Cross Border Taxation of Partnerships

Chapter 20

Vivaik Sharma & Abhay Sharma

Vivaik Sharma is lawyer and a member of the Funds and the International Tax Practice Group of Nishith Desai Associates. He is based in Mumbai. His core practice areas include fund formation, private equity fund investments, general taxation advisory and tax structuring. He has authored numerous articles and tax chapters for various publications.

Abhay Sharma is a Senior Associate at Nishith Desai Associates, Mumbai working with the Funds and the International Tax Practice Group of the firm. His practice areas include private equity investments, general taxation advisory, tax structuring and documentation. He has authored numerous articles and tax chapters for various publications including Economic Times, Business Standard, Butterworth's and CTC.

Synopsis

1. Introduction

Choice of business entities in today's globalised world depends upon myriad needs of business. The unique regulatory and taxation environments in different countries have prompted the use of novel structures. Partnerships, owing to their flexible features and relative ease of administration, have thus gained prominence as tailor-made business structures, in addition to conventional entities like body corporates. The key reason of success of partnerships as business vehicles is that typically, the partners have full power and authority to act on behalf of the partnership. Unlike corporations, partnerships are often not viewed as separate legal entities, but as an aggregation of its partners doing business under a common name.

The use of partnerships for the purpose of cross-border operations often brings up many complex international tax law issues. Such issues come up at the time of ascertaining tax liability of a foreign partnership in the country where the source of income lies ("**Source State**"). In case the foreign partnership is organized in a jurisdiction with which the Source State has concluded a double tax avoidance agreement ("**Treaty**"), one would need to determine the circumstances in which the partnership can be allowed, or denied, the benefit of such Treaty while being taxed in the Source State. In a Treaty situation, a common issue faced while ascertaining taxation of cross border partnerships is that the same entity may be treated differently for tax and legal purposes by the country of its residence and the Source State for the purposes of granting Treaty benefits.

The difference in the perception of an entity and the variance in interpretation of the Treaty, in turn gives rise to many additional issues while ascertaining tax liability of cross border partnerships. For instance, one common case is where one of the parties to a Treaty treats partnerships as distinct taxable entities while the other treats them as transparent for tax purposes and hence not view them as distinct from its partners. Further, it is also possible that a country may treat a partnership as opaque for the purposes of certain type of laws, but transparent for other set of laws. In such cases, one of the countries may not treat partnerships as eligible to claim benefits of the Treaty.

Typically, Treaties are drafted keeping in mind the taxability of individuals, companies and body corporates and fail to specify the treatment of partnerships and other entities in the Treaty, thus creating uncertainty with respect to taxation of partnerships. Interestingly, in certain cases one of the contracting States to a Treaty may rely on the laws of the other to ascertain the nature of a partnership but interpret them in a manner different from the courts and authorities of that other State. Even in cases where a State views partnerships as tax transparent and hence not covered under the ambit of a Treaty, it remains to be analysed whether the partners of that partnership could be granted the benefit of any applicable Treaty.

Suffice to say, while each country may have its own recognised principles of classifying and taxing foreign partnerships, in a globalised world with cross border investment being commonplace, such differential treatment often creates a host of issues especially from the taxation perspective. The problem is often exacerbated given the paucity of jurisprudence in many jurisdictions such as India on the subject.

This Chapter summarises the various issues around taxation of cross-border partnerships and also analyses certain important sources of jurisprudence on this point, including the report of the Organization for Economic Cooperation and Development ("**OECD**") on application of the OECD Model Tax Convention to Partnerships and certain important cases, from India and other jurisdictions, which are relevant to the topic. Since this Chapter approaches the topic with India as its focus, it would be appropriate that before delving into the international tax jurisprudence on the subject, the basic principles of law and taxation concerning partnerships in India are summarised first.

2. Section I

2.1 Partnerships and their common variants

A 'partnership' in its simplest form may be defined as an agreement or understanding, between two or more parties, where the parties agree to operate in a manner which furthers their mutual interests. The parties to such agreement of partnership are termed as 'partners' of the partnership. Such agreements for partnership may be oral or written, depending upon the laws of the country under which the partnership is organised. Another way to define partnerships is as a relationship existing between two or more persons who join to carry on a specific purpose like trade, business etc.

For a long period of time, partnerships have been popular vehicles for running most types of businesses in both countries with civil law and common law systems. Over the years, various countries have developed different variants of partnerships and therefore the characteristics of a partnership vary depending on the laws under which it is organised and also the legal system prevalent in the country of their organisation.

In India, the terms 'partnership' was first defined under section 239 of the Indian Contract Act, 1872. However, subsequently, upon enactment of the Indian Partnership Act, 1932, the definition under the Indian Contract Act, 1872 was removed and incorporated in section 4 of the Indian Partnership Act, 1932, which defines partnerships as 'the relation between persons who have agreed to share the profits of a business carried on by all or any one of them acting for all'. Section 4 of the Indian Partnership Act, 1932 further provides that the persons who have entered into partnership with one another are called individually 'partners' and collectively 'a firm' and the name under which their business is carried on is called the 'firm name'.

Therefore, the terms 'partnership' as understood under Indian laws has the following important characteristics (i) an agreement between partners; (ii) sharing of profits of business between partners, and (iii) relationship of 'agency' amongst all partners i.e. the ability of partners to bind all other partners in relation to the partnership business. In addition to the above basic characteristics, there are several other features inherent in an Indian partnership, like, absence of a separate legal personality, unlimited liability of each partner, etc.

In addition to the aforementioned general partnerships, the enactment of the Limited Liability Partnership Act, 2008 introduced a new variant of partnerships in India, i.e. the limited liability partnership ("**LLP**") wherein the liability of the partners of the LLP is limited to the extent of their contribution. The mutual rights, duties / obligations of partners of an LLP *inter se* and those of the LLP and its partners are governed by an Agreement ("**Agreement**") between partners or between the LLP and the partners. As per the LLP Act, 2008, every LLP shall have at least two designated partners who are individuals and at least one of them shall be a resident in India. In case if no partner is designated as such, or if at any time there is only one designated partner, each partner shall be deemed to be a designated partner of the LLP. A designated partner is responsible for doing of all acts, matters and things as are required to be done by an LLP in respect of compliance of the provisions of the LLP Act, 2008, including filing of any document, return, statement and the like report pursuant to the provisions of the LLP Act, 2008 and as may be specified in the limited liability partnership agreement; and shall further be liable to all penalties imposed on the limited liability partnership for any contravention of those provisions. Therefore, the responsibility of a designated partner is like that of a director of a company.

In simple terms, LLPs are business vehicles which combine the features of a general partnership and a company. The LLP Act, 2008 defines LLPs as partnerships which are formed and registered under the LLP Act, 2008. Section 3 of the LLP Act, 2008 specifically provides that an LLP is a body corporate which is formed and incorporated under the LLP Act, 2008 and is a legal entity separate from its partners. Further, LLPs have perpetual succession and their existence, rights and liabilities are independent of the partners, or a change in the partners of the LLP.

Most importantly, the LLP Act, 2008 provides that each partner of an LLP is its agent. However, the partners of an LLP are not agents of each other. Further, any obligation of the LLP whether arising in contract or otherwise is an obligation of solely the LLP and ordinarily would have to be met out of the assets of the LLP itself. The partners of an LLP are not personally liable for an obligation of the LLP, except in cases where the LLP and its partners have been found to have acted with intent to defraud creditors or for any other fraudulent purpose.

Business organisations with the same elements and characteristics as that of Indian partnerships are widespread in many other jurisdictions. The following is a brief overview of the globally known variants of partnerships.

a. General Partnerships

General partnerships are typical partnerships which have only general partners who are responsible for the management, affairs of the partnership and are responsible for the liabilities of the partnership and each of the other partners. While the finer characteristics of each general partnership depend on the specific laws of the concerned jurisdiction, they may be understood as being akin to the partnerships established under the Indian Partnership Act, 1932.

b. Limited Partnerships

A limited partnership ("**LP**") has both general partners and limited partners. The limited partners, unlike general partners, typically do not actively participate in the management of the LP and are comparable to mere investors in a business. While a general partner in LP typically has unlimited personal liability, a limited partner's liability is limited to the amount of his or her investment in the LP. While the concept of LPs is relatively unknown in India, they are quite popular in countries such as USA and UK.

c. Limited Liability Partnerships

An LLP is different from LPs as all of its partners have limited liability. LLPs are hybrid structured combining the features and, in particular, the advantages of a company and partnership. In many jurisdictions, like India, Singapore and the UK, LLPs are in the nature of body corporates. LLPs are thought suitable as business vehicles where the investors wish to take active role in the management of the business.

2.2 Taxation of Partnerships and Partners under Indian law

Income tax in India is governed by the provisions of the Income-tax Act, 1961 ("**ITA**"), which lays down provisions with respect to taxation, determination of residency, computation of income, transfer pricing, etc. As a fundamental principle under the ITA, all resident taxpayers are subjected to tax in India on their worldwide income, whereas non-resident taxpayers are taxed only on Indian source income, i.e. income received or deemed to be received in India or income that accrues or arises to them in India[1] or income that is deemed to accrue or arise in India. The principles of taxation of partnership, as provided under the ITA are summarised below.

The ITA deals with taxation of income of individuals and certain other legal persons, including 'firms'[2], which include partnerships as defined under the Indian Partnership Act, 1932 and specifically includes an LLP as defined under the LLP Act, 2008. Hence, a partnership firm is a separate taxable entity for the purposes of the ITA.[3]

A partnership constituted under the Indian Partnership Act, 1932, having Indian partners is bound to be treated as resident in India and hence liable to pay tax in India on its worldwide income. The general rate of tax leviable on income of partnerships, as prescribed under the Finance Act, 2012, is 30%[4]. However, the share of income of each partner of a partnership firm, which has been assessed in the hands of the partnership firm, is exempt from tax in the hands of such partner. While, some of the essential characteristics of partnerships may not exist in the case of LLPs, since LLPs are specifically included in the definition of 'firms' under the ITA, the principles of taxation that apply to a partnership apply in the case of LLPs as well.

1. Section 4 of the ITA stipulates the basis of charge of income tax and lays down that 'total income' of a person is subject to income tax. Total income is discussed in Section 5 of the ITA, as per which residents are taxable in India on their worldwide income, whereas non-residents are taxed only on Indian source income, i.e. income which:
    1. is received or is deemed to be received in India by or on behalf of such person; or
    2. accrues or arises or is deemed to accrue or arise in India.

2. Refer definition of 'person' in Section 2(31) of the ITA and the definition of 'firm' in Section 2(23) of the ITA

3. While under the ITA, there is no distinction between registered and unregistered partnership firms, the partnership is required to be evidenced by a written partnership deed and certain other conditions mentioned under Section 184 of the ITA.

4. Subject to education and higher education cess of 3% on the base tax rate.

It is important to note that in case a partnership is not organized within the meaning of the Indian Partnership Act, 1932 or fails to fulfil the conditions prescribed under section 184 of the ITA, it is likely that it may be treated as an association of persons ("**AOP**) and possibly be denied any deduction by way of any payment of interest, salary, bonus, commissions or remuneration made by such partnership to its partners. To elaborate, for a partnership to be taxed as a firm under the ITA, it is also required to fulfil the conditions prescribed under section 184 of the ITA. Such conditions require the partnership to be evidenced by an instrument and the individual shares of the partners be specified in that instrument. Thus, in case a foreign partnership fails to establish that it bears the same key features as a partnership established under the Indian Partnership Act, 1932, the Indian tax department may view a foreign partnership as an AOP. Interestingly, an AOP too qualifies as a separate taxable person under the ITA and the detailed rules of its taxation are provided under the law[5]. However, unlike partnerships, given that there is no express provision under the ITA providing for deduction of any salary, remuneration, bonus, and interest etc. paid to the members of the AOP, claiming such deductions may prove difficult for various reasons in case of an AOP.

---

5. Taxation of an AOP depends on whether the share of the members in an AOP is determinate or not. As per Section 167B(1) of the ITA, where the individual shares of members of an AOP in the whole or part of the income of such AOP are indeterminate or unknown, tax is charged on the total income of the AOP at the maximum marginal rate, which currently is 30%. However, in the event that the total income of any member of an AOP is chargeable to tax at a rate higher that the maximum marginal rate (for example, foreign companies are taxed at the rate of 40%), the entire income of the AOP is subject to tax at the higher rate of tax. Thus, in case a foreign partnership is treated as an AOP and where one or more of its partners are taxed at a higher rate, such higher rate of taxation shall become applicable to the income of the partnership as well.

In accordance with Section 167B(2) of the ITA, in the event that the individual shares of members of an AOP are determinate, or known, the taxation of the AOP is as follows:

(i) In case the total income of any member of the AOP (excluding his share from the AOP) exceeds the maximum amount not chargeable to tax, the entire income of the AOP will be taxed at the maximum marginal rate of tax, i.e. 30%.

(ii) In case any member of the AOP is charged to tax at a rate which is higher than the maximum marginal rate of tax, tax shall be charged on that portion of the income of the AOP which relates to the share of that member, at the higher rate, and the balance income of the AOP shall be taxed at the maximum marginal rate of tax.

Further, as per Section 28 of the ITA, any income by way of any interest, salary, bonus, commission or remuneration, by whatever name called, which is payable to a partner by a partnership firm, excluding any payments disallowed for deduction while computing tax liability of the firm, is taxed as 'gains from business or profession' in the hands of such partner, and is tax deductible for the purposes of computing tax liability of the concerned partnership firm.[6] Thus, subject to the limits prescribed under the ITA, any sum of monies paid by a partnership to its partners as salaries, interest etc. is available for deduction from the taxable income of the partnership itself. As follows from the above, a partnership firm is required to file separate tax returns from each of its partners.

As regards the taxation of non-residents in India, Section 9 of the ITA, is a deeming provision, which elucidates instances when income is deemed to have been received, accrued or arisen in India for the purposes of ascertaining tax liability of any non-resident. Section 9(1)(i) adds a legal fiction to the source based taxation rules and deems all income accruing or arising, whether directly or indirectly, through or from a business connection[7] in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India. Accordingly, a foreign partnership which is treated as resident outside India is liable to tax in India only on its India sourced income.

2.3 Cross border situations: Basic Issues

As a starting point, one of the key questions that need to be addressed in cases involving cross border taxation of partnerships is whether the income derived from the Source State is treated as being derived by the partnership itself or by its partners. This question is significant to understand as to who, amongst the partnership itself and its partners, is to be considered for the purposes of ascertaining

6. Such payments to any partner of a firm are required to meet the conditions and restrictions prescribed under Section 40(b) of the ITA.

7. There is no exhaustive definition of "business connection" in the ITA, and the term has been given an expansive interpretation by judicial pronouncements in the past. As interpreted by the Supreme Court of India in CIT Punjab vs. R.D. Aggarwal & Company, AIR 1965 SC 1526; the expression 'business connection' essentially postulates a real and intimate relation between the trading activity carried on outside India and the trading activity within India, if the relation between the two contribute to the earning of income by the non-resident. Hence, the income derived by a partnership, which is not resident in India, through its Indian business connection, should be subject to tax in India.

tax liability under domestic tax laws of the Source State and any applicable Treaty. To arrive at an answer to this question, the entity is required to be classified by the source State as either transparent or as opaque for tax purposes. While doing so, typically the Source State would seek to classify the entity as per its own laws and in addition may take into consideration the legal characteristic of the entity as per the laws under which it is organised or which it is a resident ("**State of Residence**"). It is at this juncture, that the different tax treatments of the same entity in the source State and the State of Residence, could lead to complex tax issues arising, since it is possible that the same entity is treated as tax transparent in one State, but treated as a taxable entity in the other.

An additional issue which may arise in cross border taxation of partnerships is determining the residential status of a partnership. Due to the laws of the Source State, it may be possible that a foreign partnership may be treated as a tax resident of the Source State. This may lead to a situation of double taxation since both the State of Residence and the Source State would then assert the right to tax the partnership as a resident. For instance, as per Section 6 of the ITA, for a foreign partnership to qualify as a non-resident for Indian tax purposes, it is required that the control and management of its affairs is situated wholly outside India. In all other cases, the foreign partnership may be treated as resident in India. Hence, in case where a foreign partnership, albeit established under the laws of a foreign country, has even a fraction of its control and management in India during any financial year either by virtue of one or more of its partners being present in India, it is possible that such partnership may be treated as a resident in India and thus be taxed in India on its worldwide income. In cases where a foreign partnership is organized in a jurisdiction which has concluded a Treaty with the Source State, it may be possible for the foreign partnership to apply the tie-breaker mechanism provided under the Treaty to ascertain its residential status for the purposes of the Treaty.

In the Indian context, a related issue arose before the Authority for Advance Rulings ("**AAR**") in the matter of *M/s Canoro Resources Limited.*[8] One of the questions referred to the AAR in that case was whether it is possible for a partnership firm formed under the laws of Alberta, Canada to be granted the status of 'firm' for the purpose of taxation under the ITA and whether it satisfied the conditions of Section 184 of the ITA. The Indian revenue department

8 AAR No. 779 or 2008

in that case argued that a partnership firm can be assessed as a firm under the ITA only if it is partnership firm as understood under the Indian law. It suggested that the units in the partnership in question in that case were akin to shares of a company and the shares of the partners was dependent on the units and hence variable, with the managing partner been given vast powers and where no capital could be withdrawn or returned by the partnership without the approval of the managing partner. On such grounds, the revenue department argued that the Canadian partnership was not eligible to be assessed as a firm under the ITA.

In order to answer the above question, the AAR conducted a detailed examination of the provisions of the Partnership Act of Alberta, Canada which recognized three types of partnerships, *viz* ordinary partnerships, LPs and LLPs. The AAR restricted its analyses to the provisions relevant to an ordinary partnership considering the limited question referred to it. It noted that the term 'partnership' is defined under the Canadian legislation to mean a relationship between persons carrying on the business in common with a view to make profits. Further, Section 7 of that Act states that the act of each partner binds the others as well as the firm and Section 11 makes each partner jointly liable with other partners for the debts and obligations of the firm. Section 15 of the Canadian Act provides that every partner is jointly and severally liable for all the liabilities of the firm and Section 36 provides that the partnership could be dissolved at the instance of any one partner. From its reading of the Canadian legislation on partnerships, the AAR was of the view that it was substantially similar to the Indian Partnership Act, 1932 and hence an ordinary partnership under the laws of Alberta would be understood as a partnership under the Indian partnership Act, 1932. The AAR even found that in the case before its consideration, the shares of each partner was ascertainable and hence ruled that the partnership firm in question in Alberta was to be assessed as a firm under the ITA, provided the requirements of Section 184 of the ITA are fulfilled.

Based on the above ruling of the AAR, it appears that where it is established that a foreign partnership is organised with the same basic features and characteristics as that of an Indian partnership, it should be permissible to assess such foreign partnership as a 'firm' under the provisions of the ITA. However, in this context it should be noted that any ruling of the AAR is binding on the revenue in the matter of a specific taxpayer only and cannot be treated as a generally binding precedent.

3. Section II

3.1 OECD and the Convention

As noted before, the basic issue faced while ascertaining taxation of cross border partnerships is that the same entity may be is viewed and treated differently by the country of its residence and the Source State for the purposes of granting Treaty benefits. For the purposes of applying a Treaty, the key question that arises from such variation of understanding is whether a partnership is a resident for the purposes of a Treaty, or not. The same question is analysed below in the context of the OECD Model Tax Convention ("**Convention**").

In 1963, the OECD published a draft model double taxation agreement, or the Convention, and a Commentary on each Article in the Convention, which was intended to form the basis of double taxation agreements between member countries, including the United Kingdom. Since then, new editions of the Convention have been published and updated periodically. Article 1 of the Convention provides that the Convention shall apply to persons who are 'residents of one or both of the contracting States' *i.e.* the States which are the parties to the Treaty. Further, Article 3 of the Convention states that the term 'person' includes an individual, a company and any other body of persons. Therefore, for a partnership to avail the benefits of the Convention, is required to be treated as a person as defined under Article 2 of the Convention. Further, Article 4 of the Convention provides that a person is considered as a resident of a contracting state where such person is 'liable to tax' therein by reason of his domicile, residence, place of management or any other criteria of similar nature, and includes that State and any political sub-division or local authority thereof. Hence, a fiscally transparent entity may be treated as not liable to tax in a contracting State and be denied being treated as a resident of that State.

The answer to the question as to whether a given entity is 'liable to tax' for the purposes of Article 4 of the Convention itself depends upon the manner in which it is perceived by a country. In specific reference to partnerships, the source State may apply its own laws in order to ascertain the classification of the concerned entity. Additionally, the laws of one State may provide for taxation of the income of a partnership at the level of the partnership itself, but the other State may choose to tax the income of a partnership in the hands of its partners. In both cases, there exists a possibility of either double taxation or double non-taxation in respect of the income of such partnership. This issue gets further complicated in a triangular situation, where the partners of a partnership are residents of a jurisdiction separate from the jurisdiction in which the partnership is organized, due to the different tax treatments of partnerships under the laws of each jurisdiction.

In order to address the above issues such as the one mentioned above, the OECD released a report in 1999 called '*The Application of the OECD Model Convention to Partnerships*' ("**the Report**").[9] The Report contains a comprehensive analysis of a wide variety of possible fact situations which may be faced in cross border taxation of partnership dealing with both bilateral and triangular situations. The Report also suggests solutions to such issues. A few of the various factual scenarios analyzed by the Committee in the Report are summarized herein subsequently.

As noted above, Article 1 of the Convention clearly restricts its benefit to only such persons who are residents of at least one of the contracting States. Therefore, in order to obtain the benefits of the Convention, two criteria must be fulfilled:

1) The partnership must be considered a 'person' under Article 3 of the Convention which includes an individual, a company and the other body corporate; and

2) The partnership must be considered a 'resident of a contracting State' under Article 4 of the Convention *i.e.* a person who is liable to tax therein by reason of his domicile, residence, place of management or any other criteria of similar nature.

As regards the first criterion, it has been conceded in the Report that the definition of 'person' provided under Article 3 is not exhaustive as it overtly includes only individuals, companies and other 'bodies of persons'. Although the scope of the terms 'company' and 'body of persons' are much broader than what the literal sense suggests, and though many countries include partnerships within one of these categories, the fact that a partnership has not been expressly included within the definition of 'person' has created a lack of uniformity and clarity. Accordingly, the Report, for the sake of absolute certainty, concluded that partnerships were to be specifically included within the ambit of Article 3 and that paragraph 2, of the

9. The Application of the OECD Model Tax Convention to Partnerships, (Paris: OECD, 1999), Issues in International Taxation, No. 6.

OECD Model Commentary on the Convention ("**Commentary**") on Article 3, be amended to include the following[10]:

"Partnerships will also be considered to be "persons" either because they fall within the definition of "company" or, where this is not the case, because they constitute other bodies of persons."

[Emphasis Supplied]

As regards the second criterion, the Report analyses the expression 'liable to tax', as contained in Article 4 of the Convention *vis-a-vis* the case of partnerships. As per Article 4, a person is considered a resident of a contracting State only if it is 'liable to tax' in that State. The Report states that while certain jurisdictions tax income earned by the partnership at an entity level, others tax income earned by a partnership in the hands of its partners; in which case, effectively, the partnership is 'fiscally transparent' and thus cannot be said to be 'liable to tax' under Article 4. The Report, in this regard, finally concludes that if the jurisdiction where the partnership is organised treats it as fiscally transparent, the partnership cannot be entitled to benefits under the Convention.

The Report examines two common approaches to taxation of partnerships adopted by its member countries. It observes that in many countries, the tax laws provide that income derived by a partnership, from a particular source must be computed at the partnership level, as if the partnership were a distinct taxpayer. Each partner is then allocated his share of that income which retains its character and is added to his income for purposes of determining his taxable income. Further, the taxable income of the partner, including his share of the partnership's income, is then reduced by the personal allowances and deductions to which he is entitled and tax is then determined, assessed and paid at the partner's level. In such cases, it is clear that the partnership is not itself liable to tax. As opposed to this approach, in certain other countries, the income and the tax payable is computed in a similar way, but the tax payable by the partners is then aggregated at the level of the partnership, which is then assessed for the total amount of the tax. To that extent, the Report states that in such cases, the assessment of the tax in the hands of the partnership is a collection technique that does not change the fact that the tax payable on the income of the

10. Ibid, at ¶ 29-32. It was also clarified that the express inclusion of partnerships within the ambit of the term 'national' as appearing in Article 3 was only because a partnership does not have legal personality in several countries.

partnership is determined at each partner's level taking into account the other income of that partner, the personal allowances to which he is entitled and the tax rate applicable to him (which may vary depending on his total income or his nature). In such cases also, the partnership is not liable to tax.

Analysing the common tax treatments of partnerships, the Committee agreed that for purposes of determining whether a partnership is liable to tax, the real question is whether the amount of tax payable on the partnership income is determined in relation to the personal characteristics of the partners (i.e. considering whether the partners are taxable or not, what other income they have, what are the personal allowances to which they are entitled and what is the tax rate applicable to them). If the answer to that question is yes, then the partnership should not itself be considered to be liable to tax. The fact that the income is computed at the level of the partnership before being allocated to the partners, that the tax is technically paid by the partnership or that it is assessed on the partnership as described in the preceding above will not change that result. This conclusion of the Report is extremely important since it actually serves as a test for determination of entitlement to benefits of the Convention as far as OECD's viewpoint is concerned.

Another important conclusion arrived at in the Report pertaining to partners' entitlement to the benefits of the Convention. It was concluded that whenever a fiscally transparent partnership loses entitlement to benefits under the Convention as detailed above, the individual partners would be eligible to claim benefits in respect of the share of their partnership income that is liable to tax owing to such transparency, and such income would retain the nature and source that it had in the hands of the partnership for tax purposes.[11] The most important conclusion arrived at in the report is that transparency for tax purposes is to be decided by the country of residence and the source country must adhere to such determination.[12] The Report emphasises that the source State, in applying the Convention where partnerships are involved, should take into account the way in which an item of income is treated in the resident State of the taxpayer claiming the benefit of the convention *i.e.* the Source State should take into account whether the resident State treats the partnership as transparent or opaque.

11. Ibid, at ¶ 42, 47.
12. Ibid, at ¶ 52, 53, 62.

Clearly, in itself, the Report serves as a source of jurisprudence on cross border taxation of partnerships. The OECD's view with regard to application of the Convention to partnerships has generally been accepted by many academicians and jurists on the grounds that Article 4 clearly provides against grant of Treaty benefits to a partnership that is not 'liable to tax' in its country of organization. Since the aim of the Convention is to avoid double taxation of income, when a fiscally transparent partnership does not qualify for Treaty benefits, for the reason that its income is taxed at the level of the individual partners, it is regarded sufficient that the partners are given Treaty benefits with regard to their individual share of such income.[13]

Eminent author Philip Baker has analysed the application of the Report, referring to certain important case laws which were in harmony with the conclusions arrived by the OECD in the Report[14]. He referred to the decision of the French Conseil d'Etat in *SA Diebold Courtage,*[15] which concerned taxation of rental payments by a French Company to a Dutch limited partnership under an agreement for the sale and leaseback. The partners of the Dutch partnership were both companies resident in the Netherlands. The Conseil d'Etat referred to the tax treatment of the partnership under Dutch tax law and concluded that since partnership was fiscally transparent under Dutch tax laws, it could not be treated as a resident of the Netherlands for the purposes of the Netherlands-France Treaty. The Conseil d'Etat also held that rental income was to be treated as paid to the two partners of the Dutch partnership, who were also residents of the Netherlands, and could benefit from the Treaty. Clearly, the approach of the Conseil d'Etat is in consonance with the conclusions arrived at in the Report since it essentially applied the laws of the resident State, i.e. Netherlands, in refusing Treaty benefits to the Dutch partnership. Further, in the same manner as suggested in the Report, the Conseil d'Etat granted the benefit to the partners of the Dutch partnership who coincidentally were residents of Netherlands.

An important criticism faced by the OECD approach comes from Michael Lang as to the extension of Convention benefits beyond the purview of Article 1. A partnership needs to be a 'person'

13. Jesper Barenfeld, Taxation of Cross-Border Partnerships, IBFD, 2005, at pp. 152, 153.

14. Philip Baker, The Application of the Convention to Partnerships, Trusts and other Non-Corporate Entities, GITC Review Vol. II. No. 1.

15. (1999) 2 ITLR 365

under Article 3 and 'resident' under Article 4 because the Report proceeded on the basis that Article 1 provides for benefits under the Convention. Lang has argued that Article 1 is not the basis of Treaty benefits and that the Convention applies even when a person is not 'liable to tax' in its resident jurisdiction[16]. His argument is along different lines and is based on the premise that since the Convention in itself does not put *de facto* taxation as a prerogative for taxation, the association of the 'liable to tax' test to Treaty benefits is not proper. Hence, since 'liable to tax' does not mean 'subject to tax', it cannot be considered an unconditional requirement. Thus, he argues that a transparent partnership can claim benefits under the Convention.[17] This argument can be contested by pointing out the distinction between the expressions 'liable to tax' and 'subject to tax'. While the latter considers whether the tax has been exercised in effect i.e. *de facto* taxation has occurred, the former merely implies the legal obligation to pay tax. Although the Convention does not provide for a general 'subject to tax' or *de facto* taxation requirement as pointed out in paragraph 34 of the Commentary to Article 23[18], there is no implication that Treaty benefits are to be conferred when there is no legal obligation or liability to pay tax in the resident state.

One very important scenario that the Report has failed to deal with is a case where a country gives the partnership intermediate status i.e. partly transparent and partly opaque. This is seen in the French tax treatment of limited partnerships which is complex and involves taxation at both the entity level and the partner level. A limited partnership (which has not opted to be taxed as a corporation) is taxed at two levels i.e. it is fiscally transparent as far as the profits accruing to the general partners are concerned while the profits accruing to the limited partners are taxed at the entity level by holding such profits as taxable income of the entity. Consequently, France has reserved its position with regards to this conclusion of the Report. As per the rationale used in the Report, experts have opined that the only logical position in such cases would be to recognize the partnership as a resident to the extent that it is liable to tax. Therefore, in case of a French limited partnership, benefits under the Convention would be accorded to the limited partners with regard to their share in the income earned by the partnership since the partnership is taxable with respect to them.[19]

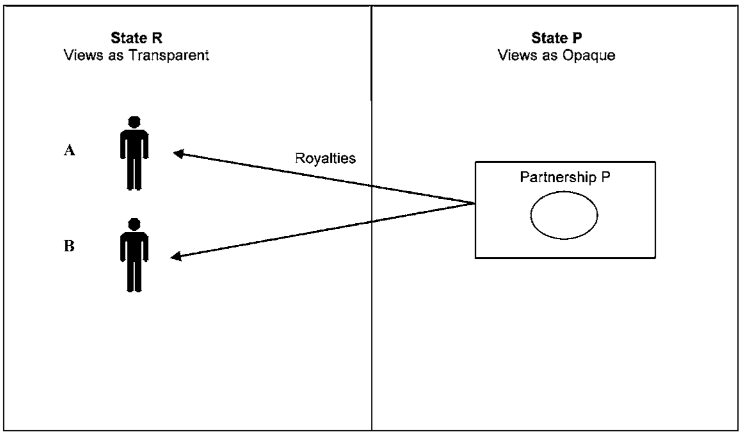
16. Michael Lang, as quoted by Jesper Barenfeld, Taxation of Cross-Border Partnerships, IBFD, 2005, at p. 158.

17. Ibid

18. A person is entitled to Treaty benefits "whether or not the right to tax is in effect exercised by the other State".

19 Ibid, at p. 154.

The Report itself is not oblivious of the absurdities caused due to the OECD's viewpoint that the Source State while taxing cross border partnerships should refer to the tax treatment of the partnership in its home jurisdiction. Example 17 of the Report discusses a case where the P is a partnership established in State P. A and B are P's partners who reside in State R. State P treats P as a taxable entity while State R treats it as a transparent entity. P derives royalty income from State P that is not attributable to a permanent establishment in that state.



In this example, State P would, under its domestic law, impose tax on the royalties in the hands of the partnership. From its perspective, P is a resident taxpayer and as such liable to tax on its income arising in State P. Thus, Article 12 of the Convention would not apply since the royalties arise in State P and are paid to a resident of State P. However, because State R allocates the income to partners A and B, they are also liable to tax on the royalties in State R as residents.

In this situation, it would be difficult to justify the application of the principles of taxation of State R by the State P since the taxation of the partnership is entirely an internal affair of State P. The Report recognised the absurdity in this approach and the majority of the Committee was of the view that it should not be applied in the given scenario.

The Report and the OECD's approach, to the extent it provides that the Source State while taxing cross border partnerships should refer to the tax treatment of the partnership in its home jurisdiction, has also been criticised on the grounds of Article 3(2) of the Convention which provides that unless the context otherwise requires, terms not defined in the Convention shall have the meaning that they have under domestic law of the contracting State that applies the Convention. Some eminent jurists have argued that since a partnership is not included in the definition of 'person' as contained in Article 3 of the Convention, Article 3(2) of the Convention implies that each contracting state could decide independently whether or not a partnership was transparent as per their domestic law. Since the determination by the residence state binds the Source State under the OECD approach, they argue that this would entail a teleological interpretation[20].

The above criticism has been answered through the interpretation given to the expression *"unless the context otherwise requires" of* Article 3(2) of the Convention by experts such as Michael Lang[21] whereby they believed that the term 'context' should include all available historical, systematic and teleological aspects which are important. It is of course possible that in the light of such arguments a country may disregard the approach adopted by the OECD and in consideration of Article 3(2) of the Convention choose to apply its own laws to decide upon the classification of partnerships.[22] It would thus be helpful, if the Report had justified adopting this approach in greater detail.

3.2 India and Treaties

India is not a member of the OECD and has not formally endorsed the OECD approach with respect to taxation of partnerships. India specifically does not agree with the view of OECD that if a contracting State disregards an entity for tax purposes and levies tax on its partners; the partners should be entitled for the benefits of the Treaty in the country where the partners are tax residents, unless the same is specifically provided for under the Treaty. The 2008 update to OECD Model Convention records this reservation as follows:

"3. Gabon, India, Ivory Coast, Morocco and Tunisia do not agree with the interpretation put forward in paragraphs 5 and 6 above of the Commentary on Article 1 (and in the case of India, the corresponding interpretation in paragraph 8.7 of the commentary on Article 4) according

20. Engelen and Pötgens as quoted by Jesper Barenfeld, Taxation of Cross-Border Partnerships, IBFD, 2005, at p. 170.

21. Jesper Barenfeld, Taxation of Cross-Border Partnerships, IBFD, 2005, at p. 170

22. Supra Note 10, at p. 172.

to which if a partnership is denied the benefits of a tax convention, its members are entitled to the benefits of the tax conventions entered into by their State of residence. They believe that this result is only possible, to a certain extent, if provisions to that effect are included in the convention entered into with the State where the partnership is situated."

Consistent to its stand, under certain Treaties concluded by India, partnerships have been specifically included, or excluded, from the scope of the Treaty. For instance under Article 3(e) of the India-USA Treaty, partnerships are specifically included under the definition of the term 'person'. Further, under Article 4 of that India-USA Treaty, it is provided that in reference of partnerships, the term 'resident of a contracting State' applies only *to the extent that the income derived by such partnership is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners*. In this regard, the technical explanation of the India-US Treaty on Article 4 provides that under U.S. law, a partnership is not taxed as such. Under the Treaty income received by a partnership will be treated as received by US resident only to the extent such income is subject to tax in the United States as the income of a U.S. resident. Thus, for U.S. tax purposes, the question of whether income received by a partnership is received by a resident will be determined by the residence of its partners rather than by the residence of the partnership itself. To the extent the partners (looking through any partnerships which are themselves partners) are subject to U.S. tax as residents of the United States, the income received by the partnership will be treated as income received by a U.S. resident. Hence, the India-US Treaty is a good example of how contracting States may provide for specific remedy, for issues of taxation of tax transparent partnerships, without overtly agreeing with the OECD approach in this regard.

Similarly, Article 3(d) of the India-Canada DTAA the definition of 'person' includes partnerships which are treated as taxable units under tax laws of a contracting State. Partnerships deriving its status as such from the law in force in a contracting State are also included in the definition of the term 'national' under Article 3(h) of that Treaty. However, Article 3(f) of the India-UK Treaty specifically excludes partnerships, except partnerships which are taxable units under the ITA. On the other hand, there are Treaties like India-Mauritius Treaty, wherein the definition of 'persons' (Article 3(e)) includes an individual, a company and any other entity, corporate or non-corporate, which is treated as a taxable unit under the taxation laws in force in the respective contracting

States, but does not specifically include partnerships and Article 4 refers to the criteria of it being "liable to tax" therein by reason of domicile, residence, place of management, etc. In such cases, it is expected that the tax treatment of the foreign partnership under the laws of the country in which it is organised would determine whether the partnership would be granted the Treaty benefits or not. For this purpose, it is important to consider the approach of India courts and tribunals towards interpretation of the term 'liable to tax'.

The term 'liable to tax' has been examined by several Indian cases in the past, which have held that this provision does not require the imposition of actual tax and the criteria to be looked at is whether the state has the right to tax the person and whether the fiscal domicile of the person lies in the contracting State. The landmark ruling in this regard is the ruling of the Supreme Court of India in the case of *Azadi Bachao Andolan*[23], which held in the context of the India-Mauritius Treaty that:

"92. In our view, the contention of the respondents proceeds on the fallacious premise that liability to taxation is the same as payment of tax. Liability to taxation is a legal situation; payment of tax is a fiscal fact. For the purpose of application of Article 4 of the DTAC, what is relevant is the legal situation, namely, liability to taxation, and not the fiscal fact of actual payment of tax. If this were not so, the DTAC would not have used the words 'liable to taxation', but would have used some appropriate words like 'pays tax'. On the language of the DTAC, it is not possible to accept the contention of the respondents that offshore companies incorporated and registered under MOBA are not 'liable to taxation' under the Mauritius Income-tax Act; nor is it possible to accept the contention that such companies would not be "resident' in Mauritius within the meaning of Article 3 read with Article 4 of the DTAC."[24]

[Emphasis Supplied]

This view has also been adopted by the Mumbai Bench of the Income Tax Appellante Tribunal ("**ITAT**") in the case of *Green Emirates Shipping*[25]. The Mumbai ITAT, in that case examined the applicability of the benefits of the India-UAE Treaty to a company which was not taxable in the UAE and held that the expression 'liable to tax" is not to read in isolation but in conjunction with the words immediately following it i.e. '*by reason of domicile, residence,*

23. [2003] 263 ITR 706

24. Ibid

25. 100 ITD 203 (Mum)

place of management, place of incorporation or any other criterion of similar nature'. Accordingly, the ITAT arrived at the decision that being 'liable to tax in the Contracting State' would also cover the cases where that other contracting State has the right to tax such persons irrespective of whether or not such a right is exercised by the Contracting State."[26] This conclusion of the ITAT is not consistent with the view of the OECD which maintains that fiscally transparent partnerships are not to be considered as liable to tax for the purposes of the Convention and hence cannot be considered for its benefit.

The OECD does acknowledge that contracting States to a Treaty should be free to specify special rules governing taxation of partnerships. An example of this could be seen in the case of *Asst. DIT vs. M/s Chiron Bhering GmbH & Co., where the* ITAT held that a German LP firm (*Kommandit Gesellschaft*) would be entitled to benefits under the India-Germany Treaty. The decision highlighted certain important principles governing the scope of the expression 'resident' under Article 4 of the India-Germany Treaty[27]. The ITAT observed that although income tax may be borne only at the level of the individual partner, under German laws, partnership firms are still assessed to trade tax. The ITAT noted that the taxpayer was a limited partnership recognized by German law and hence could be considered a 'person'. It further noted that the taxpayer was registered for payment of trade tax and filed regular returns in this regard. Rejecting the department's argument that trade tax was a tax on turnover, the ITAT observed that under the German Trade Tax Act, the basis of the levy was income from business. Moreover, the German trade tax is specifically covered under the India-German Treaty. The taxpayer would therefore, qualify as a resident and is eligible for the lower withholding rate under the Treaty. With respect to the comments in the OECD publication, the ITAT was of the view that as long as the provisions of the Treaty are unambiguous, no reference needs be made to external commentaries or foreign decisions. This case is thus an instance of special provisions under

26. Ibid.

27. Article 4 of the India-Germany tax Treaty defines 'resident' as any person who, under the laws of India or Germany, is liable to tax therein by reason of its domicile, residence, place of management or any criterion of a similar nature. A 'person' is defined to include an individual, a company and any other entity which is treated as a taxable unit under the taxation laws in force in the respective contracting States. Further, by virtue of Article 2 of the India-Germany Tax Treaty, the scope of the Treaty extends to both income tax (Einkommensteuer) and trade tax (Gewerbesteuer) as may be levied under German laws.

the Treaty which helped in ascertaining the residence status of a foreign partnership.

While the above decision of the ITAT is in conformity with the broad scope and intention behind the India-Germany Treaty, complications may arise in situations where a pass through entity may not be liable to any of the taxes specifically enumerated in Article 2 of a Treaty. This question has to certain extent been analysed and answered by the ITAT in the case of *Linklaters LLP* vs. *ITO.*[28] This case concerned a UK based law firm *i.e.* Linklaters LLP, which had during the relevant fiscal year (April 1, 1994-March 31, 1995), rendered legal advice and services to clients with respect to projects in India. In order to render such services, the partners and employees of the law firm visited India for varying periods of time. The revenue sought to tax Linklaters on grounds of having a permanent establishment in India as per Article 5(2)(k) of the India-UK Treaty. Hence, the ITAT first considered the question that whether Linklaters LLP is entitled to claim the benefits of the India-UK Treaty or not.

Prior to answering the above questions, the ITAT acknowledged the problems of asymmetric taxation of an entity, in respect of its cross border income, in the Source State and in the State of Residence. The ITAT observed that while taxing income attributable to a foreign entity, the Source State has to first decide as to how such foreign entity should be treated for domestic tax law purposes of the Source State, *i.e.* the exercise of 'foreign entity classification'. These classifications for the purposes of taxation, or the manner in which the taxpayers falling under that classification are taxed, need not be homogenous in the Treaty partners. It observed that such situations may lead to a situation of double taxation because of the fact that mechanism of relieving a taxpayer of double taxation in respect of cross border income typically takes care of international juridical double taxation i.e. the same income getting taxed twice – in the source jurisdiction as also in residence jurisdiction – in the hands of the same taxpayer. An economic double taxation of an income, on the other hand, which refers to taxability of same cross border income in the hands of different taxpayers, is not directly addressed by the tax treaties. The ITAT, hence, framed another question for itself i.e. whether the tax treaties are at all required to deal with the issue of economic double taxation of this nature, and provide remedy for relieving taxpayers of such

28 [2010] 6 Taxman 38

economic double taxation, or whether the role of treaties is confined to relieving the taxpayers only juridical double taxation. Considering the scope and intention of tax treaties, the ITAT concluded that it was not beyond the objectives of tax treaties to provide respite from economic double taxation, in addition to juridical double taxation of income.

Then, the ITAT referred to the decision of the Canadian tax Court in *TD Securities (USA) LLC* vs. *Her Majesty, the Queen*[29], in reference to the Canada-U.S Treaty. In that case it was held that a Delaware LLC, which had a single member and had elected to be fiscally transparent under the check-the-box regulations was eligible for the benefits of the US-Canada DTAA and stated that the criterion for residence under Article 4 was based on the actual taxation of income in the residence state and not the modality of taxation. The Court quoted the following passage from the Judgment of the Federal Court of Canada in the case of *IV. Gladden* vs. *Her Majesty the Queen*[30], wherein it was held that for the interpretation of a Treaty, the emphasis is on the 'true intentions' rather than 'literal meaning of the words employed':

"Contrary to an ordinary taxing statute, a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated insofar as the particular items under consideration are concerned."

Based on a review of *TD Securities (USA)* LLC, the ITAT noted that while this decision cannot be an authority for the proposition that partnership firms or fiscally transparent entities must always be extended Treaty benefits available to other taxable entities domiciled in that tax jurisdiction, it observed that this decision does certainly support the theory that it is fact of taxability of income in the residence state (in that case the income of the LLC was taxable in the hands of its members), rather than modality of such taxation, which must have greater relevance, and that the tax treaties ought to be interpreted on a contextual basis rather than on the basis of strict principles of interpretation of tax laws. Next, the ITAT adopted a twin-pronged approach in arriving at its decision of granting the Treaty benefits to Linklaters LLP, which is summarized as below.

---

29. 2010 TCC 186
30. 85 DTC 5188 at p. 5190

The ITAT observed that the term 'liable to tax' appearing in the Treaty should be interpreted in context of the expression in which it appears. The ITAT noted that 'liable to taxation by reasons of his domicile, residence, place of management or any other criterion of similar nature' makes it clear that the expression is employed in the context of ascertaining fiscal domicile. It stated that the test of fiscal domicile is, as adopted in international taxation, that a person is treated as fiscally domiciled in a tax jurisdiction in which it has a locality related attachment which leads to residence type taxation i.e. full-fledged taxation as a person resident in that tax jurisdiction. However, where the tax jurisdiction does not exercise that right to tax to a category of persons, it would be absurd to conclude that the person does not have a fiscal domicile anywhere. To avoid such absurdity, in view of the ITAT, all that matters is whether that tax jurisdiction has a right to tax or not and the actual levy of tax by the tax jurisdiction cannot govern the test of fiscal domicile.

"71. Viewed in the light of the detailed analysis above, in our considered view, it is the fact of taxability of entire income of the person in the residence state, rather than the mode of taxability there, which should govern whether or not the source country should extend treaty entitlement with the contracting state in which that person has fiscal domicile. ***In effect thus, even when a partnership firm is taxable in respect of its profits not in its own right but in the hands of the partners, as long as entire income of the partnership firm is taxed in the residence country, treaty benefits cannot be declined.****"*

[Emphasis Supplied]

The ITAT, while arriving at its decision also acknowledged that its conclusion that that a partnership firm is eligible for Treaty benefits in the source country, even if it is not taxable in its own right in the residence country, is not in consonance with the Report. It noted that as evident from the Report (paragraph 40 of the Report), even when partnership firm is not taxable in the residence in its own right, the Treaty entitlements to the firm are to be denied. However, in the same Report, at paragraph 56, the OECD report recommends that, in such a situation, the Treaty benefits should accrue to the partners in the partnership firm. However, the ITAT observed that the aforesaid solution had been rejected by India by reserving its position on the OECD's view.

Considering that the Government of India had rejected the stand taken in the Report and the changes made in the OECD

Model Convention Commentary as a result of the same, the ITAT concluded that it cannot be held that in the light of the OECD report, the partnership firm must be declined Treaty entitlement benefits. Finally, the ITAT held that the taxpayer was indeed eligible to the benefits of India-UK Treaty, as long as entire profits of the partnership firm are taxed in UK i.e. whether in the hands of the partnership firm though the taxable income is determined in relation to the personal characteristics of the partners, or in the hands of the partners directly. Clearly, the conclusions arrived at by the ITAT in the *Linklaters case* collides head on with the conclusions of the OECD's Report.

However, the judgment in *Linklater's* case raises some further questions as regards India's approach to the interpretation of the term 'liable to tax'. Firstly, the basis of the argument of the ITAT is lost where its partners are not residents of the same country as the partnership and where the partnership is in itself fiscally transparent, since in such a case, the taxation of the entire income of the fiscally transparent partnership firm is not taxed in the country of its organisation. Further, since the partners of the partnership are not taxed in that country as residents, it would be difficult to conclude that the test of fiscal domicile is met in that country. Further, the ITAT has not much elaborated upon what would determine whether or not the other State has a 'right to tax' the partnership except that in its view what is critical is that the other country should tax the entire income of the partnership as its resident. However, in the case of a fiscally transparent partnership, with its partners not being residents in the country of its organisation it may not be possible to conclude that the partnership is fiscally domiciled in the country of its organisation. Hence, the observation of the ITAT appear to be acceptable only where either the partnership is not treated as a fiscally transparent entity in the country of its organization, or where the partners are resident of that country.

In respect of the above summary of the ITAT's viewpoint on granting Treaty benefits to cross border partnerships, it is important to note that this view may lead to certain complications for the partnership or its partners in the resident State. For instance, in a case where a foreign partnership and its partners are residents of a country which treats partnerships as opaque for tax purposes. In such a case, India would tax the partnership giving it the benefits of the Treaty. Further, since the resident State would consider partnership as opaque and hence tax it separate from its partners, it may not permit the partners to avail the benefit of the taxes paid in India. Although in such cases, typically the partnership itself should be able to take benefit of the taxes paid in India, subject to the method of elimination of double taxation available under the applicable Treaty.

A recent addition to the Indian jurisprudence on taxation of cross border partnerships has come in form of a ruling of the AAR in the matter of *Schellenberg Wittmer*[31]. In that ruling the AAR was dealt with the question of taxability of income of a Swiss partnership, or its partners as per the provisions of the ITA and the India-Switzerland Treaty. The income was by way of legal fees received from its Indian clients, Notably, the Swiss partnership in question was not a taxable entity under Swiss laws and its income was assessed in the hands of its partners. It was argued before the AAR that the partnership would qualify as a 'person' for the purposes of the India-Switzerland Treaty either as a 'body of individuals' or a 'company' and hence should be eligible to the benefits of the Treaty on this count. It was also argued by the applicant that in case the partnership was not granted the benefits of the Treaty, the same may be granted to the partners in accordance with the OECD's view set out in the Report.

The AAR observed that under Swiss laws, there is no definition of the term 'person', corresponding to the definition of 'person' under the ITA which confers the Swiss partnership the status of a person. Further, the AAR also observed that a 'body of persons' is not taxable under Swiss laws as well. The AAR declined to follow the OECD commentary on Article 3 which specifies that partnerships would qualify as 'person' as defined under the Convention. The rationale behind the AARs approach was that India has not accepted the OECD's views on this subject. Accordingly, the AAR concluded that the partnership could not be termed as a person for the purposes of the India-Switzerland Treaty and hence would not be eligible to its benefits. As regards granting the benefits of the Treaty to the partners, the AAR observed that the partners could not be termed as the recipients of the income and are only entitled to their share of the profits of the partnership. The AAR declined to follow the OECD's view on this considering that there was no specific provision under the Treaty which allowed for such an approach to be followed. Accordingly, the AAR dismissed the arguments of the applicant regarding the grant of Treaty benefits to the partnerships or, in the alternative, its partners.

31. Schellenberg Wittmer along with its Partners, AAR No. 1029 of 2010

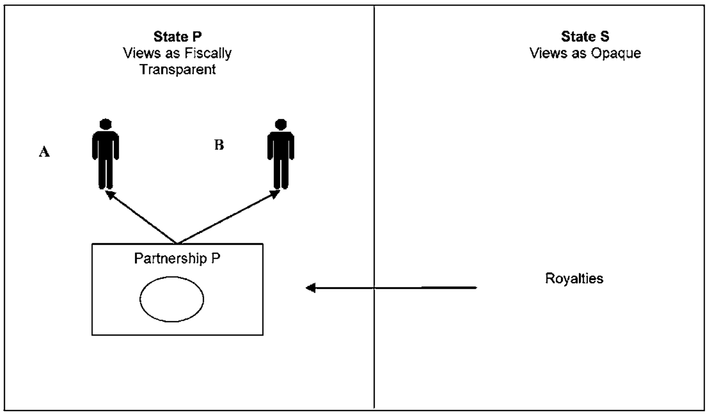
Surprisingly, the AAR while arriving at its decision did not refer to any of the existing case laws or rulings including the judgment in the *Linklaters* case. Even if the reasoning of the AAR is accepted to the extent that the partnership not being a taxable person under Swiss laws and for the purposes of Treaty and is hence not eligible for the benefits of the subject Treaty, its basis for not granting the benefit of the Treaty to the partners is debatable, especially given that in its own conclusion, it interpreted the partnership as a tax transparent entity.

4. Section III: Case Studies

Given that the approach of the OECD and India, along with certain important cases, on the subject has been summarised above, it would be helpful to analyse how such approaches would apply in the context of factual situations. For this purpose we have considered select examples analysed by the OECD in the Report .

4.1 Example 1

P is a partnership established in State P. A and B are P's partners who reside in State P. State P treats P as a transparent entity while State S treats it as a taxable entity. P derives royalty income from State S that is not attributable to a permanent establishment in State S.



OECD's View

Under domestic law of State S, the taxpayer will be partnership P, since it views the partnerships as opaque. State S could then argue that since partnership P is not entitled to the benefits of the Treaty, it can tax the income derived by P regardless of the provisions of the S-P Convention. This, however, would mean that the income on which A and B are liable to tax in State P would be subjected to tax in State S regardless of the Convention. This conclusion in view of the Committee is in direct conflict with the object and purpose of the Convention. The Committee compared that approach, under which State S applies the provisions of the Convention by reference to the treatment of the partnership under its domestic law, with another approach, under which State S considers the entitlement to Treaty benefits of A and B, both residents of State P, under the principles put forward above. Under the latter approach, State S would determine that the provisions of the Convention should be applied to restrict it from taxing the royalties since, under these principles, the income must be considered to be paid to A and B, two residents of State P, who should also be considered to be the beneficial owners of such income as these are the persons liable to tax on such income in State P. The Committee concluded that this approach was the correct one as it is more likely to ensure that the benefits of the Convention accrue to the persons who are liable to tax on the income[32].

The Report recognises that in such cases, in which the partners are not residents in the State where the partnership has been organised, additional difficulties arise in verifying a taxpayer's entitlement to Treaty benefits. Clearly, states should not be expected to grant the benefits of tax conventions in cases where they cannot verify whether a person is truly entitled to these benefits. Thus, the application of the provisions of the S-R Convention will be conditional on State S being able to obtain all the necessary information. For the sake of clarity, paragraph 3 of the Commentary to Article 4 of the Convention was further amended as follows[33]:

32. The Committee did not consider this approach to be inconsistent with the provisions of paragraph 2 of Article 3, under which terms not defined in the Convention have, unless the context provides otherwise, the meaning which they have under the domestic law of the Contracting State that applies the Convention. In the example, the tax treatment of the partnership in State P is part of the facts on the basis of which the terms of the Convention are to be applied. Thus, by referring to that tax treatment, State S does not adopt a particular interpretation of the terms of the Convention put forward by State P; it merely takes into account facts required for the application of these terms. The Committee concluded that, in any event, if an interpretation based on domestic law would lead to cases where the income taxed in the hands of residents of one State would not get the benefits of the Convention, a result that would be contrary to the object and purpose of the Convention, the context of the Convention would require a different interpretation.

33. Ibid, at ¶ 33-36.

"Where, however, a partnership is treated as fiscally transparent in a State, the partnership is not "liable to tax" in that State within the `meaning of paragraph 1 of Article 4, and so cannot be a resident thereof for purposes of the Convention. In such a case, the application of the Convention to the partnership as such would be refused, unless a special rule covering partnerships were provided for in the Convention. ***Where the application of the Convention is so refused, the partners are entitled, with respect to their share of the income of the partnership, to the benefits provided by the Conventions entered into by the States of which they are residents to the extent that the partnership's income is allocated to them for the purposes of taxation in their State of residence."***

[Emphasis Supplied]

Although the partners' eligibility to benefits of an applicable Convention was clearly accepted in the Report, several bilateral and triangular situations had to be considered involving the source state, the state of organisation of the partnership and the state of residence of the partners in order to resolve element of ambiguity concerning the taxation of cross-border partnerships.

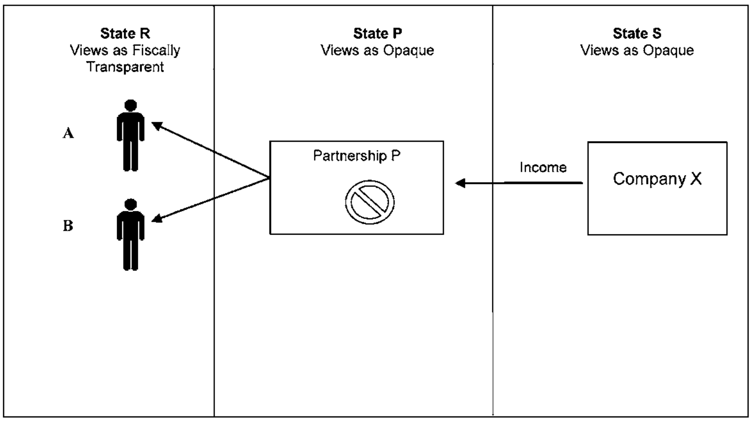
India's Viewpoint

Let us assume that the State S is India and that State P is USA. Now placing reliance on the limited jurisprudence available in the Indian context, it is likely that India would grant benefits of a Treaty to a partnership as long as the USA has a right to tax the partnership irrespective of the actual levy of tax by the tax jurisdiction.

Under Article 3 (e) of the India-USA Treaty, partnerships are specifically included under the definition of the term 'person'. Further, under Article 4 of that India-USA Treaty, it is provided that in reference of partnerships, the term 'resident of a contracting State' applies only *to the extent that the income derived by such partnership is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners*. In this regard, the technical explanation of the India-US Treaty on Article 4 provides that under U.S. law, a partnership is not taxed as such. Under the Treaty income received by a partnership will be treated as received by US resident only to the extent such income is subject to tax in the United States as the Income of a U.S. resident. Thus, for U.S. tax purposes, the question of whether income received by a partnership is received by a resident will be determined by the residence of its partners rather than by the residence of the partnership itself. Hence, in view of the conclusion arrived at by the ITAT in the *Linklaters case* and the technical explanation to the India-US Treaty, it appears that in this case, India would grant the benefits of the Treaty to the partnership.

4.2 Example 2:

P is a partnership established in State P. A and B are P's partners who reside in State R. P owns shares in X, a company that is a resident of State S. X pays a dividend to P. State P and State S treat P as a taxable entity while State R treats it as fiscally transparent.



OECD's View

Partnership P is a resident of State P as it is liable to tax therein. P should again be considered by State S to be entitled to the benefits of the S-P Convention in relation with the income it derives from that State as it is liable to tax on the income and should therefore be considered to be the recipient and beneficial owner of that income. However, partners A and B should also be considered to be entitled to the benefits of the S-R Convention with respect to the partnership income as they are also liable to tax on that income. Thus, both the S-P and S-R Conventions will restrict State S's right to tax the income, regardless of whether State S taxes these income in the hands of the partnership or of partners A and B (under its domestic rules applicable to the taxation of partnerships, it will likely tax them in the hands of the partnership). Again, the tax treatment of partnerships in State S will not have any impact on this result so that both conventions would still be applicable if State S treated partnerships as transparent rather than taxable entities. Hence, from an OECD perspective, this example presents a case where there will be a double entitlement to Treaty benefits with respect to the same income.

The Committee agreed that this double entitlement to Treaty benefits will be satisfied by State S imposing the lowest amount of tax allowed under the two treaties. Thus, if the S-R Convention restricts to 15% of the gross amount of the income the tax that can be levied by State S while the S-P Treaty restricts the tax to 10% of that amount, the obligations imposed on State S under both conventions will be satisfied if the tax imposed by State S does not exceed 10% of the income.

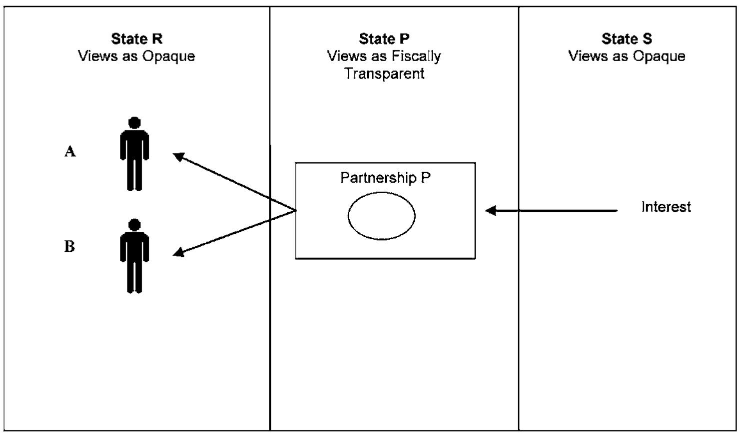
While the Committee agreed on that approach, it recognised the administrative difficulties that its implementation would generate in the case of a partnership that would have a large number of partners who would be residents of different States.

India's View

Let us assume that the State S in this case is India. In such a case, in view of the limited jurisprudence available in the form of judicial pronouncements from Indian courts and tribunals and India's reservation to the OECD's view, it is likely that India would grant the benefits of the S-P Treaty to the partnership. This argument draws strength from the fact that the partnership is treated as fiscally opaque from the perspective of both India and the State P and hence India should treat the criteria of 'liable to tax' (and the test of fiscal domicile) as fulfilled by the partnership. However, it is unlikely that India would allow itself to be restricted by the provisions of the S-R Treaty since India may not choose to look at the partners with respect of the income which is sourced by the partnership from India.

4.3 Example 3:

P is a partnership established in State P. A and B are P's partners who reside in State R. P owns shares in X, a company that is a resident of State S. X pays a dividend to P. States R and S treat P as a taxable entity while State P treats it as fiscally transparent.



OECD's View

In this situation, the partnership is not liable to tax in State P and is therefore not a resident of that state for purposes of the S-P Convention. Similarly, though P is treated as the taxpayer for purposes of the domestic law of State S and the income is allocated to P under the domestic laws of R, P is not liable to tax in State R because it is not treated as a resident. Finally, though A and B are potentially liable to tax as residents in State R, under R's allocation rules, the income is not allocated to them but to P. Thus P is not a resident of State R and A and B are not entitled to benefit from the R-S Convention with respect to the partnership's income. State S would thus be entitled to tax the income without restriction.

As a concluding remark on this example, the Report opinions that it should be noted that the tax treatment of partnerships in State S does not have any impact on the entitlement to Treaty benefits. Thus, the S-R and S-P Conventions would still not be applicable with respect to the interest if State S treated partnerships as transparent rather than taxable entities.

India's View

Let us assume that the State S in this case is India. Following the jurisprudence of the *Linklaters case* and India's reservation to the OECD's view, it is likely that India would grant the benefits of the S-P Treaty to the partnership considering that State P would have the right to entire income of the partnership under its own laws, irrespective of whether such income is actually taxed in State P. It is possible that the test of fiscal domicile in respect of interpretation of the term 'liable to tax', as discussed by the ITAT in the Linklaters case may be considered as fulfilled since the State P would have the right to tax the partnership on its entire income under its laws, irrespective of whether it actually levies tax on it or not.