TR 2013/D8 - Income tax: satisfying the 'carrying on a business at or through a permanent establishment' requirement in section 23AH where a company is taken to have a permanent establishment (PE) in relation to substantial equipment

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Draft Taxation Ruling

Income tax: satisfying the 'carrying on a business at or through a permanent establishment' requirement in section 23AH where a company is taken to have a permanent establishment (PE) in relation to substantial equipment

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What this Ruling is about

1. This draft Ruling considers the application of the requirement in section 23AH that a company 'carry on business at or through a permanent establishment (PE)', [1] in circumstances where a company is taken to have a PE:

(i) in relation to substantial equipment under paragraph (b) of the definition of PE[2] in subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936),[3] or

(ii) under an Article in one of Australia's tax treaties that deems an enterprise to have a PE if it has substantial equipment in a contracting State.[4]

[1] See, for example, subsection 23AH(2).
[2] Paragraph (b) of the definition of a PE in subsection 6(1) of the *Income Tax Assessment Act 1936* provides that a PE includes 'a place where the person has, is using or is installing substantial equipment or substantial machinery'.
[3] All legislative references in this draft Ruling are to the ITAA 1936 unless otherwise stated.
[4] In this case, the treaty PE meaning applies for section 23AH purposes rather than the subsection 6(1) meaning (see subsection 23AH(15)).

2. In particular, this draft Ruling considers whether a company that has a PE because it satisfies paragraph (b) of the definition in subsection 6(1) or, in the case where a tax treaty applies, because it has substantial equipment, automatically satisfies the 'carrying on a business' requirement in section 23AH.

3. Further, this draft Ruling considers whether a company that is taken (under an applicable tax treaty) to carry on business through the PE thereby satisfies the 'carrying on a business' requirement in section 23AH.

4. This draft Ruling does not specifically address the indicia of a business or what amounts to sufficient activity for a business to be carried on for the purpose of section 23AH.

Ruling

5. If a company is taken to have a PE in relation to substantial equipment (by the domestic law or by a tax treaty), foreign income derived by that company will not be non-assessable non-exempt income (NANE) under section 23AH unless, among other things, it is derived in actually carrying on a business at or through a PE in the foreign jurisdiction.

6. Where the subsection 6(1) definition of PE applies, a company does not automatically satisfy the requirement in section 23AH of 'carrying on a business at or through a PE' of the company merely by having a PE within the extended meaning of the expression in paragraph (b) of that definition.

7. Equally, where the definition of PE under a tax treaty applies,[5] the requirement is not automatically satisfied just because there is a deemed PE by virtue of the presence of substantial equipment.

8. Further, even if a tax treaty also deems the company to carry on a business through that PE, this does not mean that the requirement to carry on a business for the purposes of section 23AH is satisfied.

9. Whether a company is actually carrying on a business at or through the PE is a question of fact and degree to be determined having regard to the circumstances of each particular case.[6] This enquiry must objectively support the conclusion that actual business activities are being carried on. There is no scope for a positive finding that a business is being carried on unless there is real business activity occurring at or through the PE.

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[5] Subsection 23AH(15).

[6] Factors typically relevant to such a determination are discussed in Taxation Ruling TR 97/11 *Income tax: am I carrying on a business of primary production*. Also see paragraphs 35 to 37 of 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*.

10. The use of the definite article 'a' in the phrase 'carrying on a business' does not mean that the activities must comprise a single or entire business in their own right.

11. Even if a company actually carries on business at or through a PE that exists because of the presence of substantial equipment, all the other requirements of section 23AH must be satisfied in order for the provision to apply to treat the income as NANE.

12. Where a company has an indirect interest in foreign income derived by a trustee or partnership in carrying on a business at or through a PE of the trustee or partnership, and is taken by subsection 23AH(10) to have derived foreign income through a PE, that income will likewise be taken to have been derived by the company in carrying on a business. Whether the foreign income actually derived by the trustee or partnership was derived in carrying on a business is to be tested in accordance with the principles set out in paragraphs 5 to 11 of this draft Ruling.

Examples

Example 1: UK Convention Article 5 deems an enterprise to carry on business through the permanent establishment

13. *A company (MatildaCo), resident in Australia for tax purposes, is a sublessor enterprise. The company leases equipment to a United Kingdom (UK) resident company under an operating bareboat lease agreement entered into in the UK.*

14. *The leased equipment is 'substantial equipment' for the purpose of Article 5.3(b) of the United Kingdom Convention and, applying McDermott Industries (Aust) Pty Ltd v. Commissioner of Taxation,*[7] *the Australian company uses the substantial equipment in the UK. Therefore, by virtue of Article 5.3(b), MatildaCo is deemed to have a permanent establishment in the UK and to carry on business through that permanent establishment.*

15. *Although MatildaCo is deemed to carry on business through the PE for the purpose of the UK Convention, this does not satisfy the same requirement in subsection 23AH(2). That requirement is only satisfied if the company is actually carrying on a business at or through the PE.*

[7] (2005) 142 FCR 134; [2005] FCAFC 67; (2005) 2005 ATC 4398; (2005) 59 ATR 358.

Example 2: US Convention Article 5.4(b) does not deem an enterprise to carry on business through the permanent establishment

16. *A company (AusCo) resident in Australia for tax purposes is a lessor enterprise. At the expiry of a lease of equipment, the equipment is stored in the US and advertised for lease in Australia. AusCo then leases that equipment to a United States (US) resident company under an operating bareboat lease agreement entered into for a period of 18 months.*

17. *The lease was negotiated and concluded in Australia and all other activities associated with the lease were conducted from within Australia.*

18. *The arrangement does not fall for consideration under Article 8(1)(b) of the US Convention.*

19. *Under Article 5.4(b) of the US Convention, AusCo is deemed to have a permanent establishment (PE) in the US, but the treaty does not deem business to be carried on through that PE. AusCo does not conduct any business activities within the US for it to be considered to be carrying on its equipment leasing business in the US.*

20. *Although AusCo has a PE in the US it is not carrying on a business at or through the PE. Therefore, the income derived by AusCo from the lease does not come within subsection 23AH(2).*

Example 3

21. *The facts are the same as in Example 2 except that Ausco actually carries on business in the United States including by the rental of an office in the US to manage existing lease contracts and to conclude future lease arrangements.*

22. *Not only does AusCo have a deemed PE under Article 5.4(b), it is also carrying on business at or through that PE. Income derived under the lease from the US resident company satisfies the definition of 'foreign income' under subsection 23AH(15) of the ITAA 1936. The US is a listed country for the purpose of subsection 23AH(2) of the ITAA 1936 by virtue of subsection 23AH(15), subsection 320(1) of the ITAA 1936 and schedule 10 of the Income Tax Regulations 1936.*

23. *Therefore, the income will be covered by subsection 23AH(2) of the ITAA 1936 when the income is derived at a time when the taxpayer is using substantial equipment in the US and has a deemed PE in the US.*

Date of effect

24. Subject to the exception mentioned in paragraph 25 of this draft Ruling, when the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10).

25. ATO Interpretative Decision ATO ID 2011/34 (now withdrawn) took the view, contrary to the view expressed in paragraph 8 and illustrated by Example 1 of this draft Ruling, that a business would be taken to be carried on for the purposes of subsection 23AH(2) if a relevant tax treaty deemed a business to be carried on. In any case where the view set out in paragraph 8 and/or Example 1 of this draft Ruling is less favourable to a taxpayer than the former ATO Interpretative Decision, the Commissioner proposes not to undertake active compliance activities so as to apply that view in the current income year and for earlier years. However, if the Commissioner is asked or required to state a view (for example in a private ruling or in submissions in a litigation matter), the Commissioner will do so consistently with the views set out in this draft Ruling (including paragraph 8).

Commissioner of Taxation
11 December 2013

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.

Background and context

26. Broadly, section 23AH treats certain foreign branch income derived directly or indirectly by Australian resident companies as non-assessable non-exempt (NANE) for income tax purposes. It provides similar rules for foreign branch capital gains, and contains rules to ensure that foreign branch capital losses are not taken into account.

27. Subsection 23AH(2) expressly requires that the relevant income be derived by a company that is carrying on a business at or through a PE of the company. Similar wording exists in the other provisions dealing with the 'indirect' derivation of such income, and with foreign capital gains and losses.

28. Where there is a tax treaty, subsection 23AH(15) defines permanent establishment to have the same meaning as in the tax treaty, but otherwise the definition in subsection 6(1) applies.

29. The basic or primary meaning of permanent establishment in the domestic law in subsection 6(1) and in Australia's tax treaties is a place of business at or through which a person carries on a business.[8]

30. In addition to this general meaning, both the domestic law and the tax treaties also list specific cases that come within the definition. In particular, most of Australia's tax treaties include a provision corresponding to paragraph (b) of the definition of 'permanent establishment' in the domestic law, that is 'a place where the person has, is using or installing substantial equipment or substantial machinery'.

31. On its face, this indicates it is possible that having substantial machinery in a place might not also entail the actual carrying on of a business in that place. That is, the basic meaning of permanent establishment might not necessarily be satisfied.[9]

[8] The tax treaties also require the place of business must be fixed.

[9] See for example the facts of *Case H 106* 1957 TBRD (*Case H*) which were considered by the Full Federal court in *McDermott Industries (Aust) Pty Ltd v. FCT* [2005] FCAFC 67 at paragraphs 50 to 52. Whilst the Court suggested that the American company concerned may have in any event carried on business in Australia, the Board of Review No. 3 found that it had a PE on the basis of the installation of substantial equipment or machinery in Australia. However, the facts in *Case H* may be regarded as an example of a borderline situation where the presence of substantial equipment may not necessarily coincide with the carrying on of business.

32. Further, some tax treaties, in addition to deeming the presence of a permanent establishment in a place where there is substantial equipment also deem that a business is being carried on through the permanent establishment.[10]

33. An issue therefore arises as to whether having a permanent establishment by virtue of the presence of substantial equipment, either in the context of the subsection 6(1) definition or as defined in Australia's tax treaties, means that the 'carrying on a business requirement' in section 23AH is automatically satisfied.

Position where the subsection 6(1) definition of PE applies

34. If a tax treaty is not applicable, whether there is a PE for the purposes of section 23AH is to be determined according to the definition of PE in subsection 6(1) (see subsection 23AH(15)).

35. That definition provides that a PE 'means a place at or through which the person carries on any business'. This is the primary or basic meaning of the expression PE. However, the definition expressly includes some other cases, without limiting the generality of the basic meaning.

36. Notably, a PE in relation to a person includes a place where the person has, is using or is installing substantial equipment or substantial machinery (paragraph (b)).

37. The scope of the deeming rule in the Singapore Agreement definition of PE which broadly corresponds to the extended meaning conveyed by paragraph (b) of the subsection 6(1) definition was considered by the Full Federal Court in *McDermott Industries (Aust) Pty Ltd v FCT.*[11] The Court rejected the Commissioner's contention that the scope of Article 4(3)(b) of the Agreement was governed or constrained by the primary meaning of PE in Article 4(1). The Court noted that the provision 'probably operates to deem something to be that which otherwise it might not be' and as it may 'operate to expand the operation of Article 4(1) then no reading down of Article 4(3) by reference to Article 4(1) will be possible'.[12]

38. Applying this interpretative approach to the definition of permanent establishment and the words of inclusion in paragraph (b) of the subsection 6(1) definition, it is apparent that this paragraph expands the scope of the term beyond the primary meaning to include something which otherwise it might not be within the primary meaning. The meaning of the paragraph should not be coloured by the primary meaning of PE – but construed on the basis of the express language used.

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[10] See paragraphs 45 to 47 of this Draft Ruling.
[11] (2005) 142 FCR 134; [2005] FCAFC 67; 2005 ATC 4398; (2005) 59 ATR 358.
[12] [2005] FCAFC 67 at paragraph 59.

39. Moreover, the matters covered by the primary meaning and the extended meaning under paragraph (b) are not mutually exclusive. The words of inclusion do not limit the generality of the primary meaning. Accordingly, something that is a PE within the extended meaning may also be a PE under the primary meaning.

40. In the vast majority of cases it is likely that having, using or installing substantial equipment or substantial machinery at a place will also entail the carrying on of business at or through that place so that the primary meaning of the term is met. As noted in Taxation Rulings TR 2007/10 and TR 2007/11, leasing transactions involving items of substantial equipment will almost always be found to involve carrying on business because they '…usually involve entering into complex legal contracts concerning property of high value and involve regular activity such as invoicing of lease payments'.

41. However, where the presence of substantial equipment or machinery does not also involve actual business activity, the expanded meaning in paragraph (b) will apply. In this way, paragraph (b) enlarges the scope of the term to include as a permanent establishment something that would not otherwise come within its primary meaning – that is where no business is being carried on at or through the place.

42. Where paragraph (b) is satisfied, the effect is to designate that that place in relation to a person constitutes a permanent establishment. However, there is no basis to read into the extended meaning of permanent establishment that a business must also be treated as being carried on at or through that place. The express words extend the meaning of permanent establishment; they do not also impress on that extended meaning the characteristics of an actual business. Such an interpretation would add an unwarranted gloss to the provision. Were that the intent of the provision, it could easily have so provided.[13]

43. Accordingly, a company that has a PE because it satisfies paragraph (b) of the definition of PE in subsection 6(1) does not thereby meet the 'carrying on a business' requirement in section 23AH. That requirement is only satisfied by the actual carrying on of business at or through the PE.

Position where a tax treaty definition of PE applies

44. If a tax treaty applies, it is the meaning of PE in that treaty, rather than in subsection 6(1), that applies for section 23AH purposes (subsection 23AH(15)).

45. In some cases a tax treaty (usually at Article 5) deems an enterprise to have a PE in a Contracting State and to carry on business through that PE.

[13] This interpretative approach to the PE definition is consistent with conclusions the ATO has reached in a comparable statutory context. In TR 2007/11 (paragraphs 13 and 14), the view is taken that the carrying on business requirement in the relevant withholding tax provisions (subparagraph 128B(2)(b)(ii)) is not satisfied just because there is a deemed PE under subsection 6(1)).

46. For example, Article 5(3)(b) of the UK Convention[14] deems an enterprise both to have a PE and to carry on business through it if the enterprise maintains substantial equipment for rental or other purposes.

47. Similarly, Article 4(3) of the Singapore Agreement[15] deems an enterprise both to have a PE and to carry on trade or business through it in relation to the use of substantial equipment by, for or under contract with the enterprise.

48. However, this is not the case with the United States Convention[16] (see Article 5(4)). Article 5 of the New Zealand Convention[17] also does not do this, whereas the older 1995 Agreement[18] did (Article 5(4)).

Treaty only deems an enterprise to have a PE: no deeming that business is carried on through that PE

49. Unlike the definition of PE in subsection 6(1) which 'includes' the matters covered by the paragraphs that follow, the tax treaties relevantly provide that an enterprise is 'deemed' to have a PE if it uses substantial equipment in the contracting state.

50. However, the context indicates that despite the different use of language, the words are being used in the same sense and convey the same meaning.

51. Paragraph (b) of the definition in subsection 6(1) extends the meaning of PE by designating that a PE includes a place where the person has substantial equipment. In the same way, the word 'deemed' also extends the meaning of PE to include the use of substantial equipment.

52. The word 'deemed' like the word 'includes' denotes that the use of substantial equipment in the other contracting state constitutes a PE, even though those circumstances might not otherwise meet the requirements of the primary definition. For example, where the conditions for the extended meaning are satisfied, the PE is taken to exist even though the enterprise does not have a fixed place of business in that contracting state.

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[14] *Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains* [2003] ATS 22.

[15] *Agreement between the Government of the Commonwealth of Australia and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and protocols* [1969] ATS 14.

[16] *Convention between the Government of Australia and the Government of the* United *States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and protocol* [1983] ATS 16.

[17] *Convention between Australia and New Zealand for the Avoidance of Double Taxation with respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion* [2010] ATS 10.

[18] *Agreement between the Government of Australia and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect of Taxes on Income* [1997] ATS 23.

53. Accordingly, where a tax treaty 'deems' there to be a PE because substantial equipment is used in that contracting state, no inference can be drawn that a business must also be treated as being carried on at or through that place.

54. The actual carrying on of business at or through the PE must be shown as a question of fact for the purposes of section 23AH. In practical effect, the test is the same as it is in the non-treaty (subsection 6(1) definition of PE) case described in paragraphs 34 to 43 of this draft Ruling).

Treaty deems an enterprise to have a PE and to carry on business through that PE

55. Where the applicable tax treaty also deems an enterprise to carry on business through a 'deemed' PE, this has effect only in the context of the interpretation and application of the treaty and not for the purposes of section 23AH.

56. Literally, paragraph 23AH(15)(a) incorporates only 'the same meaning' of the term PE as in the double tax agreement. The Article in question does two discrete things. Firstly, it extends the meaning of PE to include the use of substantial equipment in the other State. This is the meaning that is picked up by subsection 23AH(15).The second thing the Article does is to create a statutory fiction - to 'deem a state of affairs to exist which does not'[19] - by deeming the enterprise to carry on business through that PE. What is deemed is not part of the defined meaning of the term PE and is not incorporated in the meaning of PE by virtue of paragraph (a) of the definition in section 23AH(15).

57. Further, having regard to settled principles of statutory interpretation, the application of a deeming rule that creates a fiction should not be extended by implication. As noted by Fisher J in *Federal Commissioner of Taxation v. Comber* [20] (*Comber*):

> …deeming provisions are required by their nature to be construed strictly and only for the purpose for which they are resorted to (*Ex parte Walton* (1881) 17 Ch D 746 per James LJ at 756). It is improper in my view to extend by implication the express application of such a statutory fiction. It is even more improper to so to do if such an extension is unnecessary, the express provision being capable of itself of sensible and rational application.[21]

[19] *Re East Finchley Pty Limited v. Federal Commissioner of Taxation* [1989] FCA 481 at paragraph 90, per Hill J; 89 ATC 5280; 20 ATR 1623 .
[20] (1986) 10 FCR 88; [1986] 10 FCA 92; 86 ATC 4171; (1986) 17 ATR 413.
[21] [1986] FCA 92 at paragraph 25, per Fisher J.

58. The purpose of the Article in deeming an enterprise to 'carry on business through' the PE must be ascertained in the context of the tax treaty as a whole. As highlighted in paragraph 1 of the Organisation for Economic Co-operation and Development (OECD) Commentary on Article 5 of the OECD Model:

> The main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. Under Article 7 a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business *through* a permanent establishment situated therein[22] (emphasis added)

59. The relevance of the language that deems the business to be carried on and to be carried on *through* the PE is significant because it ensures the reach of 'source' country taxation under the business profits article. It makes certain that where an enterprise has a real and substantial presence in the country in which the profits arise, the enterprise will be regarded as carrying on business within (as opposed to with) the country concerned.[23] Also, it serves a related purpose of making certain the manner of taxation where another article such as Model Convention Article 12 might otherwise apply.

60. It is therefore apparent that the device of deeming is designed for a particular purpose regarding the application of the business profits article and, on the authority of *Comber,* ought not to be extended by implication beyond that immediate context to affect the interpretation of a domestic law provision, such as section 23AH.

61. Further, a literal reading of section 23AH that requires the 'carrying on a business' test actually to be satisfied does not produce an unreasonable or irrational outcome. Rather, where section 23AH is not satisfied because no business is being carried on at or through the PE with the result that that foreign income derived is included in the company's assessable income, the foreign income tax offset provisions operate appropriately to account for any foreign tax paid. There is no tension or conflict between this construction of section 23AH and Australia's tax treaties which expressly provide that that double taxation will be relieved by way of a credit against Australian tax payable.[24]

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[22] Paragraph 2 of the Commentary on Article 5 to the Model Tax Convention on Income and on Capital as at 22 July 2010.
[23] See the commentary in Magney,TW 1994, *Australia's Double Taxation Agreements: A critical appraisal of key issues,* Legal Books, Sydney, p.13.
[24] Model Convention Article 24. See paragraph 15 of Taxation Ruling TR 2001/13 *Income tax: Interpreting Australia's Double Tax Agreements*.

62. The interpretation is also compatible with the stated rationale of the reforms to international taxation effected when the current version of section 23AH was enacted in 2004. That is, as paragraph 2.4 of the Explanatory Memorandum to the New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004 (the EM) states, whilst the reforms were broadly designed to remove 'a deterrent to Australian companies expanding their active business offshore' that was subject to the principle that '[a]ny passive or highly mobile income shifted to those offshore investments will continue to be taxed in Australia …'. In this regard, section 23AH, with its active income test and other modifications of the rules in Part X dealing with controlled foreign companies (CFC's), provides a comparable set of outcomes for residents investing offshore either directly or through a controlled entity.

63. These policy considerations indicate that a test based only on the presence of substantial equipment offshore was not intended to be a proxy for a test that requires business to in fact be carried on at or through the PE. Logically, there is no reason why this test should not apply consistently and uniformly in all non treaty and treaty cases, so that whether a particular treaty contains this proxy test or not is irrelevant when it comes to the application of section 23AH.

Carrying on a business

64. Although section 23AH refers to carrying on 'a' business at or through a PE, it is not considered that this is a different requirement from carrying on 'business' at or through a PE. In other words, there is no requirement that the activities carried on in relation to the PE constitute a stand-alone or entire business in their own right.

65. This is consistent with wording in the Explanatory Memorandum which introduced section 23AH in 1990. It is also consistent with the test for determining additional notional exempt income for an unlisted country CFC in section 403 which uses the concept 'carrying on business.' A different test for a resident conducting an offshore activity directly, as opposed to through a CFC, would not be appropriate.

Foreign income derived by interposed partnerships or trusts

66. As noted in paragraph 27 of this draft Ruling, other provisions within section 23AH look at whether certain things occur *in carrying on a business* (at or through a PE), such as those dealing with foreign capital gains and losses.[25]

[25] For example, subsections 23AH(3) and 23AH(11).

67. Subsection 23AH(10), which deals with a company's indirect interest in foreign income through one or more interposed partnerships or trusts, does not specifically mention a carrying on a business requirement. Where it applies, the company's indirect interest in foreign income derived by the relevant partnership or trustee is deemed to be foreign income derived by the company through a PE. The subsection does not also deem the income to have been derived from carrying on a business.

68. Paragraph 23AH(1)(c) confirms that the object of the section is, where partnerships or trusts are interposed between a resident company and a foreign branch, to get the same outcomes for the company as if they were not interposed.

69. Accordingly, where subsection 23AH(10) has applied to deem relevant income to have been derived by a company, subsection 23AH(2) is to be applied in respect of that income as though the resident company were placed in the shoes of the actual partnership or trust deriving the foreign income through a PE. That is, the requirements of subsection 23AH(2), including the carrying on a business requirement, are still required to be satisfied, but in order to determine whether a business is carried on in respect of the income that subsection 23AH(10) has deemed to have been derived by the company, the activities of the partnership and trust must instead be considered. In this context, the principles of this draft Ruling are to be applied in considering whether or not the partnership or trustee carries on a business at or through a PE.

Satisfying the active income test

70. Even if a person actually carries on business at or through the PE that is taken to exist, by virtue of either satisfying paragraph (b) of the definition in of PE in subsection 6(1) or the comparable provision in the applicable tax treaty, all the other requirements of section 23AH must be satisfied in order for the provision to apply to treat foreign income as NANE.

71. In particular, subsection 23AH(2) will not apply to foreign income in respect of a deemed PE in a listed country if it does not pass the active income test as it applies to section 23AH and the foreign income is adjusted tainted income (ATI) that is eligible designated concession income (EDCI) in relation to the listed country (see subsection 23AH(5)).

72. Subsection 23AH(2) will not also apply in respect of foreign income of a deemed PE in an unlisted country if it does not pass the active income test that applies for section 23AH and the foreign income is ATI (see subsection 23AH(7)).

73. Subsections 23AH(12) to (14) make some modifications for the purposes of applying these tests, including that the only income or other amounts derived by the entity were the income derived in carrying on business at or through the PE.

74. ATI has the meaning given by section 386, which includes passive income (section 446), tainted sales income (section 447) and tainted services income (section 448).

75. Passive income includes tainted rental income (paragraph 446(1)(f)) and tainted royalty income (paragraph 446(1)(g)).

76. Royalty, for this purpose, takes its subsection 6(1) definition, which would include substantial equipment lease rentals. In terms of the definition of tainted royalty income in section 317, in order for a royalty amount not to be tainted, it must (among other things) be derived in the course of a business carried on by the company, and the lessee must not be an associate of the lessor when the rentals are derived.

77. Consistently with the explanation at paragraphs 55 to 60 of this draft Ruling it follows that it is irrelevant for the purpose of satisfying that exception to the definition of tainted royalty income that the relevant treaty deems the company to carry on business through the (deemed) PE. That condition is only satisfied if the equipment lease rentals (royalties) are derived in the course of a business that is actually carried on by the company. In any case, if no business is carried on the requirement in subsection 23AH(2) is not satisfied, and there would practically be no need to consider whether the active income test is passed (subsection 23AH(12)).

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.

78. It is acknowledged that there is an alternative view that a provision in a tax treaty that deems a company to have a PE because it maintains substantial equipment there and also deems business to be carried on at or through that PE, means that the requirement under section 23AH to carry on a business is automatically satisfied.

79. Proponents of this view argue that the conclusion expressed in this draft Ruling is incompatible with the international taxation reforms enacted in 2004. The broad object of those reforms was to encourage Australian companies to expand offshore and to improve competitiveness by removing an impediment to the distribution of foreign profits and reducing compliance costs.[26]

80. Under this view, it is argued that the interpretation of section 23AH should take into account those circumstances where a treaty gives the source country taxing rights over certain profits by deeming the carrying on of business. In particular it is said that having symmetry between the treaty position and the treatment under the domestic law accommodates the tax reform context. (This is consistent with the approach taken in ATO ID 2011/34).

81. However, this approach is at odds with the plain language of section 23AH which only imports the definition of 'permanent establishment' from the applicable treaty. Moreover, it fails to address the policy considerations discussed in paragraphs 61 to 63 of this draft Ruling. For these reasons, this view is not favoured.

82. In the further alternative, it could be argued that a liberal approach to the interpretation of section 23AH is warranted because it is a provision that confers a benefit.

83. However, that principle does not permit an interpretation that supplants the clear and unambiguous words of the legislation.[27] Paragraph (a) of the definition of 'permanent establishment' in subsection 23AH(15) expressly adopts only the tax treaty meaning of permanent establishment, not the additional deemed characteristics of a business. Therefore, there is no scope for a beneficial construction of the provision that would relieve a company from satisfying the requirement to be carrying on a business at or through a PE.

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[26] See Costello, P (Treasurer) 2003, *Review of International Taxation Arrangements*, press release no 032, Canberra, 13 May and the Explanatory Memorandum to the New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004 at paragraphs 2.3 and 2.4.

[27] For a statement of this principle see the judgement of Brennan CJ and McHugh J in *IW v. City of Perth* (1997) 191 CLR 1 at 11.

Appendix 3 – Your comments

84. You are invited to comment on this draft Ruling, including the proposed date of effect. Please forward your comments to the contact officer by the due date.

85. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- be published on the ATO website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date:	**14 February 2014**
Contact officer:	**Glenn Davies**
Email address:	**glenn.davies@ato.gov.au**
Telephone:	**(07) 3213 5327**
Facsimile:	**(07) 3119 9846**
Contact officer:	**Danielle Allen**
Email address:	**danielle.allen@ato.gov.au**
Telephone:	**(08) 8208 1907**
Facsimile:	**(08) 8208 1094**
Address:	**GPO Box 9977** **Brisbane QLD 4001**

Appendix 4 – Detailed contents list

86. The following is a detailed contents list for this draft Ruling:

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 97/11; TR 2001/13;
TR 2007/10; TR 2007/11

Subject references:

- double tax agreements
- permanent establishment
- substantial equipment

Legislative references:

- ITAA 1936 6(1)
- ITAA 1936 23AH
- ITAA 1936 23AH(1)(c)
- ITAA 1936 23AH(2)
- ITAA 1936 23AH(5)
- ITAA 1936 23AH(7)
- ITAA 1936 23AH(10)
- ITAA 1936 23AH(11)
- ITAA 1936 23AH(12)
- ITAA 1936 23AH(13)
- ITAA 1936 23AH(14)
- ITAA 1936 23AH(15)
- ITAA 1936 128B(2)(b)(ii)
- ITAA 1936 Part X
- ITAA 1936 317
- ITAA 1936 320(1)
- ITAA 1936 386
- ITAA 1936 403
- ITAA 1936 446
- ITAA 1936 446(1)(f)
- ITAA 1936 446(1)(g)
- ITAA 1936 447
- ITAA 1936 448
- ITR 1936 Sch 10

Case references:

- BHP Billiton Iron Ore Pty Ltd v. National Competition Council (2008) 236 CLR 45; [2008] HCA 45
- Case H106 (1957) 8 TBRD 484
- Federal Commissioner of Taxation v. Comber (1986) 10 FCR 88; [1986] 10 FCA 92; 86 ATC 4171; (1986) 17 ATR 413
- IW v. City of Perth (1997) 191 CLR 1; [1997] HCA 30
- McDermott Industries (Aust) Pty Ltd v. Federal Commissioner of Taxation (2005) 142 FCR 134; [2005] FCAFC 67; 2005 ATC 4398; (2005) 59 ATR 358
- Re East Finchley Pty Limited v. Federal Commissioner of Taxation [1989] FCA 481; 89 ATC 5280; (1989) 20 ATR 1623
- Zickar v. MGH Plastic Industries Pty Limited (1996) 187 CLR 310

Other references:

- Agreement between the Government of the Commonwealth of Australia and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and protocols [1969] ATS 14
- Commentaries on the Articles of the Model Tax Convention on Income and on Capital, 22 July 2010
- Convention between Australia and New Zealand for the Avoidance of Double Taxation with respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion [2010] ATS 10
- Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains [2003] ATS 22
- Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and protocol [1983] ATS 16

- Costello, P (Treasurer) 2003, Review of International Taxation Arrangements, press release No 032, Canberra, 13 May.
- Explanatory Memorandum to the New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004
- Magney,TW 1994, Australia's Double Taxation Agreements: A critical appraisal of key issues, Legal Books, Sydney
- Pearce, DC and Geddes, RS 2011 Statutory Interpretation in Australia, 7th edn., LexisNexis Butterworths, Australia

ATO references

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