Tax Treatment of Cross-Border Income Derived Through a Partnership – A Finnish Perspective

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1 Introduction

Cross-border investment or business may be carried out through an entity having the legal form of a partnership. The use of partnerships for the purpose of cross-border operations involves many complex international tax law problems. The tax treatment of an arrangement in the original source state of the income, the partnership state (the state under whose laws the partnership is organized) and the residence state of the partners may be unclear and inconsistent.

Partnerships may generally be treated either as separate taxable entities or as transparent entities. The differences in the domestic tax law treatment also lead to problems in the application of tax treaties. This article examines from a Finnish perspective the tax treatment of cross-border income derived through a partnership.

2 Entities Treated as Partnerships

Finnish domestic tax law distinguishes between business partnerships and taxation partnerships. Partnerships that are general partnerships (*avoin yhtiö*, *Ay*) or limited partnerships (*kommandiittiyhtiö*, *Ky*) under Finnish law are treated as business partnerships. The same treatment also applies to any other domestic or foreign bodies of two or more domestic or foreign persons established for the purpose of conducting business for the joint interests of the partners, excluding corporate bodies (§ 4(1) of the Income Tax Act (TVL)).[1] Taxation partnerships are real property partnerships, i.e. bodies of two or more domestic or foreign persons with the purpose of developing or holding real property (TVL § 4(1)).

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1 A domestic or foreign pool of two or more taxpayers engaged in business whose purpose is to carry out a pre-agreed construction or comparable work, however, does not constitute a partnership for Finnish tax purposes. TVL § 4(2).

The partners of entities treated as partnerships for Finnish tax purposes may be either individuals or legal persons. An enterprise of at least two persons established under foreign law is generally treated as a partnership in Finland, unless the enterprise is comparable to Finnish legal persons treated as corporate bodies.[2] For example, foreign bodies that are comparable to Finnish general or limited partnerships or European Economic Interest Groupings (EEIGs) are treated as partnerships for Finnish tax purposes. A sole entrepreneur is always treated either as a corporate body or as an individual operating a sole proprietorship. The tax treatment in another country is not decisive for Finnish tax purposes.

3 Tax Treatment of Partnerships and Their Partners

3.1 Finnish Domestic Tax Law

Domestic or foreign entities that are partnerships for Finnish tax purposes are treated as transparent (pass-through) entities rather than separate taxable persons in Finland (TVL §§ 4, 16 and 16a). A partnership is only an accounting unit, and its profits are taxed as *income of* the partners. The fact that a Finnish partnership derives income from foreign sources or has non-resident partners does not alter the treatment of the partnership. If a Finnish partnership has non-resident partners, the taxable person is not the Finnish partnership but the non-resident partners, who are subject to limited tax liability in Finland.[3]

3.1.1 Finnish partnerships

The total income from both domestic and foreign sources of a Finnish business partnership is divided among the partners and taxed *as their income* (TVL § 16). Foreign-source dividends are also included in the total profits of the partnership -- unlike Finnish-source dividends, which are divided directly and separately among the partners (TVL § 16(3)). The actual distribution of profits by the partnership to the partners does not constitute taxable income for the partners (§ 6(1) of the Business Income Tax Act (EVL)).

A non-resident partner's share of the domestic-source or foreign-source profits of a Finnish partnership is considered to be Finnish-source income (TVL § 10). Thus, the profit share may be taxed in Finland as income of the non-resident partner even though Finland taxes non-residents only on Finnish-source income. The income is divided the same way as for residents *to be* taxed partly as investment income and partly as earned income, depending on the partnership's net assets. The tax rate for non-residents, however, is not

2 TVL § 4 and Bill of the Government of Finland to the Parliament of Finland (HE 256/1994) for the Acts on the Amendments to the Income Tax Act and § 6 of the Business Income Tax Act (EVL).

3 The Finnish treatment of partnerships also covers EEIGs (TVL § 16a). For more details on the Finnish approach to taxing the profits of an EEIG, see Helminen, Marjaana, *Finnish International Taxation* (WSOY, 2002), at 87.

progressive, even for earned income, unlike the tax rates applicable to residents. The tax rate for non-residents is 35% on earned income and 29% on investment income (§ 13 of the Act on Taxation of Income and Capital of Persons Subject to Limited Tax Liability (LähdeVL)). The tax is levied by way of assessment in accordance with the Act on Assessment Procedure (LähdeVL § 16). Non-resident taxpayers must therefore file a tax return.

3.1.2 Foreign Partnerships

3.1.2.1 Finnish resident partners

The profit share of a Finnish resident partner of a foreign entity treated as a partnership for Finnish tax purposes is similar to the treatment of a profit share in a Finnish partnership. The profit share is taxed as income of the Finnish resident partner even if the partnership did not make a profit distribution (TVL § 16a(1)). The partner, not the entity, is subject to tax on the entity's profits even though the entity may be treated as a separate taxable person in the state under whose laws it is organized. The profit share is fixed separately for each of the foreign entity's type of income under Finnish tax law (business income, agriculture income and personal income). The division of the profits between the different income types and income categories (earned income and investment income) is done the same way as for Finnish partnerships and their partners.[4] The share of a resident partner in the partnership's losses is deductible from the partner's profit share in future years (TVL § 16a(1) and TVL Part V).

3.1.2.2 Non-resident partners

The non-resident partners of a foreign entity treated as a partnership for Finnish tax purposes are not subject to tax on the entity's profits if the entity does not have Finnish-source income. Finland, however, basically taxes all Finnish-source income regardless of the income recipient, unless there is tax treaty or specific domestic law provision to the contrary (TVL § 9(1)). A non-resident partner of a non-resident partnership treated as a transparent entity in Finland is subject to tax on different types of Finnish-source income. Each income type is subject to the tax rate applicable to that income type within the limits allowed by a tax treaty (if any). Finland also taxes the income of a non-resident which is connected with a permanent establishment that the non-resident has in Finland for the purpose of conducting business (TVL § 9(3)).

3.1.3 Elimination of International Double Taxation

Possible international double taxation is eliminated in Finland in accordance with the Act on Elimination of International Double Taxation (MenetelmäL). In

4 Bill of the Government of Finland to the Parliament of Finland (HE 256/1994), *supra* note 2, and EVL § 6.

a non-treaty situation, both the foreign taxes paid by the foreign partnership treated as a transparent entity in Finland and the foreign taxes paid by the Finnish resident partners are creditable for purposes of determining the partners' tax liability in Finland. The possible corporate treatment abroad does not bar the credit, provided the foreign entity is treated as a partnership in Finland.[5] A tax credit is granted only if the taxpayer provides the tax authorities with the information necessary for them to determine that the taxpayer is entitled to the credit (MenetelmäL § 8).

3.2 Effect of Tax Treaties

3.2.1 The Applicable Tax Treaty

Most of Finland's tax treaties do not include any special provisions on the tax treatment of partnerships and their partners. Therefore, it may be unclear how tax treaties limit the treatment under domestic tax law. It may not be even clear who qualifies for the treaty benefits: the partnership itself or only the partners. It may also be unclear which treaty should be applied: (a) the treaty between the original source state of the income and the partnership state, (b) the treaty between the partnership state and the residence state of the partners, or (c) the treaty between the original source state of the income and the residence state of the partners. This lack of clarity may lead to conflicts in the application and interpretation of tax treaties. Conflicts of income allocation or income classification may emerge, and they may lead to international double taxation or double non-taxation.

The solution to the problem of the applicable tax treaty and the entitlement to treaty benefits depends on whether a partnership is a "resident person" of a contracting state. Most of Finland's tax treaties define the term "person" very broadly in the same way as the OECD Model Tax Convention. According to the OECD Partnership Report,[6] partnerships usually qualify as persons. Partnerships usually do not, however, qualify as residents for tax treaty purposes. For example, Finnish partnerships are not Finnish residents for purposes of most of Finland's tax treaties because partnerships are not separate taxable persons in Finland.[7] A Finnish partnership may be a taxable person for tax treaty purposes

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5 *See* Bills of the Government of Finland to the Parliament of Finland: HE 207/1992 on the Act on Amending Section 1 of the Act on Tax Credit, and HE 76/1995 on the Act on Withholding Tax of a Foreign Employee and on the Act on Elimination of International Double Taxation and on Amending some other Acts. *See also* Heiniö, Seppo, National Reporter for Finland on Subject II: The taxation of investment funds, *Cahiers de droit fiscal international*, Vol. LXXXIIb (1997), at 403, 413 (51st Congress of the International Fiscal Association, New Delhi, 1997), *and* Helminen, Marjaana, *The Dividend Concept in International Tax Law* (London, The Hague, Boston: Kluwer Law International, 1999), at 116 (dividend payments between corporate entities).

6 *See* OECD, *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation No. 6 (Paris: OECD, 1999), at 12–13 (hereafter "OECD Partnership Report").

7 *See* Matikkala, Timo, National Reporter for Finland on Subject I: International tax problems

only if the other contracting state regards the partnership as subject to tax on its global income.[8]

In many cases, a partnership does not qualify as a taxable person for tax treaty purposes. Therefore, the treaty between the original source state of the income and the residence state of each partner – not the treaty between the original source state of the income and the partnership state – determines the tax treatment of the income derived through a partnership. If the partners are not residents of the partnership state, the treaty between the original source state and the partnership state is relevant *primarily* only for purposes of determining whether the partnership is a resident and whether it constitutes a permanent establishment in the partnership state.

3.2.2 Treatment in the Original Source State

The original source state of each item of income derived by the partnership basically applies the treaty article applicable to each type of income. The original source state levies the amount of tax that is in accordance with the treaty article pertaining to the specific type of income.[9]

If the partnership is regarded as a resident person under the treaty between the original source state and the partnership state, that treaty should be applied. If, however, the partnership is not regarded as a taxable person for treaty purposes, the treaty between the original source state and the residence state of each partner should, as a rule, be applied

The problem in the last-mentioned approach is that, if the partners are resident in different states, the applicable treaty may allow the source state to levy different amounts tax. The original source state should then determine each partner's proportionate share of *each income type* and *determine separately* the tax permitted on *each partner's share*. In practice, this treatment may be very difficult if there are several partners from several tax treaty states. It is clear that this treatment is not possible if the partnership or its partners do not give the necessary information to the tax authorities of the source state.

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of partnerships, *Cahiers de droit fiscal international*, Vol. LXXXa (1995), at 183, 194 (49th Congress of the International Fiscal Association, Cannes, 1995).

8 Regarding the tax treaty concept of residence with respect to partnerships, *see* OECD Partnership Report, supra note 6, at 13–17, and Helminen, *supra* note 3, at 71-78.

9 Under most of Finland's tax treaties, the source state's taxing right applies primarily only to income and capital gains from immovable property and to dividends. The taxing right with regard to dividends is usually limited to a certain amount of tax in the same manner as in Art. 10 of the OECD Model. The source state's taxing right is thus very limited.

3.2.3 Treatment in the Partnership State

3.2.3.1 No permanent establishment

Tax treaties largely hinder the partnership state from levying any tax if the partnership is not regarded as a resident for treaty purposes and does not constitute a permanent establishment in the partnership state for the partners. In such a situation, the partnership state is generally not allowed to tax the income derived by the partnership if the partners are resident in other states. Only the income originating in the partnership state may be taxed in that state and only to the extent the income is of a type for which the applicable tax treaty grants the taxing right to the source state. With respect to most types of income, therefore, the partnership state has no taxing right.

3.2.3.2 Permanent establishment

If the partnership constitutes a permanent establishment in the state in which it is organized, that state has a taxing right. The state may tax the business profits connected with the permanent establishment even though neither the partnership nor the partners are resident in that state (see Art. 7 of the OECD Model).

3.2.3.3 When does a permanent establishment exist?

A partnership does not necessarily constitute a permanent establishment in the partnership state for a partner. The prerequisite for a permanent establishment is that the partnership and, in that sense, also the partners conduct business through the partnership.[10] For example, a business organized as a Finnish limited partnership may be regarded as constituting a permanent establishment in Finland for the non-resident general partners. The general partners participate in the partnership's business in Finland by taking part in its management.

Less clear is the question whether a Finnish partnership may constitute a permanent establishment for its non-resident limited partners. A limited partner is, after all, only an investor, and he does not take part in the everyday business of the partnership. It may be thought, however, that there is an agency relationship between the partners, each partner being a dependent agent of the other partners. On this basis, a limited partner may be taxed in the partnership state due to the existence of a permanent establishment -- at least if the general partner is resident in that state.[11]

In principle, it is possible that some of the partners are regarded as having a permanent establishment in the partnership state and some partners are not. In such a situation, only the partnership's profits attributable to the profit share of the partners having the permanent establishment are taxable in the partnership state.

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10 See Daniels A.H.M., *Issues in International Partnership Taxation* (Kluwer, 1991), at 90.

11 *Id*. at 901.

3.2.4 Treatment in the Residence State of the Partners

Especially from the perspective of the residence state(s) of the partners, it may be unclear whether the partnership's income should be treated in its entirety or whether the treatment should be determined in accordance with the different income types derived by the partnership.

If a partnership is not regarded as a separate taxable person for treaty purposes, it may be argued that the partnership's income should not be treated in its entirety, but in accordance with the different income types of which it consists. It may be argued that the tax treaty limitations should be determined separately for each income type even though the partnership's income may be treated in its entirety for purposes of domestic tax law, as is the case in Finland. For example, because Finnish partnerships are not taxable persons for treaty purposes, the income derived by a partnership should be regarded as keeping its original nature and source for treaty purposes in the hands of the partners. The answer, however, is not clear.[12]

In any case, the residence state of the partners is usually allowed to tax the partnership's income in accordance with its domestic tax law. After all, tax treaties grant the residence state the taxing right with respect to most types of income derived by a resident of that state. The question of the right income type, however, is relevant for purposes of determining the extent to which the residence state must eliminate international double taxation with respect to the possible taxes levied in the source state or the partnership state. Some treaties may also require that the exemption method be used instead of the credit method with respect to certain types of income.

3.2.5 Elimination of Double Taxation

Most of Finland's tax treaties do not mention anything about partnerships in relation to the obligation to eliminate international double taxation.[13] Even though Finland eliminates double taxation satisfactorily in a non-treaty situation with respect to the foreign taxes paid by both the partnership and the partners, a part of double taxation may not be eliminated in a treaty situation. Tax treaties require eliminating double taxation only with respect to taxes levied in accordance with the provisions of the applicable tax treaty (see Arts. 23 A and 23 B of the OECD Model). Double taxation may not be eliminated entirely in a situation involving a conflict of income classification or a conflict of income allocation.

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12 *See* OECD Partnership Report, *supra* note 6, at 15-17, *and* Matikkala, *supra* note 7, at 196-198.

13 A few tax treaties, like the treaty with Germany (SK 380/1982, SopS 18), expressly mention partnerships. According to Art. 23(6) of the Finland-Germany treaty, the partners of a partnership that is a resident of a contracting state are entitled to a tax credit or exemption with respect to income from the other contracting state.

3.2.5.1 Taxes levied in the partnership state

If a foreign partnership is not regarded as a person for treaty purposes, the partnership state is generally allowed to levy tax only if the partnership constitutes a permanent establishment for the business of the non-resident partners in the partnership state. To the extent a permanent establishment exists, the residence state of the partners is required to eliminate international double taxation with respect to the taxes levied in the permanent establishment state using either the exemption or credit method, depending on the treaty concerned. If there is no permanent establishment, however, the partnership state is not allowed to tax, and the residence state of the partners may therefore not be regarded as being required to eliminate international double taxation with respect to the taxes levied in the partnership state.

It is possible that the correct application of a tax treaty is for the partnership state to consider the partnership as a person for treaty purposes or as a permanent establishment, despite the interpretation of the residence state of the partners. In an unclear situation, different classifications may be in accordance with the provisions of a tax treaty. In such a case, the residence state should be prepared to eliminate double taxation even though it does not agree with the classification. The tax authorities should try to resolve the conflict through a mutual agreement procedure.

3.2.5.2 Taxes levied in the original source state

If the residence state of the partners considers a foreign partnership not to be a person for treaty purposes, the residence state should look at its treaty with the original source state when determining whether the taxes levied in the original source state are in accordance with the tax treaty. The original source state, however, may have applied the treaty between it and the partnership state and may have levied the source state withholding tax accordingly. If the source state in such a conflict situation levies a higher tax which is in accordance with its treaty with the residence state of the partners, the residence state may not be regarded as being required to grant a credit for the entire amount of the tax. Denying the tax credit is in accordance with a tax treaty if the interpretation that the partnership is not a person for treaty purposes is in accordance with the treaty.

Strictly interpreted, the residence state should look at both its tax treaty with the partnership state and the possible tax treaty between the original source state and the partnership state to determine the treatment that is in accordance with the treaties. Even if the partnership is not a person for treaty purposes under the first treaty, it may be a person for treaty purposes under the other treaty, and the source state tax levied in accordance with that treaty may be the correct application of the treaty. Therefore, it may be argued that the residence state should give a credit for the amount of tax levied in the original source state even though the treaty with the residence state allows a smaller amount of withholding tax. On the other hand, international double taxation with respect to this amount should already be eliminated in the partnership state using either the credit or exemption method. It may therefore be argued that elimination of double taxation in this case is not the concern of the residence state. The correct answer to this question is subject to debate.

3.2.5.3 Relation between domestic tax law and tax treaties

Tax treaties may be interpreted as not requiring the granting of tax credits as extensively as Finnish domestic law (i.e. the Act on Elimination of International Double Taxation). This raises the question whether it is in accordance with Finnish domestic tax law that, in a tax treaty situation, a Finnish resident is not entitled to a tax credit to the same extent as he is in a non-treaty situation. It is a broadly accepted principle in Finland that tax treaties may only limit the application of domestic tax law, but may not create a new taxing right. Tax treaties should not make the taxation more severe.[14]

For example, assume that a Finnish resident partner of a foreign partnership received dividends from a third state through the partnership. He or his partnership paid the withholding tax levied in the original source state in accordance with the treaty between that state and the partnership state. The tax rate was higher than the rate allowed by the treaty between the original source state and Finland. In addition, he or his partnership paid taxes in the partnership state. In a non-treaty situation, all of these taxes would qualify for a credit in the form of a normal or ordinary tax credit, i.e. up to the amount of the Finnish tax due on that income. If, in a treaty situation, the Finnish tax authorities deny part of the credit because some of the foreign taxes are regarded as not being in accordance with the applicable tax treaty, the Finnish resident partner ends up paying more tax than in a non-treaty situation. Therefore, because of the tax treaty, the taxation of the person actually became more severe.

According to Finnish domestic tax law, the Act on Elimination of International Double Taxation is applied in a tax treaty situation, unless the treaty includes a provision to the contrary (MenetelmäL § 1(1)). Tax treaties generally do not require the contrary. They just require Finland to eliminate international double taxation to a certain extent using a particular method. Tax treaties do not prohibit Finland from eliminating international double taxation more extensively in accordance with domestic law. According to the Act (MenetelmäL § 2), a Finnish resident is entitled to a credit in Finland for the foreign taxes he paid if there is no other provision that requires something else. There may, for example, be a tax treaty provision requiring the application of the exemption method instead of the credit method. There are, however, no tax treaty rules that require Finland to eliminate international double taxation to a more limited extent than that provided by Finnish domestic tax law.

The Act on Elimination of International Double taxation does not state anywhere that, in a tax treaty situation, international double taxation should be eliminated only to the extent required by a tax treaty. In a tax treaty situation, therefore, a taxpayer should be entitled at least to the foreign tax credits that he would be entitled to in a non-treaty situation. Otherwise, tax treaties would be applied in a way that made the tax burden in Finland heavier than if only

[14] This principle is referred to as the "golden rule of tax treaty law". Regarding this principle, see Helminen, *supra* note 3, at 11-12.

domestic law had been applied. This type of treatment would be in conflict with the principle that tax treaties may only limit the application of domestic tax law but may not create a new taxing right.

It is true that Finland will get less tax revenue than was agreed to in a tax treaty if Finland gives a credit for taxes which are not in accordance with the treaty. The fact that the other state levied more tax that is allowed by a tax treaty, however, is not the fault of the Finnish resident taxpayer, where the higher tax is levied even though the taxpayer provided the foreign tax authorities with evidence of his treaty entitlement. The problem concerns the division of taxing rights between two states and is a problem of those states. The tax authorities should therefore try to find a solution through the mutual agreement procedure provided for in tax treaties (see Art. 25 of the OECD Model).

In a tax treaty situation, a Finnish resident taxpayer should be entitled to a foreign tax credit at least as extensively as he would be in a non-treaty situation. In a situation involving an interpretation conflict, the credit should be granted even though the Finnish tax authorities are of the opinion that the taxes conflict with the applicable tax treaty. This type of strict interpretation and application of Finnish tax law, however, may lead to undesirable situations -- if, for example, the foreign tax that is not in accordance with a tax treaty is levied because the taxpayer failed to provide the foreign tax authorities with evidence of his residence. In this case, it is not necessary to grant the taxpayer a credit. Strictly interpreted, however, there is no provision of Finnish domestic tax law that would allow a denial of the credit even in this type of situation.

If Finland wishes to limit the tax credit to foreign taxes that are levied in accordance with a tax treaty, this should be expressly stated in Finnish domestic tax law. In the author's opinion, however, such a provision is not recommended because it could lead to unreasonable consequences for taxpayers. A provision is, however, recommended which requires a taxpayer to provide the Finnish tax authorities evidence that he gave the foreign tax authorities all the information necessary for them to be able to determine the applicability of the tax treaty to the taxpayer.

4 Final Remarks

Deriving income through a partnership creates very complex problems of international tax law, especially when countries that are tax treaty partners are involved. In theory, these problems may be solved. In practice, however, interpretation conflicts are difficult to avoid, especially if more than two countries are involved. Even if the countries concerned agreed on the interpretation and application of their tax treaties, the correct application of the treaties may be almost impossible. For example, it may be administratively impossible for the original source state of income to apply the right amount of its withholding tax if there are many partners from many different states.

Because of the complexity, it is suggested that the tax authorities of the residence states of the partners of partnerships not be too strict when eliminating double taxation with respect to the taxes paid in the other states involved. Otherwise, the use of partnerships for cross-border operations may lead to an unreasonable tax burden. In any case, the partners or the partnership may be required to provide the tax authorities with all information necessary to determine the partners' or partnership's entitlement to benefits under a tax treaty or domestic law.