THE APPLICATION OF THE CONVENTION TO PARTNERSHIPS, TRUSTS AND OTHER, NON-CORPORATE ENTITIES

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General Discussion[1]

The Commentary – at paragraphs 2 to 6.7 – discusses the application of the Model Convention to partnerships. This Commentary was substantially amended in the 2000 version following the first report of a working party set up by the CFA in 1993 to study the application of the Convention to partnerships, trusts and other non-corporate entities. That first report – the Partnerships Report – dealt with the application of the OECD Model to partnerships. Further reports are anticipated on trusts and other entities, through there are some principles discussed in the Partnerships Report which are relevant to all these entities.

The primary issue discussed in the Partnerships Report concerns the applicability of the Convention to partnerships. This is the issue which arises from Article 1 for partnerships, trusts and all non-corporate entities. Article 1 establishes that the Convention applies in general only to persons who are residents of one or both Contracting States. This generates two questions in determining the applicability of the Convention to any non-corporate entity:

(a) is the entity a person, as defined in Article 3(1)(a); and

(b) is the entity a resident of a Contracting State, as defined in Article 4(1)?

A person is defined in Article 3(1)(a) as including an individual, a company and any other body of persons. A non-corporate entity is not an individual; it may be a company, since Article 3(1)(b) defines a company as "any body corporate or <u>any entity that is treated as a body corporate for tax purposes</u>" (emphasis added): if the non-corporate entity is treated as a body corporate, then it will qualify as a person (and almost certainly be a resident of a Contracting State as well). Chiefly, a non-corporate entity will qualify as a person if it is a body of persons.

The Partnerships Report has now confirmed that partnerships constitute bodies of persons – and the Commentary to Article 3 has been amended accordingly.[2] However, the position with other non-corporate entities is less clear. Generally, trusts and other non-corporate entities will involve associations of persons, but not necessarily a <u>body</u> of persons (in the sense that the entity constitutes a body distinct from its members). Even assuming that a non-corporate entity is a person, it must still be a resident of a Contracting State. Article 4(1) defines this term to mean "any person who, under the law of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature …". This phrase is discussed under Article 4 (Residence). The view is taken there that "liable to tax" does not mean that the person must be actually paying tax in the state; entities which enjoy a complete exemption from tax are still residents of a state so long as that state could assert jurisdiction to tax the entity on its worldwide income in accordance with one of the internationally accepted bases for full tax liability (such as the establishment of the entity under the laws of that state, or the location of the management of the entity in that state). Prima facie, therefore, non-corporate entities established under the laws of a state or having their management there could be subject to full tax liability in that state. However, the problem with many non-corporate entities is that they are partially or fully transparent[3] for tax purposes in their state of establishment or management. It would be entirely inconsistent for a state to accord full fiscal transparency to an entity and yet assert jurisdiction to tax that entity on its worldwide income. Non-corporate entities which are fully transparent cannot be residents of a Contracting State. In respect of transparent partnerships, the Partnerships Report has concluded that they are not residents of a Contracting State.[4]

Thus, for all non-corporate entities, the issue of the applicability of the Convention raised by Article 1 resolves itself into the questions:

(a) is the entity a body of persons or is it treated as a body corporate for tax purposes; and

(b) is the entity fiscally transparent?

This is not, however, the end of the matter. Many of the most complex problems arise where the entity is treated differently in the Contracting States involved. Thus the entity may be treated as a body corporate and opaque in one state, while it is treated as an unincorporated association and fiscally transparent in the other state.[5] The Partnerships Report considers several scenarios where different approaches are taken by the two Contracting States. Applicability is not the only issue which arises in connection with double taxation conventions and non-corporate entities. The Partnerships Report gives examples of other issues.[6] For example, can the entity constitute a permanent establishment of its associates or give rise to a permanent establishment if the entity operates in a third State? Can the entity constitute an employer for the purposes of Article 15 (Income from Employment)? If the entity is fiscally transparent, are its associates the beneficial owners of its income?

Partnerships[7]

The application of the Convention to partnerships is discussed at paragraphs 2 to 6.2 of the Commentary to Article 1; these paragraphs were substantially amended following the Partnerships Report.

The Partnerships Report analyses the application of the Convention to partnerships largely by considering its application in eighteen scenarios. It is impossible to reproduce that discussion here, and reference is best made to the Report itself. It is not always easy to see what principles the working party applied in reaching its conclusions on each scenario. Some of the conclusions seem more pragmatic than principled. As a consequence, it is very difficult to summarise the Report. However, the following points appear from the Report, some of which have been reflected in changes to the Commentary:[8]

(a) partnerships should be considered to be "persons" within the definition in Article 3(1)(a) either because they fall within the definition of a company or because they are bodies of persons;[9]

(b) where a partnership is treated as fiscally transparent in a state, it cannot be a resident of that state for purposes of the Convention;[10]

(c) in determining whether a partnerships is fiscally transparent, the question is whether the amount of tax payable on the partnership income is determined in relation to the personal characteristics of the partners;[11]

(d) where a partnership is not entitled to the benefit of a Convention because it is fiscally transparent, the partners are entitled to the benefit of the conventions entered into by their states of residence to the extent of the partnership's income allocated to them.[12] In that situation the income derived by the partnership shall be considered to keep the nature and source it had in the hands of the partnership.[13] The income is also regarded as paid to or derived by those partners;[14]

(e) the source state, in applying a convention where partnerships are involved, should take into account the way in which an item of income is treated in the state of residence of the taxpayer claiming the benefit of the convention (i.e., broadly, the state of source should take into account whether the state of residence treats the partnership as transparent or opaque).[15]

Some of the issues arising in the application of double taxation conventions to partnerships can be illustrated from decided cases.

One can see the approach of a country of source to a foreign partnership in the decision of the French Conseil d'Etat in *SA Diebold Courtage*.[16] The French company paid rental payments to a Dutch limited partnership – a commanditaire vennootschap (CV) – in respect of an agreement for the sale and leaseback of computer equipment. The limited partner and the general partner of the CV were both companies (BV's – limited liability companies) resident in the Netherlands. Approximately 65% of the rental payments were paid on to a Swiss company. The French company contended that the rental payments were exempt from French tax under Article 12 of the France-Netherlands double taxation convention of 16th March 1973. The Conseil d'Etat held that, as the CV was fiscally transparent under Dutch tax law, it could not be a resident of the

Netherlands for treaty purposes. However, the rental income was to be treated as paid to the two BV's, who were residents of the Netherlands, and could benefit from the Convention. There was insufficient evidence to conclude that the BV's were not the beneficial owners of the rental income. The case shows the state of source looking at the tax treatment in the country of residence, and also operating a flow-through or derivative benefits approach by looking through the transparent entity to its associates.[17] This is all consistent with the Partnerships Report (though not with the French Government's reservations on the Report[18]).

One can contrast with this case the decision of the French Conseil d'Etat, where France was the source country but a French entity was involved, in *Re Société Kingroup*.[19] In that case, a Canadian company was a 33% participant in a groupement d'intérêt economique (GIE) established under French law. The GIE carried on a business in France. Under French law a GIE may have separate legal personality, but is transparent for tax purposes. The Canadian company argued that it was exempt from French tax on its share of the GIE profits under the business profits, dividends or royalties Articles of the France-Canada double taxation convention of 2nd May 1975. A GIE is not a partnership, but is taxed in a manner similar to most partnerships in France. It is not fully transparent;[20] the GIE must submit tax returns but it does not pay income tax, its associates are liable to the tax in proportion to their rights. The Conseil d'Etat noted that the GIE had its own legal personality and its own business. The Court then held that the business profits article only applied to profits derived directly by a Canadian company, and not to the share of the profits of a GIE to which the Canadian company was entitled. The share of profits of the GIE did not fall within the meaning of dividends or royalties. The Canadian company was not, therefore, exempt under the convention.

There have also been several decisions in the Netherlands concerning partnerships formed under Netherlands law.

The first case – a decision of the Hoge Raad of 10th March 1993[21] - concerned a commanditaire vennootschap (CV) – formed between a Swedish company and two Dutch companies (BV's). The Swedish company was a limited or silent partner; one of the BV's was the general partner. The CV was a closed CV which is treated as fully transparent under Dutch fiscal law; the general and limited partners are taxed directly on their share of the profits. The Swedish company argued that its share of the income was exempt from tax in the Netherlands under the business profits article of the Netherlands-Sweden double taxation convention of 12th March 1968. The Hoge Raad noted that the Swedish company held its participation in the CV as part of its worldwide business, and concluded that the income was derived through a permanent establishment in the Netherlands: the income was not, therefore, exempt under the convention.

The second case – a decision of the Hoge Raad of 23rd March 1994[22] – concerned a Belgian resident individual who was a limited partner in a Dutch closed CV. The Belgian resident was entitled to a share of the profits and to interest on his capital and current accounts; he contended these were exempt from tax in the Netherlands. The Belgian-Netherlands double taxation convention of 19th October 1970 contained an express provision stating that limited partnerships formed under Netherlands law, whose place of management is in the Netherlands, are regarded as residents of the Netherlands. Reasoning from this, the Hoge Raad concluded that the Netherlands could tax the profit share and interest on the capital of the silent partner since these were profits of an enterprise carried on by a Netherlands resident.

Several cases have concerned the state of residence considering the application of conventions to foreign partnerships. In *NV Immo-Part v. Belgium*,[23] the Court of Appeal of Brussels had to consider a Belgian resident which owned a share in a US general partnership (which in turn owned a share in a US limited partnership). The limited partnership owned land in the US. The Court concluded, by examining provisions of the general partnership agreement, that it was fiscally transparent. The income was therefore derived from land in the US, the taxpayer also having a permanent establishment at the office of the partnership in the US: the income was therefore exempt from tax in Belgium.

The English Court of Appeal in *Memec Plc v. IRC*[24] had to consider income derived by a UK company which was a silent partner in a German silent partnership formed with a German limited liability company. The silent partnership received dividends from shares in underlying companies. Under German law, the silent partnership had no separate legal personality and the general partner was the owner of the partnerships assets. The UK company claimed a foreign tax credit in respect of the dividends received by the silent partnership. The Court of Appeal examined the rights of the silent partner under German law. It rejected the claim for a tax credit, holding that the source of the UK company's income was the partnership agreement, not the dividends from the underlying companies. The distributions from the silent partnership were also not "dividends" within the terms of the tax credit article of the UK-Germany convention of 26th November 1964.[25]

An illustration of the practical application of a double taxation convention to a partnership comes from an Indian case, *Clifford Chance (UK) v. Deputy Commissioner of Income Tax*.[26] The UK partnership sent its partners and employed staff to advise in India. Article 15 of the UK-India double taxation convention of 25th January 1993 provides that a partnership is not taxable in India if members of the partnership are present for less than 90 days in a year. The Tribunal ruled that members included employed staff as well as partners, so that this limit was exceeded.

The U.K. approach to partnerships and double taxation conventions

The approach in the United Kingdom to partnerships and double taxation conventions has changed as a result of the decision in *Padmore v. I.R.C.*[27] In that case a U.K.-resident partner of a partnership managed and controlled in Jersey sought exemption from his share of the partnership profits under the terms of the 1952 double taxation arrangement between the United Kingdom and Jersey. In the High Court, Peter Gibson, J. held that a partnership was a "body of persons" so as to be capable of satisfying the definition of "resident" and benefit from the Arrangement: he focused particularly[28] on the fact that the Arrangement used the formula "body of persons, corporate or not corporate" as indicating that the expression did not have the meaning given to it by the Taxes Act.[29] Having held that the partnership income was exempt under the Arrangement, Peter Gibson, J. then went on to hold that the profits were similarly exempt in the hands of the individual partners. This decision was upheld on appeal.[30] The decision in *Padmore* has now been reversed by section 112(4) and (5) ICTA 1988.[31] Those sub-sections provide that, where a partnership resident outside the United Kingdom is relieved from United Kingdom tax on income or capital gains by virtue of a double taxation convention, a resident partner shall be taxed without regard to such convention. Thus these sub-sections reverse the specific impact of the *Padmore* decision without overruling the general holding that a partnership may be a body of persons, at least if words similar to those in the U.K.-Jersey Arrangement are employed. The OECD Model itself defines a person as including "an individual, a company and any <u>other body of persons</u>". The words employed are not the same as those in the United Kingdom-Jersey Arrangement ("body of persons, corporate or not corporate") so that it would be open to argument in England[32] that in conventions based upon the OECD Model "body of persons" does not include a partnership. However, the Commentary to the OECD Model, Article 3(1)(a) – at paragraph 2 – now states the view of the CFA that a partnership is a body of persons.

As a result of the *Padmore* case, the United Kingdom has begun to include specific references to partnerships in treaties recently negotiated.[33] Where neither state regards a partnership as a taxable entity separate from its partners, partnerships are excluded from the definition of a person.[34] Where, however, the other treaty state recognises a partnership as a separate entity, such a partnership is regarded as a person but a specific provision similar to the following is included:[35]

> "**Partnerships**
>
> Where, under any provision of this Convention, a partnership is entitled, as a resident of [ ], to exemption from tax in the United Kingdom on any income or capital gains, that provision shall not be construed as restricting the right of the United Kingdom to tax any member of the partnership who is a resident of the United Kingdom on his share of the income and capital gains of the partnership; but any such income or gains shall be treated for the purposes of Article ** (Elimination of Double Taxation) of this Convention as income or gains from sources in [ ]."

Trusts

The OECD Model and its Commentaries give virtually no guidance as to the application of double taxation conventions to trusts, trustees or their beneficiaries. The Model Articles make no mention of trusts, nor do the Commentaries as prepared by the Committee on Fiscal Affairs. The only express references to trusts and trustees are found in Observations and Reservations made by members of the OECD. Thus, for example, prior to its removal in 2000, New Zealand appended an Observation to Article 3[36] to the effect that dividends, interest and royalties received by a trustee and on which he is taxed are regarded as beneficially owned by that trustee.[37] The United Kingdom and Ireland have entered a Reservation to Article 21 concerning the right to tax income paid from a trust to a non-resident.[38] The working party established in 1993 which produced the Partnerships Report is considering the application of the Model Convention to trusts and other non-corporate entities.

Some states make express provision in their tax conventions for trusts. Thus, Canada and the United States generally provide in their treaties that a trust is within the definition of a "person".[39] The U.S. often follows this up by providing that a trust comes within the definition of a "resident" only to the extent that the income or capital gains of that trust are taxed in the hands of the trust or of the beneficiaries.[40] The United Kingdom provides in a number of its treaties that income paid out of a trust is excluded from the equivalent of Article 21 (Other Income).[41] There are a small number of judicial decisions and rulings around the world relating to trusts and international taxation,[42] however there are no cases which provide any significant clarification of the application of double taxation conventions to trusts.[43] There is a small academic literature, of which the major contribution is an article by John Avery Jones and others.[44]

A relatively straightforward trust situation may give rise to a large number of treaty issues. For example, suppose that a trust receives income and derives capital gains from different sources or property situated in different states (States S_1, S_2, S_3). The trust itself may have several trustees, some individual and some corporate, resident in different territories (States T_1, T_2, T_3). Finally, the beneficiaries may be resident in different states (States B_1, B_2, B_3) and may have different entitlements to income or capital under the trust. For the purposes of analyzing and applying double taxation conventions to trusts, the situation can be greatly simplified by examining each source of income (or capital gain) separately and each beneficiary's receipt separately. The complexity of multiple trustees can also be simplified by attributing to the trust itself, or to the trustees as a body of persons, a single residence for treaty purposes. In the absence of any authoritative guidance from the Commentaries or other sources on the application of double taxation conventions to trusts, the best one can do here is to indicate some of the questions which arise with respect to this issue.

1: Should a distinction be made between different types of trust?

Several jurisdictions make a distinction in their domestic law between the taxation of different types of trust; this distinction has been followed in the literature concerning the application of the Model Convention to trusts.[45] There is clearly something to be said for treating a trust where the beneficiary is entitled to the income as it arises (minus trustees' expenses) differently from trusts where the beneficiary has no immediate right to the income. In the latter case – where trustees may accumulate income or pay income or capital out at their discretion – no beneficiary has a right to the income or capital until the trustees decide to make a distribution. In an ideal world, it would be desirable if a single solution to the application of double taxation conventions to trusts could be reached which would apply to all types of trusts.

2: Is a trust a "person"?

According to Article 1 of the OECD Model, a convention only applies to "persons who are residents of one or both of the Contracting States". There has been some discussion in the literature whether or not a trust is a "person" within the definition provided by Article 3(1)(a) of the Model. There seems to be a consensus forming that a trust is such a person by virtue of the inclusion of a "body of persons" within the definition in Article 3.[46] One is inclined to wonder whether this issue is really as important as has sometimes been made out. If the trust itself is not a "person", surely the trustee or trustees - whether corporate or individual - are persons. If the trust as such is not entitled to the benefit of the treaty, it is hard to say why the trustee or trustees (who are in receipt of income or derive capital gains) should be excluded from the scope of the convention. There is one clear advantage, however, in favour of the view which regards the trust as a person entitled in its own right to come within the scope of the convention. If one looked at each trustee separately, and the trustees were resident in different states, it might be possible to take advantage of different treaties by paying items of income to different trustees. This could not occur if the trustees as a body were allocated to a single jurisdiction.

3: Where is the trust or the body of trustees resident?

Following on from the last point comes the issue of allocating a single residence to a trust or body of trustees. This issue arises where there is more than one trustee and those trustees are residents of different states for treaty purposes. Assuming that the trust is within the definition of a "person" but clearly not an individual, then Article 4(3) should apply to determine issues of dual residence.[47] The trust is then deemed to be a resident of the state in which its place of effective management is situated.

4: Business profits - the application of Articles 7 and 5:[48]

It is perfectly feasible that a trust may carry on a trade and this trade may be carried on where the trust is resident or in another state. Issues then arise with respect to Article 7 of the Model; in particular, whether a trust is an "enterprise of a Contracting State".[49] A further issue is whether a beneficiary may be an enterprise of a Contracting State and, if so, whether the beneficiary has a permanent establishment either where the trust is resident or where the business activities are carried on.[50]

5: Dividends, interest and royalties - the application of Articles 10, 11 and 12:

The essential issue here is whether the trustee in receipt of the dividends, interest or royalties is the "beneficial owner" of them. The view is taken elsewhere[51] that the term beneficial owner should not be given the technical meaning it has in some common law jurisdictions but should be given a broader, treaty meaning. Thus a trustee (other than one who is obliged to pay on all that he receives to a beneficiary) should be regarded as a beneficial owner. The fear is expressed, however, that judges in some common law jurisdictions would be inclined to give the domestic, technical meaning to the term "beneficial owner" and balk at the idea of regarding a trustee as the beneficial owner of income he receives. Prior to the 2000 version of the Model, New Zealand had entered an Observation to Article 3 that a trustee should be regarded as the beneficial owner of dividends, interest and royalties. This was a helpful clarification and should not be thought to imply that other states would not regard a trustee as the beneficial owner.

6: Capital gains - the application of Article 13:

It is primarily paragraph 4 of Article 13 which is at issue here, and the question which then arises is: who is the alienator of the property, the trustee or the beneficiary?[52] It seems correct (with the exception of the situation where a trustee is a bare trustee for a beneficiary) that the trustee should be regarded as the alienator of the property. The trustee would always be the owner of the asset in question, and it would usually be the trustee who decides if and when to dispose of the asset. It would be difficult to regard the beneficiary as the alienator except where the trustee is operating essentially as the nominee of the beneficiary.

A separate issue arises where the beneficiary disposes of his beneficial interest under the trust. Some states are concerned that the alienation of a beneficial interest under a trust might be used to circumvent the specific provisions dealing with immovable property or a permanent establishment in Article 13(1) and (2). Thus, for example, a beneficiary might own land in State S through a trust; if the beneficiary disposed of his beneficial interest he might argue that this was not the alienation of immovable property (taxable in State S in accordance with Article 13(1)) but rather the alienation of "other property", falling within Article 13(4) (taxable - if at all - in the state of residence of the beneficiary). Certain specific treaties therefore provide that the alienation of an interest in a trust, the property of which consists primarily of immovable property, may be taxed where that property is situated.[53]

7: What is the nature of payments made out of the trust?

Assume that a trustee receives various items of income which would be classified under different articles of the Model - dividends, interest, royalties for example. The trustee may make payments to beneficiaries at his discretion or may accumulate the income and make subsequent payments to a beneficiary out of capital. How are those payments from the trust to the beneficiary to be classified under the OECD Model?

There are at least three possible answers to this question. The first is that the payment to the beneficiary retains its original nature. Thus, for example, if the trustee received a dividend from State S, the payment to the beneficiary is also regarded as a dividend derived from a company in State S. This raises obvious difficulties of identification, particularly where the trustee has a power to accumulate income and makes a payment several years after its receipt. A second solution is that the payment to the beneficiary is classified differently from the receipt by the trustee, but that it falls within one of the specific Articles (i.e. Articles 6 to 20) of the Model. The primary candidate is likely to be Article 10 (Dividends), regarding the beneficiary as having received a dividend from the trustee; the result would be to permit the state of residence of the trustee to tax the payment up to a maximum level. The third possible answer is that the payment to the beneficiary does not come within any of the specific Articles but falls under Article 21 (Other Income). There is some basis for assuming that this is the correct answer to the classification of income paid out of a trust.[54] If so, then payments out of a trust are taxable only where the beneficiary is resident.

8: Capital - the application of Article 22:

For those States which impose a tax on capital, the issue arises as to whether the capital of a trust fund should be attributed to the beneficiary or to the trustee. In particular, under Article 22(4), "All other elements of capital of a resident of a Contracting State shall be taxable only in that State". Is the trust fund to be regarded as the capital of the trustee or the capital of the beneficiary? Since trust laws regard the assets of a trust fund as separate from the trustee's personal assets,[55] it seems more appropriate to regard the trust fund as the capital of the beneficiary. This raises problems, however, where - as is often the case - there are a class of beneficiaries entitled to benefit only at the trustees' discretion or on the happening of some future event.

9: Elimination of double taxation - the application of Article 23:

The issue here is the application of the credit or exemption provisions in the context of a trust. To take the triangular situation where a trustee in State T receives income from a source in State S and makes a subsequent payment to a beneficiary in State B. In those circumstances, there may be tax at source in State S, there may be tax in State T on the receipt of the income by the trustee and on the payment of sums to the beneficiary, and there may be taxation in State B on the receipt by the beneficiary. The relevant tax treaties may preclude or reduce some or all of these levels of taxation. However, a question may finally arise whether the trustee or the beneficiary is entitled to credit or exemption on the income each receives.

Concluding remarks on trusts

The questions set out above are the principal issues relating to the application of the Model Convention to trusts. After examining a number of these issues, John

Avery Jones and his colleagues came to the following conclusion:[56]

> "In view of the nature and flexibility of the trust relationship, the degree of uncertainty in applying treaties to trusts is not surprising even in countries where trusts are frequently used. Major problems arise over such elementary matters as what provision avoids dual residence of trustees, or the meaning of beneficial ownership, with countries taking opposite views on whether, for example, trustees of an accumulating trust are beneficial owners of the income, quite apart from the more advanced problems of trading trusts."

Further clarification of the application of the Model Convention to trusts will probably have to await the report of the working party.

Whatever future approach is adopted, it is important to recognize that it would be wrong to assume that all trusts are set up with a tax avoidance motive. However, the resolution of the issues of the application of double taxation conventions to trusts should not open up new avenues for treaty shopping.

Other, Non-Corporate Entities[57]

The working party set up by the CFA is also examining the application of the OECD Model to other, non-corporate entities. There are a range of these entities, including joint ventures, economic groupings,[58] estates, limited liability companies and various forms of collective investment schemes.[59] The general discussion above applies to these entities. Under Article 1 of the Model, for a convention to apply to these entities they must show that they are persons – i.e., generally they must show that they are bodies of persons – and that they are not fiscally transparent. The Partnerships Report also gives some indications of the approach the working party may suggest to adopt towards them. An issue – which is also relevant to partnerships and trusts – is of particular relevance to some of these entities: states recognise and apply varying degrees of fiscal transparency. It is too simplistic to regard an entity as either opaque or transparent – there is a spectrum of transparency.[60] The OECD Partnerships Report recognises that degrees of transparency exist, but left this issue for the follow-up to the Report.[61]

Briefly, one might identify at least four types of transparency:[62]

(a) complete transparency – where the entity has no existence (such as a contractual joint venture, which may not exist as an entity at all), or where the entity is completely disregarded for tax purposes;

(b) transparency with reporting obligations[63] - where the entity has a relationship with the tax authorities, under which it reports income or gains, but the tax liability is exclusively that of the participators[64];

(c) optional transparency – where the entity or its participators may elect for transparency. This may arise because the entity is prima facie opaque but can elect for transparency, or vice versa;[65]

(d) partial transparency – where part of the income of the entity is taxed in the hands of the entity and part in the hands of its participators.[66] The amount which is taxable in the hands of the entity may be variable, an example would be a trust where accumulated income is taxed in the hands of the trustees but distributed income taxed only in the hands of the recipient beneficiaries.

It is interesting to speculate whether entities which enjoy these various levels of fiscal transparency are residents of a Contracting State (always assuming that they are persons – i.e. bodies of persons). The Partnerships Report indicates that entities with complete transparency are not residents, and the same would be true according to that Report for those subject to transparency with reporting obligations.[67] Where transparency is optional, it would be a pragmatic approach to recognise that entities which elect to be taxed as corporations[68] are residents, while those that elect for transparency are not residents. There is an argument that these entities are "liable to tax" since they fall within the jurisdiction to tax of the state of incorporation but are given the option to elect for transparency. However, the better view is probably that, once they elect for transparency – so long as the election is in place - they are not liable to tax. Entities with partial transparency are clearly liable to tax on the income on which the entity is liable to tax. With respect to that part of the income which is taxed in the hands of the participators only, a "flow-through" approach would seem to be pragmatic and consistent with the Partnerships Report.

The United States is one of the few countries which has adopted a provision in its Model tax treaty and domestic legislation dealing with the application of double tax conventions to hybrid entities.[69] Broadly, this adopts a "flow-through" approach. Article 4(1)(d) of the 1996 US Model provides as follows:[70]

> "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 or a resident."

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[1] The text of this article will appear as an update to the author's *Double Taxation Agreements and International* Law (Sweet & Maxwell) and is reproduced by permission of the publishers. Aside from the specific literature on partnerships, trusts and other entities which is mentioned below under those headings, there are several articles which consider the application of double taxation conventions to all non-corporate entities. On this, see P. Lassard, C. Kyres and C. Gagnon, "Treaty Benefit Entitlements of Trusts, Partnerships and Hybrid Entities" (1997) 49 Tax Conference Report of the Canadian Tax Foundation, Chapter 33; R. Tremlay and K. Wharram, "Partnerships, Trusts, and Other Entities: Treaty Benefits" in B. Arnold & J. Sasseville (eds.) *Special Seminar on*

Canadian Tax Treaties: Policy and Practice (Canadian Tax Foundation, 2000); A. Eason, "Entity Entitlement to Treaty Benefits: A Conceptual Approach to Some Practical Problems" in B. Arnold and J. Sasseville op.cit., chapter 12; and R. Critchfield, N. Honson and M. Mendelowitz, "Passthrough Entities, Income Tax Treaties and Treaty Overrides" (1999) Tax Notes International, page 587. There is a very full discussion of the treatment of partnerships and joint ventures in international tax law in (1973) 58B Cahiers D.F.I. See also Vogel, Intro., paras. 104-107 and Art.1, paras. 18-30.

[2] At para.2.

[3] The degrees of transparency are discussed below in the discussion on non-corporate entities.

[4] At paragraph 34 and paragraph 5 of the Commentary to Article 1.

[5] For a discussion of some of the issues that arise in such cases, aside from the Partnerships Report, see also F. Engelen, "International Double Taxation Resulting from Differences in Entity Characterization: A Dutch Perspective" (1998) Intertax 38-43

[6] Examples 11 and 12 in the Report.

[7] There is a growing literature on the application of double taxation conventions to partnerships. The starting point is now the Partnerships Report, but that Report has itself generated a literature. See, for example, M. Lang, *The Application of the OECD Model Tax Convention to Partnerships: A Critical Analysis of the Report Prepared by the OECD Committee on Fiscal Affairs* (Linde Verlag, Vienna, 2000); J. Schaffner, "The OECD Report on the Application of Tax Treaties to Partnerships" (2001) Bull. IBFD 218 - 226; F. Engelen and F. Pögens, "Report on 'The Application of the OECD Model Tax Convention to Partnerships' and the Interpretation of Tax Treaties" (2000) ET 250 - 269; M. Clayson, "OECD Partnerships Report: Reshaping Treaty Interpretation?" [2000] BTR 71 - 83. There is also an older discussion in D.Tillinghast, "Tax Treaty Issues" (1996) 50 U.Miami L.R. 483 at 467 - 474. See also R. Loengard, "Tax Treaties, Partnerships and Partners: Exploration of a Relationship" (1975) 29 Tax Lawyer 31 - 67.

[8] There is also a very good summary of the Report in R. Tremblay and K. Wharram, "Partnerships, Trusts, and Other Entities: Treaty Benefits" in B. Arnold and J. Sasseville, op.cit., at paragraphs 14:32 - 35.

[9] Para.30 of the Partnerships Report, reflected in amendments to the Commentary to Art.3.
[10] Paras.34 and 35 of the Partnerships Report, reflected in amendments to para.5 of the Commentary to Art.1.
[11] Para.40 of the Partnerships Report.
[12] Paras.35 and 47 of the Partnerships Report and para.5 of the Commentary to Art.1.
[13] Para.42 of the Partnerships Report.
[14] Para.6.4 of the Commentary to Art.1.
[15] Paras.52 and 53 of the Partnerships Report and para.6.3 of the Commentary to Art.1.
[16] Decision of 13th October 1999, No.191 191, reported in RJF 12/99 No.1492. Also reported (with translation) in (1999) 2 ITLR 365. There are notes on this case by B. Gouthière (2000) ET 195 to 198 and N.Not (2000) 20 Tax Notes International 1817.
[17] One might compare this case with the decision of the Conseil d'Etat in *SA Quartz d'Alsace* – decision of 6th May 1996, No.154 217, reported at RJF 6/96 No.731, Droit Fiscal 1996 No.30 comm.988. That case concerned a Swiss partnership – originally formed as a société en commandite, but later becoming a société en nom collectif, which owned 54% of a French company. Under Swiss law the partnership had no legal personality. The Swiss partnership sought repayment of the avoir fiscal on dividends under Article 11(3) of the France-Switzerland Convention of 9th September 1966. This paragraph extended the avoir fiscal to physical persons and to companies (sociétés) owning less than 20% of French companies. The Conseil d'Etat held that the Swiss partnership was a person within the terms of the Convention since it constituted a body of persons. However, it was not a physical person for the purposes of Article 11(3) and could not benefit from the repayment of the avoir fiscal.
[18] See Reservations of France at p.63 of the Partnerships Report.
[19] Decision of 4th April 1997, No.144 211, reported in RJF 5/97 No.424 and reported (with translation) in (1997) 1 OFLR 399. There are comments on the case by A-S Croustel and P. Croudin in (1997) ET 463 - 465 and by E. Milhac in (1998) 15 Tax Notes International 1407. There are also some earlier cases on related issues: see Conseil d'Etat, decision of 4th July 1973, No.78 197, Dupont 1973,

page 330; and Conseil d'Etat, 7th March 1990, No.91 573, *Société Canny Bowen*, RJF 5/90, No.528.
[20] For a discussion of the degrees of transparency, see the discussion of other, non-corporate entities below.
[21] BNB 1993/227. There is a note on this case by R. Betten (1993) ET 312 - 314. Both of the cases mentioned here are mentioned in S. van Weeghel, "Recent Case Law" (1994) Bull. IBFD 637 - 644 at 639.
[22] BNB 1994/192; (1994) V.N.1442. There is a note on this case by P. Smit (1994) ET 234 - 237.
[23] Decision of 30th April 1998, reported in (1998) 1 ITLR 463.
[24] [1998] STC 754 confirming the decision of the High Court reported at [1996] STC 1336. There is a comment on the High Court decision in [1997] BTR 188 - 200 by J.D.B. Oliver and J.F. Avery Jones.
[25] It is interesting to contrast this with the decision of the Danish Tax Council (the Ligningsradet) of 22nd February 1994 that distributions from a Spanish limited partnership were dividends for the purposes of Article 10 of the Denmark-Spain Convention of 3rd July 1972 – see 8 Tax Notes International 1560.
[26] Income Tax Appellate Tribunal, 27th September 2001, reported in (2001) 4 ITLR 711.
[27] [1987] S.T.C. 36, affirmed by the Court of Appeal [1989] S.T.C. 493. The UK's general approach to partnerships is discussed in an exchange of correspondence printed in [1995] B.T.R. 111-114. The Inland Revenue confirmed that a partnership cannot be regarded as a UK resident for treaty purposes as it is not liable to tax in the UK.
[28] At p.48 b-c.
[29] In s.526(5) ICTA 1970, now s.832(1) ICTA 1988, which indicates that "body of persons" does not include a partnership.
[30] [1989] S.T.C. 493.
[31] Originally s.62 Finance (No.2) Act, 1987. Similar legislation was also enacted in Canada as section 6.2 of the Income Tax Conventions Interpretation Act to ensure that the *Padmore* result could not arise in Canada.
[32] Though there may be a different position in Scotland since a partnership is a separate entity under Scots law.

[33] Some earlier treaties also dealt expressly with partnership. Thus the Conventions with Cyprus (1974, Art. 3(1)(h)) and Bulgaria (1987, Art. 3(1)(e)). expressly exclude partnerships from the scope of the treaty, while that with the United States (1975 Art. 3(1)(c)) expressly included partnerships (the Convention of 1973 with Malaysia, Art. 2(1)(g), originally excluded partnerships; this was amended by Protocol in 1987).

[34] For example, Art.3(1)(e) of the U.K. - Ghana Convention of 1993 provides: "the term 'person' comprises an individual, a company and any other body of persons, but does not include a partnership;".

[35] See Art. 25(1) of the U.K. - India Convention of 1993, Art. 24 of the U.K. - Ukraine Convention of 1993.

[36] Formerly, para. 14 of the Commentary to Art. 3.

[37] Doubts have been expressed whether this Observation was really necessary and whether a trustee would be regarded as the beneficial owner in any event. See the further discussion below. New Zealand follows this Observation by providing in some of its treaties that a trust is to be regarded as the beneficial owner of dividends, interest and royalties - see, for example, Art. 2(2) of the Australia-New Zealand Convention of 1972.

[38] Para. 15 of the Commentary to Art. 21 - the same Reservation was included in the 1977 Model. Other Reservations relating to trusts have been made by Australia and New Zealand (Art. 7, Commentary para. 42) and Canada (Art. 13, Commentary para. 34).

[39] See, for example, Art. 3(1)(e) of the Canada-U.S. Convention of 1980.

[40] A "subject to tax limitation" - see, for example, the U.S.-Cyprus Convention of 1984, Art. 3(1)(a)(ii).

[41] See, for example, the U.K.-Belgium Convention of 1987, Art. 21(1).

[42] For some examples in Switzerland and the Netherlands, see the chapters by van Mens and Leemreis in Sonneveldt and van Mens (eds.); *The Trust - Bridge or Abyss between Common Law and Civil Law Jurisdictions?* (Kluwer: Deventer, 1992).

[43] There is some guidance as to the application of double taxation conventions to trusts in the UK Special Commissioner's decision in *Wensleydale's Settlement Trustees v. IRC* [1996] STC (SCD) 241. That case concerned a trust, with a trustee resident in Ireland and a trustee resident in the UK, which sought protection on capital gains.

Though the decision focused on the tie-breaker of the place of effective management, it seems to have been assumed that the trust was a person and a resident of both contracting states (hence the tie-breaker issue). The trust was not an individual, so the tie-breaker for persons other than individuals - equivalent to Art. 4(3) of the OECD Model – was applied.

[44] "The Treatment of Trusts under the OECD Model Convention" [1989] B.T.R. 41-60 and 65-102, a version of which is also published in (1989) E.T., Issue 12 (special issue). There is also a short chapter by Ineke Koele; "Trusts and the Application of the OECD Model Convention", in *The Trust - Bridge or Abyss between Common and Civil Law Jurisdictions?* (Kluwer: Deventer, 1992) which is in part a summary of the Avery Jones article. See also J. Prebble, "Accumulation Trusts and Double Tax Conventions" [2001] B.T.R. 69-82 which considers whether trusts are residents of a contracting state and also the application of the beneficial ownership limitation to trusts.

[45] JFAJ "Trusts" distinguishes between life interest trusts, discretionary trusts and accumulation trusts.

[46] See, for example, JFAJ "Trusts", pp. 65-66. See, however, the Canadian Customs and Revenue Authority Technical Interpretation 2001-0108517 to the effect that a trust is not an individual.

[47] The trust being "a person other than an individual". This point is confirmed by the decision in *Wensleydale's Settlement Trustees v. IRC* [1996] STC (SCD) 241.

[48] This issue is discussed in John Avery-Jones (supra.) at pages 84 to 89.

[49] Whether or not a trust is an "enterprise" is also relevant for Article 8 (Shipping etc.), Article 9 (Associated Enterprises) and for Article 13(3) (gains from the alienation of ships etc.).

[50] See Goldberg and Shajnfeld; "Attribution of a Trust's Permanent Establishment to its Beneficiaries" (1986) 34 Canadian Tax Journal 661.

[51] See the notes to Art. 10.

[52] Assume a triangular situation where an asset situated in State S is disposed of by the trustee who is a resident of State T for the benefit of a beneficiary who is a resident of State B. Assuming treaties between the three States based upon the OECD Model; if the alienator is the

trustee, the gain is taxable only in State T. If, however, the beneficiary is the alienator, then the gain should be taxable, under all three treaties, only in the state of residence of the beneficiary.

[53] See, for example, the Canada-Barbados Convention of 1980, Art. 14(3)(b).

[54] And is certainly supported by the Reservation made by the United Kingdom and Ireland to Art. 21. Canada also provides in the "other income" Article of several of its treaties that payments from a trust may be taxed in Canada, but only to a maximum level (generally 15%). This is a helpful and sensible way of dealing with the issue.

[55] On which see Art. 11(b) of the Hague Convention on the Law Applicable to Trusts and on their Recognition:

> "recognition shall imply in particular -
>
> (b) that the trust assets shall not form part of the trustee's estate upon his insolvency or bankruptcy;"

[56] JFAJ "Trusts", p. 101.

[57] The application of double taxation conventions to non-corporate entities is discussed in R. Tremblay and K. Wharram, "Partnerships, Trusts and other Entities: Treaty Benefits" in B. Arnold and J. Sasseville (eds.) *Special Seminar on Canadian Tax Treaties: Policy and Practice* (Canadian Tax Foundation, 2000) at pages 14:67 et seq.; in A.Eason, "Entity Entitlement to Treaty Benefits: A Conceptual Approach to some Practical Problems", ibid., pages 12:11 et seq.; and in P. Lessard, C.Kyres and C. Gagnon, "Treaty Benefit Entitlements of Trusts, Partnerships and Hybrid Entities" (1997) 49 Tax Conference of the Canadian Tax Foundation, at pages 33:23 et seq. See also Vogel, Art.1 para.30c.

[58] For an example of the application of a convention to an economic interest grouping, see the *Kingroup* decision discussed under Partnerships above.

[59] Lessard, Kyres and Gagnon, op. cit., discuss the application of double taxation conventions to: Nova Scotia unlimited liability companies, US limited liability companies (LLC's), S corporations, and US associations. Tremblay and Wharram, op.cit., discuss the application of double taxation conventions to LLC's, S corporations, unlimited liability companies, limitadas and sociétés en nom collectif. With respect to US LLC's, the Inland Revenue has expressed the view that they cannot be a resident of the US but that

treaty relief will be given to the extent that the income in question is subject to US tax in the hands of the members of the LLC resident in the US – see Inland Revenue Tax Bulletin, No.29, pages 440 to 441 and [1997] BTR 320 to 323.

[60] On this, see especially A. Eason, op.cit., page 12: 11 et seq.

[61] See paragraph 37 of the Partnerships Report.

[62] Much of the discussion in this section is derived from an unpublished paper delivered by the author to the International Tax Planning Association in 1996.

[63] A-F Coustel and P. Coudin term this "translucent" – see (1997) ET 463 at 464.

[64] This is the case for the income of partnerships in the UK, for example. The entity may also, aside from the obligation of reporting income, have a duty to withhold and account for tax on behalf of its participators.

[65] This is understood to be the case for a number of entities in France where certain entities – the société en participation, for example – are prima facie taxed as corporations but can elect for transparency, while others – for example, the société en nom collectif – are prima facie transparent but can elect to be treated for tax purposes as corporations. This is also the case for US S corporations and under the US "check-the-box" regulations.

[66] This is understood to be the case for the French société en commandite simple, where the société is taxed on the share of the limited partners, but the general partners are taxed under transparency. This is also understood to be the case in the Netherlands for the open commanditaire vennootschap, which is a taxable entity but the share of the general partners is deductible and taxed directly in their hands.

[67] Because liability is determined with reference to the characteristics of the participators.

[68] Or which have the option to elect against transparency but do not exercise that option.

[69] See the Regulations under the Internal Revenue Code s.894(c).

[70] See also Article 1(8) of the UK-US Double Taxation Convention of 24th July 2001.