

A SUMMARY OF HOW PARTNERSHIPS ARE TAXED

IN TERMS OF INTERNATIONAL LAW AND CONVENTION: AN ENTITY OR TRANSPARENT FOR TAX PURPOSES?

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Differences that affect the tax treatment of partnerships

The OECD states in the work entitled: 'Model Tax Convention on Income and On Capital, Volume 1 Taxation, Section II.2, Differences that affect the tax treatment of partnerships' that most member countries "recognise the concepts of company and of partnership for tax purposes", although the definitions of the two concepts demonstrate some variation. According to the OECD, the similarities between the legal systems in most cases of the member countries are sufficient "to ensure that what is a company or a partnership in the country where it has been established is recognised as such, for tax purposes in other countries." It is noted that problems will present "where two countries classify a given entity in the same way but treat that entity in different ways." Stated to be a difficulty that is well-known is that "while some countries treat partnerships as transparent entities, imposing no tax on the partnership itself but taxing each partner on its share of the partnership's income, others treat the partnership as a taxable unit or entity, usually taxing the partnership on its income as if it were a company."

Taxation of partnerships

A partnership is entitled to the benefits of a tax convention "where income is derived from a particular state, the determination of the tax consequences in that state will require the application of the domestic tax laws of that state, and the provisions contained in the tax conventions can be used as an intervention in restricting or eliminating the taxing rights that originate in domestic law", provided that as persons, the partnerships qualify as residents of the state. Article 1 of the Model Tax Convention provides that persons who are residents of the contracting states are entitled to receive the benefits of the tax convention entered into by these states. Partnerships may be persons, but not all partnerships qualify as residents of the state.

The OECD relates that in a state that treats the partnership "as fiscally transparent ... the partnership is not liable for tax in that state and therefore is not a resident of that state for convention purposes". Unless, of course, a special rule covering partnerships exists in the convention. Contrast this with a partnership that is treated as a unit or entity by a state, either in terms of its civil or commercial law, or in the case of the USA, by virtue of an election made by the taxpayer.

However, where the benefits of a convention are refused to the partnership, the partners should be entitled, with respect to their share of the income of the partnership to the benefits provided by the conventions entered into by the states of which they are residents. The two common approaches to taxation of partnerships examined by the OECD are as follows:

- In many countries, the tax laws provide that income derived by a partnership from a particular source must be computed at the partnership level as if the partnership were a distinct taxpayer. Each partner is then allocated his share of that income which retains its character and is added to his income for purposes of determining his taxable income. His taxable income, including his share of the partnership's income is then reduced by the personal allowances and deductions to which he is entitled and tax is then determined, assessed and paid at the partner's level. In such cases, it is clear that the partnership is not itself liable to tax.
- In other countries, the income and the tax payable is computed in a similar way, but the tax payable by the partners is then aggregated at the level of the partnership which is then assessed for the total amount of the tax.

If the partnership has been established in accordance with the law of a state, as a unit or entity, then the partnership is usually "deemed to be a resident of a contracting state" if in accordance with domestic tax law that deems incorporated entities as resident by virtue of their incorporation. In the event that the partnership "does not qualify as a resident under the principles..." as stated, it has been agreed upon by the OECD committee that "the partners should be entitled to the benefits provided by the conventions entered into by the countries of which they are residents

to the extent that they are liable to tax on their share of the partnership income in those countries".

Partnerships involving three states

According to the OECD Model Tax Convention on Income and on Capital, partnership cases that involve three states "pose difficult problems with respect to the determination of entitlement to benefits under conventions". Where a partner is a resident of one state, "the partnership is established in another state and the partner shares in partnership income arising in a third state then the partner may claim the benefits of the convention between his state of residence and the state of the source of the income to the extent that the partnership's income is allocated to him for the purposes of taxation in his state of residence".

Furthermore, if the partnership is also taxed as a resident of the state in which the partnership is established "the partnership may itself claim the benefits of the convention between the state in which it is established and the state of source". In cases such as this or a case of 'double benefits', the state of source "... may not impose taxation which is inconsistent with the terms of either applicable convention, therefore, where different rates are provided for in the two conventions, the lower will be applied".

It is stated by the OECD that contracting states "may wish to consider special provisions to deal with the administration of benefits under conventions in situations such as these, so that the partnership may claim benefits, but that partners could not present concurrent claims" (OECD, 2000). These provisions would ensure the "appropriate and simplified administration of the giving of benefits".

The OECD states that no benefits will be available under the convention between the state "in which the partnership is established and the state of source if the partnership is regarded as transparent for tax

purposes by the state in which it was established" because the partnership is not a resident for purposes of the convention (unless a special provision to the contrary exists).

If for tax purposes the partnership is regarded as transparent by the state in which the partnership is established and if the income of the partnership "is not allocated to the partner under the taxation law of the state of residence of the partner, the state of source may tax partnership income allocable to the partner without restriction".

The application of the fiscally transparent approach creates difficulties in applying tax conventions. In the situation where a partnership is not a resident of a contracting state since the partnership is not liable for tax, and the partners are liable for tax in their state of residence on their share of the income of the partnership, expectations are that the state will apply the provisions of the convention "as if the partners had earned the income directly so that the classification of the income for purpose of the allocative rules of Articles 6 to 21 will not be modified by the fact that the income flows-through the partnership".

Types of transparency

There are stated in the work of Baker (2002) to be four types of transparency: (1) complete transparency; (2) transparency with reporting obligations; (3) optional transparency; and (4) partial transparency. Baker states that in the case of complete transparency and optional transparency that it is likely that there would not be a liability for taxation of the entity. However, when partial transparency is elected these entities would be liable to tax "on the income on which the entity is liable to tax".

Baker reports that the United States is one of the countries, of which there are only a few, that has adopted a provision "in its model tax treaty and domes-

tic legislation dealing with the application of double tax conventions to hybrid entities" in what is broadly the adoption of a "flow-through" approach and which is stated in Article 4(1)(d) of the US Model (1996) as follows: "An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either contracting state shall be considered to be derived by a resident of a state to the extent that the item is treated for the purposes of the taxation law of such contracting state as the income, profit or gain of a resident."

Summary

This work has reviewed the international tax treatment of partnerships under international conventions where the partnership is either regarded as being transparent or an entity for tax purposes.

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