TR 2008/D3 - Income tax: the taxation treatment of ship and aircraft leasing profits under the ships and aircraft articles of Australia's tax treaties

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Draft Taxation Ruling

Income tax: the taxation treatment of ship and aircraft leasing profits under the ships and aircraft articles of Australia's tax treaties

Contents Para

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What this Ruling is about

1. This draft Ruling clarifies what profits derived from the leasing of ships or aircraft fall within the ships and aircraft articles[1] of each of Australia's tax treaties.[2]

2. This draft Ruling also clarifies:

- in what circumstances Australia is allocated a right to tax those leasing profits under the ships and aircraft article; and

[1] The articles of Australia's tax treaties which deal with profits from the operation of ships or aircraft or both are generally headed 'ships and aircraft article'. There are a number of variations in the wording of the headings of the applicable articles and some have no heading at all. For ease of reference, this draft Ruling will refer to these articles as the 'ships and aircraft article' when mentioning more than one of these articles collectively. When referring to this type of article in a particular tax treaty individually, this draft Ruling will state the actual heading and/or article number of the relevant article in that particular tax treaty.

[2] In addition to Australia's comprehensive tax treaties, Australia also has four airline profit agreements (APA) with France, Italy, Greece and the People's Republic of China. In addition, the Australian Commerce and Industry Office entered into an agreement with the Economic and Cultural Office of Taipei (hereinafter referred to as the Taipei Agreement). For ease of reference only, when referring generally to Australia's comprehensive tax treaties, airline profit agreements and the Taipei Agreement, this draft Ruling uses the term 'tax treaties'.

- the method of assessment of such profits to tax under the *Income Tax Assessment Act 1997* (the ITAA 1997) or the *Income Tax Assessment Act 1936* (the ITAA 1936).

3. This draft Ruling examines those paragraphs of the ships and aircraft articles in each of Australia's tax treaties that are relevant to ship and aircraft leasing profits. As the wording of some of these articles differ, the texts are set out in Appendix 3 at paragraph 218 of this draft Ruling. For the purpose of applying the principles contained in this draft Ruling, minor wording differences that exist between corresponding paragraph(s) of the article are ignored where those differences do not materially affect the taxation treatment of profits from the leasing of ships or aircraft.

Class of entities

4. This draft Ruling applies to:

- residents of Australia for tax treaty purposes (an 'Australian treaty resident'); and
- residents (for treaty purposes) of those countries with which Australia has a tax treaty (a 'treaty partner resident');[3]

that:

- engage in the operation of ships or aircraft; and
- derive profits from leasing out ships or aircraft.[4]

Scheme

5. This draft Ruling applies to leases of ships or aircraft that fall for consideration under the ships and aircraft article of Australia's tax treaties. The ships and aircraft article applies to certain 'full basis' and 'bareboat basis' leases (see paragraphs 15 and 16 of this draft Ruling) relating to the operation of ships or aircraft.

Related Rulings

6. The Commissioner has issued other Rulings that cover related issues to the ones raised in this draft Ruling. These Rulings are:

- Taxation Ruling TR 2003/2 Income tax: the royalty withholding tax implications of ship chartering arrangements.

[3] This includes residents of those agreements that, while not being tax treaties, have a similar effect for tax purposes, for example, the Taipei Agreement.

[4] Some of the ships and aircraft articles in Australia's tax treaties also require that the resident ship or aircraft operator be carrying on an enterprise. Australia's tax treaty with Romania requires that the ship or aircraft operator have its place of effective management in Australia or Romania. This draft Ruling does not deal with these requirements as they do not impact on the issue of determining what ship or aircraft leasing profits fall within the scope of the article.

- Taxation Ruling TR 2006/1 Income tax: the scope of and nature of payments falling within section 129 of the *Income Tax Assessment Act 1936*.
- Taxation Ruling 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.

Background

7. The ships and aircraft article provides for the allocation of taxing rights between Contracting States in respect of profits from the operations of ships and aircraft. The extent to which the ships and aircraft articles in Australia's tax treaties allocate taxing rights with respect to leasing profits is the central issue in this draft Ruling. In order to address this issue, the draft Ruling also considers how the ships and aircraft article applies more generally in non-leasing situations.

8. The expression 'profits from the operation of ships and aircraft' includes profits directly obtained by an enterprise from the transportation of passengers or cargo by ships or aircraft (whether owned, leased or otherwise at the disposal of the enterprise), as well as profits from activities directly connected with such operations and profits from activities which are not directly connected but are ancillary to such operations.[5] In some situations it may also include profits from non-transport operations.

9. The ships and aircraft article may be based on article 8 of the OECD Model Tax Convention on Income and on Capital (the OECD Model), or may adopt approaches to accommodate countries' particular positions. Australia's position in respect of the ships and aircraft article in its tax treaties is to preserve source taxation rights over profits from internal ship and aircraft operations, which include not just transport activities but also non-transport activities. Australia also treats as internal traffic the operations of ships or aircraft confined solely to places in Australia, even if they form part of an overall international voyage. The Commentary on article 8 of the OECD Model recognises that countries may bilaterally agree to extend the scope of article 8 to adopt both these positions.[6]

[5] See paragraph 4 of the Commentary on article 8 of the OECD Model.
[6] See paragraph 6.2 of the Commentary on article 3 of the OECD Model, concerning internal traffic and paragraph 17.1 of the Commentary on article 8 of the OECD Model concerning non-transport activities.

10. Australia's intention to depart from the OECD Model is reflected in its reservation on the OECD Model[7] which states:

> Australia reserves the right to tax profits from the carriage of passengers or cargo taken on board at one place in Australia for discharge in Australia. Australia also reserves the right to tax profits from other coastal and continental shelf activities.

The standard ships and aircraft article

11. Due to the bilateral nature of tax treaties the text of Australia's ships and aircraft articles vary from treaty to treaty. This draft Ruling focuses on the text which generally appears in the ships and aircraft articles in Australia's most recent tax treaties[8] (the standard ships and aircraft article), and then examines the major variations from that text contained in other tax treaties.

12. For the purposes of this draft Ruling, the standard ships and aircraft article is as follows:

> ARTICLE 8
>
> Ships and Aircraft
>
> 1. Profits of an enterprise of a Contracting State derived from the operation of ships or aircraft in international traffic shall be taxable only in that State.
>
> 2. Notwithstanding the provisions of paragraph 1, profits of an enterprise of a Contracting State derived from the operation of ships or aircraft may be taxed in the other Contracting State to the extent that they are profits derived directly or indirectly from ship or aircraft operations confined solely to places in that other State.
>
> 3. The profits to which the provisions of paragraphs 1 and 2 apply include profits from the operation of ships or aircraft derived through participation in a pool service or other profit sharing arrangement.
>
> 4. For the purposes of this Article, profits derived from the carriage by ships or aircraft of passengers, livestock, mail, goods or merchandise which are shipped in a Contracting State and are discharged at a place in that State shall be treated as profits from ship or aircraft operations confined solely to places in that State.

[7] See paragraph 38 of the Commentary on article 8 of the OECD Model.
[8] See Australia's tax treaties with Poland, the 2006 tax treaty with Norway (Norway 2006), the 2006 treaty with Finland (Finland 2006) and the 2006 treaty with France [note the French treaty has not entered into force]. Note also that article 8 in Australia's tax treaty with the United Kingdom is considered to have the same effect as the standard article 8, notwithstanding that the text of some of the provisions is different.

13. This draft Ruling takes a similar approach in respect of the definition of 'international traffic'. The definition of 'international traffic' that relates to the standard ships and aircraft article is as follows:

> ARTICLE 3
>
> General Definitions
>
> 1. For the purposes of this Convention, unless the context otherwise requires:
>
> …
>
> (j) the term 'international traffic' means any transport by a ship or aircraft operated by an enterprise of a Contracting State, except where the ship or aircraft is operated solely between places in the other Contracting State;

Terminology

Meaning of resident 'for tax treaty purposes'

14. The expression used in this draft Ruling of a resident 'for tax treaty purposes' refers to the residency status of a person as determined by the article in each tax treaty dealing with residence (usually article 4).

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

15. A lease of a ship or an aircraft on a full basis (also generally referred to as a 'time charter-party' in the shipping industry and as a 'wet lease' in the airline industry) refers to the charter of a ship or aircraft with the captain and crew. Paragraph 5 of the Commentary on article 8 of the OECD Model explains that a full basis lease is one that is 'fully equipped, crewed and supplied'.[9] Paragraph 15 of Taxation Ruling TR 2007/10 describes 'full basis' leases as follows:

> 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 is responsible for the technical operation and navigation of the ship or aircraft. The lessee pays hire to the owner in order to have the ship or aircraft at its disposal for the specified period of time. The lessee therefore obtains the right to commercially exploit the carrying capacity of the ship or aircraft for its own purposes.

[9] This is also explained at paragraph 1.99 of the Explanatory Memorandum to the International Tax Agreements Amendment Bill 2003 (which incorporates the 2003 United Kingdom convention).

16. Conversely, a bareboat lease (also generally referred to as a 'demise' or 'bareboat charter-party' in the shipping industry and as a 'dry lease' in the airline industry), refers to the charter of a ship or an aircraft generally without the captain and crew.[10] Paragraph 16 of Taxation Ruling TR 2007/10 describes 'bareboat basis' leases as follows:

> 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.

17. As a 'voyage charter-party' is a contract of carriage it is therefore not a lease for the purposes of this draft Ruling. The charterer under a voyage charter-party does not obtain possession of the ship or have the ship at its disposal. As noted at paragraph 34 of Taxation Ruling TR 2003/2:

> Under a voyage charter-party the ship is chartered for a specific voyage (for example Melbourne to London). It is usually used as a contract of carriage where a large quantity of cargo, requiring the entire carrying capacity of the ship, is carried between designated ports. The ship may be chartered for the voyage directly from the shipowner or sub-chartered from another charterer. Generally speaking, the charterer or sub-charterer is also the shipper under a voyage charter-party, although in some cases the charterer may have sublet some of the space to a third party.

Meaning of an 'exclusive residence country taxing right'

18. For the purposes of this draft Ruling, the expression 'exclusive residence country taxing right' refers to a situation where the tax treaty provides that only the country of residence of the lessor of the ship or aircraft is permitted to tax the particular profits of the lessor.

Meaning of a 'source country taxing right'

19. For the purposes of this draft Ruling, the expression 'source country taxing right' refers to a situation where the tax treaty allocates a taxing right to the treaty partner country in which the lessor of the ship or aircraft is not a resident (the 'source country').

[10] See paragraph 2.13 of the Explanatory Memorandum to the International Tax Agreements Amendment Bill 2001 (which incorporates the 2001 Protocol amending the United States convention) which refers to a bareboat lease as being 'generally, without crew'.

Ruling

Part A: the treatment of leasing profits under the standard ships and aircraft article

Paragraph 1

20. The standard wording adopted in paragraph 1 of the ships and aircraft article (paragraph 1) in Australia's tax treaties[11] provides an exclusive residence country taxing right over profits from the operations of ships or aircraft in international traffic, but only in respect of transport operations.

21. Paragraph 1 does not apply to provide an exclusive residence country taxing right where the ship or aircraft is operated solely between places in the other State (the source State). The definition of international traffic in article 3 excludes such internal operations from paragraph 1. This exclusion from paragraph 1 applies to voyages that start and end at the same port or airport, or in two different ports or airports in the other State, even if part of the transport takes place outside that State (for example a voyage to nowhere). However, the definition of international traffic for the purposes of paragraph 1 does include the internal leg of an international voyage even though it may involve the same passengers or cargo being loaded and unloaded in that State.[12]

22. Profits derived by a lessor from the lease of a ship or aircraft on a full basis and used by the lessee in international traffic fall under paragraph 1 as profits from the operation of ships or aircraft in international traffic.

23. Profits derived by a lessor from a bareboat lease of a ship or aircraft do not fall within paragraph 1 as profits from the operation of ships or aircraft, unless they are ancillary to the ship or aircraft operations of the lessor in international traffic.

24. A bareboat leasing activity will be 'ancillary' to the lessor's operation of ships or aircraft, notwithstanding that the activity may not need to be carried on for the purposes of the lessor's own operation of ships or aircraft, provided that the activity:

- does not make more than a minor contribution to the lessor's overall transport operations; and
- does not amount to a separate source of income or separate business operation.

25. A bareboat leasing profit will be 'ancillary' to the lessor's own operation of ships or aircraft irrespective of where the lessee uses the ship or aircraft.

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[11] See Table 1 of Appendix 3 at paragraph 218 of this draft Ruling.
[12] Note that this outcome is subject to paragraph 2 of article 8. See paragraphs 26 and 27 of this draft Ruling.

Paragraph 2

26. Notwithstanding the exclusive residence country taxing right provided over profits by paragraph 1, the standard wording in paragraph 2 of the ships and aircraft article (paragraph 2) in Australia's tax treaties[13] provides a source country taxing right over profits from the operation of ships or aircraft to the extent that the profits are derived from operations that are 'confined solely to places in that other State'.

27. Paragraph 2 applies to both transport and non-transport profits derived by a tax treaty resident. Profits from the operation of ships or aircraft confined solely to places in that other State include voyages that start and end at the same port or airport, or in two different ports or airports in the other State, even if part of the transport takes place outside that other State (without stopping at another port or airport). It also includes the internal leg of an international voyage where it involves the same passengers or cargo being loaded and unloaded in that State. Accordingly paragraph 2 applies in priority over paragraph 1 in relation to internal legs.

28. Determining profits that are derived from non-transport operations confined solely to places in the other State requires an examination of the ship or aircraft activities undertaken by the enterprise in that other State and determining whether those particular activities constitute operations which are confined to places in that State.

29. The activity or activities undertaken in the other Contracting State must be sufficient to constitute a distinct ship or aircraft operation that is identifiable separately from other ship or aircraft operations of the enterprise.

30. For a full basis lease, the profits of the lessor are considered derived from 'operations confined solely to places in that other State' when the relevant use of the ship or aircraft is confined solely to places in that other State. This includes where the ship or aircraft is used for:

- an internal leg of an international voyage where it involves the same passengers or cargo being loaded and unloaded in that other State; and
- a voyage that starts and ends at the same port or airport, or in two different ports or airports in the other Contracting State, even if part of the transport takes place outside that other State (without stopping at another port or airport).

[13] See Table 2 of Appendix 3 at paragraph 218 of this draft Ruling.

31. Profits derived from ship or aircraft operations confined solely to places in that other State will include ancillary activities on the basis that they make a minor contribution and are so closely related to those operations that they should not be regarded as a separate business or source of income. This includes a bareboat lease that is ancillary to the lessor's ship or aircraft operations that are confined solely to places in the source country.

32. Where the internal operation of the lessor is the internal leg of a broader international voyage, any ancillary bareboat leasing profits the lessor derives will be treated as arising solely in respect of the lessor's international operations, except where those international operations are only a minor part of the lessor's overall operations.

Part B: the treatment of leasing profits under non-standard ships and aircraft articles

Major variations from the standard paragraph 1

Reciprocal exemption approach

33. The relevant provisions of some of Australia's tax treaties[14] that provide a reciprocal exemption from, or limitation of, a source country taxing right, have the same practical effect as providing an exclusive residence country taxing right.

Application to non-transport operations

34. Where paragraph 1 of the ships and aircraft article in Australia's tax treaties[15] does not refer to 'international traffic', it provides an exclusive residence country taxing right in respect of both transport and non-transport profits derived from the operation of ships or aircraft.

35. This variation of paragraph 1 includes profits from a full basis lease or ancillary bareboat lease that are derived in respect of non-transport ship or aircraft operations. Apart from this difference, this broader paragraph 1 applies to leasing operations on a similar basis to the standard article 8 paragraph 1 (see paragraphs 22 to 25 of this draft Ruling).

36. Because the term 'international traffic', is defined in subparagraph (1)(k) of article 3 of the Korean convention by reference to the broader concept of 'operation of ships or aircraft', the leasing profits falling within the scope of paragraph 1 of the Korean convention are the same as those covered under the broader paragraph 1 wording.

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[14] Australia's tax treaties with the Philippines, Japan and Germany, and Australia's airline profits agreements with Italy, France, Greece and China (see Table 3 of Appendix 3 at paragraph 218 of this draft Ruling)

[15] See Table 4 of Appendix 3 at paragraph 218 of this draft Ruling.

Specific provisions dealing with leasing operations

The United States convention

37. Subparagraphs 1(a) and (b) of the shipping and air transport article in the United States convention[16] restrict the exclusive residence country taxing right to profits from the following ships and aircraft leases:

- a full basis lease where the ship or aircraft is operated in international traffic by the lessee, provided the lessor:
  - (i) either operates ships or aircraft otherwise than solely between places in the source country; or
  - (ii) regularly leases ships or aircraft on a full basis; and
- a bareboat lease which is merely incidental to the lessor's operation of ships or aircraft in international traffic.

The South African agreement

38. In the case of bareboat leasing profits, the ships and aircraft article of the South African agreement[17] not only requires that the lease be merely incidental to the international operations of the lessor, but also requires that the lessee operate the ship or aircraft in international traffic before the leasing profit will be subject to the residence country taxing right. Therefore, ancillary bareboat leases will not be included in paragraph 1 unless the lessee operates the leased ship or aircraft in international traffic.

Taipei Agreement

39. The ships and aircraft article in the *Agreement between the Australian Commerce and Industry Office and the Economic and Cultural Office of Taipei concerning the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income* (hereinafter referred to as the Taipei Agreement)[18] also requires that a lease be merely incidental to the international operations of the lessor and that lessee operate the ship or aircraft in international traffic before the leasing profit will be subject to the exclusive residence country taxing right. However, the Taipei Agreement applies not just to bareboat leases but also to full basis and voyage leases.[19]

[16] See Table 5 of Appendix 3 at paragraph 218 of this draft Ruling.
[17] See Table 5 of Appendix 3 at paragraph 218 of this draft Ruling.
[18] See Table 5 of Appendix 3 at paragraph 218 of this draft Ruling.
[19] This is the only exception to the general position in this Ruling that voyage charter-parties are not leases (see paragraph 17 of this draft Ruling).

40. This will not result in a different outcome for full basis and voyage leases. However, ancillary bareboat leases will not be included in paragraph 1 unless the lessee operates the leased ship or aircraft in international traffic.

Major variations from the standard paragraph 2

No treatment of leasing operations under paragraph 2

41. Some of the ships and aircraft articles in Australia's tax treaties[20] either:

- do not include a provision that is equivalent to the standard paragraph 2; or
- include a provision that is equivalent to the standard paragraph 2 but it is restricted to profits derived from 'carriage'.

42. As a result, the ships and aircraft article in these tax treaties does not specifically provide a source country taxing right in respect of leasing profits.

43. In such cases, leasing profits which are derived solely from internal operations will also not be dealt with under the standard paragraph 1 because they are not derived from international traffic. These profits will fall outside the scope of the ships and aircraft article or Airline Profits Agreements (APAs) and fall for consideration under the business profits article (where it is a standard business profits article)[21] the royalties article of any relevant tax treaty or domestic law (if not covered by a tax treaty provision).

Specific provisions dealing with leasing operations

<u>The South African agreement</u>

44. The requirement in the ships and aircraft article of the South African agreement[22] that a bareboat lease that is merely incidental to the international operations of the lessor must also be used in international operations by the lessee does not limit the situations where paragraph 2 applies to incidental bareboat leases, as paragraph 2 does not apply in respect of the international operations of the lessor.

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[20] Australia's tax treaties with the United States, Japan, and Korea, and Australia's airline profits agreements with Italy, France, Greece and China – see Table 6 of Appendix 3 at paragraph 218 of this draft Ruling.
[21] Some tax treaties that have a business profits article may not deal with leasing profits under that provision, for example, the Japanese agreement.
[22] See Table 7 of Appendix 3 at paragraph 218 of this draft Ruling.

Taipei Agreement

45. The requirement in paragraph 3 in the ships and aircraft article of the Taipei Agreement that a full basis, voyage basis or bareboat lease of a ship or aircraft that is merely incidental to the international operations of the lessor must also be used in international operations by the lessee does not limit the situations where paragraph 2 applies, as paragraph 2 does not apply in respect of the international operations of the lessor.[23]

Rate limits on source country taxing right

46. Certain paragraphs in the ships and aircraft articles in Australia's tax treaties with France[24], Finland 1984, Switzerland, Belgium, Netherlands and Germany[25] limit the rate of tax that can be applied under the standard paragraph 2 source country taxing right in these tax treaties to 5 per cent of the payment in respect of the carriage.

47. This restriction, however, only applies to certain full basis leasing profits that are considered to be payments 'in respect of carriage'. Other leasing profits are not subject to this rate limit and either continue to be subject to the source country taxing right under the ships and aircraft article[26] or fall for consideration under the business profits article of the relevant tax treaty.[27]

Variations in wording

48. In some of Australia's tax treaties, paragraph 2 of the ships and aircraft article refers to 'such profits' rather than 'profits of an enterprise of a Contracting State derived from the operation of ships or aircraft', and to 'derived' rather than 'extent'. These variations merely make it clearer how the provision applies, and do not make any change to the operation of the paragraph.

[23] See Table 7 of Appendix 3 at paragraph 218 of this draft Ruling for the relevant provisions in the South African and Taipei agreements.
[24] This limitation only applies to profits from the operation of 'ships' under the shipping article of the 1976 French agreement and the equivalent article in the 2006 French treaty (not yet in force).
[25] See Table 8 of Appendix 3 at paragraph 218 of this draft Ruling.
[26] This is the case for the Belgian and the Netherlands agreements.
[27] This is the case for the French, Finnish, Swiss and German agreements.

Other types of major variations to the standard ships and aircraft article

The Philippine agreement

49. Profits from the operation of ships or aircraft in international traffic are dealt with in accordance with the respective domestic laws of Australia and the Philippines, except that any tax payable on profits from the operation of ships in international traffic is subject to the limit imposed by the shipping article of the Philippine agreement, which is the lesser of:

- 1.5 per cent of the gross revenues derived from sources in that other state; and
- the lowest rate of Philippine tax that may be imposed of profits of the same kind derived under similar circumstances by a resident of a third State.

Other profits from the operation of ships or aircraft fall for consideration under the business profits article of the Philippine agreement.[28]

The Greek APA

50. As Australia does not have a comprehensive tax treaty with Greece, both Australia and Greece are free to apply their domestic law to all ship leasing profits, and to those aircraft leasing profits not covered by the Greek APA. Aircraft leasing profits not covered by the Greek APA include:

- full basis leasing profits derived from transport operations conducted solely within the Contracting State in which the lessor is not a resident (the 'source' State);
- bareboat leasing profits which are not ancillary to the lessor's international transport operations; and
- all leasing profits derived from non-transport operations.

Extensions of source country taxing right – ship operations

51. The ships and aircraft articles in Australia's tax treaties with Kiribati, Sri Lanka and Thailand[29] extend the source country taxing right beyond profits from the operation of ships 'confined solely to places in that State' to half of the profits from the operation of ships other than confined solely to places in that State. This extension will also apply to the relevant leasing profits, which for these agreements applies in respect of both transport and non-transport operations (see paragraphs 26 to 27 of this draft Ruling).

[28] See Table 3 of Appendix 3 at paragraph 218 of this draft Ruling.
[29] See Table 9 of Appendix 3 at paragraph 218 of this draft Ruling.

Part C: priority of the ships and aircraft article over the business profits article and the royalties article

Business profits article

52. Where profits from leasing ships or aircraft are covered by an exclusive residence country taxing right under paragraph 1 or a source country taxing right under paragraph 2 in the relevant ships and aircraft article, the profits are considered to be dealt with by that article. Although such profits will often also be considered to fall within the scope of the business profits article of the relevant tax treaty, the priority rule in the business profits article (see for example paragraph 6 of article 7 of the United Kingdom convention) provides that the ships and aircraft article applies to those profits. Accordingly, it is not necessary to consider whether an enterprise has a permanent establishment in Australia as the business profits article does not apply to the profits.

Royalties article

53. In certain circumstances, profits of a treaty partner lessor from leasing a ship or aircraft on a bareboat basis can fall both within the scope of the ships and aircraft article as 'profits from the operation of ships or aircraft' and within the scope of the royalties article[30] as a payment of an 'industrial, commercial or scientific equipment royalty' (if the royalties article of the relevant tax treaty includes such a payment within the royalties definition).

54. In such cases of overlap, the Commissioner considers that the treaty context demonstrates that the ships and aircraft article should take priority over the royalties article unless there are clear words to the contrary contained in the relevant tax treaty. Accordingly, the profits from leasing a ship or aircraft on a bareboat basis will be dealt with by the ships and aircraft article only.

55. In these circumstances, subsection 17A(5) of the *International Tax Agreements Act 1953* prevents section 128B of the ITAA 1936 (which deals with liability to royalty withholding tax) from applying to the leasing profits of the lessor because the leasing profits are not treated as a royalty under the relevant tax treaty.

Part D: method of taxation in Australia

56. Leasing profits of an Australian treaty resident lessor of a ship or aircraft that may be taxed in Australia in accordance with the ships and aircraft article are taxed on a net assessment basis under the ordinary provisions applicable for Australian residents (subsection 6-5(2) of the ITAA 1997).

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[30] The royalties article in Australia's tax treaties is usually located in article 12 of the treaty.

57. Leasing profits of a treaty partner resident lessor of a ship or aircraft that may be taxed in Australia in accordance with the ships and aircraft article, and that have a source in Australia,[31] are subject to tax on a net assessment basis under the ordinary income assessment provisions for foreign residents (subsection 6-5(3) of the ITAA 1997).

58. However, where the leasing profits of a lessor (who has its place of business outside Australia) of a ship meet the requirements of section 129 of the ITAA 1936 (which deals with overseas ships), section 129 of the ITAA 1936 will apply to determine the relevant taxable income of the treaty partner lessor, rather than the ordinary income assessment provisions.

Examples

Part A: the treatment of leasing profits under the standard ships and aircraft article

Example 1: leasing profits subject to an exclusive residence country taxing right – the standard paragraph 1 wording – the United Kingdom convention

59. Ausco is a resident of Australia for tax treaty purposes. Ausco operates ships between Australia and the United Kingdom for the purpose of transporting goods between the two countries. Apart from this transport activity, Ausco also regularly leases out its ships on a full basis to other companies that require a fully crewed ship for a certain period of time to transport goods between Australia and the United Kingdom. Only on a very rare occasion is Ausco approached to lease out its ships on a bareboat basis. This bareboat leasing activity amounts to, on an average annual basis, only 5 per cent of Ausco's overall shipping activities.

60. The profits Ausco derives from leasing its ships on a full basis fall within paragraph 1 of the shipping and air transport article in the United Kingdom convention and Australia, as the country of residence of Ausco, is allocated the taxing right over these profits.

61. The profits Ausco derives from leasing its ships on a bareboat basis also fall within paragraph 1 of the shipping and air transport article in the United Kingdom convention because the bareboat leasing activity is considered to be ancillary to Ausco's overall shipping activities. Accordingly, Australia, as the country of residence of Ausco, is allocated the taxing right over these bareboat leasing profits.

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[31] Many of Australia's tax treaties include deemed source rules, or alternatively there are also deemed source rules for certain countries in the *International Tax Agreements Act 1953* (legislative source provisions). In the absence of a treaty deemed source rule or legislative source provisions, Australia's common law rules for determining source will apply (see paragraph 38 of Taxation Ruling TR 2001/13 Income tax: interpreting Australia's Double Tax Agreements).

Example 2: leasing profits subject to a source country taxing right – the standard paragraph 2 wording – the New Zealand agreement

62. Seaco is a resident of New Zealand for tax treaty purposes. Seaco operates ships that transport passengers and their vehicles only between Melbourne and Tasmania.

63. On two occasions in the ten years Seaco has run this business, Seaco has also leased out one of its spare ships on a bareboat basis to entities who require a ship for slightly different routes or timeframes than that offered by Seaco. The last occasion being a bareboat lease to a company, Ventureco, who used it to take their international clients on a special sightseeing tour along the coast of Australia from Tasmania to Brisbane.

64. The profits Seaco derived from leasing the ship to Ventureco on a bareboat basis fall within paragraph 2 of the ships and aircraft article in the New Zealand agreement. The bareboat leasing activity is considered to be ancillary to Seaco's ship operations that are confined solely to places within Australia. Accordingly, Australia is allocated a source country taxing right over these bareboat leasing profits.

Example 3: leasing profits subject to a source country taxing right – the standard paragraph 2 wording – a voyage to nowhere – the Singapore agreement

65. Fishingco is a resident of Singapore for tax treaty purposes. Fishingco owns a ship that is used for fishing purposes and is based in Cairns. Fishingco enters into a full basis lease with a lessee wishing to conduct a commercial fishing expedition off the coast of Australia. The leased ship departs Cairns and is used to fish mainly in Australian waters, although it also travels into and fishes in international waters. The ship returns to Cairns where the catch is unloaded and sold. At no time during the fishing expedition does the ship stop in a port outside Australia.

66. Australia is allocated a source country taxing right over these full basis leasing profits under paragraph 2 as these profits are derived from 'ship operations confined solely to places in Australia' because the ship operations constitute a voyage to nowhere as the leased ship leaves and returns to a port in Australia and does not stop in a port outside Australia.

Example 4: leasing profits subject to a source country taxing right – the standard paragraph 2 wording – a voyage to nowhere – the Netherlands agreement

67. Surveyco is a resident of the Netherlands for tax treaty purposes. Surveyco leases one of its ships on a full basis to a lessee who uses it to survey the seabed along the western coast of Australia and the southern coast of Indonesia. During the lease, the leased ship departs from Fremantle with specialist surveyors and equipment from Perth and returns to Fremantle. During the voyage the ship does not stop in a port outside Australia, however, it does enter Indonesian waters.

68. For the same reasons as in Example 3 at paragraph 66 of this draft Ruling, the full basis leasing profits are derived from 'ship operations confined solely to places in Australia' because the ship operations constitute a voyage to nowhere as the leased ship leaves and returns to a port in Australia and does not stop in a port outside Australia. Accordingly, Australia is allocated a source country taxing right over these full basis leasing profits under paragraph 2.

Example 5: leasing profits subject to a source country taxing right – the standard paragraph 2 wording – an internal leg of an international voyage – the Canadian convention

69. Charterco is a resident of Canada for tax treaty purposes. Charterco operates aircraft for private charter between various countries in the world. Charterco's clients usually require their aircraft services within short time frames, for various purposes and lease the aircraft from Charterco on a full basis as they do not wish to, or do not have the ability to physically operate the aircraft themselves.

70. One of Charterco's clients leases an aircraft on a full basis in order to undertake the client's research activities on a continuous route between New Zealand, Fiji, Brisbane, Sydney, then back to New Zealand. The aircraft is leased for five months and travels this route a number of times during this period.

71. The operation of the aircraft between Brisbane and Sydney involves specialist researchers and equipment from Australia being loaded and unloaded for the Australian part of the research activity and voyage. This Australian leg of the overall international voyage of the aircraft is considered a distinct and separate operation of the aircraft. Accordingly, the profits from the full basis lease that relate to the time the aircraft is used by the lessee for the routes between Brisbane and Sydney are profits of Charterco from operations confined solely to places within Australia. Therefore, Australia is allocated a source country taxing right over these full basis leasing profits under paragraph 2 of the ships and aircraft article of the Canadian convention.

Part B: the treatment of leasing profits under non-standard ships and aircraft articles

Example 6: leasing profits subject to an exclusive residence country taxing right – major variation to paragraph 1 wording – the United States convention

72. The facts are the same as Example 1 at paragraph 59 of this draft Ruling except Ausco operates aircraft between Australia and the United States. Ausco does not operate aircraft within the United States.

73. The profits Ausco derives from leasing its aircraft on a full basis fall within paragraph 1 of the shipping and air transport article in the United States convention because Ausco operates the aircraft otherwise than solely within the United States. As this requirement of subparagraph 1(a) is met, there is no need to consider whether Ausco regularly leases aircraft on a full basis. Accordingly, Australia is allocated a residence country taxing right over these full basis profits.

74. The profits Ausco derives from leasing its aircraft on a bareboat basis also fall within paragraph 1 of the shipping and air transport article in the United States convention because the bareboat leasing activity is considered to be merely incidental to Ausco's overall operations of aircraft in international traffic (as prescribed in subparagraph 1(b)). Accordingly, Australia is allocated a residence country taxing right over these bareboat leasing profits.

Example 7: leasing profits (if any) subject to a source country taxing right – major variation – no equivalent to paragraph 2 – the Korean convention

75. The facts are the same as in Example 2 at paragraph 62 of this draft Ruling except that Seaco is a resident of Korea for tax treaty purposes. Seaco also derives profits from leasing its ships on a full basis between Tasmania and Melbourne.

76. The profits Seaco derives from leasing its ships on a full basis and from leasing its ship on a bareboat basis are not taxable by Australia under the ships and aircraft article of the Korean convention. This is because the ships and aircraft article of the Korean convention does not allocate a source country taxing right to Australia in such circumstances. The Article does not contain a provision dealing with profits from the operation of ships confined solely to places within the other State.

77. Whether Australia has a taxing right in respect of these leasing profits will be determined under the business profits article or royalties article in the Korean convention. In accordance with the Commissioner's view at paragraph 21 of Taxation Ruling TR 2003/2, profits from a full basis lease of a ship are not royalties, therefore, article 7 of the Korean convention will be the applicable article and Australia will only be permitted to tax if Seaco has a permanent establishment in Australia. Profits from a bareboat lease of a ship, however, are considered royalties under paragraph 20 of Taxation Ruling TR 2003/2 and as such the royalties article of the Korean convention will apply to permit Australia to impose tax of 15 per cent on the bareboat lease payment (the royalty payment).

Example 8: major variation providing rate limits on source country taxing right – the Belgian agreement

78. The facts are the same as in Example 2 at paragraph 62 of this draft Ruling except Seaco is resident of Belgium for tax treaty purposes.

79. The profits Seaco derives from leasing the ship to Ventureco on a bareboat basis fall within paragraph 2 of the ships and aircraft article in the Belgian agreement because the bareboat leasing activity is considered to be ancillary to Seaco's ship operations that are confined solely to places within Australia. Accordingly, Australia is allocated a source country taxing right over these bareboat leasing profits.

80. Paragraph 5 of article 8 of the Belgian agreement limits the source country's ability to tax profits under paragraph 2 of article 8 to 5 per cent of the amount paid or payable in respect of carriage in such operations. There is no limit in respect of amounts that are not in respect of carriage in such operations. The profits that arise under a bareboat lease are not 'in respect of carriage' (of passengers, goods etcetera) as the lease fees will be received regardless of the amount of passengers, goods etcetera carried on the ship during the lease. Hence, the 5 per cent rate limit under paragraph 5 of article 8 does not apply. As a result, Australia is not restricted by this rate limit when exercising its source country taxing right over bareboat leasing profits under paragraph 2 of article 8 of the Belgian agreement.

Example 9: major variation extending source country taxing rights for ship operations – the Thai agreement

81. Pacifico is a resident of Thailand for tax treaty purposes. Pacifico provides ship transport and freight services between Australia and Thailand. Pacifico also leases some of its ships on a full basis between Australia and Thailand.

82. The profits Pacifico derives from leasing its ships on a full basis in international traffic fall within paragraph 2 of the shipping and aircraft article in the Thai agreement. Accordingly, Australia is allocated a source country taxing right over these full basis profits. However, Australia's taxing right under paragraph 2 of article 8 of the Thai agreement (which only applies to ships) is restricted to one half of the amount of tax that would otherwise be payable in Australia in respect of Pacifico's full basis leasing profits but for this restriction.

Part C: priority of the ships and aircraft article over the business profits article and the royalties article

Example 10: the Mexican agreement

83. Touristco is a resident of Mexico for tax treaty purposes. Touristco operates specialised sightseeing tours by aircraft all over the world, including within Queensland and the Northern Territory of Australia. It does not have any offices in Australia, as it procures most of its business online.

84. Due to a scheduling mistake, Touristco had an idle aircraft in Australia for a period of three weeks. Touristco decided to lease it out on a bareboat basis to an Australian resident individual for use within the Northern Territory.

85. The profits Touristco derives from leasing the aircraft on a bareboat basis fall within paragraph 2 of the ships and aircraft article in the Mexican agreement because the bareboat leasing activity is considered to be ancillary to Touristco's aircraft operations that are confined solely to places within Australia. However, the lease payment could be regarded as a royalty under the royalties article in the Mexican agreement because it is also a payment for the right to use commercial equipment.

86. However the Commissioner considers that in such cases of potential overlap between the ships and aircraft article and the royalties article, the treaty context indicates that the ships and aircraft article should take priority unless there are clear words to the contrary contained in the relevant treaty. As a result, the profits are dealt with in accordance with paragraph 2 of article 8 of the Mexican agreement, not the royalties article with effect that the leasing profits are not treated as a royalty under the relevant tax treaty.

87. This means that Australia is allocated a source country taxing right over these bareboat leasing profits. However, Australia taxes those profits on a net assessment basis, not on a withholding basis as subsection 17A(5) of the *International Tax Agreements Act 1953* prevents section 128B of the ITAA 1936 (which relates to withholding tax) from applying.

Part D: method of taxation in Australia

Example 11: the United Kingdom convention

88. The facts are the same as Example 7 at paragraph 75 of this draft Ruling except Seaco is a United Kingdom resident for tax treaty purposes and the lease between Tasmania and Melbourne is a full basis lease to which section 129 of the ITAA 1936 applies.

89. The profits Seaco derives from leasing the ship on a full basis fall within paragraph 2 of the shipping and air transport article in the United Kingdom convention because the leasing profits are considered to be profits from ship operations confined solely to places within Australia. Accordingly, Australia is allocated a source country taxing right over these full basis leasing profits.

90. As the profits fall within section 129 of the ITAA 1936, the taxable income derived by Seaco for Australian tax purposes will be deemed to be 5 per cent of the lease payment it receives in respect of the carriage under the full basis lease. Accordingly there is no need to calculate the assessable income and deductions that relate to the full basis lease payment.

Date of effect

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

Commissioner of Taxation
9 April 2008

Appendix 1 – Explanation

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

Undefined terms

92. Many of the terms that are contained in the ships and aircraft article of Australia's tax treaties are not defined within those treaties. The majority of Australia's tax treaties contain a provision explaining the treatment of undefined terms in the general definition article. That provision provides broadly that where a term is not defined in the treaty, it takes on the meaning it has under the domestic taxation law of the country applying the treaty, unless the context otherwise requires.[32]

93. The Commissioner's approach to the interpretation of undefined terms in a tax treaty, as set out in paragraphs 63 to 76 of Taxation Ruling TR 2001/13 Income tax: interpreting Australia's Double Tax Agreements, is used in this draft Ruling to provide meaning to the undefined terms referred to in this draft Ruling.

Part A: the treatment of leasing profits under the standard ships and aircraft article

Paragraph 1

94. Paragraph 1 of the standard[33] ships and aircraft article[34] provides an exclusive residence country taxing right to profits from the operations of ships and aircraft in 'international traffic'.

95. Profits falling within this exclusive residence country taxing right under the standard wording in paragraph 1 are considered to be 'dealt with' by the ships and aircraft article and therefore do not fall for consideration under the business profits article of the relevant tax treaty (see also paragraph 52 of this draft Ruling).

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[32] For example, paragraph 3 of article 3 of the United Kingdom 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.

[33] See paragraph 12 of this draft Ruling.

[34] Australia's tax treaties with the United Kingdom and Poland and the corresponding paragraphs in Australia's APAs with Italy, France and Greece – see Table 1 of Appendix 3 at paragraph 218 of this draft Ruling.

Meaning of 'international traffic'

96. For the standard articles,[35] the term 'international traffic' is defined in the relevant definitions article of the tax treaty as 'any transport by a ship or aircraft operated by an enterprise of a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State'.[36]

97. The effect of this definition is to limit the exclusive residence country taxing right contained in paragraph 1 to transport operations (for example operations involving the carriage of passengers or cargo).

98. The definition also limits the exclusive residence country taxing right to those transport operations that are not solely operated out of, or between, places such as ports or airports in the other Contracting State.

99. This limitation provided in the definition of 'international traffic' also covers voyages that start and end at the same port or airport, or in two different ports or airports in the other Contracting State, even if part of the transport takes place outside that State provided it does not involve a stop in a port or airport in any other State. This is similar to the approach taken in the Commentary on article 3 of the OECD Model[37] which explains that a cruise ship which begins and ends in a State without stopping at a foreign port does not constitute a transport of passengers in international traffic. It is noted that in Australia's tax treaty with the United Kingdom the words 'from a place' have been inserted in the definition of 'international traffic' which removes any doubt concerning this approach. These operations fall outside paragraph 1, but fall for consideration under paragraph 2, which provides that a taxing right is allocated to the other State (the 'source country').

100. However, consistent with the OECD Model's approach, the term international traffic includes transport operations between places in the other Contracting State where the journey between places in that State (the internal leg) forms part of a longer voyage involving a place of departure and a place of arrival which is outside that State (a broader international voyage).[38] Notwithstanding that these specific operations fall within the term 'international traffic' in the standard ships and aircraft article, the internal leg may also fall for consideration under paragraph 2 if it is an operation 'confined solely to places within the other State' (see paragraphs 114 to 147 of this draft Ruling).

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[35] See paragraph 12 of this draft Ruling.
[36] The term 'international traffic' is defined in article 3 (General Definitions) of the respective tax treaties, and in article 2 of the respective APAs.
[37] Paragraph 6.3 of the Commentary on article 3 of the OECD Model – Note that article 3 of the OECD Model also uses the words 'between places', and the words 'from a place' have been added in the Australian text merely for clarity.
[38] Paragraph 6.1 of the Commentary on article 3 of the OECD Model.

Application to leasing

101. A lessor under a full basis lease is considered to be providing a service to the lessee by providing a ship fully crewed and supplied (Taxation Ruling TR 2003/2), and as a result the lessor is treated as operating the ship or aircraft. This is supported by paragraph 5 of the Commentary on article 8 of the OECD Model, which states that 'profits obtained by leasing a ship or aircraft on charter fully equipped, crewed and supplied must be treated like profits from the carriage of passengers or cargo'. Therefore, profits derived by a lessor from the lease of a ship or aircraft on a full basis fall within paragraph 1 as profits from the operation of ships or aircraft.

102. The lessor under a bareboat lease is only making available the ship or aircraft, and is not considered to be operating the ship or aircraft. Therefore profits derived by a lessor from a bareboat lease of a ship or aircraft generally do not fall within paragraph 1 as profits from the operation of ships or aircraft.

103. However, activities that are different from, but ancillary to the main shipping or aircraft operations of a non-resident enterprise are treated as part of those main operations. Accordingly, profits from a bareboat lease that is ancillary to the ship or aircraft operations of a lessor will fall within paragraph 1.

104. The basis for this approach is outlined in the Commentary on article 8 of the OECD Model. Paragraph 4 of the Commentary states that paragraph 1 of article 8 covers profits not directly connected with the operations of ships or aircraft in international traffic as long as they are ancillary to such operations. Paragraph 4.2 of the Commentary considers ancillary activities to be those which make a minor contribution and are so closely related to the operations that they should not be regarded as a separate business or source of income.

105. A bareboat leasing activity will be 'ancillary' to the lessor's operation of ships or aircraft, notwithstanding that the activity may not need to be carried on for the purposes of the lessor's own operation of ships or aircraft, provided that the activity:

- does not make more than a minor contribution to the lessor's overall transport operations; and
- does not amount to a separate source of income or separate business operation.

106. This would be the case where, for example, an enterprise operates a ship for transport purposes, but enters into a 'one-off' bareboat lease for the ship because of down time. See paragraph 145 of this draft Ruling for further detail on the factors that the Commissioner considers relevant in determining whether the leasing activity is 'ancillary' to the operation of ships or aircraft.

107. The location where the bareboat leased ship or aircraft is operated by the lessee does not change the ancillary nature of the leasing activity. As such a bareboat leasing profit will be 'ancillary' to the lessor's own operation of ships or aircraft irrespective of where the lessee uses the ship or aircraft, for example, between the two treaty partner countries or within one of the treaty partner countries.

108. Accordingly, the types of leasing profits covered by paragraph 1 are:

- a full basis lease in respect of any transport by a ship or aircraft operated in international traffic; and
- a bareboat lease which is ancillary to the lessor's transport operations of ships or aircraft in international traffic.

Paragraph 2

109. Notwithstanding the exclusive residence country taxing right provided over profits by paragraph 1, the wording in paragraph 2 of the standard[39] ships and aircraft article in Australia's tax treaties[40] provides a source country taxing right over profits from the operation of ships or aircraft to the extent they are 'confined solely to places in that other State'.

110. Profits falling within this source country taxing right under the standard wording in paragraph 2 are dealt with by the ships and aircraft article and do not fall for consideration under the business profits article of the relevant tax treaty (see also paragraph 52 of this draft Ruling).

111. The scope of paragraph 2 is not restricted by the scope of paragraph 1. The words 'notwithstanding paragraph 1' in paragraph 2 ensure that the source country taxing right afforded under paragraph 2 applies to any profits that might otherwise be subject to the exclusive residence country taxing right under paragraph 1.

112. Unlike paragraph 1, paragraph 2 applies to both transport and non-transport profits derived by a tax treaty resident where the operations are confined solely to places in the source country. This is because paragraph 2 uses the broader language of 'operations of ships or aircraft' which is not restricted to transport activities.[41] Non-transport profits include profits from operations such as fishing, dredging, crop dusting, salvage operations, and surveying.

113. Further, unlike paragraph 1, the internal operations apply not to 'where a ship or aircraft is operated solely between places', but to 'ship or aircraft operations confined solely to places in that other state'.

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[39] See paragraph 12 of this draft Ruling.
[40] See Table 2 of Appendix 3 at paragraph 218 of this draft Ruling.
[41] This is consistent with Australia's reservation to the OECD Model, see paragraph 10 of this draft Ruling.

Meaning of 'operations confined solely to places in that other state'

Operations of ships or aircraft

114. Paragraph 2 deals with an enterprise of a Contracting State that is deriving profits from the operation of ships or aircraft, and applies to provide a taxing right to the other State over any parts of those profits that are derived from operations confined solely to places in that other State. Therefore this provision involves an examination of the ship or aircraft activities undertaken by the enterprise in that other Contracting State and determining whether those particular activities constitute operations that are confined solely to places in that State.

115. The relevant activities are those that involve the physical operation of the ship or aircraft, as opposed to the activities involved in the administration of an enterprise's overall shipping or aircraft business (for example, contract negotiation, or ongoing management of ownership, lease or finance obligations relating to the ship or aircraft).

116. In considering whether or how particular activities constitute 'operations of ships or aircraft' guidance can be obtained from the ordinary meaning[42] of the term 'operation' which includes the action or process of operating.[43] Therefore, provided the activities consist of an action or process of operating in their own right, they would constitute an 'operation'.

117. However, this does not mean that any ship or aircraft activity, or group of activities will constitute a ship or aircraft operation in their own right. The activity or activities undertaken in the other Contracting State must be sufficient to constitute a distinct ship or aircraft operation that is identifiable separately from other ship or aircraft operations of the enterprise.

118. This approach can be distinguished from that taken in respect of the definition of 'international traffic'. That definition only has regard, in relation to the breadth of its internal traffic exclusion, to whether the ship or aircraft itself is operated solely between places in the other State. The reference to 'operated' is linked to the use made of 'the ship or aircraft' and in the context of transport activities this is considered to be the particular voyage undertaken by the particular ship or aircraft. For paragraph 2, however, the focus is on 'operations' with the more general reference to 'ship or aircraft' being of a descriptive nature (that is to distinguish ship or aircraft operations from other operations). Therefore, it involves examining the activities of an enterprise relating to ships or aircraft that take place in the other State, to determine whether they constituted an 'operation' or 'operations' confined solely to that State, rather than merely examining the particular voyage of a ship or aircraft. This difference is consistent with the fact that unlike the definition of 'international traffic', paragraph 2 also deals with non-transport activities, which by their nature involve a wider range of activities than the mere voyage itself (for example fishing, dredging, surveying).

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[42] See the general definitions article (usually article 3) in Australia's tax treaties which provides that any term not defined in the treaty shall, unless the context requires otherwise, have the meaning that it has under the applicable domestic laws.

[43] Concise Oxford English Dictionary, 11th Edition, 2006, the definition of 'operation'.

Transport operations

119. Whilst the terms of paragraph 2 determine the scope of the profits covered therein, certain profits are also expressly included in paragraph 2 by the deeming provision provided in paragraph 4 of the ships and aircraft article (paragraph 4) in Australia's tax treaties. Accordingly paragraph 4 has effect to ensure these profits are included within paragraph 2 by removing any doubt. Therefore it does not operate in a manner which could be said to narrow the scope of the profits falling within the source country taxing right in paragraph 2.

120. The standard paragraph 4 in the ships and aircraft article in Australia's tax treaties deems profits derived from the carriage by ships or aircraft of passengers and cargo which are shipped in a Contracting State and discharged at a place in that State to be profits from ship or aircraft operations confined solely to places in that State for the purposes of paragraph 2.

121. Paragraph 4 also deals with the profits from the Australian leg of an international voyage, where the same passengers or cargo embark or are loaded in a Contracting State and disembark or are unloaded in that State. While such profits fall within paragraph 1 by virtue of the definition of 'international traffic', they are also caught under paragraph 2 and a taxing right is allocated to that other State (the 'source country').

122. The paragraph also applies to voyages that start and end at the same port or airport, or in two different ports or airports in the other Contracting State, even if part of the transport takes place outside that State (without stopping at another port or airport), that is a voyage to nowhere.

Non-transport operations

123. Paragraph 4 does not apply to profits from non-transport ship or aircraft operations, such as fishing, dredging, crop dusting, salvage operations and surveying. Whether these profits fall within paragraph 2 must be considered under the specific terms of that paragraph.

124. Paragraph 2 deals with an enterprise of a Contracting State that derives profits from the operation of ships or aircraft, and it provides a taxing right to the other State over any parts of those profits that are derived from operations confined solely to places in that State. Therefore this provision requires an examination of the ship or aircraft activities undertaken by the enterprise in that other Contracting State and determining whether those particular activities constitute operations which are confined solely to places in that Contracting State. The fact that the activities are part of a wider business conducted outside that State does not preclude the activities from constituting an operation in that State in their own right. If they do form an operation in that State in their own right, then they will be an operation confined solely to places in that State for these purposes.

125. Whether or not activities undertaken in the other State constitute an operation in that State will depend on the type of non-transport operation and nature and extent of the particular activities being undertaken. Provided the activities consist of an active process, activity, performance and discharge of function in their own right, they would constitute an 'operation'.

126. However, this does not mean that any ship or aircraft activity, or group of activities will constitute ship or aircraft operations in their own right. The activity or activities undertaken in the other Contracting State must be sufficient to constitute a distinct ship or aircraft operation that is identifiable separately from other ship or aircraft operations.

127. For example in relation to a dredging vessel contracted to dredge a harbour in an Australian port the dredging and associated activities conducted in that Australian port area would be treated as an operation of a ship confined solely to places in Australia. The mere travel necessary for the contractor to bring the dredge to Australia, and on completion travel to another location for the next contract would not form a part of the operation.

128. On the other hand, where an enterprise operates a fishing boat that departs and finishes its voyage in the Contracting State of which it is resident, but makes a single visit to a port in the other Contracting State to refuel would not constitute a ship operation in that other State. However, if the boat re-fuels and picks up provisions from the port, departs and fishes in that other Contracting State returns to the port to unload fish, re-fuel and pick up provisions, these activities would constitute a distinct ship operation in the other State that is identifiable from other ship or aircraft operations of that enterprise. This would be the case notwithstanding that the activities are part of a larger fishing expedition that commences and finishes in the State of residence of the enterprise.

129. A further consideration is that ship or aircraft activities will be likely to be separately identifiable operations where they are part of the usual operations of the enterprise, such as where the contract for the operation of the ship or aircraft in international traffic includes use for internal flights or voyages, or internal flights or voyages are part of the usual schedule of use of the aircraft or ship. However, internal flights or voyages that form part of a broader international voyage would be unlikely to be separately identifiable operations where they are one-off arrangements that arise on an ad hoc basis. They would also be unlikely to be separately identifiable operations where they form only a minor part of the overall flight or voyage, for example in paragraph 128 of this draft Ruling where the fishing activities in Australia only constituted one day of a seven day fishing expedition.

Voyages to nowhere

130. A further issue arises where a ship or aircraft departs and returns to a location in the other State (or another location in that other State), but also travels outside the domestic waters or airspace of that State as a part of the journey. This requires consideration of whether such activities constitute an operation that is confined solely to places in that other State, or whether the operation is also undertaken in places outside that other State.

131. Some guidance can be obtained by examining the ordinary meaning of the term 'places', or 'place'. While the term has a number of meanings, in the context of the ships and aircraft article which deals with the operations of ships and aircraft in international and domestic traffic, it is considered that it is being used in a geographical sense.

132. The dictionary meaning of 'place' in a geographical sense includes:

- a particular position or point in space; a location;
- a portion of space available or designated for someone; or
- a square or short street.[44]

133. Many elements of the geographical definition link a 'place' with a physical location. This is the sense that the term would be used in paragraph 2, given that it deals with the operations of ships and aircraft in internal traffic, which would involve the use of specific physical locations, such as harbours, ports, safe anchorages airports and landing strips.

134. In this context, 'places' does not include broad concepts such as 'international airspace' or 'international waters', as these are not specifically identifiable locations that refer to a particular area occupied by a person or thing. Further, the view that 'places' refers to specific physical locations, such as ports, does not result in ship or aircraft activities being limited to a particular point on a map. In the context of paragraph 2, confined solely to 'places' refers to specific physical locations within the other Contracting State as compared to specific physical locations in other States. Therefore, activities undertaken solely within or between ports in the other Contracting State would constitute activities confined solely to places in that other State. This approach is also supported by the fact that to limit the term 'places' to a particular point on a map would produce an absurd result.

[44] Concise Oxford English Dictionary, 11th Edition, 2006, the definition of 'place'.

135. This approach is also consistent with the OECD Commentary on article 3 when considering the term 'places' in the context of 'operated solely between places in the other State'. The Commentary treats 'places' as referring to specific physical locations such as 'the place of departure' and 'place of arrival'. It also states that transport would still be between places in the other Contracting State where the ship or aircraft is operated between two places in that State, even if part of the transport takes place outside that State, and gives the example of a cruise beginning and ending in that State without stopping in a foreign port.[45] Not only does this indicate that for shipping a port is considered to be a place, but also that a place could not mean areas of a general nature such as international waters or airspace, as this would render the approach taken in the Commentary invalid.

136. Therefore ship or aircraft operations that depart from and return to locations within the other Contracting State would be confined solely to places in that State, provided the operations did not involve a stop in a port, airport, etcetera, in any other State. This would apply notwithstanding that the ship or aircraft enters international waters or airspace.

Application to leasing

137. The deeming provided under paragraph 4 is limited to profits derived from the carriage by ships or aircraft of passenger and cargo, and therefore does not apply to leasing arrangements, whether involving transport or non-transport activities. Leasing profits are not profits derived from the carriage of passengers and cargo, rather they are profits that the lessor derives from the provision of services under the lease that facilitate the carriage and are not derived from the carriage of passengers and goods. Therefore, the treatment of profits of a lessor under a full basis lease will depend on whether they fall under the expression 'operations of ships or aircraft confined solely to places in that other State' in paragraph 2.

138. As identified in paragraphs 114 to 129 of this draft Ruling, applying paragraph 2 of the ships and aircraft article requires an examination of the ship or aircraft activities undertaken in the other State, in this case by the lessor, and determining whether those activities would constitute ship or aircraft operations. The activities must be sufficient to constitute an identifiable and separate operation in that State.

[45] Paragraph 6.3 of the Commentary on article 3 of the OECD Model.

139. For a full basis lessor, the relevant activities are not the activities involving the formation of the lease itself, but the activities in respect of the provision of services under the lease.[46] These activities would consist of the tasks undertaken by a ship or aircraft, crew and other facilities when meeting the requirements of the lessee under the lease. As such a key consideration when determining the characteristics of these activities is the characteristics of the actual tasks that are undertaken. If the tasks are undertaken in the other Contracting State, then the activities would take place in that State. Further, where the tasks undertaken by the ship or aircraft, crew and other facilities is sufficient to constitute a ship or aircraft operation of the lessee, then those tasks would also be sufficient to constitute a ship or aircraft operation of the lessor.

140. This approach is supported by the Commentary on article 8 of the OECD Model which provides that the profits of the lessor must be treated the same as the profits from the carriage of passengers or cargo.[47] Implied in this approach is the consideration that the operations of the lessor should be treated the same as the operations of the lessee, particularly given the substantial nature of a full basis lease in relation to the overall shipping activity.

141. Therefore, for a full basis lease, where a ship or aircraft operation of the lessee is confined solely to places in the other State, the lessor will be considered to also have undertaken a ship or aircraft operation confined solely to places in that state. The profits of the lessor derived from that operation will be taxable in that other State.

Ancillary activity – bareboat leasing profits covered by paragraph 2

142. The issue arises as to whether ancillary activities should be covered under paragraph 2 in a similar manner as they are covered under paragraph 1. Including ancillary activities in international operations for the purposes of paragraph 1 arises in the context that international transport has 'evolved' and covers a whole range of activities, both directly and indirectly related to the transport operations and because of this diverse nature should be viewed as encompassing all these activities when determining the tax position. These diverse features of international traffic would be just as relevant for domestic transport, and the same holistic approach should be taken to determining what are shipping or aircraft operations under paragraph 2 for non-international purposes.

[46] See Taxation Ruling TR 2003/2 Income tax: the royalty withholding tax implications of ship chartering arrangements
[47] See paragraph 5 of the Commentary on article 8 of the OECD Model.

143. Therefore profits derived from ship or aircraft operations confined solely to places in that other State will include ancillary activities on the basis that they make a minor contribution and are so closely related to those operations that they should not be regarded as a separate business or source of income. This is the case for a bareboat lease that is ancillary to the ship or aircraft operations of a lessor.

144. Similar to the approach under paragraph 1, where the main activity of a lessor is the operation of ships or aircraft solely within the other Contracting State (internal operations), any profits the lessor derives from leasing ships or aircraft on a bareboat basis that are ancillary to such internal operations fall within paragraph 2 regardless of where the lessee uses the bareboat leased ship or aircraft.

145. Whether bareboat leasing profits are 'ancillary' to the internal operations of a lessor for the purposes of paragraph 2 is a matter to be determined on the facts of each case. The Commissioner considers the following factors are relevant to such a determination:

- a comparison between the lessor's internal ship or aircraft operations and the lessor's bareboat leasing activity;
- the duration of the bareboat lease or leases;
- the frequency with which the lessor engages in such bareboat leasing activity; and
- any other facts or circumstances relevant to determining whether such bareboat leasing activities are incidental to the lessor's business or are a separate business of the lessor.

146. A difficulty could arise in respect of ancillary activities where the internal operation of the lessor is the internal leg of an overall international voyage. In this situation, profits derived from an ancillary bareboat lease could be treated as allocable to both international traffic and internal traffic, which may defeat the purpose of treating the ancillary bareboat lease as part of just one business operation or source of income.

147. To address this difficulty, an ancillary bareboat lease will be treated as arising solely in respect of the non-resident's international operations, except where those international operations are only a minor part of the lessor's overall operations.

Part B: the treatment of leasing profits under non-standard ships and aircraft articles

Major variations from the standard paragraph 1

Reciprocal exemption approach

148. The relevant provisions of Australia's tax treaties with the Philippines, Japan and Germany, and Australia's APAs with Italy, France, Greece and China (see Tables 1 and 3 of Appendix 3 at paragraph 218 of this draft Ruling) provide a reciprocal exemption from, or limitation of, a source country taxing right over certain profits from ship or aircraft operations (with some requiring the operations be in international traffic or within the country of residence of the lessor).

149. Although these tax treaties and APAs do not expressly 'allocate' a residence country taxing right over certain profits from the operation of ships and/or aircraft, they have the same practical effect as providing an exclusive taxing right. That is, the source country is not permitted to tax the relevant profits under the provision.

Application to non-transport operations

150. Paragraph 1 of the ships and aircraft article in some of Australia's tax treaties[48] provides an exclusive residence country taxing right over 'profits from the operations of ships or aircraft', without limiting the provision to 'international traffic'.

151. The lack of a reference to international traffic means that the scope of this paragraph is broader than the standard Australian paragraph 1, and applies to both transport and non-transport profits derived by a tax treaty resident from the operation of ships or aircraft.

152. The major difference with the broader application of paragraph 1 from a leasing perspective is that it will include profits from a full basis lease, or ancillary bareboat lease, that are derived from non-transport ship or aircraft operations.

153. Apart from this difference, the broader words in paragraph 1 would apply to leasing operations on a similar basis to the standard words. The ordinary meaning of the expression 'profits from the operations of ships or aircraft' includes profits derived from leasing a ship or aircraft on a full basis because the provision of a ship or aircraft fully crewed and supplied under a full basis lease involves such a substantial use of the ship or aircraft that it clearly constitutes the lessor 'operating' the ship or aircraft.

154. Similarly, profits derived from leasing a ship or aircraft on a bareboat basis would not generally be considered to be profits from the operation of ships or aircraft because such leases involve the more passive provision by the lessor of the ship or aircraft to a lessee who then organises the crew and supplies required to operate the ship or aircraft.

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[48] See Table 4 of Appendix 3 at paragraph 218 of this draft Ruling.

155. However, the Commissioner considers that profits from leasing a ship or aircraft on a bareboat basis that are ancillary to the lessor's other operations of ships or aircraft should be provided the same treatment as profits from the operation of ships or aircraft and therefore included within the scope of the exclusive residence country taxing right in paragraph 1.

156. Such ancillary bareboat leasing profits are included because they are so minor and closely related to the operations of ships or aircraft by the lessor that they should not be treated as a separate business or source of income.

157. This view is consistent with the approach taken in the Commentary on article 8 of the OECD Model[49] which considers ancillary activities to be those which make a minor contribution and are so closely related to the operations that they should not be regarded as a separate business or source of income.

158. It should be noted that although paragraph 1 of the Korean convention uses the term 'international traffic', the term is defined in subparagraph (1)(k) of article 3 of the Korean convention by reference to the broader concept of 'operation of ships or aircraft', rather than the narrower concept of 'transport'. Accordingly, the leasing profits falling within the scope of paragraph 1 of the Korean convention are the same as those covered under the broader paragraph 1 wording.

Specific provisions dealing with leasing operations

The United States convention

159. While paragraph 1 of the shipping and air transport article in the United States convention[50] adopt the standard approach to paragraph 1, subparagraphs 1(a) and (b) provide restrictions on the exclusive residence country taxing right over profits from leasing activities.

160. These paragraphs provide an exclusive residence country taxing right over profits from the following ships and aircraft leases:

- a full basis lease where the ship or aircraft is operated in international traffic by the lessee, provided the lessor:
  - (i) either operates ships or aircraft otherwise than solely between places in the source country; or
  - (ii) regularly leases ships or aircraft on a full basis; and
- a bareboat lease which is merely incidental to the lessor's operation of ships or aircraft in international traffic.

[49] See paragraphs 4, 4.2, 4.3 and 5 of the Commentary on article 8 of the OECD Model.
[50] See Table 5 of Appendix 3 at paragraph 218 of this draft Ruling.

161. Therefore, only those full basis leasing profits that meet the additional requirements in subparagraph (1)(a) of article 8 of the United States convention (see the first dot point in paragraph 160 of this draft Ruling) will be the subject of the exclusive residence country taxing right in paragraph 1.

162. In the case of bareboat leasing profits, however, the requirements in subparagraph (1)(b) of article 8) of the United States convention (see the second dot point in paragraph 160 of this draft Ruling) include the same types of bareboat leasing profits as those under the standard paragraph 1 wording of Australia's tax treaties. This is because the term 'merely incidental' is considered to have the same effect as the term 'ancillary'.[51]

The Taipei Agreement

163. Paragraph 1 of the ships and aircraft article of the Taipei Agreement[52] adopts the broad approach that applies to both transport and non-transport operations. However, subparagraph 3(a) of article 8 provides that the profits to which paragraph 1 (and paragraph 2) of article 8 applies includes profits from a full time, voyage or bareboat basis lease where the lease is merely incidental to the international operation of ships or aircraft by the lessor, but only if the lessee uses the ship or aircraft in international operations.

164. A full basis lease is usually not considered to be incidental to the operation of ships or aircraft by the lessor, but is treated itself as an operation of ships or aircraft by the lessor.

165. A profit from a 'lease on a voyage basis' (or 'voyage charter-party') is, for the purposes of other Australian tax treaties, not regarded as a 'leasing profit' (see paragraph 17 of this draft Ruling). However, the Taipei Agreement refers to a voyage charter-party as a lease and therefore is an exception to this position. A lease on a voyage basis is also usually not considered to be incidental to the operation of ships or aircraft by the lessor, but is treated itself as an operation of ships or aircraft by the lessor.

166. The general requirements for bareboat leases to fall within paragraph 1 as being ancillary do not rely upon whether or not the leased ship or aircraft is used in international or internal operations. However, subparagraph 3(a) of article 8 of the Taipei Agreement applies to restrict ancillary bareboat leases from falling within paragraph 1 unless the lessee operates the leased ship or aircraft in international traffic.

[51] See paragraphs 21 to 23 of TR 2007/10.
[52] See Table 5 of Appendix 3 at paragraph 218 of this draft Ruling.

The South African agreement

167. Paragraph 1 of the ships and aircraft article of the South African agreement[53] adopts the broad approach that applies to both transport and non-transport operations. However, subparagraph 3(a) of article 8 provides that the profits to which paragraph 1 (and paragraph 2) apply include profits from a bareboat basis lease where the lease is merely incidental to the international operation of ships or aircraft by the lessor but only if the lessee uses the ship or aircraft in international operations.

168. Consequently, in the case of bareboat leasing profits, where the lease is merely incidental to the international operations of the lessor, the South African agreement requires that the lessee operate the ship or aircraft in international traffic before the leasing profit will be included in the exclusive residence country taxing right. This is consistent with paragraph 1.66 of the Explanatory Memorandum to the International Tax Agreements Amendment Bill 1999 (which incorporates the South African agreement) which states:

> Paragraph 3 extends the application of the article to profits derived from the lease of ships or aircraft on a bareboat basis, or of containers and related equipment, where the lease of such ships or aircraft, or the containers and related equipment, is incidental to the international operation of the ships or aircraft. The article only extends to such profits, however, where the lessee operates the ships or aircraft in international traffic or the containers and related equipment are so used. (emphasis added)

Variation from the standard paragraph 2

No treatment of leasing operations under paragraph 2

169. The ships and aircraft articles in Australia's tax treaties with the US, Japan, and Korea, and Australia's APAs with Italy, France, Greece and China[54] either:

- do not include a provision that is equivalent to the standard paragraph 2; or
- include a provision that is equivalent to the standard paragraph 2 but it is restricted to profits derived from 'carriage'.

170. As a result, no leasing profits are subject to a source country taxing right under the ships and aircraft article in these tax treaties or under the respective APAs.

[53] See Table 5 of Appendix 3 at paragraph 218 of this draft Ruling.
[54] See Table 6 of Appendix 3 at paragraph 218 of this draft Ruling.

The United States convention

171. There is no equivalent to the standard paragraph 2 in the shipping and air transport article of the United States convention. Although paragraph 4 of that Article[55] provides a source country taxing right over certain profits, the paragraph does not include leasing profits.

172. Paragraph 4 refers to 'profits derived from the carriage by ships or aircraft'. The words 'derived from' require a direct link between the profits and the carriage which is only met by profits from actual carriage, that is the profits derived from transporting passengers, goods, etcetera. Ship or aircraft leasing profits are profits that a lessor derives from the leasing out a ship or aircraft to a lessee to use for their own transportation needs. Such leasing profits are not derived from the lessor providing for the carriage of the lessee's passengers or cargo.

173. Accordingly, those leasing profits that are not dealt with by the exclusive residence country taxing right in paragraph 1 of the shipping and air transport article in the United States convention will fall outside the scope of that article and fall for consideration under the business profits article of that convention.[56]

The Japanese agreement and the Korean convention

174. There is no equivalent to the standard paragraph 2 in the ships and aircraft articles in the Japanese agreement and the Korean convention.[57] Both tax treaties, however, exclude 'profits from the operation of ships or aircraft confined solely to places in that other Contracting State' from paragraph 1 of the respective ships and aircraft articles. Accordingly, such profits, including full basis and bareboat leasing profits, will fall for consideration under other articles of the respective tax treaties, for example, the business profits article (where it is a standard business profits article)[58] or the royalties article.

[55] See Table 6 of Appendix 3 at paragraph 218 of this draft Ruling.
[56] The royalties article of the United States convention is not relevant in these circumstances, because payments for the 'right to use industrial commercial or scientific equipment' are not included in the definition of royalties in that article. Accordingly, profits from a bareboat lease are not royalties under the United States convention.
[57] See Table 6 of Appendix 3 at paragraph 218 of this draft Ruling.
[58] Article 4 of the Japanese agreement is not a business profits article. Subparagraph (5)(b) of article 4 excludes 'income from operating ships or aircraft' from the scope of that article.

The Italian, French, Greek and Chinese APAs

175. There is also no equivalent to the standard paragraph 2 for profits from leasing aircraft in Australia's APAs with Italy, France and Greece (see Tables 1 and 3 of Appendix 3 at paragraph 218 of this draft Ruling). Similar to the Japanese agreement and the Korean convention, these APAs are drafted so that they only provide an exemption from a source country taxing right with respect to aircraft operations in international traffic, and they do not allocate any taxing rights to the source country with respect to operations confined solely to places within the source country. The profits from these internal operations would be dealt with under other articles of the relevant comprehensive tax treaty, if there is one in place.

176. The Chinese APA[59] includes an equivalent to the standard paragraph 2 of the standard ships and aircraft article that provides a source country taxing right for internal operations, but is limited to profits 'derived from the carriage by aircraft of passenger, goods, etcetera'. This taxing right does not cover 'leasing profits' as such profits are not profits 'derived from' the carriage by aircraft (see also paragraphs 171 to 173 of this draft Ruling in relation to the same issue in the United States convention).

Italian, French and Chinese shipping articles

177. The shipping article in the respective tax treaties with Italy, France (1976) and China[60] includes an equivalent to paragraph 2 of the standard ships and aircraft article, which deals with both transport and non-transport ship operations confined solely to places in a State.

Specific provisions dealing with leasing operations

The South African agreement

178. Paragraph 2 of the ships and aircraft article of the South African agreement[61] adopts the standard paragraph 2 approach. However, subparagraph 3(a) of article 8 provides that the profits to which paragraph 2 applies include profits from a bareboat basis lease where the lease is merely incidental to the international operation of ships or aircraft by the lessor provided the lessee uses the ship or aircraft in international operations.

179. However, as paragraph 2 does not apply to international operations, subparagraph 3(a) does not limit the situations where paragraph 2 would apply to incidental bareboat leases.

[59] Paragraph (2) of article 3 of the APA – see Table 6 of Appendix 3 at paragraph 218 of this draft Ruling.
[60] See Table 2 of Appendix 3 at paragraph 218 of this draft Ruling.
[61] See Table 7 of Appendix 3 at paragraph 218 of this draft Ruling.

The Taipei Agreement

180. Paragraph 2 of the ships and aircraft article of the Taipei Agreement[62] also adopts the standard paragraph 2 approach. However, subparagraph 3(a) of article 8 provides that the profits to which paragraph 2 applies include profits from a full basis, voyage basis or bareboat lease where the lease is merely incidental to the international operation of ships or aircraft by the lessor provided the lessee uses the ship or aircraft in international operations.

181. However, as paragraph 2 does not apply to international operations, subparagraph 3(a) does not limit the situations where paragraph 2 would apply to incidental bareboat leases.

Rate limits on source country taxing right

182. Certain paragraphs in the ships and aircraft article of Australia's tax treaties with France,[63] Finland 1984, Switzerland, Belgium, Netherlands and Germany[64] limit the rate of tax that can be applied under the source country taxing right provided in paragraph 2 of those treaties to 5 per cent of the amount paid or payable (net of rebates) in respect of carriage.

183. Accordingly, the source country is limited to tax only 5 per cent of the gross lease payment that falls within this source country taxing right.

184. This restriction, however, only applies to certain full basis leasing profits that are considered to be payments 'in respect of carriage'.[65] All other leasing profits that fall within the source country taxing right of the relevant tax treaty are carved out of this rate limit (see Table 8 of Appendix 3 at paragraph 218 of this draft Ruling, where the second paragraph of each provision listed for the relevant tax treaties refers to 'profits … derived otherwise than from the carriage of passengers, livestock, mail, goods or merchandise', or such similar wording). These leasing profits either continue to be subject to the source country taxing right under the ships and aircraft article of the relevant tax treaty[66] or expressly fall for consideration under the business profits article of the relevant tax treaty.[67]

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[62] See Table 7 of Appendix 3 at paragraph 218 of this draft Ruling.
[63] This limitation only applies to profits from the operation of 'ships' under the shipping article of the 1976 French Agreement.
[64] See Table 8 of Appendix 3 at paragraph 218 of this draft Ruling.
[65] This will generally only be profits from a time charter-party where the shipper is also the charterer. This view is consistent with paragraph 38 of TR 2006/1.
[66] This is the case for the Belgian and the Netherlands Agreements.
[67] This is the case for the French, Finnish, Swiss and German agreements.

Variations in wording

185. In some of Australia's tax treaties, paragraph 2 of the ships and aircraft article refers to 'such profits' rather than 'profits of an enterprise of a Contracting State derived from the operation of ships or aircraft'. The reference to 'such profits' is considered to refer to 'profits from the operation of ships or aircraft' anyway. This would be the case even where paragraph 1 refers to 'international traffic', because if such profits also covered operations in international traffic, the definition of which excludes internal operations, it would render paragraph 2 ineffective. The variation is considered to merely make it clearer how the provision applies, and does not make any change to the operation of the paragraph.

186. In some cases, paragraph 2 may also refer to 'derived' rather than 'extent'. The use of 'extent' merely emphasises that the profits derived from the operation of ships or aircraft in internal traffic may consist of profits from an internal leg that is part of an international voyage. Again, the variation is considered to merely make it clearer how the provision applies, and does not make any change to the operation of the paragraph.

Other types of major variations to the standard ships and aircraft article

The Philippine agreement

187. Paragraph 1 of the shipping article in the Philippines agreement[68] does not provide an exclusive resident country taxing right. Rather it merely places a restriction on the rate of tax the source country can impose in relation to 'profits from the operation of ships in international traffic'.

188. Accordingly, profits from the operation of ships or aircraft in international traffic are dealt with in accordance with the respective domestic laws of Australia and the Philippines, except that any tax payable on profits from the operation of ships in international traffic is subject to the limit imposed by the shipping article of the Philippine agreement. This limit is 1.5 per cent of the gross revenues (or lower if the Philippines lower their domestic law rates on such profits). Other profits from the operation of ships or aircraft fall for consideration under the business profits article or the royalties article of the Philippine agreement.

[68] See Table 3 of Appendix 3 at paragraph 218 of this draft Ruling.

The Greek agreement

189. As Australia does not have a comprehensive tax treaty with Greece, both Australia and Greece are free to apply their domestic law to all ship leasing profits, and to those aircraft leasing profits not covered by the Greek APA. Aircraft leasing profits not covered by the Greek APA include:

- full basis leasing profits derived from transport operations conducted solely within the Contracting State in which the lessor is not a resident (the 'source State');
- bareboat leasing profits which are not ancillary to the lessor's international transport operations; and
- all leasing profits derived from non-transport operations.

Extensions of source country taxing rights – ship operations

190. While the ships and aircraft articles in Australia's tax treaties with Kiribati, Sri Lanka and Thailand[69] provide an exclusive taxing right to the resident State under paragraph 1, they also extend the source country taxing right in paragraph 2 beyond profits from the operation of ships 'confined solely to places in that State' to half of the tax that would otherwise be payable in the source country on the profits from the operation of ships other than confined solely to places in that State.

191. This means the source country:

- is permitted to impose tax at the normal domestic law rate where the profits are from the operation of ships confined solely to places in that other State (which is interpreted in accordance with paragraphs 26 to 32 of this draft Ruling); and
- must halve the domestic law amount of tax that would otherwise be payable where the profits are from the operation of ships in international traffic (that is profits from all ship operations but excluding the profits from the operation of ships confined solely to places in that other State).

192. This extension will also apply to the relevant leasing profits, which for these agreements applies in respect of both transport and non-transport operations (see paragraphs 26 to 27 of this draft Ruling).

[69] See Table 9 of Appendix 3 at paragraph 218 of this draft Ruling.

Part C: priority of the ships and aircraft article over the business profits article and the royalties article

Business profits article

193. Where the relevant ships and aircraft article allocates taxing rights over profits from leasing ships or aircraft, the profits are considered to be dealt with by that article. Although such profits will often also be considered to fall within the scope of the business profits article of the relevant tax treaty, the priority rule in the business profits article (see for example paragraph (6) of article 7 of the United Kingdom convention) provides that the ships and aircraft article applies to the profits. Accordingly, it is not necessary to consider whether an enterprise has a permanent establishment in Australia as the business profits article does not apply to the profits.

Royalties article

194. In certain circumstances, profits of a treaty partner lessor from leasing a ship or aircraft on a bareboat basis can fall within the scope of the ships and aircraft article as 'profits from the operation of ships or aircraft' and also fall within the scope of the royalties article as a payment of an 'industrial, commercial or scientific equipment royalty' (if the royalties article of the relevant tax treaty includes such a payment within the royalty definition).

195. The same issue does not arise for profits from leasing a ship on a full basis because such profits are from the provision of services and are not 'royalties' (see Taxation Ruling TR 2003/2).

196. A bareboat lease will generally fall within the scope of the ships and aircraft article where it is 'merely incidental' or 'ancillary' to the treaty partner lessor's operations of the ship or aircraft in international traffic (see paragraphs 23 to 25 of this draft Ruling).

197. Australia's tax treaties do not include an ordering rule to determine which article takes priority in such overlap situations. Applying treaty interpretation principles as set out in TR 2001/13, the priority between the ships and aircraft article and the royalties article must be determined from the treaty context.

198. The ships and aircraft article deals specifically with profits from the operation of ships and aircraft. The international nature of these activities means that it is inherently difficult to determine the source of such profits in order to allocate taxing rights.[70] The ships and aircraft article is specific to this particular industry and provides rules to make it easier for taxpayers in this industry to determine which country has the taxing right over their profits.

[70] See comments by Klaus Vogel at page 482, paragraph no. 23, 'Klaus Vogel on Double Taxation Conventions', Third Edition, Kluwer Law International, 1997.

199. In particular, by extending exclusive residence country taxation to profits from bareboat leases of ships and aircraft where the lease is ancillary to the lessor's operations of ships or aircraft in international traffic, the ships and aircraft article reduces the compliance burden of the lessor as the other country cannot assert a source country taxing right over such leases. This prevents the lessor from having to distinguish their ancillary leasing profits from their normal international transport profits.

200. By comparison, the royalties article is not directed at providing special rules for any particular industry because of the nature of the activities undertaken by that industry. The royalties article applies to all payments or credits that fall within the definition of a royalty, and allows for both the residence and source country to tax, with the later limited to a certain rate of tax on the gross royalty payment.

201. In light of the above treaty context, the ships and aircraft article is considered to take priority over the royalties article in regard to profits from the operation of ships and aircraft.[71] This context demonstrates that the intent of Australia's tax treaties is that those bareboat leasing profits that are included within the scope of the ships and aircraft article as 'profits from the operation of ships or aircraft' are to be dealt with in accordance with that article, rather than be treated as royalties under the royalties article.

202. Therefore, in cases where profits from leasing a ship or aircraft on a bareboat basis fall for consideration under both the ships and aircraft article and the royalties article of the relevant tax treaty, the leasing profit will be dealt with in accordance with the ships and aircraft article only.

203. Accordingly, where the ships and aircraft article allocates a taxing right over a bareboat leasing profit, it is considered that the treaty has dealt with the profit under the ships and aircraft article and the source country is not permitted to tax the lease payment as a royalty under the royalties article.

204. Furthermore, subsection 17A(5) of the *International Tax Agreements Act 1953* prevents section 128B of the ITAA 1936 (which deals with liability to withholding tax) from applying to the leasing profits of the lessor where:

- the lease payment received by the lessor falls within the definition of 'royalty' in subsection 6(1) of the ITAA 1936;
- the lessor is a resident of one of Australia's tax treaty partners; and
- the relevant tax treaty does not treat the lease amount paid to the lessor as a royalty.

[71] This is consistent with comments by Klaus Vogel at page 486, paragraph no. 32, 'Klaus Vogel on Double Taxation Conventions', Third Edition, Kluwer Law International, 1997, which is also referred to at paragraph 89 of TR 2003/2.

205. Subsection 17A(5) of the *International Tax Agreements Act 1953* applies in the circumstances outlined above because the conditions for its operation are met in these scenarios. In particular the tax treaty 'treats' the leasing profits of the lessor as 'profits from the operation of ships or aircraft', not as a royalty.[72]

Part D: method of taxation in Australia

206. When exercising a taxing right afforded to Australia by the ships and aircraft article, the amount of income that is taxable in Australia under that Article is limited to the 'profits' from the operation of the ship or aircraft in the relevant situation. Subsection 3(2) of the *International Tax Agreements Act 1953* provides that, for the purposes of that Act and the Assessment Acts (the ITAA 1936 and the ITAA 1997), a reference in a tax treaty to 'profits' of an activity or business shall be read, for the purposes of Australian tax, as a reference to 'taxable income' derived from that activity or business.

207. Subsection 995-1(1) of the ITAA 1997 refers to section 4-15 of the ITAA 1997 for the definition of taxable income, being assessable income less deductions. Accordingly, profits of an Australian treaty resident lessor of a ship or aircraft that may be taxed in Australia in accordance with the ships and aircraft article are taxed on a net assessment basis under the ordinary income assessment provisions for Australian residents (subsection 6-5(2) of the ITAA 1997).

208. Similarly, profits of a treaty partner resident lessor of a ship or aircraft that may be taxed in Australia in accordance with the ships and aircraft article, where the profits have a source in Australia[73], are subject to tax on a net assessment basis under the ordinary income assessment provisions for foreign residents (subsection 6-5(3) of the ITAA 1997).

[72] This is consistent with the Explanatory Memorandum to the International Tax Agreements Amendment Bill (No. 1) 2002 (which inserted subsection 17A(5) into the *International Tax Agreements Act 1953*), in particular see paragraph 3.7.

[73] Many of Australia's tax treaties include deemed source rules, or alternatively there are also deemed source rules for certain countries in the *International Tax Agreements Act 1953*. For those tax treaties that do not include a deemed source rule, Australia's common law rules for determining source will apply (see paragraph 38 of Taxation Ruling TR 2001/13).

209. In some circumstances, profits derived by a lessor (who has their place of business outside Australia) from leasing a ship on a full basis will meet the requirements of section 129 of the ITAA 1936 dealing with overseas ships (see paragraph 39 of Taxation Ruling TR 2006/1 Income tax: the scope of and nature of payments falling within section 129 of the *Income Tax Assessment Act 1936*). In such circumstances, section 129 of the ITAA 1936 deems 5 per cent of the amount paid or payable in respect of the carriage to be 'taxable income' derived by the lessor in Australia. This deeming of a taxable income amount under section 129 of the ITAA 1936 removes the need to calculate the taxable income of the lessor under subsection 4-15(1) of the ITAA 1997 by reference to the assessable income and deductions of the lessor.

210. Therefore, in these circumstances section 129 of the ITAA 1936 will apply to determine the relevant taxable income of the lessor of the ship, rather than the ordinary income assessment provisions in subsections 6-5(2) and (3) of the ITAA 1997.

Appendix 2 – Alternative views

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

Meaning of 'operations' confined solely to places in that other State

211. An alternative view to that expressed in paragraphs 114 to 118 and 123 to 129 of this draft Ruling, is that the term 'ship or aircraft operations' in paragraph 2 of the ships and aircraft article is used to describe a situation where the ships or aircraft are operated wholly within a State, rather than a situation where activities that constitute 'an operation' are conducted wholly within that State. More specifically, in determining whether profits are taxable in a State, it is necessary to look at whether the ship or aircraft is operated on a voyage which takes place wholly within that State. The relevant question for purposes of paragraph 2 is therefore whether the profits are derived from a voyage that is confined solely to places in a State.

212. On this view, profits arising from the Australian leg of an international voyage of a ship or aircraft are not profits from ship or aircraft operations confined solely to places in Australia, since the voyage does not take place wholly within Australia. The profits from carriage of passengers or cargo who only participate in that Australian leg are, however, caught by paragraph 4 of the article. Although they are not profits from 'operations confined solely to places in (Australia)' within the meaning of that term in paragraph 2, they are treated as such by virtue of paragraph 4.

213. This view has not been adopted because it is inconsistent with the interpretation of the specific words of paragraph 2 (see paragraph 118 of this draft Ruling).

Meaning of operations confined solely to 'places' in that other State – non-transport operations

214. Another alternative view to that expressed at paragraphs 130 to 136 of this draft Ruling, is that profits from non-transport operation of ships or aircraft will only constitute operations confined solely to places in that State where the operations begin and end in the source country and all of the operations take place in that country's waters or airspace.

215. Under this view, the term 'places' refers to areas of a general nature, which would include international waters or airspace. Therefore, any activity or part of an activity that takes place in areas of a general nature outside a State could not be operations confined solely to places in that State.

216. The result of this alternative view, however, is that profits from non-transport activities using a ship or aircraft in international waters or airspace would not fall under either the standard paragraphs 1 or 2 of Article 8 and would fall to be considered under the business profits Article. Accordingly, the profits from such non-transport ship or aircraft activities would be taxable solely by the residence country unless the profits are attributable to a permanent establishment in the source country, in which case the source country would also be permitted to tax the profits.

217. For Australia's tax treaties that do not include a reference to international traffic in paragraph 1 of the ships and aircraft Article[74], such profits would fall within paragraph 1 of those tax treaties and would be taxable exclusively by the country of residence.

[74] See Table 4 of Appendix 3 at paragraph 218 of this draft Ruling.

Appendix 3 – Tables of differing wording of the Ships and Aircraft Articles of Australia's Tax Treaties

218. This Appendix contains tables of differing wording of the ships and aircraft articles of Australia's Tax Treaties.

Table 1: standard paragraph 1 wording

Agreement, Convention or APA	Relevant provision	Relevant paragraph(s) of this draft Ruling
United Kingdom	1. Profits of an enterprise of a Contracting State from the operation of ships or aircraft **in international traffic** shall be taxable only in that State.	20-25, 94-108
Polish	1. Profits from the operation of ships or aircraft **in international traffic** derived by a resident of one of the Contracting States shall be taxable only in that State.	20-25, 94-108
Italian APA	1. Profits derived by an enterprise of a Contracting State from the operation of **aircraft** in **international traffic** or arising from the carriage by air of persons, livestock, goods or mail between places in that Contracting State, **shall be exempt** from tax in the other Contracting State.	20-25, 94-108
French APA	(1) A French enterprise **shall be exempt** from Australian tax on: (a) income from the operation of **aircraft in international traffic**; and (b) income and profits from the carriage by air of passengers, cargo or mail between places in France. (2) An Australian enterprise **shall be exempt** from French tax on: (a) income from the operation of **aircraft in international traffic**; and (b) income and profits from the carriage by air of passengers, cargo or mail between places in Australia.	20-25, 94-108

Greek APA	1. Profits derived by an enterprise of a Contracting State from the operation of **aircraft in international traffic** or arising from the carriage by air of persons, livestock, goods or mail between places in that Contracting State, **shall be exempt** from tax in the other Contracting State.	20-25, 94-108
[France]	1. Profits of an enterprise of a Contracting State derived from the operation of ships or aircraft **in international traffic** shall be taxable only in that State.	20-25, 94-108
Norway (2006)	1. Profits of an enterprise of a Contracting State derived from the operation of ships or aircraft **in international traffic** shall be taxable only in that State.	20-25, 94-108
Finland 2006	1. Profits of an enterprise of a Contracting State derived from the operation of ships or aircraft **in international traffic** shall be taxable only in that State.	20-25, 94-108

Table 2: standard paragraph 2 wording		
Agreement or Convention	**Relevant provision**	**Relevant paragraph(s) of this draft Ruling**
United Kingdom, Canadian, New Zealand, Singapore, French*, Italian*, German, Netherlands, Belgian, Swiss, Malaysian, Swedish, Danish, Irish, Norwegian (1982 and 2006), Maltese, Finnish, Chinese*, Austrian, Papua New Guinea, Thai, Sri Lankan, Fijian, Hungarian, Kiribati, Indian, Polish, Indonesian, Vietnamese, Spanish, Czech, Slovak, Argentine, Romanian, Russian, Mexican. (* the Shipping Article of the respective tax treaty refers only to 'ships')	2. Notwithstanding the provisions of paragraph (1), such profits may be taxed in the other Contracting State where they are profits from operations of ships or aircraft confined solely to places in that other State.	26-32, 109-147

Table 3: Major variations from standard paragraph 1 wording – Reciprocal exemption approach		
Agreement, Convention or APA	**Relevant provision**	**Relevant paragraph(s) of this draft Ruling**
Philippine	(1) The tax payable in a Contracting State by a resident of the other Contracting State in respect of profits from the operation of **ships in international traffic shall not exceed** the lesser of— (a) one and one—half per cent of the gross revenues derived from sources in that State; and (b) the lowest rate of Philippine tax that may be imposed on profits of the same kind derived under similar circumstances by a resident of a third State.	33, 148-149
German	(1) A resident of a Contracting State **shall be exempt** from tax in the other Contracting State on profits from the operation of ships or aircraft.	33, 148-149
Japanese	(1) A resident of one of the Contracting States **shall be exempt** from tax in the other Contracting State on profits from the operation of **ships or aircraft** other than operations confined solely to places in that other Contracting State.	33, 148-149
Italian APA	See Table 1	33, 148-149
French APA	See Table 1	33, 148-149
Greek APA	See Table 1	33, 148-149
Chinese APA	(1) Profits and revenues from the operation of **aircraft**, including sales of tickets and documents relating to such operations, derived by an enterprise of one of the Contracting States **shall be exemp**t from tax in the other Contracting State.	33, 148-149

Table 4: Major variations from standard paragraph 1 wording – Application to non-transport operations		
Agreement or Convention	**Relevant provision**	**Relevant Paragraph/s in Ruling**
Canadian, New Zealand, Singapore, French*, Italian*, Netherlands, Belgian, Swiss, Malaysian, Swedish, Danish, Irish, Korean, Norwegian (1982), Maltese, Finnish, Chinese*, Austrian, Papua New Guinea, Thai, Sri Lankan, Fijian, Hungarian, Kiribati, Indian, Indonesian, Vietnamese, Spanish, Czech, Slovak, Argentine, Romanian, Russian, Mexican (* the Shipping Article of the respective tax treaty refers only to 'ships')	1. Profits from the operation of ships or aircraft derived by a resident of one of the Contracting States shall be taxable only in that State.	34-36, 150-158

Table 5: Major variations from standard paragraph 1 wording – Specific provisions dealing with leasing operations		
Agreement or Convention	**Relevant provision**	**Relevant Paragraph/s in Ruling**
United States	1. Profits derived by a resident of one of the Contracting States from the operation in international traffic of ships or aircraft shall be taxable only in that State. For the purposes of this Article, profits from the operation in international traffic of ships or aircraft include: (a) profits from the lease on a full basis of ships or aircraft operated in international traffic by the lessee, provided that the lessor either operates ships or aircraft otherwise than solely between places in the other Contracting State or regularly leases ships or aircraft on a full basis; and (b) profits from the lease of ships or aircraft on a bare boat basis, provided that such lease is merely incidental to the operation in international traffic of ships or aircraft by the lessor.	37, 159-162

Taipei	1. Profits derived by an enterprise of a territory from the operation of ships or aircraft shall be taxable only in that territory. 3. The profits to which the provisions of paragraphs 1 and 2 apply shall include profits from: (a) the lease of ships or aircraft on a full time, voyage or bareboat basis, and of containers and related equipment, which is merely incidental to the international operation of ships or aircraft by the lessor, provided that the leased ships or aircraft, or the containers and related equipment, are used in international operations by the lessee; and (b) the operation of ships or aircraft derived through participation in a pool, a joint business or an international operating agency.	39, 163-166
South African	1 Profits of an enterprise of a Contracting State derived from the operation of ships or aircraft shall be taxable only in that State. 3 The profits to which the provisions of paragraphs 1 and 2 apply shall include profits from: (a) the lease of ships or aircraft on a bareboat basis, and of containers and related equipment, which is merely incidental to the international operation of ships or aircraft by the lessor, provided that the leased ships or aircraft, or the containers and related equipment, are used in international operations by the lessee; and (b) the operation of ships or aircraft derived through participation in a pool service or other profit sharing arrangement.	38, 167-168

Table 6: Major variations from standard paragraph 2 wording – No equivalent to paragraph 2		
Agreement, Convention, or APA	**Relevant provision**	**Relevant Paragraph/s in Ruling**
United States	(4) For the purposes of this Article, **profits derived from the carriage** by ships or aircraft of passengers, livestock, mail, goods or merchandise taken on board in a Contracting State for discharge in that State shall not be treated as profits from the operation in international traffic of ships or aircraft and may be taxed in that State	41-43, 171-173
Korean	(1) Profits of a resident of a Contracting State from the operation of **ships or aircraft** in international traffic **shall be taxable only** in that State.	41-43, 174
Japanese	See Table 3	41-43, 174
Italian APA	See Table 1	41-43, 175-177
French APA	See Table 1	41-43, 175-177
Greek APA	See Table 1	41-43, 175-176
Chinese APA	(2) Notwithstanding the provisions of paragraph (1), such profits and revenues may be taxed in the other Contracting State where they are profits and revenues **derived from the carriage** by **aircraft** of passengers, livestock, mail, goods or merchandise solely from one place in that other Contracting State to another place in that State.	41-43, 175-177

Table 7: Major variations from standard paragraph 2 wording – Specific provisions dealing with leasing operations		
Agreement, Convention, or APA	**Relevant provision**	**Relevant Paragraph/s in Ruling**
Taipei	2. Notwithstanding the provisions of paragraph 1, such profits shall be taxed in the other territory to the extent that they are profits derived directly or indirectly from ship or aircraft operations confined solely to places in that other territory. 3. The profits to which the provisions of paragraphs 1 and 2 apply shall include profits from: (a) the lease of ships or aircraft on a full time, voyage or bareboat basis, and of containers and related equipment, which is merely incidental to the international operation of ships or aircraft by the lessor, provided that the leased ships or aircraft, or the containers and related equipment, are used in international operations by the lessee.	45, 180-181
South African	2. Notwithstanding the provisions of paragraph 1, those profits may be taxed in the other Contracting State to the extent that they are profits derived directly or indirectly from ship or aircraft operations confined solely to places in that other State. 3. The profits to which the provisions of paragraphs 1 and 2 apply shall include profits from: (a) the lease of ships or aircraft on a bareboat basis, and of containers and related equipment, which is merely incidental to the international operation of ships or aircraft by the lessor, provided that the leased ships or aircraft, or the containers and related equipment, are used in international operations by the lessee.	44, 178-179

Table 8: Variation from standard paragraph 2 – rate limits on source country taxing right		
Agreement or Convention	**Relevant provision**	**Relevant Paragraph/s in Ruling**
French	4. The amount which shall be charged to tax in a Contracting State under paragraph 2 shall not exceed 5 per cent of the amount paid or payable (net of rebates) in respect of the carriage. 5. Paragraph 4 shall not apply to profits from the operation of ships derived by a resident of a Contracting State if - (a) his principal place of business is in the other Contracting State; or (b) those profits are derived from activities other than the carriage of passengers, cargo or mail. In such cases, the provisions of Article 6 shall apply.	46-47, 182-184
Finnish 1984	(5) The amount which shall be charged to tax in one of the Contracting States under paragraph (2) shall not exceed 5 per cent of the amount paid or payable (net of rebates) in respect of carriage in such operations. (6) Paragraph (5) shall not apply to profits from the operation of ships derived by a resident of one of the Contracting States if: (a) his principal place of business is in the other Contracting State; or (b) those profits are derived from activities other than the carriage of passengers, cargo or mail. In such cases, the provisions of Article 7 shall apply.	46-47, 182-184
Swiss	(5) The amount which shall be charged to tax in one of the Contracting States as profits from the operation of ships or aircraft in respect of which a resident of the other Contracting State may be taxed in the first—mentioned State under paragraph (2) or (3) shall not exceed 5 per cent of the amount paid or payable (net of rebates) in respect of carriage in such operations.	46-47, 182-184

	(6) Paragraph (5) shall not apply to profits derived from the operation of ships or aircraft by a resident of one of the Contracting States whose principal place of business is in the other Contracting State, nor shall it apply to profits derived from the operation of ships or aircraft by a resident of one of the Contracting States if those profits are derived otherwise than from the carriage of passengers, livestock, mails, goods or merchandise. In such cases, the provisions of Article 7 shall apply.	
Belgian	(5) The amount which shall be charged to tax in one of the Contracting States as profits from operations of ships or aircraft in respect of which a resident of the other Contracting State may be taxed in the first-mentioned State under paragraph (2) or (3) shall not exceed 5 per cent of the amount paid or payable (net of rebates) in respect of carriage in such operations. (6) Paragraph (5) shall not apply to profits derived from the operation of ships or aircraft by a resident of one of the Contracting States whose principal place of business is in the other Contracting State, nor shall it apply to profits derived from the operation of ships or aircraft by a resident of a Contracting State if those profits are derived otherwise than from the carriage of passengers, livestock, mail, goods or merchandise.	46-47, 182-184

Netherlands	(5) The amount which shall be charged to tax in one of the States as profits from the operation of ships or aircraft in respect of which a resident of the other State may be taxed in the first-mentioned State under paragraph (2) or (3) shall not exceed 5 per cent of the amount paid or payable (net of rebates) in respect of carriage in such operations. (6) Paragraph (5) shall not apply to profits derived from the operation of ships or aircraft by a resident of one of the States whose principal place of business is in the other State, nor shall it apply to profits derived from the operation of ships or aircraft by a resident of a State if those profits are derived otherwise than from the carriage of passengers, livestock, mail, goods or merchandise.	46-47, 182-184
German	5. The amount which shall be charged to tax in a Contracting State as profits from the operation of ships or aircraft in respect of which a resident of the other Contracting State may be taxed in the first-mentioned State under paragraph (2) or (3) shall not exceed 5 per cent of the amount paid or payable (net of rebates) in respect of carriage in such operations. 6. Paragraph (5) shall not apply to profits derived from the operation of ships or aircraft by a resident of a Contracting State whose principal place of business is in the other Contracting State, nor shall it apply to profits derived from the operation of ships or aircraft by a resident of a Contracting State if those profits are derived otherwise than from the carriage of passengers, livestock, mails, goods or merchandise. In such cases, the provisions of Article 7 shall apply but there shall be excluded from the profits on which any such person is charged to Australian tax any amount of profits taxed in the Territory of Papua or the Trust Territory of New Guinea.	46-47, 182-184

Table 9: Other major variations from the standard Ships and Aircraft Article		
Agreement, Convention or APA	**Relevant provision**	**Relevant Paragraph/s in Ruling**
Philippine	See Table 3	49, 187-188
Kiribati	1. Profits from the operation of aircraft derived by a resident of one of the Contracting States shall be taxable only in that State. 2. Profits from the operation of ships derived by a resident of one of the Contracting States may be taxed in that Contracting State and may also be taxed in the other State, but the tax so charged in the other State shall be reduced by an amount equal to one half of the amount which would be payable in respect of those profits but for this paragraph. 3. Notwithstanding the provisions of paragraph 1, such profits may be taxed in the other Contracting State, where they are profits from the operation of aircraft confined solely to places in that other State; and notwithstanding the provisions of paragraph 2, such profits may be taxed in the other Contracting State without reduction, where they are profits from the operation of ships confined solely to places in that other State.	51, 190-192
Sri Lankan	(1) Profits from the operation of ships or aircraft derived by a resident of one of the Contracting States shall be taxable only in that State. (2) Notwithstanding the provisions of paragraph (1), such profits may be taxed in the other Contracting State where: (a) they are profits from operations of ships or aircraft confined solely to places in that other State; or (b) they are profits, other than profits to which sub-paragraph (a) applies, from operations of ships in that other State, in which case the tax payable in that other State shall not exceed the lesser of: (i) half the amount which would be payable in respect of those profits but for this sub-paragraph; and	51, 190-192

	(ii) the lowest amount, if any, of Sri Lanka tax that may be imposed on profits of the same kind derived under similar circumstances by a resident of a third State.	
Thai	1. Income or profits from the operation of aircraft derived by a resident of one of the Contracting States shall be taxable only in that State. 2. Income or profits from the operation of ships derived by a resident of one of the Contracting States may be taxed in that Contracting State and may also be taxed in the other State, but the tax so charged in the other State shall be reduced by an amount equal to one half of the amount which would be payable in respect of that income or those profits but for this paragraph. 3. Notwithstanding the provisions of paragraph 1, such income or profits may be taxed in the other Contracting State, where they are income or profits from the operation of aircraft confined solely to places in that other State; and notwithstanding the provisions of paragraph 2 such income or profits may be taxed in the other Contracting State without reduction, where they are income or profits from the operation of ships confined solely to places in that other State.	51, 190-192

Appendix 4 – Your comments

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

Due date:	**23 May 2008**
Contact officer:	**Michael Atfield**
Email address:	**michael.atfield@ato.gov.au**
Telephone:	**(07) 3213 8640**
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Appendix 5 – Detailed contents list

220. The following is a detailed contents list for this ruling:

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2001/13; TR 2003/2;
TR 2006/1; TR 2007/10

Subject references:

- aircraft
- cross border leasing
- double tax agreements
- royalties
- shipping

Legislative references:

- ITAA 1936
- ITAA 1936 6(1)
- ITAA 1936 128B
- ITAA 1936 129
- ITAA 1997
- ITAA 1997 4-15
- ITAA 1997 4-15(1)
- ITAA 1997 6-5(2)
- ITAA 1997 6-5(3)
- ITAA 1997 995-1(1)
- ITAA 1953
- ITAA 1953 3(2)
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- ITAA 1953 Sch 26
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- Klaus Vogel on Double Taxation Conventions, Third Edition, Kluwer Law International 1997
- Explanatory Memorandum to the International Tax Agreements Amendment Bill 2003
- Explanatory Memorandum to the International Tax Agreements Amendment Bill (No. 1) 2002
- Explanatory Memorandum to the International Tax Agreements Amendment Bill 2001

- Explanatory Memorandum to the International Tax Agreements Amendment Bill 1999

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