TD 2007/D12 - Income tax: is a non-resident head lessor of substantial equipment liable for royalty withholding tax under subsection 128B(5A) of the Income Tax Assessment Act 1936 on lease payments it receives from a Singaporean resident who subleases that same equipment to an entity which operates it in Australia?

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This document has been finalised by TR 2007/11.

Draft Taxation Determination

Income tax: is a non-resident head lessor of substantial equipment liable for royalty withholding tax under subsection 128B(5A) of the *Income Tax Assessment Act 1936* on lease payments it receives from a Singaporean resident who subleases that same equipment to an entity which operates it in Australia?

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Ruling

1. Yes, the non-resident head lessor will be liable for royalty withholding tax under subsection 128B(5A) of the *Income Tax Assessment Act 1936* (ITAA 1936), except where the non-resident head lessor is a resident of the United States (US) or the United Kingdom (UK) for tax treaty purposes[1] or has a permanent establishment in Australia under one of Australia's tax treaties.[2]

[1] A US or UK resident head lessor of substantial equipment is not liable for royalty withholding tax under subsection 128B(5A) of the ITAA 1936 as the lease payments it receives are not royalties under the US or UK tax treaty respectively.

[2] This Taxation Determination only addresses the question of whether the non-resident head lessor may have a permanent establishment in Australia under a tax treaty in relation to the application of the relevant substantial equipment provision. TD 2007/D11 lists the tax treaties with a relevant substantial equipment provision.

2. In accordance with subparagraph 128B(2B)(b)(ii) of the ITAA 1936, the non-resident head lessor will be liable for royalty withholding tax because:

- the non-resident head lessor has derived a royalty paid by a Singaporean resident sub-lessor that is carrying on business in Australia through a permanent establishment, as defined under subsection 6(1) of the ITAA 1936, and
- this payment is an outgoing incurred by the Singaporean resident sub-lessor in carrying on its business in Australia at or through that permanent establishment.

3. A non-resident head lessor would not be considered to have a permanent establishment in Australia under one of Australia's tax treaties merely because the substantial equipment is being operated in Australia under the sublease between the Singaporean resident sub-lessor and the entity operating the equipment in Australia.

4. These views are not limited to leases involving a Singaporean resident sub-lessor and would apply in respect of any sub-lessor that is not a resident of Australia.

Examples

Example 1: non-resident head lessor from a non-tax treaty country

5. *A Hong Kong head lessor leases substantial equipment of an industrial nature to a Singaporean company that in turn subleases the equipment to a sub-lessee in Australia. The equipment remains in Australia for the period of the lease. The Singaporean resident sub-lessor receives lease rentals from the sub-lessee and in turn makes lease payments to the Hong Kong head lessor. This can be illustrated as:*



6. *The Singaporean resident sub-lessor is considered to have a permanent establishment in Australia under subsection 6(1) of the ITAA 1936 and to be carrying on business in Australia at or through a permanent establishment in Australia. The lease rental payments are royalties for the purposes of subsection 6(1).*

7. *The Hong Kong head lessor will be liable under section 128B(5A) of the ITAA 1936 for royalty withholding tax on the royalty payment it receives from the Singaporean sub-lessor's permanent establishment in Australia.*

Example 2: non-resident from a tax treaty country (excluding the United States and the United Kingdom)

8. *A New Zealand head lessor leases substantial equipment to a Singaporean company that in turn subleases the equipment to a sub-lessee in Australia. The equipment remains in Australia for the period of the sub-lease. The New Zealand head lessor has no other presence in Australia. The Singaporean resident sub lessor receives royalty payments from the sub lessee and makes royalty payments to the New Zealand head lessor. This can be illustrated as:*



9. *As in example 1 the Singaporean resident sub lessor is considered to have a permanent establishment in Australia under subsection 6(1) of the ITAA 1936 and to be carrying on business in Australia at or through a permanent establishment in Australia.*

10. *The equipment is not being used in Australia by the Singaporean sub-lessor under the lease with the New Zealand head lessor, but is being used in Australia under the lease the Singaporean sub-lessor has with the sub-lessee in Australia. Therefore, the equipment is not used in Australia by the New Zealand head lessor under the lease it has with the Singaporean sub-lessor and the New Zealand head lessor does not have a deemed permanent establishment in Australia under Article 5(4)(c) of the tax treaty between Australia and New Zealand.*

11. *Accordingly, subsection 17A(4) of the International Tax Agreements Act 1953 (the Agreements Act) does not exclude the payment from section 128B of the ITAA 1936. The New Zealand head lessor will be liable for royalty withholding tax on the royalty payment it receives from the Singaporean sub lessor's permanent establishment in Australia.*

Date of effect

12. It is proposed that when the final Determination is issued, it will apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that if conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination.

Commissioner of Taxation
6 June 2007

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.

13. A person is liable under subsection 128B(5A) of the ITAA 1936 to pay withholding tax[3] if they derive income that consists of a royalty and provided the requirements of subsections 128B(2B) or (2C) of the ITAA 1936 are satisfied in relation to that income.

14. Subsection 6(1) of the ITAA 1936 defines a royalty as including, amongst other things, an amount paid or credited as consideration for 'the use of, or the right to use, any industrial, commercial or scientific equipment'. Consequently, a payment from a Singaporean resident sub-lessor to a non-resident head lessor for the lease of substantial equipment will be a royalty as such leases involve 'the use of, or right to use' equipment, and the equipment is 'industrial, commercial or scientific'.[4]

15. Subparagraph 128B(2B)(b)(ii) of the ITAA 1936 states that section 128B will apply to a non-resident that derives a royalty and that royalty:

> is paid to the non-resident by a person who, or by persons each of whom, is not a resident and is, or is in part, an outgoing incurred by that person or those persons in carrying on business in Australia at or through a permanent establishment of that person or those persons in Australia.

16. Thus, the provision applies to the royalty derived by the non-resident head lessor where the Singaporean resident sub-lessor:

- has a permanent establishment in Australia (as defined under subsection 6(1) of the ITAA 1936);
- is carrying on business in Australia at or through that permanent establishment; and
- makes the lease payment to the non-resident head lessor as an outgoing incurred by it in carrying on that business.

A permanent establishment

17. Subsection 6(1) of the ITAA 1936 defines a permanent establishment to mean:

> a place at or through which the person carries on any business and, without limiting the generality of the foregoing, includes:
>
> (a) …
>
> (b) a place where the person has, is **using** or is installing substantial equipment or substantial machinery;" (emphasis added)
>
> (c) …

[3] Withholding tax means income tax payable in accordance with section 27GA or 128B of the ITAA 1936 (section 6(1) of the ITAA 1936 and section 995-1 of the ITAA 1997).
[4] See paragraphs 15 to 38 of Taxation Ruling TR 98/21 for further explanation of these phrases.

The meaning of 'using substantial equipment or substantial machinery'

18. The meaning of the words 'using substantial equipment or substantial machinery' in paragraph (b) of the definition of permanent establishment in subsection 6(1) of the ITAA 1936 has not been considered by Australian courts. However, the meaning of 'use' of substantial equipment in Article 4(3)(b) of Schedule 5 to the Agreements Act (the Singapore Agreement) was considered in *McDermott Industries (Aust) Pty Ltd v. Federal Commissioner of Taxation* (*McDermott's* case).[5]

19. Article 4(3)(b) of the Singapore Agreement provides that a Singaporean enterprise will be deemed to have a permanent establishment in Australia and to carry on trade or business through that permanent establishment 'if substantial equipment is being used in Australia by, for or under contract with the Singaporean enterprise'.[6]

20. In *McDermott's* case, where a Singaporean resident lessor leased barges to an Australian resident, the Full Federal Court held that the Singaporean resident lessor was deemed to have a permanent establishment in Australia under Article 4(3)(b)[7] of the Singapore Agreement because:

- the ordinary meaning of 'use' applied with effect that the Singaporean resident was using the barges in Australia, by leasing them to the Australian resident; or
- under the lease agreement, the barges were used within Australia by the Australian resident under contract with the Singaporean enterprise.

21. The Commissioner considers that the meaning given by the Full Federal Court in *McDermott's* case to the words, 'substantial equipment being used' in Article 4(3)((b) of the Singapore Agreement also applies to the expression 'using substantial equipment' in paragraph (b) of the definition of 'permanent establishment' in subsection 6(1) of the ITAA 1936. Accordingly, the Singaporean resident sub-lessor, by sub-leasing the equipment, is using the substantial equipment for the purposes of subsection 6(1) of the ITAA 1936.

22. For the purposes of paragraph (b) of the definition of 'permanent establishment' in subsection 6(1), the place at which the Singaporean resident sub-lessor 'is using the substantial equipment' is the physical location of the substantial equipment. As the substantial equipment is physically located in Australia, the Singaporean resident sub-lessor has a permanent establishment in Australia for the purposes of paragraph (b) of the definition of 'permanent establishment' in subsection 6(1) of the ITAA 1936.

Carrying on business in Australia at or through that permanent establishment

23. The second issue is to determine whether the Singaporean resident sub-lessor is carrying on business in Australia at or through its permanent establishment for the purposes of subparagraph 128B(2B)(b)(ii) of the ITAA 1936.

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[5] [2005] FCAFC 67.
[6] Such a permanent establishment is referred to as a 'substantial equipment permanent establishment'.
[7] [2005] FCAFC 67 at paragraph 71.

24. Whether the Singaporean resident sub-lessor is carrying on business is a question of fact. Factors typically relevant to such a determination are discussed in Taxation Ruling TR 97/11.[8] Based on those factors, the Commissioner states at paragraph 34 of Taxation Ruling TR 2006/D8 that an enterprise leasing ships or aircraft will almost always be found to be carrying on business. The Commissioner considers that this equally applies to an enterprise entering into a leasing transaction in respect of any other items of substantial equipment. Accordingly, the Singaporean resident sub-lessor is carrying on business by leasing the substantial equipment.

25. The Singaporean resident sub-lessor is considered to be carrying on this business *in Australia* because the substantial equipment that it leases to derive rental income is physically located in Australia while under the lease.

26. As the use of the substantial equipment gives rise to the permanent establishment, it is considered that the leasing business occurs through the permanent establishment.

Whether the royalty paid by the Singaporean resident is an outgoing incurred in carrying on that business

27. The Singaporean resident sub-lessor carries on all or part of its leasing business by having substantial equipment present in Australia under lease. The Singaporean resident sub-lessor makes rental payments to the non-resident head lessor.[9] As a result, the Commissioner considers that the Singaporean resident sub-lessor satisfies the requirement in subparagraph 128B(2B)(b)(ii) of the ITAA 1936 that it incurs the royalty outgoing in carrying on business in Australia through its permanent establishment in Australia. Therefore, subject to the possible operation of a tax treaty, the lease payment by the Singaporean resident sub-lessor to the non-resident head lessor is liable for royalty withholding tax under subsection 128B(5A) of the ITAA 1936.

Application where the non-resident head lessor is a resident of a country with which Australia has a tax treaty

28. If the non-resident head lessor is a resident of a country with which Australia has a tax treaty, then the non-resident head lessor may not be liable for withholding tax as the lease payments to which subparagraph 128B(2B)(b)(ii) of the ITAA 1936 applies may be excluded from withholding tax.

(a) Residents of the United States or the United Kingdom

29. Subsection 17A(5) of the Agreements Act provides that section 128B of the ITAA 1936 does not apply to royalties paid to residents of treaty partner countries where the tax treaty does not treat the amount paid as a royalty. Australia's tax treaties with the United States and the United Kingdom do not define amounts paid for the use of or right to use industrial, commercial or scientific equipment to be a 'royalty'. Accordingly, where the non-resident head lessor is a resident of the United States or the United Kingdom, no royalty withholding tax liability will arise.

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[8] See paragraphs 12 to 18 of Taxation Ruling TR 97/11.
[9] As noted at paragraphs 13 and 14 of this Determination, payments of this nature will be royalties under subsection 6(1) of the ITAA 1936.

(b) Residents of tax treaty countries other than the US and the UK

30. Under subsection 17A(4) of the Agreements Act where an amount that would have been subject to paragraphs 1 or 2 of the Royalties Article[10] of a tax treaty is excluded from the scope of the Royalties Article by another provision of the same tax treaty, then section 128B of the ITAA 1936 does not apply to that amount. An amount is excluded from being dealt with by the Royalties Article where the amount is a royalty that is effectively connected to a permanent establishment of a non-resident in Australia.

31. Whether the amount is effectively connected to a permanent establishment of the non-resident head lessor will depend on the particular facts and circumstances. Where a non-resident head lessor already has a permanent establishment in Australia (other than a substantial equipment permanent establishment) and uses that permanent establishment to lease substantial equipment to the Singaporean resident sub-lessor, then the lease payments would be considered to be effectively connected to a permanent establishment in Australia.

32. However, the Commissioner does not consider that the non-resident head lessor has a permanent establishment in Australia merely by virtue of the fact that it has a lease agreement with the Singaporean resident sub-lessor who uses the substantial equipment in Australia under a sub-lease. This is because the equipment is not being used in Australia by the Singaporean resident sub-lessor under the lease agreement between it and the non-resident head lessor, but is being used in Australia by the Singaporean resident sub-lessor under the lease agreement it has with the entity operating the equipment in Australia. Thus, the non-resident head lessor could not be considered to be using the equipment in Australia as a result of its contract with the Singaporean resident sub-lessor.

33. Nor does the Commissioner consider that the non-resident head lessor has a permanent establishment in Australia merely by virtue of the fact that the substantial equipment is ultimately operated in Australia. The non-resident head lessor does not have a lease contract with the ultimate operator, and the equipment is not being used in Australia under any other contract entered into by the non-resident head lessor.

34. Therefore, the lease payments received by a non-resident head lessor will remain subject to the Royalties Article of the Agreements Act.

[10] Article 12 of Schedule 1 to the Agreements Act.

Appendix 2 – Your comments

35. We invite you to comment on this draft Taxation Determination. 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 or relevant Tax officers. The Tax Office may use a version (names and identifying information removed) of the compendium in providing responses to persons providing comments. Please advise if you do not want your comments included in the latter version of the compendium.)

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References

Previous draft:

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Related Rulings/Determinations:

TR 98/21; TR 97/11; TR 2006/10; TR 2006/D8; TD 2007/D11

Subject references:

- leasing
- permanent establishment
- royalties
- royalty withholding tax
- Singapore tax treaty
- substantial equipment
- tax treaties
- United States
- United Kingdom

Legislative references:

- ITAA 1936 6(1)
- ITAA 1936 27GA
- ITAA 1936 128B
- ITAA 1936 128B(2B)
- ITAA 1936 128B(2B)(b)(ii)
- ITAA 1936 128B(2C)
- ITAA 1936 128B(5A)
- ITAA 1997 995-1
- International Tax Agreements Act 1953 17A(4)
- International Tax Agreements Act 1953 17A(5)
- International Tax Agreements Act 1953 Sch 1
- International Tax Agreements Act 1953 Sch 4
- International Tax Agreements Act 1953 Sch 5

Case references:

- McDermott Industries (Aust) Pty Ltd v. Federal Commissioner of Taxation [2005] FCAFC 67

ATO references

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