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Abstract
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Keywords
limited partnership, hybrid limited partnership, double taxation, OECD Model Tax Convention

HYBRID ENTITY DOUBLE TAXATION: A CASE STUDY ON THE TAXATION OF TRANS-TASMAN LIMITED PARTNERSHIPS

CRAIG ELLIFFE* AND JUN YIN**

Hybrid entities give rise to international tax problems and opportunities. Different countries tax systems treat hybrid entities in fundamentally different ways, allocating income to different parties. The tax consequences of this divergence in approach result in complex and unintended outcomes. Referring to an OECD Report on the taxation of partnerships, this article looks at whether the treatment of trans-Tasman limited partnerships under the Australian and New Zealand Convention results in double taxation or double non-taxation. It concludes that hybrid entity double taxation is mostly resolved through the operation of the Convention.

INTRODUCTION

Income sourced in one jurisdiction derived by a taxpayer resident in another country is subject to tax both in the country of source and in the country of residence. This results in double taxation. Many countries have a double tax treaty network to attract investment by eliminating double taxation and providing certainty in the taxation of various categories of income.[1]

This article discusses the tax treatment of limited partnerships in both Australia and New Zealand with reference to The Application of the OECD Model Tax Convention to Partnerships (the Partnership Report).[2] It examines whether the Australian and

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1 OECD, *Commentary on the Model Tax Convention on Income and on Capital*, vol 1 (at 22 July 2010) article 1 ¶7, declares as follows: 'The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons'.

2 OECD, Committee of Fiscal Affairs, *The Application of the OECD Model Tax Convention to Partnerships: Issues in International Taxation No 6* (1999) was adopted by the OECD Council on 20 January 1999 ('The Partnership Report'). Although the Partnership Report focuses exclusively on partnerships, the Committee of Fiscal Affairs of the OECD has recognised

New Zealand Convention (Convention) has eliminated double tax and prevented double non-taxation in various scenarios.[3] It also discusses the tax treatment in relation to trans-Tasman limited partnerships. It specifically considers the flow of a type of passive income (royalties), which has a source in either Australia or New Zealand, and is derived by either an Australian or New Zealand limited partnership.

BACKGROUND

Circumstances giving rise to double taxation

Aside from double taxation arising from taxation of both source and residence, double taxation also arises from a difference in the tax treatment of two countries. Sometimes this is because the two countries regard the same income differently. This might be called 'hybrid instrument double taxation', because the two legal jurisdictions view the underlying income flow differently.[4]

Another example of double taxation arises when a particular entity has different tax treatment in different countries, or 'hybrid entity double taxation'. Hybrid entity double taxation can result in different parties being allocated the same income by different jurisdictions.

An entity can have a different tax status in different countries because most countries adopt their own domestic entity approach to the classification of a foreign entity. Different countries consider entities differently for tax purposes and assign tax attributes accordingly. If the foreign jurisdiction regards the entity as a separate legal person for tax purposes, but the domestic jurisdiction regards it as a transparent tax entity (one that is not itself subject to tax but rather passes income and expenses through to its members or investors), then the possibility of hybrid entity double taxation (or double non-taxation) arises.

Double taxation issues regarding limited partnerships in Australia and New Zealand

Hybrid entity double taxation sometimes arises with limited partnerships. Limited partnerships are like the progeny of a company and the partnership. They have a separate legal personality distinct from its owners (like a company). This enables investors to be protected from losses or claims arising from the business activities of

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that many of the principles discussed may be useful to other non-corporate entities, including such vehicles as limited partnerships.

3 *Double Taxation Relief (Australia) Order 2010* (NZ).

4 An example of this may be one country treats income under a hybrid instrument as interest income while the other country regards it as a dividend.

the limited partnership. They also have a partnership agreement and a share of profits which generally arises in agreed proportions (like a general partnership). This enables flexible investment in terms of admission and retirement of partners, relative confidentiality and generally a flow-through tax status. Given their mixed parentage it is not surprising that countries regard them differently for tax purposes.

A limited partnership is treated as a transparent tax entity for New Zealand tax purposes despite being a separate legal person under New Zealand domestic law. In consequence, it is the limited partners that are deemed, for New Zealand fiscal purposes, to derive income and incur expenditure for tax purposes. In contrast, Australia, as New Zealand's closest economic partner, treats most limited partnerships as a separate taxpaying entity, namely a company.

When dealing with cross-border transactions involving trans-Tasman limited partnerships tax issues become difficult due to this difference in tax treatment. The risk of double or non-taxation is compounded when the partners reside in a different country from that in which the limited partnership has been established.

Issues regarding Convention treatment of limited partnerships in Australia and New Zealand

When examining case studies on the application of the Convention to passive royalty income derived by the respective limited partnerships, it becomes apparent there are very different tax consequences under different scenarios. The taxation of limited partnerships in both Australia and New Zealand, and the response in the Convention to the impost of double taxation, serve as an intriguing case study identifying both the problems and potential solution to hybrid entity double taxation.

DOMESTIC LAW WITH RESPECT TO LIMITED PARTNERSHIPS

Domestic tax law with respect to Australian Limited Partnerships

Under Australian tax law, most Australian limited partnerships (ALP) formed in Australia are corporate limited partnerships under Division 5A of the Income Tax Assessment Act 1936 (ITAA 1936). Under this Division, a 'corporate limited partnership' is a company for tax purposes. Accordingly, a limited partnership formed in Australia is most likely to be treated as a separate taxable entity under Australian domestic laws.

In contrast, the New Zealand tax law defines partnerships to include limited partnerships, which include overseas limited partnerships.[5] Australian limited partnerships are overseas limited partnerships under the *Limited Partnership Act 2008*

[5] *Income Tax Act 2007* (NZ) s YA1.

(NZ) because they are formed or incorporated outside New Zealand.[6] The *Income Tax Act 2007 (NZ)* (ITA) however excludes foreign corporate limited partnerships from the definition of limited partnership.

The critical query is whether or not an Australian limited partnership is a foreign corporate limited partnership. A foreign corporate limited partnership means a foreign limited partnership treated as a separate entity under the non-tax laws of the country concerned.[7] This is regardless of whether or not it is treated as a corporate limited partnership for Australian income tax purposes.

Although Australian limited partnerships are treated as separate corporate entities for Australian income tax purposes, they are not treated as separate entities under the non-tax laws of Australia. Therefore, an Australian limited partnership is not a foreign corporate limited partnership and is not excluded from overseas limited partnerships. Accordingly, a limited partnership formed in Australia is treated as a transparent partnership for tax purposes under New Zealand tax law. Under section HG2 of the ITA, the income of the Australian limited partnership flows through to its individual partners.[8]

Domestic tax laws with respect to the New Zealand Limited Partnership

Where a limited partnership is formed in New Zealand, its tax treatment under New Zealand domestic laws is relatively clear. The limited partnership is a partnership under section YA1 of the ITA and therefore an income flow-through entity under section HG2 of the ITA.

The tax treatment of a New Zealand limited partnership (NZLP) under Australian domestic tax law is more complex. Under Division 830 of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997), a limited partnership is a partnership for tax purposes if

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6 *Income Tax Act 2007* (NZ) s YA1; Limited Partnership Act 2008 (NZ) s 4 states:
'overseas limited partnership means a partnership formed or incorporated outside New Zealand with—
  (a) 1 or more general partners who are liable for all of the debts and liabilities of the partnership; and
  (b) 1 or more limited partners who have only limited liability for the debts and liabilities of the partnership'

7 *Income Tax Act 2007* (NZ) s YA1.

8 New Zealand Inland Revenue, 'Public Ruling BR Pub 10/01: Australian source income earned by Australian Limited Partnership and foreign tax credits' (2010) http://www.ird.govt.nz/resources/f/4/f4ccae00420d8f64be9dff4fc1b24342/pu10001-10005.pdf at 7 February 2012.

it is a 'foreign hybrid limited partnership' or a 'foreign hybrid company'.[9] Under section 830-10 of the ITAA 1997, to be a foreign hybrid limited partnership in any income year, a limited partnership must satisfy the following conditions:

(a) the limited partnership is formed in a foreign country; and

(b) foreign income tax is imposed under the law of the foreign country on the partners, not the limited partnership, in respect of the income or profits of the partnership for the income year; and

(c) the limited partnership is not a resident of another foreign country other than the country of formation for tax purposes; and

(d) at no time during the income year is the limited partnership an Australian resident; and

(e) the limited partnership is a 'Controlled Foreign Company' with at least one attributable taxpayer with an attribution percentage greater than nil.

The requirement of condition (e) in section 830-10 of the ITAA 1997 above is for the NZLP to be a controlled foreign company (CFC) under the Australian legislation. To be a CFC requires that the NZLP be a company resident in a listed country or of an unlisted country where the company is either controlled or is deemed to be controlled by a single Australian taxpayer or a small group of Australian taxpayers.[10] Under subsection 320(1) of the ITAA 1936, a listed country means a foreign country, or a part of a foreign country, declared by the regulations to be a listed country for the purposes of Part X of that Act. New Zealand is included in Part 1 of Schedule 10 of the *Income Tax Regulations 1936* (Cth) and, as a result, is declared to be a listed country under regulation 152C of the same Act.[11]

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9 A foreign hybrid company is defined in section 830-15 of the ITAA 1997 (Cth) and a New Zealand Limited partnership is unlikely to qualify (see Minter Ellison, '*The treatment of New Zealand limited partnerships under the Australian foreign hybrid regime*' (2008) http://www.minterellison.co.nz/publications/The_treatment_of_NZ_Limited_partnerships_under_the_Australian_Foreign_Hybrid_Regime_Mar_2008.pdf at 7 February 2012.

10 *Income Tax Assessment Act 1936* (Cth) s 340.

11 Australian Taxation Office, 'ATO Interpretative Decision – Income tax assessability of foreign branch income derived from New Zealand' (2009). It is noted that the ATO is reviewing this position and withdrew the Ruling on 14 May 2010 <http://law.ato.gov.au/atolaw/view.htm?docid=AID/AID200950/00001> at 7 February 2012.

Where condition (e) is not satisfied, that is, the limited partnership is not a CFC, the limited partnership may be a 'Financial Investment Fund' (FIF) under section 481 of ITAA 1936, since it is a foreign company under Australian domestic laws. Provided that conditions (a) to (d) are satisfied, a partner in such a limited partnership can, under subsection 485AA of the ITAA 1936, make an election that FIF rules do not apply to the partner's interest in relation to the FIF. In effect, Division 830 of ITAA 1997 makes the limited partnership a foreign hybrid in relation to the partner's interest in the FIF.[12] This would mean that, with respect to the partner's interest, the limited partnership is a foreign hybrid limited partnership in relation to any income year during which the election is in force.

In summary, a limited partnership formed in New Zealand may be treated as a transparent partnership for Australian tax purposes, when it would qualify as a foreign hybrid limited partnership under Division 830. This is the case if either of the following requirements are satisfied: first, that it meets conditions (a) to (e) of section 830-10 of the ITAA 1997; or, second, conditions (a) to (d) are satisfied, and the relevant partner makes an election under subsection 485AA in relation to his interests in the FIF.

In the absence of meeting these criteria, the NZLP will be treated as a company for Australian tax purposes.

TAX TREATMENT OF THE ALP IN NEW ZEALAND

The Partnership Report suggests that the starting point for the application of tax conventions with respect to income derived from a country is to examine how entities are treated by the State of source (the country where the income arises or is sourced) for the purposes of its domestic taxation.[13] Where income is derived from a particular State, the domestic tax laws of that State will first be applied to determine the tax consequences for the income in that source State. The provisions of the source State's domestic laws will determine who may be subject to tax on income in that State. Afterwards, the provisions of the tax convention may intervene to restrict or eliminate the taxing rights originating from domestic laws if a person – usually, but not necessarily, the taxpayer - identified under domestic laws, is eligible for the benefits of the tax convention in relation to that income.

In the following two sections, it is assumed that the limited partnership that is established in one State does not have a permanent establishment in the other State.

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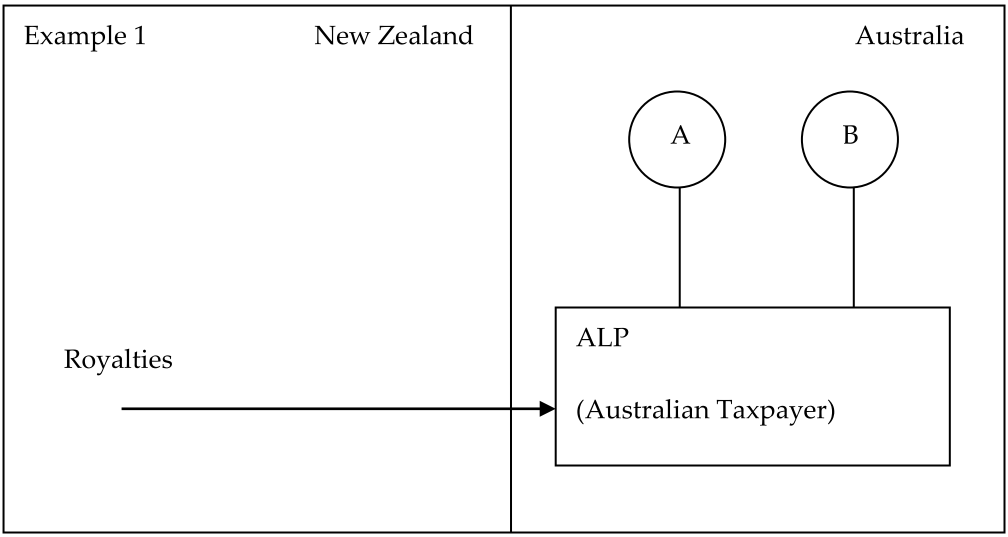
12 *Income Tax Assessment Act 1936* (Cth) s 485AA(5).

13 Above n 2.

Tax treatment of ALPs in which the partners are Australian residents

As discussed above, Australia taxes most of its limited partnerships as taxable corporate entities, while New Zealand analysis views them as transparent entities for tax purposes. This means income allocated to an ALP in Australia (for Australian tax purposes) would be allocated to the ALP's partners (for New Zealand tax purposes). Since the Convention only applies to residents for purposes of the Convention,[14] that conflict of income allocation may cause difficulties to the State of source. Accordingly, when New Zealand, as the State of source, comes to apply the provisions of the Convention, the provisions of the Convention do arguably not apply to an ALP. This is because under the New Zealand analysis, the New Zealand sourced income is being derived by the Australian partners, and not the partnership entity. This difficulty has been addressed by the Convention in cases of the ALP where the partners are Australian residents.

In example 1 illustrated below, the ALP has been established in Australia. A and B are the ALP's partners who reside in Australia. The ALP derives New Zealand sourced royalty income that is not attributable to a PE in New Zealand. Both partners have agreed that the profits will be equally shared.



14 Above n 3.

(a) The Potential for Double Tax Prior to Considering the Special Rules of the Convention

The difference in the allocation of the royalty income between two countries means the ALP is treated as a flow-through partnership for New Zealand tax purposes. Partners A and B are allocated the royalty income and hence are the relevant taxpayers under New Zealand tax law. Australia does not allocate to the partners the royalty income arising in New Zealand, although it generally treats partners A and B as residents under its domestic laws. Instead, that income is allocated to the ALP for purposes of determining the tax liability in Australia, because Australia treats the ALP as a company under its tax law.

A problem arises because generally, in order for a treaty to apply, the State sourced income needs to be derived by a resident of the other State. From a New Zealand perspective, it is partners A and B who have the partnership income allocated to them under New Zealand domestic law. New Zealand may not restrict its source based tax under this analysis. First, from a New Zealand perspective, the royalty income is arguably not beneficially owned by a resident (for tax purposes) of Australia (due to the fact that Australia does not tax partners A and B on the royalty income).[15] Secondly, from both the New Zealand and the Australian perspective, partners A and B would not be able to claim the benefits of the treaty, because it is a different person (the partnership entity) to whom the income is allocated in determining liability under their State of residence (Australia).[16]

If the end result were that the ALP was subject to tax in Australia, with no benefit for New Zealand source based taxation payable by partners A and B, then there is direct conflict with the purpose and object of the Convention to reduce or eliminate double taxation.

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[15] OECD, *Model Tax Convention on Income and on Capital*, vol 1 (at 22 July 2010) article 12 states: 'Royalties arising in a Contracting State beneficially owned by residents of the other Contracting State shall be liable only in that other State'. Under the New Zealand domestic law analysis as partners A and B are not taxed as residents *in respect of this income* the treaty would not intervene to eliminate or reduce New Zealand's source taxing rights.

[16] Above n 1 at [6.2] states: 'Where, for instance, the State of source treats a domestic partnership as fiscally transparent and therefore taxes partners on their share of the income of the partnership, a partner that is resident of a State that taxes partnerships as companies would not be able to claim the benefits of the Convention between the two States with respect to the share of the partnership's income that the State of source taxes in his hands since that income, though allocated to that person claiming the benefits of Convention under the laws of the State of source, is not similarly allocated the purposes of determining the liability to tax on that item of income in this State of residence of the person.'

(b) The Convention Anticipates this Problem

One of the Convention's responses to the problem referred to above is to ensure the limited partnership (here, the ALP) is both a person to whom the treaty applies, and clarifying that income derived by the ALP will be considered to be derived by a resident of Australia for the purposes of the Convention. Income derived by the ALP is deemed to be income derived by the resident State entity (under the treaty) to the extent that Australia taxes that income as a resident (under domestic law):[17]

> In the case of an item of income (including profits and gains) derived by or through a person that is fiscally transparent with respect to that item of income under the laws of either State, such item shall be considered to be derived by a resident of a State to the extent that the item is treated for the purposes of the taxation law of such State as the income of a resident.

Under Article 3(1)(j) of the Convention, the term 'person' in Article 1(2) includes a partnership. As the ALP is treated as a company for tax purposes under Australian domestic laws, it is allocated the royalty income, and is liable for Australian tax in respect of that income as an Australian resident. Accordingly, it is an Australian resident for the purposes of the Convention under Article 4(1). Under Article 1(2) of the Convention, such income shall be considered to be derived by the ALP, as a resident for the purposes of Australian taxation law. This means that under the Convention, both Australian and New Zealand jurisdictions agree the ALP is the relevant taxpayer regarding the royalty income. Accordingly, under Article 1(1), the ALP is eligible to the benefits of the Convention in respect of the royalty income.[18]

Article 12 is relevant to royalty income.[19] The royalty income in Example 1 arises in New Zealand. Who is the beneficial owner of the income? Since the ALP is allocated the income, and is liable to the tax on that income under Australian domestic law, one view is that it should be the beneficial owner of the income. That result is

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17 Above n 3.

18 Above n 2 [53] encourages the source State, where partnerships are involved, to take into account, as part of the factual context in the way in which a Convention is to be applied, the way the income item is treated in the jurisdiction of the taxpayer claiming the benefits of the treaty as a resident. Effectively, the OECD suggest on this approach that if the resident State treats the partnership as a taxable entity then the source State should grant the benefits of the Convention to that entity. The 2010 Australian New Zealand Convention makes it express and clear that this factual context approach is to be applied.

19 Above n 3 art 12 (1) and (2):

(1) Royalties arising in a Contracting State and beneficially owned by residents of the other Contracting State may be taxed at other State.

(2) However, such royalties may also be taxed in the Contracting State which they arise, and according to the laws of that State, a tax surcharge should not exceed 5 per cent of the gross amount of royalties.

supported by the Partnership Report, when it considers that one acceptable approach is for the source State to examine who is the beneficial owner of the income and hence the taxpayer in the State of residence.[20] Although the ALP is treated as transparent under the law of the State of source (i.e. New Zealand) and as a taxable entity under the law of the State of residence (i.e. Australia), one approach advocated by the Partnership Report is that the ALP itself, and not the partners, would be treated as the beneficial owner of the royalty income.[21]

Arguably this treatment is consistent with Article 1(2) of the Convention because it is '*considered to be derived by the resident* of a State to the extent that the item is treated for the purposes of taxation law of such State as the income of a resident' (emphasis added). The benefit of Article 12 is accordingly granted by New Zealand to the ALP. The royalty income would be taxed in the hands of the ALP in Australia under Article 12(1). These royalties will be taxed in New Zealand under subpart RF of the ITA,[22] subject to the 5% maximum rate provided under Article 12(2).

Tax treatment in relation to the ALP of which the partners are New Zealand residents

Article 12 applies when the royalty income arising in one State is paid to a resident of another State. What if the royalty income arising in New Zealand is paid to the ALP's partners who are New Zealand residents? The New Zealand analysis looks through the ALP but, as discussed above, the Australian position is that the ALP is the resident deriving the income. As the ALP is the taxpayer and the resident entity deriving the income, it does not seem to affect the Australian analysis that the partners are New Zealand residents. That is, the income is deemed derived by a resident for the purposes of the Convention (being the ALP itself).[23] Furthermore, the New Zealand partners who under New Zealand tax law are allocated the income from the ALP, would be able to claim the Australian tax paid by the ALP as a tax credit.[24]

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20 Above n 2 [54] states: 'In the case of a limited partnership treated as transparent under the laws of the State of source but as a taxable entity under the law of the State of residence, the limited partnership itself and not the partners would be treated as the beneficial owner. Because of the treatment of the income in the State of residence, the partners would not be entitled to the benefits of the Convention in those circumstances and whether the entity was so entitled would depend on whether it independently qualified as resident.'

21 Ibid ¶54.

22 *Income Tax Act 2007* (NZ).

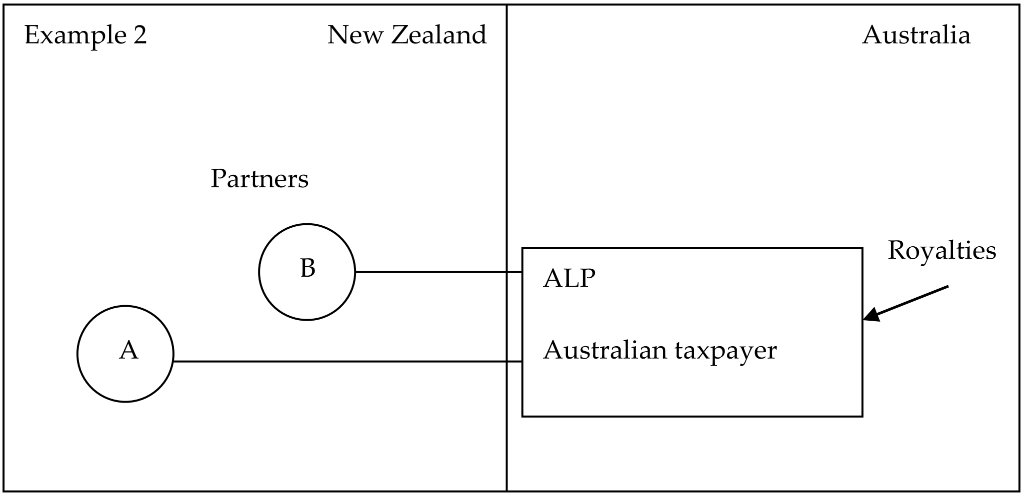
23 Above n 3 article 1 (2).

24 Above n 3 article 23 (3) which reads: 'Where, in accordance with paragraph 2 of Article 1, an item of income is taxed in a Contracting State in the hands of the person that is fiscally transparent under the laws of the other State, and is also taxed in the hands of a resident of

The above scenario can be further split into two situations. One is that the ALP derives Australian sourced income and the other is that the ALP derives New Zealand sourced income. They will be respectively discussed below using example 2 and example 3.

THE ALP DERIVES AUSTRALIAN SOURCED INCOME

Example 2 is the case where the ALP derives Australian sourced income. In the example, the ALP has been established in Australia. A and B are the ALP's partners who reside in New Zealand. The ALP derives Australian sourced royalty income that is not attributable to a PE in Australia. Both partners have agreed that the profits will be equally shared.



that other State as a participant in such person, that other State shall provide relief in respect of tax imposed by the first-mentioned State on that item of income in accordance with the provisions of this Article.'

(a) Double tax

Under Australian domestic laws, the ALP is the relevant taxpayer regarding the royalty income. However, the ALP is not a New Zealand resident and therefore is not a New Zealand resident for purposes of the Convention. Consequently, the ALP is not entitled to the benefits of the Convention. Australia is free to tax the royalty income under its domestic laws. This would mean the income on which partners A and B are liable to tax in New Zealand are fully subject to Australian tax.

(b) Application of the Convention

The New Zealand view is that, as the ALP is treated as a transparent partnership for tax purposes under New Zealand domestic laws, partners A and B are liable to tax as New Zealand residents. These partners are New Zealand residents for purposes of the Convention. The ALP is fiscally transparent under New Zealand domestic law, so the income shall be considered to be derived by partners A and B. From the Australian tax perspective however, the ALP would be regarded as a resident (in Australia) because the royalty income could be treated as ALP income under Australian law. Accordingly, partners A and B are persons covered by the Convention regarding the royalty income, as is the ALP. Both the ALP and the partners are taxed as residents of their respective Contracting States.

Although the Convention may include the ALP as a person to whom it could apply, it is questionable whether the substantive articles of the Convention apply. When taxing the ALP, Australia is taxing its own resident on the income arising in its own territory. It is purely a domestic matter under Australian taxation. One view is that Article 12 does not apply in this example, only where royalties arising from one State have been paid to a resident of the other State.[25]

As a result, the taxable income in the hands of New Zealand partners A and B is also fully subject to Australian tax. This result conflicts with the purpose and object of the Convention to, generally, reduce or eliminate double tax, and specifically, with the limitation in Article 12 to reduce Australian tax to 5 per cent of the royalty. As partners A and B are allocated the royalty income and liable to tax under New Zealand domestic law, they are the beneficial owners of the income under the

25 Above n 2 ¶131: In its view *(the majority of the Committee on Fiscal Affairs)*, the situation involves a purely domestic matter from the perspective of State P; it is simply taxing the domestic source income of a resident taxpayer and nothing in the Convention can limit that right. The fact that double taxation results because of the differing income allocations of States R and P is not a reason to limit its right to tax its residents. (*Clarification added*)

Convention. Under Article 12 of the Convention, the income is taxed in New Zealand.[26]

(c) Solution provided by the Convention

The double taxation referred to above is addressed by the Convention and some relief provided by way of tax credit rather than reduced (or allocated) taxing rights. As discussed above, partners A and B are eligible for the benefits of the Convention regarding the royalty income as they are persons covered by the Convention. Under Article 23(3), in order to eliminate the double taxation, New Zealand, as the State of residence of partners A and B, shall provide relief regarding taxes imposed on the ALP in Australia on the royalty income.[27] Consequently, partners A and B are allowed foreign tax credits under Article 23(3) for Australian income tax paid.[28] This is allowed in proportion to their partnership share of the income earned by the ALP, against their tax payable in New Zealand.

In summary, Australia is free to tax the ALP on the royalty income. However, in order to eliminate double taxation, New Zealand gives the benefits of Article 23(3) of the Convention to partners A and B. They should be given a tax credit for income tax paid by the ALP in Australia, against their New Zealand tax payable. Although there has been double taxation arising from the differing income allocation rules, a full tax credit is available under the Convention.

THE ALP DERIVES NEW ZEALAND SOURCED INCOME

Example 3 is similar to example 2, except royalty income is derived in New Zealand instead of Australia. The ALP has been established in Australia with A and B, the ALP's partners, residing in New Zealand. The ALP derives New Zealand sourced royalty income that is not attributable to a PE in New Zealand. Both partners have agreed that the profits will be equally shared.

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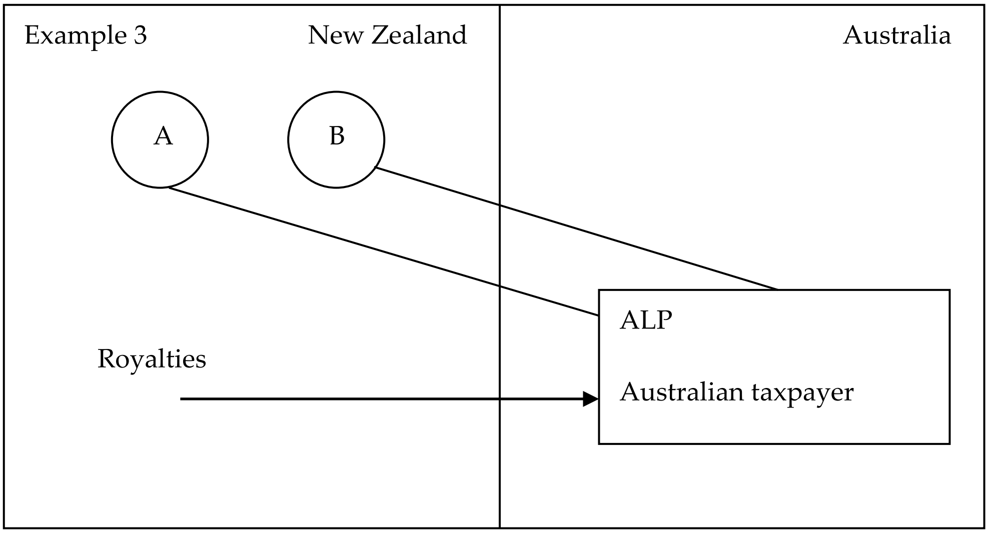
26 Ibid [132]. It is noted that some delegates, in applying the Convention, would take into account that the source State is obliged to relieve the potential resulting double taxation by applying Article 12.

27 Above n 3.

28 Regardless of whether they would be allowed a credit under *Income Tax Act 2007* (NZ) ss LJ 2, HG 2.



(a) Double tax

Under New Zealand domestic laws, partners A and B are the relevant taxpayers regarding the New Zealand sourced royalty income. However, the income is allocated to the ALP and not the partners under Australian domestic law.

Partners A and B are not liable to Australian tax regarding that income. In addition, they are not Australian residents. They are New Zealand residents for the purposes of the Convention, receiving New Zealand sourced income. Partners A and B are not entitled to the benefits of the Convention, enabling New Zealand to tax the royalty income under its domestic laws. This means the income on which the ALP is liable to tax in Australia is also subject to New Zealand tax in the hands of the partners.

(b) Application of the Convention

Similarly to example 2, New Zealand is taxing its own residents (ie partners A and B) on the income arising in its own territory. It is a purely domestic matter under New Zealand taxation. Arguably, the Convention should not prevent New Zealand from taxing the income derived by partners A and B, who are New Zealand residents.[29]

[29] Above n 1 article 1. See 'Where a partnership is treated as a resident of a Contracting State, the provisions of the Convention that restrict the other Contracting State's right to tax the partnership on its income do not apply to restrict that other State's right to tax the partners who are its own residents on their share of the income of the partnership. Some states may wish to include in their conventions a provision that expressly confirms a Contracting

Unless the Convention provides otherwise, partners A and B (who are New Zealand residents) should be subject to New Zealand tax on their New Zealand sourced income. Article 12 would not limit New Zealand's source taxing rights.

(c) Solution provided by the Convention

The Convention provides for a different outcome than that contemplated by the OECD Model.

As the ALP is treated as a company for tax purposes under Australian domestic laws, it is liable to tax as an Australian resident. It is an Australian resident for purposes of the Convention under Article 4(1). The New Zealand sourced royalty income as derived by the ALP is fiscally transparent under New Zealand domestic laws. The Convention contemplates that the royalty income shall be derived by the ALP to the extent that it is treated as the income of the ALP for the purposes of Australian taxation law.[30] Under Article 1(1), the ALP would be eligible to the benefits of the Convention regarding the royalty income. As the ALP is allocated the royalty income and is liable to income tax under Australian domestic laws, it is arguably the beneficial owner of the income.[31] Under Article 12(1) of the Convention, the income is taxed in Australia with New Zealand tax limited to 5 per cent of the gross amount of the royalty. The OECD Model and the Commentary to Article 1 contemplates no such restriction where the income from the State source is derived by partners who are also resident in that same State.

The New Zealand partners A and B may take the position that the Convention provides they would only be subject to New Zealand tax if they were the beneficial owners. In this case it can be argued the ALP is the beneficial owner and, as the Australian resident person under the Convention, [32] the party subject to tax under Article 12(1). New Zealand's taxation right is limited to 5 per cent of the gross amount of the royalties.

Inconsistency in the outcome for the tax treatment of the ALP under the Convention

The tax treatment for New Zealand resident partners investing in an ALP has very different outcomes, depending on which country royalty income is sourced from. If

State's right to tax resident partners on their share of the income of a partnership that is treated as a resident of the other States.'

30 Above n 3 article 1 (2).

31 See above n 18 that discuss ¶54 of the Partnership Report.

32 Above n 3 article 1 (2).

the income is sourced from Australia, then the ALP will be fully subject to Australian tax, with no Convention limitations. However, New Zealand will be obliged to give a full tax credit for Australian tax paid by the partnership.

In contrast, an ALP deriving New Zealand sourced income will be able to rely upon Article 12, with the result that New Zealand tax is limited to 5 per cent of the gross royalty income. It is arguable that the New Zealand resident partners would not be further subject to New Zealand tax on that income.

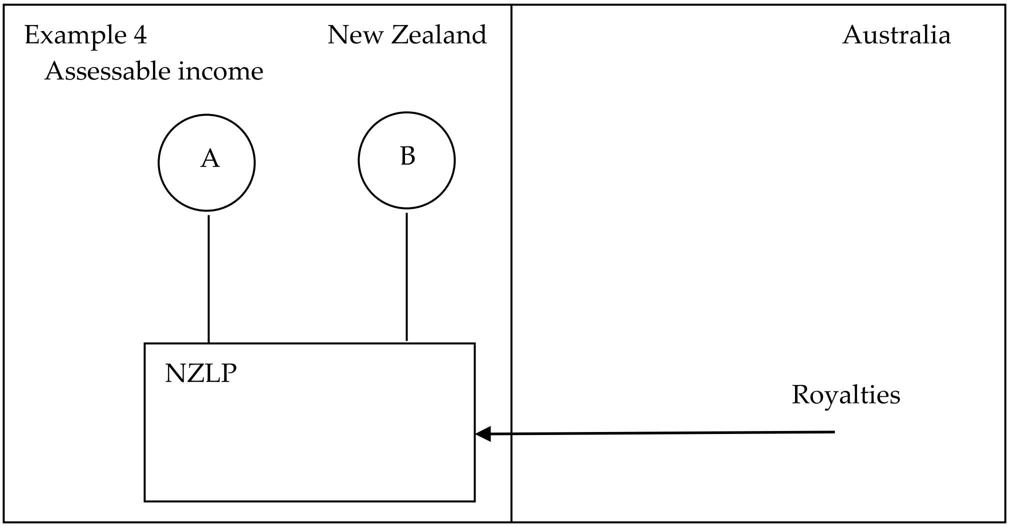
In each case, the inconsistent result is brought about by regarding the hybrid entity as an Australian tax resident. In situations where an Australian resident (the ALP) derives Australian sourced income, the Convention has little effect. In contrast, where an Australian resident derives New Zealand sourced income, the Convention has full application.

TAX TREATMENT OF THE NZLP IN AUSTRALIA

The Australian treatment of a New Zealand limited partnership depends on whether or not the limited partnership is a foreign hybrid limited partnership under Australian domestic law. If the limited partnership qualifies as a foreign hybrid limited partnership, it will be treated as a transparent partnership for tax purposes. If the limited partnership does not qualify as a foreign hybrid limited partnership, it will be treated as a company for tax purposes. In that case, the State of source faces the same difficulties regarding conflicts of income allocation as those in the cases regarding the ALP.

Tax treatment in relation to NZLP of which the partners are New Zealand residents

The tax treatment of the NZLP where partners are New Zealand residents can be illustrated in example 4. In the example, a NZLP has been established in New Zealand. A and B are the NZLP's partners, who reside in New Zealand. The NZLP derives Australian sourced royalty income not attributable to a PE in Australia. Both partners have agreed profits will be equally shared.



(a) Non foreign hybrid limited partnership

Where the NZLP does not qualify as a foreign hybrid limited partnership, it is treated as a company for tax purposes under Australian domestic laws. From Australia's perspective, the relevant taxpayer to whom income is allocated is the NZLP. Under the New Zealand domestic laws, the income is allocated to partners A and B and not to the NZLP. This means the NZLP itself as an entity is not liable to New Zealand taxation regarding that income.

Under New Zealand domestic law the NZLP, and not the partners themselves, is not regarded as a New Zealand resident. New Zealand will tax the partners themselves on the income. The non-taxation of the limited partnership means that Australia will impose tax fully on royalty income derived by the NZLP, even though this income is also taxed in the hands of partners A and B in New Zealand.

This problem of double taxation is addressed in the Convention by Article 1(2). As the NZLP is treated as a transparent partnership for tax purposes under New Zealand domestic laws, partners A and B are liable to tax as New Zealand residents. The partners are New Zealand residents for the purposes of the Convention under Article 4(1). The income shall be considered to be derived by partners A and B, and not by the NZLP, for the purposes of the Convention.[33]

The result is that Australia and New Zealand agree partners A and B are the relevant taxpayers regarding the royalty income. Accordingly, partners A and B are eligible to

[33] Ibid.

the benefits of the Convention under Article 1(1).[34] As partners A and B are allocated the royalty income and liable to tax on that income under New Zealand domestic laws, they are the beneficial owners of the income. Under Article 12 of the Convention, the income is taxed in the hands of partners A and B in New Zealand. Partners A and B are both allocated assessable income. Australia should grant the concessionary benefits under Article 12(2). That result is the royalties may also be taxed in Australia at the rate of 5 per cent.

(b) Foreign hybrid limited partnership

The result would be the same as part (a) if the NZLP satisfies the foreign hybrid limited partnership criteria, or makes the election to be treated as a foreign hybrid limited partnership for the relevant income. Under such circumstances, the NZLP is treated as a flow-through partnership for Australian and New Zealand taxation. Partners A and B are residents for purposes of the Convention and beneficial owners of the royalties. The royalties are therefore taxed in the hands of partners A and B in New Zealand under Article (1), and may also be taxable in Australia at the rate of 5 per cent.

Tax treatment of the NZLP of which the partners are Australian residents

The tax treatment will be different if the partners of the NZLP are Australian residents. This section is further split into two situations. One is that the NZLP derives Australian sourced income and the other is that the NZLP derives New Zealand sourced income. They are respectively illustrated using example 5 and example 6 below.

THE NZLP DERIVES AUSTRALIAN SOURCED INCOME

In example 5, the NZLP has been established in New Zealand. A and B are the NZLP's partners who reside in Australia. The NZLP derives Australia sourced

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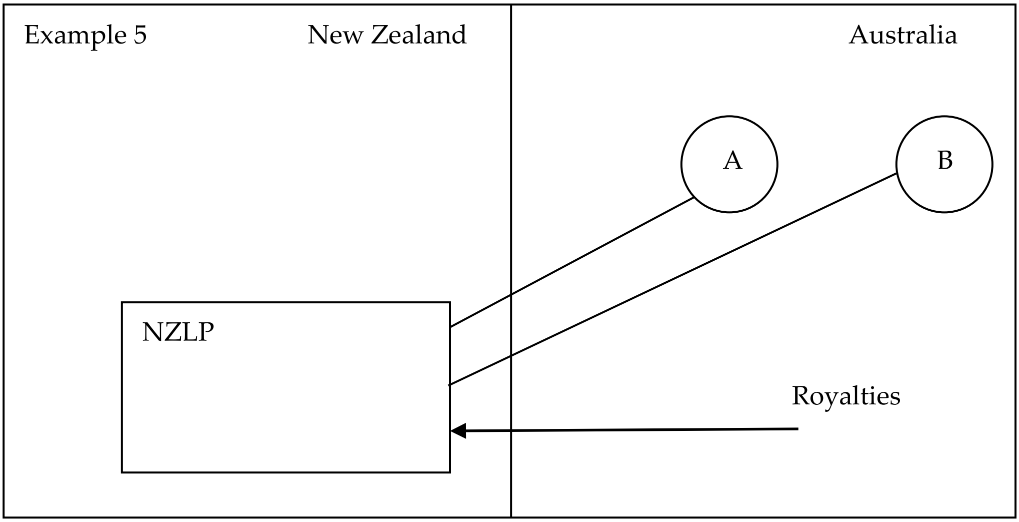
[34] Above n 1 [8.2]: 'Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. In such a case, since the income of the partnership 'flow through' to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the Conventions concluded by the States of which they are residents. This latter result will obtain even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity.'

royalty income that is not attributable to a PE in Australia. Both partners have agreed the profits will be shared equally.



(a) Non foreign hybrid limited partnership

The NZLP is treated as a taxable entity for Australian taxation if it is not a foreign hybrid limited partnership under Australian domestic laws. However, under New Zealand domestic laws, the royalties are allocated to partners A and B. Hence, the NZLP is not liable to New Zealand tax in respect of the royalties. Accordingly, the NZLP is not a resident for purposes of Convention according to Article 4(1), nor entitled to the benefits of the Convention under Article 1(1). Article 1(2) does not apply, as partners A and B are Australian residents and the income is not treated as their income under Australian tax laws. Consequently, Australia can tax the royalty income derived from its territory regardless of the Convention. This, of course, does not result in double taxation since New Zealand does not tax Australian sourced income derived by partners A and B who are non-residents of New Zealand.

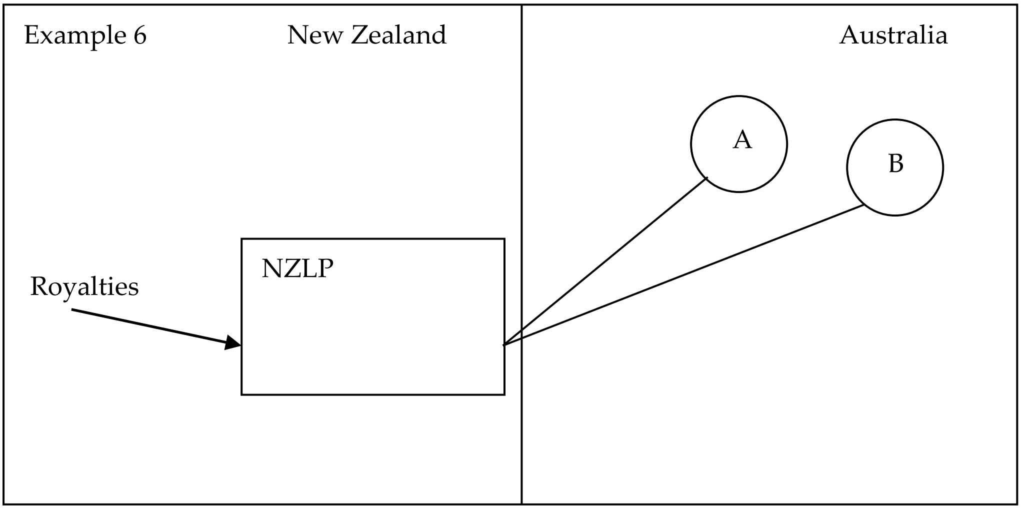
(b) Foreign hybrid limited partnership

The NZLP is treated as a partnership for Australian taxation if the NZLP qualifies as a foreign hybrid limited partnership under Australian domestic laws. Therefore, the royalties are allocated to partners A and B who are Australian residents. The relevant taxpayers are partners A and B. As discussed in section IV, the Convention should not prevent Australia from taxing its residents on the income arising from its own territory. So the royalties are taxed in the hands of partners A and B in Australia.

Both partners are allocated assessable income.[35] However, New Zealand would not tax the Australian sourced income derived by partners A and B who are non-residents of New Zealand. Therefore, no double tax arises.

THE NZLP DERIVES NEW ZEALAND SOURCED INCOME

In example 6, the NZLP has been established in New Zealand. A and B are the NZLP's partners who reside in Australia. The NZLP derives New Zealand sourced royalty income that is not attributable to a PE in New Zealand. Both partners have agreed the profits will be equally shared.



(a) Non foreign hybrid limited partnership

The NZLP is a taxable company under Australian taxation if it is not a foreign hybrid limited partnership. Under Articles 2(1) and 4(1), partners A and B are not residents for purposes of the Convention because they are not allocated the royalty income (under Australian law) and hence not liable to tax under Australian domestic laws.

The NZLP is also not a resident for purposes of the Convention because it is a non-resident of Australia (for Australian domestic purposes) and not taxed in New Zealand (for New Zealand purposes). The result here is one of double non-taxation for the NZLP.

35 *Income Tax Assessment Act 1997* (Cth) s 92.

Accordingly, under Article 1(1), neither the partners nor the NZLP are eligible to the benefits of the Convention. Article 12 will not apply as the royalties arising in New Zealand will not be derived and beneficially owned by a resident of Australia. Consequently, New Zealand is allowed to fully tax the royalty income derived in its territory regardless of the provisions of the Convention. Australia would not tax the New Zealand sourced income derived by the NZLP that is a non-resident of Australia.[36] If, however, Australia chooses to tax partners A and B, the partners may be entitled to a credit or any New Zealand tax suffered under Article 23(3).

(b) Foreign hybrid limited partnership

Where the NZLP is a foreign hybrid limited partnership, the NZLP is a transparent partnership for purposes of Australian taxation. The royalties are allocated to partners A and B under both Australian and New Zealand domestic laws. Under Article 4(1), partners A and B are residents for purposes of the Convention because they are liable to tax as Australian residents. Thus, under Article 1(1), partners A and B are eligible for the benefits of the Convention. As partners A and B are allocated the royalty income and liable to tax on that income under Australian domestic laws, they are the beneficial owners of the income. Under Article 12 of the Convention, the income is taxed in the hands of partners A and B in New Zealand. Partners A and B are both allocated assessable income. New Zealand is entitled to tax at the concessionary rate of 5 per cent (of the gross income) under Article 12(2).

Inconsistency in the outcome for the tax treatment of the NZLP under the Convention

Neither a NZLP (assuming that it does not qualify as a foreign hybrid limited partnership), nor its Australian limited partners, deriving New Zealand sourced royalty income, can obtain the benefits of the Convention. As a consequence New Zealand retains full source taxing rights subject only to its domestic rules.[37]

Tax treatment of distributions made by the ALP

Since Australia treats an ALP as a company for tax purposes, it treats distributions of the profits made by the ALP to its partners as dividends. Therefore, the income taxed upon realisation is also taxed when it is distributed to the ALP.

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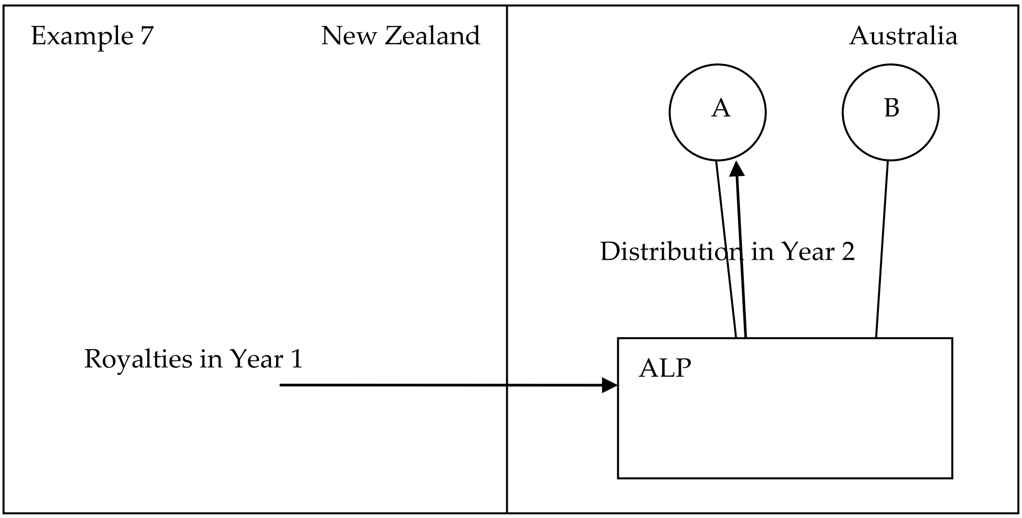
36 Non-resident deriving foreign income.

37 *Income Tax Act 2007* (NZ) subpart RF. In the case of cultural royalties this is a final withholding tax (section RF 2 (3) and (4)). Other royalties are subject to a minimum withholding tax regime with the obligation to account for the greater of the non-resident withholding tax obligation or full taxation on their income tax liability (s RF 2 (5)).

Tax treatment of distributions where the ALP's partners are Australian residents

The tax treatment of the distributions made by the ALP of which the partners are Australian residents is illustrated by example 7 below. In the example, the ALP has been established in Australia. A and B are the ALP's partners who reside in Australia. In year 1, the ALP earns New Zealand sourced royalty income that is not attributable to a PE in New Zealand. In year 2, the ALP distributes to A his or her share in the profits regarding royalty income earned in year 1.

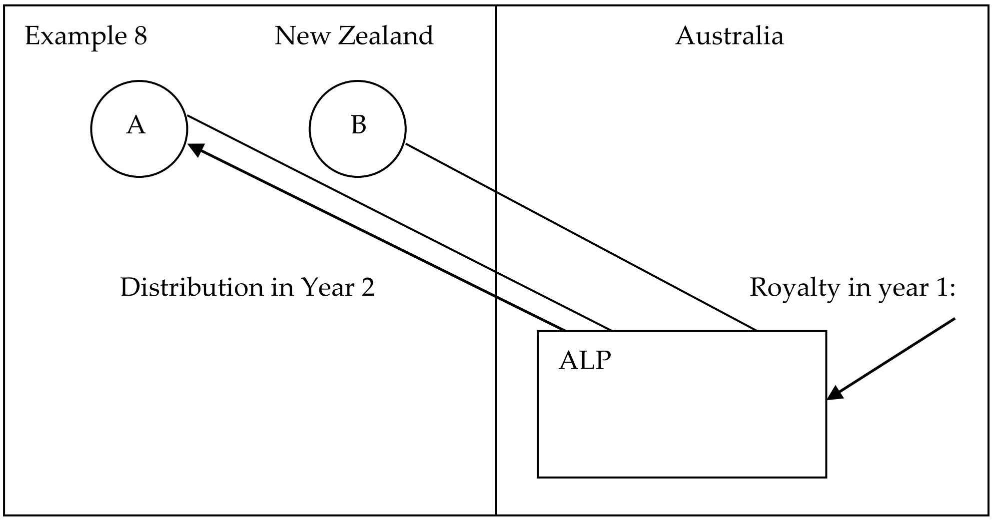


The scenario in year 1 is exactly the same as example 1. The royalties are taxed in the hands of the ALP in Australia. New Zealand, in accordance with Article 12, taxes that income at the rate of 5 per cent. In year 2, the ALP distributes a dividend to partner A and also attaches a franking credit to the dividend. Partner A is taxed at his marginal tax rate for the dividend received but is able to use the franking credit attached to offset his tax payable. New Zealand does not tax the distribution since from New Zealand's perspective, a non-resident (ie, partner A) derives overseas (non-New Zealand) sourced income.

Tax treatment of distributions where the ALP's partners are New Zealand residents

Where the partners of the ALP reside in New Zealand, tax treatment of the distributions would be different. Under such circumstances, New Zealand should grant the benefits of Article 23 of the Convention to eliminate double taxation upon generation of the profits. The subsequent distributions should be exempted from New Zealand taxation.

In example 8, the ALP has been established in Australia. A and B are the ALP's partners who reside in New Zealand. In year 1, the ALP earns Australian sourced royalty income in New Zealand. In year 2, the ALP distributes to partner A his or her share in the profits in relation to that royalty income earned in year 1. It is assumed both partners have agreed the profits will be equally shared.



(a) Tax treatment in year 1

The scenario in year 1 is exactly the same as discussed in example 2. The royalties are taxed in the hands of the ALP in Australia. Partner A is allocated assessable income which is subject to New Zealand tax with respect to partner A's share of the royalty income.[38] New Zealand, as the State of residence, will give a foreign tax credit under section LJ1 of the ITA,[39] for Australian tax levied on the income to offset partner A's tax payable. [40]

(b) Tax treatment of the distribution in year 2

In year 2, the ALP distributes an amount treated as a dividend for Australian purposes. The dividend arises in Australia and is beneficially owned by partner A, who resides in New Zealand. From New Zealand's perspective, the distribution in

38 Above n 8.

39 This is also consistent with the treatment under Article 23(3) of the Convention.

40 This will be income to the New Zealand partners under sections CB 35 and HG 2 of the *Income Tax Act 2007* (NZ).

year 2 should not be taxable since the tax has actually been levied in year 1, upon generation of the profits.[41] Following the general principles against double taxation,[42] partner A should not be taxed twice for the same economic income. Furthermore, if the Convention allowed New Zealand to tax the distribution, this would be inconsistent with New Zealand tax law under which the ALP is a transparent partnership. Since the distribution is non-taxable in New Zealand, partner A is not allowed a foreign tax credit under sections LJ1 and HG2, for the Australian income tax paid, regarding the distribution made by the ALP.

CONCLUSION

Australian and New Zealand limited partnerships involved in trans-Tasman business are a good example of hybrid entity double taxation, especially when the limited partnership is established in one country and its partners reside in the other.

Fortunately the Convention between Australia and New Zealand largely eliminates double tax (and prevents double non-taxation) which is a commendable solution to what is otherwise a complex and difficult problem. In their report to the New Zealand Parliament, the New Zealand Finance and Expenditure Committee concluded:

> A fiscally transparent entity is one that is disregarded for tax purposes, with tax imposed directly on the owners or shareholders, as happens with general partnerships. The appropriate treatment of such entities under a double tax agreement is not always obvious, particularly when the two Contracting States classify them differently for domestic law purposes. New Zealand's policy is to deal with such entities in accordance with international norms as laid down by the OECD in its 1999 report, *The application of the OECD model tax convention to partnerships*. Articles 1(2) and 23(3) of the new DTA are consistent with the policy in that report.[43]

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41 New Zealand Inland Revenue, 'Public Ruling BR Pub 10/02: Distributions Made by Australian Ltd Partnerships and Foreign Tax Credits' (2011) http://www.ird.govt.nz/resources/f/4/f4ccae00420d8f64be9dff4fc1b24342/pu10001-10005.pdf at 7 February 2012.

42 See, eg, *Commissioner of Taxes v Luttrell* [1949] NZLR 823. The arrears that had been assessed in the hands of trustees should not be included in the annuitant's assessable income in later tax years.

43 Finance and Expenditure Committee, New Zealand House of Representatives, *International treaty examination of the Convention between New Zealand and Australia for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion* (2009) 12 http://www.parliament.nz/NR/rdonlyres/0A5D7CCC-885A-4E0F-9253-B394AA3D3DA1/118261/DBSCH_SCR_4557_International treatyexaminationofthe.pdf at 7 February 2012.

Although this summary by the Finance and Expenditure Committee oversimplifies the position it can be argued that it is broadly correct.[44] The case studies discussed in this article illustrate that income sourced in one jurisdiction (either Australia or New Zealand) derived by a limited partnership in the other jurisdiction should be able to obtain the benefits of the treaty. In the case of passive income such as royalties, relief from full taxation.[45]

As a consequence of the 2010 Australian/New Zealand Convention the chance of undesirable double taxation (or arguably undesirable double non-taxation) is significantly reduced.

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44 This is not true if the limited partnership derives income from its own jurisdiction. If the income is sourced from Australia, then an ALP will be fully subject to Australian tax, with no Convention limitations. It appears likely that New Zealand will be obliged to give a full tax credit for Australian tax paid by the partnership to ALP's New Zealand resident limited partners. Similarly neither a NZLP, assuming it does not qualify as a foreign hybrid limited partnership, nor its Australian resident limited partners, deriving New Zealand source royalty income, can obtain the benefits of the Convention. As a consequence New Zealand retains full source taxing rights subject only to its domestic rules. If the Australian resident limited partners were deemed to derive partnership income it appears likely that Australia would be obliged to give a full tax credit.

45 In the case of the income being derived by the NZLP, the residence of the partners of the limited partnership will be the important issue. In circumstances where the partner is resident outside New Zealand, a key determinant of whether a partner of the NZLP is able to use the benefits of the treaty (probably not the Australian/New Zealand Convention) will be the way in which the partner's resident State regards a limited partnership-does it regard it as a transparent entity or as a taxable entity? See Partnership Report at [68]-[72], examples 7 & 8.