

THE ALLOCATION OF TAXING RIGHTS OF SHIP AND AIRCRAFT LEASING PROFITS UNDER AUSTRALIA'S TAX TREATIES

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The Australian Federal Commissioner of Taxation recently released Draft Taxation Ruling TR 2008/D3 with the stated purpose of clarifying 'what profits derived from the leasing of ships or aircraft fall within the ship and aircraft articles of each of Australia's tax treaties'. In particular, TR 2008/D3 explains the taxing rights over different types of leasing profits, such as a full basis lease in respect of any transport by a ship operated in international traffic and bareboat leases which are ancillary to the lessor transport operations of ships in international traffic. This article outlines the Commissioner's views on the application of the standard ships and aircraft articles in the tax treaties to which it is a party as well as considering the major variations on the standard adoption. In doing so, guidance is provided as to the allocation of taxing rights of ship and aircraft leasing profits under Australia's tax treaties.

1 Introduction

The taxation consequences of international transactions have always been complex. International shipping is no exception.¹ To this extent, the taxation treatment of leasing profits within the maritime industry has been considered recently, both by the Court and by the Federal Commissioner of Taxation (the Commissioner). In particular, in 2005 the Full Federal Court handed down its decision in *McDermott Industries (Aust) Pty Ltd v Commissioner of Taxation*.² In this case the question arose as to whether a fiscal non-resident had a deemed permanent establishment in Australia under the Singapore-Australia double tax treaty, thereby giving the taxing rights to Australia. Subsequent to, but independent of, *McDermott Industries*, the Commissioner released *Taxation Ruling TR 2007/10*.³ This Ruling deals with 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 treaties. Both the Federal Court decision and the opinion of the Commissioner offer insight into how the Australian taxation regime applies to particular aspects of the maritime industry and have added some certainty to the taxation of international shipping profits.⁴ However, until recently there has been no general statement as to the taxation treatment of ship and aircraft leasing profits under the ships and aircraft articles which are generally contained in all of Australia's international tax treaties.

Given the fiscal significance of ship and aircraft profits, both to the Federal Government and individual taxpayers, it is important that the application of the Australian income tax law be clarified. To this extent, the Commissioner has addressed the uncertainty by releasing a draft Taxation Ruling. Earlier this year the Commissioner released *Draft Taxation Ruling TR 2008/D3 (TR 2008/D3)* entitled 'Income Tax: the taxation treatment of ship and aircraft leasing profits under the ships and aircraft articles of Australia's tax treaties'. The aim of *TR 2008/D3* is to clarify the scope of the ships and aircraft articles of the tax treaties to which Australia is a party. Specifically, it sets out the Commissioner's views on which profits derived from the leasing of ships or aircraft fall within the relevant ships and aircraft profits provisions. *TR 2008/D3* also considers the circumstances under which Australia has the exclusive right to tax the profits and the method of assessment of those profits under the relevant *Income Tax Assessment Acts*. While the draft taxation ruling is primarily

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¹ While the specific provisions of Australia's international tax agreements focus on shipping and aircraft, this article primarily considers the application to the maritime industry.

² *McDermott Industries (Aust) Pty Ltd v Commissioner of Taxation* (2005) 142 FCR 134.

³ *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 tax Treaties.

⁴ Secondary literature provides an interpretation on these primary sources. See for example: Brabazon, M, 'International Taxation of Cross-Border Equipment Leasing', (2006) 35 *Australian Tax Review*, 127 at 131; Burton, M, 'The Meaning of 'Permanent Establishment' in *McDermott Industries Case*', *CCH Tax Week*, Issue 21, 9 June 2005; AUTHOR, 2007.

concerned with leasing profits, it also considers the more general application of the ships and aircraft article by briefly discussing non-leasing profits.⁵

2 The Current 'International' Tax Regime

Prior to a consideration of *TR 2008/D3*, it is necessary to appreciate the general operation of Australia's 'international' tax regime. The overarching principle embodied in international tax is that each jurisdiction imposes taxes according to domestic law. Therefore, when considering the tax consequences of international, or more appropriately cross-border, transactions it is a misnomer to refer to an 'international' tax regime, as put simply one does not exist. Rather, each jurisdiction has domestic legislation imposing the right to tax certain income. This domestic law is then supplemented by international tax treaties which may alter the domestic taxing rights to either prevent or enable the relevant jurisdictions the right to tax income because of certain events. These taxation laws apply to relevant taxpayers through the two broad principles of residence and source. Generally, a resident taxpayer is assessable on worldwide income, while a foreign resident is assessable on income sourced within the jurisdiction.

The application of the two principles of residence and source can lead to conflict for taxpayers entering into international or cross-border transactions, with a result for the taxpayer of double taxation. That is, the taxpayer is liable for tax on the same income in more than one jurisdiction. Therefore, the issue then becomes a question of allocating the taxing rights between the relevant domestic jurisdictions. The question then being asked is: who has the taxing rights where there is a resident taxpayer with foreign source income? For the purposes of ship and aircraft profits, the answer is often found in the double tax treaties, or agreements, to which Australia is a party. To date, Australia has negotiated 42 double tax treaties with other nations,⁶ including many trading partners. This means that the application of the ships and aircraft articles to profits derived by taxpayers often provides for the allocation of those profits and, therefore, is fiscally significant.

3 The Force and Effect of Double Tax Treaties for Ships and Aircraft

The double tax treaties mentioned operate by overriding Australia's domestic taxation regime contained in the *Income Tax Assessment Act 1936* (Cth) and *Income Tax Assessment Act 1997* (Cth). These Acts are incorporated into the *International Tax Agreements Act 1953* (Cth), with the consequence that this latter Act, along with Australia's international tax treaties which are Schedules to that Act, take priority. For the purposes of ships and aircraft, each of the double tax treaties contains an article which specifically provides for the distribution of taxing rights between the Contracting States.

Treaties are negotiated and concluded bilaterally, with the consequence that the wording of the ships and aircraft article will vary from treaty to treaty. However, Australia's double tax treaties are generally based on the *OECD Model Tax Convention on Income and on Capital*⁷. The standard ships and aircraft article provides for the exclusive taxing rights of profits from the operation of ships and aircraft in international traffic to the State of residence, or more specifically, the place of effective management of the enterprise. While Australia bases its treaty provisions on this general principle, it is subject to one major reservation. Australia has traditionally reserved the right to preserve the source jurisdiction taxing rights over profits derived from operations which are internal. Further, Australia treats operations of ships and aircraft as being internal even when they are part of an international voyage. This extension of the article, while not part of the *OECD Model Tax Convention on Income and on Capital* (*OECD Model Tax Convention*), is recognised in the commentary to that Convention. Specifically, the commentary states:

Australia reserves the right to tax profits from the carriage of passengers or cargo taken on board at one place in Australia for discharge in Australia. Australia also reserves the right to tax profits from other coastal and continental shelf activities.⁸

⁵ *Draft Taxation Ruling TR2008/D3*, paragraph 7.

⁶ UK, USA, Canada, New Zealand, Singapore, Japan, Germany, Netherlands, France, Belgium, Philippines, Switzerland, Malaysia, Sweden, Denmark, Ireland, Italy, Korea, Norway, Malta, Finland, China, Austria, Papua New Guinea, Thailand, Sri Lanka, Fiji, Hungary, Kiribati, India, Poland, Indonesia, Vietnam, Spain, Czech Republic, Taipei, South Africa, Slovakia, Argentina, Romania, Russia, and Mexico.

⁷ The first Model Tax Convention was issued in 1963 with periodical updates since. The OECD adopts the approach of an ambulatory Model Tax Convention.

⁸ Commentary to the *OECD Model Tax Convention on Income and on Capital*, Article 8, paragraph 38.

Given this major variation, rather than being able to interpret the standard OECD article entitled 'Shipping, Inland Waterways Transport and Air Transport', it is necessary to specifically consider the articles contained in Australia's double tax treaties. The most recently negotiated Australian tax treaties generally adopt an approach containing a provision effecting the reservation. The following provision in relation to ships and aircraft provides a standard illustration of the wording:⁹

ARTICLE 8

Ships and Aircraft

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

While the Australian version of the article provides for the distribution of taxing rights between the Contracting States, it does not provide any commentary for the purposes of interpretation. Given that Australia's double tax treaties generally extend the OECD Model Tax Convention to include the reservation, it then becomes difficult to rely on the generic commentary attached to the OECD Model Tax Convention. Therefore, it is necessary for relevant domestic taxing authorities to provide an interpretation where the application is not clear. In Australia this is achieved via a taxation ruling regime which allows the Commissioner to provide written binding advice on the way in which, in the Commissioner's opinion, a particular aspect of the tax regime applies to relevant taxpayers.¹⁰ The ruling regime then affords taxpayers the certainty that is often lacking.

The aim of *TR 2008/D3* is to provide certainty to taxpayers who derive profits from the leasing of ships or aircraft that are then subject to the ships and aircraft article of the double tax treaties. The category of taxpayers to which it applies is broad as it is relevant for Australian treaty residents and treaty partner residents, that is, residents of Australia for the purposes of tax treaties as well as residents of countries which has a tax treaty with Australia. It will then apply to those treaty residents who 'engage in the operation of ships or aircraft; and derive profits from leasing out ships or aircraft'.¹¹

TR2008/D3 is not the first time the Commissioner has considered the tax implications of the shipping and aircraft industries. However, it is the first to deal specifically with the ships and aircraft article. While outside the scope of the current discussion, it is worth noting that to date there have been three separate rulings issued which may also be applicable to taxpayers engaged in the shipping industry, with the first two specifically dealing with shipping, and the third considering both shipping and aircraft.

Taxation Ruling TR2003/2 Income Tax: the royalty withholding tax implications of ship chartering arrangements considers the liability to royalty withholding tax arising under the *Income Tax Assessment Act 1936* and whether a payment under a charterparty constitutes a 'royalty' being a payment for the 'use of, or the

⁹ *Draft Taxation Ruling TR2008/D3*, paragraph 12. 'International traffic' is defined in Article 3 as 'any transport by a ship or aircraft operated by an enterprise of a Contracting State, except where the ship or aircraft is operated solely between places in the other contracting state.

¹⁰ *Taxation Ruling TR 2006/10*: income tax, fringe benefits tax and product grants and benefits: public rulings.

¹¹ *Draft Taxation Ruling TR2008/D3*, paragraph 4.

right to use' equipment.¹² *Taxation Ruling TR2006/1 Income Tax: the scope and nature of payments falling within section 129 of the Income Tax Assessment Act 1936* considers the domestic law tax implications of 'payments made under arrangements relating to the carriage of passengers, livestock, mails or goods by sea internationally as well as for "coasting trade"'.¹³ The third taxation ruling to consider similar issues is *Taxation Ruling TR2007/10 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*. As previously stated, while all of the earlier Taxation Rulings deal with the taxation implications of the shipping industry, none specifically consider the taxation implications under the ships and aircraft article of the tax treaties to which Australia is a party.

The focus of the taxation rulings mentioned above, along with any decisions have tended to focus on articles of the double tax treaties other than the ships and aircraft article, or alternatively, have considered the interaction between various articles. For example, *Taxation Ruling TR2007/10* considers the business profits article which allocates profits to the source jurisdiction where there is a permanent establishment within that jurisdiction. However, the current draft taxation ruling, *TR2008/D3* is the first specifically aimed at the scope and operation of the ships and aircraft article. To this extent, it does not consider any interaction and specifically states that 'it is not necessary to consider whether an enterprise had a permanent establishment in Australia as the business profits article does not apply to the profits'.¹⁴ The reason for this is that, where the profits from ships and aircraft fall under the specific article, the business profits article provides a priority rule giving way to the specific article. The Commissioner also gives priority to the ships and aircraft article over the royalties article¹⁵ unless there are clear words to the contrary.¹⁶

4 Interpreting the Standard Ships and Aircraft Article

The object of the ships and aircraft article is to ensure that profits from operations in international traffic will be taxed in one State alone.¹⁷ The overarching taxation principles applied in this article consist of paragraph 1, which provides a residency rule, and paragraph 2, which provides an overriding source rule. Paragraph 1 of the Article allows for an exclusive residence country taxing right where profits are derived from international traffic.¹⁸ 'International traffic' is defined as 'any transport by a ship or aircraft operated by an enterprise of a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State'.¹⁹ Qualifying this taxing right is paragraph 2, which provides that where the profits are derived from operations between places solely between places in the non-residence (source) State, the taxing rights vest in that source State.

4.1 Exclusive Resident Country Taxing Rights

Consistent with previous taxation rulings the Commissioner considers the application of the ships and aircraft article to both bareboat leases and leases on a full basis. In doing so, the Commissioner states that first paragraph of the article, with its exclusive residency taxing rights, also allows the residence country to tax the profits derived by the lessor of the ship or aircraft where the lease is on a full basis²⁰ and used by the lessee in international traffic.²¹ However, the Commissioner treats a 'bareboat lease'²² of a ship or aircraft differently.

¹² *Taxation Ruling TR2003/2*, paragraphs 4-5.

¹³ *Taxation Ruling TR2006/1*, paragraph 2.

¹⁴ *Draft Taxation Ruling TR2008/D3*, paragraph 52.

¹⁵ The profits may fall within the scope of the royalties article as a payment of an 'industrial, commercial or scientific equipment royalty'.

¹⁶ *Draft Taxation Ruling TR2008/D3*, paragraph 53.

¹⁷ OECD, *Model Tax Convention on Income and on Capital*, 2008 Edition, Commentary on Article 8, 139.

¹⁸ *Draft Taxation Ruling TR2008/D3*, paragraph 20.

¹⁹ *Draft Taxation Ruling TR2008/D3*, paragraph 96.

²⁰ For taxation purposes, a 'full basis' lease is defined in *Taxation Ruling TR2007/10* as follows:

'A full basis lease involves a situation where a lessee wishes to have a ship or an aircraft for its use for a given period of time, but has no wish to operate the ship or aircraft itself. The owner of the ship or aircraft provides the captain, crew (who remain its servants) and equipment and the owner is responsible for the technical operation and navigation of the ship or aircraft. The lessee pays hire to the owner in order to have the ship or aircraft at its disposal for the specified period of time. The lessee therefore obtains the right to commercially exploit the carrying capacity of the ship or aircraft for its own purposes.'

²¹ *Draft Taxation Ruling TR2008/D3*, paragraph 22.

²² For taxation purposes, a 'bareboat lease' is defined in *Taxation Ruling TR2007/10* as follows:

'A bareboat lease involves a situation where a lessee wishes to take a ship or an aircraft and to treat it as its own for a certain period of time. The ship or aircraft will usually, but not invariably, be leased without captain and crew. The practical effect,

The profits from these leases will not be taxable by the residence country under paragraph 1 unless they are ancillary to the ship or aircraft operations of the lessor in international traffic.²³ The Commissioner states that the rationale for this is that the lessor under a bareboat lease is not operating the ship or aircraft and therefore does not fall within paragraph 1.²⁴ For taxation purposes, a bareboat leasing activity will be ancillary where it does not make more than a minor contribution to the lessor's overall transport operations and does not amount to a separate source of income or separate business operation.²⁵ For example, where a resident of Australia occasionally leases its ships on a bareboat basis, but primarily runs its own international shipping operation or leases ships on a full basis, the profits from the bareboat leases will be considered ancillary to the overall activities of the lessor and Australia, as the country of residence, will be allocated the exclusive taxing rights over the profits of its resident.

4.2 Exclusive Source Country Taxing Rights

While paragraph 1 provides an exclusive taxing right to the residence country, paragraph 2 overrides that exclusive right by providing the 'source country with taxing rights over profits from the operation of ships or aircraft to the extent that the profits are derived from operations that are 'confined solely to places in that other State'.²⁶ To this extent, paragraph 2 is given priority over paragraph 1. The Commissioner adopts a broad approach to the application of paragraph 2 stating that it applies to both transport and non-transport profits (unlike paragraph 1 which only applies to transport profits), including voyages that start and end at the same port or in two different ports, even if part of that transport takes place outside the other State.²⁷ He also includes the internal leg of an international voyage where it involves the same passengers or cargo being loaded and unloaded in that State.²⁸ Profits from ancillary activities will also be taxable by the source State under paragraph 2 on the basis that they make a minor contribution and should not be regarded as a separate business or source of income.²⁹ However, it is provided that the activity or activities undertaken must be sufficient to constitute a distinct operation that is identifiable from other operations of the enterprise.³⁰

Because paragraph 2 of Australia's ships and aircraft article is not a standard paragraph the Commissioner has provided detailed explanation of its interpretation in *TR 2008/D3*. First and foremost is a consideration of what is meant by 'operations confined solely to places in that other state'. For the purposes of determining whether paragraph 2 applies, the relevant activities are those which involve the physical operation of the ship rather than any administrative activities such as contract negotiation or ongoing management.³¹ Further, the activities undertaken in the 'other state' must constitute distinct operations which can be separately identifiable.³²

Paragraph 2 must also be read in light of paragraph 4, which at the very least clarifies the profits covered in the former paragraph, but potentially expands the scope. Paragraph 4 provides that profits derived from the carriage of passengers, livestock, mail, goods or merchandise, where they are shipped and discharged within the one State shall be treated as profits from operations confined solely to places in that State. Further, where there is an Australian leg of an international voyage and passengers or cargo embark and disembark in the one State, that State will have a taxing right over those profits derived from the activities within the Source State.³³

In addition to its application to transport operations, paragraph 2 also applies to non-transport operations. The Commissioner provides that 'whether or not activities undertaken in the other State constitute an operation in that State will depend on the type of non-transport operation and nature and extent of the particular activities being undertaken. Provided the activities consist of an active process, activity, performance and discharge of function in their own right, they would constitute an 'operation'.³⁴ The Commissioner qualifies this broad

however, is the same whether the ship is actually leased with or without captain and crew because in both situations the lessee obtains control of the captain and crew under the lease (that is they are the servants of the lessee, not the owner). The owner of the ship or aircraft also transfers the possession and navigation of the ship or aircraft to the lessee.'

²³ *Draft Taxation Ruling TR2008/D3*, paragraph 23.

²⁴ *Draft Taxation Ruling TR2008/D3*, paragraph 102.

²⁵ *Draft Taxation Ruling TR2008/D3*, paragraph 24.

²⁶ *Draft Taxation Ruling TR2008/D3*, paragraph 26.

²⁷ *Draft Taxation Ruling TR2008/D3*, paragraph 27.

²⁸ *Draft Taxation Ruling TR2008/D3*, paragraph 27.

²⁹ *Draft Taxation Ruling TR2008/D3*, paragraph 31.

³⁰ *Draft Taxation Ruling TR2008/D3*, paragraph 29.

³¹ *Draft Taxation Ruling TR2008/D3*, paragraph 115.

³² *Draft Taxation Ruling TR2008/D3*, paragraph 117.

³³ *Draft Taxation Ruling TR2008/D3*, paragraph 121.

³⁴ *Draft Taxation Ruling TR2008/D3*, paragraph 125.

interpretation by providing that ‘this does not mean that any ship or aircraft activity, or group of activities will constitute ship or aircraft operations in their own right. The activity or activities undertaken in the other Contracting State must be sufficient to constitute a distinct ship or aircraft operation that is identifiable separately from other ship or aircraft operations.’³⁵

It may be the case that a ship departs from a location within a State and returns to the same or another location within the same State but travels outside domestic waters. Where this occurs, that is, there is a ‘voyage to nowhere’, the question arises as to whether profits derived from those activities fall within the scope of paragraph 2. The Commissioner adopts the view that provided the operations do not involve the ship stopping at a port outside the State, entering international waters will not preclude the application of paragraph 2. Therefore, profits derived from ‘voyages to nowhere’ are taxed solely in the source State.

While paragraph 4 potentially expands the scope of profits which are considered to be derived from the operations of ships confined solely to places in the source state, it does not apply to leasing arrangements. This is because leasing profits are not profits derived from ‘the carriage of passengers or cargo, rather they are profits that the lessor derives from the provision of services under the lease that facilitate the carriage...’³⁶ However, paragraph 2 will apply where, as a stand alone provision, the shipping activities of the lessor are ‘sufficient to constitute an identifiable and separate operation in that State.’³⁷

Profits derived from bareboat leases may also be subject to exclusive source State taxation where, similar to the approach adopted to paragraph 1, the leasing of a ship on a bareboat basis is merely ancillary to operations which fall within paragraph 2. This will be the case no matter where the lessee uses the ship.³⁸

5 Variations on the Standard Ships and Aircraft Article

The above discussion focuses on the Commissioner’s interpretation of Australia’s standard ships and aircraft article. However, several double tax treaties to which Australia contain non-standard articles.

5.1 Variations on Paragraph 1

The first variation of note is contained in several of Australia’s agreements. Australia’s treaties with the Philippines, Japan and Germany provide a reciprocal exemption from, or limitation of the source country taxing right over profits derived from certain shipping activities. The effect of this variation is, in practice, of little significance as it has the same effect as providing the exclusive taxing right to the country of residence. Therefore, the variation is in the wording only. By way of example, the Japan-Australia agreement provides:

A resident of one of the Contracting States shall be exempt from tax in the other Contracting State on profits from the operation of ships or aircraft other than operations confined solely to places in that other Contracting State.

The second variation of note is the broader scope of paragraph 1 in more than half of Australia’s international tax agreements.³⁹ In these agreements, paragraph 1 does not limit the exclusive residence country taxing rights to profits derived from ‘international traffic’. The effect of omission is to broaden the application of paragraph 1 to cover both transport and non-transport profits, thereby including leasing profits that are not only derived from transport operations but also non-transport operations.⁴⁰

In addition to the above variations contained in numerous agreements, there are three specific agreements of note. First, the United States Convention provides specific restrictions on the exclusive residence country taxing rights over leasing activity profits.⁴¹ Secondly, the Taipei agreement applies to both transport and non-transport

³⁵ *Draft Taxation Ruling TR2008/D3*, paragraph 126.

³⁶ *Draft Taxation Ruling TR2008/D3*, paragraph 137.

³⁷ *Draft Taxation Ruling TR2008/D3*, paragraph 138.

³⁸ *Draft Taxation Ruling TR2008/D3*, paragraphs 143-144.

³⁹ Canada, New Zealand, Singapore, France, Italy, The Netherlands, Belgium, Switzerland, Malaysia, Sweden, Denmark, Ireland, Korea, Norway, Malta, Austria, Papua New Guinea, China, Thailand, Sri Lanka, Fiji, Hungary, Kiribati, India, Indonesia, Vietnam, Spain, The Czech republic, Slovakia, Russia, Argentina, Romania and Mexico.

⁴⁰ *Draft Taxation Ruling TR2008/D3*, paragraphs 151-152.

⁴¹ *Draft Taxation Ruling TR2008/D3*, paragraph 159.

operations.⁴² However, it then provides that before there is exclusive residence taxing rights, the lease must be merely incidental to the international operations of the lessor and the lessee operates ships in international waters.⁴³ The third specific agreement of note is the South African agreement which provides that in the case of bareboat leasing profits, in addition to the requirement that the lease be merely incidental to the international operations of the lessor, the lessee must operate in international traffic for the residence country to have exclusive taxing rights.⁴⁴

5.2 Variations on Paragraph 2

It will be remembered that paragraph 2 provides for an exclusive source country taxing right where profits are derived solely from internal voyages in the source country. However, Australia's agreements with the US, Japan and Korea vary from this provision by either failing to include the equivalent paragraph at all, or restricting the source State taxation rights to profits derived from carriage.⁴⁵ Where one of these treaties applies, leasing profits derived from operations solely within the source State will not be dealt with under the ships and aircraft article, but rather the business profits article or the royalties article will need to be considered.⁴⁶

There are also some agreements to which Australia is a party which limit the rate of tax that the source State can apply. A maximum of 5 per cent of the payment 'in respect of carriage'⁴⁷ is allowed in the French, Finish, Swiss, Belgian, Dutch and German agreements.⁴⁸ While these agreements limit the amount of tax assessed by the source State, the Kiribati, Sri Lankan and Thai agreements extend the source State's right to tax beyond operations confined solely in that State to 'half the profits from the operation of ships other than confined solely to places in that State'.⁴⁹

In addition to the above major variations, the South African and Taipei agreement need to be considered because of the flow-on effect of major variation to paragraph 1. First, the Commissioner provides that variation in paragraph 1 of the South African agreement will not limit the application of paragraph 2 to incidental bareboat leases.⁵⁰ Secondly, the Commissioner provides that requirement in the Taipei agreement that the lease of a ship by a lessor must also be used in international waters by the lessee does not limit the operation of paragraph 2 in that agreement.⁵¹

6 Method of Assessment

Where the profits of a lease are taxable in Australia, whether those profits are derived by an Australian treaty resident or a treaty partner resident, those profits are taxed under the ordinary provisions of the *Income Tax Assessment Act 1997*. 'Profits' under an international treaty will be given the same meaning as 'taxable income' for the purposes of Australian domestic legislation.⁵² This means that the profits are taxed on a net assessment basis. That is, the leasing profits are assessed after taking into account outgoings incurred in gaining or producing those profits.

However, in certain circumstances the ordinary income provisions may be overridden by s129 of the *Income Tax assessment Act (Cth) 1936*. This section provides:

Where a ship belonging to or chartered by a person whose principal place of business is out of Australia carries passengers, livestock, mails or goods shipped in Australia, 5% of the

⁴² *Draft Taxation Ruling TR2008/D3*, paragraph 163.

⁴³ *Draft Taxation Ruling TR2008/D3*, paragraph 39.

⁴⁴ *Draft Taxation Ruling TR2008/D3*, paragraph 38.

⁴⁵ *Draft Taxation Ruling TR2008/D3*, paragraph 41.

⁴⁶ *Draft Taxation Ruling TR2008/D3*, paragraph 43.

⁴⁷ This restriction will only apply to certain full basis leasing profits.

⁴⁸ *Draft Taxation Ruling TR2008/D3*, paragraph 46.

⁴⁹ *Draft Taxation Ruling TR2008/D3*, paragraph 51.

⁵⁰ *Draft Taxation Ruling TR2008/D3*, paragraph 44.

⁵¹ *Draft Taxation Ruling TR2008/D3*, paragraph 45.

⁵² Section 3(2) of the *International Tax Agreements Act 1953* provides that 'For the purposes of this Act and the Assessment Act, a reference in an agreement to profits of an activity or business shall, in relation to Australian tax, be read, where the context so permits, as a reference to taxable income derived from that activity or business'.

amount paid or payable to him in respect of such carriage, whether that amount is payable in or out of Australia, shall be deemed to be taxable income derived by him in Australia.

Section 129 may apply to profits derived by a lessor with a place of business outside Australia where that lessor leases a ship on a full basis.⁵³ The effect of this provision is to deem the taxable income to be 5 per cent of the amount paid or payable in respect of the carriage. As such, where this section applies, there is no requirement to calculate taxable income or deductions and no deduction is allowable against the 5 per cent for any expenditure incurred in producing income.⁵⁴

7 Conclusion

The ease of applying the ships and aircraft articles of Australia's international tax agreements is not apparent. Rather, this is a complex and often unclear area of international taxation law. However, the Commissioner, by releasing *TR2008/D3*, goes some way in clarifying these difficult provisions by outlining his interpretation of the relevant standard articles along with the different variations. As stated, the aim of the draft Ruling is to clarify 'what profits derived from the leasing of ships or aircraft fall within the ships and aircraft article of each of Australia's tax treaties'.⁵⁵ Rulings must always be read with caution, as they are merely the Commissioner's interpretation of the law, and not the law itself. However, if the aim of the draft taxation ruling is to provide clarification, appears that *TR 2008/D3* achieves this in many circumstances.

⁵³ *Taxation Ruling TR2006/1 Income Tax: the scope and nature of payments falling within section 129 of the Income Tax Assessment Act 1936* specifically considers the application of s29 ITAA36.

⁵⁴ *Union Steamship Co of NZ v FC of T* (1924) 35 CLR 209.

⁵⁵ *Draft Taxation Ruling TR2008/D3*, paragraph 1.