TAXATION OF PARTNERSHIPS AND PARTNERS ENGAGED IN INTERNATIONAL TRANSACTIONS: ISSUES IN CROSS-BORDER TRANSACTIONS IN GERMANY AND THE U.S.

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TABLE OF CONTENTS

I. INTRODUCTION ................................................................. 145

II. TAXATION OF PARTNERSHIPS IN THE DOMESTIC CONTEXT .... 147
    A. In General ........................................................................ 147
    B. The United States ............................................................. 152
        1. Character of Income ....................................................... 154
        2. Timing of Pass-Through: Taxable Year ............................ 159
        3. Reporting, Refund, and Auditing Purposes ...................... 160
        4. Sale of Partnership Interest .......................................... 160
        5. Guaranteed Payments ................................................... 162
        6. Tax Withholding ........................................................... 164
    C. Germany .......................................................................... 166
        1. Partnerships under German Civil Law ............................. 166
        2. Basic Tax Principles: Conduit or Entity ......................... 167
        3. Partnership engaged in a Trade or Business
           (gewerbliche Personengesellschaft) .................................. 168
        4. Passive Investment Partnership
           (Vermögensverwaltende Personengesellschaft) ............... 170
        5. Guaranteed Payments (Sondervergütungen) ................. 170

III. TAXATION OF PARTNERSHIPS ENGAGED IN INTERNATIONAL TRANSACTIONS ................................................................. 171
    A. The United States ............................................................. 171
        1. Partnership or Corporation ............................................. 172
            (a) U.S. Investors participating in a Foreign Entity ...... 173

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b) Foreign Investors participating in a U.S. Entity......174
2. Domestic or Foreign Entity..................................................175
3. Domestic Partner in a Domestic Partnership with
Foreign Income .................................................................176
4. Guaranteed Payments........................................................178
5. Domestic Partner in Foreign Partnership with
Domestic or Foreign Income ..............................................179
6. U.S. Foreign Tax Credit and Classification Conflict......181
   (a) U.S. treats Foreign Partnership as a Corporation......182
   (b) U.S. treats Foreign Corporation as a Partnership ....186
7. Foreign Partner participating in U.S. or Foreign
   Partnership.........................................................................188
   (a) Income Effectively Connected with a Trade or
       Business in the U.S..................................................190
       (1) Trade or Business..............................................190
       (2) Effectively Connected.................................191
   (b) Certain U.S. Source Income not Effectively
       Connected with a U.S. Trade or Business.............192
   (c) Deductions, Credits, Losses and Returns............193
   (d) Guaranteed Payments..........................................194
B. Germany ............................................................................196
   1. Domestic Partner participating in a Domestic
      Partnership that Receives Foreign Income ............197
   2. Foreign Partner participating in a Domestic
      Partnership that Receives Domestic/Foreign Income ...199
   3. Foreign Partner Participating in a Foreign
      Partnership that Receives Domestic/Foreign Income......201
   4. Domestic Partner participating in a Foreign
      Partnership that Receives Foreign Income ..............202
   5. Domestic Partner participating in a Foreign
      Partnership that Receives Domestic Income............204
IV. ENTITY CLASSIFICATION.......................................................206
   A. The United States.............................................................206
   B. Germany ..........................................................................209
       1. Domestic Entities ..................................................209
          (a) Classification................................................209
          (b) Overview of Business Entities in Germany .......210
       2. Foreign Entities.........................................................213
V. CLASSIFICATION CONFLICTS AND ENTITLEMENT TO TREATY
   BENEFITS ........................................................................213
   A. Application of Tax Treaties to Partnerships: In General ......213
   B. Corresponding Classification of Partnerships by
      Contracting States........................................................215
   C. Non-Corresponding Classification by Contracting States
      (Classification Conflict) ..............................................217
I. INTRODUCTION

This study examines basic issues in the taxation of partners and partnerships engaged in international transactions. Special consideration is given to the tax consequences resulting from the use of partnerships in cross-border transactions between the United States and Germany, the entitlement of partnerships to treaty benefits, and classification conflicts.

One of the effects of a rapidly growing global marketplace is an increased use of the partnership form in international business transactions. Although partnerships have always played a major role as business entities in the U.S. and Germany, the corporate form has traditionally been the prevailing entity choice in international investment activities, partly because the limitation of personal liability is always a major planning goal.

1. See, e.g., NEWS CORPORATION, BUSINESS OVERVIEW 1997, CHAIRMAN'S MESSAGE, available at http://www.newscorp.com/report/business (last visited Feb. 16, 2002) (attributing the company's financial success to its increased use of partnerships which minimized the company's capital exposure while increasing its presence in the global media marketplace); Paul O'Shea, A Year to Remember – 3 Cheers for a Bright New Year, available at http://www.shipcenter.com/analog/ed007.htm (last visited Feb. 15, 2002) (reporting that "some pundits have observed that alliances and partnerships [in the analog industry] are becoming more popular than mergers and acquisitions for improving productivity").

2. See ERNST & YOUNG, DOING BUSINESS IN THE UNITED STATES 23, 27–28 (1999) [hereinafter DOING BUSINESS IN THE U.S.] (stating that “[i]n the United States, most large businesses operate as corporations;” “[d]omestic investors often decide to operate in corporate form to obtain the benefit of limited liability;” and “[f]oreign corporations often operate in the United States through a separately incorporated subsidiary rather than through a branch, primarily to minimize their potential liability exposure”); ERNST & YOUNG, DOING BUSINESS IN GERMANY 30, 31 (1996) [hereinafter DOING BUSINESS IN GERMANY] (explaining that, in regards to domestic entities, "large operations are usually conducted through stock corporations or GmbHs, medium-size and family-owned businesses are often run through a GmbH & Co. KG” because of the advantages afforded from limited liability, whereas “[f]oreign investors usually operate through corporate subsidiaries or German branches” generally because of the tax advantages); URBACH HACKER YOUNG INTERNATIONAL, DOING BUSINESS IN GERMANY 8 (2002), available at http://www.uby.com/uby/ers.nsf/WWWAllDocsByID/PGID-56DLEZ?OpenDocument (stating that:

Numerous forms of organisation and structure are available to foreigners setting up businesses in Germany. German Commercial Law
However, many countries, such as the U.S. and Germany, have adopted partnership forms that combine the benefits of limited liability with a "pass-through" tax regime. As a result, partnerships are becoming increasingly popular in both domestic and international contexts.

Even though partnerships offer far greater flexibility and planning opportunities than corporations, the taxation of partnerships engaged in international activities is still afflicted with uncertainty. A major concern is the application of tax treaties to partnerships and whether partnerships are entitled to treaty benefits. The problem becomes even more complex if the contracting states differ in their tax treatment of partnerships.

distinguishes between unincorporated firms and corporations. The legal structure depends crucially on the degree of liability to creditors. A corporation is a legal entity in itself and is, hence, only liable to the extent of its capital contribution. In the case of the unincorporated company, at least one of the partners has unlimited liability of the firm's debts.

3. See Joel Rabinovitz & Eric. M. Zolt, Tax Nothings, in TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1999, at 181, 190 (PLI Tax Law and Estate Planning Course, Handbook Series No. J0-001E, 1999), available at WL 449 PLI/TAX 181 (describing a partnership as a “pass through” entity, which means that tax consequences are taxed to the partners instead of taxing the partnership directly at the entity level); see also I.R.C. § 701 (1994) (prescribing in pertinent part that “[a] partnership as such shall not be subject to the income tax imposed by this chapter”).

4. See J. William Callison, Venture Capital and Corporate Governance: Evolving the Limited Liability Company to Finance the Entrepreneurial Business, 26 J. CORP. L. 97 (2000) (noting that “limited liability partnerships (LLPs), which are recognized in all fifty states, provide liability protection to general partners”; see also UNIF. P’SHP ACT § 306(c) (1997), WESTLAW [hereinafter UPA] (prescribing that “[a]n obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the partnership” and that “[a] partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or so acting as a partner”); UNIF. LTD. P’SHIP ACT § 303 (2001), WESTLAW [hereinafter ULPA]. In Germany, the Kommanditgesellschaft ("KG") is a limited partnership-type form similar to the limited partnerships in the U.S. See § 161(1) Handelsgesetzbuch (Commercial Code) [hereinafter HGB]; see also infra notes 109, 388 and accompanying text.

5. See, e.g., Alex Y. Seita, Globalization and the Convergence of Values, 30 CORNELL INT'L L.J. 429, 443 (1997) (stating that businesses in expanding markets "set up partnerships with foreign firms, to share technology and risk, in order to create new products"); Colin Ives, Results from our Latest Survey (Mar. 2001), available at http://www.smith.williamson.co.uk/Publications/Professional_Practices/ProfessionalMarch2001.PDF (reporting that “[i]nterest in the introduction of Limited Liability Partnerships in the UK continues to grow with 89% of firms considering limiting liability saying it was likely or possible that they would consider becoming a Limited Liability Partnership” in the near future); Fred Reish & Bruce Ashton, R&L Erisa Audit Report (Oct. 1997), at http://www.reish.com/publications/article_detail.cfm?ARTICLEID=195 (explaining that limited liability partnerships “are becoming increasingly popular because they offer many of the advantages of a partnership (such as flexibility of operation), as well as protection similar to a corporation (no personal liability for the business owner for the obligations of the entity”).
If one state classifies partnerships as separate taxable entities and the other treats partnerships as fiscally transparent, a so-called “classification conflict” arises and may lead to either double taxation or double non-taxation. The significance of this issue is highlighted by a report recently issued from the Organisation for Economic Co-operation and Development (“OECD”), which had formed a Working Group in 1933 to specifically examine the application of the OECD’s Model Tax Convention (“OECD-MTC”) to partnerships and other non-corporate entities.

While an exhaustive and in-depth discussion is beyond the scope of this study, this article describes the basic principles that govern the taxation of partnerships and partners engaged in international transactions in the U.S. and Germany. In addition, this article focuses on the problems that arise from the application of tax treaties in this context.

Part II provides an overview of the different tax regimes applied to partnerships worldwide. Additionally, it sets forth the basic structure of the U.S. and German tax law as applied to the taxation of partnerships and partners in a purely domestic context. The discussion is limited to issues essential to understanding the taxation of international partnership activities. Part III discusses the taxation of partners and partnerships engaged in international transactions under the domestic laws of the U.S. and Germany. Part IV sets forth the rules applied by both countries to classify domestic and foreign entities as partnerships or corporations for tax purposes. Finally, Part V elaborates on the application of tax treaties to partnerships. Special consideration is given to the entitlement of treaty benefits of partnerships and classification conflicts.

II. TAXATION OF PARTNERSHIPS IN THE DOMESTIC CONTEXT

A. In General
Irrespective of the various legal definitions of partnerships in the U.S.\(^8\) and Germany\(^9\), a partnership under the civil laws of both countries may be broadly “defined as:(i) any contractual agreement between two or more persons (individuals or legal entities), (ii) entered into in order to share profits or losses, (iii) combined with the intention to act as partners, (iv) while recognizing the person of the other partner(s).”\(^{10}\)

In both countries, as in many other jurisdictions, partnerships have a dual nature, \(i.e.,\) a partnership contains features most often associated with corporations as well as other features most often identified with direct ownership. In many respects, a partnership is treated similar to a corporation, which exists as a separate legal entity. For example, a partnership has the ability to do business in its own name\(^{12}\) and thus to enter into transactions with third parties.\(^{13}\) The partnership keeps books

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8. See UPA § 6 (1914) (defining a partnership generally as “an association of two or more persons to carry on as co-owners a business for profit”); UPA § 101(6) (1997) (defining partnership as “an association of two or more persons to carry on as co-owners a business for profit formed under Section 202, predecessor law, or comparable law of another jurisdiction”); see also A.H.M. Daniels, Issues in International Partnership Taxation 3–4 (1991).

9. See § 705 Bürgerliches Gesetzbuch (Civil Code) [hereinafter BGB] (describing, via electronic translation, that “[b]y the articles of association the partners commit themselves mutually to promote the reaching of a common purpose in the way determined by the contract make in particular the agreed upon contributions”); § 105 HGB (describing, via electronic translation, that “a society, whose purpose is directed toward the enterprise of trade under a joint company, is an open commercial company, if with none of the partners the adhesion is limited opposite the company creditor”); see also Daniels, supra note 8, at 4.

indexes to German Codes cited in this article can be located online at http://www.steuernetz.de/gesetze and http://www.gesetze.2me.net. Translations of German text and sources in this article were performed electronically at Freetranslation.com and Google.com.


11. See Daniels, supra note 8, at 5.

12. For the United States, see UPA § 201(a) (1997) (“A partnership is an entity distinct from its partners.”). For Germany, see § 124(1) HGB (describing the legal relation of the partner to third parties). See also Daniels, supra note 8, at 5.

13. For the United States, see UPA § 301(1) (1997) (prescribing that: Each partner is an agent of the partnership for the purpose of its business. An act of a partner, including the execution of an instrument in the partnership name, for apparently carrying on in the ordinary course of the partnership business or business of the kind carried on by the partnership binds the partnership, unless the partner had no authority to act for the partnership in the particular matter and the person with whom the partner was dealing knew or had received a notification that the partner lacked authority).

For Germany, see § 124(1) HGB (describing the legal relation of the partner to third parties). See also Daniels, supra note 8, at 5.
and records, and may sue or be sued in its own name. Property may be held in the name of the partnership and in actions against partnership property, creditors of the partnership enjoy priority over creditors of the partners.

On the other hand, although a partnership resembles a corporation in many respects, it is still a mere aggregation of its participants (i.e., the partners) and essentially lacks a separate legal personality. For instance, partners are personally, jointly, and severally liable for the partnership’s debts. Furthermore, the traditional view is that the death or bankruptcy of any partner results in dissolution of the partnership.

14. For the United States, see UPA § 403(a) (1997) (“A partnership shall keep its books and records . . . at its chief executive office.”). For Germany, see § 238 HGB (describing record keeping obligations); § 242 HGB (describing the obligation for listing transactions). See also DANIELS, supra note 8, at 5.

15. For the United States, see UPA § 307(a) (1997) (“A partnership may sue and be sued in the name of the partnership.”). For Germany, see § 124(1) HGB (describing the legal relation of the partner to third parties). See also DANIELS, supra note 8, at 5.

16. For the United States, see UPA § 8 (1914); see also UPA § 203 (1997) (“Property acquired by a partnership is property of the partnership and not of the partners individually.”); UPA § 501 (1997) (“A partner is not a co-owner of partnership property and has no interest in partnership property which can be transferred, either voluntarily or involuntarily.”). For Germany, see § 124(1) HGB (describing the legal relation of the partner to third parties).

17. For the United States, see UPA § 501 (1997) (commenting that the 1997 UPA’s “[a]doption of the entity theory [under section 501] . . . has the effect of protecting partnership property from execution or other process by a partner’s personal creditors” and thus “continues the result under [section 25(2)(c) of the 1914 UPA]”). For Germany, see § 124(2) HGB (describing the legal relation of the partner to third parties); § 135 HGB (describing dissolution of the society and separating partners). See also DANIELS, supra note 8, at 5.

18. See DANIELS, supra note 8, at 5.

19. For the United States, see UPA § 306(a) (1997) (“Except as otherwise provided . . . all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed to by the claimant or provided by law.”). For Germany, see § 128 HGB (“The partners are responsible to the creditors for the commitments of the society as total debtors personally.”). See also DANIELS, supra note 8, at 5.

20. For the United States, see UPA § 31(4) (1914) (“Dissolution is caused . . . By the death of any partner[,]”). However, it should be noted that under the Uniform Partnership Act of 1997, the death of a partner no longer results in automatic dissolution, but instead results in the partner’s dissociation. See UPA § 601(7)(i) (1997). For Germany, see § 727(1) BGB (“The society is dissolved by death of one of the partners, if from the articles of association another does not result.”); § 131 HGB (“The open commercial company is dissolved . . . by the death of a partner, if from the articles of association another does not result”). See also DANIELS, supra note 8, at 5.

21. For the United States, see UPA § 31(5) (1914) (“Dissolution is caused . . . by the bankruptcy of any partner or the partnership[,]”). However, under the Uniform Partnership Act of 1997, the bankruptcy of a partner no longer results in automatic dissolution, but instead results in the partner’s dissociation. See UPA § 607(6)(i) (1997). For Germany, see § 728(2) BGB (“The society is dissolved by the opening of the bankruptcy over the fortune of a partner.”); § 131 HGB (“The open commercial company is dissolved . . . by the opening of the bankruptcy over the fortune of a partner.”). See also
The dual nature of partnerships is also reflected in the way that partnerships are taxed. Two extreme conceptions may be identified: on one hand the partnership may be taxed as an entity (“fiscal intransparency”), emphasizing its similarity to corporations. On the other hand, the partnership is nonexistent for tax purposes and serves merely as a “conduit” through which the individual partners derive their income (“fiscal transparency”). This pass-through approach emphasizes the partnership’s characteristic as a mere aggregation of its partners. Whether a particular jurisdiction adopts an intransparent (i.e., entity) approach or a transparent (i.e., conduit) approach is a matter of tax policy rather than conceptual consideration.

The entity approach is typically found in the Roman law countries, such as Spain, Portugal, and many Latin American countries. In those countries, the tax treatment of partnerships generally follows the civil law, which typically treats partnerships as separate legal entities.

Within countries that follow a conduit approach, different permutations of the concept of fiscal transparency can be identified. At one end of the scale are those systems that apply

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22. See Daniels, supra note 8, at 5.
24. See Daniels, supra note 8, at 8.

Professor Hynes explained the distinction between the civil law entity theory and the common law aggregate as follows:

The distinction between the two theories, broadly stated, is that the civil law entity (or mercantile) theory view[s] a partnership as “a body distinct from the members composing it, and having rights and obligations distinct from those of its members”. . . . Under the common law theory, a partnership is nothing more than an aggregate of its partners. If a partner leaves or dies or a new partner enters the business, the first partnership necessarily dissolves and a new partnership is formed (often by implication) because the business is now being carried on by a different aggregate of people.

Hynes, supra note 25, at 2 n.7 (citations omitted).
26. See le Gall, supra note 10, at 662–64 (providing a more detailed analysis of the four different conceptions of the tax transparency concept of partnerships).
a pure conduit approach, as can be found in the Netherlands, for example. In the Netherlands, only the partners exist for tax purposes. The partnership is considered transparent and its sole purpose is to determine each partner’s respective share of income, expenses, assets, and liabilities. The tax is computed, reported, and audited solely at the partner level as though he were operating as a sole proprietor. The same approach applies to the determination of the nature, source, and amount of income. Moreover, the partner is entitled to claim any treaty benefits, rather than the partnership.

On the other side of the scale, the representative extreme view, as found in Norway, limits the tax transparency to the payment of taxes. Here, the partnership is treated almost like a corporation with the sole difference being that the tax liability is transferred to and paid by the partners on behalf of the partnership. All elections and determinations with regard to each partner’s respective share of partnership income are made at the partnership level.

Most countries, including the U.S. and Germany, have adopted a conduit approach that lies between these two extreme permutations of tax transparency, blending both aggregate and entity concepts. In the U.S. and Germany, for example, the partnership is treated as a conduit which passes income through to the partners, but is considered as an entity for tax accounting, reporting, and audit purposes.


28. See van Raad, supra note 27, at A-23; see also Daniels, supra note 8, at 24, 29.

29. See le Gall, supra note 10, at 662.


31. See le Gall, supra note 10, at 662.


33. See le Gall, supra note 10, at 662.

34. See, e.g., Daniels, supra note 8, at 23–28; Doing Business in the U.S., supra note 2, at 24–25, 53, 69–77; Doing Business in Germany, supra note 2, at 29, 61–62, 77–86; see also le Gall, supra note 10, at 662–64.
B. The United States

The federal income taxation of partners and partnerships in the U.S. is set forth in Subchapter K of the Internal Revenue Code (the “Code”). Prior to the enactment of Subchapter K in the Internal Revenue Code of 1954, there was no comprehensive treatment of partners and partnerships in the income tax code. The small number of sections that dealt specifically with the topic were found to be confusing and inadequate.

In enacting Subchapter K, Congress particularly had to decide whether, for federal tax purposes, to treat a partnership as an entity (fiscal intransparency), or as an aggregate of its partners (fiscal transparency). An entity approach would resemble the tax treatment of C corporations in Subchapter C. A C corporation is a separate taxpaying entity and subject to a double tax regime. The corporation must annually determine and pay tax on its taxable income at the rates set forth in the Code. This income is effectively taxed again when corporate earnings and profits are distributed to the shareholders in the form of dividends. Moreover, transactions between the


38. See H.R. REP. No. 83-1337, pt. 22, at 65 (1954); S. REP. No. 83-1622, at 89 (1954). Legislators described the problem as follows: The existing tax treatment of partners and partnerships is among the most confused in the entire tax field. The present statutory provisions are wholly inadequate. The published regulations, rulings, and court decisions are incomplete and frequently contradictory. As a result partners today cannot form, operate, or dissolve a partnership with any assurance as to tax consequences. H.R. REP. No. 83-1337, pt. 22, at 65; S. REP. No. 83-1622, at 89.


40. See id.; see also CHERYL D. BLOCK, CORPORATE TAXATION 18 (1998) (discussing the disadvantage of double taxation associated with Subchapter C corporations); but see John W. Lee, Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations, and the Tax Legislative Process, 8 VA. TAX REV. 57, 104 (1988) (arguing that the “classic ‘double taxation’ problem for large C corporations, however, is virtually non-existent under the regular income tax regime “due to the cumulative effect of leverage, preferences and low rates of earning distributions, with shareholder realizations arising more frequently through capital transactions such as sales (possibly after basis step-up due to the prior owner’s death)”).

41. See I.R.C. § 11 (prescribing the general rule that corporations are subject to tax on its taxable income for each taxable year and providing tax rates for determining the corporation’s tax liability).

42. See id. § 301(c)(1) (requiring “that portion of the distribution which is a dividend shall be included in gross income”); id. § 316 (defining “dividend” for U.S. tax purposes).
corporation and its shareholders are generally treated as entered into between third parties.\textsuperscript{43}

In contrast, under a pure aggregate (\textit{i.e.}, pass-through or conduit) approach the partnership is disregarded for federal tax purposes (fiscal transparency). Instead of directly taxing the partnership, tax is imposed on the partners who must include their respective shares of partnership income, deductions, and losses in their individual taxable income, regardless of whether or not they receive actual distributions.\textsuperscript{44} Distributions by the partnership generally would be nontaxable because they are viewed as income that has already been taxed in the hands of the partners.\textsuperscript{45}

In the U.S., the Code employs a mixture of aggregate and entity rules for taxation of partners and partnerships, while the fundamental and dominating principle is that of fiscal transparency.\textsuperscript{46} The reasons for this compromise lies in the fact that entity principles\textsuperscript{47} mostly serve judicial and administrative

\textsuperscript{43}For example, when a shareholder sells property to the corporation in exchange for a promissory note, the shareholder's return will be taxable, assuming that the nonrecognition rule under section 351 does not apply to the transaction. See Block, supra note 40, at 69. However, in certain situations, such as when shareholders loan money to the corporation or sell property in exchange for a long-term note, the transaction might be reclassified to the detriment of the shareholder, \textit{i.e.}, having the loan reclassified as an equity investment for federal tax purposes. See id. at 38–39, 70–71.

\textsuperscript{44}See I.R.C. §§ 701, 702.

\textsuperscript{45}See Lind \textit{et al.}, Fundamentals of Partnership Taxation 3 (5th ed. 1998). However, the partner may recognize gain if the distributions exceed his share of partnership income and the partner's original investment in the partnership.

\textsuperscript{46}See I.R.C. § 701 (prescribing that "[a] partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities"). Section 701 provides that each partner is taxed on his or her distributive share of the partnership income. See id. The partnership merely serves as the conduit through which income passes to the partners to be reported on their individual federal income tax returns. See Richard M. Lipton, Critical Partnership Tax Issues – An Overview, in ACQUIRING OR SELLING THE PRIVATELY HELD COMPANY 2002, at 409, 421 (PLI Corporate Law and Practice Course, Handbook Series No. B0-01AH, 2002), available at WL 1313 PLI/CORP 409; see also Daniels, supra note 8, at 24–26.

\textsuperscript{47}See I.R.C. § 703(a) (prescribing that "the taxable income of a partnership shall be computed in the same manner as in the case of an individual except [for certain listed exceptions]"). The entity approach is reflected in section 703(a), which requires a partnership to determine its "taxable income" in the same manner as an individual, except that certain items listed in section 702(a) must be separately stated and certain deductions are disallowed. See id. Moreover, the character preservation rule in section 702(b) provides that "[t]he character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share . . . shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in...
procedures and thus were chosen by Congress to bring order and uniformity to the taxation of partnership operations.\textsuperscript{48} Thus, partnerships are treated as entities for purposes of determining the amount, character, and timing of partnership income items, as well as for reporting and auditing purposes. The “anomalous operating structure”\textsuperscript{49} of a partnership, lingering between separate legal entity and direct ownership, accounts for much of the complexity within Subchapter K. Even so, this generally establishes the fundamental underlying principle of fiscal transparency, which provides that the use of a partnership should affect the tax treatment of the partners as little as possible.

1. Character of Income

The character of any item of income, gain, loss, deduction, or credit is determined at the partnership level.\textsuperscript{50} As a result, certain items of income, potentially subject to different tax consequences when distributed to individual partners, are separately allocated to various statutory income groups listed in section 702(a).\textsuperscript{51} The character of income allocated to these

\textsuperscript{48} See LIND ET AL., supra note 45, at 67.


\textsuperscript{50} Compare Rev. Rul. 67-188, 1967-1 C.B. 216 (stating “each partner must also take into account separately his distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately”), with Rev. Rul. 68-79, 1968-1 C.B. 216 (stating “[t]he character of any item of income, gain, loss, deduction, or credit included in a partner’s distributive share under paragraphs (1) through (8) of section 702(a) of the Code is determined at the partnership level”). See also Powdell v. Comm’r, 55 T.C. 429 (1979) (stating that “the ‘conduit rule’ requires that for the purpose of determining the nature of an item of income, gain, loss, deduction or credit in the hands of the partnership . . . are to be characterized from the viewpoint of the partnership rather than from the viewpoint of an individual partner”); Treas. Reg. § 1.702-1(b) (2000).

\textsuperscript{51} See I.R.C. § 702(a) (1994 & Supp. V 1999). Section 702(a) prescribes that: In determining his income tax, each partner shall take into account separately his distributive share of the partnership’s—

(1) gains and losses from sales or exchanges of capital assets held for not more than 1 year,

(2) gains and losses from sales or exchanges of capital assets held for more than 1 year,

(3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or
groups must be preserved when commingled with similar types of income derived from other partner activities.\textsuperscript{52} This character preservation rule requires that “[t]he character of any item of income, gain, loss, deduction, or credit included in a partner’s distributive share . . . shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.”\textsuperscript{53} This income preservation rule is also taken into account when determining the “taxable income” for a partnership (as codified in section 703(a)) in that the partner’s income from the partnership must be separately stated and some deductions disallowed.\textsuperscript{54} Under this “entity approach,” it becomes apparent that the various elections affecting the computation of taxable income are determined at the partnership level. However, the characterization of income when determined at the partnership level can differ significantly when compared to the determination of income earned by the taxpayer (\textit{i.e.}, the partner) without the interposition of a partnership.\textsuperscript{55} Such instances deviate from the underlying principle of fiscal transparency that the use of a

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Id.; see also Treas. Reg. §1.702-1(a) (requiring each partner to separately account for “partnership income, gain, loss, deduction, or credit”). The aggregate approach “treats the entity as a transparent aggregate of its owners, who have a direct interest in the entity’s assets and tax attributes.” Rabinovitz & Zolt, supra note 3, at 192–93.

52. See I.R.C. § 702(b); see also supra note 47 (quoting section 702(b)). Section 702(b) is considered an “income” or “character preservation rule.”

53. I.R.C. § 702(b); see also supra note 47 (quoting section 702(b)); Treas. Reg. § 1.702-1(a)(8)(i)–(iii) (clarifying that some limitations on deductions are applied to the individual partner when reflecting the aggregate approach for characterizing income); DANIELS, supra note 8, at 25 (discussing the “so-called character preservation principle”).

54. See Bellis v. United States, 417 U.S. 85, 95 (1974) (holding that a law firm with three partners had “an established institutional identity independent of its individual partners”); see also I.R.C. § 703(a); supra note 47 (quoting section 703(a)). Income group election at the partnership level is referred to as the “entity approach.”

55. See Treas. Reg. § 1.702-1(a)(8)(i)–(iii) (2000) (discussing how partner income is treated under the aggregate approach); see also supra notes 51–55 and accompanying text.
partnership should affect the tax treatment of the partners as little as possible.\(^{56}\)

In *Brown Group, Inc. v. Commissioner*,\(^{57}\) the Eighth Circuit addressed the issue of whether a partner's distributive share of a foreign partnership's earnings should be taxed as foreign base company income under Subpart F of the pre-1987 version of the Internal Revenue Code. The Brown Group, Inc. (“Brown Group”) was the U.S. parent of an affiliated group of corporations that filed a consolidated tax return. The affiliate, Brown Cayman Ltd., was a controlled foreign corporation (“CFC”) incorporated in the Cayman Islands, and was also a partner in a Cayman Islands partnership that acted as the U.S. parent’s purchasing agent for goods manufactured in Brazil. The imported goods were primarily sold in the U.S. and the Cayman Islands CFC received commission income from the U.S. parent for its efforts. The issue considered by the Eighth Circuit was whether the CFC partner’s distributive share of income of the Cayman Islands partnership was foreign base company sales income under I.R.C. § 954(d)—if so, it had to be included in the gross income of the U.S. parent as Subpart F income.\(^{58}\)

The dispute focused on whether the goods from Brazil were purchased on behalf of a “related person,” as defined in section

\(^{56}\) See Rabinovitz & Zolt, *supra* note 3, at 193 (discussing Internal Revenue Service policies used to reconcile the two competing views for determining the relationship between partner and partnership—the aggregate approach treating the partnership as a transparent aggregate of its partners, and the entity approach treating the entity as separate from its partners).

\(^{57}\) 77 F.3d 217 (8th Cir. 1996), vacating 104 T.C. 105 (1995).

\(^{58}\) See *id* at 220–21; see also I.R.C. §§ 951(a), 952(a), 954(d) (1986). Under Subpart F of the 1986 Internal Revenue Code, a U.S. shareholder that controls a foreign corporation for an uninterrupted period of thirty or more days must include in its taxable gross income, its pro rata share of the controlled foreign corporation’s “Subpart F” income. I.R.C. § 951(a)(1) (1986). Under I.R.C. § 952(a)(2) (1986), “Subpart F income” included “foreign base company sales income.” Under the version of section 954(d) in effect for the taxable year of 1986, the Code defined “foreign base company sales income” in relevant part as:

Income . . . derived in connection with the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person where—

(A) the property which is purchased . . . is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and

(B) . . . in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.

I.R.C. § 954(d) (1986).
954(d)(3). The parties agreed that the U.S. parent, on whose behalf the purchases were made, was a “related person” with regard to the CFC. The taxpayer argued that the commission income was not made on behalf of a “related person” and alternatively, argued in favor of an entity theory of partnership in which the CFC’s distributive share of the partnership income would be sufficiently tested at the partnership level. In contrast, the Internal Revenue Service (“IRS”) took the position that an aggregate theory of partnership should apply. Under the aggregate theory, the CFC’s distributive share of the partnership’s commission income would be tested at the partner level as if the purchase had been made directly by the CFC. In other words, depending on whether an entity or aggregate approach applied, income that would be “Subpart F income” if received by a partner directly, could escape such characterization if received directly by the partnership.

The Eighth Circuit vacated and remanded the decision of the Tax Court, holding that the determination had to be made at the partnership level. Consequently, the Eighth Circuit found that the commission income was not foreign base company sales income, and therefore, the CFC partner’s distributive share of this partnership income did not qualify as Subpart F income. Interestingly enough, in subsequent rulings the IRS has rejected the Eighth Circuit’s decision as “contrary to the purposes of Subpart F.” Additionally, anti-abuse regulations were released

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59. See Brown Group, 77 F.3d at 220. Under the version of section 954(d)(3) in effect in 1986, the Code defined a “related person” as:

(A) an individual, partnership, trust, or estate which controls the controlled foreign corporation;

(B) a corporation which controls, or is controlled by, the controlled foreign corporation; or

(C) a corporation which is controlled by the same person(s) which control the controlled foreign corporation.


60. See Brown Group, 77 F.3d at 221 (noting that “income characterized at the partnership level retains its character when distributed to the individual partners”).

61. See id. at 218, 222–23 (holding that “a foreign partner’s distributive share of foreign partnership income cannot be deemed to be ‘Subpart F income’ where the commissions at issue did not constitute ‘Subpart F income’ under the pre-1987 statute, 26 U.S.C. § 954(d)(3)”). The court noted that the Brown Group election under § 954(d)(3) fell through a Subpart F “loophole” that had been closed in subsequent enactments of the Code and stated that “the IRS does not have the power to recast partnership transactions or apply the aggregate approach for transactions occurring prior to the effective dates.” See id. at 222.

62. I.R.S. Notice 96-39 1996-3 C.B. 209 (stating that “[t]o permit a CFC to avoid subpart F by earning income through a partnership under circumstances in which the income would be subpart F income if earned directly by the CFC would be contrary to the
that allow the IRS to apply the aggregate approach in “appropriate circumstances” and to disregard the literal language of the partnership provisions in order to avoid results like the one reached in the Brown Group decision.\(^63\)

In Revenue Ruling 68-79,\(^64\) the IRS ruled that the holding period of property had to be determined at the partnership level. At issue was whether a partner had to characterize his distributive share of partnership capital gain as long-term capital gain when computing his gross income. The gain arose from the partnership’s sale of stock that was held by it as an investment. Because the partnership had held the stock for more than six months, the gain at the partnership level was characterized as long-term capital gain. However, at the time the partnership sold the stock, the partner’s holding period for his partnership interest was less than six months. The IRS ruled that because the holding period of property had to be determined at the partnership level, the partner had to treat his distributive share of the partnership gain as long-term capital gain even though the holding period threshold was satisfied by the partnership and not by the partner.\(^65\)

Similar to the rules discussed above, under section 703(b), most elections “affecting the computation of taxable income derived from a partnership” are made at the partnership level.\(^66\) However, certain exceptions are set forth in subparagraphs (1), (2), and (3), where the election is made by the individual partners.\(^67\)

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\(^{63}\) See Treas. Reg. § 1.701-2 (2000) (providing anti-abuse rules governing subchapter K); see also id. § 1.701-2(b)(3)(e) (allowing the Commissioner to “treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision”); I.R.S. Notice 96-39 1996-2 C.B. 209 (noting that “the courts have recognized that the aggregate approach may be applied in appropriate circumstances”).


\(^{65}\) See id.


\(^{67}\) See id. Section 703(b) prescribes that:

Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership, except that any election under—

1. subsection (b)(5) or (c)(3) of section 108 (relating to income from discharge of indebtedness),
2. section 617 (relating to deduction and recapture of certain mining exploration expenditures), or
3. section 901 (relating to taxes of foreign countries and possessions of the United States), shall be made by each partner separately.
2. Timing of Pass-Through: Taxable Year

The partnership has its own taxable year.68 Each partner is taxed on his distributive share of the partnership income in the taxable year of the partner in which (or with which, if the taxable years correspond) the partnership’s taxable year ends.69 The partnership’s choice of its taxable year, however, is generally restricted and determined by reference to the partner’s taxable year.70 For instance, the partnership’s taxable year has to correspond with the taxable year of one or more partners having a more than 50% interest.71 If a majority interest does not exist, the partnership has to adopt its taxable year to that of all

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68. See id. § 706(b)(1)(A) (“The taxable year of a partnership shall be determined as though the partnership were a taxpayer.”); CHARLES R. LEVUN, CCH PARTNERSHIP TAX PLANNING AND PRACTICE ¶ 2500 (2000) (“A partnership has its own tax year, which may be either a calendar year or a fiscal year.”).

69. See I.R.C. § 706(a). Section 706(a) prescribes that:
In computing the taxable income of a partner for a taxable year, the inclusions required by section 702 and section 707(c) with respect to a partnership shall be based on the income, gain, loss, deduction, or credit of the partnership for any taxable year of the partnership ending within or with the taxable year of the partner.

70. See id. § 706(b)(1). Section 706(b)(1) provides in pertinent part:
(B) Taxable year determined by reference to partners

Except as provided in subparagraph (C), a partnership shall not have a taxable year other than—

(i) the majority interest taxable year (as defined in paragraph (4)),

(ii) if there is no taxable year described in clause (i), the taxable year of all the principal partners of the partnership, or

(iii) if there is no taxable year described in clause (i) or (ii), the calendar year unless the Secretary by regulations prescribes another period.

(C) Business purpose

A partnership may have a taxable year not described in subparagraph (B) if it establishes, to the satisfaction of the Secretary, a business purpose therefor. For purposes of this subparagraph, any deferral of income to partners shall not be treated as a business purpose.

71. See I.R.C. § 706(b)(1)(B); see also LEVUN, supra note 68, at ¶ 2500.05 (“A partnership is generally required to conform its tax year to that of its partners.”).
partners having an interest of 5% or more, or to the calendar year if the partners do not have a common year.

3. Reporting, Refund, and Auditing Purposes

The partnership is an entity for reporting, refund, and audit purposes. The partnership is required to file an informational tax return (Form 1065) with the IRS, stating the items of its gross income and deductions. In addition, each partner must file an individual tax return (Form 8082) either treating partnership income items in a manner consistent with the treatment of those items on the partnership return, or notifying the IRS of any inconsistencies. Administrative proceedings such as audit and refund matters are generally handled at the partnership level.

4. Sale of Partnership Interest

The sale or exchange of a partnership interest is governed by a modified entity approach that avoids the cumbersome asset-by-asset evaluation that is required under a pure aggregate approach. Additionally, this modified entity approach reduces the possibilities of a conversion of ordinary income into capital.

72. See I.R.C. § 706(b)(1)(B)(ii); see also LEVUN, supra note 68, at ¶ 2500.05 (explaining that “[i]f no common tax year can result from any combination of partners with a majority interest, the partnership’s required tax would be the tax year of all its ‘principal partners’” and defining a principal partner as “one who has an interest of five percent or more in partnership profits and capital”).

73. See I.R.C. § 706(b)(1)(B)(iii); see also LEVUN, supra note 68, at ¶ 2500.05 (“If no tax year can be established under either [the majority interest rule or the principal partner rule], then the required tax year is the tax year that results in the least aggregate deferral of income.”).

74. See I.R.C. § 6031(a) (requiring “a return for each taxable year, stating specifically the items of its gross income and the deductions allowable” and all other information as required by applicable forms and regulations, plus the names and addresses of partners “entitled to share in taxable income” and the amount of each partner’s distributive share); see also LEVUN, supra note 68, at ¶ 3020.07 (“The primary purpose of Form 1065 is to provide the IRS with information concerning whether a partnership had a net profit or loss from its business operations during the tax year.”).

75. See I.R.C. § 6222(a)–(b); see also LEVUN, supra note 68, at ¶ 7000.15 (“If a partner fails to treat a partnership item consistently with its treatment on the partnership return and fails to notify the IRS of the inconsistency, the IRS may make computational adjustments to the partner’s return and assess tax on partners to achieve consistency.”).

76. See I.R.C. §§ 6223–6223 (setting out procedures for partners’ notification of and participation in administrative proceedings, assessment, and judicial review of administrative adjustment requests); see also LEVUN, supra note 68, at ¶ 7000 (Scope of Partnership Audit Rules).

77. See LEVUN, supra note 68, at ¶ 6000.10 (Modified Entity Approach to Transfers of Partnership Interests).
gains, which an entity approach would have facilitated.\textsuperscript{78} The modified approach reflects the fact that a partner is viewed as holding an interest in the partnership rather than in the partnership’s assets.

Under the modified entity approach, the sale or exchange of a partnership interest is treated as a disposition of a unitary capital asset.\textsuperscript{79} The partner’s basis in his partnership interest (“outside basis”) is separate and distinct from the partnership’s basis in its assets (“inside basis”).\textsuperscript{80} However, parity between inside and outside basis is generally maintained through permanent adjustments to the outside basis.\textsuperscript{81} Under section 741 of the Code, a partner who sells his partnership interest is generally treated as recognizing capital gain or losses, regardless of whether the partnership’s underlying assets qualify for such treatment.\textsuperscript{82} An exception to this rule is provided under the so-called “collapsible partnership rules” of section 751(a).\textsuperscript{83} Under

\textsuperscript{78} See LIND ET AL., supra note 45, at 238.

\textsuperscript{79} See LEVUN, supra note 68, at ¶ 6000.05 (“A partnership interest is generally considered to be a capital asset in the hands of the partner, and a transferor partner will recognize capital gain or loss upon its sale or exchange . . . .”).

\textsuperscript{80} See id. at ¶ 1600 (“Each partner is considered to have a basis for his interest in a partnership (sometimes referred to as the partner’s ‘outside basis’), separate and apart from his share of the basis of each partnership asset (sometimes referred to as the partner’s ‘inside basis’).”).

\textsuperscript{81} See id. at ¶ 1640 (Adjustments to Basis of Interest During Life of Partnership); see also I.R.C. §§ 722–723 (prescribing that the basis of a contributing partner’s interest in a partnership acquired by a contribution of property or money is the adjusted basis of the property and the amount of money at the time the contribution is made, increased by the amount of gain recognized to the contributing partner); I.R.C. § 705(a) (prescribing the general rule for determination of a partner’s interest); I.R.C. § 753 (stating that “the amount includible in the gross income of a successor in interest of a deceased partner [is] . . . considered income in respect of a decedent”).

\textsuperscript{82} See I.R.C. § 741 (1994 & Supp V 1999). Section 741 provides the rules for recognition and character of gain or loss on a sale or exchange as follows:

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items).

\textit{Id.}

\textsuperscript{83} See id. § 751(a) (treating the amount of money received from the sale of unrealized receivables and inventory items which have appreciated substantially in value “as an amount realized from the sale or exchange of property other than a capital asset”); see also LEVUN, supra note 68, at ¶ 6030.05 (explaining that:

A major exception to the entity approach in the case of a sale or exchange of a partnership interest is in the treatment of amounts attributable to inventory items and to unrealized receivables. In order to prevent the conversion of potential ordinary income into capital gain by certain transfers of property interests, gain attributable to these items is treated as ordinary income. (citations omitted)).
this exception, a partner may still be required to recognize ordinary income upon the sale of his partnership interest, if the partnership has ordinary income assets that have appreciated in value. The obvious intent underlying section 751 is to prevent partners from converting ordinary income into capital gain.

5. Guaranteed Payments

Guaranteed payments are of some significance for partnership activities in the international context. Their diverging tax treatment in different jurisdictions can open up considerable tax planning opportunities but can also be a trap for the unwary.

Transactions between a partner and her partnership are governed by sections 707(a) and 707(c). Section 707(a) provides that payments made to a partner acting in a non-partner capacity are treated as payments made to a third party. Section 707(c) contains a similar provision for “guaranteed payments,” i.e., payments made to a partner in his capacity as a partner, provided they are made for services or the use of capital and determined without regard to the partnership income. Both provisions have the same tax effect as they treat those payments as made to an unrelated, third person. The payee, i.e., the partner acting in a non-partner capacity under section 707(a) or receiving a guaranteed payment in his capacity as a partner under section 707(c), receives ordinary income which in turn is generally deductible by the partnership. However, while guaranteed payments are treated as payments made to a non-partner for purposes of determining income to the partner and deductibility to the partnership, they are treated as part of

84. See I.R.C. § 751; see also LEVUN, supra note 68, at ¶ 6030.05.
85. See I.R.C. § 707(a), (c).
86. See id. § 707(a) (describing the treatment of transactions between a partner and the partnership when the partner is not acting in the capacity as a partner).
87. See id. § 707(c). Section 707(c) prescribes the rule regarding guaranteed payments as follows:

To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).

88. See I.R.C. § 707(a), (c).
the partner’s distributive share of income with regard to timing and other tax consequences.\textsuperscript{89}

The statutory definition in section 707(c) makes clear that only payments made to a partner in his capacity as a partner qualify as guaranteed payments.\textsuperscript{90} However, there is still a certain degree of uncertainty with regard to the second requirement—”[t]o the extent determined without regard to the [partnership] income.”\textsuperscript{91} While payments based on the partnership’s net income clearly do not qualify under section 707(c), it is uncertain whether payments measured as a percentage of gross income constitute guaranteed payments.\textsuperscript{92}

The reference to “income” in section 707(c) is generally interpreted to mean taxable income and not gross income. However, in Revenue Ruling 81-300,\textsuperscript{93} the IRS ruled that a real estate management fee measured by a percentage of gross income qualified as a guaranteed payment under section 707(c).

Sections 707(a) and 707(c) were both introduced to the Code to reverse the tax treatment of guaranteed payments by the courts,\textsuperscript{94} according to which a partner could not deal with his own partnership like an unrelated third person.\textsuperscript{95} Consequently, the

\textsuperscript{89} See Treas. Reg. § 1.707-1(c); see also LEVUN, supra note 68, at ¶¶ 5200.10, 5200.15.

\textsuperscript{90} See I.R.C. § 707(c); see also LEVUN, supra note 68, at ¶ 5200.05 (explaining that in order to determine whether a payment to a partner is a guaranteed payment, “it is . . . necessary to determine whether the partner acted for the partnership in his or her capacity as a partner or as a nonpartner”).

\textsuperscript{91} See I.R.C. § 707(c); see also supra note 87 (quoting section 707(c)).

\textsuperscript{92} See Pratt v. Comm’r, 64 T.C. 203, 212–13 (1975), aff’d, 550 F.2d 1023 (5th Cir. 1977) (holding that where the general partners of two limited partnerships received fees based on a percentage of the partnership’s gross income, the fees did not qualify under I.R.C. § 707(a) because the services were within the scope of the partnership’s activities). The Fifth Circuit did not, however, resolve whether the payments qualify as “guaranteed payments” under I.R.C. § 707(c). See Pratt v. Comm’r, 550 F.2d 1023, 1025–27 (5th Cir. 1977); see also LEVUN, supra note 68, at ¶ 5200.05 (“One of the most common, and yet continually perplexing, situations concerns payments to a partner that are based on a percentage of the partnership’s gross income.”).

\textsuperscript{93} Rev. Rul. 81-300, 81-2 C.B. 143 (distinguishing “guaranteed payments” as payments made in compensation from a payment representing a “share of partnership profits”).

\textsuperscript{94} See Estate of Tilton, 8 B.T.A. 914, 918 (1927) (holding that “so-called partnership salaries are no more than a distribution of anticipated profits if paid prior to the end of the partnership accounting period and may in fact turn out to be withdrawals of capital” and are, therefore, not income for the taxable year); see also Lloyd v. Comm’r, 15 B.T.A. 82, 88–89 (1929) (reasoning that salaries paid to partners should “be deducted in arriving at the net profits to be distributed to all of the partners” and if the amount paid to a partner “was paid out of his own capital, it represents a return of capital” and is not taxable; however, to the extent the amount a partner is paid comes out of the capital of the other partners, “it constitutes taxable income to him”).

\textsuperscript{95} I.R.C. § 707(c) was also enacted to eliminate the “unrealistic and unnecessarily complicated” computations when fixed payments to a partner in his capacity as a partner
courts treated “salary” or “interest” payments made by the partnership to its partner as distributions attributable to the partner’s distributive share of partnership income.\textsuperscript{96} In other words, because the partnership and its partners were not separate taxpaying entities, those payments were not considered as taxable income to the partner but mere distributions relating to the partner’s distributive share. Basically, the argument behind the courts reasoning was that no one can earn money from himself.\textsuperscript{97} It should already be noted at this point that this is still the view Germany adopts with regard to the tax treatment of guaranteed payments.\textsuperscript{98} In the international context, the diverging tax treatment of guaranteed payments can lead to double taxation and double non-taxation.

6. Tax Withholding

A partnership’s withholding obligation with regard to FDAP income (i.e., Fixed or Determinable Annual or Periodical income) depends on whether the partnership is domestic or foreign.\textsuperscript{99} Payments to a domestic partnership are not subject to withholding even though it may have foreign partners.\textsuperscript{100} Instead, the partnership is required to withhold tax as a withholding agent for items of income included in the distributive share of a foreign partner.\textsuperscript{101} A U.S. partnership’s withholding obligation applies to any distributions of an amount subject to exceed partnership taxable income. See H.R. REP. NO. 83-1337, pt. 22, at 68 (1954) (stating “[t]he bill provides that payment of a fixed or guaranteed amount for services shall be treated as salary income to the recipient and as a business deduction to the partnership”); S. REP. NO. 83-1622 at 92 (1954) (clarifying that “[t]he House bill provides that payment of a fixed or guaranteed amount for services is to be treated as salary to the recipient and allowed as a business deduction to the partnership”); see also Miller v. Comm’r, 52 T.C. 752, 761 (1969) (explaining that the committee reports describing the reasons for the enactment of section 707 indicate that the intention was to apply the entity theory to transactions between partners and the partnership).

\textsuperscript{96} See cases cited supra note 94; see also case cited infra note 141.

\textsuperscript{97} See Comm’r v. Moran, 236 F.2d 595, 598 (8th Cir. 1956) (clarifying the Code does not treat a partnership as a separate taxable entity such that a partner cannot be an employee of his own partnership).

\textsuperscript{98} See infra note 137 and accompanying text.


\textsuperscript{100} See Treas. Reg. § 1.1441-5(b)(1) (2000); Stoffregen et al., supra note 99, at A-70 (“A payment to a domestic partnership is treated as a payment to a U.S. payee and, therefore, not subject to withholding under § 1441 even if certain of the partners are foreign.”).

\textsuperscript{101} See Treas. Reg. §1.1441-7(a); see also Stoffregen et al., supra note 99, at A-69.
withholding or to guaranteed payments made to a foreign partner. Assuming that the partnership withholds on a distributive share before the income is actually distributed, withholding is usually not required upon actual distribution to the foreign partner.

Payments to foreign partnerships are subject to more complex withholding obligations. As a general rule, payments to a foreign partnership are treated as payments made directly to its partners. Thus, for determining whether the payment was made to a U.S. or foreign person, the individual partners, and not the partnership, will be considered the payees. If a partner itself is a partnership (or another pass-through entity), it will be looked through for tax purposes until a partner is reached that is not a pass-through entity.

Income that is “effectively connected” with a trade or business in the U.S. is taxable in the U.S., however there is no withholding obligation when it is paid to a partnership. In order to prevent this income from escaping U.S. taxation entirely, section 1446 of the Code requires foreign and domestic partnerships to withhold tax at the highest applicable statutory rate with respect to a foreign partner’s distributive share of income effectively connected with the conduct of a trade or business in the U.S. The foreign partner must file a U.S. tax return, and receives a credit of the “partner’s share of the withholding tax paid by the partnership.”

103. See Treas. Reg. § 1.1441-5(b)(2); Stoffregen et al., supra note 99, at A-71 (“If a partnership withholds on the distributive share prior to making the actual distribution, withholding will not be required on the subsequent distribution.”).
105. See Treas. Reg. § 1.1441-5(c)(1)(ii) (stating that if the partnership qualifies as a “withholding foreign partnership,” then the withholding agent is not required to withhold on the payment to the partnership; instead, the foreign partnership itself is liable for collecting the tax on the distributive share of its foreign partners); Stoffregen et al., supra note 99, at A-71 (“In the case of payments to foreign partnerships, the revised regulations (unlike the former regulations) generally adopt a look-through approach, treating a payment to a foreign partnership as a payment to its partners.”).
107. See Stoffregen et al., supra note 99, at A-75 to A-76.
108. See I.R.C. § 1446 (1994); see also Stoffregen et al., supra note 99, at A-75 to A-76.
110. I.R.C. § 1446(d)(1). Section 1446(d)(1) prescribes that:
    Each foreign partner of a partnership shall be allowed a credit under section 33 for such partner's share of the withholding tax paid by the partnership under this section. Such credit shall be allowed for the partner's taxable year in which (or with which) the partnership taxable year (for which such tax was paid) ends.
imposes the withholding obligation regardless of whether there is an actual distribution.\textsuperscript{111}

C. Germany

1. Partnerships under German Civil Law

Similar to the U.S., partnerships under German civil law have a dual nature that is reflected in the tax treatment of partners and partnerships under German tax law. The most important forms of partnership under German civil law are the general partnership (\textit{offene Handelsgesellschaft}, or “\textit{oHG}”)\textsuperscript{112} and the limited partnership (\textit{Kommanditgesellschaft}, or “\textit{KG}”).\textsuperscript{113} A limited partnership with a corporate general partner (usually a \textit{Gesellschaft mit beschränkter Haftung}, or “\textit{GmbH}”) is called a \textit{GmbH & Co. KG}.\textsuperscript{114} In addition, there is the civil law partnership (\textit{Gesellschaft Bürgerlichen Rechts}, or “\textit{GbR}”)\textsuperscript{115} and the silent partnership (\textit{stille Gesellschaft}).\textsuperscript{116} A relatively new form of

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\textsuperscript{111} See I.R.C. § 1446(a). The general rule under section 1446(a) is stated as follows:

(a) General rule.

If—

(1) a partnership has effectively connected taxable income for any taxable year, and

(2) any portion of such income is allocable under section 704 to a foreign partner,

such partnership shall pay a withholding tax under this section at such time and in such manner as the Secretary shall by regulations prescribe.


\textsuperscript{113} See §§ 161 et seq. HGB; see also PRICE WATERHOUSE, supra note 112, at 65; Killius, supra note 112, at A-19, A-28; Schwdetzky, supra note 112, at 1331.

\textsuperscript{114} See PRICE WATERHOUSE, supra note 112, at 65; Killius, supra note 112, at A-19; Schwdetzky, supra note 112, at 1331 & n.1 (describing the general form of a German GmbH).

\textsuperscript{115} See §§ 707 et seq. BGB; see also PRICE WATERHOUSE, supra note 112, at 66; Schwdetzky, supra note 112, at 1331 n.1 (noting that “Germany has several specialized partnerships, one of which is a general partnership organized for non-commercial purposes, the Gesellschaft Bürgerlichen Rechts (GbR)” and that the “GbR is taxed as a partnership”).

\textsuperscript{116} See §§ 230 et seq. HGB; see also DOING BUSINESS IN GERMANY, supra note 2, at 29–30; Schwdetzky, supra note 112, at 1331 n.1 (noting that the German “silent partnership” established under Germany’s Commercial Code “is something of a misnomer
partnership in Germany is the *Partnerschaft*, a partnership similar to the U.S. limited liability company intended for professionals to limit the individual partner’s liability.\(^{117}\)

Interestingly, German civil law does not treat partnerships as separate legal entities like corporations,\(^ {118}\) but merely confers a separate legal status for certain purposes. For example, although the German partnership keeps its own books and records and may sue or be sued in its own name,\(^ {119}\) it is legally recognized as a mere aggregation of its partners. The partners are jointly and severally liable for the partnership's debts, and death or bankruptcy of any partner will generally result in the dissolution of the partnership.\(^ {120}\)

2. Basic Tax Principles: Conduit or Entity

While a comprehensive illustration of the domestic taxation of partners and partnerships under German tax law is beyond the scope of this article,\(^ {121}\) the following selected general principles are important to understand how Germany taxes the income derived by partnerships engaged in international transactions. As in the U.S., the fact that German partnerships are not separate legal entities is reflected in the fact that they are not separate taxpaying entities but rather fiscally transparent.\(^ {122}\) The German partnership serves as a mere conduit in which the income and losses flow through to, and are taken into account by, the partners on their individual income tax returns.\(^ {123}\) German partnership taxation is a mixture of

\(^{117}\) See *Le Groupe Monassier France* – *Patrimoine et Entreprise*, *General Presentation of German Companies*, http://www.group.monassier.com/droit/international/eng_de2-2-1.html (last visited Feb. 16, 2002) (describing the *Partnerschaft* as a new company form which became effective on July 1, 1995, and resembles "the general partnership and designed especially for the liberal professions"); see also *Price Waterhouse*, *supra* note 112, at 66 (describing this new form of partnership as a *Partnerschaftsgesellschaft* and explaining that it "is intended to provide a legal vehicle for multidisciplinary professional services").

\(^{118}\) See Killius, *supra* note 112, at A-28 (explaining that a partnership in Germany "is not a legal entity").

\(^{119}\) See *supra* notes 14–15 and accompanying text.

\(^{120}\) See *supra* notes 19–21 and accompanying text.

\(^{121}\) For a comparative analysis of the (domestic) partnership taxation in the U.S. and Germany, see Schwidetzky, *supra* note 112.

\(^{122}\) See Killius, *supra* note 112, at A-57 (explaining that "[a] partnership is not a taxable entity as such for income tax purposes").

\(^{123}\) See Killius, *supra* note 112, at A-57 ("The profits or losses of a partnership are attributed directly to the partners and taxed under the income tax rules in the case of individual partners and under the corporate income tax rules in the case of corporate partners."); Schwidetzky, *supra* note 112, at 1331–33 (stating that Germany does not
aggregate and entity concepts similar to that in the U.S. but with significant differences. For example, the partnership is not subject to income tax but serves as a separate entity for accounting purposes and the characterization of income. Many elections are made and profits computed at the partnership level. However, each partner is taxed on the respective share of partnership income, regardless of an actual distribution. Unlike the widely elective U.S. classification system under the “check-the-box” regulations to determine whether an entity is taxed as a corporation or partnership, the German Corporate Tax Act strictly enumerates, in accordance with the civil law classification, which entities are taxed as corporations. Entities not listed are taxed as partnerships, i.e., as fiscally transparent.

3. Partnership engaged in a Trade or Business (gewerbliche Personengesellschaft)

Similar to I.R.C. § 61, the German Income Tax Act taxes individuals only on certain items of income enumerated in § 2(1) of the Income Tax Act. Theoretically, partnerships, like an

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125. Decisions by the Bundesfinanzhofs (Supreme Tax Court) acknowledge the “dual nature” of German partnership taxation. See Bundesfinanzhofs (BFH), 1976 BStBl II 744; Bundesfinanzhofs (BFH), 1976 BStBl II 748; Bundesfinanzhofs (BFH), 1977 BStBl II 145; Bundesfinanzhofs (BFH), 1981 BStBl II 164; Bundesfinanzhofs (BFH), 1984 BStBl II 751; Bundesfinanzhofs (BFH), 1984 BStBl II 761; Bundesfinanzhofs (BFH), 1984 BStBl II 762.
126. Koerperschaftsteuergesetz (Corporation Tax Act) [hereinafter KStG].
127. See §§ 1, 3 KStG. For example, entities listed under § 1 KStG are translated as:
   1. Finance companies (corporations, limited partnerships on shares, limited companies, mountain-legal trade unions);
   2. Acquisition and producers’ and consumers’ cooperative societies;
   3. Cooperative insurance companies on mutuality;
   4. other legal entities of the private right;
   5. not-legally responsible associations, institutes, donations and other purpose abilities of the private right;
   6. Enterprises of commercial kind of legal entities of the public right.
Id.
128. See § 2(1) Einkommensteuergesetz (Income Tax Act) [hereinafter EStG]. The items of income subject to tax liability under § 2(1) EStG are translated as follows:
   1. An income from land and forestry,
   2. An income from industrial concern,
individual taxpayer, can earn any specific class of income, except income from the conduct of services as an employee. However, under § 15(1)(No.2) of the Income Tax Act, the partner is taxed for profits from the conduct of a trade or business if: (1) the partnership is engaged in a trade or business, and (2) the partner qualifies as an entrepreneur (Mitunternehmer). The classification of the partner’s income, as derived from the conduct of a trade or business, is made solely at the partnership level and determined by the partnership’s activities. The characterization is then preserved in the hands of the individual partners. A partner qualifies as an entrepreneur, broadly speaking, if he participates actively in the conduct of the partnership’s business and takes the economic risk of the partnership’s activities. Any other activity by the partnership, e.g., rental activity, income from capital investments, or any other activity by the partnership that is not considered conduct of its trade or business, is also deemed part of the partnership’s trade or business. In other words, the partnership’s conduct of a trade or business “infects” its other income-producing activities, with the result that the partner only earns income from the conduct of a trade or business through his or her participation in the partnership.

3. An income from independent work,
4. An income from not-independent work,
5. An income from capital abilities,
6. An income from letting and farm lease,
7. Any other income in the sense of § 22, the taxpayer during his unrestricted income tax obligation or as domestic income during his limited income tax obligation obtains. To which Einkunftsart the income belongs in the individual case, determines itself according to § 13 and § 24.

*Id.*

129. See § 2(1)(No.4) EStG (prescribing tax liability for “Einkünfte aus nichtselbständiger Arbeit” which is translated as “income from not-independent work”); see also § 19 EStG (defining “not-independent work” for income tax purposes).
130. See § 2(1)(No.2) EStG (prescribing tax liability for industrial concerns); see also § 15 EStG (defining “industrial concern” for income tax purposes).
131. A different qualification of the income at the partner level, however, may occur in rare circumstances.
132. So-called Mitunternehmerinitiative.
133. So-called Mitunternehmerrisiko.
134. See Bundesfinanzhofs (BFH) GrS, 1984 BStBl II 751; Bundesfinanzhofs (BFH) GrS, 1984 BStBl II 768.
135. See § 15(3)(No.1) EStG (defining the scope of income from industrial concerns).
136. So-called Infektions oder Abfärbetheorie, which is translated as “infections or stained theory.”
137. See § 15(3)(No.1) EStG.
4. Passive Investment Partnership  
*(Vermögensverwaltende Personengesellschaft)*

While a partnership engaged in a trade or business is the most common form of partnership in Germany, different rules apply to partnerships that are exclusively engaged in passive investment activities, such as renting out its property or receiving interest from its capital investments. The extent of these investment activities must remain within certain limits set by the courts. Passive investment partnerships *(Vermögensverwaltende Personengesellschaft)* can only receive rental income from the rental of property or interest for the use of capital.\(^{138}\) In addition, passive investment companies have to use the cash method for computing their income, while commercial partnerships must use the accrual method.\(^{140}\)

5. Guaranteed Payments *(Sondervergütungen)*

Guaranteed payments in Germany are treated much like guaranteed payments in the U.S. prior to the enactment of I.R.C. § 707(c).\(^{141}\) Thus, unlike treatment under current U.S. law,

\(^{138}\) Translated as “fortune-administering unincorporated firm.”


An fortune-administering unincorporated firm does not obtain commercial income under normal conditions. The income from the participation in the society is however a proportionately commercial income, if certain partners themselves are commercially active or are commercially coined/shaped. From the not commercial income (e.g., letting and farm lease) of the fortune-administering unincorporated firm a proportionately commercial income becomes with certain partners in such a case (*Umqualifizierung*). The portion depends on the participation quota of the partners. The fortune-administering unincorporated firm receives thereby no commercially infected status. The statement of the proportionate commercial income with certain partners takes place with the profit statement of the fortune-administering unincorporated firm.).

\(^{140}\) See Schwidetzky, supra note 112, at 1335. The term “cash method” is used for the German term *Überschäftberechnung*, and the term “accrual method” is used for *Gewinnermittlung durch Betriebsvermögensvergleich*. Both accounting methods under German tax law have some similarities with their U.S. “counterparts,” but they also deviate from each other significantly. *Id.* at 1335.

\(^{141}\) See Cagle v. Comm'r, 539 F.2d 409, 413–14 (5th Cir. 1976) (describing how guaranteed payments were treated as part of the partner’s “distributive share of partnership profits and losses” and thus “not proper deductions from income in computing partnership net income” before the enactment of Section 707(c) and how after enactment such payments are “treated as ordinary income to the partner receiving the payment and as a deductible expense to the partnership, if such payment fell within the specifications of Section 61(a) or Section 162(a) of the Code”).
Germany does not recognize guaranteed payments as deductible payments by the partnership and as taxable income of the partner, but as mere distributions attributable to the partner’s distributive share of income. As will be shown in the discussion of classification conflicts, the diverging tax treatment of guaranteed payments in the international context may lead to double non-taxation of such payments if not resolved in a tax treaty.

The German Income Tax Act applies different rules with regard to the characterization of guaranteed payments at the partnership level, depending on whether the partnership is engaged in the conduct of a trade or business (gewerbliche Personengesellschaft) or if it is merely a passive investment partnership (Vermögensverwaltende Personengesellschaft). If the partnership is engaged in a trade or business under § 15(1)(No.2) of the Income Tax Act, guaranteed payments that would ordinarily constitute income from the conduct of services, interest or royalties, are recharacterized at the partnership level as business profits and are taxed as such in the hands of the partners. No recharacterization, however, takes place in the case of a passive investment partnership. Thus, payments made by a passive investment partnership to its partner for his or her services, for the use of capital, or for any other such reasons, are taxed to the partner as compensation for services, interest, and so on.

III. TAXATION OF PARTNERSHIPS ENGAGED IN INTERNATIONAL TRANSACTIONS

A. The United States

The preceding part set forth the basic principles of the taxation of partners and partnerships in the domestic context. Under the concept of fiscal transparency, the partnership is not a separate taxable entity. Instead, the income tax

142. See § 15(1)(No.2) EStG.
143. See id.; see also § 13 EStG (noting that the same recharacterization applies to partnerships engaged in agriculture and forestry); § 18(4) EStG (noting that partnerships which receive income solely from professional services are also recharacterized the same way).
144. See § 15(1)(No.2) EStG (stating that “indirectly over one or more unincorporated firms partner taken part stands for the partner directly taken part directly; it is to be regarded as joint contractors of the enterprise of the society”).
145. See id.
146. See DOING BUSINESS IN THE U.S., supra note 2, at 53 (1999) (“For U.S. tax purposes, partnerships are conduit entities not subject to taxation at the entity level”);
consequences are attributed to the individual partners. The same rules apply if the partnership engages in international transactions. In addition, under Subchapter K of the Code, the federal income tax consequences of using a partnership in the international context, as well as the ways in which the international tax rules apply, depend on the following factors:

1) whether the entity is a partnership or a corporation;

2) whether the entity is a domestic or a foreign partnership;

3) whether the income involved is domestic or foreign income; and

4) whether the partner is a U.S. resident or a foreign person.

1. Partnership or Corporation

Similar to that which occurs in a purely domestic context, the U.S. federal income tax consequences diverge substantially depending on whether the taxpayer engages in international transactions in the form of a partnership or in the form of a corporation. Moreover, the different tax concepts may raise some difficult issues in international tax law with regard to the application of double tax treaties and tax withholding, where the U.S. classifies an entity as a partnership or branch and another country classifies it as a corporation, or vice versa. It, therefore, seems appropriate to briefly outline the different tax


147. See I.R.C. § 701 (1994); see also supra note 46 (quoting section 701); DOING BUSINESS IN THE U.S., supra note 2, at 53 (“[P]artners are taxed currently on their distributive share of partnership taxable income regardless of whether any distributions are made, and current losses sustained by the partnership are passed through and deductible at the partner level.”); Lipton et al., supra note 146, at 199.

148. See I.R.C. §§ 301, 316 (stating the rules for corporations); id. §§ 701–702 (stating the rules for partnerships); see also Stoffregen et al., supra note 99, at A-3 (describing how “under the U.S. tax laws, the taxation of business income depends on the form in which business is conducted”).

149. This dilemma is often referred to as “classification conflict.” See supra notes 6–7 and accompanying text.
consequences that follow from doing business in the form of a partnership or a corporation if (1) a U.S. investor participates in a foreign entity and (2) a foreign investor participates in a U.S. entity.

(a) U.S. Investors participating in a Foreign Entity

The tax consequences for a U.S. resident who participates in a foreign entity are significantly different with regard to recognition of income and timing, depending on whether the foreign entity is classified as a partnership or a corporation for U.S. tax purposes.\(^{150}\) A U.S. shareholder in a foreign corporation is generally taxed only when the corporation repatriates its profits in the form of dividends.\(^{151}\) Thus, participation in foreign corporations results in deferred taxation to the U.S. shareholder who is taxed only on receipt of foreign source dividends.\(^{152}\) A U.S. partner in a foreign partnership,\(^{153}\) however, will be taxed immediately on his distributive share of the partnership’s income, whether or not he receives actual distribution from the partnership.\(^{154}\)

In addition, the entity classification may have an impact on the classification and source of the income.\(^{155}\) For example, a foreign partnership receives rents from property located in the U.S. Under the Code source rules, rental income from property located in the U.S. is treated as source-based income, and thus constitutes U.S. source income to the partnership.\(^{156}\) Because of the income preservation rule, the character of the income must be preserved as it is passed through to the partner.\(^{157}\)

\(^{150}\) See DANIELS, supra note 8, at 49.

\(^{151}\) See I.R.C. § 61(a)(7).

\(^{152}\) See id.; see also I.R.C. §§ 951–964, 1296–1297 (1994 & Supp. V 1999); DANIELS, supra note 8, at 49. It should, however, be noted that Congress considerably restricted the tax deferral on passive foreign source by enacting Code sections 951–964 on controlled foreign corporations and Code sections 1296–1297 on passive foreign investment companies.

\(^{153}\) The same applies to a U.S. member of a foreign limited liability company that is treated as a U.S. partnership for U.S. tax purposes.

\(^{154}\) See I.R.C. § 702 (Income and Credits of Partner); see also DANIELS, supra note 8, at 50.

\(^{155}\) See DANIELS, supra note 8, at 51–52.

\(^{156}\) See I.R.C. § 861(a)(4) (stating that “the . . . gross income [from the rental of property located in the United States] shall be treated as income from sources within the United States”); see also Peter H. Blessing, Source of Income Rules, 905 TAX MGMT. (BNA) A-47 to A-50 (2001) (discussing the rules governing rent and royalty income from use of property).

\(^{157}\) See I.R.C. § 702(b); see also supra note 47 (quoting section 702(b)); supra note 52–53 and accompanying text (discussing the income preservation rule); Stoffregen et al., supra note 99, at A-32 (discussing the taxation of a foreign partner’s share of a
Consequently, the partner also receives U.S. source rental income.\textsuperscript{158} In contrast, if a foreign corporation receives rent from U.S. property, the corporation earns U.S. source rental income,\textsuperscript{159} but the subsequent distributions to the shareholder are characterized and sourced according to the rules applicable to dividends.\textsuperscript{160} As a result, the shareholder earns foreign source dividend income.\textsuperscript{161}

(b) Foreign Investors participating in a U.S. Entity

The U.S. tax consequences for a foreign investor can vary substantially depending on whether he participates in a U.S. partnership or corporation. For example, if a U.S. business organization is owned equally by a U.S. citizen and a nonresident alien, the corporation will be taxed on its worldwide income.\textsuperscript{162} On the other hand, in the case of a U.S. partnership, the U.S. partner will be taxed on his share of the partnership’s worldwide income, whereas the nonresident partner only has to include in income his share of the partnership’s income from U.S. sources or income that is effectively connected with the partnership’s U.S. business.\textsuperscript{163}

\begin{footnotes}
\item[158] See I.R.C. § 702(a); see also supra note 51 (quoting section 702(a)); Stoffregen et al., supra note 99, at A-32.
\item[159] See I.R.C. § 861(a)(4); see also Blessing, supra note 156, at A-47 to A-48.
\item[160] See I.R.C. § 861(a)(2); see also Blessing, supra note 156, at A-21 to A-22.
\item[161] See I.R.C. § 861(a)(2); see also Blessing, supra note 156, at A-21 to A-22 (explaining that “[i]f the payor is not incorporated under the laws of one of the 50 states or the District of Columbia, the dividends paid by it generally are treated as foreign source income”).
\item[162] See George G. Bogert & George T. Bogert, The Law of Trusts and Trustees § 10 (2d ed. rev. 1984) (“A U.S. corporation is taxed on its worldwide income, but a foreign corporation not engaged in a U.S. trade or business is subject to U.S. tax only on its income from U.S. sources.”); see also I.R.C. §§ 11(a), 61(a), 63(a).
\item[163] See Robert F. Hudson, Jr., Use of Non-Corporate Vehicles for Foreign Investment in the United States, in FOREIGN INVESTMENT IN THE UNITED STATES 1989, at 355, 400 (PLI Tax Law & Estate Planning Course, Handbook Series No. J4-3629, 1989), available at WL 285 PLI/TAX 355; see also I.R.C. § 871(b) (“A nonresident alien individual engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 1 or 55 on his taxable income which is effectively connected with the conduct of a trade or business within the United States.”); I.R.C. § 875(1) (prescribing that “a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged”); Blessing, supra note 156, at A-104 (“In the case of a partnership that is engaged in a trade or business in the United States, each partner is considered, under § 875(1), to be so engaged, with the result that income derived by the partnership that is effectively connected with its trade or business is taxed to each partner as effectively connected income.”); Stoffregen et al., supra note 99, at A-30 to A-35.
\end{footnotes}
2. Domestic or Foreign Entity

A partnership is "domestic" if it is "created or organized in the United States or under the law of the United States or of any State."\(^{164}\) If a partnership does not qualify as domestic, it is treated as foreign.\(^{165}\) Because a partnership is not a separate taxing entity under the Code, it has relatively little tax implication, regardless of whether the partnership is domestic or foreign. The tax consequences for a partnership that engages in international transactions depend mainly on whether its partners are residents or foreigners, or whether the partnership's income is domestic or foreign. Nevertheless, the characterization as domestic or foreign is of some significance for purposes of Subchapter F of the Code as well as for purposes of tax withholding.

A domestic partnership is a "United States person."\(^{166}\) For purposes of Subpart F of the Code, a "United States shareholder" is defined as a "United States person" that owns 10% or more of the total combined voting power of all classes of voting stock of a controlled foreign corporation.\(^{167}\) The shareholder is required to include in his income each year his pro rata share of the controlled foreign corporation's income.\(^{168}\) Thus, for purposes of qualifying as a U.S. shareholder under Subpart F, the domestic partnership is treated as a single U.S. shareholder regardless of the number of partners and whether the partners qualify as U.S. persons. Moreover, payments to a domestic partnership are not

\(^{164}\) I.R.C. § 7701(a)(4) (1994 & Supp. III 1997) (stating that “[t]he term ‘domestic’ when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or any State unless, in the case of a partnership, the Secretary provides otherwise by regulations”).

\(^{165}\) See id. § 7701(a)(5) (“The term ‘foreign’ when applied to a corporation or partnership means a corporation or partnership which is not domestic.”).


\(^{167}\) See I.R.C. § 951(b) (1994). Section 951(b) prescribes that:

For purposes of this subpart the term “United States shareholder” means, with respect to any foreign corporation, a United States person (as defined in Section 957(c)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.


\(^{168}\) See I.R.C. § 951(a) (1994 & Supp. V 1999) (noting that every person defined as a “United States shareholder" of corporate stock on the last day, in such year, on which such corporation is a controlled foreign corporation shall include [his pro rata share] in his gross income, for his taxable year . . . .”); Treas. Reg. § 1.951-1(a) (2000); see also Yoder, supra note 167, at A-16 (“Only a U.S. Shareholder’s pro rata share of § 951(a) items is currently included in its U.S. gross income.”).
subject to withholding, even if all of the partnership’s partners are foreign. Instead, the partnership is required to withhold tax upon distribution to its foreign partners.\textsuperscript{169}

A domestic or foreign partnership is considered a “resident” if it “at any time during its taxable year is engaged in trade or business in the United States.”\textsuperscript{170} It is irrelevant whether its partners are residents or not, and whether, and to what extent, the partnership is engaged in a trade or business abroad.\textsuperscript{171} A partner of a U.S. resident partnership is taxed at the graduated rates applicable to U.S. resident partners, and the partner must file a U.S. tax return.\textsuperscript{172} If a resident partnership makes interest payments, it is required to withhold tax.\textsuperscript{173}

3. Domestic Partner in a Domestic Partnership with Foreign Income

\textsuperscript{169} See Stoffregen et al., \textit{supra} note 99, at A-70 (“A payment to a domestic partnership is treated as a payment to a U.S. payee and, therefore, not subject to withholding under \$ 1441 even if certain of the partners are foreign.”); see also I.R.C. \$ 1441(a) (1994). Section 1441(a) prescribes in pertinent part the general rule for withholding as follows:

\begin{quote}
Except as otherwise provided . . . , all persons, in whatever capacity acting (including . . . all officers and employees of the United States) having the control, receipt, custody, disposal, or payment of any of the items of income specified in subsection (b) (to the extent that any of such items constitutes gross income from sources within the United States), of any nonresident alien individual, or of any foreign partnership shall . . . deduct and withhold from such items a tax equal to 30 percent thereof, except that in the case of any item of income specified in the second sentence of subsection (b), the tax shall be equal to 14 percent of such item.
\end{quote}

\textit{Id.}


\textsuperscript{171} See Thomas S. Wisialowski, \textit{U.S. Taxation of Foreign Partners}, in \textit{TAX PLANNING FOR DOMESTIC \& FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES \& OTHER STRATEGIC ALLIANCES} 2000, at 273, 311 (PLI Tax Law \& Estate Planning Course, Handbook Series No. J0-002W, 2000), available at WL 470 PLI/TAX 273 (noting that (1) the site where the partnership conducts its trade or business is controlling; (2) where the partnership is formed is not determinative; and (3) a foreign partner in a partnership that is engaged in a U.S. trade or business is deemed to be engaged in a U.S. trade or business, without regard to the actual activities of the foreign partner in the United States); see also Stoffregen et al., \textit{supra} note 99, at A-21.

\textsuperscript{172} See Hudson, \textit{supra} note 183, at 400; Stoffregen et al., \textit{supra} note 99, at A-32, A-35.

\textsuperscript{173} See I.R.C. \$ 1446(a); Treas. Reg. \$ 301.7701-5 (2000); Stoffregen et al., \textit{supra} note 99, at A-21, A-70 (stating that “the U.S. trade or business of a resident partnership is imputed to its foreign partners, subjecting them to U.S. tax on their share of effectively connected income” while “[i]nterest paid by a nonresident partnership is generally foreign source” and explaining the withholding rules on payments to foreign partners or partnerships).
Under U.S. federal income tax law, mechanical source rules are applied to determine the source of income. Sections 861–865 of the Code, and the regulations there under, establish whether income is domestic, i.e., derived from sources within the U.S. (“U.S. source income”), or foreign, i.e., derived from sources outside of the U.S. (“foreign source income”). Because a U.S. resident taxpayer is taxed on his worldwide income, a domestic partner in a domestic partnership may want to classify his income as foreign so that he will be entitled to a tax credit for foreign taxes paid on his foreign source income.

The conduit principle applies to the receipt of foreign source income, and thus the source and character of the foreign income are determined at the partnership level and passed through to the partners. In addition, under the character preservation rule the foreign source income received by the partnership will retain its foreign source and classification (as business income, interest, rents or royalties, or any other such thing) in the hands of the partners. For example, foreign income of a domestic partnership will be treated as foreign source business income if attributable to a business conducted abroad through a permanent establishment. Foreign interest, rents, or royalties received by the partnership will be treated as foreign business income if attributable to a partnership trade or business; otherwise they will be treated as foreign investment income.

Similarly, the treatment of foreign losses of the partnership is not different from that of domestic losses. The losses pass through to the partners and can be deducted from each partner’s income. The character of the partnership’s foreign losses is preserved in the hand of the partner and reduces his foreign

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174. See generally Blessing, supra note 156.
176. See id. § 901; see also Stoffregen et al., supra note 99, at A-49 (“Foreign taxes paid or accrued by a partnership flow through to the U.S. partners, who, subject to various possible limitations, may claim a direct tax credit under 901”).
177. See I.R.C. § 702(b); see also supra note 47 (quoting section 702(b)); Lim & Lee, supra note 27, at 1094–95.
178. See Blessing, supra note 156, at A-104 (“The character and source of partnership income carries over to the partners in their distributive shares of partnership income. . . . For example, a partner’s distributive share of the partnership’s foreign source dividend income is income from foreign sources to the partner.”); see also I.R.C. § 904(d) (noting that the character of foreign income becomes especially important with regard to the allocation of the foreign source income to the separate baskets set forth in I.R.C. § 904(d) when computing the foreign tax credit limitations).
179. See I.R.C. § 862 (defining taxable income from sources outside the U.S.).
180. See id. § 862(1), (4).
181. See id. §§ 165(a), 702(b); see also sources cited supra note 47 (quoting sections 702(b), 703(a)); supra note 50–53 and accompanying text.
source income for foreign tax credit limitation purposes.\footnote{See I.R.C. § 904(a) (referring to limitations on the total amount of tax credit taken); see also id. § 904(k)(5) (referring to the recapture of "overall foreign loss").} Whether foreign income or loss is ordinary or capital is also
determined under domestic tax rules at the partnership level.\footnote{See, e.g., Rev. Rul. 68-79, 1968-1 C.B. 310 (confirming that "[t]he character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (8) of [Section 702(a)] [of the Code] is determined at the partnership level").} A domestic partner includes in income his share of the partnership's foreign source income for the partner's taxable
year, with or within which the taxable year of the partnership ends.\footnote{See, e.g., Rev. Rul. 68-79, 1968-1 C.B. 310 (confirming that "[t]he character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (8) of [Section 702(a)] [of the Code] is determined at the partnership level").}

4. Guaranteed Payments

The application of the source rules to guaranteed payments is not entirely clear because of their ambivalent nature as (taxable) income for some tax purposes, and as part of the partner’s distributive share for other tax purposes.\footnote{See I.R.C. § 706(a) (1994); see also supra note 69 and accompanying text.} The regulations provide that guaranteed payments are considered as income only for purposes of I.R.C. §§ 61(a) (inclusion in partner's gross income) and 162(a) (deduction to the partnership as trade or business expense).\footnote{See id. § 1.707-1(b).} For all other purposes, they are regarded as a partner’s distributive share of ordinary income.\footnote{See id. at 760 (stating that the "sole question" in determining if the guaranteed

Similarly, in *Carey v. United States*, the Court of Claims held that a fixed annual distribution received by an accounting firm partner while serving in the firm’s Tokyo office was a guaranteed payment within the meaning of the Code and had to be regarded as compensation for personal services performed outside the U.S., rather than as part of a partner’s share of the partnership’s distributive income. Hence, *Miller* and *Carey* indicate that guaranteed payments made to a partner for services performed outside the U.S. will be treated as income and sourced under the place of performance rule.

In order to ensure consistent treatment for questions of source, guaranteed payments should generally be treated as income and sourced under the respective source rules. Accordingly, guaranteed payments for the use of capital will be subject to the interest source rules. The source of rents or royalties received by the partner for the partnership’s use of tangible or intangible property is determined by the place of location or use of the property.

5. Domestic Partner in Foreign Partnership with Domestic or Foreign Income

A domestic partner who participates in a foreign partnership is taxed on his worldwide income under the normal individual tax rates applicable to U.S. citizens or residents.
The partner includes in income his entire distributive share in the foreign partnership’s income—both domestic and foreign.\textsuperscript{199} The only difference from the U.S. partner’s point of view in the taxation of the foreign partnership’s income is that he will receive a foreign tax credit for the foreign taxes paid either directly by him or indirectly by the partnership on the foreign partnership’s foreign income.\textsuperscript{200} On the other hand, no tax credit is available to the domestic partner on domestic income that is subject to tax in the foreign partnership’s country of residence.\textsuperscript{201} The determination of the income source, as derived by a foreign partnership for U.S. tax purposes, is determined under the U.S. source rules at the partnership level.\textsuperscript{202} Similarly, the characterization of the foreign partnership’s domestic and foreign income as passive or active, capital or ordinary, business income, rents, royalties, or otherwise, is made as if it had been realized directly by the foreign partnership and is then passed through to the domestic partners.\textsuperscript{203}

\textit{International Taxation: Impact of the Proposed 863(d) and (e) Regulations on the Satellite Industry}, 23 LOY. L.A. INT’L & COMP. L. REV. 579, 580 (2001) (“The United States subjects its own people to U.S. tax on income from sources within the United States (U.S. source income) and income from sources outside of the United States (foreign source income).”); see also I.R.C. § 61(a) (defining gross income); I.R.C. § 63(a) (defining taxable income); I.R.C. § 1(a)–(g) (prescribing the tax rates applied to taxable income in the U.S.).

\textsuperscript{199} See I.R.C. §§ 702(a), 702(b); see also supra note 51 (quoting section 702(a)); supra note 47 (quoting section 702(b)); DANIELS, supra note 8, at 53; Davis & Lainoff, supra note 198, at 261 (restating the rule that “[a] partner must take into account separately its distributive share of any partnership item if such treatment would result in a different tax liability”); Stoffregen et al., supra note 99, at A-55 (explaining that: Partnerships, whether foreign or domestic, resident or non-resident, are not separate taxable entities for U.S. federal tax purposes. Each partner is treated as receiving directly its allocable share of each item of partnership income, loss, deduction, and credit. The allocation of partnership items is determined under the allocation provisions of the partnership agreement as adopted by the partners, provided those allocations have substantial economic effect.)

\textsuperscript{200} See I.R.C. §§ 702(a)(6), 901(a), 904; see also DANIELS, supra note 8, at 53. “U.S. taxpayers are generally permitted to credit foreign income taxes against their U.S. tax liability.” Stoffregen et al., supra note 99, at A-59. “A direct credit for foreign tax paid or accrued by any U.S. person is allowed under section 901.” \textit{Id.} Additionally, “[t]axpayers are required to determine their gross and net income from sources within and without the United States for purposes of determining the limitation under \$ 904 on their ability to credit foreign taxes against their U.S. tax liability.” \textit{Id.} at A-56.

\textsuperscript{201} See Davies & Lainoff, supra note 198, at 580 (“The United States claims the primary right to tax only U.S. source income, and therefore it does not allow foreign credits to offset this tax.”). \textsuperscript{202} See I.R.C. §§ 861–865 (1994 & Supp. V 1999) (prescribing the source rules relating to foreign income).

\textsuperscript{203} See I.R.C. § 702(b) (1994); see also supra note 47 (quoting section 702(b)). This is often referred to as the “character preservation rule.”
Domestic income of a foreign partnership consists of (1) U.S. source “fixed or determinable annual or periodical” (“FDAP”) gains, profits, and income,\(^\text{204}\) and (2) income derived from any source that is effectively connected with the conduct of a trade or business in the U.S. (active income).\(^\text{205}\) The remainder of the foreign partnership’s income is foreign. Again, for a U.S. partner, the characterization of the foreign partnership’s income as domestic or foreign is only relevant with regard to the foreign tax credit. Unlike the nonresident partner, whose distributive share of U.S. source FDAP income is taxed at a flat rate of 30% without any deductions and is typically subject to withholding,\(^\text{206}\) the U.S. resident partner is taxed at the graduated rates applicable to U.S. persons.\(^\text{207}\) Timing also follows the domestic rules.\(^\text{208}\) Notwithstanding the literal language of section 707(c) and the regulations,\(^\text{209}\) the source of guaranteed payments made by a foreign partnership to a domestic partner should be determined under the U.S. source rules.\(^\text{210}\)

6. U.S. Foreign Tax Credit and Classification Conflict

As discussed in the previous section, when a domestic partner participates in a foreign partnership, there is some uncertainty about whether a domestic taxpayer is entitled to a foreign tax credit if the taxpayer participates in a foreign entity that is the subject of a classification conflict. Two situations have to be distinguished for purposes of the foreign tax credit: one in which the U.S. treats a foreign partnership as a corporation, and

\(^\text{205}\) See id. § 871(b) (Income Connected with United States Business); see also id. § 864(c) (defining “effectively connected income”); Kirby Scarborough, The Foreign Investor in the United States: Disclosure, Taxation and Visa Laws, 19 INT’L LAW 85, 99–102 (1985) (explaining that “[g]enerally, effectively-connected income wherever derived is taxed to the foreign taxpayer at the graduated rate applicable to a U.S. taxpayer of the same legal nature as the foreign taxpayer”); Stoffregen et al., supra note 99, at A-32 (explaining that similar to a U.S. partner, “a foreign partner is accordingly taxable on his distributive share of the partnership’s [effectively connected income] at graduate rates and on a net basis”).
\(^\text{206}\) See I.R.C. §§ 871(a), 881(a); see also Stoffregen et al., supra note 99, at A-37 (“The 30% tax on U.S. source investment income is collected by means of imposing a withholding requirement on the payer.”).
\(^\text{207}\) See sources cited supra note 198.
\(^\text{208}\) See discussion supra Part II.B.2.
\(^\text{209}\) See I.R.C. § 707(c); Treas. Reg. § 1.707-1(c) (2000); see also supra note 87 (quoting section 707(c)).
\(^\text{210}\) See Blessing, supra note 156, at A-104 to A-105 (discussing the source of income rules associated with partnerships); Stoffregen et al., supra note 99, at A-40 to A-42 (discussing guaranteed payments).
one in which the U.S. treats a foreign corporation as a partnership.

(a) U.S. treats Foreign Partnership as a Corporation

Neither the Code nor the regulations expressly deal with the foreign tax credit in a classification conflict where the U.S. treats a foreign partnership as a corporation. Instead, the regulations merely provide that “[t]he person by whom the tax is considered paid . . . is the person on whom foreign law imposes legal liability for such tax . . . .”

The first case in which a court had to identify the technical taxpayer under foreign law for purposes of the foreign tax credit was Biddle v. Commissioner, decided by the Supreme Court in 1938. The Court had to decide whether an individual U.S. shareholder of a British corporation could credit the foreign taxes paid by the corporation if the foreign tax system allowed the shareholder to impute the taxes paid by the corporation against his personal income tax liability. The Supreme Court denied the shareholder a tax credit because the foreign tax was legally imposed on the corporation and not on the shareholder. Moreover, the court held that it was contrary to the principles of the U.S. tax system to treat an individual shareholder as a taxpayer, for a tax technically imposed on a corporation, for purposes of the foreign tax credit.

It is important to note that in Biddle no classification conflict arose. Therefore, the decision merely provides authority for the suggestion that only the technical taxpayer of the foreign tax is entitled to a tax credit, and that the person on whom the foreign jurisdiction imposes the tax has to be determined in accordance with the principles of the U.S. tax

211. See Daniels, supra note 8, at 55.
212. Treas. Reg. § 1.901-2(f)(1) (2000); see also Daniels, supra note 8, at 55.
213. 302 U.S. 573 (1938).
214. See id. at 579–82 (noting that this is often called an “integrated system,” and it provides for a deemed paid credit for shareholders receiving distributions). The corporation is the initial taxpayer, but essentially, tax paid by the corporation on distributions is attributed to the shareholder who would apply the attributed tax as a credit against his tax on the dividend. As a result, the distributions would only be taxed once, at the individual income tax rates of the shareholder. See Peter C. Canellos, Corporate Tax Integration: By Design or By Default?, in Corporate Tax Reform: A Report of the Invitational Conference on Subchapter C 132–35 (George K. Yin & George Mundstock eds., 1988) (providing an overview of different techniques for achieving integration).
215. See Biddle, 302 U.S. at 581.
216. See id. at 581–82.
217. See Daniels, supra note 8, at 55.
system. Biddle, however, provides no authority for the question of whether a tax credit should be granted in the case of a classification conflict, where it is usually inconsistent with the principles of the U.S. tax system to treat the technical taxpayer of a foreign tax as the taxpayer for purposes of the credit. This issue was later addressed in Abbot Laboratories International Co. v. United States.

In Abbot Laboratories, the court had to decide whether a U.S. corporation which participated in Colombian and Argentine sociedades de responsabilidad limitada could credit the taxes both countries imposed on the profits of the sociedades. Under Colombian and Argentine law, the taxes in issue were imposed on the participants as “partners” regardless of an actual distribution, i.e., the sociedades were taxed similarly to partnerships in the U.S. Under U.S. law, the sociedades are considered corporations, and profits are not taxed unless they are repatriated in the form of dividends.

The U.S. shareholder argued, based on the rationale of Biddle, that he should be entitled to a direct foreign tax credit under section 131 of the Internal Revenue Code of 1939 (i.e., the predecessor of current section 901), because he was legally liable for the taxes under foreign law. The district court, however, denied the credit, stating that the determination of the technical taxpayer for purposes of the foreign tax credit did not turn solely on the legal incidence of the taxes under foreign law.

The decision appeared to be heavily influenced by the fact that the income of the sociedades was taxed by the foreign jurisdictions in the hands of the partners, but was not yet subject to tax in the U.S. because the plaintiff U.S. shareholder had not received any distributions from the entity. In other words, a decision in favor of the plaintiff would have provided it with the opportunity to seek the advantage of a foreign tax credit and at the same time would have deferred the taxation of the income on which the foreign taxes were imposed. Consequently, the court held that a U.S. corporation is not entitled to a foreign tax credit.

218. See Elizabeth A. Owens, The Foreign Tax Credit 376 (1961) (“A more difficult problem arises when it is inconsistent with the principles of the United States tax system, including the operation of the credit, to treat the technical taxpayer as the taxpayer for purposes of the credit.”).
220. See id. at 326.
221. See id. at 328–29.
222. See id.
223. See id. at 328.
even though it is legally liable for the foreign taxes as a “partner,” if the income subject to the foreign tax has been earned by an entity treated as a corporation under U.S. law, and if the income has not been taxed in the U.S. in the year the credit is claimed.\footnote{224} Notwithstanding the fact that in \textit{Abbot Laboratories} the technical taxpayer under foreign law was denied a tax credit, the policy\footnote{225} behind the decision can be reconciled with \textit{Biddle}, in that it would have been inconsistent with the principles of U.S. tax law to allow a taxpayer a tax credit on income that has not yet been taxed in the U.S.

A situation similar to \textit{Abbot Laboratories} was at issue in Revenue Ruling 72-197.\footnote{226} Here, a domestic joint venture with foreign operations was classified as a corporation in the U.S., but as a partnership under foreign tax law.\footnote{227} Consequently, the foreign country taxed the U.S. venturers as “partners” on their respective share of the venture’s net profits.\footnote{228} The Service denied the domestic venture, taxable as a corporation, a direct credit under section 901, but held that the individual venturers who were liable for the tax under foreign law could claim a direct tax credit within the limitations of section 904.\footnote{229}

In short, the ruling applies the principles set forth in \textit{Biddle} in that it grants the tax credit only to the taxpayer who is technically liable for the taxes imposed under foreign law. Moreover, because the ruling involved a domestic joint venture, there was no tax deferral of the venture’s profits in the U.S. that would have resulted in the denial of a tax credit under \textit{Abbot Laboratories}. However, while Revenue Ruling 72-197 is in accordance with the principles set forth in \textit{Biddle} and \textit{Abbot Laboratories}, it remains consistent with the policy of preventing taxpayers from exploiting inconsistencies between U.S. and foreign tax law.

\begin{footnotes}
\item[224] See id. at 328–29; see also I.R.C. §§ 901, 902 (1994 & Supp. V 1999). It is important to note that the court’s denial in \textit{Abbot Laboratories} of a tax credit under section 131 (predecessor of current section 901) might have been influenced by the fact that the plaintiff corporation was entitled to an (indirect) foreign tax credit (under current section 902) upon distribution of a dividend from the foreign corporation. See \textit{Abbot Labs.}, 160 F. Supp. at 327–28. The court, therefore, expressly limited its decision to the situation where the shareholder was a corporation entitled to a credit (under current section 902).
\item[227] See id.
\item[228] See id.
\item[229] See id. (emphasizing that “[t]he fact that the separate entity is not recognized under the law of the foreign country does not alter the requirements of the statute”).
\end{footnotes}
Laboratories, the ruling does not answer the question of how the U.S. participators should effectively use the foreign tax credit because the income distributed by the venture will be classified as a U.S., and not foreign, source dividend.

The implications of Revenue Ruling 72-197 are even more interesting in the context of foreign joint ventures. Although the Ruling dealt solely with a domestic joint venture, the holding would appear to apply to a foreign joint venture that is classified as a corporation under U.S. tax law and as a partnership under foreign law. The characterization as domestic or foreign does not seem to be material because the basis of the holding, that the direct credit is allowable to a taxpayer that is legally liable for the foreign tax, applies in either situation. Accordingly, if Revenue Ruling 72-197 is applied to a foreign joint venture, Davies and Lainoff argue that a U.S. venturer would be able to claim a direct tax credit under section 901, while on the other hand enjoying a tax deferral on the venture's profits. This result occurs because, contrary to the case of a domestic joint venture, the foreign joint venture's profits are not taxed in the U.S. unless they are repatriated to the U.S. participators in the form of dividends. The problem with this interpretation, however, is that it is inconsistent with the principles set forth in Abbot Laboratories. A more persuasive argument is that, in accordance with Revenue Ruling 72-197 (which allows a direct foreign tax credit subject to the limitations of section 904), the foreign tax credit can only be used effectively in a joint venture if there are sufficient distributions by the foreign entity to its participators.

To summarize, under the principles set forth in Biddle and Abbot Laboratories, a U.S. resident shareholder of a foreign entity that is classified as a corporation in the U.S. and as a

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230. But see Daniels, supra note 8, at 56.
231. See id. at 57; see also I.R.C. § 861(a)(2) (1994).
232. See Davis & Lainoff, supra note 198, at 173 (discussing that if a foreign joint venture is classified as a foreign corporation, its earnings will generally qualify for a tax deferral under U.S. tax law).
233. See id.
234. See Carl Estes II, Paul Farber & Arthur A. Feder, Partnerships and Joint Enterprises in International Tax Law, in LVIIIb STUDIES IN INTERNATIONAL FISCAL LAW 158–59 (1973). Additionally, Revenue Ruling 72-197, applied to a foreign joint venture, would not have the problem of the ruling in its original holding of explaining how the U.S. resident participator should actually credit the foreign taxes, because, if the venture is foreign, the distributions received by the U.S. participator would qualify as foreign source dividends and would be creditable under the foreign tax credit provisions. See Rev. Rul. 72-197, 1972-1 C.B. 215; see also I.R.C. §§ 901, 904 (1994 & Supp. V 1999).
partnership under foreign law, is not entitled to a foreign tax
credit even though the U.S. shareholder is legally liable for the
foreign taxes paid as a “partner,” if the income subject to the
foreign tax has not been distributed to the U.S. participator and
taxed in the U.S. in the year the credit is claimed.235 However,
Abbot Laboratories, viewed from an *argumentum a contrario*
point of view, and Revenue Ruling 72-197, applied to a foreign
venture, imply that the U.S. shareholder should be able to credit
the foreign taxes imposed on him as a “partner,” provided there
are sufficient current distributions by the foreign entity.236

(b) U.S. treats Foreign Corporation as a Partnership

The opposite situation of a classification conflict is explicitly
dealt with in section 901(b)(4), which grants a direct foreign tax
credit to a U.S. individual partner if a foreign entity qualifies as
a corporation under foreign law but is treated as a partnership
for U.S. tax purposes.237 It is difficult to understand why section
901(b)(4) grants a tax credit only to domestic individual partners
and not to corporate partners in a foreign entity.238 The
allowance of a foreign tax credit to both U.S. individual and
corporate partners would be in accordance with the principles
of the U.S. tax system as required in *Biddle* and *Abbot Laboratories*
because treatment of the foreign entity as a partnership under
U.S. law means that the foreign entity’s profits are taxed in the
U.S. on a current basis, regardless of an actual distribution.239
Thus, while *Abbot Laboratories*, applying *Biddle*, denies a tax
credit in a classification conflict where a foreign partnership is
treated as a corporation in the U.S., it also implies that as long
as a foreign corporation is qualified as a partnership in the U.S.,

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235. See *Biddle v. Comm'r*, 302 U.S. 573, 581 (1938); *Abbot Labs. Int'l Co. v. United
237. See I.R.C. § 901(b)(4) (1994) (prescribing that “[s]ubject to the limitation of
section 904” a foreign tax credit will be allowed “[i]n the case of any nonresident alien
individual not described in section 876 and in the case of any foreign corporation, [for]
the amount determined pursuant to section 906”); see also *OWENS*, supra note 218, at 403–04.
As discussed by Owens:

In [the situation where individual partners are not liable for payment of
a foreign tax], the issue is simply what is to be done when a foreign
country taxes an enterprise as a corporation or a separate taxable entity
while the United States taxes it as a partnership and thus taxes the
individual participants separately. It is apparent that section 901(b)(4)
was intended to take care of this situation, but that section is limited to
individual partners.

*OWENS*, supra note 218, at 403–04.

238. See *OWENS*, supra note 218, at 403–04.
239. See *Biddle*, 302 U.S. at 580; *Abbot Labs.*, 160 F. Supp. at 326.
the U.S. resident partner should be able to credit the foreign taxes even if they are imposed on the entity under foreign law.\textsuperscript{240} Additionally, contrary to the classification conflict scenario where a foreign partnership is treated as a corporation in the U.S., when a foreign corporation is treated as a partnership, the foreign entity’s profits are taxed to the U.S. partners on a current basis without being subject to tax deferral—this appeared to be the decisive reason for the court in \textit{Abbot Laboratories} to deny the domestic partner a tax credit.\textsuperscript{241}

The question of whether a corporate partner was entitled to claim a foreign tax credit in a section 901(b)(4) situation was raised in \textit{Arundel Corp. v. United States}.\textsuperscript{242} This case asked if a U.S. corporate participant in a Puerto Rican joint venture was entitled to claim a tax credit for its proportionate share of the foreign taxes.\textsuperscript{243} Under the laws of Puerto Rico, the joint venture was treated as a corporation for the taxes at issue, and thus the taxes were imposed on the venture as a separate taxable entity.\textsuperscript{244} The U.S., conversely, classifies a joint venture as a partnership.\textsuperscript{245} The Commissioner denied the U.S. corporate partner a credit on the grounds that the Puerto Rican taxes were imposed on the partnership as a separate taxable entity, and therefore the plaintiff was not the technical taxpayer.\textsuperscript{246} In addition, the Commissioner held that section 901(b)(4) grants a credit only to individual taxpayers.\textsuperscript{247}

The Tax Court, on the other hand, did grant a credit to the U.S. corporation.\textsuperscript{248} However, the decision is of limited guidance because the Tax Court managed to circumvent the discussing whether section 901(b)(4) also applies to a corporate partner.\textsuperscript{249} The court construed the Puerto Rican Commercial Code in such a manner that it could argue the individual participants in the

\begin{itemize}
\item \textsuperscript{240} See DANIELS, \textit{supra} note 8, at 55 (opining that “[t]he reasoning in \textit{Biddle} indicates that the principles of U.S. tax law are a crucial factor in determining the taxpayer for the U.S. foreign tax credit” and “[t]his would imply that, in any event, as long as under U.S. tax laws, a foreign entity is classified as a partnership, the U.S. resident participators should be entitled to credit the foreign taxes, even if they are imposed upon the entity”).
\item \textsuperscript{241} See \textit{Abbot Labs.}, 160 F. Supp. at 329.
\item \textsuperscript{242} 102 F. Supp. 1019, 1020 (Ct. Cl. 1952).
\item \textsuperscript{243} See \textit{id.}
\item \textsuperscript{244} See \textit{id.}
\item \textsuperscript{245} See I.R.C. § 7701(a)(2) (1994) (prescribing that “[t]he term ‘partnership’ includes a . . . joint venture”).
\item \textsuperscript{246} See \textit{Arundel}, 102 F. Supp. at 1020.
\item \textsuperscript{247} See \textit{id.} at 1021.
\item \textsuperscript{248} See \textit{id.} at 1023.
\item \textsuperscript{249} See \textit{id.}
\end{itemize}
venture were legally liable for the Puerto Rican taxes that were imposed on the venture as a separate taxable entity.\textsuperscript{250} Having decided that the individual participants were subject to the Puerto Rican taxes instead of the venture, there was no need for the court to discuss the section 901(b)(4) issue raised by the Commissioner.\textsuperscript{251}

As Owens points out, the court’s finding would have been correct even assuming that the individual partners were definitely not liable for payment of the foreign tax.\textsuperscript{252} As discussed above, the current inclusion of the foreign entity’s profits in the income of the U.S. participants (treated as partners for purposes of U.S. tax law) would be perfectly in accordance with the principle in the U.S. tax system, which provides for double taxation relief to a resident taxpayer whom domestic law attributes and currently taxes foreign source income.

To summarize, it appears to be reasonable from a tax policy point of view to grant a tax credit to both individual and corporate U.S. participators in foreign corporations where, in a classification conflict, the U.S. treats a foreign corporation as a partnership. However, the express language of section 901(b)(4), which explicitly deals with this classification conflict situation, indicates that under current U.S. tax law only individual partners are entitled to credit foreign taxes.\textsuperscript{253}

7. Foreign Partner participating in U.S. or Foreign Partnership

Because partnerships are not considered separate taxpaying entities,\textsuperscript{254} it makes no difference under U.S. tax law whether a foreign partner participates in a U.S. or a foreign partnership.\textsuperscript{255} The taxation of foreign partners follows the rules for the taxation of nonresident alien individuals\textsuperscript{256} and foreign corporations,\textsuperscript{257} and

\begin{itemize}
\item \textsuperscript{250} See id.
\item \textsuperscript{251} See id.
\item \textsuperscript{252} See OWENS, supra note 218, at 403 (explaining that “[e]ven assuming . . . that the individual partner’s were definitely not liable for payment of the tax, the rest of the court’s reasoning [in Arundel] and the more persuasive part of the opinion would remain true”).
\item \textsuperscript{253} See supra note 237.
\item \textsuperscript{254} See supra notes 46–49, 146 and accompanying text.
\item \textsuperscript{255} See DANIELS, supra note 8, at 73. A partnership is “domestic” if it is “created or organized in the United States or under the law of the United States or of any State.” I.R.C. § 7701(a)(4) (1994). If a partnership does not qualify as domestic, it is treated as foreign. See id. § 7701(a)(5).
\end{itemize}
is based on the source principle. Generally, a foreign partner is only taxable on his distributive share of the partnership’s:

1) (foreign or domestic) income which is effectively connected with the partner's conduct of a trade or business in the U.S., and

2) certain U.S. source income not effectively connected with a U.S. trade or business.

The taxation of both forms of income is significantly different. U.S. source income that is effectively connected with a U.S. trade or business will be taxable to foreign persons at the graduated rates applicable to U.S. persons or corporations. Tax is usually imposed on net business income including capital gains, i.e., appropriate deductions and credits will be allowed in determining the U.S. tax liability. Section 1446 requires foreign and domestic partnerships to withhold tax at the highest applicable statutory rate with respect to a foreign partner's distributive share of income effectively connected with the conduct of a trade or business in the U.S. The foreign partner must file a U.S. tax return and will receive a refund if the amount withheld exceeds the substantive tax liability. Section 1446 imposes the withholding obligation regardless of whether there is an actual distribution. In contrast, most of the forms of U.S. source income received by a foreign person that are not

257. See id. § 7701(a)(4)–(5), (9) (defining a “foreign corporation” to be a corporation not organized under the laws of the United States, any state, or the District of Columbia).

258. See I.R.C. § 871 et seq. (Tax on Nonresident Individuals); id. § 881 et seq. (Tax on Income of Foreign Corporations); see also Blessing, supra note 156, at A-1 (“Nonresident aliens, foreign corporations, and certain trusts and estates are subject to U.S. income tax on income that is derived from U.S. sources and on certain foreign source income that is considered effectively connected with a U.S. trade or business, but are exempt from tax on other foreign source income.”). For a theoretical analysis of the source rules, see Robert L. Palmer, Toward Unilateral Coherence in Determining Jurisdiction to Tax Income, 30 HARV. INT’L L.J. 1, 49–63 (1989).

259. See I.R.C. §§ 871(a), 881(a) imposing in both provisions a 30% withholding tax on gross income of specifically listed income forms, “and other fixed or determinable annual or periodical gains, profits, and income,” commonly referred to as FDAP income; see also Treas. Reg. § 1.1441-2(a) (2000); DANIELS, supra note 8, at 73–80.

260. See id. §§ 871(b), 882(a)(1).

261. See id. §§ 873, 882(c).

262. See id. § 1446(a)–(d).


265. See id. § 1446(a)(2); see also supra note 111 (quoting section 1446(a)); discussion supra Part II.B.6 (discussing tax withholding).
effectively connected with a U.S. trade or business will be taxed at a 30% flat rate (or lower treaty rate) withholding tax on gross income. The characterization as “effectively connected” or FDAP income and the determination of the source of the income as U.S. or foreign is consequently of crucial importance for the taxation of the foreign partner. The conduit principle and character preservation rule applied to a foreign partner means that the source and the character of the income are determined at the partnership level and that this classification will be retained while the income is passed through to the partners.

(a) Income Effectively Connected with a Trade or Business in the U.S.

Section 871(b)(1) imposes tax on a foreign person’s income if he or she is (1) engaged in a trade or business within the U.S. during the taxable year, and (2) the income is effectively connected with the conduct of a trade or business within the U.S.

(1) Trade or Business

Section 875(1) provides that “a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged.” The test whether a partnership is engaged in a trade or business within the U.S. is the same as in the case of a nonresident alien individual. Thus, section 875(1) implies that a partnership is not, by definition, considered to be engaged in a trade or business and imputes the partnership’s U.S. activities to the foreign partner. Accordingly, if a partnership conducts a trade or business in the U.S., each foreign partner will be deemed to be conducting a U.S. trade or business. Some commentators

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266. See I.R.C. §§ 871(a)(1), 881(a).
267. See Craik v. United States, 31 F. Supp. 132, 135 (Ct. Cl. 1940) (setting forth the basic principles of the taxation of foreign partners before the enactment of Subchapter K and the character preservation rule (I.R.C. § 702(b))). In Craik, the court held that a nonresident alien, who was a member of a domestic partnership operating in the U.S., was not taxable on his distributive share of the partnership income received from sources without the U.S., because Congress intended partnership income should be treated as though the partners had received it individually. Id.
268. See I.R.C. § 871(b)(1).
269. Id. § 875(1).
271. DANIELS, supra note 8, at 74.
272. See I.R.C. § 875(1).
273. Difficulties can arise, however, from the fact that the question of whether a
are of the view that section 875(1) also applies for other purposes, such as the imputation of a partnership’s permanent establishment to its partners.\textsuperscript{274} The Code does not contain a definition of the term “trade or business.” The statute only provides guidelines by treating certain activities as a trade or business\textsuperscript{275} and excluding others.\textsuperscript{276} The determination of whether an activity constitutes a trade or business is made by the IRS and by the courts based on the facts and circumstances in each case.\textsuperscript{277}

(2) Effectively Connected

A foreign partner (\emph{i.e.}, a nonresident alien individual or foreign corporation) who is engaged in a trade or business in the U.S. will only be taxed on such income items that are “effectively connected” with the conduct of a U.S. trade or business.\textsuperscript{278} As set forth in section 864(c), different requirements apply to the different categories of effectively connected income, and depend on whether the income is domestic or foreign.\textsuperscript{279}

U.S. source capital gain and FDAP income is effectively connected with the conduct of a U.S. trade or business if it is “derived from assets used in or held for use in the conduct of such trade or business” (“asset use test”), or if “the activities of such trade or business were a material factor in the realization of the income . . . .” (“business activities test”).\textsuperscript{280} Gain from the disposition of U.S. real property interests is deemed to be effectively connected.\textsuperscript{281} All other income from sources within the U.S., other than the types of noneffectively connected U.S. source income from the partnership is engaged in a U.S. trade or business can in turn depend on a partner’s U.S. activities on behalf of the partnership. Because a partner can also deal with the partnership in a non-partner capacity, the tax consequences of his activities for the partnership may not always be clear. See Stoffregen et al., \emph{supra} note 99, at A-31 (discussing \emph{United States v. Balanovski}, 236 F.2d 298 (2d Cir. 1956), \textsuperscript{rev’g on this issue}, 131 F. Supp. 898 (S.D.N.Y. 1955), \textsuperscript{cert. denied}, 352 U.S. 968 (1956), which deals with the distinction between a partner acting for the partnership and acting for himself).

\textsuperscript{274} See \textsc{Daniels}, \emph{supra} note 8, at 75 (referring to Stanford G. Ross, \textit{United States Taxation of Aliens and Foreign Corporations: Foreign Investors Tax Act of 1966 and Related Developments}, 22 \textsc{Tax L. Rev.} 279, 279–366 (1967)).

\textsuperscript{275} See I.R.C. §§ 871(c)–(d), 882(d), 897(a).

\textsuperscript{276} See id. § 864(b).

\textsuperscript{277} See, \emph{e.g.}, Snow \emph{v. Comm’r}, 416 U.S. 500, 504 (1974); Spermacet Whaling & Shipping Co. \emph{v. Comm’r}, 30 T.C. 618, 633 (1958), aff’g 281 F.2d 646 (6th Cir. 1960); \textit{see generally} Joseph Isenbergh, \textit{The "Trade or Business" of Foreign Taxpayers in the United States}, 61 \textsc{Taxes} 972 (1983).

\textsuperscript{278} See I.R.C. § 864(c)(1).

\textsuperscript{279} See id.

\textsuperscript{280} \textit{Id.} § 864(c)(2)(A)–(B).

\textsuperscript{281} See id. § 897(a)(1).
income set forth in section 871, is deemed to be effectively connected with the conduct of a trade or business within the U.S. (“force of attraction” principle).\footnote{282} Foreign source income is generally not treated as effectively connected income unless it consists of one of the three categories set forth in section 864(c)(4)(B)\footnote{283} and is attributable to an office or other fixed place of business in the U.S.\footnote{284} A foreign corporate partner engaged in a trade or business in the U.S. will be subject to the branch profits tax in addition to the regular corporate income tax.\footnote{285}

(b) Certain U.S. Source Income not Effectively Connected with a U.S. Trade or Business

A foreign partner who is not engaged in a U.S. trade or business is taxed only on certain categories of U.S. source income:

1) Fixed or determinable annual or periodical income (FDAP income).\footnote{286}

\footnote{282}{Income to which the force of attraction principle applies will be taxed at full U.S. rates even though it has no actual connection at all with a trade or business in the U.S. See id. § 864(c)(3).}

Income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual or a foreign corporation if such person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable and such income, gain, or loss—

(i) consists of rents or royalties for the use of or for the privilege of using intangible property described in section 862(a)(4) derived in the active conduct of such trade or business;

(ii) consists of dividends or interest, and either is derived in the active conduct of a banking, financing, or similar business within the United States or is received by a corporation the principal business of which is trading in stocks or securities for its own account; or

(iii) is derived from the sale or exchange (outside the United States) through such office or other fixed place of business of personal property described in section 1221(a)(1), except that this clause shall not apply if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer in a foreign country participated materially in such sale.

\textit{Id.}}
\footnote{284}{See id. § 864(c)(4)(A).}
\footnote{285}{See id. § 884(a).}
\footnote{286}{See id. § 871(a)(1)(A).}
2) Gains from the sale of intangible property. \(^{287}\)

3) Gains attributable to an original issue discount on certain debt obligations. \(^{288}\)

4) Capital gains if the taxpayer has been present in the U.S. for 183 days or more during the taxable year. \(^{289}\)

Portfolio interest is statutorily exempted from the withholding tax on interest if it is received from an entity in which the recipient owns less than 10% of the equity. \(^{290}\) Even though there is no specific authority, the 10% requirement should be tested at the partnership level rather than at the level of each individual partner. \(^{291}\) This view better corresponds with the statutory regime of Subchapter K, under which various elections and determinations with regard to taxable income are determined at the partnership level in accordance with an entity approach.

Absent a lower treaty rate, the income is taxed at a flat 30% rate on gross income and subject to withholding at the source. \(^{292}\) However, if an item of the above categories of U.S. source income is (or is treated as) effectively connected with the conduct of a trade or business in the U.S. under the principles set forth in section 864(c), it is treated as effectively connected income and taxed as such. \(^{293}\) Moreover, under the “force of attraction” principle, all income from sources within the U.S., other than the types of non effectively connected U.S. source income set forth in section 871, is deemed to be effectively connected with the conduct of a trade or business within the U.S. \(^{294}\)

(c) Deductions, Credits, Losses and Returns

A foreign person is generally only entitled to a ratable share of the partnership’s deductions if, and to the extent that, they are

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287. See id. § 871(a)(1)(D).
288. See id. § 871(a)(1)(C).
289. See id. § 871(a)(2).
290. See id. §§ 871(h)(1) & (3)(A), 881(c)(1) & (3)(B).
291. E.g., portfolio interest is earned by a partnership that has two foreign partners, each of whom owns a 9% interest in the partnership.
293. See id. § 864(c)(1)–(3).
294. See id. § 864(c)(3).
attributable to income that is effectively connected with a trade or business in the U.S. An exception is provided for in sections 873(b) and 882(c)(1)(B), which allow certain deductions on noneffectively connected income. Thus, for example, a foreign partner may apply losses (attributable to his share of effectively connected income and U.S. source FDAP income) against gross income, and the excess may be carried back for two years and forward for twenty years. However, a nonresident may not claim any deductions or credits from gross income unless a “true and accurate” return is filed. A foreign partner who is engaged in a trade or business in the U.S. must file a tax return for the taxable year even if he or she has no effectively connected income for the year or is exempt from taxation by statute or treaty. No tax return is required if the foreign partner is not engaged in a trade or business in the U.S. and his or her tax liability is fully satisfied by withholding.

(d) Guaranteed Payments

The tax treatment of guaranteed payments received by a foreign partner is generally the same as if received by a domestic partner. Arguably, guaranteed payments should be treated as income rather than as part of the partner’s distributive share for purposes of determining whether the guaranteed payment has a domestic or foreign source and has to be sourced under the respective source rules.

Because the foreign partner is only taxed on certain U.S. source income and income effectively connected with a U.S. trade or business, the additional question arises as to when guaranteed payments are effectively connected with a trade or business in the U.S. In particular, it has to be decided whether the “effectively connected” determination has to be made at the partnership level in accordance with general principles of partnership taxation, or at the partner level because the definition of a guaranteed payment in section 707(c) (i.e., a payment made to one who is not a partner) implies that a

295. See id. §§ 873(a), 882(c)(1).
296. See id. §§ 873(b), 882(c)(1)(B).
297. See id. § 172(b)(1)(A).
298. See id. §§ 874(a), 882(c)(2).
299. See id. § 6012(a).
301. See I.R.C. § 707(c); see also supra note 87 (quoting section 707(c)).
partnership and the partner have to be treated as separate taxpaying entities. If the determination is made at the partnership level and then imputed to the partner, the guaranteed payment is effectively connected with the conduct of a U.S. trade or business of the partner if the partnership is so engaged. On the other hand, if the determination is made at the partner level, the guaranteed payment will not qualify as “effectively connected” unless the partner himself is engaged in a U.S. trade or business, i.e., there will be no imputation from the partnership to the partners. As Daniels points out, the tax treatment of guaranteed payments, in accordance with its definition as payments made to a partner in a non-partner capacity, implies that the “effectively connected” determination should be made at the partner level. Consequently, guaranteed payments made to a foreign partner may constitute foreign source income but would be considered as effectively connected to the partner’s U.S. trade or business only if the partner is so engaged, regardless of the partnership’s activities. However, the issue is afflicted with much uncertainty and still awaits a firm and convincing conclusion.

302. See I.R.C. § 707(c); see also supra note 87 (quoting section 707(c)).
303. See DANIELS, supra note 8, at 82–83.
304. See id.
305. See id. Daniels has framed the issue and conclusion as follows:

The basic question is whether [the] test is to be applied at the partnership’s level or at the level of the partner receiving the guaranteed payment. . . . Under the conduit theory, the asset use test is applied at the partnership level. If it is found that the money or the tangible or intangible property is used or held in the U.S. business, the guaranteed payment is effectively connected with the U.S. business of the partner. Under the entity theory, the asset test is applied at the partners’ level. The payment is considered as being received by one who is not a partner. Therefore, the guaranteed payment cannot be considered as effectively connected with a U.S. business, provided the recipient is not otherwise engaged in a U.S. business.

A consistent approach of treating guaranteed payments would be based on the entity theory, which would imply that guaranteed payments made by a partnership engaged in a U.S. trade or business could have a U.S. source, but would not be considered to be effectively connected to a U.S. business provided the partner is not otherwise engaged in a U.S. trade or business.

Id.
306. See id.
307. See id. (stating that “[t]he area is . . . murky and comparable to the question of how to treat a sale of a partnership interest by a foreign partner”); see also Harvey P. Dale, Effectively Connected Income, 42 TAX L. REV. 689, 705 n. 97 (1987).
B. Germany

The German tax law does not provide an express statutory provision that defines when a partnership is regarded as "domestic" or "foreign." Generally, a partnership is considered "domestic" if (1) it is created or organized under German law, and (2) the location from where the activities of the partnership are controlled is in Germany.\(^{308}\) In order to determine whether income received by a partnership engaged in a trade or business\(^{309}\) has a domestic or foreign source, Germany uses the concept of permanent establishment (\textit{Betriebsstätte, Betriebsstättenprinzip}).\(^{310}\) The income has a foreign source if it is realized through a foreign permanent establishment of the partnership.\(^ {311}\) For purposes of computing the partnership’s taxable income, the permanent establishment is deemed a distinct and separate enterprise from the partnership.\(^ {312}\) However, payments made by the permanent establishment to the partnership’s headquarters in return for interest, rents, or royalties, such as loans or the transfer of other business assets, are not deductible by the permanent establishment in computing its profits.\(^ {313}\) Business assets are attributed to the foreign permanent establishment if they are regarded as belonging to the permanent establishment from an economic point of view (\textit{wirtschaftliche Zugehörigkeit}).\(^ {314}\) Thus, for example, royalty

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308. Ort der Geschäftsleitung, § 10 Abgabenordnung (Tax Code) [hereinafter AO].
309. The concept of permanent establishment only applies to a partnership engaged in a trade or business (\textit{gewerbliche Personengesellschaft}), but not to a passive investment partnership (\textit{vermögensverwaltende Personengesellschaft}). Whether dividend, interest, or rental income received by a passive investment partnership qualifies as foreign is determined by the "source rules" enumerated in § 34d EStG (1977). \textit{See especially} No.6 and No.7. § 34d(No.6)-(No.7) EStG prescribes, via electronic translation, that foreign income is:

6. An income from capital abilities (§ 20), if the debtor domicile, management or seat in a foreign state has or the capital ability by foreign landed property is secured;

7. An income from letting and farm lease (§ 21), as far as the immovable fortune or the entirety of things in a foreign state occupies or the rights were left for use in a foreign state.

Id.

310. \textit{See} DANIELS, \textit{supra} note 8, at 60 ("Under German tax law, taxation of foreign business profits is based on the concept of permanent establishment (\textit{Betriebsstätte})."); \textit{see also} PRICE WATERHOUSE, \textit{supra} note 112, at 160 ("A foreign partner will be deemed to be conducting business in Germany through a permanent establishment, and that partner’s share will be taxed as though it were permanent establishment income.").
312. \textit{See id.} at 60; \textit{see also} Judgment of Jan. 21, 1972, Bundesfinanzhofs (BFH), 1972 BStBl. II 374.
313. \textit{See} DANIELS, \textit{supra} note 8, at 60.
314. \textit{See id.} The \textit{wirtschaftliche Zugehörigkeit} test is similar to the "asset use" and
income received by the partnership would constitute foreign source business income, if the intangible property has to be attributed to the foreign permanent establishment.\footnote{See \textit{id.} at 60.}

1. Domestic Partner participating in a Domestic Partnership that Receives Foreign Income

A domestic partner is taxed on his worldwide income, which includes his distributive share of the partnership’s foreign source income.\footnote{See \$ 1 EStG (prescribing income tax obligation for individual partners); \$ 1 KStG (1997) (prescribing tax liability for corporate partners); \textit{see also Doing Business in Germany}, \textit{supra} note 2, at 63 ("Resident individuals are liable to personal income tax on their worldwide income, subject to specific limitations in tax treaties.").} However, a foreign tax credit is provided for foreign taxes paid by the partner on his distributive share of the foreign source income.\footnote{See \$ 34d EStG (defining foreign income); \textit{see also Doing Business in Germany}, \textit{supra} note 2, at 56 ("Individuals are entitled to the foreign tax credit . . . with the exception of the indirect or ‘deemed-paid’ tax credit.").} Only German law is applied in computing the foreign source income received by a domestic partnership. Consequently, in the case of a domestic partner participating in a domestic partnership engaged in a trade or business, the partner is taxed on his distributive share of the partnership’s foreign source income attributable to its foreign permanent establishment. As in a purely domestic context, the partner (provided that he also qualifies as an entrepreneur) will only receive (foreign) business and trade income from the permanent establishment. Other foreign source income, as enumerated in \$ 34d(2)(A) of the Income Tax Act, received by the domestic partnership or its foreign permanent establishment, such as foreign source dividend, interest, and rental income, will be reclassified as foreign source business income.\footnote{See \$ 34d(2)(A) EStG.}

Foreign source dividend, interest, or rental income received by a domestic passive investment partnership is not subject to a reclassification at the partnership level and will be taxed in the hands of the domestic partners as foreign source dividend, interest, or rental income respectively.

Foreign source income received directly by a partner that is not attributable to the domestic partnership or its foreign permanent establishment will be taxed directly to the partner under the respective class of income.\footnote{See Killius, \textit{supra} note 112, at A-59 to A-66 (discussing the taxation of resident individuals in Germany).} It will not be treated as

\footnote{“business activities” test under U.S. law.}
income of the partnership or its permanent establishment and consequently no reclassification takes place.

Guaranteed payments by a domestic partnership engaged in a trade or business made to its domestic partner for services or the use of capital by the foreign permanent establishment, constitute foreign source income and will be reclassified as (foreign) business income.  As in the domestic context, the foreign source guaranteed payments are simply included in the partner’s distributive share of partnership income and cannot be deducted by the foreign permanent establishment in computing its income. The partnership’s foreign income is taxed to the partner in the taxable year in which it is received by the partnership, regardless of an actual distribution to the partner.

Foreign losses are, as a general rule, fully recognized by the domestic partnership in computing its taxable income. The partnership’s income, reduced by the foreign losses, is then passed through to the partners and taxed in the taxable year in which they were incurred by the partnership. Thus, the offset of foreign losses against income (domestic and foreign) solely takes place at the partnership level and cannot be used directly by the individual partners. However, the Income Tax Act limits the current recognition of foreign losses for certain classes of passive income, enumerated in § 2a of the Income Tax Act. Losses from foreign investment activities can only be offset against income in the current taxable year, provided the income belongs to the same class of passive income and was derived from the same foreign country. Foreign passive losses in excess of the respective class of such income can be carried forward and deducted from such income in future years.

Because the partnership is not a separate taxpaying entity, double tax relief for foreign taxes imposed on partnership income has to be provided for at the partner level.


321. See Greif & Fischer, International Income Tax Problems of Partnerships, National Report Germany, in LXXXa CAHIERS DE DROIT FISCAL INTERNATIONAL 231, 235 (1995) (pointing out that it is not clear whether the non-deductibility of foreign source guaranteed payments is based on § 15(I)(No.2) EStG (income tax act) that provides for non-deductibility in the purely domestic context, or on the principle of permanent establishment, which generally does not recognize transactions between the partnership and its permanent establishment).


323. See § 2a EStG (defining negative income associated with foreign purchases).

324. See supra notes 118–20, 122–25 and accompanying text.
Under § 34d of the Income Tax Act, a domestic partner is allowed a tax credit for foreign taxes imposed on his distributive share of the foreign source income.\textsuperscript{325} Thus, the fact that the income is earned through a partnership does not hinder the individual partner in seeking relief from double taxation.

2. Foreign Partner participating in a Domestic Partnership that Receives Domestic/Foreign Income

Germany taxes a foreign partner who participates in a domestic partnership only on certain types of domestic income, enumerated in § 49 of the Income Tax Act (\textit{beschränkte Steuerpflicht}).\textsuperscript{326} As in the case of a domestic partner, the partnership, though an entity for accounting purposes, is treated as fiscally transparent, and the income is taxed in the hands of the partners.\textsuperscript{327}

A foreign partner in a domestic partnership that is engaged in a trade or business only earns income from the conduct of a trade or business through the partnership, provided the income is attributable to a permanent establishment (\textit{Betriebsstätte}) in Germany\textsuperscript{328} and the foreign partner qualifies as an entrepreneur (\textit{Mitunternehmer}).\textsuperscript{329} Income attributable to the German permanent establishment that would normally qualify as (domestic) dividends, interest, or rentals, etc. under § 49 of the Income Tax Act, is reclassified at the partnership level as income from a domestic trade or business.\textsuperscript{330} Guaranteed payments made to the foreign partner and attributable to the domestic

\textsuperscript{325} See § 34d EStG (defining foreign income).
\textsuperscript{326} See § 49 EStG (defining domestic income for limited income tax obligation purposes); see also \textsc{Daniels}, supra note 8, at 83; Killius, supra note 112, at A-69 (explaining that “[n]onresident individuals are subject to limited tax liability (\textit{beschränkte Steuerpflicht}), which covers only certain items of income derived from German sources as enumerated in Section 49 of the EStG”).
\textsuperscript{327} See supra note 324 and accompanying text; see also supra notes 118–20, 122–25 and accompanying text.
\textsuperscript{328} See \textsc{Price Waterhouse}, supra note 112, at 160 (“A foreign partner will be deemed to be conducting business in Germany through a permanent establishment, and that partner’s profit share will be taxed as though it were permanent establishment income.”); Killius, supra note 112, at A-69 (“Under the terms of Germany’s tax treaties a nonresident individual has to have a [permanent establishment] in Germany for business profits to be subject to German tax.”).
\textsuperscript{329} See \textsc{Daniels}, supra note 8, at 85; see also § 15(1)(No.2) EStG (defining “income from [an] industrial concern” in pertinent part as “the shares in the profits of the partners of open commercial company, limited partnership and another society, at which the partner is an entrepreneur [joint contractor] of the enterprise”); § 49(1)(No.2) EStG (defining domestic income for limited income tax obligation purposes as “income from [an] industrial concern”).
\textsuperscript{330} See § 49(1)(No.2) EStG.
permanent establishment are also part of the foreign partner’s distributive share of the partnership’s business income and not deductible by the partnership.  

Other domestic income received by the foreign partner that is not attributable to the partnership’s domestic permanent establishment is taxed to the partner if it falls within one of the categories of income enumerated in § 49 of the Income Tax Act. However, Germany does not tax the foreign partner on his share of the domestic partnership’s income that is attributable to a foreign permanent establishment. The foreign partner in a domestic partnership that is engaged in a trade or business is taxed on his net income at the graduated rates applicable to a German resident partner and is not subject to withholding. 

The taxation of net income implies that the foreign partner may offset losses attributable to the partnership’s domestic permanent establishment against all of his domestic income taxable under § 49 of the Income Tax Act. Losses attributable to a domestic partnership’s foreign permanent establishment, however, are not deductible from the foreign partner’s domestic income because profits derived from the foreign permanent establishment are not taxable in Germany. Losses are currently deductible or may be carried back for one year and up to two million German marks and carried forward for an unlimited time and amount. However, domestic income of the foreign partner that is collected through tax withholding, i.e., passive income, is not available for a tax carry-over. As for the domestic partner, losses from passive investment activities can only be offset against the same class of passive income of the foreign partner.

A different tax treatment results if the foreign partner participates in a domestic passive investment partnership.

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331. See Daniels, supra note 8, at 87.
332. See § 49 EStG; see also Killius, supra note 112, at A-69 (listing the items of income under § 49 EStG).
333. See Judgment of Feb., 2, 1988, Bundesfinanzhofs (BFH), 1988 BStBl. II 663.
334. See § 32a (1) EStG (Income Tax Tariff); § 50(3) EStG (prescribing special regulations for taxpayer limits); see also Doing Business in Germany, supra note 2, at 61 (explaining that “partners must include their distributive shares of partnership profits and losses in income for federal corporate and personal income tax purposes”); Killius, supra note 112, at A-59 to A-66 (discussing the taxation of resident individuals in Germany).
336. See § 50(1)–(2) EStG; see also § 10d EStG (Loss Departure).
337. See § 50(2) EStG; see also KPMG, supra note 335, at 63 (explaining that “losses can only be set off against similar types of income generated in the same state”).
Because the dividend, interest or rental income received by the partnership is not reclassified as business income, the foreign partner is only taxed on such domestic income items listed in § 49 of the Income Tax Act. The most significant difference, however, exists with regard to the collection of the taxes. The foreign partner in a passive investment partnership is taxed on gross income which is collected through withholding. Even though many questions concerning the taxation of passive investment companies engaged in international transactions still remain unresolved, taxation on gross income and collection through tax withholding implies that losses and other deductions cannot be used to offset respective passive profits.338

3. Foreign Partner Participating in a Foreign Partnership that Receives Domestic/Foreign Income

The tax treatment of a foreign partner who participates in a foreign partnership is generally not different from a foreign partner who earns income through a domestic partnership. Because the foreign partnership is not a separate taxable entity and treated as fiscally transparent under German tax law, the foreign partner is only taxed on his distributive share of the foreign partnership’s domestic income that is enumerated in § 49 of the Income Tax Act.339 Income items not listed in § 49 of the Income Tax Act are not taxable in Germany. Thus, income received by a foreign partnership that is attributable to a German permanent establishment will be taxed to the foreign partners as domestic business income.340 Any other class of domestic income, such as dividends, interest, or rentals attributable to the conduct of a trade or business through the domestic permanent establishment, will be reclassified as business income. Guaranteed payments made to the foreign partner and attributable to the domestic permanent establishment are also part of the foreign partner’s distributive share of the partnership’s business income and not deductible by the partnership.

Domestic income earned directly by a foreign partner which is not attributable to the foreign partnership’s domestic permanent establishment, or income earned through a foreign

338. See Greif & Fischer, supra note 321, at 231, 240.
339. See sources cited supra notes 326, 332.
340. See § 15(1)(No.2) EStG; § 49(1)(No.2) EStG; see also Killius, supra note 112, at A-69 (noting that if a permanent establishment “is found to exist in Germany, all income properly allocable to the [permanent establishment] . . . may be taxed in Germany”).
partnership that is solely engaged in passive investment activities in Germany, is only taxed to the nonresident partner if it falls within one of the classes of income listed in § 49 of the Income Tax Act. The foreign partner is taxed on business income under § 49(1)(No.2) of the Income Tax Act,\textsuperscript{341} and on net income, subject to the same tax rates as a resident taxpayer;\textsuperscript{342} this income is not subject to tax withholding.\textsuperscript{343} In contrast, passive income taxable under § 49(1)(No.2) of the Income Tax Act is taxed on gross income and collected through withholding.\textsuperscript{344}

4. Domestic Partner participating in a Foreign Partnership that Receives Foreign Income

The tax consequences for a German resident taxpayer who participates in a foreign partnership are significantly different depending on whether the foreign partnership is qualified as a corporation or partnership for German tax purposes.\textsuperscript{345} The determination depends solely on German tax principles regardless of how the foreign jurisdiction classifies the entity. If the foreign partnership is classified as a corporation under German law, the domestic “partner” will generally be taxed as a shareholder only when profits are repatriated in the form of corporate distributions or gain from the sale of the corporation’s stock.\textsuperscript{346}

It is not clear whether the domestic taxpayer who participates in such a “hybrid” entity is entitled to claim a tax credit against his German tax liability for the foreign taxes

\begin{footnotes}
\item[341] See § 49(1)(No.2).
\item[342] See Killius, supra note 112, at A-31 (“Income tax is imposed on resident and non-resident individuals at progressive rates that range from 19.9% to 48.5% in 2001 and 2002, and that are scheduled to drop gradually to 15% and 42%, respectively, by 2005.”).
\item[343] See id. As Killius explains:
   In the case of resident taxpayers, the tax base is the net income and, where the income tax is collected by way of withholding at the source . . . the withholding tax is simply a prepayment on account of the income tax and is refundable if no income tax is due. In the case of nonresident individuals, income tax is assessed on net income in certain instances only. In other instances, the tax is settled by way of final withholding on gross receipts.
\item[344] Id.
\item[345] See DANIELS, supra note 8, at 58–59.
\item[346] See id. at 58 (“Classification as a corporation results in a deferral of taxation at the participator’s level, until the income of the foreign entity is distributed.”); Killius, supra note 112, at A-71 (describing the rules regarding the tax liability of non-resident individuals for dividends and capital gains).
\end{footnotes}
paid. The German tax authorities are likely to deny a credit in such a situation because there is no separate identity from a strictly legal point of view, between the person or entity claiming the tax credit and the person or entity on which, under German classification rules, the tax is imposed by the foreign jurisdiction. Most commentators, however, are of the opinion that the domestic taxpayer should be entitled to a tax credit. They argue that § 34c of the Income Tax Act has to be construed in accordance with its legislative purpose to avoid double taxation and regard the “identity of tax subjects” requirement as meaning economic identity rather than a strictly legal identity.

In contrast, in the opposite case of a classification conflict (i.e., Germany classifies a foreign corporation as a partnership), it is generally accepted that the domestic taxpayer is entitled to a tax credit for the foreign corporate and withholding taxes attributable to his share of the profits on which he is currently taxed in Germany as a partner. As Daniels points out, a possible reason for allowing a tax credit in this situation may be that, “from a German tax point of view, the persons claiming the credit (the individual partners) are identical to the persons who are considered to be earning the foreign income” and currently have to tax it in Germany.

If there is no classification conflict and the foreign partnership is also classified as a partnership under German Law, the domestic “partner” will be taxed immediately on his or her share of the foreign partnership’s income. German tax principles are applied exclusively to determine the domestic partner’s share of the foreign partnership’s income and coincide with the taxation of a domestic partner in a purely domestic context. The partnership is treated as fiscally transparent, but income is deemed to be earned by the partnership, which is treated as an entity for income computing purposes and passed

347. See DANIELS, supra note 8, at 62; see also § 34c EStG (pertaining to individual taxpayers); § 26 KStG (pertaining to corporate taxpayers).
348. So-called Steuersubjektidentität, which is electronically translated as “tax subject identity.”
350. See HARALD SCHAUERBURG, INTERNATIONALES STEUERRECHT 629 (2d ed. 1998) (giving an overview of the different viewpoints).
351. See id.
352. See DANIELS, supra note 8, at 63.
353. Id.
354. See sources cited supra notes 316, 322.
through to, and taxed in, the hands of the partners. The domestic partner’s share of the foreign partnership’s foreign income is part of the partner’s worldwide income. Foreign taxes paid by the domestic partner are creditable against his domestic tax liability or, if the taxpayer elects so, can be deducted from his domestic taxable income.

The aforementioned double taxation relief under § 34c(1) and (2) of the Income Tax Act only applies to foreign taxes imposed by the country from which the income originates. Taxes, however, imposed on the foreign partnership’s income that was earned from and taxed by a third country (e.g., withholding tax on passive income received by the foreign partnership from a third country) are not covered. This is because under German tax principles, income derived by the foreign partnership from a third country, or such income which is attributable to a foreign permanent establishment, is considered as income derived from the country of residence of the foreign partnership or the country where the foreign permanent establishment is located. Nevertheless, some double taxation relief for withholding taxes on third-country income may be provided for by § 34c(3) of the Income Tax Act which entitles the domestic taxpayer to deduct such taxes from his domestic taxable income.

5. Domestic Partner participating in a Foreign Partnership that Receives Domestic Income

For a German resident partner who participates in a foreign partnership that receives domestic income, it is of some significance with regard to his entitlement to a tax credit

356. See supra notes 118, 308–15 and accompanying text.
357. See supra note 316 and accompanying text.
358. See § 34c(1) EStG (pertaining to individual taxpayers); see also § 26(1) KStG (pertaining to corporate taxpayers); see also KPMG, supra note 335, at 44, 63 (explaining that, in the context of individual taxpayers, “[f]oreign income taxes that are substantially similar to the German income tax may be credited against the German tax liability, limited to the amount of German income tax payable on that income from a foreign country (per country limitation)” and, in the context of corporate taxpayers, “foreign income taxes paid on that income may be credited against the [corporation’s] German tax liability”).
359. See § 34c(2) EStG (pertaining to individual taxpayers); § 26(2) KStG (pertaining to corporate taxpayers); see also KPMG, supra note 335, at 44, 63 (explaining that, in the context of an individual taxpayer, as an alternative to the foreign tax credit “foreign income tax can be deducted from the German tax base” and, in the context of corporate taxpayers, “[i]f the foreign tax is not creditable, it is regularly allowed as a deduction instead”).
360. See § 34c(1)–(2) EStG.
361. See § 34c(3) EStG.
whether such domestic income is attributed to the foreign partnership (which is, under German tax principles, generally treated as fiscally transparent, but as an entity for purposes of computing “its” taxable income), or directly to the domestic partner. Similar to a domestic partner participating in a domestic partnership that receives foreign income, domestic income received by a domestic partner in a foreign partnership will generally be considered as earned by the foreign partnership and not by the individual partners. This applies to foreign partnerships regardless of whether they are, under German tax law, regarded as being engaged in a trade or business or in mere passive investment activities. An exception, however, applies to foreign partnerships that are engaged in a trade or business if the domestic income is attributable to a German permanent establishment. In this case, the domestic income is not deemed to be earned by the foreign partnership, but earned directly by the domestic partner through his or her domestic permanent establishment.

The treatment of the domestic income as either earned by (or more precisely through) the foreign partnership or as earned directly by the domestic partner is likely to have the following consequences for the domestic partner’s eligibility for double-taxation relief. The very careful phrasing of the preceding sentence indicates that there is much uncertainty in this area and many problems still have to be resolved.

If the domestic income is attributed to the foreign partnership, it is most likely that the domestic partner is not entitled to claim a tax credit on German withholding taxes imposed on certain items of passive income. Even though it could be argued that the domestic income is in fact “foreign” from the domestic partner's perspective because it is received through a foreign partnership, the German withholding taxes do not constitute “foreign taxes” to be creditable under § 34c(1) of the Income Tax Act. Greif and Fischer argue the domestic taxpayer cannot claim a tax credit because there is no identity between the person or entity claiming the credit (i.e., the partnership) and the person or entity on which the tax is imposed (i.e., the partner). On the other hand, some commentators

363. See discussion supra part III.B.1.
364. See Greif & Fischer, supra note 321, at 231, 243.
365. For the “identity” requirement in order to be entitled to a tax credit under § 34c EStG, see supra notes 347–49 and accompanying text.
366. See Greif & Fischer, supra note 321, at 243.
argue that the tax credit should be available if, under foreign law, the income is deemed distributed in the taxable year it was earned. Because such a situation would be treated as a current dividend distribution under German law, the profits would be immediately and at once taxed to the German participators. In fact, it seems to be reasonable to grant a tax credit under such circumstances. Moreover, the situation is similar to where the foreign partnership earns income from a third country on which the third country imposes a withholding tax. However, § 34c(3) of the Income Tax Act that normally provides some relief from double taxation in such third country constellations is not applicable because the German withholding tax does not constitute a “foreign” tax. Thus, in such a situation, double taxation could only be avoided if the partnership’s country of residence provides for a tax credit for the German withholding taxes against the domestic partner’s tax liability in the partnership’s country of residence.

No problem, however, exists with regard to taxes imposed by the foreign partnership’s country of residence on the partnership’s domestic income. Such taxes are clearly creditable by the German partner against his taxes on his worldwide income under § 34c(1) and (2) of the Income Tax Act.

IV. ENTITY CLASSIFICATION

A. The United States

Effective January 1, 1997, the IRS issued new regulations under I.R.C. § 7701, popularly known as “check-the-box,” that allow taxpayers to treat domestic unincorporated business organizations and certain foreign business organizations as partnerships or as associations on an elective basis. The check-the-box regulations significantly simplify the former four-factor approach for classifying entities, which was difficult to apply

367. See DANIELS, supra note 8, at 62.
368. See § 34c(3) EStG.
369. See id. at § 34c(1), (2).
371. Prior to 1996, in characterizing business entities, the old section 7701 regulations invoked six corporate characteristics identified by the Supreme Court: (1) associates, (2) objective to carry on business and divide the profits, (3) continuity of life, (4) centralized management, (5) free transferability of ownership interests, and (6) limited liability. See Morrissey v. Comm’r, 296 U.S. 344 (1935). Because existence of (1) and (2) are common to both corporation and partnership, for purposes of differentiating between
and sometimes generated uncertainties, especially with respect to foreign entities.\textsuperscript{372} Moreover, since the historical differences between corporations and partnerships under local law have become increasingly blurred by many state legislators in recent years, tax treatment as a partnership or corporation was already more or less elective under the old system by carefully drafting the memorandum of association or the partnership agreement.\textsuperscript{373} As a result, the “increasingly formalistic rules” under the prior regulations were found obsolete and replaced “with a much simpler approach that generally is elective.”\textsuperscript{374} The following discussion outlines the basic principles of the check-the-box regulations.\textsuperscript{375}

The new entity classification regulations apply to both domestic entities and, with certain modifications discussed below, to foreign organizations. Generally, an “eligible entity,” \textit{i.e.}, a business entity that is not automatically classified as a corporation \textit{per se} pursuant to Treasury Regulation section 301.7701-2(b), can elect its classification for U.S. federal tax purposes regardless of its classification under local law.\textsuperscript{376}

Treasury Regulation section 301.7701-2(b)(1)–(7) specifies under which circumstances domestic business entities are automatically treated as corporations \textit{per se}.\textsuperscript{377} In addition, the regulation lists foreign entities that always will be classified as corporations under U.S. tax law such as the German

\begin{itemize}
\item both entities, only the remaining four are considered the “four-factor test.”
\item \textsuperscript{373} See IRS Notice 95-14, 1995-1 C.B. 297.
\item \textsuperscript{374} Notice of Proposed Rulemaking and Hearing, 61 Fed. Reg. 21,989, 21,990 (May 13 1996).
\item \textsuperscript{376} See Treas. Reg. § 301.7701-3 (2000) (stating that “[a] business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal law purposes as provided in this section”).
\item \textsuperscript{377} See id. § 301.7701-2(b)(1)–(7).
\end{itemize}
Aktiengesellschaft ("AG"). Special grandfather rules provide that the foreign business entities listed as corporations per se will nevertheless be classified as partnerships if certain requirements under Treasury Regulation section 301.7701-2(d)(i)–(iv) are met. Eligible domestic entities that existed prior to the effective date of the regulations are generally also able to retain their current classification, in which case no election need be filed.

Business entities other than per se corporations ("eligible entities") may elect to be treated as either a corporation or a partnership, provided they have at least two members. Because a fundamental characteristic of a partnership is the presence of associates, an entity with a single owner cannot qualify for partnership treatment. Nevertheless, an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner, and thus be treated as a sole proprietorship, branch, or division.

The regulations provide default classification rules for both domestic and foreign entities. The purpose of the default classification rules is to provide most eligible entities with classifications they would choose anyway. An eligible entity that wants to stay with the default classification is not required to file an election. A domestic eligible entity will be, unless the entity elects otherwise, treated as a partnership if it has two or more members, or disregarded as an entity separate from its owner if it has a single owner. While domestic eligible entities are considered formed with an intent to qualify for partnership treatment, the preferred classification of foreign entities is less predictable.

378. See id. § 301.7701-2(b)(8).
379. See id. § 301.7701-2(d)(i)–(iv).
380. See id. § 301.7701-3(b)(3)(i) (stating the general rule that "unless the entity elects otherwise, an eligible entity in existence prior to the effective date of this section will have the same classification that the entity claimed under §§ 301.7701-1 through 301.7701-3 as in effect on the date prior to the effective date of this section").
381. See id. § 301.7701-3(a) ("An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.").
382. See id.
383. See id. § 301.7701-3(b)(1) (pertaining to domestic eligible entities); id. § 301.7701-3(b)(2) (pertaining to foreign eligible entities).
384. See id. § 301.7701-3(b)(1).
The IRS, under the check-the-box-regulations, follows the Treasury Department’s belief that a foreign entity will desire to be treated as a partnership for U.S. tax purposes if any of the organization’s members has personal liability for the debts of the organization. Consequently, a foreign eligible entity is classified as a partnership if it has two or more members and at least one member does not have limited liability. Similarly, the foreign entity is disregarded as an entity separate from its owner for U.S. tax purposes if the single owner does not have limited liability. On the other hand, the foreign entity qualifies as a corporation if all members have limited liability. Technical rules for the election process, i.e., time and place of filing, etc., are found in Treasury Regulation section 301.7701-3(c).

B. Germany

1. Domestic Entities

(a) Classification

Unlike the mostly elective classification system under the check-the-box regulations in the U.S., the taxation of German entities as corporations or partnerships is determined by statute and is not elective. Corporations, i.e., separate legal and taxpaying entities, are subject to corporate income tax and the double-tax regime of the Corporate Income Tax Act (Körperschaftsteuergesetz, “KStG”), and are enumerated in § 1(1) of the Corporate Tax Act. The most important corporations are the Aktiengesellschaft (“AG”), Kommanditgesellschaft auf Aktien (“KgaA”), and Gesellschaft
mit beschränkter Haftung ("GmbH"). All other business entities are partnerships and taxed under a pass-through system similar to that in the U.S. The most important partnerships under German law are the Gesellschaft des bürgerlichen Rechts ("GbR"), offene Handelsgesellschaft ("oHG"), Kommanditgesellschaft ("KG"), the GmbH & Co. KG, and the stille Gesellschaft.

(b) Overview of Business Entities in Germany

The following chart gives an overview of the most important forms of business organizations in Germany and their main characteristics.

(“KG”), the civil law counterpart to the U.S. limited partnership, unknown to Anglo-American law. See DOING BUSINESS IN GERMANY, supra note 2, at 29. The KgaA has at least one individual general partner with unlimited liability. See id. The interests of the limited partners are represented by share certificates and, from their point of view, this vehicle is comparable to an ordinary corporation, and consequently taxed as such under the German Corporate Tax Act. See Killius, supra note 112, at A-19.

394. Translated as a “company with restricted liability,” it is the counterpart to a U.S. limited liability company (LLC). See Killius, supra note 112, at A-19.

395. See generally discussion supra Part II.B.2.

396. The counterpart to a civil law partnership. See supra note 115 and accompanying text.

397. The counterpart to a general partnership. See supra note 112 and accompanying text.

398. The counterpart to a limited partnership. See supra note 113 and accompanying text.

399. The counterpart to a limited partnership with a corporate general partner. See Judgment of June, 25, 1984, Bundesfinanzhofs (BFH), 1984 BStBl. II 751–70 (illustrating that the supreme tax court rejects the argument that a limited partnership with a corporate general partner should be, according to its economic functioning, taxed as an association under the Corporate Tax Code). Besides the fact the GmbH & Co KG was not listed as a taxable entity in the Corporate Tax Act, the court argued it would be contrary to the structure of the Corporate Tax Act if one could disregard the civil law form of an organization and tax it according to its economic substance. Id. See also DANIELS, supra note 8, at 16–17; supra note 114 and accompanying text.

400. A silent partnership. See supra note 116 and accompanying text. A typical silent participation arrangement (typische stille Gesellschaft) under § 230 HGB resembles more a creditor-debtor relationship than a partnership and constitutes interest income to the silent “partner” under § 20(1)(No.4) EStG. In essence, the silent participant agrees to contribute a stipulated amount (or an asset) to a merchant (sole proprietor, partnership, or corporation) in exchange for a share in the profits (and, possibly, the losses). See Killius, supra note 112, at A-15. The atypical silent partnership (atypische stille Gesellschaft), in contrast, is treated and taxed as a partnership. See id. at A-16. Unlike the typical silent “partner,” the partner in an atypical silent partnership participates in the management, or will not only share in the profits and losses but also in the appreciation or depreciation of the silent partnership’s assets. See id. at A-16.

401. See OECD REPORT, supra note 6, at 93–95. For a more a more detailed discussion, see Killius, supra note 112, at A-19.
### Table 1: German Corporations

<table>
<thead>
<tr>
<th>1. common abbreviation of entity</th>
<th>AG</th>
<th>GmbH</th>
<th>KGaA</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. English translation</td>
<td>Limited liability company</td>
<td>Limited liability company</td>
<td>Partnership limited by shares</td>
</tr>
<tr>
<td>3. Does the entity file a tax return?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>4. Is tax on the income of the entity assessed on the entity itself?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?</td>
<td>The company</td>
<td>The company</td>
<td>The partners / company</td>
</tr>
<tr>
<td>6. If the tax is paid by the members, how is the income classified for tax purposes?</td>
<td>N/A</td>
<td>N/A</td>
<td>Business income</td>
</tr>
<tr>
<td>7. Is the rate and type of tax applicable to the entity’s income determined on the basis of the members?</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>8. Is tax imposed on the recipient when the income of the entity is distributed to its members, etc.?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>9. If the answer to 8 is yes, how is that income classified for tax purposes?</td>
<td>Dividends</td>
<td>Dividends</td>
<td>Dividends</td>
</tr>
<tr>
<td>10. Does your country consider the entity as a “company” for purposes of tax treaties?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>11. Do you consider the entity a “resident” for purposes of tax treaties?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

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402. The share of the general partner is deducted from the tax base of the company. The general partner must include this share in his income tax return.

403. However, in the case of the general partner, the answer is no.

404. This question is unclear as far as the general partner is concerned.
Table 2: Other German Business Entities

<table>
<thead>
<tr>
<th>1. common abbreviation (or name) of entity</th>
<th>GbR</th>
<th>oHG</th>
<th>KG</th>
<th>Stille Gesellschaft</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. English translation</td>
<td>Civil law partnership</td>
<td>General partnership</td>
<td>Limited partnership</td>
<td>Silent partnership</td>
</tr>
<tr>
<td>3. Does the entity file a tax return?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>4. Is tax on the income of the entity assessed on the entity itself?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?</td>
<td>The partners</td>
<td>The partners</td>
<td>The partners</td>
<td>The partners</td>
</tr>
<tr>
<td>6. If the tax is paid by the members, how is the income classified for tax purposes?</td>
<td>Dependent upon nature of activity 405</td>
<td>Business income</td>
<td>Business income</td>
<td>Investment income 406</td>
</tr>
<tr>
<td>7. Is the rate and type of tax applicable to the entity’s income determined on the basis of the members?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>8. Is tax imposed on the recipient when the income of the entity is distributed to its members, etc.?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>9. If the answer to 8 is yes, how is that income classified for tax purposes?</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>10. Does your country consider the entity as a “company” for purposes of tax treaties?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>11. Do you consider the entity a “resident” for purposes of tax treaties?</td>
<td>No 407</td>
<td>No 408</td>
<td>No 409</td>
<td>No</td>
</tr>
</tbody>
</table>

405. Income from agriculture or forestry, from independent services, business income or investment income.
406. The active partner earns business income.
407. Under specific provisions of conventions the entity may be deemed to be a resident for the purposes of the convention.
408. See note 407.
409. See note 407.
2. Foreign Entities

Germany uses a corporate resemblance test to determine whether a foreign entity is classified as a corporation or partnership for income tax purposes. Under this test, established in 1930 by the Reichsfinanzhof\textsuperscript{410} in its landmark Venezuela case,\textsuperscript{411} the foreign entity is classified and taxed like the German counterpart that it resembles most in its legal structure and economic functioning.\textsuperscript{412} This determination depends solely on German tax principles; the classification of the foreign entity under the civil law and tax law of its country of residence is not decisive.\textsuperscript{413} However, the resemblance test depends on all the relevant facts and circumstances of each case, including the foreign entity’s memorandum of association.\textsuperscript{414} While the test sounds quite practical in theory, its application may prove difficult, particularly in cases where the foreign entity is unknown to German civil law, such as the Anglo-American trust.\textsuperscript{415}

V. CLASSIFICATION CONFLICTS AND ENTITLEMENT TO TREATY BENEFITS

A. Application of Tax Treaties to Partnerships: In General

Natural and judicial persons (e.g., corporations or other associations) usually face no difficulties claiming the benefits of a tax treaty. They are “person[s]” under Article 3(1)(a) of the Organization for Economic Co-operation and Development Model Tax Convention (“OECD-MTC”)\textsuperscript{416} and qualify as “resident[s] of a Contracting State” under Article 4 of the OECD-MTC because

\textsuperscript{410}See Daniels, supra note 8, at 103. The Reichsfinanzhof was the predecessor of the Bundesfinanzhof (supreme tax court).

\textsuperscript{411}Judgment of Feb. 12, 1930, Reichsfinanzhof, 1930 RStBl 444; see also Judgment of July 17, 1968, Bundesfinanzhof (BFH), 1968 BStBl II 695.

\textsuperscript{412}See Schauburg, supra note 350, at 697; Knobbe-Kruik, supra note 322, at 540.

\textsuperscript{413}See Daniels, supra note 8, at 104.

\textsuperscript{414}See id. at 103–04.

\textsuperscript{415}See id. at 144 (referring to Hans-Jürgen Würster, Die Anerkennung ausländischer Körperschaften im deutschen Ertragssteuerrecht, in FINANZRUNDSCHAU 88–591 (1980)).

\textsuperscript{416}OECD-MTC, supra note 7, art. 3(1)(a) (defining person as “an individual, a company and any other body of persons”).
they are separate taxpaying entities subject to tax in their country of residence.\footnote{417} Significant problems arise with regard to the application of tax treaties to partnerships in the event their tax treatment by the contracting states differs.\footnote{418} Generally, tax treaties do not contain special provisions dealing with partnerships or classification conflicts. Partnerships are considered as “person[s]” for purposes of the OECD-MTC,\footnote{419} but do not qualify as “resident[s]” under Article 4 unless they are not treated as separate taxpaying entities.\footnote{420} States such as Germany and the U.S. consider partnerships as fiscally transparent and it becomes apparent that partnerships are not entitled to treaty benefits.\footnote{421}

An exception exists when the contracting states expressly confer the ability to claim treaty benefits upon partnerships under their tax treaties, regardless of whether they qualify as residents.\footnote{422} Germany has adopted such an approach in a small number of its tax treaties, especially with countries that traditionally view partnerships as separate legal entities under their civil laws, such as Belgium,\footnote{423} Japan,\footnote{424} and Spain.\footnote{425} In these cases, Germany grants the foreign partnership (a separate legal entity in its country of residence) the treaty benefits under the applicable tax treaty, and in return, German partnerships, though fiscally transparent, enjoy the treaty benefits, such as reduction of the foreign withholding tax on foreign source income in the other state. The chart below gives an overview of the partnership’s ability to claim treaty benefits.\footnote{426}

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\footnote{417}{See id. art. 4 (defining the term “residence of a Contracting State” as “any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof”).}

\footnote{418}{See le Gall, supra note 10, at 709.}

\footnote{419}{See OECD-MTC, supra note 7, art. 3(1)(a).}

\footnote{420}{Id. art. 4.}

\footnote{421}{Many of the German tax treaties (e.g., those with Japan, Italy, and Canada) have not adopted the phrase “any other body of persons” from Article 3(1)(a) of the OECD-MTC. Consequently, under those German tax treaties, partnerships do not even qualify as “persons.”}

\footnote{422}{This is called \textit{partielle Abkommensberechtigung}, which translated means “partial agreement authorization.”}

\footnote{423}{See Convention for the Avoidance of Double Taxation, Apr. 11, 1967, F.R.G.-Belg, arts. (3)(1)(No.4), 4(1), LEXIS 92 TNI 88-20.}

\footnote{424}{See Agreement for the Avoidance of Double Taxation, Apr. 22, 1966, F.R.G.-Japan, art. 7(7), LEXIS 95 TNI 175-61.}

\footnote{425}{See Convention for the Avoidance of Double Taxation, Dec. 5, 1966, F.R.G.-Spain, art. 4(4), LEXIS 95 TNI 174-67.}

\footnote{426}{See Greif, \textsc{Steuerrecht International Tätiger Unternehmen} 563 (Mössner 2d ed. 1998).}
B. Corresponding Classification of Partnerships by Contracting States

Complications do not arise when both contracting states correspond in their qualification of partnerships. A corresponding qualification of partnerships for tax purposes relates to a corresponding application of the respective tax treaty. The partnership is definitely entitled to the treaty benefits when regarded as a separate taxable entity by both contracting states because it qualifies as a person and resident under the treaty.427

In contrast, consider the situation where a partnership with two partners, X and Y, has been established under the laws of State A, where the partnership carries on a business. Partner X is a resident of State A and partner Y is a resident of State B. Both states under their domestic laws, treat partnerships as fiscally transparent, i.e., as non-existent for tax purposes. Article

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427. See OECD-MTC, supra note 7, arts. 3(1)(a), 4; see also supra notes 416–17.
7 of the A-B tax treaty (similar to the OECD-MTC)\textsuperscript{428} avoids the double taxation of business profits by providing, that “[t]he profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.”\textsuperscript{429} However, because an enterprise of a contracting state is defined as an “enterprise carried on by a resident of a Contracting State,”\textsuperscript{430} the application of Article 7 fails in this case because the partnership is not a taxable entity under the domestic laws of both states and hence does not qualify as a resident under Article 4.\textsuperscript{431}

The above result, however, is considered inappropriate\textsuperscript{432} and it is widely agreed that the partners are entitled to the treaty benefits instead of the partnership itself.\textsuperscript{433} Under this view, each partner is considered as carrying on an enterprise of State A. In other words, the partnership’s business, carried on through its permanent establishment in State A, is imputed to each partner individually. The permanent establishment is regarded both as a distinct and independent enterprise for purposes of the application of the treaty as well as for the allocation of income.\textsuperscript{434} Consequently the (individual or corporate) partners are entitled to claim the application of Article 7 of the A-B treaty, which mimics the OECD-MTC, provided that they are residents of either State A or B.\textsuperscript{435}

To summarize situations in which both contracting states qualify partnerships as being fiscally transparent, it is not the partnership itself but each partner who would be entitled to the treaty benefits. The partner, however, is required to be a resident of the partnership’s country of residence or the other contracting state.

\textsuperscript{428} For purposes of the following examples, the hypothetical treaties are based upon the OECD-MTC.

\textsuperscript{429} See OECD-MTC, supra note 7, art. 7(1).

\textsuperscript{430} See id. art. 3(1)(c) (stating that “the term ‘enterprise’ applies to the carrying on of any business”).

\textsuperscript{431} See id. art. 4.

\textsuperscript{432} See ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, 1963 & 1977 OECD MODEL INCOME TAX TREATIES AND COMMENTARIES: A COMPARATIVE PRESENTATION 20 (1987) (stating, “[i]n such a case, it may assist toward classification if each participation in a partnership is looked upon as a separate enterprise . . . .”).

\textsuperscript{433} For the United States, see Donroy Ltd. v. United States, 301 F.2d 200, 207 (9th Cir. 1962); Unger v. Comm’r, 58 T.C.M. (CCH) 1157 (1990). For Germany, see Judgment of Jan. 29, 1964 Bundesfinanzhof (BFH), 1964 BStBl II 164; GREIF, supra note 426, at 563–64.


\textsuperscript{435} See OECD-MTC, supra note 7, art. 7.
C. Non-Corresponding Classification by Contracting States (Classification Conflict)

If partnerships are classified as separate taxable entities by one contracting state and as fiscally transparent by the other, or vice versa, a “classification conflict” arises. Generally, tax treaties contain no provisions that expressly address or resolve such situations. The non-corresponding application of a tax treaty by the contracting states may lead to a double taxation or a double non-taxation. It is important to remember in these cases that the entity qualification by the contracting states for purposes of the application of a tax treaty is separate and distinct from each state's application of its domestic tax laws to the entity in question. It is beyond the scope of this work to examine these problems with regard to every item of income a partnership may earn. The discussion, therefore, focuses on business profits and guaranteed payments as the most important and controversial areas.

1. Partnership’s Country of Residence treats Partnership as Entity (Fiscally Intransparent)

The following example sets the scene for a situation where the partnership is qualified as a taxable entity by its country of residence but treated as fiscally transparent by the other contracting state (e.g., country of residence of its partners or source country from which it earns income). Such a classification conflict always arises under the U.S.-Germany tax treaty when a U.S. partnership elects to be taxed as a corporation in the U.S. for federal income tax purposes under the check-the-box regulations. This is because Germany applies a corporate resemblance test under its foreign entity qualification rules, which in turn always characterizes U.S. partnerships as fiscally transparent.

EXAMPLE: PS is a partnership established in State P where it carries on a business. State P treats PS as a taxable entity. PS receives foreign source income from State S which, under its classification rules, treats PS as fiscally transparent and attributes the income to the partners as taxpayers.

436. See DANIELS, supra note 8, at 152.
437. See discussion supra Part IV.B.2.
438. See DANIELS, supra note 8, at 153 (providing a similar working example).
PS is a taxable entity under the laws of State P and therefore, as a P-resident, is entitled to the benefits of the P-S treaty with regard to its S-source income. As a result, State S can only impose tax on the business profits of PS to the extent that they are attributable to a permanent establishment of PS in S. Interest payments made to PS that arise in State S can only be taxed by State S subject to the reduced 10% withholding tax rate. From the perspective of State S the tax consequences may be entirely different. Broadly speaking, three different views may be identified.

Under the first view, both the foreign entity’s qualification for treaty purposes, as well as the foreign entity’s taxation in State S, solely depends on State S’s domestic tax laws. Under this approach, State S regards PS as fiscally transparent and consequently denies it the benefits of the P-S treaty. Moreover, State S, under its domestic income attribution rules attributes PS’s S-source income not to the partnership but to its partners as taxpayers.

Most commentators are of the opinion that, instead of the partnership itself, the partners should be entitled to the treaty benefits, provided they are residents of one of the contracting states. They argue that Articles 3(1)(a) and (b) of the OECD-MTC have to be construed according to the primary goal

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439. See OECD-MTC, supra note 7, art. 4.
440. See id. art. 7.
441. Provided PS is the beneficial owner of the interest and the S-source interest is not effectively connected with a permanent establishment of PS in S. See id. art. 11(2).

Article 11(1)–(2) provides that:

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 percent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

Id.

442. See DANIELS, supra note 8, at 153.
444. See, e.g., SCHAUMBURG, supra note 350, at 788.
of tax treaties, which is the avoidance of double taxation.\textsuperscript{445} According to this view, which seems to be the prevailing opinion in Germany,\textsuperscript{446} the partnership’s business carried on through its permanent establishment in State P is imputed to each partner individually.\textsuperscript{447} The permanent establishment is regarded as a distinct and independent enterprise for treaty purposes.\textsuperscript{448} In other words, each partner is considered as carrying on an enterprise of State P and consequently entitled to the treaty benefits of the P-S treaty, provided they are residents of either State P or S. Hence, under Article 7 of the P-S treaty, State S has no right to tax the S-source income in the hands of the S or P resident partners because PS has no permanent establishment in State S.\textsuperscript{449}

Under the second view, gaining considerable support in Germany, the partnership’s qualification for treaty purposes by its country of residence is also binding for the application of the tax treaty by the other contracting state.\textsuperscript{450} However, the country of residence’s tax treatment has no impact on the domestic taxation of PS by that other state. State S taxes the foreign partnership’s income solely based on its domestic tax laws. Therefore, because tax treaties do not provide for independent income attribution rules, even if State S considers PS as a resident of State P for treaty purposes, it still applies its domestic tax laws and income attribution rules to PS’s income. Consequently, the partnership’s business profits are only taxable in State P, its country of residence.

Unless the profits are repatriated to the S-resident partners in the forms of dividends, State S is precluded from taxing the business profits by Article 7 of the P-S treaty.\textsuperscript{451} If PS pays dividends to its S-resident partners, then the fact that State S is

\textsuperscript{445} See Greif & Fischer, supra note 321, at 246; Detlev Jurgen Piltz, Die Personengesellschaft im Internationalen Steuerrecht 134 (1981); see also Judgment of Nov. 9, 1966, Bundesfinanzhof (BFH), 1966 BStBl II 88.

\textsuperscript{446} See Greif, supra note 426, at 557.

\textsuperscript{447} Id.

\textsuperscript{448} See Debatin & Endres, supra note 434, at 232.

\textsuperscript{449} A few commentators deny a double taxation relief completely. They argue that the partners, though generally entitled to treaty benefits under the P-S treaty if residents of either state, cannot claim double taxation relief in the situation set forth in the example because there is no identity between the person or entity claiming the double taxation relief (partners) and the person/entity on which the tax is imposed by the foreign jurisdiction (partnership). See Ebling, supra note 349, at 227–45.


\textsuperscript{451} See OECD-MTC, supra note 7, art. 7.
bound by State P’s qualification for treaty purposes results in State S also treating the payments as dividends, even though it would normally regard them as the partner’s distributive share of the partnership’s profits. Dividend treatment for treaty purposes in State S means that Articles 10 and 23A(2) of the P-S treaty are applicable and that the treaty allows State S to impose tax on the distributions. 452 However, because State S follows the partnership’s country of residence qualification purely for treaty purposes, it still qualifies those payments as part of the partner’s distributive share of the partnership’s profits under its domestic tax laws. Assuming that State S, such as Germany or the U.S., does not tax partnership profits upon its distribution to the partners, it will not impose tax on the dividends even though it might have the right to do so under the tax treaty. As a result, double taxation will be generally avoided under this view, not necessarily because of an entirely corresponding application of a tax treaty, but because the contracting state, who treats the partnership as fiscally transparent, does not impose tax on actual distributions by the partnership to its partners under its domestic tax laws.

The difference between the first view and the second view is that the latter allows the partnership itself to claim the treaty benefits, and therefore, double taxation relief no longer depends on the residence of the partners in one of the contracting states. However, while both approaches avoid double taxation in most cases, they do not always offer double taxation relief. 453

For example, absence of a permanent establishment in State S leads to double taxation arising to the extent that S-source business profits are attributed to partners who are residents of a third country (assuming that no tax treaty between State S and the third country is in force that provides for double taxation relief). 454 State S would not be prevented from taxing the S-source profits in the hands of the third country partners

452. See id. art. 10(1) (stating that “[d]ividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other state”); id. art. 23A(2) (stating that:
Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from the other State).

453. See DANIELS, supra note 8, at 154–56.

454. See OECD-MTC, supra note 7, art. 7.
because they are not covered by the P-S treaty.\footnote{455} State P, on the other hand, which has the sole right to tax the partnership’s S-source business profits under Article 7 of the P-S treaty, will not grant double tax relief for the taxes imposed by State S on the partners who are residents of a third country.\footnote{456} Likewise, if there is a permanent establishment in State S, then State S has the right to tax the business profits attributable to such permanent establishment in the hands of the partners under Article 7 of the P-S treaty.\footnote{457} Double taxation may arise if State P does not provide for double taxation relief at the partnership level because, from its perspective, the partnership itself has not been subject to tax in State S.

Probably the most consistent approach towards resolving such classification conflicts from a tax policy perspective would be the third view that qualification by the partnership’s country of residence binds the other state not only for treaty purposes but also for purposes of its domestic tax laws.\footnote{458} The difference in the tax consequences as set forth under the second view would be that State S is not only allowed to tax the dividends under Article 10 of the OECD-MTC, but would also tax the distributions as dividends under its domestic tax laws.\footnote{459} State S consequently grants double taxation relief by exempting from tax an amount equal to the tax imposed on the dividends by the partnership’s country of residence.\footnote{460}

While this approach might best resolve the classification conflict where the partnership is qualified as a taxable entity by its country of residence but treated as fiscally transparent by the other contracting state, it does not represent the current state of the law that the OECD, the U.S., or Germany has adopted.\footnote{461} The often significantly diverging national concepts of taxation of partners and partnerships have, until today, frustrated any attempt by the OECD to find a uniform and standardized arrangement under the Model Tax Convention. While many of these difficulties may be resolved through a better coordination

\footnote{455} See id.  
\footnote{456} See id.  
\footnote{457} See id.  
\footnote{458} So-called Qualifikationsverkettung. See DANIELS, supra note 8, at 159.  
\footnote{459} See OECD-MTC, supra note 7, art. 10(1); see also supra note 452 (quoting art. 10(1)).  
\footnote{460} See OECD-MTC, supra note 7, art. 23A(2); see also supra note 452 (quoting art. 23A(2)).  
\footnote{461} However, it is interesting to note that the German Internal Revenue considers this approach for classification conflicts arising between Germany and the United States. See GRIEF, supra note 426, at 558.
of the application and interpretation of some of the provisions of the tax conventions, \textsuperscript{462} it is currently up to the individual states to identify such problems in their tax treaties and to resolve them on a bilateral basis.\textsuperscript{463} One possibility would be to make more use of provisions in the individual tax treaties that expressly entitle partnerships to treaty benefits regardless of its, or its partners', status as resident(s) in one of the contracting states.\textsuperscript{464}

2. Partnership's Country of Residence Treats Partnership as Fiscally Transparent

In the reverse case of a classification conflict, the country where the partnership was organized classifies it as fiscally transparent, while the contracting state treats it as a taxable entity (e.g., country of residence of its partners or source country from which it earns income). Accordingly, the partnership is not considered a resident of the country where it has been established because it is not subject to tax in that state\textsuperscript{465} and thus is not entitled to treaty benefits.

Assume for example,\textsuperscript{466} partnership PS has been organized under the laws of State P, which treats it as fiscally transparent. All of PS's partners are also residents of State P. PS receives income from sources in State S, which treats it as a taxable entity. Under the domestic income attribution rules, State S will attribute all of the S-source income to PS as a taxable entity. Nevertheless, State S will deny PS the benefits of the P-S treaty because PS is not subject to tax in State P, and therefore does not qualify as a resident under the treaty. In other words, State S does not consider the S-source income for treaty purposes as earned by a P-resident (even though all of PS's partners are also residents of State P). On the other hand, State P will attribute the income to the partners and generally provide for double taxation relief in accordance with the P-S treaty at the partner level. However, because State S's right to impose tax on the

\textsuperscript{462} See OECD REPORT, supra note 6, at 11.

\textsuperscript{463} See OECD-MTC, supra note 7, art. 1 cmt. n.6 (stating that “Contracting States are however left free to examine the problems of partnerships in their bilateral negotiations and to agree upon such special provisions as they may find necessary and appropriate”).

\textsuperscript{464} So-called “partielle Abkommensberechtigung,” translated as “partial agreement authorization”; see also Lethaus, Wege zur Abkommensberechtigung von Personengesellschaften, in FESTSCHRIFT FUR WOLFGANG RITTER 429 and 455 (1997).

\textsuperscript{465} See OECD-MTC, supra note 7, art. 4; see also SCHAUMBURG, supra note 350, at 853.

\textsuperscript{466} See DANIELS, supra note 8, at 153–54 (providing a similar working example).
S-source income is not limited by the P-S treaty, double taxation may easily arise.\textsuperscript{467}

In the situation of a classification conflict where the entity does not qualify as a resident in the state in which it has been organized, it is apparent the diverging treaty application and income attribution by the contracting state can easily lead to double taxation or double non-taxation. Many attempts have been made to resolve this problem by arguing that the residency requirement of Article 4 does not require actual taxability of the partnership in its country of residence, but merely that the partnership is somehow autonomous or akin to a separate legal personality for tax purposes. Under this view, at least in countries such as the U.S. and Germany, which generally treat partnerships as fiscally transparent but also as entities for some tax purpose (e.g., for accounting and income reporting purpose), the partnerships would be entitled to treaty benefits. However, such a view is not compatible with the clear and unequivocal language in Article 4.\textsuperscript{468}

The most consistent approach to resolve the reverse case of a classification conflict would be to tie the other contracting state’s application of the treaty and the income attribution rules to the rules as they are applied by the country under the laws of which the partnership has been organized.\textsuperscript{469} However, while this approach might offer the most consistent solution, it does not reflect the current law. The prevailing view is the partnership cannot claim treaty benefits in a reverse classification conflict. Until the law develops further, the contracting states have to seek solutions at the level of the individual tax treaty, \textit{i.e.}, to provide for provisions expressly entitling partnerships to the benefits of the respective treaty, regardless of the partnerships status as a resident.

3. Innovative Approach under the U.S. Model Treaty and U.S.-Germany Treaty

The U.S.-Germany Treaty, which followed the U.S. Model Treaty, adopted an innovative approach. Residence under the treaty and, consequently, the partnership’s entitlement to benefits, is determined with reference to the person, who under the laws of the other treaty partner, is required to include the

\textsuperscript{467} See id. at 156.
\textsuperscript{468} See OECD-MTC, supra note 7, art. 4; see also SCHAUMBURG, supra note 350, at 854.
\textsuperscript{469} So-called \textit{Qualifikationsverkettung}; see also DANIELS, supra note 8, at 161.
income item in question in gross income. Article 4(1)(b) of the U.S.-Germany Treaty follows the old U.S. Model Treaty and provides in pertinent part that:

in the case of income derived or paid by a partnership . . . [the term “resident”] applies only to the extent that the income derived by such a 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 or beneficiaries.

This provision treats partnerships organized in the U.S. or Germany as residents of either the U.S. or Germany. However, to qualify as a resident, it is not sufficient that the partnership merely has its place of management or organization in one of the contracting states. This treaty requires the income received by the partnership to be taxed in its state of organization as income of a resident of that state. It is sufficient if the income is taxed in the resident partner’s hands and not just the partnership itself. However, while this provision deserves credit for conferring upon partnerships the right to claim treaty benefits, regardless of the domestic laws of the contracting states, it is far from providing a comprehensive solution for the problems arising from classification conflicts. For instance, this provision does not

471. See United States Model Income Tax Convention, June 16, 1981, LEXIS 85 TNI 42-33. Article 41(b) of the old U.S. Model Treaty defined the term “resident of a Contracting State” in pertinent part as:

in the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries.

Id. Article 4(1)(d) of the current 1996 U.S. Model Treaty contains a similar provision:

An item of income, profit or gain derived through an entity that is financially transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such a contracting State as the income, profit or gain of a resident.

473. See id.
474. See DEBATIN & ENDRES, supra note 434, at 204–05.
475. See DANIELS, supra note 8, at 192; see also GRIEF, supra note 426, at 556 noting
indicate which country’s laws control the determination of whether an entity is considered a corporation or a partnership. In addition, it does not provide for a corresponding application of the treaty by the contracting states in such situations. 476

D. Guaranteed Payments

Conflict in the tax treatment of guaranteed payments may arise in two instances and result in double taxation or double non-taxation. 477 First, in the case of taxing a partnership’s profits, a conflicting tax treatment of guaranteed payments occurs if partnerships are classified as separate taxable entities in one contracting state and as fiscally transparent by the other, or vice versa. Secondly, a classification conflict results if both contracting states treat partnerships as fiscally transparent but deviate from each other in the taxation of guaranteed payments. Countries such as Germany regard guaranteed payments as part of the partner’s distributive share of the partnership’s income, and taxes the guaranteed payments as business profits. 478 Other countries, such as the U.S., regard guaranteed payments as made by the partnership to an independent third person. 479 Consequently, those countries, like the U.S., allow the partnership to deduct such payments and tax them according to the nature of every payment, e.g., as compensation for services, interests, or royalties.

Double non-taxation is likely to result if the partnership, under the domestic laws of its country of residence, is entitled to deduct guaranteed payments. This result will occur if the partnership’s country of residence treats the partnership as an entity or treats it as fiscally transparent, but regards guaranteed payments as made to an independent third party. The issue in these situations is whether, for purposes of the tax treaty, guaranteed payments constitute business profits under Article 7 of the OECD-MTC or trigger the application of the treaty provisions (depending on their nature as income from personal services, interest, royalties, etc.). Most tax treaties, including the U.S.-Germany treaty, as well as the OECD and U.S. model
treaties, do not expressly deal with guaranteed payments. They also do not contain an exact definition of which income items constitute business profits.

The following example is based upon the old U.S.-Germany tax treaty situation where the diverging tax treatment of guaranteed payments results in double non-taxation. A U.S. L.L.P, engaged in a trade and business in the U.S., pays interest...
on a loan received from its German partner. Under U.S. tax law, the interest payments are treated as payments made to a third party, and consequently are deductible by the partnership. Germany, on the other hand, treats the interest as part of the German partner’s distributive share in the partnership’s profits. Because the L.L.P. has no permanent establishment in Germany, Germany would not be entitled to impose tax on the payments.

However, the German Federal Tax Court, when confronted with such a situation, held that the payments were generally taxable in Germany as interest under the old U.S.-Germany tax treaty. The decision was in accord with the prior view the German tax authorities had taken. The court referred to the general treaty principle that income items dealt with in other articles of the treaty were not covered by the permanent establishment principle of Article 7 of the OECD-MTC.

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483. See I.R.C. § 707(c).

484. See U.S.-Germany Treaty of 1954, supra note 482, art. 7. Article 7(No.1)–(No.3) provided that:

1. Interest on bonds, notes, debentures, securities or on any other form of indebtedness (including debts secured by mortgages or other encumbrances on real property) derived by a natural person resident in the Federal Republic or by a German company shall be exempt from tax by the United States.

2. Interest on bonds, notes, debentures, securities or on any other form of indebtedness (including debts secured by mortgages or other encumbrances on real property) derived by a resident or corporation or other entity of the United States shall be exempt from tax by the Federal Republic.

3. Paragraph 1 or paragraph 2 of this Article shall not apply if the recipient of the interest has a permanent establishment in the United States, for purposes of paragraph 1, or in the Federal Republic, for purposes of paragraph 2, and the debt-claim giving rise to the interest is effectively connected with such permanent establishment.

Id.


487. See U.S.-Germany Treaty of 1954, supra note 482, art. 3(No.5). Article 3(No.5) prescribed that:

The term “industrial or commercial profits” means income derived by an enterprise from the active conduct of a trade or business, including income derived by an enterprise from the furnishing of services of employees or other personnel, but does not include income dealt with in Article VI paragraphs 1 to 6 (dividends), Article VII paragraphs 1 and 2 (interest), Article VIII paragraphs 1 to 3 (royalties), Article IX (income from real property and natural resources), Article IX A paragraphs 1, 2 and 4 (capital gains) and Article X (labor and personal services).

Id. Article 7 of the current U.S.-Germany tax treaty, which deals with business profits,
The court then reasoned such interest payments would qualify as business profits only in the rare situation where the debt claim on which the interest is paid is attributable to a permanent establishment in the U.S. ("permanent establishment prerogative").

Basically, the court tied the German treaty application to the qualification of guaranteed payments as interest by the U.S. as the source country, instead of applying domestic tax principles under which the payments would be considered nontaxable business profits.

Because such interconnection of national tax principles, for purposes of the treaty application, is unknown to the current German law, German commentators have heavily criticized the decision.

Double taxation is likely to arise in the reverse case where a German partnership pays guaranteed payments to a foreign partner whose country of residence treats the payments as made to a third party. For example, payments by a German partnership to a U.S. partner are taxable in Germany as business profits under Article 7 of the U.S.-Germany treaty.

The U.S., on the other hand, will tax these payments under the respective treaty provisions as interest, royalties, etc. From the U.S.'s perspective, the treaty grants the right to tax the guaranteed payments exclusively to the U.S. Thus, the U.S. will have no treaty obligation to provide for double-taxation relief for the foreign taxes imposed by Germany. The U.S. partner, in the end, can avoid double taxation because he is entitled to a tax credit under the domestic laws, provided the guaranteed payments constitute foreign source income.

Because there are no special treaty rules for guaranteed payments in the U.S., the following discussion focuses provides for a preferred application (i.e., a prerogative) over treaty provisions like the one quoted. See U.S.-Germany Treaty of 1989, supra note 470, art. 7.

488. So-called betriebsstättenvorbehalt. Such a prerogative of the permanent establishment principle of Article 7 of the U.S.-Germany Treaty of 1989 can also be found in Articles 10(No.5) (dividends) and 12(No.3) (royalties) of the U.S.-Germany Treaty of 1989. See U.S.-Germany Treaty of 1989, supra note 470, arts. 10(No.5), 12(No.3).


491. Also referred to as "Qualifikationsverkettung."


494. See id.

495. See I.R.C. §§ 901(a), 904(a) (1994).

specifically on the special rules governing the tax treatment of guaranteed payments in Germany. Guaranteed payments made by a German partnership to its foreign partners always constitute business profits under Article 7 of the OECD-MTC.\(^{497}\)

The tax treatment in the reverse case (i.e., guaranteed payments made by a foreign partnership to its German resident partners) depends on whether the foreign partnership is treated as fiscally transparent or as an entity by the partnership’s country of residence.

If the partnership is treated as an entity, then it is entitled to treaty benefits. Most German commentators\(^ {498}\) argue that as a consequence of the partnership’s entitlement to treaty benefits, guaranteed payments have to be treated as made to a third party. Thus, despite the fact that Germany would normally consider such payments as nontaxable business profits,\(^ {499}\) Germany will tax them under the respective treaty provisions as interest, royalties, etc., and provide for double taxation relief for the foreign taxes imposed by the partnership’s country of residence (source country).

Conversely, if the partnership is treated as fiscally transparent, it cannot claim treaty benefits. Furthermore, most commentators\(^ {500}\) are of the opinion that each contracting state applies the treaty in accordance with its domestic laws. Consequently, Germany would apply Article 7 of the OECD-MTC and thus would be excluded from taxing the guaranteed payments. In order to avoid a possible double non-taxation, both the German courts\(^ {501}\) and tax authorities\(^ {502}\) take the position that Germany, in its application of the respective tax treaty, is bound by the tax treatment of guaranteed payments in the other contracting state.

The different tax treatment of guaranteed payments by the German courts and tax authorities, depending on whether or not the partnership is taxed as an entity in its country of residence, is clearly an inconsistent application of treaty principles. Moreover, the application of tax treaties based on the qualifications by the other contracting state does not represent the current law in Germany.

\(^{497}\) See OECD-MTC, supra note 7, art. 7.

\(^{498}\) See GRIEF, supra note 426, at 573.

\(^{499}\) See OECD-MTC, supra note 7, art. 7.

\(^{500}\) See Debatin, supra note 492, at 1181.


On the other hand, the position taken by most commentators, that domestic tax principles solely govern the application of tax treaties with regard to guaranteed payments, is likewise flawed because it can result in either double taxation or double non-taxation. Although it can be argued that double non-taxation, while undesirable, does not violate treaty principles, double taxation clearly does.

The discussion shows that the diverging tax treatment of guaranteed payments under the national laws makes it difficult to find universally applicable solutions. An example for a bilateral attempt to resolve such conflicts at the treaty level can be found in the current U.S.-Germany treaty. Article 23, protocol 21 of the U.S.-Germany treaty provides that in the case of a classification conflict between both countries, Germany avoids double non taxation by using the tax credit method rather than by the exemption method, provided that such income is not taxed in the U.S. or is only subject to inappropriately reduced taxation.

VI. CONCLUSION

The taxation of partnerships and partners engaged in international transaction is complex and inflicted with much uncertainty. Many countries, such as the U.S. and Germany, have adopted a conduit approach combining aggregate and entity concepts, which makes the taxation of partnerships a highly complex area of the income tax in a purely domestic setting. The problems multiply, if partnerships engage in international transactions, particularly if a tax treaty applies. The complexity and problems are mainly caused by the different national tax concepts. In addition, tax treaties do not follow standardized concepts and generally do not address the question of how to treat partnerships for treaty purposes.

Contrary to many civil law countries like Germany, most Anglo-Saxon countries, including the U.S., believe their tax rules relating to partnerships apply reasonably well in the international arena. However, it is commonly agreed that revision is necessary in at least two major areas.

505. Also referred to as the “Switch-Over-Clause;” see also DEBATIN & ENDRES, supra note 434, at 400, 401.
506. See le Gall, supra note 10, at 661. For the U.S., see Brown & Rabinowitz, supra note 496, at 661. For Germany, see Greif & Fischer, supra note 321, at 231–60.
First, under most treaties, including the OECD-MTC and the U.S. Model Treaty, partnerships are not entitled to treaty benefits. This inevitably leads to significant problems where partnership and partner(s) are located in different states. Second, the different national tax treatment of partnerships as entity or fiscally transparent, and the failure of entity classification rules at the treaty level, may lead to double taxation or double non-taxation. Such a result is not in accord with the principles of domestic and international tax laws. While the OECD has correctly pointed out that the very different national tax concepts make it troublesome to find universally applicable solutions,\textsuperscript{507} it is not an argument precluding partnerships from treaty benefits in the Model Convention.\textsuperscript{508}

This article has demonstrated that such attempts are not necessarily doomed to failure. As shown in the examples of business profits under Article 7 of the OECD-MTC and the taxation of guaranteed payments, a universal solution for classification conflicts may be to bind the contracting state to the tax principles of the source country for purposes of both the application of the treaty and the application of income attribution rules. Furthermore, a successful attempt at the bilateral level to avoid double non-taxation of guaranteed payments in the case of a classification conflict can be found in Article 23, protocol 21 of the U.S.-Germany treaty.

With regard to the partnership’s recognition for treaty purposes, this article supports the view that it is highly desirable and every attempt should be made to entitle partnerships to treaty benefits. A step in the right direction is the innovative approach taken in the U.S. Model treaty,\textsuperscript{509} which ties the partnership’s residency (and hence entitlement to treaty benefits) to the residency of its partners. However, the complex provision has high administrative burdens and does not resolve classification conflicts. Therefore, partnerships should be recognized for treaty purposes and entitled to treaty benefits regardless of the partnership’s or their partners’ status as residents.

\textsuperscript{507} See OECD-MCT, supra note 7, art. 1, cmt. n. 6.

\textsuperscript{508} See le Gall, supra note 10, at 707.

\textsuperscript{509} See U.S. Model Treaty, supra note 471, art. 4(1)(d).