EDITOR

FLORIAN HAASE

TAXATION OF INTERNATIONAL PARTNERSHIPS 2ND EDITION

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Taxation of International Partnerships - 2nd edition

Why this book?
The taxation of partnerships in an international context is undoubtedly one of the most complex areas of (international) tax law. It is also of great importance from a practical point of view. This is particularly due to two conflicting principles: Some countries treat partnerships as taxable entities, while others treat them as opaque or transparent and only see the partners as taxpayers for tax purposes. This difference in approach can lead to double taxation as well as double non-taxation. In addition, specific problems can arise in the case of triangular situations.

The tax treatment of partnerships is so difficult and so important from both a practical and academic/theoretical point of view that, in 1999, the OECD published an extensive report on this subject, the so-called "OECD Partnership Report". This document set forth in great detail the view of the OECD with respect to the taxation of international partnerships from the perspective of the state of source as well as the state of residence. The Report contained some general remarks on the taxation of partnerships but was mainly built on examples of specific cases and their tax treatment.

In 2024, the OECD Partnership Report celebrated its 25th anniversary. Consequently, it is time again to investigate if and how the ideas of the OECD have been adopted and – in light of BEPS and the discussion on hybrids in particular – further developed by various jurisdictions, just as the 1st edition of this book did 10 years ago. As in that 1st edition, this book aims first to give a short introduction on the taxation of international partnerships in individual jurisdictions and then, second, to answer the problems posed in the examples in the Partnership Report from each jurisdiction's perspective and in light of new developments. To get the full picture, the jurisdictions covered include the economically most important EU Member States and other European countries like Switzerland and the United Kingdom, as well as Australia, Brazil, Canada, China and the United States.

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Taxation of International Partnerships
2nd Edition

25 Years OECD Partnership Report: Past, Present and Future

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Table of Contents

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Part One

Taxation of International Partnerships

Chapter 1

Introduction

Florian Haase

1.1. An overview and brief history

The history of legal forms of partnerships is undoubtedly a success story. In many jurisdictions, partnerships nowadays play a vital economic role. In some major countries, like Germany for instance, there are even more partnerships than any other legal form. Recent surveys have shown that around 80% of all registered German companies still bear the legal form of a partnership. Often, but not necessarily, this has historic reasons because the concept of partnerships is usually much older than, for example, limited liability companies. This is particularly true for countries whose economic success is based on trade and merchants. In Germany, for instance, the first partnerships were known as early as 1300, whereas the other "international bestseller" – the German limited liability company (GmbH) – was first established in 1892, when the Law Governing Limited Liability Companies (GmbHG) passed parliament.

However, in many countries today, partnerships as well as corporations are highly technical and very elaborate legal forms. As a rule of thumb, one could not say that – in terms of market acceptance – corporations are still less efficient or less successful than partnerships, although there are still some countries in which partnerships are simply not very widely used, particularly in Eastern Europe, Asia or Arabian countries. There are also countries that are just about to open partnerships for foreign partners, as India has done in the course of the past years.

By the same token, however, it is also a fact that in many countries partnerships are a lot more flexible than corporations from a legal point of view. The law that governs corporations is usually much stricter and more rigid, and the shareholders of a corporation cannot necessarily agree on what they like. Moreover, experience shows that, in some industries, the legal form of a partnership goes along with a great deal of trust in the owners of the partnership, which results in particular from the unlimited personal liability of the partners that is innate to the traditional unlimited partnerships; the limited partnership that is used today even more often is a comparatively young legal form. Be that as it may, many people think that truly honourable merchants should use their personal funds and monies in case their company is likely to file for insolvency proceedings, and it is therefore small wonder that in some very traditional industries (e.g. private banks, merchant or maritime sectors), the unlimited liability partnership still seems to be the preferred legal form.

A further reason for the success of partnerships may also be seen in their legal variety. In many countries, there are more legal forms of partnerships to choose from than with respect to their corporate counterparts. There are usually unlimited partnerships, limited partnerships, limited liability partnerships, general partnerships, partnerships at will, silent or dormant partnerships, etc., not to mention – on a European level – the European Economic Interest Grouping (EEIG). The EEIG was introduced in 1985 through the Council Regulation (EEC) No 2137/85 of 25 July 1985 on the European Economic Interest Grouping, the objective of which was to create a new legal entity based on European law to facilitate and encourage cross-border cooperation. The EEIG, however, is treated for tax purposes as a partnership in many countries.

When it comes to corporations, on the contrary, there are usually only two or three different types of corporations on a national level that entrepreneurs can use, although significant development on a European level in this area has been seen during the last 15 years: the Council Regulation on the Statute for a European Company 2157/2001 is an EU Regulation containing the rules for a public EU company, called *Societas Europaea* (SE), which was given a lot of hype but was not, in fact, very successful in practice. There is also a statute allowing European Cooperative Societies, and a couple of years ago it was proposed that the SPE company form (i.e. the European private company) should be introduced across the EU and EEA area from July 2010 onwards.

The reason for the great variety of partnerships can surely be explained by the fact that dynamic entrepreneurs need to find the right, flexible and tailor-made legal form for their economic undertakings, so that some kind of economic necessity urged the respective legislative bodies in many countries to react to these requirements and provide for legal forms that meet the needs of entrepreneurs and their customers alike. A silent partner, for example, naturally pursues different goals than a general partner who is subject to an unlimited personal liability and also, as a consequence, the needs for regulation and protection are very much different.

Another reason for the wide use of partnerships is the comparatively low entry level. Unlike corporations, partnerships in most countries are not "incorporated" or even registered in a commercial or trade register, and if there is a notification requirement, the submission is merely recorded and not verified. When jurisdictions do not even foresee a formal registration or notification, the real number of partnerships can only be estimated very roughly because there is no way to count reliable numbers. In some countries, all you need to form a partnership is a joint goal of at least two partners, purposely or not purposely. It may, therefore, well be that the partners do not even know that they are acting in the legal form of a partnership.

Partnerships are traditionally used in specific industries and for specific (legal and sometimes illegal) goals. For instance, many family offices use partnerships to structure the wealth of high net worth individuals and families. Many international holding structures use partnerships, and partnerships are also widely used to conceal beneficial ownership of large sums of monies – the latter of which is, of course, mainly due to the fact that there is often no registration requirement for partnerships (*see* earlier).

Partnerships are furthermore used, for example, for closed-end real estate funds and joint ventures in the oil and gas industry, or as vehicles to pool voting rights or some other interests of stakeholders. Partnerships are used between spouses to clarify rights and duties with respect to each other, or they are sometimes used to avoid or minimize taxes in general (think of the classic Dutch CV/BV structures), particularly when they become part of "orphanized structures" (mostly in connection with trusts or foundations). The variety of intended purposes is almost endless, both in theory and in practice.

Setting this aside, it is very clear that, nowadays in many countries, the law of partnerships usually lacks strict rules that cannot be amended by the partners. Instead, contractual freedom and less formal rules govern the law of partnerships, which is interesting not only for commercial entrepreneurs, family-owned businesses, ship owners and start-ups, but sometimes even for private equity or venture capital investors. In particular, the latter investors from the United States like to use European partnerships since they offer them freedom with respect to profit sharing, voting rights, earn-outs and exits.

But partnerships are not only attractive from a legal point of view. In many countries, the taxation of partnerships is also very beneficial for the partners when compared with corporate investment structures. In Germany, for instance, limited partnerships have long been used as the prime example of an investment vehicle for inbound real estate investments since they offered benefits with respect to trade tax and debt financing. The classic German (and later also Austrian) GmbH & Co. KG was, in fact, only born in order to combine legal and tax benefits at the same time.

On an international level, the picture of partnerships is very much diversified. One finds in many countries the above-mentioned variety in terms of numerous different types of partnerships and structures, whereas other countries hardly use partnerships as commercial vehicles and only know two to three different legal types. This, however, does not necessarily say anything about the practical influences of partnerships. In some countries like India, South Africa or China, partnerships, for instance, were not allowed at all a few years ago or, at least particularly, foreign investors were barred from becoming a partner in such a partnership – let alone the fairly poor market acceptance. The latter is still true for countries like Spain (at least in certain industries or business sectors) or certain countries in Eastern Europe.

Other countries do not know limited liability partnerships, which is obviously disadvantageous in fair competition for investments from abroad. Again, other countries, such as Germany, the Netherlands or Norway, use partnerships in certain industries for historic reasons, if we think of the shipping industry.

Moreover, from the legal perspective, things get easily complicated if jurisdictions follow different legal concepts as regards the attribution of legal ownership. Some countries treat a partnership as an "ownership in common", i.e. each co-owner actually has a share in the property. Consequently, the value of the property is, as it were, divided between the co-owners, although the mere physical substance of the assets is undivided and the right to possession can only be exercised jointly. Upon the death of a co-owner, their share in the property passes to their personal representatives.

On the contrary, "joint ownership", as some countries call the right to possession of the partners in a partnership, is something very different. The value of the property is then not divided, but all joint owners together own the property; they hold it, as it were "with one hand". In many common law jurisdictions, for instance, a co-ownership in common has historically only been possible in equity, whereas a joint ownership has long been the only possible legal co-ownership of land. As such, the division of the value substance into "shares" exists only as a matter concerning the internal relationships between co-owners, but not as a matter of binding outside force.

Since there is no share, which upon a co-owner's death can devolve upon their personal representatives, their right accrues to the other co-owners and – upon the death of the last surviving co-owner – passes on to their personal representatives.

1.2. A myriad of legal rules … and questions

Courts, academic literature and law practice in many jurisdictions have developed a myriad of legal rules around the two main above-mentioned legal concepts pertaining to partnerships and have solved the most important questions accordingly: can a partnership bear legal rights and duties? Are corporations treated as partnerships in the period of time between the submission for registration and the actual registration in the commercial register? Is there a difference between management capacity and representation of a partnership? Can partnership rights and duties be transferred to non-partners? Is there a fiduciary duty of the partners towards each other and towards the partnership? How many partners are needed to form a partnership, and what happens to the partnership and its property if one of the two remaining partners leaves the partnership? Do partnerships need a formal registration? What about profit sharing that is not proportionally reflected by the partnership share? Are partnerships without a personal liability of its partners allowed? Many other questions could easily be added to this list, but it is clear nowadays that at least most of the fundamental legal questions around partnerships have been answered sufficiently.

The history of partnerships from a legal perspective has, in many states, every now and then demonstrated interdependencies between the legal questions and corresponding tax questions. Are partnerships taxed differently from corporations and, if so, why? How is it decided whether a foreign entity is treated as a partnership or as a partnership – is the legal fact pattern decisive or does tax law require a different treatment? Can partners make use of losses that are derived by the partnership? Are there different tax rules for partners who do not bear an unlimited personal liability? How is a situation taxed in which one of the two remaining partners leaves the partnership?

As mentioned at the outset and based on the previous analysis, countries have developed different concepts of partnership taxation. Some countries treat partnerships as "flow-through" entities. Flow-through taxation means that the entity does not pay taxes on its income; instead, the owners of the entity pay tax on their "distributive share" of the entity's taxable income, even if no funds are distributed by the partnership to the owners. In this context, many jurisdictions permit the owners of the entity to agree how the income of the entity will be allocated among them but require that this allocation reflects the economic reality of their business arrangement, as tested under complicated rules with much detail in practice.

Some countries, on the other hand, treat partnerships for tax purposes as corporations or quasi-corporations, or "opaque", which is significantly more than the corporate doctrine of "piercing the corporate veil" for liability purposes, and – again – some countries allow partnerships to choose which regime shall be applicable. In summary, the dual nature of a partnership for tax purposes – at times an aggregation of its partners and at times an entity – complicates partnership taxation throughout many countries, particularly because only few people have been able to articulate a comprehensive statement of when the aggregate aspect and when the entity aspect should predominate.

Bearing all this in mind, the taxation of partnerships in an international context is particularly one of the most complex areas of (international) tax law. Apart from the problems under the national tax law of many jurisdictions, this is particularly due to two conflicting principles: some countries treat partnerships as taxable entities, while others treat them as transparent and only see the partners as taxpayers for tax purposes. This situation can lead to double taxation or double non-taxation. Particular problems can furthermore arise in triangular situations.

The aforementioned problems boil down to some extent to the question of whether the partnership or its partners are protected under existing double tax treaties. In this context, the question of whether or not a taxpayer qualifies as a "resident of a Contracting State" within the meaning of article 4(1) of the OECD Model goes to the very heart of the application of a double tax treaty. During the past decades, tax courts, scholars and practitioners alike have approached this topic from many different perspectives and angles. Although there seems to be some common understanding of the requirements and consequences of the treaty entitlement status, international tax practice reveals that it is far from being sufficiently investigated. This is not only due to problems that arise in the national tax law of contracting states for the first time but also because traditional legal institutes and problems are reassessed and treated differently over time, which is particularly true for the treatment of partnerships.

Treaty entitlement or treaty eligibility of taxpayers is a core subject of international tax law from a methodological perspective and is highly topical, theoretically challenging and – at the same time – of immense practical relevance. It is highly topical, as Seminar G of the IFA Congress 2011 in Paris has demonstrated, albeit especially with respect to the peculiarities of collective investment vehicles. The IFA Mumbai Congress in 2014, however, again brought this topic to the agenda. It is theoretically challenging since particularly treaty entitlement of (international) partnerships, triangular cases in general or the treatment of elective regulations in national tax law (like, for example, the US check-the-box regulations) still leave many questions unanswered. Last but not least, the subject is of immense practical relevance for the determination of the treaty entitlement is *condicio* sine qua non for the application of any double tax treaty. The question of treaty entitlement has to be answered not only for the application of a tax treaty as such in principle but is in particular decisive for the allocation of the power to impose taxes between two contracting states.

The tax treatment of partnerships is so difficult and so important from a practical and an academic/theoretical point of view that the OECD, back in 1999, published an extensive report on this subject – the so-called "OECD Partnership Report". This report expressed in great detail the view of the OECD with respect to the taxation of international partnerships from the perspective of the state of source, as well as the state of residence. The Report contained general remarks on the taxation of partnerships but was mainly built on examples of specific cases and their tax treatment.

In 2014, the OECD Partnership Report celebrated its 15th anniversary. This was the time when the idea for the first edition of this book was born. Ten years later now, we are celebrating the 25th birthday of the Report. Consequently, it is high time to investigate if and how the ideas of the OECD have been adopted by the different jurisdictions over time, though the results of the Report are somewhat inconsistent to a significant extent and are not always easy to realize from a practical point of view. Moreover, the tax authorities of many countries seem to be increasingly reluctant to accept the OECD as an authority, particularly at the bottom level of the local tax offices, and also given the fact that, most recently, the United Nations is pushing forward and leaving its mark on the architecture of the international tax system as we have known it for the past roughly 100 years. Indeed, the OECD Model and the OECD Commentary are technically mere recommendations that might be used when it comes to interpreting a tax treaty, but without any binding effect, and in recent times the tax authorities seem to make use of this to their advantage.

Notes

Notes

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