or other purposes for longer than 12 months (emphasis added)

100. To the extent that the same words used in the UK Convention reflect the same meaning in the US Convention, the above could be seen as indicative of the meaning of Article 5(4)(b) in the earlier US Convention, that is that the term maintains merely requires that the lessor 'has' the equipment.

101. Accordingly, for the above reasons and to the extent that a ship or aircraft is substantial equipment for the purposes of Article 5(4)(b), the Commissioner considers that the interpretation of the expression 'maintains … for rental or other purposes' means that lessors who lease ships or aircraft that are operated by the lessee in Australia can fall within the scope of Article 5(4)(b).

Subleasing and chains of entities

102. It is common practice for ships and aircraft to be leased through a number of chains of entities, with a number of layers of leases entered into before the equipment is ultimately subleased to an entity that actually operates the equipment in Australia.

103. The only lessor in such chains of leases that will be considered to maintain the ship or aircraft for rental or other purposes within Australia, and thus have a permanent establishment in Australia under Article 5(4)(b), will be the final sublessor in the chain that leases directly to the lessee who operates the equipment within Australia for more than 12 months.

104. It is only once the ship or aircraft is under lease to the final lessee who operates it within Australia that it can be said that the equipment is maintained for rental purposes 'within Australia'. It is only at this point that there is a sufficient connection with Australia for a permanent establishment to be deemed to exist. Therefore, the remaining subleasing arrangements up the chain do not meet all the requirements of Article 5(4)(b) as the lessors are not maintaining the ship or aircraft for rental purposes 'within Australia'.

The application of the expression 'substantial equipment' to ships and aircraft

105. The term 'substantial equipment' is not defined in the US Convention nor in any other Australian tax treaty. There is also no definition of the term in a relevant context in Australian domestic income tax law for the purposes of Article 3(2) of the US Convention.

Meaning of 'equipment'

106. The relevant meanings of the word 'equipment' in the Macquarie Dictionary[15] are: anything used in or provided for equipping, a collection of necessary implements (such as tools).

107. Paragraphs 33 to 38 of Taxation Ruling TR 98/21 Income Tax: withholding tax implications of cross border leasing arrangements, point to a number of cases and other references indicating that the meaning of the term 'equipment' should be determined according to the context in which it appears and that when used in a treaty context it has a broad meaning.[16] In particular, paragraph 18 of IT 2660 Income Tax: Definition of Royalties states that, in the context of the definition of 'royalty', the term 'equipment' does not have a narrow meaning and includes such things as machinery and apparatus.

108. Consistent with paragraph 34 of TR 98/21 and the cases cited therein, a particular item does not necessarily have to be something ancillary to, or part of a greater whole to be considered 'equipment'.[17] As a result, an entirety such as a ship or aircraft would be an item of 'equipment' for purposes of Article 5(4)(b).

Meaning of 'substantial'

109. The relevant meanings of the word 'substantial' in the Macquarie Dictionary[18] are:

- of ample or considerable amount, quantity or size;
- of real worth or value;
- of or relating to the essence of a thing; essential, material, or important.

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[15] 5th Edition, 2001.

[16] See observations by the members of Taxation Board of Review Number 3 in *Case H106* (1957) 8 TBRD 484, discussions by O'Bryan and Ashley JJ in *Mayne Nickless Ltd v. FC of T* 91 ATC 4621; (1991) 22 ATR 198 in referring to *Coltman and Anor v. Bibby Tankers Ltd* [1988] AC 276; [1987] 3 All ER 1068, and the two OECD Reports relating to equipment leasing – *The Taxation of Income Derived from the leasing Industrial, Commercial or Scientific Equipment* (adopted by the Council of the OECD on 13 September 1983) and *The Taxation of Income from the Leasing of Containers* (adopted by the Council of the OECD on 13 September 1983).

[17] The examples provided at paragraph 1.63 of the UK Explanatory Memorandum also provide support for this view in that entireties such as oil and drilling rigs and grain harvesters are provided as examples of what would be 'substantial equipment'.

[18] 5th Edition, 2001.

110. In considering the meaning of the word 'substantial' in the context of the term 'substantial loss or damage' in the *Trade Practices Act 1974*, Deane J in *Tillmanns Butcheries Pty Ltd v. Australian Meat Industry Employees' Union*[19] stated:

> The word 'substantial' is not only susceptible of ambiguity: it is a word calculated to conceal a lack of precision. In the phrase 'substantial loss or damage', it can, in an appropriate context, mean real or of substance as distinct from ephemeral or nominal. It can also mean large, weighty or big. It can be used in a relative sense or can indicate an absolute significance, quantity or size. The difficulties and uncertainties which the use of the word is liable to cause are well illustrated by the guidance given by Viscount Simon in *Palser v. Grinling* (1948) AC 291 where, after holding that, in the context there under consideration, the meaning of the word was equivalent to 'considerable, solid or big', he said: 'Applying the word in this sense, it must be left to the discretion of the judge of fact to decide as best he can according to the circumstances of each case . . . ' (1948) AC, at p 317.

111. In analysing the substantial equipment provision, Article 4(3)(b), in the Singapore Agreement, the Full Federal Court in *McDermott Industries (Aust) Pty Ltd v. Commissioner of Taxation*,[20] stated:

> it is clear that the article is concerned with equipment that is not in a relative, or in an absolute sense, insubstantial.

112. Therefore, the Commissioner considers that whether the equipment in question is 'substantial' is a question of fact and degree to be determined:

- on balance, according to the facts and circumstances of each particular case;[21] and
- in an absolute sense, that is, when viewed independently; not in comparison with something else; or
- in a relative sense; that is, by comparing it to something else.[22]

General position

113. Having regard to the contextual matters discussed above, the Commissioner considers that it would be extremely rare for a ship or aircraft not to be substantial equipment for the purposes of Article 5(4)(b). By reason of their size alone, ships and aircraft would be expected to constitute substantial equipment in an absolute sense.

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[19] (1979) 42 FLR 331, p. 348; (1979) 27 ALR 367.
[20] [2005] FCAFC 67, paragraph 55; (2005) 219 ALR 346; (2005) 2005 ATC 4398; (2005) 59 ATR 358; (2005) 142 FCR 134.
[21] This is also consistent with the UK Explanatory Memorandum which states that the meaning of the term 'substantial' depends on the relevant facts and circumstances of each individual case.
[22] In accordance with the Macquarie Dictionary definition of the terms 'absolute' and 'relative'.

114. If taxpayers consider they have an exceptional case, advice can be sought from the Tax Office concerning the application of the tax law to their particular circumstances.

Is the lessee's residence and place of execution of the lease relevant?

115. Article 5(4)(b) is not concerned with the residency status of the lessee nor the place of execution of the lease. As long as the conditions for the operation of the provision are met, Article 5(4)(b) can apply:

- whenever a US enterprise *has* the equipment under lease to either an Australian resident, another US resident or a resident of a third country; and
- irrespective of whether the lease contract is executed in Australia, the US or a third country.[23]

The ownership status of the lessor in relation to the leased ship or aircraft

116. Article 5(4)(b) does not require that the US enterprise own the equipment. The provision can therefore apply in cases where the US enterprise:

- owns the equipment; or
- 'physically possesses' the equipment under licence, lease or bailment etc from another enterprise (irrespective of the residency status of that other enterprise).

The scope of the 'hire-purchase agreement' exclusion

117. Article 5(4)(b) expressly excludes 'equipment let under a hire-purchase agreement' from falling within the scope of the provision.

118. The term 'hire-purchase agreement' is not defined in the Convention. There are various domestic law meanings of the term.[24]

[23] Also, in relation to Article 7, Australia has source of income rules for treaty and domestic law purposes. See Article 27 of the US Convention and Article 21 of the UK Convention.

[24] For example, Divisions 240 and Division 40 of the ITAA 1997 and section 128AC of the ITAA 1936.

119. The hire-purchase exclusion in Article 5(4)(b) ensures that those lease agreements that would otherwise be treated according to the Interest Article (Article 11) do not fall within Article 7.[25] This ensures that the lease arrangement (the interest component of the lease payment) is taxed in accordance with domestic interest withholding tax (IWT) provisions, rather than taxed on an assessment basis under Article 7.[26] Therefore, the principle espoused under TR 98/21 provides the most appropriate domestic law meaning in this context because it determines when domestic IWT treatment applies to cross border leasing arrangements.

120. The Commissioner considers the term 'hire-purchase agreement' in the US Convention refers to a lease agreement which TR 98/21 states is treated in accordance with domestic IWT provisions because the paramount purpose of the lease is for the purchase of the equipment.

121. While TR 98/21 adopts a broad meaning for the term 'hire-purchase agreement' in section 128AC of the ITAA 1936,[27] that provision also specifically includes certain other similar agreements in addition to hire-purchase agreements. The Commissioner considers the term, as used in the context of US Convention, is not restricted to the specific use of the term in section 128AC, but rather the term includes all leases that fall within section 128AC in accordance with the fundamental principle in TR 98/21.

122. In TR 98/21,[28] the Commissioner adopts a fundamental distinction between leases where the paramount purpose of the lease is for the hire of the equipment and those where the paramount purpose is for the purchase of the equipment. This is to delineate between those cross border leases where the income from such leases falls within domestic law IWT provisions and those leases where the income falls within the royalty withholding tax provisions, respectively.[29]

123. Paragraph 7 of TR 98/21 explains that the:

> paramount purpose of a transaction is to be decided by having regard to all surrounding circumstances and commercial consequences of the transaction (such as the passing of the incidents of ownership and economic risks to the lessee and other matters).

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[25] Unless the income is effectively connected to a permanent establishment arising under another paragraph of Article 5.

[26] Prior to the removal of equipment royalties from the definition of 'royalty' by the 2001 US Protocol, profits from leases where the paramount purpose of the lease was for hire were dealt with under Article 12 of the US Convention.

[27] Paragraph 74 states: '…, there is no reason why the words hire-purchase should not themselves be given a broad meaning consistent with legislative purpose of collecting interest withholding tax on the implicit interest element in lease transactions with a financing element. … In the ATO's view, the term as used in section 128AC should be given a broad meaning which is consonant with the modern usage of the term.'

[28] See paragraphs 7, 8, and 30-32 of TR 98/21.

[29] This fundamental distinction is also evident in a number of other Rulings published by the Commissioner, such as IT 28, 2051, 2236, 2519, 2594, 2660, TR 95/30 and TR 98/21, TD 93/187 and TD 94/20.

124. The fundamental distinction espoused in TR 98/21 is consistent with the approach taken in the Commentary on Article 12 (Royalties) of the 1977 OECD Model at paragraph 9 which, at that time, also needed to make such a delineation because equipment royalties where included in the Article 12 of the OECD Model.[30] The Commissioner's interpretative approach is also consistent with the United States Technical Explanation to the 1982 US Convention which states:

> Under Australian law the lessee under a 'hire-purchase' agreement (a lease accompanied by certain lessee purchase options or rights) is treated for tax purposes as the owner of the leased property. The exception for hire-purchase agreements in this Article and elsewhere in the Convention (see Article 12 (Royalties)) was inserted at the request of Australia to distinguish such agreements from leases respected as such for tax purposes. …. Similarly, under the Internal Revenue Code, the terms of a 'lease' may be such that for U.S. tax purposes the lessee is treated as the owner of the property. For the purposes of United States tax the exception for 'hire-purchase' agreements simply confirms such treatment, which would also apply in the absence of such an explicit exception. See paragraph 2 of Article 3 (General Definitions).

125. Therefore, in accordance with the principle espoused in TR 98/21 for determining whether income from an equipment lease will be subject to domestic IWT provisions, a 'hire-purchase agreement' for the purposes of the US Convention will include:

- those leases where the element of purchase is paramount and a financing element exists;[31]
- leases for effective life with a financing element;[32] and
- a terms purchase or an instalment sale.

126. Where the lease agreement does not fall within the meaning of 'hire-purchase agreement', the income from the lease is dealt with according to Article 5(4)(b). Those leases falling within the meaning of 'hire-purchase agreement' will be dealt with under Article 11 of the Convention.

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[30] The reference to leasing of industrial commercial or scientific equipment (equipment royalties) was omitted from the definition of 'royalty' in the Article 12 of the OECD Model in 1992. As a consequence, paragraph 9 of the Commentary on Article 12 was also omitted at that point. That same reference was also omitted from Article 12 of the US Convention by the 2001 amending Protocol and is not contained in the 2003 UK Convention.

[31] These are recognised to be the two basic ingredients of a hire-purchase agreement. See *Warman v. Southern Countries Car Finance Corporation Ltd WJ Ameris Car Sales (Third Party)* [1949] 2 KB 576 per Finnemore J quoted at paragraph 72 of Taxation Ruling 98/21. The financing element of a hire-purchase agreement is explained at paragraph 81 of Taxation Ruling TR 98/21.

[32] The Commissioner considers this type of lease is in substance equivalent to a purchase. See paragraphs 50-52 of Taxation Ruling TR 98/21.

The 'period of more than 12 months' condition

Temporary interruptions

127. Article 5(4)(b) refers to an enterprise maintaining substantial equipment within Australia for a period of more than 12 months. The equipment needs to be physically present within Australia for a continual[33] period in excess of 12 months. Short breaks for holidays, repair time or other natural incidents of business do not constitute a break in the continuity of the period of the equipment being maintained within Australia for the purposes of calculating the more than 12 month period.

128. Similar language to that used in Article 5(4)(b) is used in Article 5(2)(h) of the Convention to provide for a building site or construction, assembly or installation project to constitute a permanent establishment providing it exists *for more than 9 months*. The Commentary[34] on Article 5.3 of the OECD Model (the provision corresponding to Article 5(2)(h) of the Convention) confirms that the more than 9 months threshold period is a continual one. It explains that seasonal or temporary interruptions of activity do not cause a permanent establishment to cease to exist.

129. If a ship or aircraft is temporarily transported out of Australia, for example, for repairs or maintenance to be carried out occasionally in a twelve month period, this interruption will not break the continuity of the period. As a matter of practicality, the period of the temporary interruption will not be included in calculating the continual period of more than 12 months. However, the period before the ship or aircraft is taken out of Australia and the period after it is returned to Australia are added together to calculate the time threshold. Alternatively, if an ship or aircraft is transported out of Australia for more than just a temporary period or purpose, for example as part of its participation in regular international transport routes, this interruption would constitute a break in the continuity of the equipment being maintained within Australia. In such a case, the calculation of the time period would be reset each time the equipment is taken out of Australia.

Replacement equipment

130. Where a ship or aircraft that is maintained by a US enterprise within Australia has to be replaced by the US enterprise with a new ship or aircraft, for example, because the original is damaged or destroyed, the calculation of the 12 month time period will not be interrupted. Such a situation is considered to fall within the above notion of natural incidents of business such that it should not break the calculation of the 12 month period.

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[33] 'Continual' refers to something that happens frequently or even regularly but with interruptions, while continuous refers to something that occurs constantly without interruptions. See Rooke C *A Grammar Booklet for Lawyers,* Law Society of Upper Canada, 1991, page 28.

[34] See paragraphs 11 and 19 of the Commentary on Article 5 of the OECD Model.

Aggregating time of individual equipment

131. Article 5(4)(b) applies where a US enterprise maintains only one aircraft or ship within Australia, or a number of ships or aircraft within Australia. The term 'substantial equipment' encompasses substantial equipment in both the singular and plural sense. This position is consistent with the approach taken in *McDermott Industries (Aust) Pty Ltd v. Commissioner of Taxation*[35] where although a number of barges were chartered under various lease agreements, the Full Federal Court did not consider each individual barge as a separate item of substantial equipment, but instead considered them collectively and held that 'CCS had … *a* permanent establishment in Australia' … 'because the *barges* in question, being admittedly substantial equipment, were being used in Australia …'.

132. The time threshold in Article 5(4)(b) determines when the leasing activity of a non-resident lessor of substantial equipment maintained in Australia is sufficient to allow source country taxing rights over the related profits. The provision is concerned with the type of business the non-resident enterprise is involved in, that is, whether the enterprise is involved in the economic activity of leasing substantial equipment within Australia. The provision is not concerned with whether the enterprise maintains for leasing purposes the exact same item of substantial equipment (that is, a particular ship or aircraft) in Australia for the 12 month period.

133. It follows that the time threshold will be satisfied where a US enterprise maintains for rental or other purposes:

(a) one aircraft or ship (which is substantial equipment in its own right) within Australia for more than 12 months; or

(b) a number of aircraft or ships within Australia, where at least one of the aircraft or ships is maintained within Australia at any one point in time during a continual period of 12 months.

134. An example of the latter situation would be where a US enterprise maintains one aircraft for rental or other purposes within Australia for eight months and another aircraft for ten months. Although neither aircraft individually satisfy the more than 12 month period, if the time period for each aircraft overlap or are sequential such that at any one point in time during a 12 month continual period the US enterprise maintains at least one aircraft within Australia, the time threshold will be satisfied.

[35] [2005] FCAFC 67, at paragraph 71; (2005) 219 ALR 346; (2005) 2005 ATC 4398; (2005) 59 ATR 358; (2005) 142 FCR 134.

135. Where a US lessor enters into an arrangement that seeks to adopt a form over substance approach to avoid the application of the provision, the Commissioner may give consideration to the application of anti-avoidance provisions; for example, where a ship or aircraft is transported out of Australia for a relatively short time once in a 12 month period for the principal purpose of avoiding the operation of Article 5(4)(b).[36]

The Article 7(1) condition for an Australian taxing right that the US enterprise carries on business through a permanent establishment in Australia

Profits of an enterprise of a Contracting State

136. Based on the meaning of 'enterprise' from Australian domestic tax law and *Thiel's* case,[37] a US lessor that is the subject of this Ruling will be an 'enterprise' for purposes of Article 7. The legal and financial requirements for leasing ships or aircraft would invariably result in corporate or other commercial structures conducting this type of activity.

137. Furthermore, the profits derived from conducting the activity of leasing out ships or aircraft are 'business profits' of the US enterprise for the purposes of Article 7(1). The leasing out of ships or aircraft clearly constitutes an activity of a business or commercial character. The activity falls within the meaning given to the term by the High Court in *Thiel.*

'Carrying on business'

138. Article 5(4)(b) deems a non-resident enterprise to have a permanent establishment in Australia, but it does not also deem the non-resident enterprise 'to carry on business through that permanent establishment'.

139. Whether a US enterprise 'carries on business' in leasing a ship or aircraft, for the purposes of Article 7(1) is a question of fact and degree to be determined on balance according to the facts and circumstances of each particular case.[38]

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[36] Paragraph 18 of the Commentary on Article 5 of the OECD Model also points to the application of anti-avoidance rules for combating abuses of such time thresholds.

[37] In *Thiel v. Federal Commissioner of Taxation* (1990) 64 ALJR 516; (1990) 94 ALR 647; (1990) 90 ATC 4717; (1990) 21 ATR 531; (1990) 171 CLR 338, the High Court held that 'profits of an enterprise' in Article 7 of the Swiss tax treaty has to be given a wide meaning, not to be limited just to profits derived from the carrying on of any business but to also include any profit of a business nature or commercial character, or profit from an adventure in the nature of trade.

[38] In *Ferguson v. Commissioner of Taxation (Cth)* (1979) 26 ALR 307; (1979) 79 ATC 4261 at 471; (1979) 9 ATR 873, at 884; (1979) 37 FLR 310, it was considered that the question of whether a taxpayer's activities should be characterised as a business is primarily a matter of general impression and degree.

140. Australian courts have identified a number of indicators that are relevant in determining whether a taxpayer's activities constitute the carrying on of a business. These indicators and some of the cases in which they have been applied are discussed in some detail in TR 97/11.

141. As noted in the Full Federal Court decision in *Stone v. FC of T*,[39] no single indicator is determinative, rather all of the indicators must be considered. Whether a business is being carried on is based on the overall impression gained after looking at the activity as a whole and the intention of the taxpayer undertaking it.

142. The Commissioner considers that the term 'carries on business' in Article 7(1) refers to a wide concept of business, one which includes leasing ships or aircraft.

143. In *American Leaf Blending Co. Sdn Bhd v. Director-General of Inland Revenue (Malaysia)*[40] Lord Diplock stated, 'in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business.' In *Lilydale Pastoral Co Pty Ltd v. FC of T*,[41] Pincus J considered that 'the purchase of property to rent out, whether or not after renovating it, and the proprietorship of that property, constitute an undertaking of a business or commercial kind.' The word 'undertaking' was held to refer to a physical structure or a total business.[42] In line with these cases the letting of property out for rent can constitute 'carrying on business'.

144. Shipping and aircraft leasing arrangements usually involve entering into complex legal contracts concerning property of very high value and are undertaken by commercial entities for the purpose of deriving a profit. Such leases are of an enduring commercial nature and involve regular activity, such as invoicing and receipt of lease payments. It therefore follows that a US lessor enterprise engaged in the activity of maintaining ships or aircraft for rental or other purposes within Australia under Article 5(4)(b) will be carrying on business for the purposes of Article 7(1).

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[39] 2003 ATC 4584; (2003) 53 ATR 214; (2003) 198 ALR 541; (2003) 130 FCR 299; [2003] FCAFC 145. Note, this approach was not overturned in the later High Court appeal of this decision, *FCT v. Stone* [2005] HCA 21; (2005) 79 ALJR 956; (2005) 215 ALR 61; (2005) 2005 ATC 4234; (2005) 59 ATR 50; [2005] ALMD 4469; [2005] ALMD 4470.

[40] [1978] AC 676; [1978] 3 All ER 1185, at page 1189. Note that it was also stated at page 1189 that this inference is not necessarily able to be drawn in the case of a private individual.

[41] (1987) 72 ALR 70 at 77; (1987) 15 FCR 19; 87 ATC 4235; 18 ATR 508.

[42] *FC of T v. Top of the Cross Pty Ltd and Travel Holdings (Aust) Pty Ltd* (1981) 37 ALR 623; (1981) 12 ATR 413; (1981) 57 FLR 294 per Bowen CJ and Ellicott J and applied in *Lilydale Pastoral Co Pty Ltd v. FC of T* 72 ALR 70 at 77; (1987) 87 ATC 4235; (1987) 18 ATR 508; (1987) 15 FCR 19 per Pincus J.

145. It is common practice in the shipping or aircraft leasing industry for special purpose vehicles (SPVs) to be set up for one ship or aircraft leasing transaction. In such cases, the Commissioner considers that the SPV lessor of the ship or aircraft will generally still be carrying on business for the purposes of Article 7(1) because of the commercial structure under which the lease is arranged and the enduring nature of the business activity involved with these leases. This is irrespective of the fact that it may be a one-off leasing arrangement of the SPV.

Carrying on business 'through' a permanent establishment

146. Under Article 5(4)(b), the deemed permanent establishment is an 'activity' permanent establishment, that is the activity of maintaining a ship or aircraft for rental or other purposes within Australia. The important difference between an 'activity' permanent establishment and the 'fixed place of business' permanent establishment that exists under Article 5(1) is that the former has no dependence on a fixed situs or location.

147. Accordingly, when a US lessor enterprise is found to have a deemed permanent establishment in Australia under Article 5(4)(b), the issue is whether they are carrying on business through the activity permanent establishment, as opposed to through a fixed place of business permanent establishment. Therefore, there is no need to establish that the US lessor is carrying on business through a particular place in Australia.

148. The Commissioner considers that the US lessor enterprise will be carrying on business 'through' its deemed permanent establishment in Australia for the purposes of Article 7(1) because:

- the business carried on by the US lessor is the leasing of ships or aircraft; and
- this leasing business is carried on 'through' the activity of maintaining ships or aircraft for rental purposes within Australia (the deemed permanent establishment).

149. In these circumstances, there is in fact nothing else carried on through the activity permanent establishment other than the ship or aircraft leasing business of the US lessor enterprise.

Part B. The UK Convention

150. All references in this Part are to the 2003 United Kingdom Convention unless specified otherwise. This Part addresses the same factors and issues in relation to the relevant provisions of the UK Convention with the main focus being on matters which differ from the US Convention.

The shipping and aircraft leases that are the subject of Article 7

151. Australia has a taxing right under Article 7.1 in respect of profits derived by an enterprise of the UK from certain types of ships and aircraft leases only to the extent the profits are attributable to a permanent establishment, as defined in Article 5, of the enterprise in Australia.

152. In respect of the categories of leases covered by this Ruling Article 7 deals with profits arising from leases of ships and aircraft that are not dealt with by Article 8. The following lease is not dealt with by Article 8 and falls for consideration under Article 7:

- a lease on a bareboat basis of a ship or aircraft where the lease is not 'directly connected or ancillary' to the UK lessor's operation of ships or aircraft in international traffic (regardless of whether the ship or aircraft is used in international traffic or otherwise by the lessee).

The meaning of 'directly connected or ancillary'

153. The meaning of 'directly connected or ancillary' is not explained in the UK Explanatory Memorandum. However based on the explanation provided in the OECD Model Commentary as referred to at paragraphs 80 to 84 of this Ruling the operative effect of the expression is to restrict the application of Article 8 to those bare boat leases where:

- the primary activity of the lessor is the operation of ships or aircraft in international traffic; and
- the lessor's bareboat leasing activity makes a minor contribution to, and is so closely related to, this primary activity that it does not amount to a separate business or source of income for the lessor.

154. Therefore, in relation to a bareboat lease, Article 7 will be the applicable Article where the enterprise does not operate ships or aircraft in international traffic itself, or if it does undertake such operations, its bareboat leasing activity:

- is not carried on primarily for the purpose of its own shipping or aircraft transportation operations; and
- makes more than a minor contribution to its overall international traffic operations; or
- amounts to a separate source of income or separate business operation.

The permanent establishment provisions of Articles 5.1, 5.2, 5.6 and 5.7

155. See earlier explanations at paragraphs 85 and 86 of this Ruling, although note the equivalent provisions to Articles 5(4)(a) and 5(5) in the US Convention are Articles 5.6 and 5.7 in the UK Convention respectively.

The permanent establishment deeming provision of Article 5.3(b)

156. The opening words of Article 5.3 deem a UK enterprise to have both a permanent establishment in Australia *and* to carry on business through that permanent establishment where any of the conditions described in the various subparagraphs of Article 5.3 are applicable to the circumstances of the enterprise. This deeming occurs whether or not the enterprise has a *fixed place of business* in Australia within the meaning of Articles 5.1 and 5.2. This deeming also applies for the purposes of the Convention as a whole, including Article 7. See paragraphs 90 and 91 of this Ruling for further explanation.

157. For those aspects of Article 5.3(b) of the UK Convention that are identical to those of Article 5(4)(b) of the US Convention the same issues arise in relation to the interpretation of the respective subparagraphs as already explained in Part A. The following paragraph explains the remaining aspect of Article 5.3(b) of the UK Convention that is different to Article 5(4)(b) of the US Convention.

The Article 7.1 condition for an Australian taxing right that the UK enterprise carries on business through a permanent establishment in Australia

158. Article 7.1 requires that, for present purposes, the UK lessor of the ship or aircraft to carry on business in Australia through the permanent establishment. This requirement is deemed to be met by the lead in phrase to Article 5.3 of ‘an enterprise shall be deemed to have a permanent establishment in a Contracting State and to carry on business through that permanent establishment’.

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.

Meaning of 'maintains'

159. An alternate view is that the meaning of the term 'maintains' in Article 5(4)(b) is limited to the second of the relevant ordinary meanings above, which would require the keeping to be in terms of the keeping in working order, for example, by carrying out a repair or maintenance function on the relevant equipment. Under this view, the activities of the lessor would only fall within the meaning of 'maintains' for the purposes of Article 5(4)(b) in instances where the lessor, its agents or employees perform all or part of the repair or servicing of the equipment or ensure the lessee's performance of the repair and servicing functions for the leased ship or aircraft. However, the Commissioner does not consider this to be the correct view for the reasons stated in paragraphs 93 to 102 in the Explanation section of the Ruling.

160. There are also other factors which, when viewed in total, indicate that this alternate view would not have been the intended application of the provision.

161. Firstly, commercial practice within the shipping and aircraft industry indicates that lessors of the equipment will generally contract with third parties to have their equipment repaired or maintained. If the above alternative view were to be adopted, Article 5(4)(b) could potentially have extremely minimal practical application. Furthermore, maintenance arrangements could be structured so that the conditions for the operation of Article 5(4)(b) might never be met.

162. Secondly, the alternate view creates greater incentive for the substantial equipment to be removed from Australia when maintenance is required between periods when the equipment is under lease.

163. Finally, there may be no need for a lessor to service or repair the substantial equipment over the course of a particular 12-month period or at all in that period. It would be an absurd result for a permanent establishment not to be deemed in such instances compared with cases where servicing and repairs of the equipment were conducted and a permanent establishment was deemed to exist.

164. Another variation to this view is that, even if it is accepted that 'maintains' is meant in the sense of 'to keep', it is only the lessee rather than the lessor that 'keeps' the substantial equipment because the lessee has possession and control of the equipment for the term of the lease. Again, the Commissioner does not consider this view to be correct for the reasons stated in paragraphs 93 to 102 in the explanation section of the Ruling.

Carrying on business 'through' a permanent establishment

165. An alternative view that has been put to the Commissioner is that the business the US enterprise lessor is carrying on is not carried on through a permanent establishment in Australia when the US enterprise undertakes all the activity in respect of negotiating and concluding the lease for a ship or aircraft outside of Australia. For example, for dry leases of aircraft, it has been suggested that the activities undertaken by the US lessor[43] occur predominantly before the commencement of the lease. It is said that the only connection to Australia in such instances is the residence of the lessee and the location of the equipment. The enterprise has no other physical connection to Australia.

166. Furthermore, it has been argued that given the lack of a physical connection to Australia, a US lessor that merely leases an aircraft in this way does not, as a matter of fact, conduct a business through a permanent establishment in Australia.

167. The Commissioner does not consider the alternative view to be the correct one for the reasons stated in paragraphs 147 to 150 in the explanation section of the Ruling.

[43] These activities may include obtaining finance to acquire the equipment, negotiating the acquisition equipment and the dry lease contract, arranging for the physical delivery to the lessee normally outside Australia and the receipt of lease rental payments.

Appendix 3 – Your comments

168. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date. (Note: The Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel. The Tax Office may use a sanitised version (names and identifying information removed) of the compendium in providing its responses to persons providing comments. Please advise if you do not want your comments included in a sanitised compendium.)

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