TR 2002/D11 - Income tax: the royalty withholding tax implications of chartering and similar arrangements

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Draft Taxation Ruling

Income tax: the royalty withholding tax implications of chartering and similar arrangements

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Preamble

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

Class of person/arrangement

1. This Ruling applies to non-residents who:

   (a) charter industrial, commercial or scientific (ICS) equipment such as ships and aircraft (the arrangement under which such equipment is chartered is called a charterparty);

   (b) lease other ICS equipment on a dry or wet basis

   to residents of Australia.

2. This Ruling also applies in those situations involving permanent establishments (PE) where:

   (a) The charterparty or lease is between two residents of Australia and the royalty income is attributable to a PE outside Australia of the recipient of the royalty income (paragraph 128B(2C)(a) and sub-paragraph (b)(i) ITAA 1936).

   (b) The charterparty or lease is between two non-residents and the royalty is an expense attributable to a PE of the payer of the royalty in Australia (paragraph 128B(2B)(a) and subparagraph (b)(ii) ITAA 1936).

   (c) An Australian resident charters or leases the ICS equipment to a non-resident and the payment is, income attributable to a PE of the resident in a country outside Australia, and, an outgoing of the non-resident

attributable to a PE in Australia
(paragraph 128B(2C)(a) and sub-paragraph (b)(ii)).

3. The arrangements to which this Ruling applies are more particularly described as:

- a demise charterparty where, for example, a ship is chartered without the captain and crew (also known as a bareboat or dry charterparty or dry lease);
- a time charterparty where, for example, a ship is chartered with captain and crew (also known as a wet charterparty or wet lease);
- a voyage charterparty where the charterer is also the shipper;
- a simple lease of ICS equipment, for example, a crane or motor vehicle (also known as a dry lease or dry hire); and
- a lease of ICS equipment which comes with an operator, for example, a crane with an operator and a motor vehicle with a driver (also known as a wet lease or wet hire).

Issues Discussed in the Ruling

4. This Ruling considers the liability to royalty withholding tax (RWT) arising under the *Income Tax Assessment Act 1997* ('ITAA 1997') and the *Income Tax Assessment Act 1936* ('ITAA 1936') of the class of persons to whom this Ruling applies in respect of payments made for the chartering or leasing of ICS equipment. As charterparties normally involve the chartering of ships for the carriage of goods by sea, the Ruling will in the main discuss the tax issues in this context. Aircraft chartering and dry and wet leases of other ICS equipment are in the main similar to ship chartering (for instance a dry lease is the equivalent to a bareboat charterparty and a wet lease to a time charterparty). Therefore, subject to variations to fit the circumstances of each case, the principles discussed in the context of ship chartering also apply to aircraft chartering and leases of other ICS equipment.

5. This Ruling considers the question of whether a payment under a charterparty or lease of other ICS equipment constitutes a 'royalty' (a term defined in subsection 995-1(1) (ITAA 1997)) being a payment for the 'use of, or the right to use' equipment. Relevant to this question is also the subsidiary question as to whether the payment, or part of the payment, is for rendering services and thus falls outside the definition of 'royalty'.

6. This Ruling is not concerned with the effect of the Ships and aircraft Articles or its interaction with the Royalty Articles in Australia's Double Tax Agreements (DTAs).

Background

Liability for royalty withholding tax

7. RWT is a liability arising under subsections 128B(2B), 128B(2C) and 128B(5A) (ITAA 1936) to pay income tax on royalty income.

8. The term 'royalty' is defined in subsection 995-1(1) (ITAA 1997). Under this subsection 'royalty' has the meaning given by subsection 6(1) (ITAA 1936).

9. Subsection 6(1)(ITAA 1936) defines 'royalty' or 'royalties' in so far as is relevant to this Ruling as follows:

> **"royalty" or "royalties"** includes any amount paid or credited, however described or computed, and whether the payment or credit is periodical or not, to the extent to which it is paid or credited, as the case may be, as consideration for -
>
> (a)……..;
>
> (b) the use of, or the right to use, any industrial, commercial or scientific equipment;
>
> (c)……..;
>
> (d) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of,……..… any such equipment as is mentioned in paragraph (b)…..….

10. The principal issue arising with respect to charterparties is whether the arrangement between the shipowner and the charterer is a contract for services (e.g., a contract for the carriage of goods) or a contract for the use of, or the right to use, the vessel. In the former case the payments will be for services and not royalties. In the latter case the payments will be royalties as defined for tax purposes.

11. A related issue is whether payments under a time charter can be apportioned or dissected into payments that are royalty payments and payments for the services provided by the captain and crew. If the answer is in the positive, the further question that arises is whether the latter payments also fall within paragraph 6(1)(d) (ITAA 1936) of the definition of 'royalty'.

Shipping trade practice

12. The transportation of goods is, generally speaking, arranged by the exporter or importer of goods (**shippers**) depending on whether the sale is made on f.o.b., c.i.f. or other bases. The nature of the contractual arrangements entered into for the carriage of goods by sea (which are generally referred to as contracts of affreightment - **COA**) are to a large extent influenced by the nature and size of the cargo to be carried. A shipper of a small quantity of goods is likely to reserve space on a liner ship which is in the business of carrying goods for several shippers between advertised routes around the world (**liner services**). Here, the contract for the carriage of goods by sea is between the shipowner and shipper and is prima facie governed by a **Bill of Lading** ordinarily issued by the master of the ship to the shipper.

13. By contrast, a shipper of a large quantity of goods may require the entire carrying capacity of a ship to carry its goods to a particular destination. In this case the contract of carriage is likely to be governed by a **voyage charterparty** between the shipper and shipowner.

14. Shipowners do not always directly undertake to carry the goods of shippers on their vessel. They may simply charter their vessels to another party (the **charterer**) who will then enter into a COA with the shipper. As between the shipowner and the charterer their rights and obligations will be governed by the form of contract known in the trade as a **charterparty**. In this context, the arrangement entered into between shipowner and charterer may be a **time charterparty** or a **demise charterparty.**

15. The main distinctions between the various COA referred to above may be summarised as follows:

> **Liner services** - The shipowner is providing a cargo carrying service with the **bill of lading** being prima facie evidence of the contract of carriage. (See paragraphs 38-44).
>
> **Voyage charterparty** – The shipowner undertakes to carry the charterer's cargo (the charterer also being the shipper) between specific points. The contract of carriage in this case is the charterparty with the bill of lading being a mere receipt and a document of title. (See paragraphs 45-51).
>
> **Demise charterparty** – The shipowner transfers to the charterer for a period of time not only the possession but also the navigation of the ship. The services of the master and crew may or may not be added to a demise charterparty. Where the ship comes without a master and crew it is called a **bareboat charterparty**. The charterer will then engage it's own master and crew to manage and navigate the ship. The demise

charterer may then use the ship for liner services or sub-charter the ship under a time charterparty or voyage charterparty to others. (See paragraphs 52-54).

Time charterparty – Like a demise charterparty, the shipowner is placing his ship for an agreed time at the disposal of the charterer who is free to employ it for its own purposes within the permitted contractual limits of the charterparty. Unlike a demise charterparty, a time charterparty involves a division of the ship's management. The charterer controls the commercial function of the ship and is therefore responsible for the expenses of such activities. The shipowner retains possession of the ship through the control it has over the master and crew who remain in the employment of the shipowner. The shipowner is responsible for the navigation of the ship through the master and crew. In almost all cases, the charterer uses the ship to engage in the business of carriage of goods by sea, by making further COA under bills of lading or voyage charterparties with third parties. (See paragraphs 55-70).

16. A further difference is in the characterisation of the amount payable under each COA. With a demise and time charterparty 'hire' is payable according to the amount of time the vessel is placed at the disposal of the charterer. 'Hire' is the price paid for the use of the vessel. With liner services and voyage charterparty 'freight' is payable for carriage of the cargo. This difference is also reflected in the way the two amounts are calculated. (See paragraphs 71-82).

17. Not all COA fall neatly within the four classical arrangements discussed above. In modern shipping practice, there are a variety of commercial arrangements that often make it difficult to identify the nature of the arrangement and who the carrier is. A ship may be the subject of several charterparties in a chain. The form of charterparties may include a variety of hybrids such as a trip charter, a consecutive voyage charter and the long-term freighting contract.

18. The object of this Ruling is to determine the character of payments made by a charterer to a shipowner or by a sub-charterer to a charterer and so on under the three classical charterparty arrangements. This entails an understanding of the relationship that exists between a shipowner and charterer or sub-charterer and charterer and the nature and purpose of the charterparty.

19. This Ruling is not concerned with the contractual relationship that may exist between the shipper of goods and the shipowner, the charterer or the sub-charterer where the contract of carriage involves a time charterparty. Special rules have developed under both common law and under international conventions known as the Hague Rules 1924, the Hague/Visy Rules 1968 and the Hamburg Rules 1978 which

govern the rights and obligations of the carrier and the shipper. These Rules have been adopted by major maritime and cargo owning countries. Some of these Rules are entrenched in legislation. The relevant Statute in Australia is the *Carriage of Goods by Sea Act 1991 (Cth)*.

20. The Hague and Hague/Visy Rules generally apply to contracts of carriage of goods by sea covered by a bill of lading. The Hamburg Rules have a wider application and generally apply to all contracts of carriage of goods by sea. As time charterparties normally contain a clause empowering the master of the ship or its agent to issue bills of lading on behalf of the shipowner it is often found that the shipowner is one of the carriers for the purposes of these Rules and also under common law.

21. These Rules do not apply to charterparties. In other words, the relationship that exists between shipowner and charterer under a charterparty is not affected. They simply determine the rights and obligations as between carrier and shipper but not between shipowner and charterer.

22. With one exception, discussed in paragraphs 136-138, the above Rules and the application of the common law that determine the rights and obligations between shipper and carrier, have no relevance to the issues covered by this Ruling.

Ruling

23. Payments made under a demise charter party (see paragraph 15) and dry lease of other ICS equipment will be subject to RWT (see paragraph 15). Demise charter parties are tantamount to the lease of equipment and clearly fall within the definition of 'royalty' as they meet the criteria of the payment being for the *use of, or the right to use* the ship. (See paragraphs 52-54).

24. Payments under a time charterparty and wet lease of other ICS equipment will also be subject to RWT (see paragraph 15). The essence of these payments is for the *use of, or the right to use* the ship or the other equipment (see paragraphs 55–82).

25. To the extent that part of a payment made under a time charterparty and wet lease can be apportioned or dissected as being referable to the services performed by the captain and crew or operator/driver, such part will nonetheless be subject to RWT under paragraph 6(1)(d) (ITAA 1936) of the definition of royalty. (See paragraphs 121-135).

26. Payments under a voyage charterparty are not considered to be royalties. (See paragraphs 45-51).

Date of effect

27. This Ruling applies to royalties derived by a non-resident during the 1993-1994 year of income and subsequent years of income of the non-resident. This Ruling does not apply to equipment royalties paid under a pre-18 August 1992 contract. This Ruling also does not apply to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Liability to pay RWT

28. The liability to pay RWT is found in subsection 128B(5A) (ITAA 1936) which provides that RWT is payable on the gross amount of the royalty at the rate declared by Parliament. That rate is currently 30% tax on the gross amount of royalty reduced to 10% under most of Australia's DTAs.

29. By subsection 128B(2B) (ITAA 1936), RWT applies to income that consists of a royalty derived by a non-resident and:

(a) Is paid to the non-resident by a resident of Australia. No RWT applies where the royalty paid by the resident is an outgoing incurred in carrying on business in a foreign country at or through a PE of the resident in that country (paragraph 128B(2B)(a) and subparagraph (b)(i)).

(b) Is paid to the non-resident by another non-resident and the royalty paid is an outgoing incurred by the second non-resident in carrying on business in Australia at or through a PE in Australia (paragraph 128B(2B)(a) and subparagraph (b)(ii)).

30. The liability for RWT is further extended under subsection 128B(2C) (ITAA 1936) to two other situations where a PE is involved, namely:

(a) Where a royalty is paid by an Australian resident to another Australian resident and the royalty income is derived by the second mentioned Australian resident in carrying on business at or through a PE in a country outside Australia. No RWT applies if the royalty paid by the first mentioned Australian resident is an outgoing wholly incurred by that resident in carrying on business at or through a PE in a country outside

Australia (paragraph 128B(2C)(a) and sub-paragraph (b)(i));

(b) Where a royalty is paid to an Australian resident by a non-resident and:

(i) the royalty income is income of the resident in carrying on business at or through a PE in a country outside Australia; and

(ii) the royalty is an outgoing of the non-resident in carrying on business at or through a PE in Australia (paragraph.128B(2C)(a) and sub-paragraph (b)(ii)).[1]

31. The crucial aspect of the definition of royalty contained in subsection 6(1) (ITAA 1936), (see paragraph 9), in the context of charterparties is whether payments made under a demise, time or voyage charterparty can be said to be amounts paid or credited as consideration for:

- the use of, or the right to use, the ship; or
- the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of the ship.

32. The contradistinction to the payment being for the 'use of, or the right to use' the equipment and hence a royalty is that the payment is for services rendered. The distinction between royalties and payments for services rendered is considered in Taxation Ruling IT 2660 but only in the context of payments for the supply of know-how.

33. Paragraph 25 of IT 2660 states:

> 'Payments for services rendered and work done are not royalties unless the services are ancillary to, or part and parcel of, enabling relevant technology, information, know-how, copyright, machinery or equipment to be transferred or used. **Whether the payment is a royalty payment or a payment for services depends on the nature and purpose of the arrangement giving rise to the payment**. Only those payments which are for the use of, or the right to use, property or a right belonging to another person are "royalties" within the definition' (emphasis added).

34. Other aspects of the paragraph 6(1)(b) (ITAA 1936) definition of 'royalty' such as the question of what constitutes 'industrial,

[1] RWT is not payable where a DTA applies and subsection 17A(4) of the *International Tax Agreements Act 1953* operates to exclude a royalty from section 128B.

commercial or scientific equipment' have been considered in Taxation Rulings IT 2660 and TR 98/21. These Rulings conclude that, in the context of the tax definition of the term 'royalties', the word 'equipment' does not have a narrow meaning and would include such things as machinery, apparatus, ships and aircraft (see paragraphs 18 of IT 2660 and paragraphs 33-38 of TR 98/21).

35. The function and nature of charterparties and the meaning attributed to terms like 'use' or 'the right to use' by case law and in the treaty context of the Royalty Article will demonstrate that payments under demise and time charterparties fall within the definition of 'royalty'. On the other hand, payments under a voyage charterparty and for liner services will be for the carriage of goods and constitute payments for services and not royalties.

Shipping law and practice

36. A brief introduction to shipping trade practice is given in paragraphs 12-22 of this Ruling. A more detailed examination of this practice and the law governing shipping trade follows. In particular, this part considers the nature of the various contractual arrangements that shippers, shipowners and charterers enter into, the legal and commercial relationship between the parties and the difference between payments for the hire/letting of a ship ('hire') and 'freight' payments for the carriage of goods.

37. Note however that, because of the complexity of contractual arrangements that exist in the shipping trade, it is difficult to lay down hard and fast rules as to whether an arrangement falls within a particular class of charterparty. The circumstances and terms of the documents may differ in different cases and must therefore be carefully considered.

The bill of lading contract of carriage

38. The bill of lading is one of the main documents evidencing the contract of carriage of goods by sea between shipper and carrier. The contract itself is made when the shipper books space on the carrier's ship, long before the goods are actually delivered to the ship for carriage. The contract is reduced to writing when the bill of lading is issued. The bill of lading is then, prima facie, evidence of the terms of the contract.[2]

39. The bill of lading serves two other purposes - it is a receipt for the goods shipped and is also a negotiable document of title to the goods shipped. A COA may also be contained in or evidenced by

[2] The "Ardennes" (1950) 84 LI L Rep 340; [1951] 1 K.B. 55 (C.A.)

other documents of title such as a sea waybill or mate's receipt which are also receipts for the goods shipped but not negotiable documents (see Article 1 (b) *Carriage of Goods by Sea Act 1991*).

40. The bill of lading is normally issued by the master of the ship engaged in liner services to the shipper at the time the goods are put on board the ship. The fee paid by the shipper for the carriage of goods under a bill of lading is called 'freight'.

41. The payment of 'freight' by the shipper to the carrier is clearly a payment for the carriage of goods and therefore a payment for services and not a royalty payment.

42. The large variety of commercial transactions in modern shipping practice can make the identification of the carrier difficult. This is particularly so where the ship is the subject matter of several charterparties. While special rules exist to govern the rights and obligations of the carrier and shipper (see paragraph 19) the identification of the carrier broadly remains a question to be determined according to the facts and circumstances of each particular case.

43. Where the bill of lading evidences the contract of carriage and the bill is a shipowner's bill (i.e., one issued by the master on behalf of the shipowner), the contract of carriage at law is between the shipowner and the shippers. Where the bill of lading is a charterer's bill (i.e., one issued by the master on behalf of the charterer) the contract of carriage is between the charterer and the shippers.

44. In the context of the subject matter of this Ruling, the 'freight' paid by a shipper to a carrier will not be a royalty. However, the contract of carriage may not be evidenced by a bill of lading but rather by the charterparty document itself. If the charterparty is the contract of carriage between a shipper and a carrier, the fee paid under the charterparty is likely to be a payment for services. One situation where this arises is in the case of a voyage charterparty.

Voyage charterparty[3]

45. Under a voyage charterparty the ship is chartered for a specific voyage (e.g., Melbourne to London). It is usually used as a contract of carriage where a large quantity of cargo, requiring the entire carrying capacity of ship, is carried between designated ports. The ship may be chartered for the voyage directly from the shipowner or sub-chartered from another charterer. The charterer or sub-charterer is also the shipper under a voyage charterparty.

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[3] *Shipping Law*, by Martin Davies and Anthony Dickey, second edition, LBC Information Services 1995, chapter 10; *Carriage Of Goods By Sea*, by John F Wilson, third edition, Chapters 1 & 3.

46. When the charterer ships goods under a voyage charterparty, a bill of lading is still usually issued when the goods are shipped on board the chartered ship. In these circumstances, there are two documents which appear to regulate the relationship between the charterer and the shipowner – the voyage charterparty and the bill of lading. Which of these two documents evidences the contract of carriage is again a question of fact depending on the documents and circumstances of each case.

47. By way of general principles, in the case where the charterer is also the shipper of the goods, the bill of lading acts only as a receipt for, and a document of title to, the goods. The contract of carriage between the charterer-shipper and the shipowner-carrier is the voyage charterparty.[4]

48. In contrast, if a time charterer enters into a voyage sub-charterparty, and if the shipowner issues a bill of lading to the voyage sub-charterer on shipment of the goods, the bill of lading does act as evidence of a contract of carriage between the shipowner and the voyage sub-charterer.[5] If the time charterer were to issue a bill of lading in its own name to the voyage sub-charterer, the contract of carriage between these two parties would be the voyage sub-charterparty and not the bill of lading. Note that the relationship between the shipowner and time charterer will, in both cases, still be governed by the time charterparty.

49. Another basic characteristic of a voyage charterparty, in contrast to a time charterparty, is that 'freight' is payable under the former, whereas 'hire' is payable under the latter[6] (see distinction in paragraphs 71-82).

50. In the case where the charterer is also the shipper (see paragraph 47 above), the charterer's payment to the shipowner for the carriage of its goods under the voyage charterparty will be in the nature of 'freight' and not a royalty. In the case where the shipper is the voyage sub-charterer (see paragraph 48 above) the payments made to the time charterer under the voyage sub-charterparty will also be in the nature of 'freight' and not royalty.

51. Based on the above, payments under a time charterparty to a shipowner are in the nature of 'hire' and not 'freight'. Secondly, because of the existence of two separate relationships – shipowner and time charterer, and shipowner as carrier of the goods of the voyage sub-charterparty - the shipowner may appear to be entitled to two lots of payments, the 'hire' payable under the time charterparty and the

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[4] *Rodoconachi Sons & Co v. Milburn Brothers* (1886) 18 Q.B.D 67 and *The Ship "Socofl Stream" v. CMC (Australia) Pty Ltd* [2001] FCA 961.
[5] *Hi-Fert Pty Ltd v. Kiukiang Maritime Carriers Inc* (2000) 173 ALR 263
[6] *Skibs Snefonn v. Kawasaki Kisen Kaisha (The Berge Tasta)* [1975] 1 Lloyd's Rep. 422 at 424

'freight' payable under the bill of lading issued to the voyage sub-charterer. This point is further considered in paragraphs 136-138 below.

Demise charterparty[7]

52. Most shipping textbooks and case authorities describe a demise charterparty, as a lease of the ship by the owner to the charterer for an agreed period of time, in exchange for periodic payments of 'hire'.[8]

53. A charterparty by demise is one where the charterer obtains possession and control of the ship. The general test to determine this, is to see 'whose servants the master and crew are'.[9] It has been said that if the control of master and crew in the navigation of the ship passes to the charterer he has possession and, generally speaking, the master and crew will be regarded as the servants of the person who has the power of appointing and dismissing them.[10]

54. In these circumstances, the payments clearly fall within the definition of 'royalty', being amounts paid as consideration for the 'use of, or the right to use' the ship.

Time charterparty[11]

55. Caution is called for when reading earlier authorities where, the nature of and the character of payments under, a time charterparty have been considered. One reason for this is that some of the maritime law cases are concerned with maritime cargo claims rather than the relationship between a shipowner and time charterer. Secondly, a change occurred over time in the use of the word 'freight' in the shipping trade (see paragraphs 71-82 below). Thirdly, there are few maritime cases dealing directly with the question of whether a time charterparty is a contract for services, or a contract for the use of the ship. Finally, except with regard to aircraft (see paragraphs 104-109

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[7] See references under notes 3 supra and 11 below.

[8] e.g. *Scrutton on Charterparties and Bills of Lading* (note 11 below) states at page 59 'A charter by demise operates as a lease of the ship itself, to which the services of the master and crew may or may not be superadded'.

[9] *Australasian United Steam Navigation Co Ltd v. The Shipping Control Board* (1945) 71 CLR 508 per Latham CJ at 521. *Baumwoll Manufactur von Carl Scheibler v. Furness* [1893] AC 8

[10] See *Australasian United Steam Navigation Co Ltd* case at 521-522, note 9 supra.

[11] *Carriage of Goods by Sea*, supra, note 3, chapter 4; *Shipping Law*, supra, note 3, chapters 10 & 13; *Time Charters*, by Michael Wilford, Terence Coghlin and John D Kimball. fourth edition, 1995, Lloyd's of London Press Ltd; *Australian Maritime Law*, by MWD White, The Federation Press 1991, chapter 5; *Carver's Carriage by Sea*, thirteenth edition by Raoul Colinvaux, London Stevens & Sons 1982, chapter 5 sub-chapter 6; *Scrutton on Charterparties and Bills of Lading*, twentieth edition, London Sweet & Maxwell 1996, sections IV and XVI

below) the nature of a time charterparty as to whether it is one of 'use' or 'services' has not been considered previously in a taxation context.

56. In the main, judicial comments on the nature of a time charterparty are by way of obiter dicta. The descriptions given to a time charterparty, in particular, are often general and confusing to say the least. Some of the more recent case authorities spell out the economic substance of a time charterparty and give a better description of its nature and purpose and the character of payments made.

57. It may be appropriate to begin with the description given to a time charterparty by Lord Bingham of the House of Lords in the case of *Whistler International Limited v Kawasaki Kisen Kaisha Limited*.[12] At page 641 His Lordship states:

> 'A time charterparty such as the present represents a complex commercial bargain between owner and charterer. The owner undertakes for the period of the charter to make his vessel available to serve the commercial purposes of the charterer. To this end the hull, machinery and equipment of the vessel are to be in a thoroughly efficient state, the capacity and fuel consumption of the vessel are specified and the vessel is to be ready to receive the charterer's intended cargo. The owner undertakes these obligations in consideration of the charterer's undertaking to **pay for the hire of the vessel** at an agreed rate.
>
> **The charterer agrees to pay hire for the vessel because he wants to make use of it**. Crucial to the bargain, for him, are the terms which require the master to prosecute his voyages with the utmost despatch, which provide that the master (although appointed by the owner) shall be under the orders and directions of the charterer as regards employment and which require the charterer to furnish the master from time to time with all requisite instructions and sailing directions.
>
> The complexity of a time charterparty derives partly from the fact that ownership and possession of the vessel, which remain in the owner, are separated from **use of the vessel**, which is **granted to the charterer**, and partly from the peculiar characteristics and hazards of carriage by sea……The owners are to remain responsible for the navigation of the vessel.' (Emphasis added).

58. In the same case, Lord Hobhouse also recognised that the employment of a vessel and its navigation reflected different aspects of the operation of the vessel. 'Employment' embraces the economic aspect- the exploitation of the earning potential of the vessel.

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[12] *Whistler International Limited v. Kawasaki Kisen Kaisha Limited*, [2000] 1 AC 638

'Navigation' embraces matters of seamanship. A voyage charter is different to a time charter because under the former it is the owner who is using the vessel to trade for his own account. He decides and controls how he will exploit the earning capacity of the vessel, what trades he will compete, what cargoes he will carry. He bears the full commercial risk and expense and enjoys the full benefit of the earnings of the vessel.

59. On the other hand, under a time charter the owner still has to bear the expense of maintaining the ship and the crew. He still carries the risk of marine accidents and has to insure his interest in the vessel appropriately. But, in return for the payment of hire, he transfers the right to exploit the earning capacity of the vessel to the time charterer. His Lordship goes on to say that where the charter is for a period of time rather than a voyage, and the remuneration is calculated according to the time used rather than the service performed, the risk of delay is primarily on the charterer. The shipowner's right to remuneration is unaffected.

60. In *The "Nanfri"*[13] the House of Lords also described the nature and purpose of a time charterparty as being a contract for the use of the ship to enable the charterer to carry on his trade. And, as early as 1918 the House of Lords had in *Fred Drughorn Ltd v. Rederiaktiebolaget Trans-Atlantic*[14] described a charterparty as '…prima facie it is a contract for the hiring or use of **the** vessel'.

61. Justice Toohey of the High Court of Australia in *Laemthong International Lines Co Ltd v. BPS Shipping*[15] described charterparties by quoting from what is said in *Carver's Carriage By Sea*[16] namely:

> "Most commonly……..charterparties are made for the purpose of securing to the charterer the *use* merely of the ship on a particular voyage or series of voyages. He does not desire to interfere with the manner in which she is to be navigated, nor is the shipowner willing to part with his control over her ….Contracts in which the possession of the ship is handed over to the charterer are very much less frequent. But they are at times made. A recent dictum that 'a demise charterparty has long been obsolete' is not true. Occasionally charterparties are

[13] *Federal Commerce And Navigation Ltd v. Molena Alpha Inc.* (*The "Nanfri"*) [1979] 1 Lloyd's Rep 201 (HL), per Lord Wilberforce and Lord Fraser at pages 206 and 210 respectively.
[14] *Fred Drughorn Ltd v Rederiaktiebolaget Trans-Atlantic,* [1919] AC 203 at 207 per Viscount Haldane.
[15] *Laemthong International Lines Co Ltd v. BPS Shipping,* (1997) 190 CLR 181 at p. 192
[16] *Carver's Carriage by Sea,* 13th edition (1982), vol 1 at 410-411. The joint judgment of Gaudron, Gummow and Kirby JJ make similar reference and also to pages 416-417.

made in such doubtful shapes that it is difficult to tell whether, in fact, the possession does or does not pass to the charterer."

62. Shipping law cases have not always been consistent in the way they describe the purpose and nature of a time charterparty. This is the reason for the note of caution in paragraph 55 above. There are a number of cases where the nature and purpose of a time charterparty is described as being a **contract** by the shipowner **to render services** by his servants and crew.

63. A case which is often cited for that proposition is the opinion expressed by MacKinnon L.J. in *Sea and Land Securities v. Dickinson*[17] where he states at pages 69-70:

> 'A time charterparty is, in fact, a misleading document, because the real nature of what is undertaken by the shipowner is disguised by the use of language dating from a century or more ago, which was appropriate to a contract of a different character then in use. At that time a time charterparty (now known as a demise charterparty) was an agreement under which possession of the ship was handed by the shipowner to the charterer for the latter to put his servants and crew in her and sail her for his own benefit. A demise charterparty has long been obsolete. The modern form of time charterparty is, in essence, one by which the shipowner agrees with the time charterer that during a certain named period he will render services by his servants and crew to carry the goods which are put on board his ship by the time charterer. But certain phrases which survive in the printed form now used are only pertinent to the older form of demise charterparty. Such phrases, in the charterparty now before the court, are: "the owners agree to let," and "the charterers agree to hire" the steamer. There was no "letting" or "hiring" of this steamer.
> ……The ship at all times was in the possession of the shipowners and they simply undertook to do services with their crew in carrying the goods of the charterers. As I ventured to suggest quite early in the argument, between the old and the modern form of contract there is all the difference between the contract which a man makes when he hires a boat in which to row himself about and the contract he makes with a boatman that he shall take him for a row.'

64. The above passage may be seen as providing an alternative view to the subject matter of this ruling. But, it is clearly not consistent with the current understanding and economic substance of a time charterparty as discussed in the House of Lords and the High Court of Australia cases mentioned above. The fact that the modern printed forms of the various charterparties continue to speak in terms

[17] *Sea and Land Securities v. Dickinson* [1942] 2 K.B. 65.

of 'hire', 'letting' and 'freight' as the case requires reflect the current custom in the shipping trade. The different character of 'hire' and 'freight' payments is a further indicator that a time charter is a contract for the use of a ship.

65. Other cases refer to a time charterparty as a contract for the **services of a ship**, master and crew or one where the **shipowner places the ship, master and crew at the disposal of the charterer**.[18] Still in other cases a time charterparty is described in the same case and sometimes by the same judge interchangeably as 'a contract for services' and as a 'contract for the use of' a ship.[19] For instance, Lord Hobhouse in *Whistler International*, above, after clearly stating that the owner transfers to the time charterer the right to exploit the earning capacity of the vessel, later on in a different context states that a time charter is not a contract of carriage but describes it as a contract for the provision of the service of a crewed vessel.

66. The question arises that, if the contract of carriage for goods by sea is represented by the bill of lading or by the voyage charterparty what is the nature of services allegedly provided under a time charterparty? The services provided in the nature of the carriage of goods are under the bill of lading and voyage charterparty. Except for the navigation of the ship by the master and crew, no other services can be identified under a time charterparty.

67. It could be argued that where cases describe a time charterparty as a 'contract for the services of a ship' or 'the placement of a ship at the disposal of the charterer' what is really said is that the ship is made available to the charterer for his use.

68. Legal textbooks on the subject are also not consistent in the way they describe the purpose and nature of a time charterparty. For instance, *Carriage of Goods by Sea, Shipping Law,*[20] *Australian Maritime Law*[21] and *Carver's Carriage by Sea* (see paragraph 61 above) tend to describe the purpose and nature of a time charterparty as contracts for the use or the hiring of the ship.

69. On the other hand, *Time Charters*, and *Scrutton on Charterparties and Bills of Lading*[22] describe a time charter as a contract for the provision of services. However, *Time Charters* at page 536 states that under American law a charterer's interest under a time charter is regarded simply as a contract for the use of the vessel giving the time charterer no proprietary interest in the ship.

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[18] *Italian State Railways v. Mavrogordatos* [1919] 2 K.B. 305; *Tankerexpress A/S v. Compagnie Financiere Belge Des Petroles S.A.* [1949] A.C. 76.
[19] *Australasian United Steam Navigation case*, supra, note 9.
[20] Supra, note 3, at pages 4 & 86; and at page 166 respectively.
[21] Supra, note 11, at pages 111 & 126.
[22] Supra, note 11 at page 530 and at p.59 respectively.

70. One shipping case where the issue as to whether the engagement of a ship was a contract for services, or a contract for the use of the ship, arose in *The Queen of the South*.[23] In this case, motor boats, suitably manned, were used to moor and unmoor the ship, *Queen of the South* and to convey her crew between the ship and the shore. The case arose in the context of an action in rem against the *Queen of the South* which was only available if the claim arose out of an agreement relating to the carriage of goods in a ship or to the 'use or hire' of a ship. The boats were by definition regarded as ships. Brandon J. held that the engagement of the boats was an agreement for the 'use or hire' of the boats and not an agreement relating to the rendering of services. He conceived that there might be an agreement for services in a case where there was only some incidental and minor use of a ship.

Character of payments under charterparties - distinction between 'freight' and 'hire'

71. While descriptions given by case authorities on the nature and purposes of a time charterparty are unclear, the characterisation given by case authorities and others to payments made thereunder give a better indication.

72. Recent shipping law cases make it clear that 'hire' is different to 'freight'. There is also general consensus amongst legal textbook writers on the subject that 'hire' is different to 'freight'. Ordinary and commercial dictionaries make the distinction.

73. The nature of 'hire' and 'freight' was considered carefully by Lord Denning M.R. in *The 'Nanfri'*.[24] In this case the ship *Nanfri* was time chartered by the owners to the charterer who had sub-chartered it to third party shippers. The time charterparty provided for the payment of 'hire' calculated at $5 per ton deadweight per calendar month. The time charterer deducted certain amounts from the 'hire' payable due to time lost caused by the slow steaming of the ship. The owners objected and threatened to withdraw the charterer's authority to sign bills of lading as agents of the owners unless certain conditions were met.

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[23] *Corps v. Owners of the Paddle Steamer Queen of the South (The Queen of the South)* [1968] P 449, [1968] 1 All ER 1163. **Note**: *The Queen of the South* is one case in a line of authorities which decided that charterparties fell within the expression 'use or hire' of a ship appearing in English Acts concerned with the jurisdiction of certain courts (see: *The Alina* (1880) 5 Ex.D. 227*; R. v. Judge of the City of London Court* (1883) 12 QBD 115; *The Conoco Britannia* [1972] 2 QB 453; *The Eschersheim* [1976] 1 WLR 430; *Gatoil International Inc. v. Arkwright-Boston Manufacturers Mutual Insurance Co.* [1985] AC 255; *The Antonis P. Lemos* 1 AC 711.

[24] *Federal Commerce And Navigation Ltd v. Molena Alpha Inc*. (*The "Nanfri"*) [1978] 2 Lloyd's Rep 132 (C.A.)

74. The charterer treated the owner's threat as a repudiation of the charterparty and terminated it. The issues before the court were whether the time charterer had a right to make the deductions (a right to equitable set-off) and whether the charterer had validly terminated the charterparty. Under a settled rule of law 'freight' is payable in full without deduction. The question that arose was whether the rule of law also applied to 'hire'.

75. In the course of determining that question Lord Denning M.R. said at page 139:

> 'At one time it was common to describe the sums payable under a time charter-party as "freight". Such description is to be found used by judges and text book writers of great distinction. But in modern times a change has come about. The payments due under a time charter are usually now described as "hire" and those under a voyage charter as "freight". This change of language corresponds, I believe, to a recognition that the two things are different. **"Freight" is payable for carrying a quantity of cargo from one place to another. "Hire" is payable for the right to use a vessel for a specified period of time, irrespective of whether the charterer chooses to use it for carrying cargo or lays it up, out of use.** Every time charter contains clauses which are quite inappropriate to a voyage charter, such as the off-hire clause and the withdrawal clause.' (Emphasis added).

76. The case went on appeal to the House of Lords only on the 'termination' issue and was decided in the charterer's favour. Nevertheless, the House of Lords described the nature and purpose of time charters as being for the use of the ship (see paragraph 60 above).

77. A more recent case on the distinction between 'hire' and 'freight' is *The "Cebu" No.2*.[25] In this case the owners of the ship "Cebu" time chartered it to a charterer who in turn sub-time chartered the ship to a sub-charterer who in turn sub-sub time chartered the ship to the defendants who used the ship to carry the cargo of shippers. The issue was whether the owners were entitled to the 'hire' under the sub-sub-time charter under a clause in the head time charter which gave the owners a lien over all cargoes and all sub-freights for any amount due under the head time charter. It was held that sub-freights did not include sub-time or sub-sub-time charter hire. In other words, time charter 'hire' was not 'freight'.

78. The court traced the history of the use of the word 'freight' and concluded that a change in the use of the term in the shipping trade came about in modern times. That is, sometime before 1946 when the

[25] *Itex Itagrani Export S.A. v. Care Shipping Corporation and Others (The "Cebu" No. 2)* [1990] 2 Lloyd's Rep. 316

widely used standard NYPE time charter amended form which consistently uses the word 'hire' was published. By 1950, at least, the popular Baltime form also consistently called the periodic payments under a time charter 'hire'.

79. The court also observed that specialist dictionaries, namely, Ivamy's Dictionary of Shipping Law, 1984 and Brodie's Dictionary of Shipping Terms, 1985, relevantly defined 'freight' and 'hire' as follows:

> **'Freight**: The remuneration payable in respect of the carriage of goods by sea under a voyage charter-party or bill of lading.'
>
> **'Hire**: A sum of money to be paid to the ship owner by a charterer under a time charter-party for the use of the vessel.'

80. The court noted that legal textbooks probably tend to be a little behind the time in reflecting changes in specialist vocabulary. Indeed, the current editions of legal textbooks referred to in this Ruling now clearly make the distinction between 'hire' and 'freight' often citing cases like *The Nanfri* and *The Cebu No.2* as authorities.

81. The difference between 'hire' and 'freight' is also reflected in the computation of the two. 'Hire' is computed by reference to the carrying capacity of the ship. It is calculated on the basis of a fixed sum per ton of the vessel deadweight for a specific period of time or an amount per day. It is normally payable in advance at monthly or semi-monthly intervals. Generally speaking, 'freight' is computed by reference to the quantity of cargo carried. In the oil tanker trade, the rate per metric tonne of cargo is normally established by *Worldscale* (Worldwide Tanker Nominal Freight Scale). This is a Table of rates giving the amount of dollars per ton of cargo for each of a number of standard routes. 'Freight' is normally payable on delivery of the goods at the point of discharge unless the agreement expressly provides otherwise.

82. The payment of 'hire' under a time and demise charterparty reflects the facts that the payments are for the use of the ship. On the other hand, the payment of 'freight' under a bill of lading contract of carriage and a voyage charterparty reflect the fact that the payments are for the carriage of goods.

Other factors indicating that payments under a time charterparty are for use rather than for services

83. The definition of 'royalty' looks at the characterisation of the payment from the perspective of the payer (the charterer) not the supplier of the equipment (the shipowner). The characterisation of payments under time and demise charterparties as 'hire' by case law and shipping practice, as discussed in this Ruling, are in themselves,

weighty factors in support of the view that such payments are royalties. This view is reinforced by the case authorities on the nature and purpose of these charterparties and the meaning of 'use of, or right to use' in the context of maritime law and tax law cases.

84. There are other factors which may also assist with the characterisation question. Some of these factors were also considered in some of the cases discussed in this Ruling. Broadly, they include:

- The basis on which the contract price has been calculated and the extent to which the contract price relates to costs borne by the shipowner in supplying or granting the right to use the ship.
- The significance or uniqueness of the asset.
- The role the asset plays in generating income.

85. The calculation of 'hire' by reference to the carrying capacity of the ship and not by reference to the personal efforts and skills of the master and crew is clearly a factor pointing to the supply and use of a ship. The charterer is responsible for all fuel, towage and pilotage and other charges in operating the ship. The costs of manning the ship are borne by the shipowner. Insurance on the vessel is also paid by the shipowner although in some cases the charterer assumes liability to indemnify the owner for insurance costs. While these costs are not directly charged to the charterer, the shipowner will in the main recoup these costs indirectly through the 'hire' charge.

86. The uniqueness of a ship and its significance in the role it plays in the carriage of goods by the charterer and in generating income for the shipowner is unquestionable. Its size, complexity and value are not characteristics of equipment used merely as a tool of trade.

87. A bareboat charterparty is clearly a contract for the supply and use of a ship. The supply of a ship is also the essence of a time charterparty. The charterer's interest is to secure a ship and use it to trade on his own account. The addition of the master and crew is only an adjunct to the main purpose. While navigation is necessary, it is the carrying capacity of the ship that plays a more dominant role in generating income for both shipowner and charterer. The ship generates service income for the charterer from the carriage of goods and, 'hire' income for the shipowner from giving the use or the right to use the ship to the charterer.

88. The charterer controls the commercial operation of the ship and has exclusive use of it during the period of the charterparty. A time charterparty is not an arrangement under which the use of the

ship is minor or incidental (as per Brandon J in *The Queen of the South*).[26]

89. The shipowner bears little risk of substantially diminished income from the supply of the ship or grant of right to use. The charterer pays a flat rate for the time he hires the ship. The risk of finding employment for the ship falls solely on the charterer. The charterer also bears the risk of delay caused by such factors as bad weather, congestion in ports or strikes of stevedores. His only relief is to be found in the 'off-hire' clause which generally provides that he is not required to pay for time lost due to circumstances which are attributable to the shipowner or the vessel, such as engine failure or crew deficiencies.

90. Having physical possession of an item of equipment is normally associated with a leasing arrangement. One source of confusion in this context arises because of the division of the ship's management. The navigation of the ship is with the shipowner but the charterer controls the commercial operations of the ship. This division occurs because of a special clause in a time charterparty which states that 'the master (although appointed by the owners) shall be under the orders and directions of the charterers as regards employment and agency'.

91. The appointment of the master and crew is said, under shipping law, to give a shipowner possession of the ship.[27] But according to a line of authorities[28] the absence of possession is not detrimental to a finding that arrangements concerning equipment known as 'wet hires' or 'wet charterparties' are for the 'use or the right to use' the equipment. What is also important is the control that the charterer exerts over the use of the ship.

92. Indeed, the charterer exercises real control over the ship in the tasks that the ship is employed to perform. The charterer provides instructions as to what goods to carry, where to load and unload the goods, how the goods should be stored on the ship and what route to be taken. In short, all of these and other instructions are concerned with how the ship shall be used.[29] The dominant aspect of a time charterparty is the supply of a ship to the charterer who will then direct what services it is to perform. The economic exploitation of the earning potential of the ship rests with the charterer.

93. Another relevant factor is whether the owner uses the equipment concurrently to provide significant services to parties other than the charterer. This would not happen under a time charterparty as

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[26] Supra, paragraph 70 and note 23.
[27] *Australian United Steam Navigation case*, supra, note 9.
[28] *Infra*, paragraphs 97-99, 101-108.
[29] As per Lord Bingham in *Whistler International Limited*, supra, note 12 at page 644.

the charterer obtains exclusive use of the ship during the specified period.

94. Identifying the risks associated with the ownership and use of the ship and who bears them may also help in determining the predominant nature of a time charterparty.

95. One important consideration in this context is the fact that the charterer undertakes to indemnify the shipowner for all consequences or liability that may arise from the master signing bills of lading by the orders of the charterer or his agents or otherwise complying with such orders or directions. Such an indemnity extends to damages to the ship by compliance with those directions.

96. In brief, the risk of finding employment for the ship, the risk associated with the carriage of goods on the ship and the risk of delay are borne directly or indirectly through the indemnity by the charterer. The incidence of these risks assists in identifying the true nature of a contract. If the shipowner bears the risks it would indicate that the shipowner is providing a transportation service to the charterer. But, as the charterer bears these risks it indicates that the shipowner is not providing a transportation service to the charterer. Therefore, a time charterparty is not a contract of transportation services between the shipowner and the charterer. The risks borne by the shipowner are those associated with the navigation (excluding perils of the sea) and not with the employment of the ship.

97. Some of the above factors were discussed in *Brambles Australia Ltd v. Commissioner of Taxation (NT)*[30] and were considered as being suggestive of an arrangement for the use of equipment rather than one for the provision of services. This case was concerned with the hire of mobile cranes with operators (wet hires). The issue for the consideration of the court was whether the arrangement was a 'hiring arrangement' as defined under Northern Territory Stamp Duty legislation. In brief, the expression was defined to include 'an arrangement under which goods are or may be **used**……**by** a person other than the owner of those goods'.

98. The court held that the arrangement was one of 'use' and not one for the supply of crane services. The court noted that the hirer did not have exclusive possession of the crane, the operator was not the employee of the hirer and the owner supplied the fuel. While these facts pointed to the provision for services, there were other factors which pointed in the opposite direction. These were: the fact that the hirer generally provided instructions to the operator as to what was to be lifted, in what order, and when and where it was to be placed; the fact that the hirer indemnified the owner for any loss of or damage to

[30] *Brambles Australia Ltd v. Commissioner of Taxation (NT)* 93 ATC 4888 (1993) 26 ATR 587 as per Mildren J.

the crane whilst on hire; the hirer had exclusive use of the crane during the period of hire and the conditions of the contract referred to the customer as the 'hirer' and the transaction as a 'hire'.

99. The court adopted the ordinary meaning of 'used by' and 'hire' and concluded that the transfer of exclusive possession of the crane was not necessary. Morling J observed that even if a more technical meaning was adopted the arrangement still fell within the definition of 'hiring arrangement'. His Honour referred to *Palmer On Bailment*, 2nd edition, 1991, (pages 470, 483 & 488) where reference is made to cases where the owner of a chattel such as a machine makes it available, with an operator, to a third party. Palmer observed that contracts of this kind are 'normally designated leasing or hiring of machines' and, at page 488, states that a **bailment exists so long as the general course of work is to be directed by the person chartering the machine.**[31]

Tax cases on time charterparties and the meaning of the expression 'use of, or the right to use'

100. The meaning of the above expression has been considered by several case authorities and in detail in Taxation Ruling TR 95/32 in the context of the development allowance and investment allowance provisions and has been given a wide meaning. Similarly, IT 2660 at paragraph 16 states, 'The concept of payment "for the use of, or the right to use" covers all forms of exploitation of a right or property short of outright sale of the right or property'.

101. For the purposes of the present Ruling it is the term 'use' has been given its ordinary and natural meaning and as such is said to be of 'wide import'.[32] The term 'right to use' is also said to be of wide import and to have its ordinary and natural meaning. In *Tourapark Pty Ltd v. FCT*[33] Aickin J explained the term at (ATR) 849; (ATC) 4,111, which appeared in sub-sub-paragraph 82AA(a)(ii)(C) ITAA 1936 dealing with the investment allowance, as follows:

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[31] It is noted that *Palmer On Bailment*, 2nd edition, 1991 at p.193 expresses the view that a bailment cannot exist for a ship under a time charter because it is a contract for the rendering of services by the shipowner. In support, he refers to the observation of Robert Goff J in *The Lancaster* [1980] 2 Lloyd's Rep. 497 at 502. The case is one of those cases which, on one hand, describe a time charter as one where 'hire is payable for the use and hire of the ship' (at 502) and, on the other hand, as 'a contract of services' (at 500). In view of the case law discussed in this Ruling and the fact that the expression 'use of, or right to use' in the definition of 'royalty' is given its ordinary meaning and not a technical one, the observation of *Palmer On Bailment* at 193 is not accepted.

[32] *Ryde Municipal Council v. Macquarie University* (1978) 139 CLR 633 as per Gibbs ACJ at 637; *Council of the City of New Castle v. Royal Newcastle Hospital* (1956-57) 96 CLR 493 as per Taylor J at 515.

[33] *Tourapark Pty Ltd v. FCT* (1982) 12 ATR 842; 82 ATC 4,105

> 'It seems to me that the purpose of subsub para (C) is to operate as a "dragnet" provision to pick up any other right to use which might be devised or which might arise in the conduct of some particular kind of business.'

Later at (ATR) 850; (ATC) 4,111, Aickin J commented that sub-sub-paragraph (C) added:

> 'a "catchall" provision in quite general terms to pick up cases where there is no grant of possession but there is a right to use. An example will be the grant of a right to enter an owner's premises and there use the owner's machine tools or other equipment, and the ingenuity of financiers and manufacturers might provide other examples'.

102. Indeed, the case authorities state that the meaning of the terms in any particular case depend to a great extent on the context in which they are employed. There is nothing in the context of the definition of 'royalties' which would give the term a narrow construction. In fact, the context of the domestic definition of 'royalty' suggests that the ordinary and wider meaning should be given. As a 'catchall' provision the term 'the right to use' would indeed catch the use of a ship under a time charterparty where possession of the ship is with the owner.

103. The cases of *Hamilton Island Enterprises Pty Ltd v. FCT*[34] and *Kirby v. FCT* [35] are two cases which considered charterparties involving aircraft in a taxation context. The tax issue in both cases was concerned with entitlement to the investment allowance. The relevant provisions excluded entitlement to the investment allowance if the item of equipment was used in certain disentitling circumstances. For example, if within twelve months after the helicopters were first used by the taxpayer there was use by another person.

104. The taxpayer in *Hamilton Island Enterprises Pty Ltd* leased two helicopters which, in the main, were chartered with a pilot and assistant to an associated company, Sea World Pty Ltd (Sea World). Sea World used the helicopters for joy or scenic flights to its customers. The taxpayer argued that the arrangement with Sea World was for the supply of the services of a pilot and his assistant as distinct from a contract of bailment of the helicopters. The court referred to the broad meaning given in *Tourapark Pty Ltd.* above, to the term 'use' and the 'catchall' term of 'right to use' which picks up cases where there is no grant of possession. In the circumstances, the court held that the taxpayer had granted 'the use' of the helicopters to Sea World.

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[34] *Hamilton Island Enterprises Pty Ltd v. FCT*, (1982) 43 ALR 519; 13 ATR 220; 82 ATC 4302
[35] *Kirby v. FCT*, 87 ATC 4503

105. The aircraft in *Kirby* was leased by a partnership in which Mr Kirby was a partner. The partnership had engaged a company (Jet Charters) to operate the jet as agent for the partnership. The jet was manned with pilot and crew as employees of the partnership. Jet Charters chartered the jet to several freight forwarders including TNT who used it to carry freight. Both the trial judge (Tadjell J) and on appeal, the Federal Court by majority (Jenkinson and Ryan JJ, Sweeney dissenting) found that there was use by another person.

106. In *Kirby*, Tadjell J, considered that aircraft charter agreements were to be classified in much the same way as maritime charterparties, subject always to variations to fit the circumstances of each case. In support, he cites from learned writers on the subject such as *Shawcross and Beaumont, Air Law*.[36] Also, relying on such cases as *Fred Drughorn Ltd*, above,[37] His Honour concluded that conventionally, the subject matter of a contract of charter of an aircraft is the hire of it. Such a contract is on its face a contract for the use of the aircraft by the charterer.

107. Tadjell J quotes from *Shawcross and Beaumont, Air Law* where at (V)(51) the learned authors describe the purpose of a voyage charter (or flight charter) and time charter as: 'Flight and time charters have in common the fact that it is the use of the aircraft which is obtained.' His Honour concludes that this is in direct analogy with marine charters not by demise, ie, voyage and time charters.

108. Jenkinson J of the Federal Court of Australia also expressed the opinion that the arrangement was not one for the carriage of freight or for the carriage of freight by a particular flight (implying a voyage charter). The carriage of freight was a business activity of TNT in the course of which it used the aircraft that the partnership made available to it. This was supported by the finding that the remuneration payable under the agreement with Jet Charters was unrelated to the weight or volume of what was carried (see point discussed at paragraph 81 above).

109. At VII(64) *Shawcross and Beaumont, Air Law* makes the general statement that the subject matter of a contract of charter is the hire of an aircraft, with or without crew. They state that as between the owner (or operator) of the aircraft and the charterer, the rights and obligations of the parties will in general be governed by the express or implied terms of their contract. As between the owner (or operator) of the aircraft and passengers (or owners of cargo), other than the charterer, carried in the aircraft, the rights and obligations of the parties may be determined by the applicable legislation relating to carriage by air or the relevant common law. The relevant legislation in Australia is the *Civil Aviation (Carriers' Liability) Act 1959* (Cwth)

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[36] *Shawcross and Beaumont, Air Law*, 4th edition, 1993, vol 1 at (VII)(64).
[37] Paragraph 60 and note 14, supra.

which adopts the *Warsaw Convention* for the unification of certain rules relating to international carriage by air.

110. The three main types of air charters, the 'voyage charter' or 'flight charter', the 'time charter' (collectively known as 'wet charters' or 'wet leases') and the 'demise charter' (also known as 'dry' or 'bare hull' charter or 'dry lease') are explained by *Shawcross and Beaumont, Air Law* at V(51)-V(53). The nature and purpose of these air charters is analogous to the description given to similar maritime charters. In other words, both maritime and air charters perform similar functions and are governed by similar rules.

Treaty meaning of 'royalties'

111. With one exception, the definition of 'royalties' in the Royalty Articles of Australia's DTAs are similar to the subsection 6(1) (ITAA 1936) definition with regard to payments for the 'use of, or the right to use', any ICS equipment. They have, in the main, evolved from the same historical background. That is, the definition of 'royalties' evolved from the United Kingdom treaty definition and it was intended to have the same meaning as the equivalent part of the definition in the UK treaty. The exception is the United States Convention, which was amended by the Protocol dated 27 September 2001 to remove the reference to ICS equipment from the definition of 'royalties' contained in the Convention.

112. The expression 'use of, or the right to use' is not defined in the DTAs. Therefore, the domestic law meaning of that expression is to be applied unless the context of the Royalty Articles requires otherwise. There is nothing in the context of the Royalty Articles which suggests that a narrow meaning should be given to the expression. In fact, the context points to giving the expression a wide meaning.

113. In determining context it is appropriate to consider the OECD Commentary on ICS equipment leasing 'royalties' in the Royalties Article of the OECD Model Tax Convention. The relevant OECD Model is the *1977 Model Double Taxation Convention on Income and on Capital* (1977 OECD Model) as the reference to ICS equipment has been deleted from the definition of 'royalties' in Article 12 of the 1992 OECD Model.

114. Article 12 of the 1977 OECD Model included in the definition of the term 'royalties', payments 'for the use of, or the right to use, industrial, commercial or scientific equipment'. None of the terms contained in the expression are defined. However, at paragraph 9 of the Article, the Commentary does distinguish between royalties paid for the use of equipment and payments constituting consideration for the sale of equipment (e.g., payments under a hire-purchase

agreement). It concludes that in the case of leasing in particular, the sole or at least the principal, purposes of the contract is normally that of hire. This suggests that the words 'use' and 'right to use' have a wide import since only those cases where the sale element is paramount are excluded (see similar conclusion reached in paragraph 16 of IT 2660).

115. The term 'ICS equipment' is also not defined in Australia's DTAs or the OECD Model. However, there are sufficient indications in the text and context of Australia's DTAs as well as the OECD Model and Commentary to suggest that 'ICS equipment' has a broad meaning and includes ships, aircraft, drilling rigs, apparatus, machinery, containers, motor cars, wax figures and so on.[38] The inclusion of such a variety of equipment within the term 'ICS equipment' is itself suggestive of a wider meaning of the expression 'use of, or the right to use'. Otherwise, why include such equipment if payments for their use are not 'royalties'.

116. The Report on the leasing of ICS equipment,[39] at paragraph 5, states that 'in the field of transport an enterprise may prefer leasing a container, a truck or a ship rather than asking the services of a transportation enterprise'. Two points emerge from this statement. First, that in the field of transportation the vehicle used for such transportation is equipment (this would include aircraft and other motor vehicles). Secondly, the statement recognises that these items of equipment are capable of being used for the purposes of transportation as well as form the subject matter of a lease. It can be inferred from this statement that in the context of charterparties some charterparties provide a transportation service and others are for the purposes of use.

117. Further indications as to context may be derived from the Commentary on the Ships and aircraft Article (Article 8). This Article gives preference to taxing the profits obtained from leasing a ship or aircraft on charter fully equipped, manned and supplied and the occasional bareboat charter under Article 8 instead of Article 12. While the Commentary is silent on the point, it is reasonable to infer that time charterparties falling outside the scope of the Ships and aircraft Article (e.g. because the ship or aircraft is not used in international operations) and regular bareboat chartering would fall under the Royalties Article.

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[38] For a detailed discussion of the meaning of 'ICS equipment' see paragraphs 33-38 of TR 98/21. More particularly see OECD Reports on, 'The Taxation Of Income Derived From The Leasing Of Industrial, Commercial Or Scientific Equipment (paragraphs 5, 10, 12 and 21) and, The Taxation Of Income Derived From The Leasing Of Containers (paragraphs 13 and 40) published in Trends in International Taxation, 1985 and Volume II of 1997 OECD Model.

[39] See note 38, supra.

118. Klaus Vogel[40] when discussing the effect of Article 8 of the 1977 OECD Model on the leasing of a ship or aircraft recognises that as a general rule income from a bareboat charter would fall under the Royalty Article. It is only the 'occasional' (which he describes as 'casual') bareboat charter that falls outside the Royalty Article. Another example, which would fall within the Royalty Article, is where a shipping operator leases a ship on a bareboat charter basis and instead of using it in its shipping operations it subleases the ship on a bareboat charter basis to a third party.

119. Indeed, many permutations can arise where income from the lease of a ship or aircraft under a bareboat charter or time charter will fall under the Royalty Article and not the Ships and aircraft Article. The references to the OECD Commentary on the Ships and aircraft Article and Klaus Vogel are used in this Ruling to support the view that ships, aircraft bareboat and time charterparties are capable of falling within the Royalty Article. This ruling, however, does not deal with the relationship between the Ships and aircraft Article and the Royalty Article.

120. The meaning of 'royalty' as derived from the UK treaty context is also explained at paragraphs 50-57 of CITCM 875. Paragraph 56 of the CITCM makes it clear that payments for the lease or charter of a ship or aircraft which do not fall within the scope of the Ships and aircraft article of the UK agreement are 'royalties' as defined in the Royalty article of that agreement.

The issue of apportionment and the application of paragraph 6(1)(d) (ITAA 1936) of the definition of "royalty"

Apportionment

121. The issue of apportionment only arises with respect to time charterparties because the navigation of the ship in contrast to the supply of the ship for the charterer's use might be considered to be the provision of services. It is recognised at paragraph 25 of IT 2660 that: 'Payments for services rendered and work done are not royalties unless the services are ancillary to, or part and parcel of, enabling relevant……machinery or equipment to be …….used'.

122. The definition of the term 'royalty' under both the Royalty Articles and domestic law adopts, the use of the expression, 'to the extent to which', which is the principle of apportionment. This principle is also recognised in paragraph 35 of IT 2660.

123. However, the view taken in this Ruling is that the dominant purpose of a time charterparty is the use of a ship and its navigation is only 'ancillary and subsidiary' to the use of the ship

[40] Klaus Vogel on Double Taxation Conventions, Kluwer, p 390, m no.32.

(see paragraphs 127-135 on the '*Meaning of ancillary and subsidiary'*). Any amount that in principle can be apportioned out of the 'hire' payable, to reflect the service component, will therefore fall within paragraph 6(1)(d) (ITAA 1936) of the definition of 'royalty'.

124. Most of the Royalty Articles of Australia's DTA's contain an 'ancillary and subsidiary' provision similar to paragraph 6(1)(d) (ITAA 1936) of the domestic definition of 'royalties'. The exceptions are the United Kingdom, Singapore, Japan, Germany and France DTAs.

125. However, it is observed that the OECD Commentary on Article 12 also adopts a similar principal/ancillary purpose test to mixed contracts (see paragraphs 12 & 13 of Commentary to 1977 OECD Model). The Commentary states at paragraph 12:

> 'The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a **reasonable apportionment**, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. **If**, however, **one part** of what is being provided **constitutes by far the principal purpose of the contract and the other parts** stipulated therein **are only of an ancillary and largely unimportant character**, **then** it seems possible to **apply to the whole amount** of the consideration **the treatment applicable to the principal part'**. (Emphasis added).

126. While the words of the Commentary are different to the words in the 'ancillary and subsidiary provision' the words achieve the same result.

Meaning of ancillary and subsidiary

127. The *Concise Oxford Dictionary* shows little difference in the meaning of the two terms. **'Ancillary'** is given the meanings: 'providing essential support to a central service or industry; subordinate; subservient; an auxiliary or accessory'. **'Subsidiary'** is given the meanings: 'serving to assist or supplement; auxiliary; an accessory'. The *Macquarie Dictionary* gives 'ancillary' the meaning of accessory; auxiliary and 'subsidiary' as serving to assist or supplement; auxiliary; supplementary; subordinate or secondary.

128. The meaning of the term 'ancillary' has also been considered in various United Kingdom cases concerned with capital allowance and Value Added Tax (VAT). In *Sarsfield (Inspector of Taxes) v.*

Dixons Group plc[41] it was said that the term "ancillary" **connotes a subservient or subordinate role**. In this case a capital allowance could not be claimed on expenditure incurred on industrial buildings used as retail shops or for any purposes ancillary to the purpose of a retail shop. The *taxpayer* purchased a warehouse which was used exclusively for servicing retail shops of an associated company. The court held that the warehouse was used for a purpose which was ancillary to the purpose of a retail shop. Had the taxpayer used the warehouse in a separate and independent business of servicing a variety of customers (not just retail shops) the position might have been different.

129. As the nature and purpose of a time charterparty is to secure the use of the ship to the charterers for its business, the navigation of the ship can only be seen as playing a subservient or subordinate role to the use of the ship. These activities are not separate activities of the shipowner in supplying navigation services to other members of the shipping industry.

130. Although the context in which the VAT cases have been considered is different, and caution may be called for, the cases nonetheless give valuable guidance on the meaning of 'ancillary'.

131. Several tests have been applied. The tests have similarities with the approach adopted by the OECD Commentary on mixed contracts (see paragraph 125). However, in recent times, courts have tended to approach the question by looking at the commercial reality of the transaction and in that light determining what the essential features or dominant purpose of the mixed transaction is. This test was applied by the House of Lords in the *Card Protection Plan*[42] and *British Telecommunications*[43] cases.

132. Revisiting some of the features of a time charterparty, what the charterer bargains for is for the use of a manned ship. The operating costs of the ship are directly met by the shipowner but indirectly recovered from the charterer through the 'hire' charge. The risks associated with the use of the ship fall on the charterer. On the other hand, the navigational risks fall on the shipowner. Applying the 'essential features and commercial reality test', the commercial reality of a time charterparty is that the charterer wants the use of a manned ship to carry out its own business of carriage of goods without the worry of having to navigate it. It is the very essence of a time

[41] *Sarsfield (Inspector of Taxes) v. Dixons Group plc* [1997] STC 283. Other cases adopting a similar test are *Green v. Britten & Gilson* [1904] KB 350 per Matthew LJ at 357 and *R v. HM Treasury, ex parte Smedly* [1985] 1 All ER 589 per Slade LJ at 599.

[42] *Card Protection Plan Limited v. Commissioners of Customs and Excise* (House of Lords decision) [2002] 1 AC 202, [2001] BVC 158.

[43] *Customs and Excise Commissioners v. British Telecommunications plc*, [1999] 3 All ER 961, [1999] STC 758, [1999] BVC 306

charterparty that the ship be a manned ship otherwise the result would be a totally different transaction, namely, a demise charterparty.

133. When looking at a time charterparty in terms of its features and commercial reality, it is clear that the dominant feature and commercial reality of a time charterparty is the use of the carrying capacity of the ship to carry the goods of third parties. In so far as the navigation of the ship is a separate feature of the time charterparty, it is on the above authorities, 'ancillary' to the use of the ship.

134. Another test applied by the European Court of Justice in the *Card Protection Plan* case coming out of the *Madgett* case[44] was that, 'a service must be regarded as ancillary to a principle service if it does not constitute for customers an aim in itself, but a means of better enjoying the principal service supplied'. In terms of the *Madgett* test it is clear that the services of the master and crew are 'but a means of better enjoying the use of the ship' and not an aim in itself.

135. The definition of royalty in paragraph 6(1)(d) (ITAA 1936) requires that the relevant assistance not only be 'ancillary and subsidiary' but also that it be 'furnished as a means of enabling the application or enjoyment' of the equipment. The nature and purpose of a time charterparty as discussed above clearly meets this requirement.

Entitlement to 'freight' and 'hire' under charterparties

136. Paragraphs 48 to 51 of this Ruling allude to the possibility that the contract of carriage may be with the shipowner where the bill of lading is a shipowner's bill and this may lead to two lots of payments being made to the shipowner, one for 'freight' and one for 'hire'. Where the bill of lading is a shipowner's bill the law gives the shipowner the right to demand the bill of lading 'freight'.[45] Where the bill of lading is a charterer's bill the charterer is entitled to receive the bill of lading 'freight'. In these cases the shipowner is likely to have a lien over the bill of lading 'freight' for any unpaid 'hire'.

137. These rights are only effective in certain circumstances where default has occurred under the time charterparty for non-payment of 'hire'. If there is no default, the law requires that the shipowner account for the freight to the charterer.[46] However, the existence of these rights and any successful claims against 'freight' in the exercise

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[44] *Customs and Excise Commissioners v. Madgett and Baldwin*, [1998] STC 1189, [1998] BVC 458

[45] *Wastwater Steamship Co. v. Neale* (1902) 86 LT 266; *Wehner v. Dene SS. Co* [1905] 2 KB 92 at p 99; *Molthes Rederi v. Ellerman's Wilson Line* [1927] 1 KB 710; *Wagstaff v. Anderson* (1880) 5 CPC 171*; Tradigrain v. King Diamond Marine Limited (The Spiros C")* [2000] 2 Lloyd's Rep. 319.

[46] *Wehner v. Deane and Tradigrain*, supra, note 45.

of these rights does not alter the nature and purpose of a time charterparty. Nor do they change the character of the payments received under a time charterparty by the shipowner. By way of general observation, payments made in consequence of the exercise of these rights would be recovered as compensation payments and take on the same character as the thing compensated for, i.e., 'hire'.

138. In fact, case authorities referred to in paragraph 136 above, when discussing the context in which the time charterer negotiates and receives the freight from shippers in his own right, recognise the fact that the shipowner has contracted by the time charterparty that for the use of the ship he will be satisfied with a different sum, namely, the 'hire'.[47]

Examples

Example 1

139. Nigerian shipowner A enters into a charterparty with Australian resident charterer C whereby A agreed to let and C agreed to hire the ship for four months. The charterer is to provide and pay for provisions and wages of master, officers, engineers and crew. Owner to pay insurance and maintain steamer in an efficient condition during service. Charterer to provide and pay for coal, port charges, pilotage, etc. Payment for use and hire of ship to be at the rate of $300,000 per calendar month, hire to continue until delivery of ship to owners, unless lost. Owner had option of appointing chief engineer. C appointed and paid master, officers and crew; A appointed chief engineer. A was registered as owner and managing owner.

140. The charterparty in this case is a demise charterparty. A has parted with the possession and control of the ship since in the main the master and crew are the servants of the charterer. The monthly hire of $300,000 is subject to RWT.

Example 2

141. A Bermuda shipowner and an Australian resident company (charterer) enter into what the parties describe as a time charterparty for a period of 10 years. The charterer uses the ship exclusively to carry goods of third party shippers from Australia to customers overseas. The ship is provided fully manned with master and crew. The master and crew were originally employees of the shipowner. However, pursuant to a Ship Management Agreement (SMA) between the shipowner and a management company (the Manager) the master

[47] *Wehner v. Deane*, supra, note 45 at p. 99 and *Tradigrain*, supra, note 45 per Rix LJ at paragraph 36 p.328.

and crew become the employees of the Manager with powers to fire and hire. Under the SMA the shipowner is required to reimburse the Manager in respect of the operations and maintenance of the ship and the employment of the master and crew.

142. Under both the time charterparty and SMA the master was to be under the orders and directions of the charterer as regards employment, and agency. In addition, the navigational risks were being shared on a 50/50 basis between the shipowner and charterer. The charterer also had the right to sub-let the ship. The charterer was to pay hire of $8M per annum. The hire charged contained a capital element with a particular rate of return as well as an operating element which included the wages paid to the master and crew.

143. The arrangement is not a voyage charterparty since the charterer is not the shipper. Although called a time charterparty by the parties, the arrangement appears to be a hybrid between a bareboat charterparty and a time charterparty. This is because there is an attempt by the shipowner to separate the manning of the ship by handing it over to the Manager. Secondly, the shipowner and charterer are sharing the navigational risks which, under a time charterparty, are ordinarily borne by the shipowner.

144. Irrespective of whether the arrangement in this case is a time or bareboat charterparty, the whole of the amount of hire of $8M will be subject to RWT.

Example 3

145. A bulk carrier owned by O of Panama is time chartered to C of the Cayman Islands who in turn sub-charters the vessel to an Australian coal exporter for the carriage of 150,000 tons of coal from Newcastle to Indonesia. The cargo takes up the whole carrying capacity of the carrier. The freight to be paid for the voyage is calculated at the rate of $50 per ton. The master and crew are the servants of O. The master issues a bill of lading in respect of the cargo to be carried as agent of the time charterer (i.e., a charterer's bill of lading).

146. In this example, the arrangement between the time charterer and the exporter of coal is a voyage charterparty. There is a contract for the carriage of the coal between C and the Australian coal exporter as evidenced by the voyage charterparty. The bill of lading in this case acts only as a receipt and a document of title. The freight payable under the voyage charterparty is not subject to RWT. However, since the coal is shipped in Australia 5% of the freight payable to C will be subject to Australian tax under section 129 ITAA 1936.

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Your comments

148. If you wish to comment on this draft Ruling, please send your comments promptly by **11 October 2002** to:

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Commissioner of Taxation
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- bareboat charter
- charterparties
- demise charter
- dry lease
- equipment leasing
- freight
- hire
- royalties
- royalty
- royalty article
- royalty withholding tax
- right to use
- time charter
- use
- voyage charter
- wet lease

Legislative references:
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