TR 2007/11 - Income tax: withholding tax and related implications for a non-resident head lessor or hire-purchase provider of substantial equipment where the equipment is obtained by another non-resident entity that subleases, subprovides or leases it for use in Australia

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This document has changed over time. This is a consolidated version of the ruling which was published on *19 December 2007*

Taxation Ruling

Income tax: withholding tax and related implications for a non-resident head lessor or hire-purchase provider of substantial equipment where the equipment is obtained by another non-resident entity that subleases, subprovides or leases it for use in Australia

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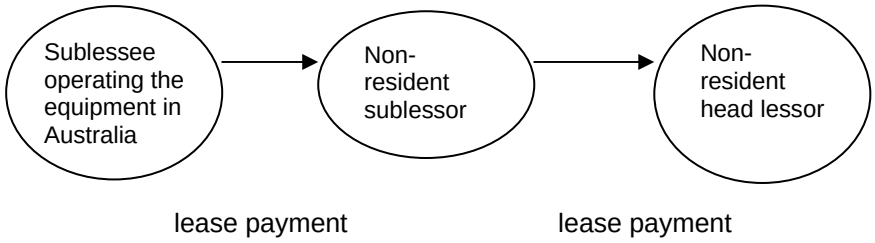
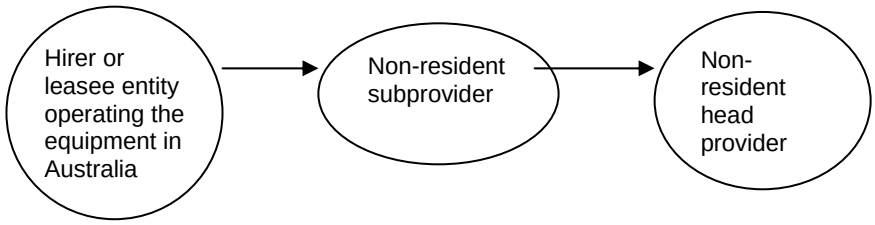
What this Ruling is about

1. This Ruling considers whether withholding tax or tax on an assessment basis applies to all or part of a payment a non-resident lessor (the head lessor) receives from leasing substantial equipment to another non-resident (the sublessor) who subleases the equipment to an entity who operates the equipment in Australia (the sublessee) (see the diagram below).



2. This Ruling also considers whether withholding tax or tax on an assessment basis applies to all or part of a payment a non-resident hire-purchase provider (the head provider) under a hire-purchase agreement[1] receives from providing substantial equipment to a non-resident hirer (the subprovider) who provides or leases the equipment to an entity who operates the equipment in Australia (see the diagram below).



3. In particular, the Ruling considers whether all or part of the payment will be subject to royalty or interest withholding tax pursuant to subparagraph 128B(2B)(b)(ii) or 128B(2)(b)(ii) of the *Income Tax Assessment Act 1936* (ITAA 1936) because it is an outgoing incurred by the sublessor or subprovider in carrying on business in Australia at, or through, a permanent establishment in Australia.

4. In addressing this issue, the Ruling examines the implications of the Full Federal Court decision in *McDermott Industries (Aust) Pty Ltd v. Federal Commissioner of Taxation* [2005] FCAFC 67 (*McDermott*). The Court held that a non-resident lessor had a permanent establishment in Australia under Article 4(3)(b) of the tax treaty between Australia and Singapore (the Singapore Agreement), on the basis that barges leased to an entity that operated them in Australia constituted substantial equipment being used in Australia either by the lessor itself, or by the lessee under contract with the lessor.

[1] For the purposes of this Ruling, the term 'hire-purchase agreement' has the same meaning as it does in Taxation Determination TD 2007/31 Income tax: is a non-resident enterprise that under a hire-purchase agreement hires out substantial equipment to another entity that uses the equipment in Australia deemed to have a permanent establishment in Australia under Article 4(3)(b) of the tax treaty between Australia and Singapore or equivalent provisions in other Australian tax treaties? and in Taxation Ruling 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. See paragraph 32 of TR 2007/10 for the definition of the term.

Class of entities

5. This Ruling applies to a non-resident head lessor who leases substantial equipment to a non-resident sublessor who subleases the equipment to an entity who operates the equipment in Australia. The Ruling also applies to a non-resident hire-purchase provider who, under a hire-purchase agreement, provides substantial equipment to a non-resident hirer who either subprovides or leases the equipment to an entity who operates the equipment in Australia.

6. It also applies to entities or persons required under section 12-280 or 12-285 of Schedule 1 to the *Taxation Administration Act 1953* (TAA) to withhold amounts from royalties, and to entities or persons required under section 12-245 or 12-250 of Schedule 1 to the TAA to withhold amounts from interest.

Scheme

7. The Ruling applies to both leases and hire-purchase agreements involving substantial equipment.

8. This Ruling applies to a payment derived by a non-resident head lessor or hire-purchase provider that either:

- is a royalty; or
- includes an amount of deemed interest pursuant to subsection 128AC(5) of the ITAA 1936,

for the purposes of the withholding tax provisions in section 128B of the ITAA 1936.

9. In relation to leases, the Ruling only applies to payments for the lease of substantial equipment on a 'bareboat' basis (for example the lease of a ship by itself). It does not apply to payments for a 'full basis' lease (for example where a ship is also provided with captain and crew)[2] as payments for full basis leases are made for the provision of services by the lessor, not for the right to use the substantial equipment. For further discussion of this issue see Taxation Ruling TR 2003/2 Income tax: the royalty withholding tax implications of ship chartering arrangements.

10. The Ruling deals with situations where the non-resident head lessor or hire-purchase head provider is a resident of a country with which Australia:

- has a tax treaty; or
- does not have a tax treaty, that is, where domestic tax law provisions alone apply.

[2] For further explanation of a full basis lease, see paragraph 15 of TR 2007/10.

11. The Ruling deals solely with the tax position of the non-resident head lessor or hire-purchase head provider. However, determining the tax position of the non-resident head lessor or head provider requires taking into account certain tax aspects of the sublessor or subprovider in relation to the application of the withholding tax provisions. The tax position of the sublessor or subprovider itself may differ depending upon whether the sublessor or subprovider is a resident of a country with which Australia has a tax treaty.

Ruling

Lease agreements

Non tax treaty situations

12. A sublessor who subleases substantial equipment to an entity that operates the equipment in Australia is considered to have a permanent establishment in Australia under paragraph (b) of the definition of permanent establishment in section 6(1) of the ITAA 1936.

13. A payment a non-resident head lessor receives from leasing that substantial equipment to the sublessor will be subject to royalty withholding tax if the sublessor is carrying on business at or through the permanent establishment referred to above[3]. That will not be the case if the lease contracts between the sublessor and sublessee are entered into outside Australia and no other activities, apart from the receipt of lease rentals, are conducted by the sublessor in Australia.

14. However, if the sublessor carries on business activities such as undertaking maintenance checks or conducting lease negotiations in Australia at or through the permanent establishment, then the sublessor is carrying on business at or through the permanent establishment with the effect that the payment it makes to the head lessor will be subject to royalty withholding tax.

Tax treaty situations

15. Where the non-resident head lessor is a resident of the United States (US), the United Kingdom (UK) or Norway[4] for tax treaty purposes, it will not be liable for royalty withholding tax because the payment is not a royalty for the purposes of the definition of 'royalty' in these treaties. The Australian tax consequences for residents of these countries in relation to the substantial equipment provisions of the respective treaties are explained in Taxation Ruling TR 2007/10.

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[3] Taxation Rulings TR 98/21 sets out those circumstances where royalty withholding tax, rather than interest withholding tax, will apply to payments under certain types of lease arrangements. This issue is also discussed at paragraph 45 of this Ruling.

[4] References in this Taxation Ruling to Australia's tax treaty with Norway are references to the 2006 tax treaty between Australia and Norway.

16. A non-resident head lessor will also not be liable for royalty withholding tax where, under one of Australia's tax treaties, the non-resident head lessor itself has a permanent establishment in Australia to which the lease payments are effectively connected.

17. For the purposes of paragraphs 15 and 16 of this Ruling, tax on an assessment basis will apply where the non-resident head lessor itself has a permanent establishment in Australia to which the lease payments are effectively connected.

18. A non-resident head lessor will not have a permanent establishment[5] in Australia merely because the substantial equipment is being operated in Australia under a sublease between a non-resident sublessor and an entity operating the equipment in Australia.

19. Where a payment is not subject to a royalty withholding tax liability by virtue of paragraphs 12 and 13 of this Ruling, the payment will still be taxable in the hands of the head lessor on an assessment basis under subsection 6-5(3) of the *Income Tax Assessment Act 1997* (ITAA 1997) where a tax treaty applies such that:

(a) the non-resident sublessor has a deemed permanent establishment in Australia under the tax treaty;

(b) the Royalties Article includes payments for the use of industrial, commercial or scientific equipment (equipment royalties) within the definition of royalties; and

(c) the Source of Income Article deems[6] the equipment royalty to have a source in Australia for the purposes of Australia's domestic tax law provisions.

Hire-purchase agreements

20. Circumstances may arise were, instead of a chain of lease agreements, there is a chain of hire-purchase agreements, or a hire-purchase agreement at one level then a lease by the hirer (the subprovider) to an entity who operates the equipment in Australia.

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[5] That is, a permanent establishment under a provision corresponding to Article 4(3)(b) of the Singapore Agreement. See paragraph 17 of TD 2007/31 for a list of those Australian tax treaties that contain such provisions.

[6] The majority of Australia's tax treaties include a provision that deems income to have an Australian source for Australia's domestic tax law purposes in circumstances where Australia is allocated a right to tax that income under a provision of the tax treaty. However, Australia's tax treaties with Japan, the Netherlands, France and Russia do not include such a provision for royalties.

21. In the case of a chain of hire-purchase agreements, the Commissioner considers that a non-resident subprovider that provides substantial equipment to an entity that uses it in Australia under a hire-purchase agreement will not, by that fact alone, be considered to have or be using substantial equipment and thus will not have a permanent establishment in Australia under paragraph (b) of the definition of permanent establishment in section 6(1) of the ITAA 1936. Accordingly, where the non-resident subprovider obtains the substantial equipment under a hire-purchase agreement with a non-resident head provider, no interest withholding tax liability arises under subsection 128B(5) of the ITAA 1936 with respect to any part of the payment derived by the non-resident head provider[7]. In these circumstances there are no other tax treaty implications as the payment is considered to fall outside the scope of Australia's tax treaties.

22. However, if the non-resident subprovider has a permanent establishment in Australia based on other factors, an interest withholding tax liability arises unless the non-resident head provider also has a permanent establishment in Australia and satisfies subparagraph 128B(3)(h)(ii) of the ITAA 1936, in which case the payment will be taxed on an assessment basis. The application of a tax treaty would not change these tax outcomes.

23. In a mixed hire-purchase/lease situation, where the non-resident hirer:

- obtains the substantial equipment under a hire-purchase agreement with a non-resident head entity; then
- provides the equipment, under a lease agreement, to an entity that operates it in Australia,

the considerations contained in paragraphs 12 to 14 of this Ruling will apply when determining whether interest withholding tax applies in respect of any part of the payment made to the non-resident head entity.

[7] Taxation Ruling TR 98/21 sets out those circumstances where interest withholding tax rather than withholding tax, will apply to part of a payment under certain types of lease arrangements.

Examples

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

24. A Hong Kong head lessor leases substantial equipment of an industrial nature to a Singaporean company that in turn subleases the equipment to a sublessee in Australia which operates the equipment in Australia. Both lessors are in the equipment leasing business. Both leases are entered into in Singapore and there are no requirements for the lessors to undertake any further activity in respect of the equipment. After entering into these leases the equipment is taken to Australia for the period of the lease. The Singaporean resident sublessor receives lease rentals from the sublessee and in turn makes lease payments to the Hong Kong head lessor. This can be illustrated as:

25. By leasing the substantial equipment to an entity that operates it in Australia, the Singapore resident sublessor is considered to have and be using substantial equipment in Australia. Accordingly, the Singaporean resident sublessor is considered to have a permanent establishment in Australia under paragraph (b) of the definition of permanent establishment in section 6(1) of the ITAA 1936.

26. However, the Singaporean resident sublessor does not conduct any of its leasing business through the permanent establishment, that is, through the place in Australia where the equipment is located while under lease. Accordingly, the lease payment made by the Singaporean resident sublessor to the Hong Kong head lessor is not an outgoing incurred by the sublessor in carrying on business in Australia at or through its permanent establishment in Australia for the purposes of subparagraph 128B(2B)(b)(ii) of the ITAA 1936.

27. Accordingly, the Hong Kong head lessor is not liable under section 128B(5A) of the ITAA 1936 for royalty withholding tax on the royalty payment it receives from the Singaporean sublessor's permanent establishment in Australia.

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

28. A New Zealand head lessor leases substantial equipment to a Singaporean entity that in turn subleases the equipment to a lessee in Australia. The Singapore entity and the Australian entity conduct lease negotiations and enter into the lease in Australia and the terms of the lease require the Singapore lessor to conduct routine maintenance on the equipment during the lease. The equipment remains in Australia for the period of the sublease. The New Zealand head lessor has no other presence in Australia. The Singaporean resident sublessor receives royalty payments from the sublessee and makes royalty payments to the New Zealand head lessor. This can be illustrated as:

29. For the same reasons as in Example 1 the Singaporean resident sublessor is considered to have a permanent establishment in Australia under paragraph (b) of the definition of permanent establishment in section 6(1) of the ITAA 1936.

30. The lease payment made by the Singaporean resident sublessor to the New Zealand head lessor is considered to be a royalty outgoing incurred by the sublessor in carrying on part of its leasing business through the permanent establishment. This is because the sublessor conducts a range of business activities such as contract negotiation and completion and maintenance checks on the equipment while the equipment is located in Australia during the period of the lease. Accordingly, the Singaporean resident satisfies the requirements of subparagraph 128B(2B)(b)(ii) of the ITAA 1936 and the royalty payments to the New Zealand head lessor are prima facie subject to royalty withholding tax, subject to the application of the tax treaty between Australia and New Zealand (the New Zealand Agreement).

31. For the purposes of the New Zealand Agreement, the equipment is considered to be used in Australia under the lease the Singaporean sublessor has with the sublessee in Australia, but it is not being used in Australia by the Singaporean sublessor under the lease with the New Zealand head lessor. Therefore, the equipment is not used in Australia by the New Zealand head lessor and the New Zealand head lessor does not have a deemed permanent establishment in Australia under Article 5(4)(c) of the New Zealand Agreement.

32. Accordingly, subsection 17A(4) of the *International Tax Agreements Act 1953* (the Agreements Act) does not exclude the payment from section 128B of the ITAA 1936. The New Zealand head lessor is, therefore, liable for royalty withholding tax on the royalty payment it receives from the Singaporean sublessor's permanent establishment in Australia under subsection 128B(5A) of the ITAA 1936. Article 12(2) of the New Zealand Agreement limits the rate at which Australia can impose royalty withholding tax to 10 per cent of the gross lease payment.

Example 3: head lessor resident in the United Kingdom for tax treaty purposes

33. The facts are the same as Example 2 except that the head lessor is resident in the United Kingdom for tax treaty purposes. In this case, although the royalty payment from the Singapore sublessor to the United Kingdom head lessor would prima facie be subject to royalty withholding tax under subparagraph 128B(2B)(b)(ii) of the ITAA 1936, the tax treaty between Australia and the United Kingdom (the UK Convention) does not include such payments within the definition of 'royalties' in Article 12.3 of the UK Convention.

34. Accordingly, subsection 17A(5) of the Agreements Act applies and section 128B of the ITAA 1936 does not apply to the lease payment received by the United Kingdom head lessor.

Example 4: hire-purchase agreement

35. The facts are the same as Example 2 except that both agreements are hire-purchase agreements. In this case, the payment from the Singapore subprovider to the New Zealand head provider contains a deemed interest component under subsection 128AC(5) of the ITAA 1936. As the agreement is a hire-purchase agreement, the Singapore subprovider does not have a permanent establishment in Australia under paragraph (b) of the definition of permanent establishment in section 6(1) of the ITAA 1936.

36. Accordingly, the New Zealand head provider is not liable to interest withholding tax on the deemed interest component of the lease payment it receives from the Singapore subprovider under subsection 128B(5A) of the ITAA 1936.

Example 5: non-resident head lessor subject to tax on an assessment basis

37. The facts are the same as Example 1 except that the non-resident head lessor is resident of Malaysia for tax treaty purposes. As with Example 1, the Malaysian head lessor is not liable under section 128B(5A) of the ITAA 1936 for royalty withholding tax on the royalty payment it receives from the Singaporean sublessor's permanent establishment in Australia because the sublessor is not carrying on business in Australia through that permanent establishment.

38. However, the Malaysian head lessor is liable to tax in Australia on an assessment basis because the royalty payments it receives from the Singapore sublessor are deemed to have an Australian source under the Malaysian Agreement. This outcome arises because the Singapore sublessor of the equipment has a deemed permanent establishment under Article 5.4(b) of the Malaysian Agreement and therefore the royalty payment (which is a royalty under Article 12.6(a)(ii) of the Malaysian Agreement) incurred by the Singapore sublessor in connection with that deemed permanent establishment is deemed to arise in Australia under Article 12.4 of the Malaysian Agreement.

39. As Australia is allocated a right to tax the royalty payment from the Singapore sublessor's deemed permanent establishment to the Malaysian head lessor under Article 12.1 of the Malaysian Agreement, the royalty payment is deemed to have an Australian source for the purposes of Australia's domestic tax law under Article 22 of the Malaysian Agreement. Accordingly, the Malaysian head lessor is liable to tax on an assessment basis in relation to the Australian sourced royalty payments it derives under subsection 6-5(3) of the ITAA 1997.

Date of effect

40. This Ruling applies to years of income commencing after 29 April 2005, being the date of the *McDermott* decision. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
19 December 2007

Appendix 1 – Explanation

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

General position

Relevant withholding tax provisions

41. A person is liable under subsections 128B(5) and 128B(5A) of the ITAA 1936 to pay withholding tax[8] if they derive income that consists of interest or a royalty and the requirements of subsections 128B(2), (2A), (2B) or (2C) of the ITAA 1936 are satisfied in relation to that income. However where the person is a resident of a country which has a tax treaty with Australia it should be noted that these outcomes are subject to relevant tax treaty considerations.

42. In accordance with the nature of withholding tax the TAA prescribes obligations upon relevant payers of royalties or interest to withhold the tax from the recipients.

Royalty withholding tax

43. Subsection 995-1(1) of the ITAA 1997 defines a royalty to have the meaning given by subsection 6(1) of the ITAA 1936 which includes, amongst other things, an amount paid or credited as consideration for 'the use of, or the right to use, any industrial, commercial or scientific equipment'.[9] Consequently, a payment from a non-resident sublessor to a non-resident head lessor for the lease of substantial equipment will be a royalty as such leases involve 'the use of, or right to use' equipment, and the equipment is 'industrial, commercial or scientific'.[10]

44. Subparagraph 128B(2B)(b)(ii) of the ITAA 1936 states that section 128B of the ITAA 1936 will apply to income derived by a non-resident that consists of a royalty and that royalty:

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

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[8] Withholding tax means income tax payable in accordance with section 27GA or 128B of the ITAA 1936 (section 6(1) of the ITAA 1936 and section 995-1 of the ITAA 1997).

[9] See paragraph (b) of the definition of royalty or royalties in subsection 6(1) of the ITAA 1936.

[10] See paragraphs 15 to 38 of Taxation Ruling TR 98/21 for further explanation of these phrases.

Interest withholding tax

45. Certain arrangements covered by this Ruling will not be subject to royalty withholding tax as they contain a deemed interest component under section 128AC of the ITAA 1936. Thus, interest withholding tax applies to the deemed interest component where subparagraph 128B(2)(b)(ii) of the ITAA 1936 is satisfied. This is consistent with the view in Taxation Ruling TR 98/21[11] where the Commissioner considers that cross border leases of equipment that fall within section 128AC of the ITAA 1936 are subject to interest withholding tax rather than royalty withholding tax. Under that Ruling the Commissioner considers section 128AC of the ITAA 1936 applies to:

- those leases where the element of purchase is paramount and a financing element exists;
- leases for effective life with a financing element; and
- a terms purchase or an instalment sale with a financing element.[12]

46. For the purpose of this Ruling, the above types of cross border agreements are referred to collectively as 'hire-purchase agreements' and they fall within the scope of this Ruling as per paragraphs 2 and 7 of this Ruling.

47. Subparagraph 128B(2)(b)(ii) of the ITAA 1936 states that section 128B of the ITAA 1936 will apply to income derived by a non-resident that consists of interest and that interest:

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

48. Thus, subparagraphs 128B(2)(b)(ii) and 128B(2B)(b)(ii) of the ITAA 1936 apply respectively to interest or a royalty derived by a non-resident head lessor or hire-purchase provider where a non-resident sublessor or subprovider:

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

[11] Taxation Ruling TR 98/21 Income tax: withholding tax implications of cross border leasing arrangements
[12] See, in particular, paragraphs 7 to 10 of TR 98/21.

Subsection 6(1) definition of permanent establishment

Definitions using the composite phrase 'means and includes'

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

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

50. This definition states that a permanent establishment 'means' a generally described thing and 'includes' certain specifically listed things, in particular, paragraph (b) of the definition. An initial consideration is whether it is necessary to meet the requirements in the chapeau that follow the words 'means' before a permanent establishment will exist when applying paragraph (b) of the definition. For example, whether a place where substantial equipment is being used must also be a place at or through which the person carries on business.

51. Where 'means' and 'includes' are used together it is considered that the items under 'includes' operate to either avoid doubt that certain matters are taken to fall within the scope of that designated meaning[13] or to extend the operation of the items covered under 'means'.

52. This view is consistent with the approach taken by the High Court decision in *Darrin Zicker v. MGH Plastic Industries Pty Ltd*[14] (*MGH Plastics*). In that case, the Court considered the following definition of the term 'injury' in section 4 of the *Workers Compensation Act 1987 (NSW)*:

> In this Act, 'injury':
>
> (a) means personal injury arising out of or in the course of employment;
>
> (b) includes:
>
> (i) a disease which is contracted by a worker in the course of employment and to which the employment was a contributing factor; and
>
> (ii) the aggravation, acceleration, exacerbation or deterioration of any disease, where the employment was a contributing factor to the aggravation, acceleration, exacerbation or deterioration; and
>
> (c) does not include …

[13] Statutory Interpretation in Australia, Pearce and Geddes, 6th Edition, paragraph 6.60 at pages 243-244.
[14] [1996] HCA 31.

53. In concluding that the aneurism suffered by the appellant in this case was in fact a disease, the High Court expressed the following views as to the proper construction of the relevant 'includes' part of the definition:

> It can be accepted that, by introducing par (b) with the word 'includes', the categories of 'injury' are extended beyond and do not contract the categories of 'personal injury' in par (a).

54. The view that each of the items contained under 'includes' are distinct and mutually exclusive categories in respect to each other and the items under 'means' is supported in the following ways:

- the use of 'includes' expanding the scope of the definition;
- in *MGH Plastics*, the Court indicated that cosmetic changes to the structure of the provision made it even clearer that the components of the definition of 'injury" were to be ascertained by reference to distinct and mutually exclusive categories;
- in the specific items listed under 'includes' in subsection 6(1), some paragraphs refer to 'carrying on a business' while others do not. It is arguable that if the general requirement to carry on business was meant to apply to the included items then the *ad hoc* references to carrying on business are unnecessary. Alternatively, if they were included for emphasis, then it would have been appropriate to include them for all the included items; and
- as 'carrying on a business' is already referred to in the definition, it would have been more likely that the reference in the included items would have been to 'carrying on the business' rather than just repeating a general requirement. It follows that, based on the construction of the provision, some items in the included list were not intended to have a carrying on business requirement and those that were are dealt with by a specific reference to carrying on business.

55. In conclusion, to meet paragraph (b) of this definition, a non-resident does not need a permanent establishment as described in the chapeau of the definition if it is one of the permanent establishments included in the definition by the listed paragraphs. Accordingly, where a non-resident meets paragraph (b), they will be considered to have a permanent establishment without needing to also meet the requirement of carrying on a business through the permanent establishment.

56. It is noted that Taxation Ruling TR 2002/5[15] indicates that the subsection 6(1) reference to 'a place at or through which the person carries on any business' equates to the general concept of 'fixed place of business' in the 1946 UK Double Tax Agreement and the 1953 US Double Tax Convention and has as its essence a degree of permanence. However, paragraph (b) of the definition of permanent establishment in subsection 6(1) is an express addition to the subsection 6(1) meaning and does not deal with a place where a person carries on business, so TR 2002/5 is not applicable to determining its meaning.[16]

Meaning of the terms 'has' and 'using'

57. The meaning of the words 'using substantial equipment or substantial machinery' in paragraph (b) of the definition of permanent establishment in subsection 6(1) of the ITAA 1936 has not been considered by Australian courts. However, the meaning of substantial equipment being 'used' by, for or under contract in Article 4(3)(b) of the Singapore Agreement was considered by the Full Federal Court in the *McDermott* decision.

58. The Full Federal Court in *McDermott* ruled on the interpretation of Article 4(3)(b) of the Singapore Agreement. This tax treaty provision provides that a Singaporean enterprise will be deemed to have a permanent establishment in Australia and to carry on trade or business through that permanent establishment if substantial equipment is being used in Australia by, for or under contract with the Singaporean enterprise.

59. In this case, the Singapore enterprise, CCS, was leasing barges on a bareboat basis to an Australian entity, McDermott Industries, who used the barges for their own business purposes in Australia. A bareboat lease of equipment generally involves no captain or crew being provided by the lessor with the equipment. The lessor transfers possession and technical operation/navigation of the equipment to the lessee under the lease agreement. Accordingly, the lessor of the equipment is not considered to be actively involved in the operation of the equipment.

[15] Taxation Ruling 2002/5: Income tax: permanent establishment – what is 'a place at or through which a person carries on any business'?
[16] In particular, see paragraphs 5 and 13 of TR 2002/5.

60. The Commissioner argued that CCS did not have a permanent establishment in Australia under Article 4(3)(b) of the Singapore Agreement based on a number of grounds, one of which being that the proper construction of the provision requires that the relevant enterprise has a 'significant presence' in the relevant State. The Commissioner further submitted that no permanent establishment should be found to exist merely as a consequence of ownership of property giving rise to passive income such as rent, interest, dividends and royalties.[17]

61. In relation to the specific language of the provision, the Commissioner argued that:[18]

> … the expression 'used ... by, for or under contract with' in Article 4(3)(b) did not stipulate three different and alternative occasions of usage. Rather it expressed a single complex idea (said to be a 'hendiadys'), namely use in furtherance of the enterprise whether directly by the non-resident or indirectly, by others for the non-resident or under contract (to operate or use the equipment in the conduct of the enterprise) with the non-resident.

62. The Full Federal Court rejected the arguments put by the Commissioner in this case and concluded that CCS did have a deemed permanent establishment in Australia. In particular, the Court stated the following when interpreting Article 4(3)(b) of the Singapore Agreement:[19]

> There is nothing particularly difficult about the language used in Article 4(3) of the Singapore Agreement. On its face it operates to deem there to be a permanent establishment in Australia if the Singapore enterprise (in the present case CCS), inter alia, owns 'substantial equipment' (here a barge) which is used in Australia, inter alia, under contract with the Singapore enterprise. The relevant use might, but need not be, use by an Australian enterprise. All that is required is that there is a use of the equipment in Australia and that the use be 'under contract'. On the face of it there is no difficulty in concluding that a bare boat charter entered into between CCS and MIA of barges, used only in Australian waters in the relevant period, falls within Article 4(3).

63. After considering the context, object and purpose of the treaty, the Court concluded that there was nothing in the context of Article 4 of the Singapore Agreement that required a reading down of the natural meaning of the provision.

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[17] See *McDermott Industries (Aust) Pty Ltd v. Commissioner of Taxation* [2005] FCAFC 67 at paragraph 28.
[18] [2005] FCAFC 67 at paragraph 30.
[19] [2005] FCAFC 67 at paragraph 39.

64. The Court considered that the 'substantial' nature of the equipment provided policy justification for subjecting a non-resident lessor of the equipment to tax in Australia, when it stated:[20]

> Floating oil rigs are a good example of equipment which would properly be treated as substantial. It does not seem surprising that the owner of such a rig which had granted rights of use under a bailment agreement for reward should be treated as having a permanent establishment in the place where the rig is and where it is used, and thus be liable to be assessed for tax on the basis of the income derived from the rig in the jurisdiction where the rig is and where it is used and not the place of residence of the owner.

65. When confirming that adventitious use of equipment in Australia would not create a deemed permanent establishment, the Court clarified what type of use it considered would create a deemed permanent establishment. The Court stated that 'the contemplated use must be a real use of the asset in Australia to gain income.'[21]

66. Accordingly, the Court held that a permanent establishment was deemed to arise because the substantial equipment was being used in Australia either by the Singaporean resident itself or alternatively by McDermott Industries under contract with the Singaporean resident.[22]

67. The Commissioner considers that the broad meaning given by the Full Federal Court in *McDermott's* case to the words, 'substantial equipment being used' in Article 4(3)(b) of the Singapore Agreement also applies to the expression 'using substantial equipment' in paragraph (b) of the definition of 'permanent establishment' in subsection 6(1) of the ITAA 1936. The terms 'used' and 'using' derive from the same verb 'use', with the only difference between the two being their tense. The context in which the terms are used are also very similar as both the tax treaty provision (Article 4(3)(b)) and the domestic law provision (paragraph (b) of the definition of permanent establishment in subsection 6(1) of the ITAA 1936) include the use of substantial equipment in Australia in what constitutes a permanent establishment where otherwise a standard ('fixed place of business') permanent establishment might not otherwise exist.

68. In *McDermott*, the Singapore resident lessor of the substantial equipment was held to be using the equipment in Australia itself regardless of the fact that it had no other physical presence in Australia and it was the Australian lessee of the equipment that was physically operating the equipment in Australia. Accordingly, the Commissioner considers a non-resident sublessor, by subleasing the equipment to another entity that operates the equipment in Australia, is considered to be using the substantial equipment itself for the purposes of paragraph (b) of the definition of permanent establishment in subsection 6(1) of the ITAA 1936.

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[20] [2005] FCAFC 67 at paragraph 55.
[21] [2005] FCAFC 67 at paragraph 70.
[22] [2005] FCAFC 67 at paragraph 71.

69. The Commissioner further considers that in light of the broad interpretative approach taken by the Court in *McDermott* to the term 'used' in Article 4(3)(b) of the Singapore Agreement, a broad ordinary meaning is also appropriate for the term 'has' in paragraph (b) of the definition of permanent establishment in section 6(1) of the ITAA 1936. The Macquarie Dictionary defines the term 'has' to mean, amongst other things, 'to possess; own; to hold for use'. While a sublessor does not possess or own substantial equipment, it holds the equipment for use in the sense that it holds the equipment for its business purposes of leasing the equipment to other entities. Accordingly, the Commissioner considers a non-resident sublessor who leases substantial equipment to another entity that operates the equipment in Australia, 'has' the substantial equipment for the purposes of paragraph (b) of the definition of permanent establishment subsection 6(1) of the ITAA 1936.

Hire-purchase agreements

70. The issue arises as to whether a non-resident who provides substantial equipment to an entity which operates it in Australia under a hire-purchase agreement, rather than a bareboat lease, meets the requirements of paragraph (b) of the definition of permanent establishment in section 6(1) of the ITAA 1936. In particular, the issue is whether under a hire-purchase agreement the hire-purchase provider 'has or is using substantial equipment'.

71. There is no specific reference in the ITAA 1936 or any related extrinsic material that indicates how a hire-purchase agreement is to be treated for the purposes of paragraph (b) of the definition of permanent establishment in section 6(1) of the ITAA 1936. However, there are provisions of the ITAA 1936 and the ITAA 1997 that deal with specific aspects of hire-purchase agreements and these are contained in section 128AC of the ITAA 1936 and Divisions 40 and 240 of the ITAA 1997. These provisions generally have the effect of re-characterising the hire-purchase agreement from one where the legal ownership remains with the hire-purchase provider until the end of the agreement, to one where it is treated as an initial sale combined with a loan arrangement over the equipment.

72. Consideration has been given to the treatment of hire-purchase agreements when dealing with equivalent provisions to paragraph (b) of the definition of permanent establishment in section 6(1) of the ITAA 1936 contained in Australia's tax treaties, which deem a permanent establishment to exist if substantial equipment is being 'used by, for or under contract with an enterprise'.[23] In TD 2007/31 it was concluded that in the context in which the provision applied it was appropriate to treat the hire-purchase agreement as, in effect, an initial sale of the equipment together with a loan arrangement. The context referred to included, for example, section 128AC of the ITAA 1936, Divisions 40 and 240 of the ITAA 1997 and paragraph 9 of the Commentary on Article 12 of the *1977 OECD Model Double Taxation Convention on Income and on Capital*.

73. When the text of paragraph (b) was originally inserted in then section 128A of the ITAA 1936[24] it was noted in the relevant Explanatory Memorandum[25] that:

> The substance of sub-sections (4) and (5) corresponds closely with definitions of 'permanent establishment' found in double taxation agreements entered into by Australia.

74. This connection was recognised by Gzell J in *Unisys Corporation Inc v. Federal Commissioner of Taxation* (2002) ATC 5146; 51 ATR 386 when he noted that the language of subsection 128B(2B) of the ITAA 1936 was drawn from international tax law. He then applied international tax law considerations when considering the meaning of the term 'business' in subsection 128B(2B) of the ITAA 1936 to conclude that:

> In my view, in light of the attitude taken to what constitutes a business for the purposes of the business profits article, from which the language of s 128B(2B) of the *Income Tax Assessment Act 1936* emanates, ULP carried on business in the US for the purposes of that provision.[26]

75. These considerations lead the Commissioner to conclude that when considering the tax treatment of hire-purchase agreements under paragraph (b) of the definition of permanent establishment in section 6(1) of the ITAA 1936, the provision should be construed in a way that is broadly consistent with the meaning that it has in Australia's tax treaties. In this particular situation, any differences in wording between the respective provisions are not relevant when considering their application to hire-purchase agreements.

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[23] Article 4(3)(b)of the tax treaty between Australia and Singapore, or its equivalent in other tax treaties

[24] Subsequent changes to move the provision to section 6 of the ITAA 1936 did not make any change in the basis on which the withholding tax on dividends and interest is applied – see the Explanatory Memorandum to the Income Tax Assessment Bill 1968, paragraph (a) of clause 3.

[25] Explanatory Memorandum to the Income Tax and Social Services Contribution Assessment Bill (No. 3) 1959, Clause 6, Dividend payments to non-residents.

[26] At page 5154.

76. Therefore, consistent with the position taken in TR 2007/10 in respect of tax treaties, hire-purchase agreements of substantial equipment should be treated as, in effect, an initial sale of the equipment together with a loan arrangement for the purposes of paragraph (b) of the definition of permanent establishment in section 6(1) of the ITAA 1936. As the substantial equipment is treated as if it has initially been disposed of by the non-resident hire-purchase provider it is not a place where that non-resident has or is using substantial equipment or substantial machinery. Accordingly, the non-resident provider does not have a permanent establishment in Australia for the purposes of paragraph (b) of the definition of permanent establishment in section 6(1) of the ITAA 1936.

77. Therefore, when dealing with a chain of hire-purchase agreements where:

- an entity is operating substantial equipment in Australia under a hire-purchase agreement with a non-resident subprovider; and
- that non-resident subprovider obtained that equipment under a hire-purchase agreement with another non-resident enterprise (the head provider),

no interest withholding tax liability arises under subsection 128B(5) of the ITAA 1936 with respect to any part of the payment derived by the non-resident head provider. There are also no tax treaty implications as the payment is considered to fall outside the scope of Australia's tax treaties.

78. However, if the non-resident subprovider has a permanent establishment in Australia based on other factors, an interest withholding tax liability will arise unless the non-resident head provider also has a permanent establishment in Australia and satisfies subparagraph 128B(3)(h)(ii) of the ITAA 1936, in which case the payment will be taxed on an assessment basis. The application of a tax treaty would not change these tax outcomes.

79. In a mixed hire-purchase/lease situation, where the non-resident hirer:

- obtains the substantial equipment under a hire-purchase agreement with a non-resident head provider; then
- provides the equipment, under a lease agreement, to an entity that operates it in Australia,

the considerations contained in paragraphs 12 to 14 of this Ruling will apply when determining whether interest withholding tax applies in respect of any part of the payment made to the non-resident head provider.

A 'place' where a person is using substantial equipment

80. Under paragraph (b) of the definition of permanent establishment in subsection 6(1), the permanent establishment is 'a place where the person … is using … substantial equipment'. Accordingly, the permanent establishment under this provision is the physical location of the substantial equipment while it is being used by the lessor during the lease period.

81. For the reasons explained at paragraphs 49 to 56 of this Ruling, the reference to 'a place where the person … is using substantial equipment' in paragraph (b) of the definition of permanent establishment in subsection 6(1) of the ITAA 1936 does not require geographical permanence (or fixedness). Accordingly, the 'place' referred to in paragraph (b) of the definition of permanent establishment in subsection 6(1) of the ITAA 1936 is where the sublessor uses substantial equipment in Australia, regardless of whether that equipment is mobile and is operated under the lease in various locations within Australia.

Carrying on business in Australia at or through that permanent establishment

'Carrying on business'

82. Where a non-resident sublessor of substantial equipment has a permanent establishment under paragraph (b) of the definition of permanent establishment in subsection 6(1) of the ITAA 1936 for the reasons outlined above in this Ruling, the next issue to determine is whether they are carrying on business in Australia at or through that permanent establishment for the purposes of subparagraphs 128B(2)(b)(ii) and 128B(2B)(b)(ii) of the ITAA 1936.

83. Whether a non-resident sublessor is carrying on business is a question of fact and degree to be determined on balance according to the facts and circumstances of each particular case.[27] Factors typically relevant to such a determination are discussed in Taxation Ruling TR 97/11.[28] Based on those factors, the relevant case law[29] and the complexity of the arrangements entered into by commercial lessors of high value equipment, the Commissioner states at paragraph 36 of TR 2007/10 that an enterprise leasing ships or aircraft will almost always be found to be carrying on business.

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[27] In *Ferguson v. Commissioner of Taxation (Cth)* (1979) 26 ALR 307; (1979) 79 ATC 4261 at 471; (1979) 9 ATR 873, at 884; (1979) 37 FLR 310, it was considered that the question of whether a taxpayer's activities should be characterised as a business is primarily a matter of general impression and degree.

[28] See paragraphs 12 to 18 of Taxation Ruling TR 97/11 Income tax: am I carrying on business of primary production?.

[29] See *American Leaf Blending Co. Sdn Bhd v. Director-General of Inland Revenue (Malaysia)* [1978] AC 676; [1978] 3 All ER 1185, at page 1189; *Lilydale Pastoral Co Pty Ltd v. FC of T* (1987) 72 ALR 70 at 77; (1987) 15 FCR 19; 87 ATC 4235; 18 ATR 508; and *Unisys Corporation Inc v. Federal Commissioner of Taxation* (2002) ATC 5146 at 5153 and 5154; 51 ATR 386.

84. The Commissioner considers that the view expressed in TR 2007/10 with respect to leased ships and aircraft is equally applicable to a non-resident sublessor entering into a leasing transaction in respect of any other item of substantial equipment. In particular, the reasoning provided at paragraph 166 of TR 2007/10 is equally applicable to other forms of substantial equipment, as similar to ships and aircraft, substantial equipment leases:

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

85. Accordingly, a non-resident sublessor will almost always be found to be carrying on business by virtue of its leasing of substantial equipment.

Royalty outgoing incurred in 'carrying on business in Australia at or through a permanent establishment in Australia'

86. As previously explained in this Ruling, the permanent establishment under paragraph (b) of the definition of permanent establishment in section 6(1) of the ITAA 1936 is the physical place where the leased substantial equipment is located in Australia while being used pursuant to the lease. Accordingly, for the purposes of subparagraph 128B(2B)(b)(ii) of the ITAA 1936, it is necessary to determine whether the non-resident sublessor is carrying on its leasing business at or through that particular place in Australia where the leased equipment is located.

87. Whether the non-resident sublessor is carrying on a business in Australia at or through that permanent establishment requires an examination of the business activities of the enterprise that relate to the permanent establishment to determine whether they have been undertaken in Australia through that permanent establishment. For the sublessor in the business of leasing and subleasing, the activities of the business will usually involve entering into leasing contracts and other activities concerning the equipment.

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

Royalty withholding tax implications where a non-resident head lessor is a resident of a country with which Australia has a tax treaty

89. If a non-resident head lessor is a resident of a country with which Australia has a tax treaty, the non-resident head lessor needs to consider if it is:

- liable to tax on an assessment basis because a tax treaty deems the royalty payment derived by the head lessor to have an Australian source for the purposes of Australia's domestic tax law provisions (see paragraphs 90 and 91 of this Ruling); and
- not liable for royalty withholding tax because the lease payments are excluded from withholding tax by the operation of subsections 17A(4) or 17A(5) of the Agreements Act (see paragraphs 92 to 97 of this Ruling).

Deemed source of income rules

90. As explained above, no royalty withholding tax liability will arise for a head lessor of equipment under subsection 128B(5A) of the ITAA 1936 where the non-resident sublessor is not carrying on business through its permanent establishment in Australia. However, in such cases, the head lessor may still be liable to tax in Australia on an assessment basis where the royalty has an Australian source for the purposes of subsection 6-5(3) of the ITAA 1997.

91. Such a liability will arise under subsection 6-5(3) of the ITAA 1997 for the head lessor where the following conditions are met:

- the non-resident sublessor is a resident of a tax treaty country that contains a provision corresponding to Article 4(3)(b) of the Singapore Agreement and they are accordingly deemed to have a permanent establishment in Australia;[30]
- the Royalties Article of the relevant tax treaty includes payments for the use of industrial, commercial or scientific equipment (equipment royalties) within the definition of royalties;[31]

[30] See paragraph 17 of TD 2007/31 for a list of the relevant tax treaties with such a provision.
[31] See, for example, Article 12.6(a)(ii) of the tax treaty between Australia and Malaysia (Malaysian Agreement).

- the Royalties Article deems the equipment royalty (being a liability incurred in connection with, and borne by, the non-resident sublessor's deemed permanent establishment in Australia) to 'arise' in Australia and accordingly allocates Australia a right to tax the royalty;[32] and
- due to this Australian taxing right, the Source of Income Article of the relevant tax treaty deems the equipment royalty to have a source in Australia for the purposes of Australia's domestic tax law provisions.[33]

Residents of the United States, the United Kingdom or Norway

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

93. The Australian tax consequences for residents of these countries in relation to the substantial equipment provisions of the respective treaties are explained in TR 2007/10. Further, where a non-resident head lessor already has a permanent establishment in Australia (other than a substantial equipment permanent establishment) and uses that permanent establishment to lease substantial equipment to a non-resident sublessor, then the lease payments would be considered to be effectively connected to a permanent establishment in Australia.

Residents of tax treaty countries other than the US, UK and Norway

94. Under subsection 17A(4) of the Agreements Act, where an amount that would have been subject to paragraphs 1 or 2 of the Royalties Article[34] of a tax treaty is excluded from the scope of the Royalties Article by another provision of the same tax treaty, then section 128B of the ITAA 1936 does not apply to that amount. An amount is excluded from being dealt with by the Royalties Article where the amount is a royalty that is effectively connected to a permanent establishment of a non-resident in Australia.

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[32] See, for example, Article 12.4 and 12.1 respectively of the Malaysian Agreement.
[33] See, for example, Article 22 of the Malaysian Agreement.
[34] Article 12 of Schedule 1 to the Agreements Act.

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

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

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

Appendix 2 – Detailed contents list

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

References

Previous draft:

TD 2007/D12

Related Rulings/Determinations:

TR 97/11; TR 98/21; TR 2002/5; TR 2003/2; TR 2006/10; TR 2007/10; TD 2007/31

Subject references:

- cross border leasing
- double taxation agreements
- hire-purchase agreements
- interest withholding tax
- leasing profits
- permanent establishment
- royalty withholding tax
- Singapore
- substantial equipment

Legislative references:

- ITAA 1936 6(1)
- ITAA 1936 27GA
- ITAA 1936 128A
- ITAA 1936 128AC
- ITAA 1936 128AC(5)
- ITAA 1936 128B
- ITAA 1936 128B(2)
- ITAA 1936 128B(2)(b)(ii)
- ITAA 1936 128B(2A)
- ITAA 1936 128B(2B)
- ITAA 1936 128B(2B)(b)(ii)
- ITAA 1936 128B(2C)
- ITAA 1936 128B(3)(h)(ii)
- ITAA 1936 128B(5)
- ITAA 1936 128B(5A)
- ITAA 1997 6-5(3)
- ITAA 1997 Div 40
- ITAA 1997 Div 240
- ITAA 1997 995-1(1)
- International Tax Agreements Act 1953 17A(4)
- International Tax Agreements Act 1953 17A(5)
- International Tax Agreements Act 1953 Sch 1
- International Tax Agreements Act 1953 Sch 2
- International Tax Agreements Act 1953 Sch 4
- International Tax Agreements Act 1953 Sch 5
- International Tax Agreements Act 1953 Sch 6
- International Tax Agreements Act 1953 Sch 7
- International Tax Agreements Act 1953 Sch 10
- International Tax Agreements Act 1953 Sch 16
- International Tax Agreements Act 1953 Sch 23
- International Tax Agreements Act 1953 Sch 46
- TAA 1953
- TAA 1953 Sch 1 12-245
- TAA 1953 Sch 1 12-250
- TAA 1953 Sch 1 12-280
- TAA 1953 Sch 1 12-285
- Workers Compensation Act 1987 (NSW)

Case references:

- American Leaf Blending Co. Sdn Bhd v. Director-General of Inland Revenue (Malaysia) [1978] AC 676; [1978] 3 All ER 1185
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- McDermott Industries (Aust) Pty Ltd v. Commissioner of Taxation [2005] FCAFC 67; (2005) 219 ALR 346; (2005) 142 FCR 134; (2005) 2005 ATC 4398; (2005) 59 ATR 358
- Unisys Corporation Inc v. Federal Commissioner of Taxation (2002) ATC 5146; 51 ATR 386

Other references:

- Explanatory Memorandum to the Income Tax and Social Services Contribution Assessment Bill (No. 3) 1959
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ATO references

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