

EDITOR
FLORIAN HAASE



TAXATION OF INTERNATIONAL PARTNERSHIPS 2ND EDITION

IBFD

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.

Title:	Taxation of International Partnerships - 2nd edition
Date of publication:	June 2025
ISBN:	9789087229535 (print), 9789087229559 (PDF), 9789087229542 (e-pub)
Type of publication:	Book
Number of pages:	626
Terms:	Shipping fees apply. Shipping information is available on our website.
Price (print/online):	EUR 180 USD 196 (VAT excl.)
Price (eBook: e-Pub or PDF):	EUR 144 USD 158 (VAT excl.)

Order information

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Taxation of International Partnerships

2nd Edition

25 Years OECD Partnership Report:
Past, Present and Future

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ISBN 978-90-8722-953-5 (print)

ISBN 978-90-8722-954-2 (eBook, ePub); 978-90-8722-955-9 (eBook, PDF)

NUR 826

Table of Contents

List of Authors

xxiii

Part One Taxation of International Partnerships

Chapter 1:	Introduction	3
	<i>Florian Haase</i>	
1.1.	An overview and brief history	3
1.2.	A myriad of legal rules ... and questions	7
1.3.	BEPS and hybrids	10
1.4.	Chapter specifics and guidelines	11
1.4.1.	Country survey guidelines	11
Chapter 2:	General Concepts of Partnership Taxation	13
	<i>Florian Haase</i>	
2.1.	Main concepts	13
2.1.1.	Flow-through taxation	13
2.1.2.	Separate entity approach	14
2.1.3.	Elective regulations	14
2.2.	Treaty entitlement as the core issue	15
2.3.	OECD Partnership Report 1999	22

Part Two Country Surveys

Chapter 3:	Australia	27
	<i>Michael Dirkis</i>	
3.1.	General	27

3.2.	Domestic law	28
3.2.1.	General partnership	29
3.2.2.	“Tax law” partnership	30
3.2.3.	Limited partnership	30
3.2.4.	Venture capital (incorporated limited liability) partnerships	32
3.3.	Tax subject	34
3.3.1.	Taxation of domestic partnerships	34
3.3.1.1.	General and tax partnerships	34
3.3.1.2.	Limited partnership	37
3.3.1.3.	Venture capital (incorporated limited liability) partnerships	39
3.3.1.4.	Treatment of Australian interests in foreign hybrids	40
3.3.2.	Taxation of foreign partnerships	42
3.4.	Tax treaty issues	43
3.4.1.	Treaty entitlement	46
3.4.2.	Australia as the state of residence	47
3.4.3.	Australia as the state of source	48
3.4.4.	Triangular cases	49
3.5.	Examples of the OECD Partnership Report	49
3.5.1.	Example 1	49
3.5.2.	Example 2	51
3.5.3.	Example 3	52
3.5.4.	Example 4	53
3.5.5.	Example 5	54
3.5.6.	Example 6	55
3.5.7.	Example 7	55
3.5.8.	Example 8	56
3.5.9.	Example 9	57
3.5.10.	Example 10	58
3.5.11.	Example 11	59
3.5.12.	Example 12	61
3.5.13.	Example 13	62
3.5.14.	Example 14	63
3.5.15.	Example 15	64
3.5.16.	Example 16	65
3.5.17.	Example 17	66
3.5.18.	Example 18	67
3.6.	Conclusions	68

Chapter 4:	Austria	69
	<i>Valent Bendlinger and Jürgen Romstorfer</i>	
4.1.	General	69
4.2.	Domestic law	70
4.2.1.	Civil law aspects	70
4.2.2.	Tax aspects of Austrian partnerships	71
4.2.3.	Tax aspects of foreign partnerships	72
4.3.	Tax treaty law	76
4.3.1.	General	76
4.3.2.	Tax treaty entitlement	77
4.3.3.	Austria as the state of residence	80
4.3.4.	Austria as the state of source	80
4.3.5.	Triangular cases	81
4.4.	EU law	82
4.4.1.	Parent-Subsidiary Directive	82
4.4.2.	Merger Directive	83
4.4.3.	Interest and Royalties Directive	85
4.5.	Examples of the OECD Partnership Report	86
4.5.1.	Example 1	86
4.5.2.	Example 2	87
4.5.3.	Example 3	89
4.5.4.	Example 4	91
4.5.5.	Example 5	92
4.5.6.	Example 6	93
4.5.7.	Example 7	94
4.5.8.	Example 8	95
4.5.9.	Example 9	97
4.5.10.	Example 10	98
4.5.11.	Example 11	99
4.5.12.	Example 12	101
4.5.13.	Example 13	102
4.5.14.	Example 14	103
4.5.15.	Example 15	104
4.5.16.	Example 16	105
4.5.17.	Example 17	106
4.5.18.	Example 18	106

Chapter 5:	Brazil	109
	<i>Marcos Andre Vinhas Catão</i>	
5.1.	General	109
5.2.	Concept and nature	110
5.2.1.	Importance: Tax and corporate effects of the constitution of a partnership	111
5.3.	Partnerships under Brazilian tax law	113
5.3.1.	Consortiums	113
5.3.2.	<i>Sociedades em Conta de Participação</i>	117
5.4.	Examples of the OECD Partnership Report	119
5.4.1.	Example 1	119
5.4.2.	Example 2	120
5.4.3.	Example 3	122
5.4.4.	Example 4	123
5.4.5.	Example 5	124
5.4.6.	Example 6	125
5.4.7.	Example 7	126
5.4.8.	Example 8	127
5.4.9.	Example 9	127
5.4.10.	Example 10	128
5.4.11.	Example 11	129
5.4.12.	Example 12	129
5.4.13.	Example 13	130
5.4.14.	Example 14	131
5.4.15.	Example 15	132
5.4.16.	Example 16	132
5.4.17.	Example 17	133
5.4.18.	Example 18	133
Chapter 6:	Canada	135
	<i>Geoffrey Loomer</i>	
6.1.	General	135
6.2.	Domestic law	136
6.2.1.	Legal aspects	136
6.2.2.	Tax aspects	138
6.2.2.1.	Taxation of partnership income	138

6.2.2.2.	Tax treatment of partnership interest	139
6.2.2.3.	Taxation of domestic partnerships with foreign partners	140
6.2.2.3.1.	Effect of fiscal transparency	140
6.2.2.4.	Income types and tax rates	141
6.2.2.5.	Taxation of foreign partnerships	143
6.2.2.5.1.	Classification of foreign partnerships	143
6.2.2.6.	Taxation of partners	146
6.3.	Tax treaty issues	147
6.3.1.	Entitlement to treaty benefits	147
6.3.2.	Canada as the state of residence	148
6.3.3.	Canada as the state of source	149
6.3.4.	Triangular cases	151
6.4.	Examples from the OECD Partnership Report	152
6.4.1.	Example 1	152
6.4.2.	Example 2	154
6.4.3.	Example 3	155
6.4.4.	Example 4	158
6.4.5.	Example 5	162
6.4.6.	Example 6	163
6.4.7.	Example 7	165
6.4.8.	Example 8	166
6.4.9.	Example 9	167
6.4.10.	Example 10	168
6.4.11.	Example 11	169
6.4.12.	Example 12	170
6.4.13.	Example 13	171
6.4.14.	Example 14	172
6.4.15.	Example 15	173
6.4.16.	Example 16	174
6.4.17.	Example 17	175
6.4.18.	Example 18	176
Chapter 7:	China	179
	<i>Jianhong Liu</i>	
7.1.	General	179
7.2.	Domestic law	180
7.2.1.	Legal aspects	180

Table of Contents

7.2.2.	Tax aspects	182
7.2.3.	Taxation of domestic partnerships	183
7.2.4.	Taxation of foreign partnerships	185
7.3.	Tax treaty issues	186
7.3.1.	Treaty entitlement	186
7.3.2.	China as the state of residence	188
7.3.3.	China as the state of source	188
7.3.4.	Triangular cases	189
7.4.	Examples of the OECD Partnership Report	189
7.4.1.	Example 1	190
7.4.2.	Example 2	191
7.4.3.	Example 3	192
7.4.4.	Example 4	193
7.4.5.	Example 5	194
7.4.6.	Example 6	195
7.4.7.	Example 7	195
7.4.8.	Example 8	197
7.4.9.	Example 9	198
7.4.10.	Example 10	199
7.4.11.	Example 11	199
7.4.12.	Example 12	203
7.4.13.	Example 13	204
7.4.14.	Example 14	206
7.4.15.	Example 15	207
7.4.16.	Example 16	208
7.4.17.	Example 17	209
7.4.18.	Example 18	210
Chapter 8:	France	213
	<i>Philippe Derouin and Camille Ortiz</i>	
8.1.	General	213
8.1.1.	Partnerships are “translucent”	213
8.1.2.	Case law and controversy	214
8.1.3.	Recent evolution	215
8.2.	Domestic law	216
8.2.1.	Legal aspects	217
8.2.2.	Tax aspects	219
8.2.2.1.	Determination of partnership income	220

8.2.2.2.	Partners' taxation	221
8.2.2.3.	Accounting and tax obligations – Audit procedures	221
8.2.2.4.	Gains or losses made upon the disposal of a partnership interest	222
8.2.2.5.	Tax exemptions in a partnership context	223
8.2.2.6.	Partnerships as paying agents on passive income	224
8.2.3.	Taxation of foreign partners in French partnerships	224
8.2.3.1.	French-source income	224
8.2.3.2.	Foreign-source income (triangular situations)	225
8.2.4.	Taxation of foreign partnerships	226
8.3.	Tax treaty issues	228
8.3.1.	Treaty entitlement	229
8.3.1.1.	French partnerships and foreign partners	229
8.3.1.2.	Foreign partnerships	230
8.3.2.	France as state of residence of the partners	231
8.3.3.	France as the state of source	232
8.3.3.1.	French partnerships	232
8.3.3.2.	Foreign partnerships	232
8.3.4.	Triangular cases	232
8.4.	Examples of the OECD Partnership Report	233
8.4.1.	Example 1	233
8.4.2.	Example 2	234
8.4.3.	Example 3	234
8.4.4.	Example 4	235
8.4.5.	Example 5	235
8.4.6.	Example 6	235
8.4.7.	Example 7	236
8.4.8.	Example 8	236
8.4.9.	Example 9	237
8.4.10.	Example 10	237
8.4.11.	Example 11	238
8.4.12.	Example 12	238
8.4.13.	Example 13	240
8.4.14.	Example 14	241
8.4.15.	Example 15	242
8.4.16.	Example 16	242
8.4.17.	Example 17	242
8.4.18.	Example 18	243

Chapter 9:	Germany	245
	<i>Florian Haase</i>	
9.1.	General rules of partnership taxation	245
9.2.	Available classes of partnerships	245
9.3.	Tax law classification	247
9.3.1.	Commercial partnerships	248
9.3.2.	Deemed-commercial partnerships	253
9.3.3.	Non-commercial partnerships	254
9.4.	Relationship between partners and “their” partnership	256
9.5.	Tax rates/earnings retention	259
9.6.	Procedural aspects of income determination	261
9.7.	Election to corporate tax regime	261
9.8.	Application of tax treaties	262
9.8.1.	Commercial partnerships	262
9.8.2.	Deemed-commercial partnerships	266
9.8.3.	Non-commercial partnerships	267
9.9.	Examples of the OECD Partnership Report	268
9.9.1.	Example 1	269
9.9.2.	Example 2	270
9.9.3.	Example 3	272
9.9.4.	Example 4	273
9.9.5.	Example 5	275
9.9.6.	Example 6	276
9.9.7.	Example 7	277
9.9.8.	Example 8	279
9.9.9.	Example 9	281
9.9.10.	Example 10	283
9.9.11.	Example 11	284
9.9.12.	Example 12	286
9.9.13.	Example 13	287
9.9.14.	Example 14	289
9.9.15.	Example 15	290

9.9.16.	Example 16	291
9.9.17.	Example 17	293
9.9.18.	Example 18	293
Chapter 10:	India	295
	<i>Bijal Ajinkya and Kinjal Buaria</i>	
10.1.	General	295
10.2.	Taxation under Indian domestic law	296
10.2.1.	“Person”, “firm” and “partnership” – Definition, scope and meaning	296
10.2.2.	“Partnership” under the Partnership Act	297
10.2.3.	“Partnership” under the LLP Act	298
10.2.4.	“Partnership” under the ITA	299
10.3.	Legal status of a partnership firm	300
10.3.1.	Residency rule for a partnership firm	301
10.3.2.	Taxation of partnerships: Relevant principles and provisions	302
10.4.	Indian exchange control regulations	305
10.4.1.	An overview of India’s exchange controls	305
10.4.1.1.	Inbound investment in Indian partnerships	306
10.4.1.2.	Outbound investment by Indian partnerships	307
10.5.	Taxation under double taxation avoidance agreements	308
10.5.1.	Scheme of international taxation in India	308
10.5.2.	Relevance of the OECD Commentary in Indian context	309
10.5.3.	Relevant provisions of the Commentary	309
10.5.4.	India’s positions on the Commentary	314
10.5.5.	Intention of DTAA’s and their liberal interpretation	315
10.5.6.	India’s position as to whether a tax residency certificate is sufficient for claiming benefit under the DTAA	317
10.5.7.	India’s judicial approach to tax international partnerships	319
10.5.8.	Taxing international partnerships	326

10.6.	Examples of the OECD Partnership Report	327
10.6.1.	Example 3	328
10.6.2.	Example 4	330
10.6.3.	Example 5	331
10.6.4.	Example 6	332
10.6.5.	Example 7	334
10.6.6.	Example 8	337
10.6.7.	Example 9	338
10.6.8.	Example 10	339
10.6.9.	Example 14	340
10.6.10.	Example 16	341
10.6.11.	Example 17	342
10.6.12.	Example 18	343
Chapter 11:	Italy	345
	<i>Maricla Pennesi and Alessia Busca</i>	
11.1.	General	345
11.2.	Domestic law	346
11.2.1.	Legal aspects	346
11.2.2.	Tax aspects	348
11.2.3.	Taxation of domestic partnerships	349
11.2.4.	Taxation of foreign partnerships	355
11.2.5.	Hybrids	357
11.2.6.	Global minimum tax	363
11.3.	Tax treaty issues	365
11.3.1.	Treaty entitlement	365
11.3.2.	Italy as the state of residence	373
11.3.3.	Italy as the state of source	376
11.3.4.	Triangular cases	378
11.4.	Examples of the OECD Partnership Report	378
11.4.1.	Example 1	379
11.4.2.	Example 2	380
11.4.3.	Example 3	381
11.4.4.	Example 4	382
11.4.5.	Example 5	383
11.4.6.	Example 6	384
11.4.7.	Example 7	384
11.4.8.	Example 8	386

11.4.9.	Example 9	387
11.4.10.	Example 10	388
11.4.11.	Example 11	390
11.4.12.	Example 12	391
11.4.13.	Example 13	392
11.4.14.	Example 14	393
11.4.15.	Example 15	394
11.4.16.	Example 16	395
11.4.17.	Example 17	396
11.4.18.	Example 18	397
Chapter 12:	Netherlands	399
	<i>Paulus Merks, Volodimir Toetsja and Mathijs Zwiers</i>	
12.1.	General	399
12.2.	Domestic law	399
12.2.1.	Legal aspects of Dutch partnerships	399
12.2.2.	Tax subject	401
12.2.3.	Taxation of domestic partnerships	402
12.2.4.	Reverse hybrid entities	403
12.3.	Tax qualification of foreign partnerships	404
12.3.1.	History of Dutch tax qualification of foreign partnerships	404
12.3.2.	2025 update regarding the Dutch classification of foreign partnerships	407
12.4.	Cross-border situations	408
12.4.1.	Treaty entitlement	408
12.4.2.	The Netherlands as the state of source	409
12.4.3.	Treaty application in multiple jurisdictions	409
12.5.	Examples of the OECD Partnership Report	410
12.5.1.	Example 1	411
12.5.2.	Example 2	412
12.5.3.	Example 3	413
12.5.4.	Example 4	414
12.5.5.	Example 5	415
12.5.6.	Example 6	415
12.5.7.	Example 7	416
12.5.8.	Example 8	417

12.5.9.	Example 9	418
12.5.10.	Example 10	419
12.5.11.	Example 11	420
12.5.12.	Example 12	421
12.5.13.	Example 13	423
12.5.14.	Example 14	424
12.5.15.	Example 15	424
12.5.16.	Example 16	425
12.5.17.	Example 17	426
12.5.18.	Example 18	427
Chapter 13:	Singapore	429
	<i>Nicholas Neo</i>	
13.1.	General	429
13.2.	Domestic law	430
13.2.1.	Legal aspects	430
13.2.1.1.	General partnerships	431
13.2.1.2.	Limited liability partnerships	431
13.2.1.3.	Limited partnerships	432
13.2.2.	Tax subject	433
13.2.3.	Taxation of domestic partnerships	434
13.2.3.1.	General partnerships	434
13.2.3.2.	Limited liability partnerships	434
13.2.3.3.	Limited partnerships	435
13.2.3.4.	Non-resident partners	435
13.2.3.5.	Payments to partnerships with non-resident partners	436
13.2.4.	Taxation of foreign partnerships	437
13.2.4.1.	Foreign LLPs and LPs	437
13.2.4.2.	Other foreign partnerships	437
13.2.4.3.	Certainty through tax treaties	438
13.3.	Tax treaty issues	439
13.3.1.	Treaty entitlement	439
13.3.2.	Singapore as the state of residence	439
13.3.3.	Singapore as the state of source	440
13.3.4.	Triangular cases	440
13.4.	Examples of the OECD Partnership Report	441
13.4.1.	Example 1	441
13.4.2.	Example 2	442

13.4.3.	Example 3	443
13.4.4.	Example 4	444
13.4.5.	Example 5	445
13.4.6.	Example 6	445
13.4.7.	Example 7	446
13.4.8.	Example 8	447
13.4.9.	Example 9	447
13.4.10.	Example 10	449
13.4.11.	Example 11	449
13.4.12.	Example 12	450
13.4.13.	Determination of “employer” for the purposes of article 15	453
13.4.14.	Example 13	454
13.4.15.	Example 14	454
13.4.16.	Example 15	455
13.4.17.	Example 16	456
13.4.18.	Example 17	457
13.4.19.	Example 18	457
Chapter 14	Spain	459
	<i>Ignacio del Val</i>	
14.1.	General	459
14.2.	Domestic law	459
14.2.1.	Legal aspects	459
14.2.2.	Tax aspects	460
14.2.3.	Taxation of domestic partnerships	462
14.2.4.	Taxation of foreign partnerships	466
14.3.	Tax treaty issues	468
14.3.1.	Treaty entitlement	468
14.3.2.	Spain as the state of residence	469
14.3.3.	Spain as the state of source	469
14.3.4.	Triangular cases	470
14.4.	Examples of the OECD Partnership Report	470
14.4.1.	Example 1	471
14.4.2.	Example 2	472
14.4.3.	Example 3	474
14.4.4.	Example 4	475
14.4.5.	Example 5	476

14.4.6.	Example 6	477
14.4.7.	Example 7	478
14.4.8.	Example 8	479
14.4.9.	Example 9	480
14.4.10.	Example 10	481
14.4.11.	Example 11	483
14.4.12.	Example 12	485
14.4.13.	Example 13	487
14.4.14.	Example 14	488
14.4.15.	Example 15	489
14.4.16.	Example 16	491
14.4.17.	Example 17	492
14.4.18.	Example 18	492
Chapter 15:	Switzerland	495
	<i>Samuel Dürr and Marius Breier</i>	
15.1.	General	495
15.2.	Domestic law	495
15.2.1.	Legal aspects	495
15.2.1.1.	General partnership	496
15.2.1.2.	Limited partnership	497
15.2.1.3.	Civil law partnership	497
15.2.2.	Tax subject	498
15.2.2.1.	Taxation of domestic partnerships	500
15.2.2.2.	Taxation of foreign partnerships	501
15.3.	Tax treaty issues	503
15.3.1.	Treaty entitlement	503
15.3.2.	Switzerland as the state of residence	505
15.3.3.	Switzerland as the state of source	506
15.3.4.	Triangular cases	507
15.4.	Examples of the OECD Partnership Report	507
15.4.1.	Example 1	507
15.4.2.	Example 2	508
15.4.3.	Example 3	509
15.4.4.	Example 4	510
15.4.5.	Example 5	511
15.4.6.	Example 6	512
15.4.7.	Example 7	513

15.4.8.	Example 8	514
15.4.9.	Example 9	516
15.4.10.	Example 10	517
15.4.11.	Example 11	519
15.4.12.	Example 12	520
15.4.13.	Example 13	522
15.4.14.	Example 14	523
15.4.15.	Example 15	524
15.4.16.	Example 16	525
15.4.17.	Example 17	526
15.4.18.	Example 18	527
Chapter 16:	United Kingdom	529
	<i>Michael McGowan</i>	
16.1.	General	529
16.2.	Domestic law	531
16.2.1.	Legal aspects	531
16.2.2.	Tax aspects	533
16.2.3.	Taxation of domestic partnerships	536
16.2.4.	Taxation of foreign partnerships	538
16.3.	Tax treaty issues	541
16.3.1.	Treaty entitlement	541
16.3.2.	United Kingdom as the state of residence	542
16.3.3.	United Kingdom as the state of source	543
16.3.4.	Triangular cases	544
16.4.	Examples in the OECD Partnership Report	545
16.4.1.	Example 1	545
16.4.2.	Example 2	546
16.4.3.	Example 3	547
16.4.4.	Example 4	548
16.4.5.	Example 5	549
16.4.6.	Example 6	549
16.4.7.	Example 7	550
16.4.8.	Example 8	551
16.4.9.	Example 9	552
16.4.10.	Example 10	553
16.4.11.	Example 11	554
16.4.12.	Example 12	555

16.4.13.	Example 13	556
16.4.14.	Example 14	557
16.4.15.	Example 15	557
16.4.16.	Example 16	558
16.4.17.	Example 17	559
16.4.18.	Example 18	560
Chapter 17:	United States	563
	<i>Linda E.S. Pfatteicher, Frank Caratzola and Frank Marano</i>	
17.1.	General	563
17.2.	Domestic law	563
17.2.1.	Legal aspects	563
17.2.1.1.	Partnership forms	563
17.2.1.1.1.	General partnership	564
17.2.1.1.2.	Limited partnership	564
17.2.1.1.3.	Limited liability partnership	565
17.2.1.1.4.	Limited liability company	565
17.2.2.	Tax aspects of partnerships generally	566
17.2.2.1.	Formation	566
17.2.2.2.	Pass-through principle	567
17.2.2.3.	Check-the-box elections	567
17.2.2.4.	Reporting requirements	568
17.2.3.	Taxation of US partnerships	568
17.2.3.1.	Entity v. aggregate theory	568
17.2.3.2.	Formation and contributions	569
17.2.3.3.	Operations, allocations and sale treatment	570
17.2.3.3.1.	Basic operations	570
17.2.3.3.2.	Allocations and distributions	571
17.2.3.3.3.	Sale treatment for US partners	572
17.2.3.4.	Non-US partners of US partnerships	572
17.2.3.4.1.	Withholding	572
17.2.3.4.2.	Branch profits tax	574
17.2.4.	Taxation of foreign partnerships	575
17.2.4.1.	Classification of foreign partnerships	575
17.2.4.2.	Foreign tax credits	575
17.3.	Tax treaty issues	576
17.3.1.	Regulatory framework	577
17.3.2.	Hybrid entities	581

17.4.	Examples of the OECD Partnership Report	584
17.4.1.	Example 1	584
17.4.2.	Example 2	585
17.4.3.	Example 3	586
17.4.4.	Example 4	588
17.4.5.	Example 5	589
17.4.6.	Example 6	589
17.4.7.	Example 7	591
17.4.8.	Example 8	591
17.4.9.	Example 9	593
17.4.10.	Example 10	594
17.4.11.	Example 11	595
17.4.12.	Example 12	596
17.4.13.	Example 13	597
17.4.14.	Example 14	598
17.4.15.	Example 15	599
17.4.16.	Example 16	601
17.4.17.	Example 17	601
17.4.18.	Example 18	602

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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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