TR 2007/10 - 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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Australia's tax treaties and other agreements except for the Taipei Agreement are set out in the Australian Treaty Series. The citation for each is in a note to the applicable defined term in sections 3AAA or 3AAB of the International Tax Agreements Act 1953.

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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 publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (unless we are satisfied that the ruling is incorrect and disadvantages you, in which case we may apply the law in a way that is more favourable for you – provided we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

What this Ruling is about

Class of entities

1. This Ruling applies to:

   (i) enterprises of United States (US) residents for the purposes of the 1982 Tax Convention with the United States[1] as amended by the 2001 Protocol[2] (the US Convention); and

   (ii) enterprises of United Kingdom (UK) residents for the purposes of the 2003 Taxation Convention with the United Kingdom[3] (the UK Convention),

that lease out ship(s) or aircraft where the leasing 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 2A.
[3] *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 an aircraft.

3. This Ruling distinguishes such leases from those (finance) 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.[4] 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.[5]

Issues discussed in this Ruling

6. This Ruling explains the circumstances under which profits derived by an enterprise of a US or UK resident (US or UK enterprise) from the shipping or aircraft leases to which this Ruling applies are considered to fall within Article 7 of the respective US and UK Conventions. For those profits that are dealt with by 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.

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[4] Paragraph 6 of Article 7 in both the US and UK Conventions provide an ordering rule that gives Article 8 priority over Article 7. Accordingly, where Article 8 does not deal with the profits (that is, it does not allocate a taxing right over the profits to one or both Contracting States), they fall for consideration under Article 7.

[5] For further explanations of the character of a voyage charterparty, see paragraphs 13, 22, 34 to 40 of Taxation Ruling TR 2003/2 Income tax: the royalty withholding tax implications of ship chartering arrangements.

8. This Ruling then addresses a number of issues concerning the relevant permanent establishment provisions of Article 5 of the respective Conventions. The major focus of this 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
- the lessor is subject to an Australian source country taxing right under Article 7.

9. This 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 this Ruling.

11. This 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. This Ruling does not deal with block space and free sale code-sharing arrangements.

12. This Ruling only applies to the tax treaties concluded by Australia with 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 an 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 an 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)[6] 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 an aircraft generally without the captain and crew.[7]

15. A full basis lease involves a situation where a lessee wishes to have a ship or an 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 remains 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 an 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 (US lessor enterprises) 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;

[6] See paragraph 1.99.
[7] See paragraph 2.13 of the Explanatory Memorandum to the International Tax Agreements Amendment Bill (No. 1) 2002 which refers to a bareboat lease as being 'generally, without crew'.

- a full basis lease where the ship or aircraft is operated in international traffic by the lessee, provided that the US lessor enterprise:

  (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 lessor enterprise from one of the above types of leases of a ship or an 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 profits of UK enterprises as lessors (UK lessor enterprises) from a bareboat lease of a ship or an aircraft where the lease is not 'directly connected or ancillary' to the UK lessor enterprise's operation of ships or aircraft in international traffic.

20. Profits derived by a UK lessor enterprise from the above type of lease of a ship or an 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 within 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. Article 7 will be the applicable Article where the US or UK lessor 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 'substantial equipment'

24. 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.

25. Given the ships and types of aircraft that are the subject of leases to which this Ruling applies, the Commissioner considers that it would be extremely rare for such ships 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, these ships or aircraft would be expected to constitute substantial equipment in an absolute sense.

Meaning of 'maintains … for rental or other purposes … within Australia'

26. The expression 'maintains … for rental or other purposes … within Australia' in Article 5(4)(b) of the US Convention and Article 5.3(b) of the UK Convention applies to situations where the actions of a US or UK lessor enterprise are directed toward keeping one or more of its ships or aircraft present within Australia for leasing purposes. Thus, a US or UK lessor enterprise will be considered to maintain ships or aircraft within Australia where that lessor:

(a) directs or otherwise requires that the ships or aircraft be used by the lessee within Australia; or

(b) already has ships or aircraft located within Australia which are available for lease in Australia, and those ships or aircraft are used within Australia.

27. For the purposes of paragraph 26(a) of this Ruling, a lessor would direct or otherwise require that the ships or aircraft be used by the lessee within Australia if there is a requirement in the lease that they be physically located or used within Australia. However, a lessor would not be considered to direct or otherwise require that the ships or aircraft be used by the lessee within Australia where:

- the ships or aircraft are of a general nature such that they can be used in most locations;
- the lessor has no requirement as to where the lessee ultimately uses the equipment; and
- it simply eventuates that the lessee brings the ships or aircraft to Australia and uses them in Australia.

Subleasing and chains of entities

28. Where a ship or an aircraft is leased through a chain of entities, the Commissioner will apply the tests in paragraphs 26 and 27 of this Ruling to determine whether a US or UK lessor enterprise in that chain is maintaining the ship or aircraft for rental or other purposes within Australia. In applying the tests to a US or UK lessor who is part of a chain of entities, the Commissioner considers the actions of the US or UK lessor alone (that is, as distinct from those of the lessee or any sublessees) to determine whether the US or UK lessor is maintaining ships or aircraft for rental or other purposes within Australia.

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

29. 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.

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

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.

The scope of the 'hire-purchase exclusion'

32. 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 express or implied 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.

33. As a result, where a ship or an 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 the financial accommodation inherent in these types of leases is dealt with under the Interest Article (Article 11) of the respective Conventions.

34. Where a US or UK lessor enterprise 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 lack of express deeming to 'carry on business in Australia through that permanent establishment' in Article 5(4)(b) of the US Convention

35. A US lessor enterprise 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 business in Australia through that deemed permanent establishment.[8] Whether this is the case is a question of fact and degree having regard to the circumstances of each particular case.

36. Based on the indicators identified by Australian courts for determining what constitutes carrying on business and the complexity of the arrangements entered into by commercial lessors of high value equipment, the Commissioner considers that a US enterprise leasing a ship or an aircraft will almost always be found to be carrying on business. See paragraphs 157 to 167 of this Ruling for an analysis of the relevant factors and circumstances.

37. Where the lease contracts are entered into outside Australia and no other activities, apart from the receipt of lease rentals arise in Australia, the mere presence of the leased equipment in Australia does not constitute carrying on business in Australia through the deemed permanent establishment of the US lessor. To satisfy Article 7(1) of the US Convention, the US lessor would need to be undertaking more of the activities constituting its leasing business within Australia, such as undertaking maintenance checks on the ships or aircraft in Australia or conducting lease negotiations in Australia.

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

38. 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.

[8] No such condition applies under the UK Convention because Article 5.3 of the UK Convention expressly deems the enterprise to carry on business through the permanent establishment (see paragraph 180 of this Ruling).

39. 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 and lease negotiations by the US lessor in Australia, 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.

40. 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.[9]

41. Therefore, if Americo has a permanent establishment in Australia under Article 5 and if it is carrying on business in Australia through that permanent establishment, Australia will have a taxing right under Article 7(1) in respect of Americo's leasing profits that are attributable to the permanent establishment.

42. 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 the ship is advertised and leased out while the ship is present in Australia. Accordingly, 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.

43. 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 business in Australia through its deemed permanent establishment by making the ship available for lease from Australia including advertising and negotiating the lease agreement 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

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

45. 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.

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[9] For the purposes of this example, it is assumed that Article 8 does not apply as per paragraph 17 of this Ruling. However, when examining instances of this kind it will be necessary to consider the application of Article 8.

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

46. 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.

47. 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.

48. 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.

49. 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 a bareboat basis – whether such leasing activity is merely incidental to its other ship operations

50. 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.

51. 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.

52. Marineco is approached by another company on 1 January 2006 whilst one of Marineco's 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 2006.

53. The regularity and extent with which Marineco sub-leases 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.

54. 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 of Marineco, within the meaning of Article 5, in Australia.

55. 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.

56. 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.

Example 5: bareboat lease of aircraft by an enterprise not engaged in aircraft operations and lessee uses the aircraft exclusively within Australia

57. Rentalco is a US enterprise that leases aircraft on a bareboat basis. Rentalco does not also operate aircraft itself, for example, for air transport purposes. Rentalco negotiates and concludes a bareboat lease agreement at its offices in the United States with a lessee who needs three aircraft for its own transport operations. The lease does not require that the aircraft be used in any particular location.

58. Rentalco does not have any offices or employees outside of the United States and as such delivers the aircraft to the lessee in the United States. The lessee brands the aircraft with its own logos and uses them exclusively within Australia for its own business purposes. The period of the lease is 36 months. During this period, the lessee deposits monthly rental payments for the aircraft directly into the Lessor's US bank account.

59. The facts indicate that Rentalco does not have a fixed place of business or dependent agent in Australia within the meaning of Article 5. Furthermore, Rentalco is not deemed to have a permanent establishment in Australia under Article 5(4)(b) because Rentalco's actions are not considered to be directed at keeping the aircraft under lease in Australia. This is the case because Rentalco does not require that the aircraft be used in Australia and the aircraft were not made available for lease from Australia. Rentalco, therefore, is not maintaining the aircraft for rental purposes within Australia for the 36 month lease period.

Example 6: subsequent bareboat lease of aircraft by an enterprise where new lessee uses the aircraft exclusively within Australia

60. The facts are as in Example 5 except that, at the end of the 36 month lease period, the lessee asks Rentalco if it can leave the three aircraft at Sydney. Rentalco agrees and decides to keep the aircraft in a holding bay in Sydney. Whilst the aircraft are advertised as available for lease from Sydney, lease negotiations are conducted in the US. The new lessee agrees to lease the three aircraft for two years and uses them exclusively within Australia for the lease term.

61. Rentalco is considered to be maintaining the aircraft for rental purposes within Australia because the three aircraft were:

- present in Australia when Rentalco made them available for lease;
- made available for lease from Australia; and
- used by the lessee exclusively within Australia for more than 12 months.

62. Consequently, for the purposes of the new lease Rentalco is deemed to have a permanent establishment under Article 5(4)(b) for the duration of the two year lease period.

63. Whilst Rentalco has a deemed permanent establishment in Australia it is still necessary to determine whether it is carrying on business in Australia through this deemed permanent establishment for the purposes of Article 7(1). Based on the facts of this case Rentalco does not conduct sufficient business activities within Australia for it to be considered to be carrying on its aircraft leasing business in Australia.

64. As a result, Rentalco is not carrying on business in Australia through its deemed permanent establishment and Australia is not allocated a taxing right over the leasing profits under Article 7(1).

Section C: the UK Convention: full basis leases

Example 7: full basis lease of an aircraft by an international aircraft operator and lessee uses aircraft in international traffic

65. 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 two of its aircraft that it does not require for its own transport operations. It leases the aircraft 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.

66. The profit derived by Royalco is from a full basis lease of 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 8: international aircraft operator who regularly leases aircraft on bareboat basis – whether such leasing activity is directly connected or ancillary to its other aircraft operations

67. 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.

68. One of Charterco's aircraft is leased by an Australian company for a period of 20 months. In accordance with the requirements of the lease, the lessee uses the aircraft exclusively for Australian domestic transport.

69. 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 aircraft activities that it is not considered 'directly connected or ancillary' to its other international aircraft transport operations.

70. 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 is required to use 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).

71. 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).

72. 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 9: a temporary interruption

73. The facts are as in Example 8 except that ten months into the lease, the Australian lessee flies the aircraft to New Zealand for a week of maintenance checks.

74. 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 10: more than a mere temporary interruption

75. The facts are as in Example 8 except that the 20 month lease has now expired, and the aircraft stays in Australia because the Australian lessee decides to re-lease it from Charterco for another 20 months. There is no requirement in the new lease that the aircraft be used exclusively within Australia.

76. The lessee uses the aircraft for both domestic and international transport routes as part of its new commercial practice of rotating its aircraft over various routes. This 'rotation' practice of the Australian lessee involves the aircraft being regularly rotated between domestic routes, such as Sydney to Perth, and international routes, such as Melbourne to Fiji.

77. In this case, Charterco will not be deemed to have a permanent establishment under Article 5.3(b) because, although the aircraft is leased from Australia, it is not operated by the lessee within Australia for a continual period of more than 12 months. The international trips are regularly undertaken such that each time the aircraft is used on one of its regularly scheduled international routes this constitutes a break in the period the aircraft is being operated by the lessee in Australia. As a result Australia would not have a taxing right under Article 7 over the leasing profits in respect of the new lease.

Date of effect

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

79. This Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
19 December 2007

Appendix 1 – Explanation

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

Introduction

80. 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.

81. Accordingly, this section of this Taxation Ruling is divided into two Parts. Part A (commencing at paragraph 87) addresses the relevant factors and issues in the context of the provisions of the US Convention. Part B (commencing at paragraph 171) addresses those factors and issues in the context of the corresponding provisions of the UK Convention.

Undefined terms

82. 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.

83. 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.

84. 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.

85. 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.

86. Taxation Ruling TR 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

87. 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 application of the expression 'substantial equipment' in relation to ships and aircraft;

  (ii) the meaning of 'maintains … for rental or other purposes … within Australia';

  (iii) the 'more than 12 months' threshold period condition;

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

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

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

88. 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.

89. 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.[10] The following leases are not dealt with by Article 8 and thus fall for consideration under Article 7.

A lease on a full basis of a ship or an 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 an 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'

90. 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.

91. 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.[11]

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[10] 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.

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

92. The meaning of the undefined term 'merely incidental',[12] 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.[13] 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'.

93. 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.

94. 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.

[12] 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.

[13] 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)

95. 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.[14]

96. 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)

97. Article 5(4)(b) of the US Convention deems an enterprise of one of the Contracting States to have a permanent establishment in the other Contracting State where:

> it maintains substantial equipment for rental or other purposes within that other State (excluding equipment let under a hire-purchase agreement) for a period of more than 12 months.

98. 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.

99. 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.

100. 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.[15]

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

[15] 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 to 37 of Taxation Ruling TR 2001/13: Income tax: Interpreting Australia's Double Tax Agreements.

101. 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.

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

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

103. 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'

104. The relevant meanings of the word 'equipment' in the Macquarie Dictionary[16] are: anything used in or provided for equipping; a collection of necessary implements (such as tools). Accordingly, the term 'equipment' can mean a single item or multiple items.

105. Paragraphs 33 to 38 of Taxation Ruling TR 98/21[17] 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.[18] 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.

106. 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'.[19] As a result, an entirety such as a ship or an aircraft would be an item of 'equipment' for purposes of Article 5(4)(b).

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[16] 5th Edition, 2001.

[17] Taxation Ruling 98/21 Income tax: withholding tax implications of cross border leasing arrangements

[18] 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).

[19] 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'.

Meaning of 'substantial'

107. The relevant meanings of the word 'substantial' in the Macquarie Dictionary[20] 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.

108. 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*[21] 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.

109. In analysing Article 4(3)(b) of the Singapore Agreement (the substantial equipment provision in that tax treaty), the Full Federal Court in *McDermott Industries (Aust) Pty Ltd v. Commissioner of Taxation*,[22] stated:

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

110. 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;[23] and
- in an absolute sense, that is, when viewed independently; not in comparison with something else; or

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[20] 5th Edition, 2001.
[21] (1979) 42 FLR 331, p. 348; (1979) 27 ALR 367.
[22] [2005] FCAFC 67, paragraph 55; (2005) 219 ALR 346; (2005) 2005 ATC 4398; (2005) 59 ATR 358; (2005) 142 FCR 134.
[23] 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.

- in a relative sense; that is, by comparing it to something else.[24]

ATO position

111. Having regard to the contextual matters discussed above and the ships and types of aircraft that are the subject of cross-border leases to which this Ruling applies, the Commissioner considers that it would be extremely rare for these ships or aircraft not to be substantial equipment for the purposes of Article 5(4)(b). By reason of their size alone, such ships and aircraft would be expected to constitute substantial equipment in an absolute sense.

112. 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.

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

113. The ordinary meaning of the term '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.

114. The relevant meaning of the term 'maintain' in the Macquarie Dictionary[25] is:

- to keep in existence or continuance, preserve; retain; and
- to keep in a specified state, position etc.

115. This indicates that in the context of Article 5(4)(b), to maintain something requires a positive element of keeping it in a particular state or position. Also, the broader reference to 'maintains substantial equipment …. in Australia' in Article 5(4)(b) indicates that the focus of the provision is on keeping substantial equipment in the physical location of Australia. The requirement that an 'enterprise' maintains substantial equipment indicates that, taken as a whole, the actions of the enterprise are to be directed towards keeping the substantial equipment in Australia. The reference to 'for rental or other purposes' indicates that the actions of the enterprise are to be directed towards keeping the substantial equipment in Australia for its own use or for use by others such as lessees.

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[24] In accordance with the Macquarie Dictionary definition of the terms 'absolute' and 'relative'.
[25] 5th Edition, 2001.

116. Accordingly, for the purposes of leasing of ships or aircraft, the Commissioner considers a US lessor enterprise maintains substantial equipment in Australia where its actions are directed towards keeping the ships or aircraft in Australia. Where the lessor enterprise's actions are not so directed, this indicates that the lessor is not maintaining ships or aircraft in Australia.

Whether actions are directed toward keeping the ships or aircraft in Australia

117. Where the ships or aircraft are located outside Australia before being leased in Australia, the actions of the US lessor enterprise have to be directed towards an outcome that the ships or aircraft are relocated to Australia for their use in Australia. This does not necessarily mean that the US lessor enterprise must itself relocate the ships or aircraft to Australia in order for its actions to be so directed. For example, a US lessor enterprise may require, as a condition of the lease, that the leased ship or aircraft be physically located only within Australia for the term of the lease. Such a requirement regarding use of the ship or aircraft only within Australia would be sufficient for these purposes.

118. Where the ships or aircraft are located outside Australia before being leased in Australia, situations will also arise where the actions of the lessor are not directed towards keeping the ships or aircraft within Australia. This would arise, for example, where the ships or aircraft are of a general nature such that they can be used in most locations, the lessor has no requirement as to where the lessee ultimately uses the equipment, and it simply eventuates that the lessee brings the ships or aircraft to Australia and uses them in Australia. In these circumstances, the lessor would be considered to be indifferent as to where the ships or aircraft are to be used under the lease.

119. Where however the ships or aircraft are already located in Australia, are made available for lease in Australia and are actually used in Australia, the Commissioner considers that these facts demonstrate that the actions of the US lessor enterprise are directed towards keeping the ships or aircraft in Australia. This will be the case regardless of whether the US lessor enterprise brought the ships or aircraft to Australia to make them available for leasing, had the ships or aircraft constructed in Australia, or simply allowed them to remain in Australia for the purpose of leasing following the expiry of a previous contract.

120. This will also be the case regardless of whether the lease agreement requires the leased ships or aircraft be used in Australia during the lease, or whether the US lessor enterprise makes the ships or aircraft available for lease worldwide and they are then used by the lessee in Australia.

121. Thus, a US lessor enterprise will be considered to maintain ships or aircraft within Australia where that lessor:

(a) directs or otherwise requires that the ships or aircraft be used by the lessee within Australia; or

(b) already has ships or aircraft located within Australia which are available for lease in Australia, and those ships or aircraft are used within Australia.

Relevance of Lease Terms

122. When considering paragraph 119(a) of this Ruling, the extent to which a lessor directs or otherwise requires that the ships or aircraft be used by the lessee within Australia will depend to some degree on the particular terms of the lease.

123. A non-restrictive permitted use clause would be indicative that the lessor does not direct or otherwise require that the ships or aircraft be used by the lessee within Australia. Even where there is a requirement in the lease that the ships or aircraft cannot be used in a 'dangerous area' or that use is limited to the Asia/Pacific region, the lessor would not be considered to be directing or requiring that the ships or aircraft be used in Australia. Accordingly, these types of requirements would not alone result in the Commissioner considering that the lessor maintains the ships or aircraft in Australia.

124. A requirement that the ships or aircraft must be returned to the lessor after the lease expires would further indicate that the lessor is indifferent as to where the ships or aircraft are used under the lease.

125. Requirements in a lease that the place of delivery or redelivery, place of registration, governing law or tax indemnification be in or related to Australia do not of themselves indicate that the lessor is directing or otherwise requiring that the ships or aircraft be used by the lessee within Australia. While these factors may prima facie contemplate a connection with Australia, they may merely be a product of the fact that the lease is with an Australian operator.

126. A requirement in the lease that the ships or aircraft must be physically located or used within Australia would evidence that the lessor is directing that the ships or aircraft be used by the lessee in Australia. Alternatively, where the overall circumstances of the lease arrangement and/or the nature of the equipment indicate that the ship or aircraft can only, in a practical sense, be used within Australia (and nowhere else) then the lessor will be considered to be directing that the ship or aircraft be used by the lessee in Australia.

127. A mere extension to the term of a lease does not make the lessor's action in entering into that extension directed at keeping the ships or aircraft in Australia.

128. 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 equipment is already located in Australia and a US lessor enterprise takes the equipment out of Australia without any commercial reason for doing so and subsequently re-leases it into Australia.

Subleasing and chains of entities

129. It is common practice for ships and aircraft to be leased and subleased through one or more entities before they reach the entity that actually operates them. In such instances, the entities involved are said to be part of a chain of entities. In relation to a particular lease between two entities in a chain, it is the contractual agreement between those two entities which is relevant to determining whether a US lessor enterprise in the chain has a permanent establishment in Australia under Article 5(4)(b).

130. The Commissioner considers that a US lessor enterprise in a chain of entities maintains ships or aircraft for rental or other purposes within Australia where the US lessor enterprise requires that the relevant ships or aircraft be used within Australia, or the US lessor enterprise already has ships or aircraft located within Australia which are leased or made available for lease within Australia by the US lessor enterprise.

131. Where a US lessor enterprise holds ships or aircraft outside Australia before they are leased, and the actions of the lessor are not directed towards keeping the ships or aircraft in Australia, the lessor will not be considered to maintain the ships or aircraft within Australia. This would be the case even if the lessee requires a sublessee in the chain to use the ships or aircraft within Australia, or the lessee already has ships or aircraft located within Australia under the lease and makes them available for sublease within Australia.

132. In other words, in applying the reasoning in paragraphs 113 to 128 of this Ruling to a US lessor who is part of a chain of entities, the Commissioner considers the actions of the US lessor alone (that is, as distinct from those of the lessee or any sublessees) to determine whether the US lessor is maintaining ships or aircraft for rental or other purposes within Australia.

The 'period of more than 12 months' condition

133. If the requirements above are satisfied with effect that the lessor is maintaining ships or aircraft in Australia it is necessary also to establish that the equipment was maintained within Australia for the requisite period of time, in order to meet the full requirements of the provision. Paragraphs 134 to 144 of this Ruling explain issues which may arise in relation to the requisite time period).

Aggregating time of individual equipment

134. 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. As per paragraph 102 of this Ruling, 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*[26] 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 …'.

135. 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.

136. 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.

137. 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.

[26] [2005] FCAFC 67, at paragraph 71; (2005) 219 ALR 346; (2005) 2005 ATC 4398; (2005) 59 ATR 358; (2005) 142 FCR 134.

Replacement equipment

138. Where a ship or an 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.

Temporary interruptions

139. Paragraph 6.1 of the Commentary on Permanent Establishment Article (Article 5) of the OECD Model states in relation to a permanent establishment for the purposes of Article 5(1) of the OECD Model that 'temporary interruptions of activities do not cause a permanent establishment to cease to exist.'[27]

140. The Commissioner considers that this aspect of a permanent establishment for the purposes of Article 5(1) of the OECD Model also applies to permanent establishments brought into existence by operation of Article 5(4)(b). Hence, consistent with paragraph 6.1 of the Commentary on Article 5 of the OECD Model, the substantial equipment needs to be physically present within Australia for a continual[28] period of more then 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.

141. Ultimately, what constitutes a temporary interruption to the time period of more than 12 months for Article 5(4)(b) purposes depends on the facts and circumstances of each particular case. 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.

142. For example, if a ship or an aircraft is temporarily transported out of Australia for a week of repairs or maintenance to be carried out in a twelve month period, this interruption will not break the continuity of the period (see Example 9, paragraph 73 of this Ruling).

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[27] Similar sentiments are also expressed in relation to temporary interruptions at paragraphs 11 and 19 of the Commentary on Article 5 of the OECD Model.

[28] '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.

143. On the other hand, if a ship or aircraft is transported out of Australia for more than just a temporary period, 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.

144. 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 an 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).[29]

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

145. 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:

- where a US enterprise leases ships or aircraft 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.[30]

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

146. 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).

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[29] 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.

[30] 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.

The scope of the 'hire-purchase agreement' exclusion

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

148. The term 'hire-purchase agreement' is not defined in the Convention. There are various domestic law meanings of the term.[31]

149. 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.[32] 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.[33] 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.

150. 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.

151. While TR 98/21 adopts a broad meaning for the term 'hire-purchase agreement' in section 128AC of the *Income Tax Assessment Act 1936* (ITAA 1936),[34] 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 of the ITAA 1936, but rather the term includes all leases that fall within section 128AC of the ITAA 1936 in accordance with the fundamental principle in TR 98/21.

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[31] For example, Division 240 and Division 40 of the *Income Tax Assessment Act 1997* and section 128AC of the ITAA 1936.

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

[33] 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.

[34] 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.'

152. In TR 98/21,[35] 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.[36]

153. 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).

154. 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 were included in the Article 12 of the OECD Model.[37] 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).

[35] See paragraphs 7, 8, and 30 to 32 of TR 98/21.
[36] This fundamental distinction is also evident in a number of other Rulings published by the Commissioner, such as IT 28, IT 2051, IT 2236, IT 2519, IT 2594, IT 2660, TR 95/30 and TR 98/21, TD 93/187 and TD 94/20.
[37] 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.

155. 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;[38]
- leases for effective life with a financing element;[39] and
- a terms purchase or an instalment sale.

156. 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.

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

Profits of an enterprise of a Contracting State

157. Based on the meaning of 'enterprise' from Australian domestic tax law and *Thiel v. Federal Commissioner of Taxation* (*Thiel's* case),[40] a US lessor that is the subject of this Ruling will be an 'enterprise' for the 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.

158. 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.*

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[38] 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.

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

[40] 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.

'Carrying on business'

159. 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'.

160. Whether a US enterprise 'carries on business' in leasing a ship or an aircraft, for the purposes of Article 7(1) is a question of fact and degree to be determined having regard to the circumstances of each particular case.[41]

161. 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.

162. As noted in the Full Federal Court decision in *Stone v. FC of T*,[42] 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.

163. 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.

164. In *American Leaf Blending Co. Sdn Bhd v. Director-General of Inland Revenue (Malaysia)*[43] 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*,[44] 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.[45] In line with these cases the letting of property out for rent can constitute 'carrying on business'.

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[41] 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.

[42] 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.

[43] [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.

[44] (1987) 72 ALR 70 at 77; (1987) 15 FCR 19; 87 ATC 4235; 18 ATR 508.

[45] *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.

165. In *Unisys Corporation Inc v. FC of T*,[46] Justice Gzell considered that, notwithstanding the narrowness of the profit margin from the licensing and sub-licensing of the rights and that little other activity was necessary, the mere taking on of license and sub-licensing intellectual property rights was the acquiring and exploitation of valuable rights. He concluded that:

> In my view, in light of the attitude taken to what constitutes a business for the purposes of the business profits article, from which the language of section 128B(2B) of the *Income Tax Assessment Act 1936* emanates, ULP carried on business for the purposes of that provision.

166. Shipping and aircraft leasing arrangements usually involve entering into complex legal contracts concerning property of high value and involve regular activity, such as invoicing and receipt of lease payments. They are undertaken by commercial entities for the exploitation of valuable rights for the purpose of deriving a profit. 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).

167. 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 fact that it involves the acquiring and exploitation of valuable rights. This is irrespective of the fact that it may be a one-off leasing arrangement of the SPV.

Carrying on business in Australia 'through' a permanent establishment

168. Even though a US lessor that maintains a ship or aircraft in Australia may have a deemed permanent establishment in Australia, and constitute an enterprise carrying on business, it is still necessary to establish that it is carrying on business in Australia through that permanent establishment. This requires an examination of the business activities of the enterprise that relate to the deemed permanent establishment to determine whether they have been undertaken in Australia through that permanent establishment.

[46] 2002 ATC 5146 at 5153 and 5154; 51 ATR 386.

169. Where the lease contracts are entered into outside Australia and no other activities, apart from the receipt of lease rentals arise in Australia, the mere presence of the leased equipment in Australia does not constitute carrying on business in Australia through the deemed permanent establishment of the US lessor. To satisfy Article 7(1) of the US Convention, the US lessor would need to be undertaking more of the activities constituting its leasing business within Australia, such as undertaking maintenance checks on the ships or aircraft in Australia or conducting lease negotiations in Australia.

170. Thus, a requirement by the US lessor that it's ship or aircraft must be used by a lessee within Australia, while sufficient to conclude that the US lessor has a deemed permanent establishment in Australia, is not, in itself, sufficient to demonstrate that the US lessor is carrying on a leasing business in Australia. A similar outcome would apply for a requirement by the US lessor that its ship or aircraft be made available for lease from Australia following the expiry of the contract.

Part B – the UK Convention

171. 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

172. 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.

173. 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 an 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'

174. 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 90 to 94 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.

175. 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

176. See earlier explanations at paragraphs 95 and 96 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)

177. 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 97 to 101 of this Ruling for further explanation.

178. 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. Article 5.3(b) of the UK Convention is identical to Article 5(4)(b) of the US Convention to the extent that it states that an enterprise shall be deemed to have a permanent establishment where:

> it maintains substantial equipment for rental or other purposes within that other State (excluding equipment let under a hire-purchase agreement) for a period of more than 12 months.

179. 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

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

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Related Rulings/Determinations:

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