

Taxation of Partnership - Legal national reports for the Nordic Tax Research Council's annual meeting, 2015 in Aarhus

1 Denmark

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Report

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Axel Hilling (Ed.)

Taxation of Partnership - Legal national reports for the Nordic Tax Research Council's annual meeting, 2015 in Aarhus

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Abstract: This joint report includes the five legal national reports on the taxation of partnership in the Nordic countries. The general contents of these reports are summarized and thoroughly analyzed in Liselotte Madsen's General report, published in this issue of the NTaxJ. For additional information, details on legislative measures etc. we find it important, however, to also publish the national reports in full length. We hope you will find it valuable as well.

The respective national reports appear in alphabetic order, in regard to the country which regulation is presented. Name of the country reporter and contact information are presented in the beginning of each report.

Keywords: Partnership; shared liability partnerships; limited partnerships; internal partnerships; shipping partnerships; Nordic taxation

1 Denmark

By Inge Langhave Jeppesen

1.1 Corporate legal regulations

1.1.1 Company law rules for personal companies

Freedom of contract applies in the Danish company law. This means that the owners can choose the form of company that best suits the type of business they wish to operate. There are a number of different types of company

from which to choose. Capital companies comprise of public limited companies and private limited companies, both of which are regulated by the Danish Companies Act (*selskabsloven*). Unlimited companies (such as sole trader businesses or partnerships), known in Denmark as personal companies (*personselskaber*), are an alternative to capital companies. The fundamental difference between these two types of company is the owners' liability. Liability is limited in relation to capital companies, while in the case of unlimited companies at least one owner is liable for the whole of the company's debt Friis Hansen and Krenchel (2014).

In Denmark, there are four common types of unlimited companies, namely partnerships, limited partnerships, partner companies, and jointly owned shipping firms. It is important to be aware of the fact that personal companies are not regulated by company law legislation but are regulated by company law practice. Therefore, the regulation of personal companies is established by nonbinding rules of practice Friis Hansen and Krenchel (2014); Madsen (2011).

A partnership (*interessentskab*) is a cooperation that is based on an agreement between at least two participants about the operation of a common business enterprise (Friis Hansen and Krenchel 2014). Partnerships are defined in detail in §2(1) of the Danish Act on Undertakings Carrying on Business for Profit (*lov om visse erhvervsdrivende virksomheder*) as: "... a business activity, where all the participants are personally liable, unlimited and jointly and severally, for the activity's obligations". In relation to practice, there is a modified subsidiary liability. This means that the participants first become liable when a claim has been brought against the partnership and has not been paid within reasonable time Friis Hansen and Krenchel (2014). Resulting from joint liability, a partner who pays off a debt belonging to the partnership can then make a subsequent claim against the other partners. Due to a lack of company law regulation, it can be difficult to determine whether a business association is a partnership or joint ownership. Joint ownership is recognized as exist-

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ing where a number of people jointly own a common asset without forming a company. If, on the other hand, in the course of regulating a business enterprise it is established that there are business activities involving the participation of the association's participants, then this is considered a partnership and, thus, a company Friis Hansen and Krenchel (2011).

A limited partnership (*kommanditselskab*) is defined in §2(1) of the Danish Act on Undertakings Carrying on Business for Profit as: “a business activity, where one or more participants, the general partners, take on unlimited personal liability; and, if there are several participants who are jointly and severally liable for the business' obligations, they do so while one or more participants, the limited partners, have limited personal liability for the business' obligations”. Therefore, a limited partnership is characterized by the fact that not all the participants have taken on unlimited liability because the limited partners' liability is limited to the value of their deposits. This is an indirect subsidiary liability. This means that it is only the limited partnership or its bankruptcy estate that may require the limited partners to pay off the residual liability Friis Hansen and Krenchel (2014). The general partner will often be a Danish private limited liability company with a minimum amount of capital.

A partner company (*partnerselskab*) is an in-between option, between a limited partnership and a capital company, being comprised of, on the one hand, a general partner who takes on unlimited liability and, on the other, participants who own shares and have limited personal liability. Under §5(1)(21) of the Danish Companies Act, a partner company is defined as a limited partnership, “... where the company's limited partners have invested a particular amount of capital, which is divided into shares ...”. With the necessary adjustments, a partner company is regulated by the provisions of the Danish Companies Act in accordance with §358. This means that the Danish Companies Act sets out the framework for a partner company's operation. One consequence of the Act's regulation is that, *inter alia*, a partner company must be formed with a minimum capital of DKK 500,000 of which DKK 125,000 must be liquid. It also means that a Memorandum of Association must be drafted and filed with the Danish Business Authority (*Erhvervsstyrelsen*), so that the partner company can achieve legal capacity. In addition, company rules (*vedtægter*) and rules about minority protection must be drawn up. Further, it is a requirement that a partner company has a management structure that corresponds to a public limited company Madsen (2011).

A jointly owned shipping firm (*partrederi*) is the only form of company that may be used when several persons

own a ship together. According to §102 of the Marine Act (*søloven*), when a ship is owned by a number of joint owners, each joint owner only takes on personal liability for the company's obligations that is equivalent to his or her share of the company's capital. As the use of jointly owned shipping firm is quite limited, it will not be discussed in further detail here.

1.1.2 Company law rules for formation, changes in ownership, and selling of a business

The fact that there is no legal regulation of personal companies also means that, as a starting point, there are no provisions regulating, for example, the formation of personal companies. Instead, activities such as establishing a personal company simply happen according to an agreement between at least two company participants.

A partnership is established when at least two people come together to operate a business. There will often be an agreement that regulates the relationship between the partners, but this is not necessarily the case. From the outset, there is a declaratory understanding that a partner cannot withdraw from the business association and, therefore, a partner's withdrawal can only happen by agreement with the other partner or partners. Entry into and withdrawal from a partnership is based on an agreement between the partners, including whether entry or withdrawal must be accompanied by a payment. If consent in relation to a change of debtor is not received, then the partner who is withdrawing becomes liable for the partnership's debt, as it exists immediately prior to withdrawal Madsen (2011).

In the case of limited partnerships, the consequences of withdrawal are different if it is a general partner or a limited partner who seeks to withdraw from the partnership. A general partner cannot withdraw from a limited partnership without the consent of all the limited partners. However, a general partner can terminate the limited partnership upon giving reasonable notice. On the other hand, a limited partner's liability is limited to his or her investment or share in the partnership (*kommanditanparten*) and, therefore, it is assumed that he or she may freely assign the share to another. However, the limited partner cannot terminate the limited partnership Madsen (2011).

1.2 Tax law regulation

1.2.1 Qualification of companies

Under Danish tax law, a company's liability to tax is provided for in §1 of the Corporation Tax Act (*selskabsskatteoven*). In reference to personal companies, two particular categories in the Corporation Tax Act are relevant to distinguish them from other types of companies. These are companies with limited responsibility under §1(1)(2) of the Act; and other associations under §1(1)(6).

Paragraph 1(1)(2) of the Corporation Tax Act applies, *inter alia*, to "... other companies, in which none of the participants are personally liable for the company's obligations, and where the profits are shared in relation to the participants' invested capital". Thus, §1(1)(2) of the Corporation Tax Act establishes two essential criteria excluding personal companies from capital companies: none of the participants may have personal liability; and profits are to be shared in direct relation to invested capital. Delimitation that is more detailed occurs in practice, where the question of personal liability is central.

As a starting point, a company is the taxable entity when none of the participants have personal liability. Therefore, according to tax law, a personal company exists when at least one participant is personally liable. The significance of a limit on personal liability has been evaluated in judicial as well as administrative practice.

Examples of a general limitation on liability exist in the Danish practice concerning partnership projects (*anpartsprojekter*), which are set up for the purpose of saving on or postponing the payment of taxes. The participants were personally liable from the outset. However, when the underlying agreements, including a partnership agreement, a leasing agreement and a loan agreement, were considered as a whole, the reality was that the participants had cut themselves off from any risk and, subsequently, liability. Therefore, the companies in question were taken to be regulated by §1(1)(2) of the Corporation Tax Act.¹ Thus, a general limitation on liability can have an influence on the qualification of an entity for tax purposes.²

¹ It should be noted that the status as partnership was not overruled by the courts with reference to the liability limitation, but with an assessment that the participants did not have property rights to the assets in the company. Thus they were not allowed to deduct for depreciation: see TFS 2000, 1011 H.

² A more detailed discussing of the case law in the area can be seen in Liselotte Madsen in *Den skatteretlige behandling af personselskaber*, pp. 70–75.

In cases of a specific liability limitation, depending on the agreements in existence, the number of creditors and the size of the creditors' claim in relation to the association's total debt, it can mean that the association is not a personal company Madsen (2011).

In Danish tax law, particularly in relation to limited partnerships, whether the status of a limited partnership as a personal company is conditional upon a general partner being a part owner has been discussed. The judgment in TFS 1990, 21H refers to the fact that, in administrative practice, deposits by the limited partners are associated with a right of ownership of the business' assets. It is unclear, however, whether this reference to administrative practice is also a basis for finding that a right of joint ownership is a condition for the existence of a personal company Madsen (2011). This question has led to a significant discussion in Danish tax law – a discussion that may be summed up with the following quote: "With the above practice following TFS 1990, 21 H, it may be concluded that the right of joint ownership referred to in the practice of the administrative authorities and the Eastern High Court is not an indispensable requirement of a general partner. The right of joint ownership, however, will continue to be a central criterion in the evaluation of whether there is a personal company" Madsen (2011, 61). Therefore, it may be concluded that a general partner's right of joint ownership is not decisive in deciding whether a limited partnership qualifies as an independent tax subject or as a transparent association.³

Paragraph 1(1)(6) of the Corporation Tax Act is an aggregate clause, which covers body corporates that are not included in any of the other tax liability provisions of the Act. The provision contains no real guidance on how these body corporates may be distinguished from fiscally transparent entities.

It is clear from practice in the area that the criterion of limited liability is complemented by other criteria. In this context, weight is given to the purpose of the association. If the purpose is nonprofit or charitable, then it is likely that the association is covered by §1(1)(6) of the Corporation Tax Act Pedersen et al. (2015). In practice, there are similarly a number of criteria that point to the existence of a personal company:⁴

- The withdrawing participant has a right to a sizeable share of the association's assets.

³ A detailed presentation and discussion of the issue can be found in Liselotte Madsen, *Den skatteretlige behandling af personselskaber*, pp. 49–61.

⁴ See TFS 1999, 419 H and SKM2001.417VLR.

- The assets or sales price is shared among the participants on the dissolution of the association.
- Important decisions require unanimity among the participants.
- The association has a trading / business purpose.
- The association has few owners.
- The participants' ownership rights to assets are proportionate.

In summary, it can be concluded that personal liability is central in relation to the qualification of a personal company. Thus, at least one company participant must take on personal liability for a company to qualify as such. There must be a concrete evaluation of any liability limitations when assessing the form of company being used; and in any event, general liability limitations can mean that an association is not a personal company.

A consequence of qualifying as a personal company is that an association will be transparent for tax assessment. Total transparency applies in Danish tax law.

In addition, it should be noted that in some of the Danish special antiabuse provisions, fiscally transparent entities are defined as: "... legal persons, which do not constitute body corporates pursuant to Danish tax law, but whose conditions are regulated by company law, a company agreement or rules of association".⁵

1.2.2 Ongoing taxation

Total transparency implies that taxation occurs at the participant level. This means that every participant is taxed according to his or her share of the income and expenses. However, it may be the subject of agreement that the profits are not shared according to the share of ownership, but according to the contribution made to the running of the business Madsen (2011). A participant in a personal company can be both a natural and a legal person; and it is the rules that apply to natural persons and to companies respectively, that regulate ongoing taxation.

In relation to spouses who reside together, according to §25 A(1) of the Tax at Source Act (*kildeskatteloven*), a special rule applies requiring the result of a business to be taxed under the name of the spouse who to largest extent operates it, even if both spouses participate. This situation may be regarded as a violation of transparency. Under §25 A(8), however, there is the opportunity to choose

an equal distribution of the business' result if both spouses have participated in running the business to an equal extent and are liable to the same extent for the business' obligations.

A significant consequence of the fact that income is calculated and taxed at the participant level is that each participant makes choices, allowed for by the legislation, in connection with the calculation of taxable income. These choices include, for example, whether to make deductions for depreciation, including the amount to deduct; the choice of the valuation principles to use in relation to inventory and work in progress; and the choice of the accrual principle in relation to certain capital gains. It also means that some personal company participants may be affected by the special Danish rules on taxation of professional traders of stocks, bonds and real estate (*næringsbeskatning*), while others from the same personal company are covered by the normal rules on taxation of capital gains. Finally, it means that the natural person may choose to be taxed according to the special scheme for taxation of self-employed with an ongoing taxation of the business income of 23.5 percent.⁶ If a natural person participates in more than one trading personal company, all of his or her shares in the companies' results must be included in the special scheme.

When a participant has calculated his or her share of the personal company's income and expenses and has made the choices discussed above, this calculation of income is included in the statement of taxable income for the natural person or company. If the income is showing a loss this is dealt with in accordance with the general rules that apply to the participant – whether a natural person or a company.

In relation to a natural person, a loss can be offset by the participant's general income, following the net income principle in §4 of the State Tax Act (*statsskatteloven*).⁷ An excess loss is carried forward and offset by any spouse's income and can generally be carried forward and offset in the taxpayer's and the spouse's income in the next income year, in accordance with the applicable rules. This presup-

⁵ This is the case in the second sentence of §2(1) of the Tax Assessment Act (*ligningsloven*) and in §2 C(3) of the Corporation Tax Act.

⁶ When the special scheme for taxation of self-employed is used, the personal company participant can save-up in the company for a continually low tax rate. This is also possible, even if the personal company participant has withdrawn funds from the personal company, when the withdrawn funds are kept within the frames of the special scheme for taxation of self-employed. This means that the funds have not been withdrawn according to the rules in the special scheme for taxation of self-employed.

⁷ For some partnerships the right to carry forward losses does not exist. Reference is made to Section 6.

poses that the personal company's income is considered to derive from a business enterprise.⁸

The natural person can choose to let taxation happen according to the rules in the special scheme for taxation of self-employed (*virksomhedsskatteoven*). If the natural person uses the special scheme, then a loss will be covered by the special carryback rule that applies in that scheme. This means that the loss will be offset by any amount deposited in the accumulated profits account (*konto for ops-paret overskud*). The effect of this is that the withdrawn amount will eliminate the loss and that the on account business tax (*virksomhedsskat*) that has already been paid on the withdrawn amount, will be paid to the taxpayer.

If the participant is a company that is fully liable to tax in Denmark and the personal company is based in Denmark, the loss is reported in the company's statement of income. If the income statement subsequently results in a loss, this may be carried forward and offset in a later financial year. This should happen in accordance with the loss restriction rules in §§12–12D of the Corporation Tax Act that apply to Danish companies being liable to tax.

If the participant is a company fully liable to tax in Denmark and the personal company owns a permanent establishment or real estate abroad, the participant-company will be covered by the territorial principle, in accordance with §8(2) of the Corporation Tax Act. This means that the income from a permanent establishment abroad – regardless of whether it results in a profit or a loss – as a general rule is not included in the Danish income statement. However, a number of exceptions apply. The territorial principle, therefore, does not apply to income stemming from international shipping and aviation activity; neither does it apply when the source country does not have the right to tax the permanent establishment pursuant to a double taxation treaty or other international agreement.

If the participant is a foreign company, the income will be liable to tax in Denmark, following the rules that apply in relation to limited tax liability. Any loss may be carried forward pursuant to the rules that apply to companies under §§12–12D of the Corporation Tax Act.

The actual tax is calculated and paid pursuant to the rules that apply for a natural person or company respectively.

⁸ If the loss comes from a so-called hobby enterprise, then it cannot be offset by other income, just as it cannot be carried forward and offset by income in the following years – neither from a hobby or other income sources. In these cases, offsetting the loss and carrying it forward is essentially excluded.

In the following section, some of the particular conditions that apply in relation to taxation of personal companies' ongoing income will be mentioned. Specifically, transfers between the personal company and the participant; the implications of limited liability; and the significance of joint liability will be discussed.

1.2.2.1 Transfers between the personal company and the participant

As a starting point, following from transparency under tax law, a participant in a personal company is taxed on his or her share of the personal company's losses or profits. Therefore, the question is how should transfers between the personal company and the participant be dealt with under tax law? Are the participant's deposits and withdrawals of no direct significance for the statement of income, or do deposits and withdrawals constitute separate remuneration, which influences the statement of taxable income?

Even though a transfer to a participant is called "wages," it will be deemed to constitute a part of the distribution of profits and, therefore, it is not deductible in the personal company. The wage agreement that should be in place between the personal company and the participant will thus appear to be simply an agreement between the participants about the sharing of profits that does not necessarily reflect ownership Madsen (2011). However, tax law literature presents an argument that participants, in certain situations, can receive wages from personal companies with a consequent right of deduction for the other participants in the personal company when making up their income statement. This will occur if the participant's share of ownership in the company is very small and, in reality, the participant has no influence on the decisions made in the personal company, or if the participant is generally considered an employee Madsen (2011); Pedersen et al. (2015). For example, this may be the case for a participant in a partner company. It can also occur with a limited partner in a limited partnership, who operates as the caretaker of the company.

If the participants in a personal company have agreed to earn interest on their capital deposits in the personal company, this will not constitute a separate remuneration. A capital deposit represents an investment in the company and a capital return is simply included as a part of the distribution of profits.⁹

⁹ See LSM 1955, 101 and Tfs 1996, 256 LSR.

Another question is whether the remuneration received by a participant in a personal company in return for making one or more assets available to the personal company is simply a part of the profit share or whether it can be regarded as a separate remuneration?

In Danish tax law, the court has examined remuneration in the form of interest payments on a participant's loan to the personal company.¹⁰ In the actual case, a loan by a participant to the personal company was regarded as a contribution regarding, the part of the loan that could be attributed to the participant who had made the loan. Therefore, there was no right to deduct the interest that the personal company had to pay for that part of the loan. On the contrary, the part of the loan that was attributed to the other participants in the company was regarded as a loan. Consequently, the other participants can make a deduction for interest, upon which, in turn, the participant providing the loan must pay tax.

This decision has been criticized Madsen (2011). The criticism builds upon an interpretation that, because of total transparency, when there is an agreement between the personal company participants about payment of remuneration for making an asset available to one or more participants, that remuneration must be seen as a distinct remuneration. This means that the participant who receives remuneration must pay tax based on, for example, interest, royalty or lease, while the other participants can deduct the expense in accordance with the rules that apply for the particular type of remuneration Madsen (2011).

Due to a lack of case law in the area, it is unclear whether such remuneration should be dealt with as distinct remuneration with a right of deduction and subsequent taxation, or whether it forms part of the distribution of profits.

1.2.2.2 The consequences for limited liability

The limited partners in a limited partnership and the participants in a partner company take on limited liability with their investments. With a view to counteracting a limited partner being able to deduct a loss that is greater than the amount he or she is liable for, a deduction account (*fradragsskonto*) exists. This account has been developed in practice on the basis of the decision in LSRM 1974, 38 and UfR 1983, 8 HR (*Ligningsrådets anvisning in the TS-cirkulære* 1990, 1) and, today, may be found in *Den Juridiske Vejledning*, section C.C.3.3.4.

The deduction account is calculated as the sum of:

- a) “Capital deposit that may be regarded as subordinated loan capital. Both paid and payable deposits are to be included;
- b) Purchase price for acquisition of a share of the company from another participant. Both the paid purchase price and the acquired deposit liabilities are to be included;
- c) Obligations that follow from a limited partner's joint and several liability as a debtor for the company's debt, to the extent that the obligation finally affects him or her without recourse against the other participants;
- d) Share in the limited partnership's profits;
- e) Taxed profits on the selling of the limited partnership assets to the extent that the gains correspond to depreciation having been deducted from the account;
- f) Share in the limited partnership's profits through the sale of the company's assets as well as share in the limited partnership's realized capital gains (such as capital gains on redemption of loans) to the extent that this amount remains deposited in the company on the same conditions as subordinated loan capital”.¹¹

When making up the deduction account, the following amounts shall be deducted:

- g) “Share in the company's operating deficit deducted from the income statement;
- h) Depreciation and devaluation, which is deducted from a share of the company's assets;
- i) Advance depreciation as a result of the application of allocation to the investment fund or deposits on the startup account;
- j) Advance depreciation on a share in the company's assets;
- k) Share in the limited partnership's realized economic loss (not tax deductible costs and losses from the company's sale of assets) to the extent that the amounts strain the limited partner's capital account in the limited partnership and they do not match the tax writeoffs or reductions”.¹²

The idea behind the deduction account is that the participant cannot deduct losses that exceed the amount that the participant has deposited or may deposit in the form

¹⁰ See LSRM 1983, 121.

¹¹ Den juridiske vejledning, section C.C.3.3.4

¹² Den juridiske vejledning, section C.C.3.3.4.

of deposit, liability, or any of the other conditions that are mentioned in (a)–(f) above. The balance on the deduction account expresses the maximum amount that the limited partner can deduct either as his or her part of a loss realized by the limited partnership or as depreciation.¹³

To the limited partner in a partner company, the subordinated loan capital represents the nominal share capital.¹⁴ It is unknown whether it also includes a premium for share subscription. It is also unknown whether it includes subordinated loans to the partner company. It has been argued that it should be the case when the limited partner has waived the right of recourse against the other company participants Hansen (2014).

As long as the deduction account is positive, a participant can deduct both loss and depreciation from his or her participation, to the extent that the deduction stays within the balance on the deduction account. If the amount of the loss and depreciation exceeds the deposit, first, access to depreciation is restricted and, next, access to use loss is restricted. Where the deduction account may have become positive, loss that has been covered by a deduction limit is carried forward and used in a later income year.¹⁵ Unlimited depreciations can simply be omitted and carried out later.¹⁶

The interaction between the deduction account and the ability to depreciate assets means that the participants in personal companies cannot depreciate an asset if the deduction account is zero or negative. This is also the case even though the income in a limited partnership is positive in the relevant income year. However, there is one exception in practice that if the profit remains in the business as subordinated loan capital, depreciation is still allowed, so long as the depreciation remains within the amount by which the profit exceeds the negative deduction account.¹⁷

If the deduction account falls into negative, an amount that is the equivalent of the negative deposit shall be treated as income. This does not apply, however, if the

negative deposit is due to an economic loss, which is not deducted in the income statement.¹⁸

1.2.2.3 The meaning of joint liability

Joint liability means that a company participant may be liable for a loss, deficit, or debt in the personal company. This may involve a loss that follows directly from the personal company participant's joint liability, and it may involve a loss that follows from a personal company participant's uncollectible right of recourse against another personal company participant.

When a situation involves liability for loss that directly flows from joint liability, this may be deducted as an operating loss if certain conditions are met. In Danish tax law, a deduction for operating losses is not regulated independently but the right to deduct is determined with the help of two criteria – the causal criterion and the subject criterion. In relation to loss that results from joint liability, the causal criterion is relevant Madsen (2011).

The causal criterion arises out of §6 of the State Tax Act, which provides that there is a right to deduct an operating loss if it is the result of a normal operating risk. Therefore, if a personal company is required to pay compensation, for example, then the participants in the personal company with joint liability will be liable for this payment. If the compensation constitutes a normal operating risk then it will be deductible in the statement of the taxable income. In reality, compensation takes on the character of an operating cost that affects the personal company and can be deducted by the participants in the personal company as a result of the need for transparency.¹⁹ In practice, the right to deduct for other payments that come as a result of joint liability must also be assessed against the causal criterion.²⁰ In reference to practice, it is decisive to the right to deduct that the loss that brings on liability arises out of a normal operating risk.

¹³ The deduction account and its statement are explained in detail and analysed in Liselotte Madsen, *Den skatteretlige behandling af personselskaber*, pp. 160–177.

¹⁴ In SKM2013.790.SR, the deduction account was increased in connection with converting the amounts owing to the limited partner in the partner company to shares. The conversion created a capital deposit.

¹⁵ In SKM2013.790.SR, the increase of the deduction account in connection with debt conversion meant that the limited partner received a deduction for previous years' loss that had not previously been deducted.

¹⁶ Den juridiske vejledning, section C.C.3.3.4.

¹⁷ See LSRM 1982, 166 and Den juridiske vejledning, section C.C.3.3.4.

¹⁸ See TFS 1988, 566 SD and Den juridiske vejledning, section C.C.3.3.4.

¹⁹ In Tfs 1987, 59 H the Supreme Court acknowledges that a lawyer who participates in a legal partnership can deduct compensation paid by the legal business that resulted from liability for a negligent action by another participant in the personal company. See, in general, Liselotte Madsen, *Den skatteretlige behandling af personselskaber*, pp. 219–224 for a close analysis of this problem.

²⁰ See LSRM 1963.140 and an analysis of the case in Liselotte Madsen, *Den skatteretlige behandling af personselskaber*, pp. 224–225.

The loss may also concern an uncollectible right of recourse against another company participant. This can result if, for example, the personal company has a deficit or because another participant has made unjustified withdrawals. The right of recourse gives rise to a claim for the participant who has had to cover such losses, in favor of another participant. This claim is regarded as a receivable. Therefore, the question is whether there may be a deduction for the loss brought about by the right of recourse. In Danish tax law, deduction for loss on a receivable is regulated in the Tax on Capital Gains on Bonds and Securities Act (*kursgevinstloven*). The provisions are different depending on whether the personal company participant is a company or a natural person.

As a rule, according to §3 of the Tax on Capital Gains on Bonds and Securities Act, companies may make a deduction for loss on receivables. Under §4(1) of the Act, an exception to the rule applies in relation to loss on claims against consolidated companies²¹ such losses are usually not deductible. Therefore, in general, companies can deduct losses due to a right of recourse against the other personal company participants unless it involves consolidated companies.

In relation to natural persons, the right to make a deduction is determined in accordance with §§14–17 of the Tax on Capital Gains on Bonds and Securities Act.²² Since January 27, 2010, §14 of the Act provides for a general deduction for the loss on receivables encountered by natural persons.²³ Losses on receivables on closely related persons and receivables on companies where the creditor is a main stockholder are excluded in §14(2) of the Act. Paragraph 14 provides that loss encountered on a receivable arising after January 27, 2010 may always be deducted unless it is covered by the exception in §14(2). The acquisition costs for a recourse claim turning into a receivable makes up the amount that the participant had to spend to pay out the claim.

Paragraph 17 of the Tax on Capital Gains on Bonds and Securities Act, as *lex specialis*, also provides for a de-

duction on receivables, although it is limited to losses on receivables that "... have been acquired as remuneration in trade and for losses on receivables that are additionally acquired in connection with the commercial operation of the business". The provision states that a deduction for this type of loss shall be determined in accordance with §6 of the State Tax Act. There is a rich practice in this area demonstrating that the decisive factor in relation to the right to make a deduction is that the loss is connected to the operation of the personal company. In practice, it appears that loss on a recourse claim that arises out of a deficit in the personal company is connected to the operation in such a way, that it may be deducted on the basis of §17 of the Tax on Capital Gains on Bonds and Securities Act.²⁴ On the other hand, loss suffered because a personal company participant has made unjustified withdrawals does not have the requisite connection to operations to allow the loss to be deducted under §17. Instead, this type of loss relates to lending between the company participants and will, today, only be deductible based on §14 of the Tax on Capital Gains on Bonds and Securities Act.²⁵

The status on deductibility for loss due to a recourse claim is, therefore, that such loss may be deductible pursuant to §17 of the Tax on Capital Gains on Bonds and Securities Act, when the loss has the necessary connection to operations – and, in the event, as personal income. Alternatively, the loss may be deductible in accordance with §14 of the Tax on Capital Gains on Bonds and Securities Act, with the limitation that follows from §14(2) of the Act – and, in the event, as capital income.²⁶

1.3 Sale of the share in a personal company

The way the formation of personal companies and the sale of shares in a personal company is treated in Danish tax law reflects the significance of the total transparency prin-

²¹ Described briefly, §4(2) of the Tax on Capital Gains on Bonds and Securities Act defines consolidated companies as existing where the same shareholders directly or indirectly own more than 50 percent of the capital or the votes in each company.

²² In addition, §13 of the Tax on Capital Gains on Bonds and Securities Act provides for deduction for losses on receivables realised by natural persons acting as professional traders with bonds and securities. Such loss is deductible as personal income. This provision is not very relevant for right of recourse connected with personal companies.

²³ L 112, 2009/2010.

²⁴ See, for example, TfS 1999, 985 V, U 1983, 1108 Ø, LSRM 1981, 205 and TfS 1996, 256 LSR. These decisions are all discussed by Liselotte Madsen in *Den skatteretlige behandling af personselskaber*, pp. 227–230.

²⁵ See, for example, TfS 1996, 256 LSR, TfS 1997, 619 Ø, TfS 2000, 62 H and LSRM 1956, 28. These decisions are mentioned by Liselotte Madsen in *Den skatteretlige behandling af personselskaber*, pp. 230–234.

²⁶ Paragraph 14(1) of the Tax on Capital Gains on Bonds and Securities Act provides that a net inventory of gain and loss must be carried out, where §23 of the Capital Gains Act and §22 of the Taxation of Capital Gains on Sale of Shares Act are also relevant. In addition, there is a minimum amount of 2,000 kr. so that the amount of the loss must exceed 2,000 kr. before a deduction may be made.

ciple, which is used in Danish tax law. As a consequence of the transparency principle, every participant owns a share of each and every asset and liability in the personal company. When there is change in the ownership structure, the consequence is that shares in each asset and liability are regarded as purchased or sold. This principle about part sale and part purchase was established by the Supreme Court decision in UFR 1983, 318 H.²⁷

With the formation of a personal company, the principle has the effect that the individual participant is deemed to have sold a share of any asset and liability transferred to the personal company. Due to transparency, the shares are regarded as sold to the other company participants. At the same time the participant has purchased a share of the assets and liabilities transferred to the personal company by the other participants in the personal company. As far as this relates to assets and liabilities, which are subject to taxation on capital gains, the formation of a personal company will bring about taxation of the company participants in relation to whatever is deposited.

The principle about part sale and part purchase also means that changes in the ownership structure is regarded as a sale and respective purchase of the assets and liabilities that form part of the partnership's common assets. For example, if there are three participants in a personal company, each one of whom own a third of the company, and one of the partners wishes to withdraw, this will mean that he has disposed of his third of the company's assets and liabilities and transferred them to the two remaining company participants. They have acquired one-sixth of the personal company's shares and liabilities and, following this, each owns a half of the assets and liabilities in the personal company. As a result of the part purchase, they will have acquired the relevant assets and liabilities at different times and for different values.²⁸

The principle about part sale and part purchase does not apply; however, when a participant's ideal proportion of a personal company is sold directly to the incoming

participant. It is only the statements of income for these two that are affected by the sale and purchase, while the other company participants are not affected for taxation purposes.²⁹

In relation to the closing down of a personal company, the taxation of the participants also happens in accordance with the transparency principle. This occurs in one of two ways. If the personal company has sold its activity before actual closing down, taxation of the individual participant will occur consistently with the transparency principle in connection with the participant's share of the realized capital gains that are triggered by cession. In this event, the actual closing down alone will trigger a distribution of cash or debt. On the other hand, if the personal company's assets and liabilities are handed over to the participants as part of the dissolution, consistent with the principle about part sale and part purchase, this will trigger taxation of the participants for the capital gains, which are regarded as having been realized in connection with the transfer.

It has been debated whether a part sale in connection with changes in the ownership structure is regarded as partly closing down the business. In SKM2007.56.HR, the Supreme Court decided that this is the case. This has an effect on the taxation of the gain or the loss that may occur to the operating equipment which is regarded as partly sold.

In Danish tax law, depreciation of operation equipment follows the balance principle (*saldometoden*) found in §5(2) of the Depreciation Act (*afskrivningsloven*), where the acquisition cost for an operating equipment is included on the balance and the selling price is left off. At the end of the year, depreciation is calculated as up to 25 percent of the balance. This means that there is no actual statement of profit or loss in relation to selling the asset. Instead, it only affects the balance; and the profit or loss only indirectly affects the income statement in the form of smaller or larger depreciations in the coming income years. Paragraph 9 of the Depreciation Act constitutes a special rule, which shall be used when equipment is sold as part of closing down a business. Paragraph 9 of the Depreciation Act requires that there is a final statement of profit or loss in connection with the selling, which, as a starting point, must be included in the statement of income in the year of disposal. Following the Supreme Court's decision referred to above, part sale of operating equipment must be dealt with pursuant to §9 of the Depreciation Act and, in the case of a profit, taxation is triggered

²⁷ A partnership owned shares in a Danish company. There were six partners. The partnership nominally transferred 600,000 kr. in shares from the common assets to the particular partner to a particular partner, who thus became the direct owner of nominally 100,000 shares. In reality, there was no offset in assets between the partners but the Supreme Court found that each partner had undertaken a part sale and part purchased of the relevant shares.

²⁸ Something similar will happen if the ownership is increased by one person, who will own 25 percent of the personal company. In this situation, the existing personal company participants each have ceded 25 percent of their shares to the incoming personal company participant.

²⁹ Den juridiske vejledning, section C.C.6.6.

at the time of cession while, in the case of a loss, a deduction will be triggered immediately.³⁰

In practice, there has been a particular tendency for lawyers and accountants – the so-called Copenhagen model (*københavnmodel*) – following which lawyers and accountants are not regarded as having bought or sold goodwill in connection with buying into or withdrawing from a personal company. The Danish tax authorities acknowledge this practice, provided that it is part of the parties' agreement and it is commercially justifiable.³¹

1.4 Special antiabuse rules

Following the transparency principle, participation in a personal company leads to the opportunity to deduct depreciations on the assets of the personal company at the level of the participant. Therefore, to a great extent, personal companies have been used as part of tax planning in the form of the so-called partnership projects (*anpartsprojekter*), because a loss can be offset against other income and, therefore, postpone taxation of it. It is especially interesting for natural persons.

The measures in §4(1)(9) and (11) of the Act on Personal Income (*personskatteloven*) are intended to limit the opportunity to take advantage of personal companies in tax planning. The provisions apply to income in self-employed businesses, when the number of owners is greater than 10, and to income from rental of depreciable operating equipment and ships, regardless of the number of owners. In relation to both situations, it is a precondition that the taxpayer does not participate in the business operations to a significant extent. Income from a partnership project is capital income. Losses may only be set off against income from the partnership project. Thus, it is not permissible to offset the loss against other income. Participants in partnership projects are additionally required to submit a common tax account statement with common depreciating, which must be taken into account in the income statement.

Paragraphs 2 A and 2 C of the Corporation Tax Act also provide for special antiabuse rules that are intended to prevent the taxpayer from taking advantage of different

qualifications of an entity in two different states in order to achieve a tax benefit.³² The provisions build upon a principle that the Danish qualification of the entity follows the qualification that the entity has in the foreign state.

In accordance with §2 A of the Corporation Tax Act, a company that is either fully or partly liable to tax in Denmark (taxable entity) and consolidated with a legal person in a foreign state will be requalified as a fiscally transparent entity when the company is regarded as a fiscally transparent entity according to the rules of the other state. It is a condition that there is control, as defined in §3B of the Tax Control Act (*skattekontrolloven*), between the overseas legal person and the Danish company,³³ and that the foreign state is a member of the EU, the EEA, or has a double taxation agreement with Denmark, in accordance with §2 A(4) of the Corporation Tax Act.

Without this provision, the consolidated companies may be able to take advantage of the mismatch in qualifications to achieve favorable tax treatment in relation to the interest on an internal company loan. The Danish company would have a deduction for interest expenses on internal company debt when making the Danish income statement. Interest earned would not be taxed in the foreign state, because the interest payment to the consolidated company in the foreign state could be regarded as an interest payment between a branch and headquarters. When a Danish company is requalified as a fiscally transparent entity under Danish tax law, the owners are always deemed to have a permanent establishment in Denmark, following §2 A(8) of the Corporation Tax Act. This means that the company does not have a deduction for interest or royalties that are paid to the overseas owners, because the payments will be deemed to be payments between a branch and headquarters. It also means that any dividend payments will not be considered to constitute dividends and, therefore, there is no withholding tax on the dividend.³⁴

³⁰ Paragraph 9 of the Depreciation Act contains a special rule in the event of loss. If not all operation agents are ceded, deduction for the loss will be postponed until such a time as they are ceded.

³¹ See a report on this practice in Rapport om den skattemæssige bedømmelse af goodwill ved sammenlægning, opsplnitning, ind- og udtræden af personejede advokat- og revisionsvirksomheder, December 2003, p. 22.

³² The provisions concern the overall problem about hybrid mismatch, which is one of the themes in the BEPS report and provides for the Danish solution to the problem. The provisions are *inter alia* discussed by Jane Bolander and Liselotte Madsen in National og global beskyttelse mod skattespekulation ved brug af hybride selskaber i U.2014B.385 and by Liselotte Madsen, SEL §2 A og §2 C – Når den skatteretlige subjekt kvalifikation ændres, pp. 303-320 in Festskrift til Jan Pedersen.

³³ This means that the overseas company must own, directly or indirectly, more than 50 percent of the capital or 50 percent of the votes in the Danish company: §3B of the Tax Control Act.

³⁴ See the Tax Minister's answers to questions 20 (skatteministerens svar på spørgsmål 20) in Annex 76, L 119, 2003/04.

Requalification does not mean that a company's assets and liabilities will be regarded as sold. In accordance with §2 A(5) of the Corporation Tax Act, requalified transparent units are considered to have "succeeded" in respect of the relevant assets and liabilities, losses that may be carried forward and source limited losses.

The provision in §2 C of the Corporation Tax Act regulate the opposite situation. This is where entities that constitute transparent entities become requalified as companies liable to tax under §1(1)(2) of the Corporation Tax Act. Requalification occurs when the direct owners who possess more than 50 percent of the capital in the fiscally transparent entity are based either in a state where such an entity is considered a company liable to tax or in a non EU state with whom Denmark has not a double taxation agreement about relief of withholding tax on dividends.

The purpose of the provision is to prevent exploitation of the different qualifications of the same entity in the two states. Without the measure, for example, an American company could place intangible assets in a Danish limited partnership. If the activity in the limited partnership did not constitute a permanent establishment, the return on the intangible assets will not be taxed in Denmark. Neither will it be taxed in the United States, because the company there is considered a company liable to tax. Therefore, one may have reached a situation of double nontaxation of the return on the intangible assets, which will first trigger taxation in cases of dividend distribution to the American owner.³⁵ When an entity is requalified as a company liable to tax, this ensures that it is regarded as a taxable entity according to Danish tax law, thus allowing Denmark to tax the return in question.

Requalification does not result in a personal company's assets and liabilities being taken as sold, unless they are no longer taxable in Denmark, pursuant to §2 C(4) of the Corporation Tax Act. Under §2 C(5) of the Act, the requalified company is considered to have "succeeded" in relation to the assets and liabilities. In relation to participants, requalification means that the selling of shares is covered by the Taxation of Capital Gains on Sale of Shares Act (*aktieavancebeskatningsloven*) and distributions represent dividends. Under §2 C(6) and (7) of the Corporation Tax Act, the acquisition cost of the ownership share is calculated as the taxable value of the participant's ownership share at the time of requalification.

³⁵ The decision in SKM2008.446.SR is an example of such a situation and is the direct reason for enactment of the provision in §2C of the Corporation Tax Act.

Paragraph 2 of the Tax Assessment Act (*ligningsloven*) states that transactions between parties with a decisive influence shall occur at arm's length. This applies to agreements between parties with a decisive influence, so long as at least one of the parties is a taxable legal person. The definition of decisive influence in §2 of the Tax Assessment Act is also used in relation to decisions made under §11 of the Corporation Tax Act, about thin capitalization. When a decision is being made about whether a decisive influence exists between a legal person and a personal company, due to the requirement of transparency, it is the relationship between the company participant and the legal person that must be evaluated. This means that if there is not a participant who owns more than 50 percent of the votes or capital, then there will not be decisive influence; and, therefore, the provisions on thin capitalization will not be relevant.

Paragraph 2(1)(2) of the Tax Assessment Act was amended with a view to ensuring that the provisions on thin capitalization are also relevant in situations where a personal company is the direct owner of the capital company. Thus, in accordance with that provision, a fiscally transparent entity is deemed to be a legal person for the purposes of §§2(1), first sentence, and 2(3) of the Tax Assessment Act.³⁶ In combination, these provisions ensure that the personal company is not fiscally transparent in relation to determining decisive influence, thus securing that a loan from a personal company to a legal person constitutes a controlled debt, when there is decisive influence between the personal company and the legal person.³⁷

1.5 National principles for international relations

If a Danish personal company has foreign owners, it follows from the transparency that the foreign owners are to be regarded as the taxpayer.³⁸ The foreign owners will be

³⁶ The following is clear from the last point in §2(1) of the Tax Assessment Act. The provision is a reaction to the ownership structure, which capital funds chose in connection with the purchase of companies in Denmark. The purchase often happened through a Danish limited partnership with a number of overseas participants, none of whom had a decisive influence. See the preparatory work to the Act L 116, 2005/2006.

³⁷ The interest must be determined at arm's length and a limitation on deduction of interest may happen: see §11 of the Corporation Tax Act.

³⁸ This presupposes that the Danish personal company is not requalified: §2 C, Corporation Tax Act.

subject to limited tax liability in Denmark to the extent that this is provided for in §2 of the Taxation at Source Act and §2 of the Corporation Tax Act. Under Danish law, the personal company is a fiscally transparent entity and, therefore, distributions do not constitute returns, but on the contrary will typically derive from a permanent establishment or real estate in Denmark. In such cases, the income deriving from the personal company will be subject to limited tax liability in Denmark.

In practice, it is clear that the qualification of a foreign entity must happen with reference to Danish domestic tax law. Therefore, in deciding whether a specific case relates to a taxable entity or a fiscally transparent entity, it is the criteria set out in Section 2 above that are decisive. In other words, the question of the personal liability of at least one of the participants, the entity's general purpose and the criteria that have also developed in practice are the relevant factors.³⁹ The foreign qualification is not decisive in relation to the Danish qualification,⁴⁰ and it is unclear whether the foreign qualification has influence on the assessment under domestic law.

The situation where foreign personal companies qualify as such under Danish domestic tax law is decisive when deciding whether relief for double tax can be granted and whether dividends are subject to the withholding of taxes. Thus, it is clear in practice that the Danish qualification in combination with the provisions in the double taxation agreements is decisive in answering these questions. This may be demonstrated by some examples from practice.

In cases where a foreign entity (liable to tax in the foreign state) qualifies as a personal company, thus fiscally transparent, under Danish tax law, the Danish qualification of the services that flow from the foreign company is decisive for the relief from double taxation. This occurs with reference to Article 23, point 69.3 of the OECD's model convention, where it is stated that a distinction must be drawn between the generation of profits and the distribu-

tion of those profits; and that the state of residence – in this case, Denmark – "... should not be expected to credit the tax levied by the State of source upon distribution against its own tax levied upon generation..."⁴¹

In another example from practice, a Danish personal company is 100 percent owned by an English limited liability partnership (LLP), which, in turn, is owned by natural persons and has its home base in Switzerland. The Danish company is a Danish private limited company and, thus, a taxable entity. The English LLP is a fiscally transparent entity in accordance with English law, while it is deemed to be a taxable entity under Danish tax law. Pursuant to Swiss law, the company will be considered a taxable entity. In deciding whether dividend tax should be withheld upon distribution by the Danish company to the English LLP, it was decisive that both Denmark and Switzerland deemed the entity to be a taxable entity. In considering Article 1, point 6.5 of the OECD's model convention, it was clear that Denmark as the source state may withhold dividend tax in such a situation.⁴²

Another example is also found in practice, where the qualification of an overseas entity occurs in part according to Danish domestic law and in part according to a double taxation agreement between Denmark and the foreign state. In accordance with Icelandic law, an entity is found to be taxable; while, according to Danish domestic law, it is deemed to be a personal company and thus a fiscally transparent entity. With reference to the Nordic double taxation agreement, however, weight is given to the fact that Denmark is obliged to acknowledge the Icelandic qualification of the association.⁴³

³⁹ See TFS 1999, 411 LR and SKM2008.491.SR. See also SKM2012.426.SR and SKM2014.10.SR, where the National Tax Board in its decision lists a number of criteria that are relevant to an evaluation of qualification. The situation is also discussed by Jane Bolander and Steffen Sværke in the Danish national report on Qualification of taxable entities and treaty protection, *Cahiers de droit fiscal*, volume 99 b, pp. 286–287.

⁴⁰ See SKM2012.426.SR, where the National Tax Board found that an English LLP constitutes an independent tax subject in accordance with §1(1)(2) the Corporation Tax Act, even though it does not qualify as independent to tax in England. In SKM2014.10.SR a Belgian SCS was found to be an independent tax subject in Belgium, although it qualified as a personal company under Danish law.

⁴¹ See SKM2014.10.SR, where a Belgian SCS that was owned by a Danish limited partnership, which was in turn owned by 9 Danish limited partners, was found to be a personal company under Danish law. In accordance with Belgian law, it was deemed to be an independent tax subject, which is why both company tax was paid and dividend tax was withheld in Belgium. Following Danish law, it was found to be a personal company and the dividends were, therefore, found to be a non-taxable transfer between two units. With the Danish tax calculation credit was only granted for the company tax that was paid in Belgium and not for the dividend tax because the dividends had not been taxed in Denmark.

⁴² See SKM2012.426.SR, which is also discussed by Jane Bolander and Steffen Sværke in *Kvalifikation af skattesubjekter og traktatbeskyttelse* in SU 2014, 306 and the Danish national report entitled *Qualification of taxable entities and treaty protection*, *Cahiers de droit fiscal*, volume 99 b, p. 290.

⁴³ See SKM2008.491.SR, where the question was whether there was limited tax liability on any dividends from the Danish company. It should be noted that the decision has been criticised because it did not touch upon double taxation in any way, as the Icelandic association was owned by a Danish holding company. When Denmark

The interplay between national law and foreign law about personal companies, being part of international groups, is also regulated by the provisions in §§2 A and 2 C of the Corporation Tax Act, as discussed in Section 6 above. If these provisions affect an entity, it is the foreign qualification of the entity that determines the Danish qualification. Therefore, foreign law steers the Danish law in this situation. For a description of the consequences, see Section 6 above.

1.6 Other conditions

Transparency, as it applies to personal companies in Danish tax law, means that lending from a capital company to a personal company is deemed to be a loan to the personal company participant. Provided that the personal company participant is a natural person, the loan can be regulated by §16 E of the Tax Assessment Act. This provision states that certain shareholder loans are requalified to dividend or wages for the shareholder.⁴⁴ This occurs when the shareholder is a natural person, who directly or indirectly owns more than 50 percent of the votes or capital in a company. As a personal company is a fiscally transparent entity, it will be the personal company participant who, through his share of ownership in the personal company, owns more than 50 percent of the votes or capital.⁴⁵ When the loan is regulated by the Tax Assessment Act, the consequence is that the loan does not exist in a tax law context, the personal company participant is taxed on the loan as wages or dividends and the personal company's payment of interest is not considered to constitute interest in the statement of the personal company participant's taxable income.

1.7 Concluding remarks

In Danish tax law partnerships, limited partnerships, partner companies, and jointly owned shipping firms are all regarded totally transparent. This implies that taxation occurs at the participant level. The participant can either be

deemed the Icelandic association to be a personal company, it was the owners of the company that received the distribution and, thus, there was no double taxation. See Lena Engdahl in Kan en DBO udpege rette indkomstmodtager – endda i en situation uden dobbeltbeskatning? I SU 2008, 314.

⁴⁴ As an exception to this rule, lending that is granted as a part of a business arrangement is not covered.

⁴⁵ See SKM2014.14.SR and SKM2014.15.SR.

a natural person or a legal person. Therefore taxation will take place in accordance with the rules which prevail for natural persons respectively legal persons.

The transparency principle makes it necessary to have rules regarding the ongoing taxation, consequences following from the limited liability and the sale of a share in a personal company. With regard to the sale of a share in a personal company case law shows that a principle about part sale and part purchase prevails. The principle means that it is necessary to be aware when changes in the ownership structure occurs.

In Danish tax law, several antiabuse rules are aimed at preventing the use of personal companies as part of tax planning – both on a national and international level. Especially on the international level some complex rules are found to be preventing the taxpayer to benefit from a different qualification of the personal company in two states. The Danish solution to the problem of hybrid mismatch arrangements implies a requalification of the entity – a requalification that reflects the way the entity is qualified in the foreign state.

Finally, it is important to be aware that the transparency principle means that the personal company does not exist in a tax law context. Thus if a loan is disbursed from a company to a personal company it will be regarded as a shareholder loan in Danish tax law, if the owner of the personal company holds the majority of the shares in the company. This means that though the shareholder doesn't directly benefit from the arrangement, the loan may still be regarded as dividend or salary.

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2 Finland

By Markku Järvenoja

2.1 Company law aspects

As defined in the Act on General Partnerships and Limited Partnerships (Partnership Act), a partnership is a legal entity. It is formed when two or more persons, individuals or legal entities, have agreed, verbally or in writing, to carry on a business or professional activities on a collaborative basis with a common economic goal. The company has legal capacity and owns its capital. The legal capacity of the partnership is created by the agreement and does not depend upon registration in the Trade Register. A bill according to which a partnership would be created upon registration in the Trade Register has been issued to the Parliament. The new government shall probably after the parliament election. In a general partnership, all partners are personally responsible for the liabilities of the partnership. In a limited partnership general partners are personally responsible for the liabilities of a partnership but the liability of a limited partner does not extend beyond his capital contribution. From the company law point of view, the striking difference between partnerships and corporations is the responsibility for the liabilities. In a limited liability company a shareholder is not personally responsible for the liabilities of the company. The liability has been transferred from the partners to the entity itself. The assets of the partners do not constitute a safeguard for third parties. This transfer of liabilities is *prima facie* the main distinguishing feature between partnerships and corporations.

The Partnerships Act contains relatively few provisions and many of those provisions are discretionary. Most of the nonmandatory provisions of the Partnerships Act

can be set aside by agreeing otherwise in the partnership agreement and this allows contractual flexibility for the partners to arrange their business in such a way that suits them best. The application of the law is almost entirely discretionary; the partners can agree in the partnership agreement to deviate from the default regulations. In private equity investment partnerships, in addition to the partnership agreement, the partners often enter also into a shareholder's agreement including more detailed provisions on the internal relations between the partners.

As the partnership is a legal entity, it can enter into agreements with its partners. Payments made to a partner acting in a nonpartner capacity are treated as made to one who is not a partner. Remunerations paid to a partner for services rendered to the partnership can be deducted from the partnership income.

The Partnerships Act does not provide for an instrument representing the partners' ownership interest, but the interest can be described as a "share of the partnership". The share of the partnership encompasses *inter alia* the duty to invest the initial contribution, the right to the future profits of the company and governance rights. The initial contribution of each partner, as well as the rights to the future profits of the partnership, should be agreed upon in the partnership agreement. Unless anything else is agreed, the partners are allowed to an interest pro rata on their contribution, whereafter the profits are distributed equally between the partners.

A share of the partnership, or any part of it, is not transferable, unless otherwise agreed in the partnership agreement or unless all the partners (including the silent partners) give their consent to the transfer.

A new partner may be admitted to a partnership via changing the partnership agreement and possibly a capital contribution to the partnership. A new partner can be admitted to a partnership also via a purchase a partnership interest or part of it from another partner.

The duration of a partnership is agreed in the partnership agreement. The duration of the partnership can be perpetual, agreed to last for only a fixed term or subject to a notice of termination under some agreed conditions. The Partnerships Act guarantees the right to demand that the partnership shall be dissolved under certain conditions. A partner has the right to demand the dissolution of a partnership if

- they have terminated the partnership agreement and the notice period has elapsed,
- the agreed partnership period has ended,
- another partner is declared bankrupt or their partnership share is distrained,

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- another partner has died and there was or is no agreement on the continuation of operations despite this, or
- the preconditions for the company to continue operations have ceased.

In the case of a limited partnership, however, it must be noted that the dissolution of the company cannot be demanded on the basis of the silent partner's death or bankruptcy, or the distraint of their partnership share; instead, the other partners are entitled to redeem the partner's share.

Under normal circumstances, the partners decide on placing the company into liquidation. If the assets of the partnership are sufficient to satisfy the claims of the creditors, the remaining assets are distributed to the partners and the partnership is dissolved. On the other hand, if the debts exceed the assets, the remaining debts are distributed to the general partners who are personally liable for the debts. The Partnerships Act also provides that a unanimous decision of the partners may close down the partnership without any separate liquidation proceedings. This requires a unanimous decision by all partners, including silent partners.

The overall number of partnerships has decreased significantly in the latest 20 years, as opposed to, for example, limited companies.

Silent partnerships are not known in the statutory Finnish civil law.

2.2 Tax Law aspects

2.2.1 Qualification of companies

For tax purposes, companies are divided into two groups: separate persons and transparent entities for tax purposes. Section 3 of the Income Tax Act (ITA) defines that a limited company is a corporation for tax purposes. A corporation is treated as separate person for tax purposes. Section 4 of ITA divides partnerships into two categories: business partnerships and taxation partnerships. Business partnerships includes a general partnership, a limited partnership, a shipping company under joint ownership, and a joint operation, which has been established to carry on business by two or more persons, and which is meant to act in the partners' common interest. However, joint ventures formed by two or more taxpayers engaged in business activity for performing a specified construction work or other similar work are not treated as partnerships.

The concept "taxation partnership" refers to a partnership constructed only for taxation purposes. Taxation partnerships are real property partnerships, i.e., bodies of two or more domestic or foreign persons with the purpose of cultivating or holding real property. Taxation partnerships can be regarded as transparent as also losses occurred in them are attributed to be taken into consideration at the partner's level. Taxation partnerships are partially tax accounting entities and depreciations concerning jointly owned buildings on the real estate are to be made at the partnership level. An exception to this main rule is that the partners' interest expenses related to the acquisition of the real estate are deducted at the partners' level.

The taxation model for partnerships was under pressure to change for decades. Independent tax liability was to be changed into partner or shareholder taxation. This was justified mainly by two arguments: first, shareholder taxation was the international rule, and second, there was a need to prevent tax avoidance. However, the transition to shareholder taxation did not mean that the structure or operative model of partnerships would have changed. This is strongly supported by the account of partnership company structures and regulations outlined in the articles of partnership examined by Järvenoja (2013). Even today, a silent partner has no practical impact on a limited partnership's operations. In reality, the transition to shareholder taxation affected the operation of the taxation authorities and administrative courts. The expressed reason, however, was that the legal reform was aimed at preventing the foundation of partnerships solely for the purpose of minimizing tax progression.

2.2.2 Computation of taxable income

The main rule is that the net income of the partnership is computed at the partnership level in the same way as the net income of a corporation.

Partnership can have three types of income: business income, passive (personal) income, and agricultural income. Taxable income is calculated for each income source separately. Tax loss from, for example, passive income cannot be transferred to be deducted from business income in any case.

Business partnerships are generally subject to tax accounting and the taxable income calculated for the partnership is attributed to be taxed as an income of the partners. Expenses are deductible at the level of the partnership. Tax depreciations are made at the partnership level. Partnerships are also treated as employers, for example,

as regards withholding liability on wage taxes. Partnerships are treated as investors when calculating the length of ownership of partnership assets.

There are also some exceptions to the rule that income is computed in the same way as for corporations. To alleviate the tax burden, partnerships are allowed to form an operating reserve. The accumulated unused reserve at the end of the tax year must not exceed 30 percent of the wages and salaries subject to withholding paid by the partnership during the previous 12 months. Only partnerships with individuals as partners have the right to create an operating reserve.

Interest on a debt incurred for the purpose of a business activity may be deducted in computing net income of the business. This may be an incentive into arrangements where the loan is taken by the partnership but the money is distributed to the partners. As a result, the debts of the partnership may exceed its assets. This may cause problems with the deductibility of interest expenses in situations of negative equity in a partnership. Traditionally the actual use of the funds borrowed is traced and this determines the deductibility of the interest expenses as business costs. Mechanical rules for the allocation of the deduction of interest expenses are, however, included in the BITA.

Reasonable remuneration paid to a partner for services rendered to the partnership may be deducted from the partnership's income and is taxed as the income of the recipient partner. The partner can lease or rent business assets to the partnership. The partner can also grant a loan to the partnership. Thus other guaranteed payments like contractual interest, lease payments, and royalty payments made at arm's length basis are treated as deductible for the partnership and taxable to the partner. The lease payment or rental income is taxed as capital income for an individual partner and taxable income for a corporate partner. Interest income is taxed as capital income for an individual partner and taxable income for a corporate partner.

Interest expenses are normally treated as deductible from business income. However, if the partnership has negative equity at the end of fiscal year, the right to deduct interest expenses from business income is restricted. The negative equity is the residual when the balance sheet negative equity is corrected by deducting the unutilized tax losses and adding the limited partners' capital contributions. The residual is multiplied by basic rate of interest plus one percentage point.

Dividends received by the partnership are subject to special regulations. The idea is that the dividend income would be taxed in the hands of a partner in the same way

as it would be if the partner had received it directly herself or himself. Therefore, taxation of dividend income is quite complicated. The treatment of dividends is an exception to the partnership being treated as an income accounting entity. Business dividends are, however, included in the net business income of the partnership. Business-related dividends are included in the business income at the partnership level. The tax relief on dividend taxation will be realized in the partner's taxation. If the partner is a corporate entity, the part of partner's share is tax exempt, which equals with partner's share of the partnership's taxable income. Dividend income for a corporation is tax exempt income. For an individual, 15 percent of a business-related dividend income is tax exempt income. For example, if there are two general partners, an individual and a corporation, in a general partnership with equal shares in partnership income and the partnership receives a dividend income of 1,000 and other business income of 1,000, for the corporate partner. 500 of the income share is tax exempt and 500 taxable business income and for the individual partner 75 ($15\% \times 500$) of the income share is tax exempt, and 925 is taxable business income. Nonbusiness dividends "flow through" the partnership and are not included into partnership income when the net nonbusiness income of the partnership is computed. Thus, if dividend income received by the partnership is passive income, it is not included in the partnership taxable passive income. Dividend is totally transparent and is taxed as partner's income in the same way as if she or he had received it directly from the distributing company.

Tax losses cannot be transferred to the partners' level for income tax purposes in any case, although they can be carried forward at the partnership level for 10 years. This applies both to normal ongoing business losses and in cases where the partnership is liquidated (SAC 1993 B 522). The right to utilize tax losses at the partnership level are, however, forfeited if more than 50 percent of the partnership interests have changed ownership during the year tax loss occurred or following years.

Partnerships cannot make a voluntary election to be taxed in the same way as corporate entities. Neither can the same legal structure be treated as a taxable entity vis-à-vis some of its partners and a nontaxable entity vis-à-vis the other partners. Because partnerships are subject to tax accounting and losses are carried forward at the partnership level, it can be argued that the concept of transparency of partnership taxation is limited to being concerned only the taxable income and directly attributed dividends.

2.2.3 Taxable income attribution to the partners

When net income of a partnership has been computed, it must be allocated to each of partners. The ITA requires that partners are taxed according to the shares the partners have in the income of partnership. According to the partnership agreements, the profit shares of active partners in partnerships are in practice not agreed upon according to the Partnership Act's profit distribution model. As a general rule, these shares are determined by the partnership agreement and they are very rarely questioned. In practice, the provisions in the Partnership Act on profit distribution are not at all followed in general partnerships and between general partners in limited partnerships. In tax practice, partnership agreement provisions have been agreed as basis for determination of income shares on partners' level.

The fact that there are very few judicial rulings shows that the profit distribution principles determined in the partnership agreements have a dominant role in estimating income shares. Thus it can be concluded that profit share and income share have the same meaning in this sense. On the other hand, it is interesting that it can also be observed from the practice based on the partnership agreements that the profit shares are generally not based on the partner's shares or the capital investment of the partner. The conclusion therefore might be that in regard to the taxation of the profit of partnerships, the agreement outlined by the partners is almost always accepted, even if it is not clearly tied to the partners' capital investment or capital share.

In a family partnership, however, the allocation of income between partners may not favor any partner. As a general rule, the allocation of income between partners in a family partnership should be judged by an arm length's principle. It is not always easy to determine what unrelated partners would have agreed upon. The provisions in the Partnership Act cannot be regarded as standards for the allocation of profits between partners in a family partnership as they relate to situations where partners have not included provisions concerning profit allocation in their agreement. According to the private law, the partnership agreement is always given priority, and partnership agreements often differ from the provisions in the Partnership Act.

The transition to shareholder taxation has had very little material effect on the persons in law, which can also be seen in the fact that company structures have remained unchanged. The effects of the reform have been great as regards the authorities implementing or supervising the regulations, as well as in the field of judicial practice, as

instances of the implementation of Section 28 in the Tax Assessment Act have decreased significantly.

The principle that the partnership income preserves its source character is followed when partnership taxable income is attributed to the partners. Accordingly, business income of the partnership is taxed as business income of the partner. This means, that business income on the partnership level is taxed in the same source of business income as partners' business income from its own capacity according to SAC 1998:30. Business carrying partners, for example, corporations, can offset their own business losses against attributed business taxable income share of the partnership based on the abovementioned decision of SAC. The same principle is also applied in taxation of sole entrepreneur who is running his own entrepreneurship business, SAC.

In the case of individual partners that do not carry on business themselves, character preservation does not have much practical relevance because the business income is anyhow apportioned to capital income and earned income. Capital income (investment income) is defined as the proceeds from capital, gains arising from the disposal of assets (capital gains), and other income yielded by assets. Earned income is defined as any other income than capital income.

If the partners are individuals, the partnership income is taxed at the partner level either as capital income at a flat tax rate of 30 or 33 percent or as earned income at progressive tax rates. The distinction between capital and earned income is made on basis of partnership's net wealth. A 20 percent interest of the partner's share of the partnership's net wealth is determined as capital income and the rest of the share of the partnership income is taxed as earned income. The partner's share of the partnership's personal (passive) income is taxed as capital income. The same rules apply also on limited partner's share of the partnership's income. Limited partner's share of the partnership's net wealth is usually determined equal as the capital contribution made by the limited partner.

Capital gains from alienation of real estate or securities belonging to partnership's fixed assets, which are part of the partnership's net income, are subject to special regulation. A partner's share of capital gains included in his share of partnership income is always taxed as capital income.

If a corporate entity acts as a partner, the attributed income is taxed with 20 percent corporate tax rate.

Legal praxis has taken a stand on the question of whether the altered profit distribution outlined in the articles of partnership can act as the basis for determining income shares. The rulings have been favorable on the part

of those liable for tax when the principles determined in the partnership agreements have been in line with the actual profit distribution. Changes in partnership agreement have also been agreed in tax practice even in cases where the changes have been informed to tax authorities after the tax assessment has been finalized (SAC 2000/1989) on the presumption that the actual profit distribution has taken place according to the new partnership agreement and the statuses of partners have changed.

The income for the closed fiscal year is taxed in those partners' hands, who are partners at the date the partnership ends its fiscal year. The partnership income can also be attributed to be taxed in those partners' hands, who have been partners in the partnership at the time the profits were derived or based on the ownership time of the partnership interest in particular tax year. This will be done, especially if a partner who has resigned has taken out profits from the partnership before his resignation.

The taxable income is always taxed upon its realization to the partnership and the actual distribution has no effect for taxation purposes.

2.2.4 Profit distribution, capital investments, and returns of capital

In shareholder taxation, the partner's share of the taxable income that has been confirmed for the partnership is taxed as the partner's income. This income share is in practice based on the shares of the partnership's income agreed upon between the partners of the partnership. Profit distribution is agreed upon in the partnership agreement. Since the transition to shareholder taxation, there have been no published rulings stating that the profit distribution principles outlined in the articles of partnership could not be used as the basis for determining income shares.

Since the 1980s, the judicial literature has presented consideration of implementing the same principles to this sort of capital transfer as was done in the case of capital transfers between a limited company and its shareholder. This line of thought was furthered within the field of tax policy in 1989, when the Partnership Act came into force. The Partnership Act removed any ambiguity regarding the legal personality of partnerships and the ownership of partnership assets. These factors created a need to reform the provisions of tax law and to define capital transfers between the partnership and the partner as yields. Later, this idea was further strengthened, which led to the reform of the regulations regarding the entity on whom taxation of value increase is imposed.

The capital contribution is a tax-free income for the partnership. Section 6 of BITA states that a capital contribution into a corporation is a tax-free income for the corporation. According to the established tax practice, the same principle is analogously applied in partnership taxation. A contribution in kind may trigger a taxable capital gain for the partner as the contribution is valued at a fair market value, thus the increase in value would be a taxable gain for the partner.

Profits distributed are tax-free income for the partner. Capital returns without a change in partnership interest is also regarded as tax-free income for the partner. Even though her partner's equity becomes negative due to the assets taken into private use the return does not trigger capital gain taxation. Capital returns with a change in partnership interest is, however, regarded as a sale of a part of the partnership interest. Normally this does not trigger a capital gain as the partner can deduct from the capital return the same amount of her acquisition cost for the partnership interest.

From tax practice point of view, profit distribution is not the most essential issue for partner's taxation. More important feature in partnership taxation is the asset transfers from partnership to partner's private use (private drawings). A partner may transfer assets into private use more than her investments and undistributed profit shares are without triggering taxable income. Thus it is possible that the partner's equity becomes negative without income taxation. The negativity will be added into capital gain when the partnership interest is alienated or the partner resigns from the partnership. If the transfer is in kind, the asset transferred is valued at fair market value for partnership taxation. Thus value increases will be taxable income or gain for the partnership.

Finnish balance-sheet loaning refers to a situation where the partner makes a tangible investment, e.g., a property or building, in the company. Within civil law, this tangible asset is regarded as the property of the partner, whereas within tax law, it is deemed to be the partnership's property. In Finnish balance-sheet loaning, the tax right is withdrawn from its company law base and is transferred to an economic reference. The acceptability of the taxation of Finnish balance-sheet loans has been based solely on legal praxis. The Finnish Tax Administration has issued an official instruction that balance-sheet loaning of assets is not anymore acceptable for tax purposes.

2.2.5 Admissions, resigning, and sales of partnership interest

The concept of partnership interest has not been defined within taxation-related legislation. The meaning of the concept has been analyzed through the regulation and development of legal praxis regarding the sale of partnership interest. As the Income Tax Act (TVL) §45 does not contain any kind of positive definition of the concept of sale, legal praxis plays a vital role in determining what legal actions are considered to be sale of partnership interest according to the provision. The regulation regarding sale of partnership interest has remained on an abstract and narrow level. In practice, however, this has meant that the courts have been left with significant power of decision.

A new partner may be admitted to a partnership via changing the partnership agreement and possibly a capital contribution to the partnership. The new partner may invest money or contribution in kind, e.g., a real estate.

The admission to the partnership does not mean for tax purposes that other partners would have alienated part of their partnership interests on a taxable alienation. Thus, no capital gain taxation is possible, unless the partner's share of the partnership's equity is negative. If this is the case, part of the partner's interest is deemed to be transferred in a taxable alienation, SAC 2005:68. The equivalent part of the negative equity is taxed as capital gain.

A new partner can be admitted to a partnership also via a purchase a partnership interest or part of it from another partner. The sale of partnership interest is regarded as a sale of a separate asset similar to the sale of shares in a corporation. For the existing partner, it is a question of capital gain from sale of a partnership interest or part of it.

The sale has no effects on the taxation of the partnership. If more than 50 percent of the interests in a partnership have changed ownership, the right to carry over losses is, however, forfeited.

When the capital gain is computed the partner's share of the undistributed profits of the partnership are added to the initial investment when the partnership interest was acquired. This can be defended on the grounds that it would be possible to distribute the profits to the partner who could then make a capital contribution to the partnership. Thus the double taxation of retained earnings is avoided. The adjustment is based on the net book profit of the partnership, not taxable income.

Distributions in excess of retained earnings and capital contributions, i.e., partner's negative equity, are taxed indirectly when the partnership interest is sold. Such distributions are added to the gain when the capital gain on the sale of partnership interest is computed. Thus the part-

ner's negative equity is taxed at investment income tax rate.

When taxation is imposed on economic events, it is natural that tax law pays most attention to the economic side of the partnership interest. In matters of selling partnership interest, the focus is thus laid on the contribution to the partnership capital and its significance in determining the amount of the partner's share. The account performed on the partnership agreement showed that in the agreement, the partners did not tie the size of the partnership interest to the size of the contribution to the partnership capital.

According to the Partnership Act, a general partner has one partnership interest whose size may vary. Respectively, in tax law, the partner is deemed to have one partnership interest. However, legal praxis has interpreted the growth of a partner's share as the start of the ownership period of a new part of the partnership interest. Such an interpretation can be justified by the idea that the ownership period is a concept only used within tax law. In regards to another tax law concept, namely acquisition cost, it has in such cases been deemed to be distributed between the partnership interest in accordance with their relative size.

The trickiest interpretation problems within tax law arise in situations requiring determination as to whether a sale of partnership interest has occurred. In tax law, legal acts within civil law, i.e., transactions, trade, or similar legal actions, act as the grounds for sale. Partnership Act regulates the grounds on which a sale of a partnership interest has a legal impact on other partners and the partnership, but it does not determine when a sale of a partnership interest is deemed to happen. Within tax law, there is thus no strong interpretational support from partnership law for situations where a partner resigns from the partnership, a new partner joins the partnership, or the partnership interest increases without the signature of a specific sales agreement. The trickiest cases are those in which a partner has a negative share of equity capital.

Within tax policy, it is clear that a partner's negative share of equity capital has to be accounted for as their income liable for tax when they resign from the partnership or the partnership is liquidated, at the latest. In regards to sale of a partnership interest, negative equity capital poses a problem for interpretation and ruling, as the Partnership Act regulates that the partner will not be freed of their liability for the partnership's liabilities and obligations that have arisen during their partnership. However, the partners can agree among themselves that the partner conveying his partnership interest is not obligated to pay the deficit of this share to the partnership. The Supreme Administrative Court's rulings show that the interpretation in

legal praxis has moved toward the above-mentioned tax policy objective.

The partnership is not deemed to dissolve when a partner is resigning.

2.2.6 Liquidation of partnership

The taxation of partnership liquidation is carried out as if the assets of the liquidated partnership would be transferred for a fair market value. Liquidation proceeds are calculated at partnership level and taxed as taxable income for partners.

Liquidation of a partnership is in the partner's taxation treated according to the decision from SAC (SAC 2000:71) as a sale of the partnership interest. This means that there is a possibility for a capital gain if the partner's distributive portion is higher than his acquisition cost of the partnership interest. It is also possible that there is a capital loss if the amount of partnership's liabilities transferred to the partner is higher than the assets or the acquisition cost of the partnership interest. Capital losses may only be set off against capital gains arising in the same year or the following five years.

Unutilized tax losses of the partnership cannot be transferred to the partners at the liquidation.

2.2.7 Private Equity Investment Limited Partnerships

According to Section 9 of ITA the tax treatment of nonresident limited partners of Finnish private equity investment limited partnerships differs from the tax treatment of other partners in partnerships. The special treatment applies provided that there is an applicable tax treaty between Finland and the partner's state of residence. If the Finnish limited partnership is engaged only in private equity or venture capital activities, the limited partner is taxed for his share of the profits of the partnership only to the extent that the income would be taxed in Finland if the partner received it directly. The tax consequences are thus the same that would apply, if the partner received the income directly. If a type of income is tax exempt for a nonresident, it is tax exempt even if it is received via a partnership. Tax treaty benefits available to that type of income are also applicable. This limited extent of taxation applies even if the partnership would be treated as a permanent establishment for the partner. According to the decisions SAC 2007:10 and 2007:11, no withholding tax can be collected on that type of income.

2.2.8 Foreign partners in the Finnish partnership

The nonresident partner's share of the domestic or foreign-source profits of a Finnish partnership is considered to be Finnish-source income (Section 10 of ITA) and may be taxed in Finland as income of the nonresident partner. This provision gives Finland right to tax the foreign partner on his share of the income from the Finnish partnership. The Finnish partnership has a permanent establishment in Finland and thus Finnish-source income. According to the decision SAC 2002:34, the foreign partner is considered to have Finnish-source income, which has derived from a permanent establishment in Finland. Thus the income share of a nonresident partner in a partnership is taxable in Finland as Finnish source income.

The income is divided in the same way as for resident individuals to be taxed as capital income and earned income of the individual partners. The taxation is carried out by assessment in accordance with the Act on Assessment Procedure. The nonresident taxpayer must file a tax return.

2.2.9 Foreign partnerships

The concept of foreign partnership is not defined by tax law. Foreign partnerships are subject to similar tax treatment that applies to domestic partnerships. The profit share of the Finnish resident partner is taxed as the partner's income even when the partnership does not make a profit distribution. The partners and not the foreign entity are regarded as being liable for tax for the entity's profits even though the entity may be treated as separate tax subject in the foreign state. The profit share is fixed separately for each income source of the foreign entity: business income, personal income, and agriculture income. The division of the profits between different income sources and income categories is carried out in the same way as for Finnish partnerships. The resident partner's share of the partnership's tax losses is deductible from the partner's profit shares in the future years. Nonresident partners of the foreign entity are not subject to tax for the entity's profits if the entity does not have Finnish-source income.

Possible international double taxation is eliminated in Finland in accordance with the Act on the Elimination of International Double Taxation. Foreign taxes paid by the foreign partnership and the Finnish resident partners are both creditable in taxation of the partners in Finland. The possible corporate treatment abroad does not bar the credit provided that the foreign entity qualifies for the partnership treatment in Finland.

2.2.10 Partnership as a member in group of companies

A partnership may be a member in domestic or cross-border group of companies. As taxation principles applied on Finnish partnership taxation are normal, the benefits of partnership in group structure are normally quite minimal. Under certain circumstances, Finnish limited liability companies may grant group contributions to each other even if they are members in a cross-border structure. But if the Finnish limited liability company is a subsidiary or a sub-subsidiary of a partnership, the right to deduct the granted group contribution is lost.

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3 Iceland

By Erna Hjaltested

3.1 Introduction

In the previous years, the most common type of company in Iceland has been the limited liability company or the private limited liability company. This development is mainly due to the limited liability of the owners toward creditors and third parties, the reasonable cost of establishing a private limited liability company and because the tax rules for these companies have been considered rather beneficial. In 2009, changes in the taxation of limited liability companies and their dividends⁴⁶ decreased their popularity

and instead the number of limited partnerships increased significantly.⁴⁷ This change in the tax legislation for limited liability companies in 2009 was called the 20/50 rule and provided that a dividend of up to 20 percent of the equity was taxed as capital income in the hands of the shareholders. Half of any dividend payment exceeding 20 percent of a company's equity was taxed as wages and half as capital income. This change in the legislation affected limited liability companies considerably and is considered to have caused the before-mentioned shift in a choice of business form from private limited liability companies to limited partnerships. The 20/50 rule has since been abolished with effect from January 1, 2014.⁴⁸

Limited liability companies have been regulated in Iceland since 1921 and when the EEA Agreement entered into force on January 1, 1994 the legislation in this area was adapted to EU legislation Björgvinsdóttir (2004).

Partnerships have, however, historically also been commonly used as an organization to conduct business in. As already mentioned, their popularity has increased among small and medium enterprises in the past few years due to a less favorable tax regime for limited liability companies and also because the partnership form is more flexible than the limited liability company. Subsequently, the number of newly registered partnerships, especially limited partnerships, has been on the increase.

3.2 Company law aspects

3.2.1 Introduction – history

There are three main types of partnerships under Icelandic law where at least one of the partners has unlimited liability for the partnerships liabilities. The unlimited liability is the decisive factor that distinguishes partnerships from other types of business organizations. The most common one is the general partnership, but the number of limited partnerships and partnerships limited by shares has increased in later years.

3.2.2 General partnership (*sameignarfélag*)

General partnerships are regulated by Act 50/2007 on General Partnerships, which came into force on January 1,

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46 Act No 128/2009 amending the Income Tax Act No 90/2003 (Icel.).

47 The number of newly registered limited partnerships has increased by 219 percent since 2009.

48 Act No 142/2013 amending the Income Tax Act No 90/2003 (Icel.).

2008.⁴⁹ Before the entry into force of this Act, there was no general legal act on general partnerships in force in Iceland and the law in this area consisted of a few legal provisions but mostly judicial practice. Partners in a general partnership, which conduct a business jointly, have unlimited liability for the partnership's obligations.⁵⁰ Usually, the partners enter into a partnership agreement when establishing the partnership and register the general partnership with the Public Register of Enterprises where the partnership agreement is filed. A partnership needs to have at least two partners and the partners can be an individual or a legal entity.⁵¹ The partners cannot, however, be a married couple. There is no minimum capital required by law as that is left up to the partners to agree upon. The reason why it wasn't considered necessary to set a minimum capital requirement in the General Partnership Act is the unlimited liability of the partners. To dissolve the general partnership, all partners need to agree on the dissolution, a winding-up committee should be established, a notification posted to alert all creditors, and finally the Public Register of Enterprises should be notified of the dissolution. Partnership agreements can also provide for more detailed rules on the dissolution of the partnership.

3.2.3 Limited partnership (*samlagsfélag*)

In a limited partnership, there is at least one partner that has unlimited liability for the partnership's obligations but other partners bear limited liability, which is then limited to their financial contribution to the partnership. There are a few legal provisions covering this type of partnership, which can be found in the Act on Commercial Registries, Firms and Proxy No 42/1903 but no general act on limited partnerships is in place. A limited partnership is established by a partnership agreement and should be registered with the Public Register of Enterprises where the partnership agreement is filed. There is no minimum capital required by law as that is left up to the partners to agree upon. A limited partnership needs to have at least two partners but the partners can be an individual or a legal entity. The partners cannot, however, be a married couple. To dissolve the limited partnership, all partners need to agree on the dissolution.

3.2.4 Partnership limited by shares (*samlagshlutafélag*)

A partnership limited by shares is a partnership entered into between one or more jointly and severally liable partners, known as managing partners, and one or more shareholders, who are only liable to lose their investment amount. The managing partner can also be a shareholder. Partnerships limited by shares are governed by the Act on Limited Liability Companies No 2/1995⁵² but specific provisions therein only apply to partnerships limited by shares. The minimum capital requirement is the same as in a public limited liability company or 4 million ISK.

3.3 Tax law aspects

3.3.1 Introduction

Icelandic tax law provides that general and limited partnerships, as well as partnerships limited by shares can at establishment choose whether they want to be taxed as an independent entity for tax purposes or whether the partnership should be considered transparent for tax purposes.⁵³ To become an independent entity for tax purposes, the partnership agreement reflecting this choice along with a registration form has to be filed with the Public Register of Enterprises.⁵⁴ In the case of partnerships, this choice is irreversible and the deciding factor on how independent tax entities are distinguished from transparent entities. If the partnership chooses not to become an independent tax entity it is treated as transparent and any income derived from the partnership is taxed as business income in the hands of the partners Knudsen (1985). The rules on the taxation of general and limited partnerships are the same and the discussion below will therefore only distinguish between the two if there is a difference, which needs to be highlighted. Respectively, if a partnership limited by shares chooses to be an independent tax entity, it is taxed in the same manner as a limited liability company. The discussion below will describe the general tax rules applicable to partnerships, but it should be kept in mind that entities operating in the financial sector are liable to additional taxes, levied on the total amount of debt of a

⁴⁹ <http://www.althingi.is/lagas/nuna/2007050.html>

⁵⁰ Article 8 of the General Partnership Act (Icel.).

⁵¹ Article 6 of the General Partnership Act (Icel.).

⁵² Chapter XX of the Act on Limited Liability Companies No 2/1995 (Icel.) concerns partnerships limited by shares.

⁵³ Litra 1 and 3, paragraph 1, Article 2 of the Income Tax Act No 90/2003 (Icel.).

⁵⁴ Litra 1, paragraph 1, Article 2 of the Income Tax Act No 90/2003 (Icel.).

financial institution,⁵⁵ wages, and profits exceeding 1 billion ISK respectively.⁵⁶

3.3.2 Taxation of a partnership as an independent tax entity

The tax base of a partnership, which is taxed as an independent tax entity, is calculated in the same way as a limited liability company. That means that the same items can be deducted from the gross income as in a limited liability company, except that the partnership does not enjoy a participation exemption for dividends and is therefore subject to 20 percent income tax on dividends received, which is the same tax rate as individuals would pay on that type of income. The tax percentage is, however, different. Partnerships are subject to a 36 percent tax on their profits while limited liability companies are subject to 20 percent tax. The partners in a partnership are, however, not taxed again on the distributions from the partnership whereas individuals receiving dividends from a limited liability company are taxed with a 20 percent tax.

3.3.2.1 Depreciation

The same rules on the depreciation of tangible fixed assets apply to any type of business under Icelandic law.

3.3.2.2 Loss

A partner in a partnership taxed as an independent tax entity cannot deduct loss from the partnership from any other business income the partner may have. This is in line with the partnership being tax independently, so that any gain or loss is limited to the partnership and is not transferred to the partners.

If a partner provides the partnership with a loan, the interest, given that it is comparable to interest calculated between unrelated parties, is deductible from the partnership's profits.

3.3.2.3 Payments from the partnership

A partner who devotes most of his time working for the partnership should pay himself the minimum imputed wage, which depends on in which line of business the partners are in.⁵⁷ According to the rules on the minimum imputed wage, the amount that should be calculated as wages therefore differs depending on the relevant sector. Wages are subject to social security contribution, municipal tax, and are deductible from the profits of the partnership. The remaining profits of the partnership are then taxed at the partnership level with a 36 percent tax. Once distributed to the partners it is not taxed further.

3.3.3 Taxation of a partnership when transparent for tax purposes

Icelandic tax law provides that the net method of taxation is applied when calculating the tax for each partner Vilhjálmsson (2003). This entails that the difference between the gross income and deductible costs of the partnership is divided between the partners depending on their share in the partnership as taxable income. The income is then subject to personal income tax in the case of individuals, which is progressive starting at 37.30 percent and peaking at 46.24 percent.⁵⁸ If the partner is a limited liability company, it is taxed along with other business income at the 20 percent corporate income tax rate. The partners can, therefore, be subject to different tax rates depending on their individual circumstances.

3.3.3.1 Depreciation

The same rules on the depreciation of tangible fixed business assets apply to any type of business under Icelandic law.

3.3.3.2 Loss

If the partnership is run at a loss, the loss should also be divided between the partners according to the provisions of the partnership agreement, which usually would reflect

⁵⁵ See, Act No 155/2010 on the Bank Tax (Icel.).

⁵⁶ See, Act no 165/2011 on the Financial Activities Tax (Icel.).

⁵⁷ Rules No 1172/2014 on the minimum imputed wage for 2015, published in *Stjórnartíðindi* on 19 December, 2014 (Icel.).

⁵⁸ Personal income tax rates, including municipal income tax for 2015.

their share in the partnership. Loss incurred from the partnership which is a transparent tax entity can be deducted from other business income of the respective partner Vilhjálmsson (2003). Loss incurred from a partnership which is an independent tax entity is, however, not deductible from other business income.⁵⁹ The limited liability of participants in a limited partnership does not affect the possibility of deducting loss from the tax base of the participant.

3.3.3.3 Payments from the partnership

Payments from the partnership to its partners are taxed differently depending on their nature; interest for instance would be taxed at a 20 percent income tax rate in the hands of an individual partner, which is the tax rate applicable to interest income of individuals. A certain part of the income from the partnership would, however, always qualify as wages and be taxed as such and also be subject to social security contribution and municipal tax.

3.3.4 Taxation of a partnership limited by shares

Since 2006, partnerships limited by shares can also choose whether they want to be transparent or independent for tax purposes.⁶⁰ If the partnership limited by shares decides to be an independent taxed entity, it is taxed in the same way as limited liability companies in Iceland at a 20 percent income tax.⁶¹ Distribution of the profits is considered a dividend and taxed at a 20 percent income tax in the hands of shareholders who are individuals and partnerships. A corporate shareholder would enjoy a participation exemption and therefore this type of income would be deductible from its business income.⁶² If a partnership limited by shares decides to be a transparent entity its income is taxed in the hands of the partners. As the partnership is transparent a corporate shareholder would benefit from a participation exemption when receiving dividends.⁶³

⁵⁹ ÚRN 111/1986 and 635/1989.

⁶⁰ Act No 77/2006 amending the Income Tax Act No 90/2003 (Icel.).

⁶¹ Litra 1, paragraph 1, Article 2 of the Income Tax Act No 90/2003 (Icel.).

⁶² Litra 9, paragraph 9, Article 31 of the Income Tax Act No 90/2003 (Icel.).

⁶³ Advance ruling from the Internal Revenue Service No 4/2007.

3.4 Change in the ownership of a partnership and dissolution

When a general partnership is established, the partners can contribute certain assets to the partnership, although there is no minimum requirement for this contribution by law. In some cases, this transaction can be considered as a sale and any capital gains from the sale is taxed in the hands of the partner.

A partnership agreement would normally set some limitations as to how a partner can sell or pledge his or her share in the partnership. This is to be expected as it is very important who your partner in a partnership is, not the least due to the unlimited liability of at least some of the partners. When a new partner enters the partnership, the partner is considered to be buying a share in the partnership's assets and liabilities. The partner would usually become liable for any of the partnership's liabilities, also from the time before he joined the partnership, unless the partnership agreement states otherwise.

Therefore, the partnership agreement would usually also provide for rules on how a partner can leave the partnership and redeem his share in the partnership. Usually, this requires six months' notice but the partner is entitled to the value of his share at the point in time when s/he decides to leave.

Generally, the partnership agreement also provides for rules on how the partnership should be terminated. If only one partner remains in the partnership, the partnership is terminated. In cases when a partnership is established for an unlimited period of time, a notice from one of the partners would start the dissolution procedure.

The taxation of the partner when selling their share in the partnership is different, depending on whether the partnership is a transparent or an independent tax entity Vilhjálmsson (2003). In the case of a transparent tax entity, the partner is considered to be selling a share in different types of assets and the attached liabilities. The gain can therefore be calculated differently depending on the asset and on the rules on depreciation of these assets Vilhjálmsson (2003). In the case of an independent tax entity, the partner is considered to be selling his or her share in the capital of the partnership minus liabilities and the original contribution, i.e., the net method is used to determine the capital gain.

3.5 Antiavoidance rules

There are various antiavoidance rules in Icelandic tax law but no general antiavoidance provision. Article 57

of the Income Tax Act is what scholars and the courts have deemed to be the closest to what could be considered a general antiavoidance provision. Ad verbatim the rule affirms the principle that transactions between parties should be made at arm's length and that tax authorities can redetermine the value of property and services if their price is unusual. Many have nevertheless argued that the scope of Article 57 of the Income Tax Act is wider and that the provision in fact contains a general antiavoidance rule Valdimarsson (1999). The Supreme Court has, in any event, held that a transaction may be disregarded if its main purpose is to avoid taxation. It can therefore be said that Icelandic courts have agreed to a "substance over form" approach to some extent Agnarsdóttir and Jensdóttir (2014). On that basis, tax authorities have recharacterized some transactions, deeming them to be entered into for the sole purpose of avoiding taxes. There is, however, not a special antiavoidance rule aimed at partnerships and a partnership would not be considered an independent tax entity unless it had requested so at establishment.

3.6 National rules relating to international aspects

According to the General Partnership Act, a partnership is considered Icelandic when registered in Iceland or in the case of a nonregistered partnership if the majority of the partners reside in Iceland and the major part of the business takes place in Iceland. A partnership can therefore be considered Icelandic according to the General Partnership Act, even if the partners are foreign. The partnership can choose between being an independent tax entity or a transparent tax entity. A foreign partner in a partnership that is transparent would be taxed on any business income derived from Iceland based on provisions in the Income Tax Act on limited tax liability. If a partner is a foreign company and the partnership is not an independent tax entity, it is also possible that the shareholder's operations in Iceland would be considered a permanent establishment. Such an estimate would first and foremost depend on Icelandic law and secondly on the tax treaties Iceland is party to. Provisions on limitation of benefits in double tax agreements could, on the other hand, limit the possibilities of such a partnership to make use of such an agreement but this would need to be assessed on a case by case basis.

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4 Norway

By Gro Ekrem Berg

4.1 Company law

4.1.1 Qualification of companies

4.1.1.1 Introduction

Businesses assessed as partnerships (DLS) are regulated with regard to company law by Act 83 of June 21, 1985 on partnerships. Shipping partnerships are also regulated in detail in Chapter 5 of Act 39 of June 24, 1994 on the Norwegian Maritime Code for businesses assessed as partnerships.

Initially, we will briefly discuss what constitutes a company in accordance with the Partnership Act, followed by a few words about the different types of company in accordance with the Partnership Act. Shipping partnerships are referred to in item 4.1.1.3.

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4.1.1.2 Companies in accordance with the Partnership Act.

4.1.1.2.1 General

The provision of Section 1-1 of the Partnership Act stipulates three cumulative conditions that must be fulfilled for a company to exist in the context of the Partnership Act:

1. The operations must be considered as a "business activity."
2. This business activity must be run at the "joint expense and risk" of several partners.
3. At least one of the partners must have an "unlimited personal liability" for the enterprise's obligations.

Condition no. 1 marks the delimitation between an ordinary joint ownership (statutory joint ownership) and a company. A joint ownership as such does not carry out a "business activity". There are no such business activity requirements for limited liability companies, which are separate taxpaying entities. The requirement states that the activity must be able to yield a surplus. It must have a certain scope and duration.

Condition no. 2 marks the delimitation between a sole proprietorship and a company. A sole proprietorship has only one active party.

In companies and associations that are separate tax entities, all owners will have a limited liability. This particularly applies to foreign companies for whom it can be difficult to define a boundary between a company equivalent to a Norwegian business assessed as a partnership and those equivalent to a limited liability company, etc. (see item 4.2.4.2).

A business assessed as a partnership may be established by entering into a partnership agreement. The company shall be regarded as formed once the partnership agreement has been signed by all partners. From the preparatory works to the Act, it is apparent that such form requirements are not critical to validity. Once the three previously mentioned conditions have been fulfilled, a company will exist even if such requirements as to form are not observed.

The partnership meeting is the company's highest authority. In principle, all partners (except silent partners) shall attend the partnership meeting. The company is under no obligation to form a board or appoint a general manager but if a board or general manager exist, they are in principle obliged to attend the partnership meeting.

Companies that come under the Partnership Act shall register in the Register of Business Enterprises in accordance with Act 78 of June 21, 1985 on the Registration of

Business Enterprises (which does not apply, however, to internal partnerships) but is not a condition that must be fulfilled in order to consider a general partnership as having been established.

4.1.1.2.2 General partnerships (ANS and DA)

A general partnership is defined in Section 1-2, first paragraph (b) of the Partnership Act as a partnership in which the partners have unlimited personal liability in respect of the company's total obligations, either divided or for parts which together constitute the company's total obligations and which appear as such to third parties. Companies in which liability is divided are regarded as a DA (shared partner liability). Shared liability must be registered in the Register of Business Enterprises or known to creditors in order to have any effect on creditors.

The company's creditors must first raise a claim against the company. If the company does not pay within 14 days as required, the creditors may approach the individual partners. Creditors may also directly approach the partners if it is obvious that the company is unable to pay.

Partners who have settled a company debt may claim recourse (repayment) from the company or from the other partners (cf. Section 2.5 of the Partnership Act).

A general partnership has *locus standi*, rights, and obligations before a court of law and other authorities (cf. Section 2-1 of the Partnership Act).

Section 2-3 of the Partnership Act stipulates that the partners shall establish a partnership agreement and that this shall be signed by the partners (although not silent partners if such partners exist in the company). As a minimum the partnership agreement shall contain provisions about the company's business name, names, and places of residence of all partners (except silent partners), the objective of the company, the municipality in which the company has its head office, whether or not the partners shall make a partnership contribution, and, if so, the value of invested assets (cf. Section 2-3 of the Partnership Act).

There is no requirement under the Partnership Act for the partners to make a partnership contribution in the company, although this is often regulated in the partnership agreement (cf. Section 2-6 of the Partnership Act).

4.1.1.2.3 Limited partnerships (KS)

Section 1-2 first paragraph (e) of the Partnership Act defines a limited partnership as a company in which at least one partner has unlimited liability (general partner) in respect

of the company's obligations and in which at least one other partner has limited liability in a stipulated amount in respect of the company's obligations (limited partner) without being a silent partner. Limited partnerships are regulated in more detail in Chapter 3 of the Partnership Act.

Limited partnerships have *locus standi*, rights and obligations before a court of law and other authorities (cf. Section 2-1 of the Partnership Act).

A partnership agreement shall be drawn up, which, in addition to what is pursuant to Section 2-3 of the Partnership Act, shall contain provisions regarding the partners in respect of company obligations, company capital, as well as how high a proportion of this is tied-up capital (cf. Section 3-1 second paragraph of the Partnership Act), partners' contribution obligations, payment of company capital, and whether or not the general partner or general manager is entitled to run another enterprise (cf. Section 3-2 of the Partnership Act).

The company shall have specific company capital, of which at least 40 percent shall be tied-up capital (cf. Section 3-1 of the Partnership Act). The tied-up capital shall be paid into the company, at least 20 percent prior to registration in the Register of Business Enterprises and the remainder no later than two years after the company was registered. There shall be at least one general partner who must invest at least 10 percent of the company capital, own at least 10 percent of the company's net capital at any given time, and have at least an equally large share of the surplus and deficit. The individual limited partner shall make a contribution of at least NOK 20,000 (cf. Section 3-5 of the Partnership Act).

If the tied-up capital is not paid in to the company within the two-year deadline, the company can be dissolved. If the company continues to operate even though the limited partnership has been dissolved, the regulations regarding general partnerships shall come into effect. This means that the partners must now assume unlimited liability for the company's obligations.

Loans from the company to the partners are limited in accordance with the regulations in Section 3-17 of the Partnership Act. Loans or collateral must be within the free (not tied-up) equity.

4.1.1.2.4 Internal partnership (IS)

Section 1-2 first paragraph (c) of the Partnership Act defines an internal partnership as a company that does not appear as such to third parties. It is most often one person (physical or company) who has the unlimited liability and who

acts externally, often referred to as the principal. There may be several parties who act externally. In an internal partnership, one or more partners can be silent partners. A silent partner is a partner for whom it has been agreed that there shall be no external participation and that the partner has limited liability only in a stipulated amount.

There is no requirement regarding a written partnership agreement.

It is the principal (principals) who act externally who have *locus standi*, rights, and obligations in accordance with the Partnership Act (cf. Section 2-1 second paragraph). The company's creditors must relate to the principal (principals) and may not approach the silent partners (cf. Section 2-4 fourth paragraph of the Partnership Act).

4.1.1.3 Shipping partnerships

Shipping partnerships are regulated in more detail in Chapter 5 of the Norwegian Maritime Code and fall outside of the regulations of the Partnership Act (cf. Section 1-1 fourth paragraph of the Partnership Act).

Shipping partnerships are companies whose objective is to run a shipping enterprise and in which the members have unlimited liability for the company's obligations, either jointly or in relation to their shares in the company (shared/pro rata) (cf. Section 101 of the Norwegian Maritime Code). In practice, a shipping partnership can be considered a liability partnership that runs a shipping enterprise.

4.1.2 Changes to the ownership circle

4.1.2.1 Entry

Upon entrance of new partners following formation of the company, the partners entering the company shall agree in writing to the partnership agreement. The provisions of the partnership agreement will then also be binding upon the new partners. The partnership agreement determines whether the entering partners shall pay a contribution.

The Register of Business Enterprises shall also be notified when new partners enters, in accordance with Chapter 4-1 of the Register of Business Enterprises Act.

The new partners shall be liable for the company's obligations. Unless otherwise agreed, this also applies to obligations that have arisen before any new partner has entered the company (cf. Section 2-4 of the Partnership Act).

4.1.2.2 Change of ownership

Unless otherwise agreed, transfer of ownership share (wholly or partially) to a new owner requires the consent of the other partners (cf. Section 2-28 of the Partnership Act). The partners may agree that the ownership share may be transferred freely. It is often agreed that the other partners will also have an option to buy the shares. The option to buy shares is regulated in detail in Section 2-29 of the Partnership Act. Such an agreement can be practical if, for example, there are many partners and the share is a pure capital investment that does give any entitlement to managing the company.

The acquirer assumes the transferor's rights and obligations. The transferor is still liable for the obligations that were incumbent on the company on the date of transfer. The transferor can be exempted from the obligations upon written request to be exempted from liability. If the creditors do not respond to the request, the transferor shall be exempt from liability three months after the request was received by the creditors. See Section 2-30 of the Partnership Act.

4.1.2.3 Withdrawal

A partner has the right to withdraw from the company. This is regulated in detail in Sections 2-32 to 2-35 of the Partnership Act. Partners may demand to be bought out with six months' notice. The buyout price shall be determined by the value of company shares upon expiry of the period of notice.

4.1.2.4 Exclusion

In certain instances, for example, if a partner acts in serious breach of the business relationship or has entered bankruptcy or composition proceedings, the partner may, upon written notification, be excluded from the company via a buyout in accordance with Section 2-36 of the Partnership Act.

The resolution shall be made at a partnership meeting, or in a court of law, where applicable. The provisions of Sections 2-33 to 2-35 apply correspondingly.

4.1.3 Liquidation/cessation

Liquidation and cessation of a company is regulated in detail in Sections 2-37 to 2-42 of the Partnership Act. Resolu-

tions on buyouts shall be passed in partnership meetings. In certain instances, an individual partner can demand that the company be dissolved immediately. This applies when the partner's rights have been violated through a serious breach of the business relationship and reference to withdrawal in accordance with Section 2-32 of the Partnership Act cannot be deemed reasonable, or when substantial grounds would otherwise indicate dissolution. The resolution shall be made at a partnership meeting, or in a court of law, where applicable.

A liquidation board will normally be appointed. The Register of Business Enterprises shall be notified of the resolution on dissolution and creditors shall be notified via announcement to submit claims within six weeks of the announcement. The individual partner can request that the company obligations are settled or that adequate collateral is pledged for them. Following this, a liquidation settlement shall be presented to the partnership meeting. Once the liquidation settlement has been approved, the date of liquidation must be registered in the Register of Business Enterprises.

4.2 Tax law

4.2.1 Qualification of companies

Which companies shall be assessed as partnerships is pursuant to Act no. 14 Section 2-2 second paragraph no. 14 on Tax. These are liability partnerships (ANS, including companies with shared partner liability (DA), limited partnerships, (KS), internal partnerships (IS), and other companies included in Section 1-1 first paragraph of the Partnership Act. There are also shipping partnerships (cf. Chapter 5 of the Norwegian Maritime Code). For a more detailed description of the types of companies, see item 4.1.1.

Spouses who have sole ownership (no other owners) of a liability partnership (ANS and DA) and limited partnership, KS, must fulfil detailed regulations stipulated in Section 10-48 of the Tax Act and Section 10-48-1 of the FS-FIN Regulations in order to be assessed as a partnership. Out of notoriety considerations, requirements have been stipulated that a turnover statement must exist and that the company must be registered in the Register of Business Enterprises. If the spouses have sole ownership of an internal partnership (cannot be registered in the Register of Business Enterprises), for tax purposes, this will be considered as a sole proprietorship.

Foreign entities with Norwegian partners shall be assessed in accordance with regulations that correspond to the Norwegian regulations, see item 4.2.4.2.

4.2.2 Taxation – ongoing and in the transfer of assets

4.2.2.1 Introduction

Businesses assessed as partnerships are per definition not separate tax entities. Income and capital are taxed on partners who are separate tax subjects. Partners can be both physical persons (personal partners) and legal persons such as companies and amalgamations, etc. (referred to in the report as company partners), for example, limited liability company or business assessed as a partnership (DLS). If a DLS owns shares in another DLS, the share of income and capital from the underlying DLS shall be included in the income and capital of the DLS that owns the shares, etc., until the point when there is a partner who is a separate tax subject.

Transactions between the company and partners shall be regarded as transactions between independent tax subjects (cf. Section 10-45 of the Tax Act). Exceptions are made on certain conditions through the regulations regarding intragroup transfers in Section 11-21 of the Tax Act.

Taxation of partners in businesses assessed as partnerships are regulated in Sections 10-40 to 10-49 of the Tax Act for income tax and Sections 4-40 to 441 for assets.

In the Norwegian tax reforms of 2006, the risk-free return method was introduced regarding the taxation of company and business income. The method means that companies are initially taxed on an ongoing basis on their income (surpluses and deficits). Tax is also paid on dividends from the company to personal partners for that part of the dividends that exceed a calculated risk-free yield on the invested capital (risk-free return). Both ongoing surplus tax and dividends to personal partners shall be taxed in the general income of the revenue basis, in which the tax rate at present is 27 percent.⁶⁴ The risk-free return method applies to both limited liability companies and DLS' but technically it is implemented somewhat differently due to assessments as a partnership in DLS. The implementation method for limited liability companies is described as the "shareholder model" and for DLS as the "partner model". In addition, self-employed persons are taxed in accordance with another variant of the risk-free return method, which is described as the "business model."

⁶⁴ The tax rate for general income at present is 27 percent. For personal taxpayers in a municipality in Finnmark or in the municipalities of Karlsøy, Kvænangen, Kåfjord, Lyngen, Nordreisa, Skjervøy, and Storfjord in Troms county, the tax rate is 23.5 percent. This applies to all general income.

In respect of company partners, no dividend tax shall be implemented. This is in order to avoid chain taxation. However, company partners shall enter three percent of the dividends in accordance with Section 2-38, sixth paragraph of the Tax Act.

The risk-free return method ensures that the income of personal partners is taxed in a relativity similar manner to income from independent business activity. Thus, the method helps to prevent tax avoidance when reclassifying income. Marginal tax on owner income is $27 + ((1 - 0.27)27) = 46.71$ percent. Owner income does not give entitlement to the accrual of rights in the Norwegian National Insurance scheme.

In the tax reforms of 2006, the exemption method was also introduced in Norway. The exemption method means that a company that is generally exempt from tax on dividends and profits on shares and units will also not receive any deductions for corresponding loss. The purpose is to prevent share income, etc. from being taxed several times in the owner chain (chain taxation). The exemption method also applies in the case of ongoing income taxation of businesses assessed as partnerships. The provisions regarding the exemption method may be found in Section 2-38 and Section 10-41 second paragraph of the Tax Act.

Even if the exemption method in principle means exemption from tax at the company level, 3 percent of income shall be recognized as income.⁶⁵ This income recognition is based on the cost of acquisition of such income being deductible and is intended to be a stipulated compensation for this.

In principle, the exemption method also applies when company partners realize shares (see item 4.2.3.4.3).

4.2.2.2 Net assessment method

From the net assessment method in Section 10-41 of the Tax Act, it follows that profit/loss shall be calculated for a company as if it was a separate tax entity. The company as a calculation unit has its own tax positions. This means that if, for example, the company sells an asset, the gain or loss in respect of the asset shall be calculated at a company level. Depreciation also occurs at a company level, which

⁶⁵ In other words, income recognition at 3 percent applies to exempted income at a company level in accordance with Section 10-41 second paragraph. In addition, company partners shall also enter 3 percent of the dividends from DLS in accordance with Section 2-38 of the Tax Act.

means that the partners receive individual depreciation on company assets. The exemption method, regarding tax exemption for certain companies, etc., income on shares and other assets (cf. Section 2-38 of the Tax Act), is applicable when calculating income at a company level (cf. Section 10-41 second paragraph). The exemption method means that, in principle, share income, etc. is exempt from tax at a company level. However, the company shall enter 3 percent of the exempt income in accordance with Section 10-41 second paragraph and Section 2-38 sixth paragraph of the Tax Act. Share income, etc. from companies in low tax countries that have not actually been established in or run an actual enterprise within an EEA country shall be taxed anyway (cf. Section 238 third paragraph of the Tax Act).

The calculation of surpluses and deficits is similar for partners regardless of whether they have limited or unlimited liability (joint and several liability or shared liability) or whether they are personal partners or company partners.⁶⁶

If one or more partners receive remuneration for work (remuneration for work input/owner salary) in accordance with Section 226 of the Partnership Act, this shall be deducted before any surplus or deficit is allocated between the partners.

Interest on capital investments credited to the partners in accordance with Section 2-25 second paragraph of the Partnership Act is not an operating expense for the company and is therefore not a deduction that affects the calculation of surpluses and deficits for the company. Such interest will be a surplus dividend for the partners, and shall be treated as a dividend.

Once income and assets have been determined at a company level, income and assets shall be allocated to the partners. If the partners have not agreed on another allocation, the income will be distributed in accordance with the principles of the Partnership Act, which means equally large shares to each of the owners. However, for partners who have made a partnership contribution, the interest shall be distributed first, in accordance with Section 2-25 second paragraph of the Partnership Act. The partners may agree on a different allocation if they wish. For Norwegian businesses assessed as partnerships, income is often

⁶⁶ It is true that the specific provision for partners who are insurance companies in Section 2-38 seventh paragraph of the Tax Act means that the exemption method cannot apply for their share of income that would otherwise have been exemption method income for the company. The reason for the regulation is that these partners receive deductions for allocations in accordance with Section 8-5 of the Tax Act and that there would be no symmetry if the income was tax free.

distributed in accordance with ownership shares or earnings.

Upon realization of shares in the course of a year, surpluses and deficits shall be allocated proportionally between transferor and acquirer in accordance with the number of months they have owned the shares. The transfer month shall be assigned to the acquirer. This means that if the shares are sold in July and on the date of transfer there is a probable deficit, but that at the end of the year there is, in any case, a surplus, e.g., because the company has sold a property recognized as a major gain, then the seller and buyer shall be attributed one-half (6/12) of the surplus each.

Both personal partners and company partners shall be taxed on any surplus at the present rate of 27 percent. Partners with unlimited liability (joint and several liability or shared liability) can fully coordinate income from DLS with other income. This means that any deficit from a DLS can be deducted from other income or vice versa.

Partners with limited liability (limited partners and silent partners) cannot deduct the deficit from a DLS in other income, but must carry it forward against subsequent surplus or profit from the company (cf. Section 10-43⁶⁷ of the Tax Act).

4.2.2.3 Transfer of assets from companies and partners

4.2.2.3.1 Introduction

Transfer of assets from partners to companies will be either paid-up partnership contributions or loans.

Transfer of assets from companies to partners will take the form of either remuneration for work, repayment of paid-up equity, dividends, or loans.

4.2.2.3.2 Remuneration for work

Remuneration for work is an allowance personal partners are entitled to for work input in the company's business (cf. Section 2-26 of the Partnership Act). This will reduce the surplus or increase the deficit. Limited partners and silent partners can receive the allowance classified as salary.

⁶⁷ This provision entered into force on January 1, 2015. It replaces the previous deduction framework for limited partners and silent partners in the former Section 10-43 of the Partnership Act.

In respect of partners, remuneration for work is usually business income (at present 27 percent), personal income (Section 12-2 (b) of the Tax Act) (at present 11.4 percent), and surtax (at present 9 percent⁶⁸ for income above NOK 550,550, 12 percent above NOK 885,600).

Employer's national insurance contribution is not calculated for the remuneration for work.

Remuneration for work that has not been paid shall still be taxed in the year of accrual. The partner will then have a receivable on the company. If the receivable is converted into equity, it shall be considered paid-up equity from the date of conversion.

4.2.2.3.3 Paid-up equity

Paid-up taxable equity constitutes the framework for the tax-free amount a partner can be repaid from the company without triggering extra tax in accordance with Section 10-42 of the Tax Act or income recognition in accordance with Section 2-38 sixth paragraph of the Tax Act. Paid-up taxable equity on shares will in principle correspond to historical partnership contribution (total contributions— repayment of paid-up equity) in the company from unit holders (current and previous).

If a dividend does not cover a partner's tax on the surplus component or if there is a deficit in the DLS, corrections to paid-up equity shall be made in accordance with Section 10-42 seventh paragraph of the Tax Act, so-called not real contributions and tax benefit on deficit (not real repayment)⁶⁹. This is to ensure an identical fiscal effect as for limited liability companies and shareholders. Such corrections shall be made for both personal partners and company partners. Deficits that must be carried forward due to restrictions on coordination access for partners with limited liability in accordance with Section 10-43 of the Tax Act do not constitute grounds for such corrections.

For shares prior to January 1, 2006, there are separate transitional rules stipulating that paid-up equity shall be equal to the partner's actual share of the company's tax value as per January 1, 2006 (cf. Section 10-49-2 of the FS-FIN Regulations). In the period following this date, the

same corrections shall be made for paid-up equity as always.

4.2.2.3.4 Dividends

For personal partners, dividends are liable for tax as general income in accordance with the regulations in Section 10-42 of the Tax Act. Company partners shall enter 3 percent of the dividend in accordance with Section 2-38 sixth paragraph of the Tax Act.

In principle, a dividend is any transfer of assets including cash transfers, transfers of every type of asset, provision of services, as well as the partner's whole or partial use of the company's assets. This also applies when the transfer of assets is an actual loan (item 4.2.2.3.5), or when it is classified as remuneration from work (item 4.2.2.3.2), or repayment of paid-up equity (item 4.2.2.3.3).

Interest on capital investments credited to the partners in accordance with Section 2-25 second paragraph of the Partnership Act will trigger tax on the date of the actual dividends and not on earned income.

In respect of calculating the taxable income for personal partners in accordance with Section 10-42 of the Tax Act, an allowance shall be made for tax calculations on the partner's surplus shares, risk-free returns, in accordance with Section 10-42 fifth paragraph and any unused risk-free returns from previous years.

The risk-free return equals the basis for the deductible risk-free return multiplied by a risk-free interest rate. For the income year 2014, the risk-free interest rate was 0.9 percent. The basis for the deductible risk-free return is the sum of the net cost price of company shares, acquisition costs, and the partner's contributions in the company, with the addition of unused risk-free returns from previous years. The contribution shall be equal to the value at the end of the year. Repayment of paid-up equity reduces the basis for the deductible risk-free return.

Dividends to company partners shall be recognized at three percent in accordance with Section 238 sixth paragraph of the Tax Act. The basis for calculating shall be reduced by tax on the partner's surplus shares. No deduction shall be made for risk-free returns. The effective tax rate is then 0.81 percent on the dividends.

In the event of chain ownership of a DLS (a DLS that owns another DLS), income recognition in accordance with Section 2-38 sixth paragraph shall occur on dividends in the individual link, i.e., in all links.

⁶⁸ For personal taxpayers in a municipality in Finnmark or in the municipalities of Karlsøy, Kvænangen, Kåfjord, Lyngen, Nordreisa, Skjervøy, and Storfjord in Troms county, the tax rate is 7 percent.

⁶⁹ The partner's share of the company's total equity does not change. An opposite correction must therefore be made in accrued equity.

4.2.2.3.5 Loans

Loans between companies and partners must be tangible⁷⁰ in order to be regarded as loans in a tax context. For Norwegian businesses assessed as partnerships, there are no general regulations in respect of company law that limit access to providing credit and collateral to partners (owners) and their associated parties as there are for limited liability companies in accordance with Section 8-7 to 8-11 of the Limited Liability Companies Act/Joint Stock Public Companies Act.⁷¹ However, for limited partnerships, Section 3-17 of the Partnership Act sets limits on when the company can offer loans to partners. Loans and any collateral must remain within the free equity.

Interest income shall be taxed as capital income in accordance with Section 5-20 of the Tax Act, and a deduction will be granted for debt interest in accordance with Section 6-40 of the Tax Act. This applies to both calculation of income at a company level, and for partners.

Interest must reflect the market situation. This is pursuant to the regulations on discretionary determination in the case of a commonality of interest in Section 13-1 and in Section 10-45 of the Tax Act stipulating that transactions between partners and the company shall be considered as transactions between independent parties.

Interest free or reasonable loans from the company to partners shall be treated at the company as withdrawals in accordance with Section 5-2 of the Tax Act. Income supplements at the company shall be set at the market rate.

Partners shall be granted a deduction for debt interest corresponding to the recognized interest benefit at the company. The interest benefit shall also be treated as a dividend for the partners, or as remuneration for work or repayment of paid-up equity if conditions for this are in place.

In the case of rent free or reasonable loans (assumed to be genuine loans and not partnership contribution) to the company, the company shall be granted a deduction for interest on debt, and a corresponding income recognition of the interest benefit on the part of the partner (cf. Section 10-45 and Section 13-1 of the Tax Act). The interest benefit

shall be set at the market rate. The interest benefit shall be treated as a contribution for the partner.

Interest on loans from personal taxpayers (no requirement for the taxpayer to be a partner) to the company that is not linked to a multiple debt instrument or bank deposit may be subject to extra tax in accordance with the regulations in Section 5-22 of the Tax Act. The purpose of the regulations is to prevent transfer of assets on the back of too high interest being taxed unnaturally favorably, as the company will receive a deduction for interest expenses, while the interest income will also be capital income for the lender. The regulations are in addition to normal taxation of interest income as capital income (general income) in accordance with Section 5-20 of the Tax Act.

Remission of loans or interest from businesses assessed as a partnership to partners will normally be liable for tax as a dividend to the partners, or as remuneration for work or repayment of partnership contribution if conditions for this are in place. If the remission of debt, however, is attributable to payment difficulties on the part of the partner, this will not represent a taxable benefit for the partner.

4.2.2.4 Type of liability – relationship between partners and the relationship with creditors

Which type of liability the different partners must assume in order to cover the company's obligations are described in item 4.1.1.2. As described in this item, creditors who wish to submit a claim directly toward the partners, must initially submit a claim to the company. 14 days after submission of the claim, the creditor may approach the individual partners. Contributions made by a partner under the provisions of the partnership agreement are to be considered a contribution in the company (paid-up equity, which increases the input value and basis for risk-free return). If a partner covers debt, etc. beyond this, the partner may, in principle, claim recourse from the company or the other partners under the provisions of their obligations.

If the taxpayer does not receive the excess from the company or the other partners due to an inability to pay, the loss is deductible if it has been incurred as a result of business activity. This will always be the case when the company runs the business. The loss will be deducted on the date it is finally confirmed.

Partners with limited liability who have guaranteed the company's obligations may claim recourse from the company, and from the other partners, where applicable, if the guarantee obligation is made valid. If the guarantor does not receive the excess from the company or the other

⁷⁰ What constitutes a genuine loan, etc. is dealt with in the *Lignings-ABC 2014/15* under the heading “Loans from employers/own company”, item 5.

⁷¹ It is true that it is prohibited to distribute the company's assets when this will clearly harm the interests of the company or creditors, in accordance with Section 2-26 fourth paragraph of the Partnership Act. Partners have a reversal obligation if funds have been distributed in breach of the provision.

partners due to an inability to pay, the loss is deductible if it has been incurred as a result of business activity. The loss will be deducted on the date it is finally confirmed.

4.2.3 Establishing a company and realization

4.2.3.1 Establishing a company

A company is established when two or more people start a business together that fulfils the requirements of Section 11 of the Partnership Act (see item 4.1.1). When establishing a company, it is only limited partnerships that require the partners to make contributions in the company (see item 4.1.1.2.3). To the extent that the partners make contributions, both cash and contributions in kind (assets), the relevant partner's input value and paid-up equity on the shares shall increase. For contributions in kind, the arm's length principle shall be observed. The price shall be set as between independent parties (cf. Section 131 of the Tax Act). The assets shall receive a new input value from the company and shall be considered as realized by the partners and can trigger ordinary taxation. This is because transactions between partners and the company shall be considered as transactions between independent parties (cf. Section 10-45 of the Tax Act).

A DLS can also be established through the merging of two DLSs or that one DLS demerges (splits). The regulations on tax-free mergers of DLS are regulated in Section 113 of the Tax Act. The regulations on tax-free demergers of DLS are regulated in Section 11-5 of the Tax Act.

If a person running a sole proprietorship takes on one or more associates, this shall also be considered as a newly established DLS. A sole proprietorship is considered, in principle, as realized for its owner. Entrance of new partners can, however, be tax free in accordance with the regulations on tax-free conversion in Section 11-20 of the Tax Act and Section 11-20 of the FSFIN Regulations.

4.2.3.2 Entry

The entry of one partner is not regarded as realization for the other partners. The input value and paid-up equity on the shares shall be added to the contribution in the company, where applicable.

4.2.3.3 Withdrawal and exclusion

When a partner withdraws from the company (in the case of withdrawal or exclusion) in accordance with the regulations of the Partnership Act (see items 4.1.2.3 and 4.1.2.4), shares for the withdrawn partner are considered realized (cf. Section 1044 of the Tax Act). The calculation of any gains or losses shall be performed in the normal way (see item 4.2.3.4).

Such withdrawal or exclusion pursuant to the provisions of the Partnership Act shall not be regarded as realization for the other partners.

4.2.3.4 Full or partial realization of shares

4.2.3.4.1 Introduction

The regulations on gains or losses upon realization, including redemption of shares and dissolution of the company are regulated in Section 1044 of the Tax Act. In principle, the provisions apply to both personal partners and company partners, although for company partners who come under the exemption method, there are extensive exemptions from tax obligations for profit or right to deduct for loss in accordance with Section 2-38 of the Tax Act. The general rule in Section 10-44 of the Tax Act is initially dealt with in item 4.2.3.4.2, followed by exemptions in item 4.2.3.4.3.

Dissolution raises a number of special problems and is dealt with in item 4.2.3.5.

4.2.3.4.2 Gains and losses upon realization of partnership capital

When realizing parts in a business assessed as a partnership, gains are, in principle, liable for tax and losses are deductible for the party realizing the shares (cf. Section 10-44 of the Tax Act).

Gains or losses are set to net compensation upon realization, after deduction of the realization costs and input value. The input value is the net cost price of the shares and acquisition costs, plus the partner's contribution in the company and adjusted for change in the deductible risk-free return during the period of ownership in accordance with Section 10-42 seventh paragraph of the Tax Act (not real contributions and tax benefit on deficit). Upon realization of parts of the shares, the input value shall be allocated proportionally.

In respect of personal partners, any profit shall be reduced by unused risk-free returns.

Partners with limited liability (limited partners and silent partners) who have deficits to carry forward in accordance with Section 10-43 of the Tax Act may enter this deficit as a deduction in any profit.

If the company was established after 2006 and the partnership capital have not been previously realized, the input value and paid-up equity will be the same.

In respect of partnership capital from before January 1, 2006, there are separate transitional rules for setting input values as per January 1, 2006 (see Section 10-49-1 of the FSFIN Regulations). In the period following this date, the same corrections as above shall be made for input values for the period after January 1, 2006.

For partnership capital acquired through inheritance or as a gift, the acquirer shall continue the testator's or the donor's input value (cf. Section 10-46 and Section 10-33 of the Tax Act). If the gift has been donated or if the testator died before January 1, 2014, the lowest sales value on the date of transfer and inheritance tax basis shall be used as a basis for the input value.

4.2.3.4.3 Exemptions – the exemption method

Partners who come under the exemption method shall, in any case, not be taxed on profit or be eligible to deduct for loss upon realization of partnership capital in a DLS (cf. Section 2-38 second paragraph (b) of the Tax Act). Gains or losses can, however, be liable for tax/deductible loss in accordance with the regulations in Section 2-38 third paragraph (e) and (f) of the Tax Act.

The exemption method applies to partners who are limited liability companies, public limited liability companies, savings banks, independent finance enterprises, mutual insurance companies, cooperative enterprises, unit investment trusts, bankrupt estates, administration estates (if the debtor in bankruptcy is a company, etc. of the type covered by the exemption method), associations, foundations, municipalities and county councils, intermunicipal companies, and companies wholly owned by the state. The same applies to corresponding foreign companies (e.g. European companies (SE) that are domiciled in Norway and European cooperative enterprises (SCE) that are domiciled in Norway).

In other words, in principle, these partners are exempt from gains and are not eligible to deduct for losses upon realization of shares.

However, gains will be liable for tax if the DLS's total market value of shares, units, etc., which fall outside the

exemption method (cf. Section 2-38 third paragraph (a-d)⁷² of the Tax Act), at any time during the last two years up to the recovery date (realization date) has exceeded 10 percent of the company's total value of shares, etc.

However, losses will be deductible if the DLS's total market value of shares, units, etc., which fall outside the exemption method (cf. Section 2-38 third paragraph (a-d) of the Tax Act), for a period of two years prior to the date of the loss (realization date) has exceeded 10 percent of the company's total value of shares, etc.

4.2.3.5 Tax dissolution

4.2.3.5.1 Introduction

A DLS may be considered as dissolved with regards to tax even if it has not been dissolved in terms of company law. This is initially referred to in item 4.2.3.5.2.

The tax treatment during the year of dissolution must be undertaken at both company level and partner level. At a company level the tax treatment is undertaken for income, costs and any gains/losses to the company's assets (see item 4.2.3.5.3). At a partner level the dissolution shall be regarded as a realization of shares from the partners to the company (see item 4.2.3.5.4).

4.2.3.5.2 When is the company dissolved with regards to tax?

There are new regulations regarding when a DLS shall be regarded as dissolved with regards to tax with effect from the income year 2015 in Section 10-44-2 of the FSFIN Regulations. A business assessed as a partnership shall be considered dissolved with regards to tax when

- a) the company is registered in the Register of Business Enterprises and a formal dissolution and liquidation have taken place in accordance with the regulations of the Partnership Act. For more information about this, see item 4.1.3.
- b) the company is registered in the Register of Business Enterprises, the business has been wound up and in the two preceding income years the company has not submitted a turnover statement or other state-

⁷² This applies, for example, to shares in a company in a low tax country outside the EEA.

ment referred to in Section 4-9 of the Tax Assessment Act, i.e., obligatory tax assessments for DLS.

- c) the company is not registered in the Register of Business Enterprises and the business has been wound up.
- d) parts have changed ownership in such a manner that subsequently only one owner of the previous company's assets or business remains. However, this does not apply if the remaining owner transfers parts of the company to another party within eight months of the change of ownership. If the remaining owner has taken over shares resulting from an inheritance, the change of ownership shall be considered as having taken place on the date of distribution or undivided estate acquisition.
- e) the company enters bankruptcy proceedings. Dissolution shall be considered as taking place on the date that the bankruptcy proceedings open.

Conversion from a DLS to a company or an amalgamation that is a separate tax entity (e.g., limited liability company), in principle, is also regarded as dissolution of a DLS. This type of conversion, however, may be tax free in accordance with the regulations in Section 11-20 of the Tax Act and Section 11-20 of the FFIN Regulations.

4.2.3.5.3 Tax treatment during the year of dissolution – company level

Income in the company shall be determined in the normal way during the year of dissolution until the company is considered dissolved. The company must realize its assets to third parties or to one of the partners prior to dissolution. Sales fees, gains or losses during the year of dissolution shall be handled in accordance with the normal regulations. If assets are given away or sold at a reduced price, the regulations on exemptions in Section 5-2 of the Tax Act may come into effect. Benefits (the value of gifts or gift elements) upon withdrawal shall then be entered as the company's general income. All tax positions must be settled during the year of dissolution.

Income shall be distributed amongst the partners in accordance with the normal regulations.

4.2.3.5.4 Tax treatment during the year of dissolution – partner level

In respect of partners, a distinction must be made between the transfer of assets prior to the date of settlement and transfer of assets in connection with the dissolution.

The transfer of assets prior to the date of settlement shall be taxed in accordance with the normal regulations referred to in item 4.2.2.3.

Assets transferred in connection with the dissolution shall be considered a part of the realization fee (output value): Any assets shall be valued at their sales value.

Any gains or losses shall be determined in the normal manner as referred to in item 4.2.3.4.

4.2.4 National principles for international conditions

4.2.4.1 Introduction

Norwegian taxation is based on two principles:

The global income principle: All income and assets from both Norway and abroad are liable for tax to Norway for both physical persons who are resident and companies who are domiciled in Norway (see Section 2-1 ninth paragraph and Section 2-2 sixth paragraph of the Tax Act).

The source principle: Income from Norwegian sources and assets associated with Norwegian sources shall be taxed in Norway, see Section 2-3 of the Tax Act.

In respect of surplus from a DLS, the global income principle applies (cf. Section 2-1 ninth paragraph (personal partners) and Section 22 sixth paragraph (company partners) of the Tax Act). If a tax agreement does not exist or there is a tax agreement based on the credit principle on the Norwegian side, the partners may claim credit for foreign tax in accordance with the regulations in Section 16-20 of the Tax Act. This applies to both the partners' and the company's tax. If a tax agreement exists based on the exemption method, the Norwegian taxation right may be superseded. Typically, this may apply where a company has a permanent operating base in the other country.

Gains on the realization of parts in companies that operate abroad are liable for tax in accordance with the general regulations. Losses are also deductible. If the other country (source country) considers such disposal of shares as sale of underlying working capital, double taxation may arise. If Norway has a tax agreement with the other country, the tax agreement will determine whether Norway grants credit for tax imposed on the other country. If the tax agreement is based on the exemption method, it will be assumed that Norway cannot tax the gain.

Basically, the global income principle also applies for dividends to personal partners in accordance with Section 10-42 of the Tax Act. For a tax obligation to exist, the partner must be liable for tax to Norway on the date of distribution. The tax liability applies only to dividends associated with income that is or has been liable for tax to Norway. If a business assessed as a partnership runs an enterprise in which the business income for the partners is liable for tax in its entirety, the tax liability to Norway in accordance with Section 2-3 first paragraph (b) of the Tax Act and the Norwegian taxation right is not superseded following a tax agreement, the total dividends from the company to such partners will be fully liable to tax in accordance with Section 1042 of the Tax Act.

There are no special regulations for DLS in group arrangements, with the exception of the regulations regarding intragroup transfers in accordance with Section 11-21 of the Tax Act. There is no corporate taxation in Norway and DLSs are not covered by the regulations on group contributions. Rather, the tax positions of the individual tax entities are taken into account. Income and assets from DLS are included in the partners' income. If a DLS owns another DLS, the income and assets of the underlying DLS must be included in the income and assets of the DLS that owns the shares.

The tax liability is, however, limited by the tax agreements and certain provisions of internal law (see Sections 2-34 and 2-37 of the Tax Act).

In order to ensure the Norwegian tax base, Norway has several sets of regulations regarding taxation in certain situations. This concerns, for example, the regulations on:

- tax obligation on contributions and withdrawals from a Norwegian area of taxation in accordance with Sections 14-60 to 14-66 of the Tax Act,
- tax obligation on emigration (exit) of persons (Section 10-70 of the Tax Act), companies (Section 10-71), and assets etc., which are removed from the Norwegian area of taxation (Section 9-14 of the Tax Act),
- tax obligation on advance on remuneration for work, etc. (Section 14-43 of the Tax Act),
- limitation on deduction for interest between associated parties (Section 6-41 of the Tax Act),
- transfer pricing (TP), and
- nonstatutory piercing of the corporate veil.

Item 4.2.4.2 below deals with which foreign companies shall be assessed as partnerships. Item 4.2.4.3 deals with how Norwegian partners in these companies are taxed. Item 4.2.4.4 describes how foreign partners are taxed on income from "Norwegian" DLS or DLSs that have a permanent operating base in Norway.

4.2.4.2 Which foreign companies shall be assessed as partnerships?

When assessing whether a foreign company should be treated in accordance with the regulations on assessment as a partnership, it is generally assumed that the foreign company, materially wise, must be considered a company in accordance with the Partnership Act. This means that Norwegian partners shall be assessed as partnerships based on participation in the relevant company, if the foreign company fulfils the conditions of Section 11 of the Partnership Act (see item 4.1.1.2.1).

Foreign companies that Norwegian partners invest in and are assessed as a partnership are primarily private equity funds. The funds are often organized as limited partnerships, which have many similarities to Norwegian limited partnerships. Limited partnerships most often have a general partner (GP) who has unlimited liability in accordance with local legislation or the partnership agreement. The other owners usually have limited liability.

In a statement of principles published on April 9, 2015, the Directorate of Taxes has defined its views regarding what is required to be regarded as a UDLS (foreign business assessed as a partnership).

In the issue of assessment as a partnership, the actual position the different parties have in or toward the company with regard to company law in the country in which the company is registered, as well as which positions result from the agreement between the parties, must be considered. Statoil Holding (Rt. 2012 s. 1380).

When considering the type of assessment, the Directorate of Taxes assumes that it is basically sufficient that the GP has an "unlimited personal liability" that the GP in accordance with the partnership agreement and internal law in the country of registration is liable for the company's external obligations.

The GP is considered a partner in the fund for "joint expense and risk" when the GP has a financial interest as to whether the foreign fund runs at a surplus or deficit. This situation can occur when the GP has made a capital contribution, which gives an entitlement to surplus dividends or obligation to cover deficits in the same way as other partners. This applies even if the surplus is small.

The Directorate of Taxes assumes that a foreign fund can qualify for assessment as a partnership even if the GP does not have an obligation to make a partnership contribution in the fund. Often in such cases the unlimited liability will commit the GP to covering the residual obligation if the fund recorded a deficit, while the GP is also entitled to a share of the surplus if the company enters a qualified surplus position. The Directorate of Taxes assumes that in

such cases the GP will have such a financial interest in the business relationship that the conditions for assessment as a partnership will be fulfilled.

In certain cases, the right to income flows and liability for company operation will be allocated to different legal subjects (e.g., to screen any income flows from liability). If the GP has made a partnership contribution, which gives entitlement to surplus dividends and an obligation to cover deficits in the same way as other partners in the company, this will also support the notion that the GP is a partner for “joint expense and risk” in the company. If the GP has no financial interest in whether the company is running at a profit or loss, the GP will not be a partner for “joint expense and risk” in the company. The company will thereby not be considered a UDLS.

4.2.4.3 Taxation of Norwegian partners in a UDLS

For Norwegian partners in foreign businesses assessed as partnerships (UDLS) income and assets from the UDLS shall be taxed in accordance with the internal law regulations in Sections 10-40 to 10-49 and Sections 4-40 and 4-41 of the Tax Act (prior to tax agreements, etc. becoming applicable) in the same way as income from Norwegian DLS. This means that the Norwegian partners must transform the foreign accounts into Norwegian tax accounts. This reworking presents several challenges, for example, whether the exemption method shall be applied, the limit between debt and equity and timing of income.

For Norwegian partners in a UDLS, a condition for being granted a deduction for deficits is that the deficit can be documented. In accordance with Section 10-41 first paragraph, second item, partners must expressly declare that all supporting material for the company's accounts will be submitted at the request of the tax authorities. If they make such a declaration but are nonetheless unable to submit the documentation, they will risk a surtax being imposed (cf. Act 24, Section 10-2 on Tax Assessment).

4.2.4.4 Taxation of foreign partners

Foreign partners (resident or domiciled abroad) in a DLS who operate a business in Norway are normally liable to tax on current surpluses in accordance with Section 10-41 of the Tax Act (cf. Section 2-3 first paragraph (b) of the Tax Act). If the company is considered as having a permanent operating base in Norway, the partners shall also be regarded as having a permanent operating base in Norway. Whether Section 2-3 of the Tax Act covers the realization of

shares is regarded with some uncertainty, even if the Ministry of Finance assumed this in two rulings included in Utv. 1998 s. 432 and Utv. 200 s. 420.

In order for dividends to be liable to tax in Norway, in accordance with Section 10-42 of the Tax Act, the partners must be liable to tax in Norway on the date of distribution. In addition, the tax liability applies only to dividends associated with income that are or have been liable for tax to Norway. If a business assessed as a partnership runs an enterprise in which the business income for the partners is liable for tax in its entirety, the tax liability to Norway in accordance with Section 2-3 first paragraph (b) of the Tax Act and the Norwegian taxation right is not superseded following a tax agreement, the total dividends from the company to such partners will be fully liable to tax. If the partner is fully taxed on the dividends, he or she may also claim risk-free returns in the same way as Norwegian partners.

If a foreign partner is considered to be running a business through a permanent operating base in Norway (i.e., when only a proportion of the partner's share of business income is liable to tax in Norway), in the income year, or in some of the four preceding years, the partner may claim the tax obligation for dividends, in accordance with Section 10-42 of the Tax Act, is limited proportionally (see Section 10-47 first paragraph of the Tax Act and Section 10-47 of the FSFIN Regulations).

If it is obvious that the dividend must be considered as originating from an enterprise that is not taxed in the country on the basis of a tax agreement, or on the basis of a limited tax obligation in accordance with Section 2-3 of the Tax Act, the partner may, in exceptional cases, also claim that dividends liable to tax are limited proportionally, even if he or she does not fulfil the conditions of Section 10-47 first paragraph of the Tax Act and that only parts of the business income are liable to tax in Norway (cf. Section 10-47 second paragraph).

A condition for limitation is that the taxpayer fulfils the requirements for documentation (cf. Section 10-47 fourth paragraph of the Tax Act). The partner must document that the conditions have been fulfilled and provide the necessary information so that the tax authorities can determine income liable to tax (dividends in accordance with risk-free returns, which are liable for tax to Norway).

If the claim cannot be settled by expiry of the deadline for submitting tax returns, the claim must be presented no later than six months after the claim can be settled. Claims cannot be presented more than three years after expiry of the income year (cf. Section 10-47 fifth paragraph of the Tax Act).

If the partner's dividend is reduced in accordance with the regulations in Section 10-47 of the Tax Act, the risk-

free return shall also be reduced by the same proportion as the dividends (cf. Section 10-47 sixth paragraph and Section 1047-1 eight paragraph of the FSFIN Regulations).

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5 Sweden

By Martin Berglund

5.1 Introduction

This report examines how *personelskaber* (Danish for *partnerships*) in Sweden are taxed and regulated according to private law. The instructions from The Nordic Tax Research Council for the national reports state that *personelskaber* refers to the type of company that is not an independent taxpayer but rather companies that are fiscally transparent. The companies can be of two types: (1) companies where each partner has equal and unlimited responsibility for company obligations, (2) companies where some partners have equal and unlimited responsibility for company obligations, and other partners have limited responsibility. In Swedish law, general partnerships (*handelsbolag* in Swedish) fall under the first category, while limited partnerships (*kommanditbolag* in Swedish) are included in the second category.

Examination of other types of companies within Swedish law is outside the scope of this report. The co-owners of limited liability companies (*aktiebolag* in Swedish) have limited responsibility for the company's obligations.⁷³ In a nonregistered partnership (*enkelt bolag* in Swedish), which is not a legal person, the partners

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⁷³ Companies Act (2005:551) Chapter 1, Section 3.

are not jointly liable for obligations. Rather, only those partners involved in a particular contract or similar legal act are responsible for it.⁷⁴ The following thus only examines general partnerships and limited partnerships.⁷⁵ When both types of companies are referred to, the term “partnership” is used.

5.2 Corporate Law Aspects

5.2.1 General

In Swedish private law, partnerships are regulated by the Partnership and Non-registered Partnership Act (1980:1102) (“Partnership Act”). According to the act, a limited partnership is a special form of partnership.⁷⁶ The Partnership Act is made up of four chapters. Chapter 1 contains basic provisions regarding partnerships, for example the requirements for formation of a partnership. Chapters 2–4 regulate, in turn, general partnerships, limited partnerships and nonregistered partnerships. Section 5.2.2 examines general partnerships, followed by Section 5.2.3, which discusses limited partnerships. The examination here is limited to issues that are significant for the tax law review that follows. This means, for example, that regulations on partnership administration are not significantly addressed.

5.2.2 General Partnerships

5.2.2.1 Requirements for Formation of a Partnership

A partnership is formed when “two or more persons have agreed to jointly engage in business activities in a partnership and the partnership has been registered in the trade register”.⁷⁷ In Swedish law, there is a basic, partly uncodified concept of what constitutes a company, where the least defined content forms the basis for the nonregistered partnership.⁷⁸ The first requirement is an agreement on formation of a partnership between at least two people. The Partnership Act contains no specific formal require-

⁷⁴ Partnership and Non-registered Partnership Act (1980:1102) (referred to below as “PA”) Chapter 4, Section 5.

⁷⁵ So-called “limited companies” are also not examined in this report. For information on this form of company see Nial (1955, 425 ff.)

⁷⁶ PA, Chapter 1, Section 2.

⁷⁷ PA, Chapter 1, Section 1.

⁷⁸ For the following see NJA II 1980 p. 439 f. and 443 f. See also e.g. Dotevall (2009, 19 ff.); Johansson (2011, 31 ff.); Nial (1955, 24 ff.)

ments for the partnership agreement, which, therefore, must comply with the general regulations on formation and validity of contracts.⁷⁹ A company agreement can thus be made verbally as well as in writing by all legal entities that have legal capacity. Both natural persons and legal persons can be partners in a general partnership. The legal consequences when a partnership contract is declared invalid differ depending on whether or not the consequences are with regard to the relationship between partners or to third parties.⁸⁰

The second and most important requirement in forming a partnership is regarding its purpose. The partnership contract must contain a common purpose for the partners. The purpose of the partnership includes both an objective, for example to create a profit for the partners, and an object of the partnership, in other words the activity carried out to achieve the objective. It is precisely the common purpose that distinguishes the partnership from other contractual relationships, such as joint ownership.

A third requirement usually given is that the partners are obligated to work for the common purpose. This can be done through contribution of capital or labor. It is not enough for partners to only contribute to the purpose. There must also be an obligation to contribute. Without such an obligation, the partners can rather be considered as beneficiaries. There need not, however, be any company assets for a partnership to exist.

Thus, for a general partnership to exist, these three general requirements for formation of a partnership must be fulfilled. Specific for a general partnership is that the object of the partnership is to “engage in business”. It should be noted that the purpose of the partnership need not necessarily be to make a profit, but it is adequate that the purpose is to engage in business. Normally, the purpose is of course to make a profit for the partners. The concept of “business” in the Partnership Act has the same general meaning as in private law, for example to determine who is a proprietor of a business in the case of consumer purchases and to determine when the requirement to maintain accounting records applies to natural persons.⁸¹ Business refers to economic activities that can be considered professional.

Formation of a partnership that complies with these requirements is, as noted, considered a general partnership if it is registered. Inclusion in the Register of Partnerships is thus a requirement for the partnership to be a legal

entity. Prior to registration, the entity is considered a non-registered partnership without legal capacity.

5.2.2.2 The Mutual Rights and Obligations of the Partners

The point of departure is that the partners themselves decide upon their mutual relationship by coming to an agreement.⁸² The Partnership Act includes almost only non-mandatory requirements regarding the mutual relationship.⁸³ Other than management, the regulations apply primarily to distribution of profits. The profit consists of the surplus remaining after each partner has received both interest on their investment in the partnership and for expenses necessary or beneficial to the partnership, as well as a reasonable remuneration for the management.⁸⁴ This profit must be divided equally between the partners.⁸⁵ If the partners have only agreed on the distribution of profits, but not on losses, the same allocation principles apply to losses. The same applies in the reverse situation.

The partners have the right to receive their share of the surplus when the annual financial report or end-of-year accounts are completed.⁸⁶ If a partner does not claim their share before the end of the following financial year, the share is instead added to that partner's investment. This cannot, however, lead to a change in shares in the partnership as stipulated in the partnership agreement without the consent of the other partners.

5.2.2.3 The Relationship between a General Partnership and Partners to Third Parties

The basic legal consequences of compliance with the requirements of forming a partnership are that the partnership can procure rights and incur liabilities as well as plead a cause before a court and other government agencies.⁸⁷ This legal capacity and legal standing means that

⁷⁹ Especially Contracts Act (1915:218).

⁸⁰ See Nial (1955, 65 ff.)

⁸¹ For this and the following see NJA II 1980 p. 445.

⁸² PA, Chapter 2, Section 1.

⁸³ There is only one mandatory regulation, which is with regards to management (PA, Chapter 2, Section 5). A partner that is excluded from the management of a partnership still has the right to inspect the accounts of the partnership and be informed about the matters of the partnership.

⁸⁴ PA, Chapter 2, Sections 6 and 7 and 13. Conversely, partners are obligated to pay interest on debts to the partnership.

⁸⁵ PA, Chapter 2, Section 8.

⁸⁶ For the following see PA, Chapter 2, Sections 9 and 10.

⁸⁷ PA, Chapter 1, Section 4.

the partnership is recognized as a legal person in relation to a third party. The representatives of the partnership, which are each of the partners unless otherwise agreed,⁸⁸ can thus enter into agreements or other legal transactions and represent the partnership in processes or other matters. Other than this rule, the Partnership Act's regulations regarding the relationship of partnerships to third parties are in principle mandatory in nature.

All the partners are "jointly and severally liable for all the obligations of the partnership".⁸⁹ This means that the general partnership's creditors can direct their demands either toward the general partnership or toward one of the partners, whose responsibility is not limited to a specific amount. Creditors do not need to make a claim against the partnership before making a claim against one of the partners.⁹⁰ If a partner must pay any debts of the partnership, the partner can then make a claim of recourse against the partnership. Ultimately, a claim of recourse can be brought against the other partners, but the extent of this right is debated. A new partner is also responsible for past liabilities the partnership has incurred, but the general rule is that partners that withdraw from the partnership are not responsible for later liabilities.⁹¹

5.2.2.4 The Joining and Retiring of Partners as well as Transfer of Shares

The rules that apply with regard to joining and retiring from a partnership concurs in part with general contractual principles. There are, however, certain specific regulations in the Partnership Act. Since partnerships in many respects are based on personal inputs of the partners in the form of labor, a unanimous agreement of the partners is required for a new partner to join the partnership.⁹² For a partner to withdraw from the partnership without the partnership being terminated, the unanimous agreement of the partners is required, since it means a change in the partnership agreement. That withdrawal is possible when there is such an agreement is a consequence of the partners together having control of the partnership agreement.

⁸⁸ PA, Chapter 2, Section 17.

⁸⁹ PA, Chapter 2, Section 20.

⁹⁰ This is not specifically given in the text of the law. See, e.g., Rodhe (1985, 336 f.)

⁹¹ PA, Chapter 2, Section 22. A partner that has withdrawn is however responsible for subsequent obligations if the partnership's other contracting parties are in good faith regarding the partner's withdrawal. On how this is determined see e.g. NJA 1995 p. 654.

⁹² PA, Chapter 2, Section 2.

The extent to which new and past partners are responsible for liabilities of the partnership are given in the previous section.

An alternative to retiring from a partnership with the agreement of the other partners is that the partners terminate the partnership agreement. The partnership is then placed in liquidation after six months following the termination.⁹³ These regulations are nonmandatory. For example, a partnership agreement may be entered for a specific length of time, or some other notice period may be agreed upon. If the partnership agreement is terminated and liquidation is therefore pending, the partners can instead together agree that the partner who has terminated the agreement must withdraw from the partnership.⁹⁴ This regulation is in alignment with the principle given above that withdrawal is possible with unanimous agreement of the partners. If the partner who has terminated that partnership agreement does not agree to withdraw, it is however possible for the other partners, if they are in agreement, to exclude the partner in question.⁹⁵ The excluded partner then has the right to compensation equivalent to the amount that would have been received if the partnership was dissolved.

A partner can transfer their economic rights in the partnership without the other partners' consent. This does not mean however that the person making the transfer is retiring from the partnership or that the acquirer is joining the partnership. As was just mentioned, joining and withdrawal require, in principle, the unanimous agreement of the partners. What can be transferred is the right to receive the economic rights partners are entitled to, for example remuneration for work carried out or a share in the profits of the partnership.⁹⁶

5.2.3 Limited Partnerships

With certain exceptions, regulations in the Partnership Act for general partnerships also apply to limited partnerships.⁹⁷ The differences pertain to the condition that limited partnerships have partners whose obligation is limited to the capital invested. A partner who has unlimited obligation exactly as in general partnerships is referred to as a *general partner*, while a partner with limited obliga-

⁹³ PA, Chapter 2, Section 24.

⁹⁴ PA, Chapter 2, Section 29.

⁹⁵ PA, Chapter 2, Section 30.

⁹⁶ PA, Chapter 2, Section 21.

⁹⁷ PA, Chapter 3, Section 1.

tion is referred to as a *limited partner*.⁹⁸ A limited partnership cannot be owned exclusively by limited partners, and nonprofit organizations and foundations cannot be general partners. If this is the case, the limited partnership is reclassified as a general partnership.⁹⁹ It can, however, be noted that limited liability companies can be general partners in a limited partnership.

A limited partner in a limited partnership can be described as a person who has invested capital in the partnership but does not personally participate in the management or other activities. Thus, it is stated that a limited partner does not have the right to participate in the management if no other agreement has been reached.¹⁰⁰ As well, a limited partner cannot represent the partnership in the way that each partner in a general partnership normally can.¹⁰¹

Even in a limited partnership, the partners can themselves come to an agreement on division of profits. If there is no agreement on the size of the profit that must be allocated to a limited partner, the allocation does not necessarily take place in the same way as for other partners, but rather the right must be determined according to equity.¹⁰² Since the allocation between general partners in the partnership is not specifically regulated for limited partnerships, it must take place equally according to the number of partners just as in the case of an ordinary general partnership.

5.3 Tax Aspects

5.3.1 Introduction

Taxable entities in Swedish law are, other than natural persons, Swedish legal persons and foreign legal persons.¹⁰³ The main rule is that legal persons with adequate relations to Sweden are unlimited liable to tax. Swedish registered partnerships are of course legal persons in Swedish law, but not in the sense of the Income Tax Act (ITA).¹⁰⁴ Generally, it can be said that a general partnership is not itself taxable for its income, but rather the partners are. The tax aspects are examined here as follows: Taxation of

income in Swedish partnerships is addressed in Section 5.3.2. Section 5.3.3 takes up issues regarding disposal of shares in a general partnership. Section 5.3.4 gives a description of Swedish taxation of foreign partnerships. Subsequently in Section 5.3.5, there is a discussion of the opportunities for obtaining foreign tax credit on general partnership income. Finally, Section 5.3.6 addresses some specific income tax regulations that are especially intended to counteract undesirable tax planning with partnerships.

5.3.2 Taxation of Partnership Income

Taxation of income from partnerships is regulated in ITA, Chapter 5. Unlike other legal persons, Swedish registered partnerships are not taxed on their income, but rather the partners are taxed on this income.¹⁰⁵ Since according to private law, the income held by a partnership is its own in its capacity as a legal person, the question arises as to how this taxation, in detail, should be designed.

The method of taxing income from Swedish registered partnerships is regulated in ITA, Chapter 5, Section 3. Each partner “shall be taxed for as large an amount as is equivalent to their share of the general partnership’s [...] income, regardless of whether or not the amount is taken out of the company”. Swedish partnerships are therefore considered fiscally transparent, which means that they, in principle, are not an independent taxable entity. The partners are taxed on an ongoing basis for the partnership’s revenue, and at the same time are not taxed at all on distributions received from the partnership. The method presumes, however, that the profit is first calculated for the partnership. The partnership is therefore recognized for tax purposes as an income calculation unit. This method means that determination of the tax base takes place at the partnership level. The revenue and expenditures of the partnership are added and deducted as income and expenses in the ITA income category of business income.¹⁰⁶ The surplus or deficit is then calculated by all income being reduced by all costs.¹⁰⁷ It should be noted that a partnership can thus have bookkeeping entries related to the

⁹⁸ PA, Chapter 1, Section 2 and Chapter 3, Section 8.

⁹⁹ PA, Chapter 3, Section 2.

¹⁰⁰ PA, Chapter 3, Section 4.

¹⁰¹ PA, Chapter 3, Section 7.

¹⁰² PA, Chapter 3, Section 5.

¹⁰³ Income Tax Act (1999:1229) (“ITA” below), Chapter 6, Sections 3-4 and Chapter 6, Sections 7-8.

¹⁰⁴ ITA, Chapter 2, Section 3.

¹⁰⁵ ITA, Chapter 5, Section 1.

¹⁰⁶ Here it can be noted that the private law concept “business activity” (see e.g. PA, Chapter 1, Section 1, and Accounting Act [1999:1078] Chapter 2, Section 6) is wider than the equivalent tax law concept in ITA, Chapter 13, Section 1. In other words, theoretically, the current income of a partnership could be assigned to other types of revenue than business activity. In practice, however, it will not occur.

¹⁰⁷ ITA, Chapter 14, Section 21.

partners that influence the taxable profit.¹⁰⁸ As was mentioned earlier, this has to do with, for example, remuneration to a partner for management of the partnership. These are deducted before earnings are for tax purposes allocated to the partners.¹⁰⁹ Income and expenditures that for a natural person are regularly assigned to the ITA income category of capital income, namely current capital income as well as capital gains and losses, are taxed as regards partnerships mainly in the ITA income category of business income.¹¹⁰ An important exception is however the capital gains and losses of a partnership's real property and condominiums. These are assigned to the category capital.

Other entries that affect the taxable result than normal income and expenses are also considered at the partnership level. This concerns deductions that are a result of fiscal accrual accounting regulations and deductions for contributions to compensation funds.¹¹¹ Interest payments and deductions for contributions to expansion funds based on the income of the partnership are, however, made at the partner level, in other words, after the profit of the partnership has been divided among the partners.¹¹² The regulations on interest allocations intend to create a neutral fiscal allocation of a natural person's income between the ITA income categories of capital income and business income. It is therefore not reasonable to carry out any interest allocation at the partnership level. The purpose of expansion funds is for self-employed persons to be able to some extent achieve taxation that is neutral in relation to limited liability companies. It is therefore reasonable even here to apply the regulations at the partner level.

Thus, after the partnership's taxable income is determined, it must be divided among the partners. There are no specific tax regulations on how this division of income should in detail be carried out. Tax law in this context relies on private law. As concluded above, the regulations for allocation of profit according to the Partnership Act are nonmandatory. It thus rests first with the partners to agree among themselves on how to allocate the profit. Alternatively, the profit must be allocated equally between

the partners. In established case law, private law profit allocation to partners has in general been accepted for taxation purposes. There are, however, exceptions where there are tax law deviations from this profit allocation. In Case *RÅ 2002 ref. 115 I-II* there were developments in the basis for determination in this regard. The Supreme Administrative Court ("SAC") also summarized previously applicable principles in the area. According to SAC, the partners' agreed allocation can be deviated from "if it involves an unauthorized transfer of income or is unreasonable and mainly induced for tax reasons".¹¹³ If there is deviation from the private law allocation, the court makes its own judgment on what allocation is equitable.

To clarify these very general criteria, the court initially referred to earlier rulings. According to SAC, the determination had previously been based on "factors such as the size of the capital contributions of the partners, the labor input of the partners, the relationship between the partners, business risks, and if the distribution can be assumed to have taken place to achieve tax advantages". These factors show that what first and foremost should be determined is whether the allocation of profit is in reasonable proportion to the partners' investment in the partnership in the form of capital or labor. Factors such as relationship between the partners and risk-taking may be relevant for the question if there is a reasonable proportion between the investment in the partnership and what the partner gets in return. Such factors can also be relevant for the issue of whether or not the main reason for allocation can be assumed to be to derive tax benefits.

In one of the joined cases in *RÅ 2002 ref. 115*, SAC made a reallocation of profit, while the agreed allocation of profit was accepted in the second case. It is clear that the judgment means that it is possible to deviate from profit allocation valid according to private law, and that this will depend on a distinct *in casu* examination.

How the profit from a partnership is treated at the level of a partner depends on whether or not the partner is a legal person or a natural person. For legal persons, all income falls under the ITA income category of business income,¹¹⁴ which is why a legal person's share of the profit from a partnership is included in the calculation of the legal person's total income from business activity. The tax rate is 22 percent. For natural persons, this share of the result in a partnership is considered as a separate source of

108 These are deducted before the partnership's taxable result is determined. See e.g. *RÅ 1959 ref. 40*.

109 See e.g. *RÅ 1968 Fi 945* and Mattsson (2005, 159 f.)

110 ITA, Chapter 13, Section 4.

111 Replacement reserve is specifically given in ITA, Chapter 31, Section 2. That the taxable periodization takes place at the partnership level is due to the result being calculated there.

112 See especially ITA, Chapter 33, Sections 19-20, as well as Chapter 34, Sections 2 and 12-13.

113 SAC referred here to the previous cases *RÅ 1957 Fi 2409*, *RÅ 1988 not. 291*, *RÅ 1990 not. 274*, *RÅ 1995 ref. 35* and *RÅ 1997 not. 126*.

114 ITA, Chapter 14, Section 10.

income.¹¹⁵ This means that a surplus or deficit in a partnership cannot be equalized by the taxpayer's other business income. For natural persons, the surplus from partnerships is finally added to the surplus from other sources of income and taxed according to a progressive scale of between about 30 and 57 percent.

The extent to which a partner is at all subject to taxation for the income from a partnership is determined by whether or not the partner is unlimited or limited liable to tax.¹¹⁶ If the partner is unlimited liable to tax, they are taxed for their share of the partnership's income, independently of where in the world it originates.¹¹⁷ If the partner has instead limited tax liability in Sweden, they are taxed only for such types of income from the partnership that Sweden is entitled to tax as a source state. This above all means that non-Swedish resident partners in Swedish partnerships will be taxed for income from permanent establishments in Sweden and for disposal of real property in Sweden.¹¹⁸

Such remunerations to partners that, according to what has been mentioned above, are deducted before the result of the partnership is calculated (e.g., reasonable remuneration for management), are taxable for the partner that received the benefits according to what they received. Such remunerations are taxed in either the ITA income category of capital income or business income, depending on if they are considered as income from labor or yield from assets. The remunerations should, however, never be taxed in the ITA category of employment income. Not even salaries that a partner receives from a partnership are assigned as an employment income, but rather such remunerations are categorized as business income.¹¹⁹

Income from limited partnerships is mainly taxed in accordance with what is described above. There are, however, exceptions regarding limited partners, as they have a limited liability for the obligations of the partnership. If a deficit occurs in a limited partnership, a lim-

ited partner in a limited partnership may not deduct a greater amount than what, together with previous years' deductible losses, exceeds what the partner put into the partnership.¹²⁰ As a limited partner in a limited partnership does not need to cover a deficit with an amount greater than their capital investment, it can be asserted that it is theoretically correct that a deficit in the limited partnership must not be allocated to the limited partner to an extent that exceeds their capital investment. Prior to this prohibition on deductions, limited partnerships could easily be used for various forms of tax evasion.¹²¹

5.3.3 Disposal of Shares in a Partnership

Even though the revenue from a partnership continuously flows to the partners according to what has been described in Section 5.3.2, the shares in a partnership are regarded for tax purposes as an asset that can be disposed of by the partners. Shares in a Swedish partnership are never taxed in the ITA income category of business income.¹²² The starting point is that disposal of a share of a partnership is seen as disposal of an asset that can result in a taxable capital gain or a deductible capital loss in the income category of capital income.¹²³ The equivalent applies to legal persons, with the difference being that the profit or loss are instead classified as a business income.¹²⁴ The calculation of capital gains takes place in both cases by reducing the remuneration by the cost amount (the acquisition cost and improvement expenses) and expenditures for the disposal.¹²⁵ Specific regulations on taxation for disposal of shares in a partnership are found in ITA, Chapter 50. Both redeeming a share and dissolving the partnership are considered in the same way as a disposal.

Adjusted acquisition cost is a key concept for disposal of shares in a partnership. Calculation of the capital gains in Swedish tax law is made up of the just mentioned cost amount of the acquisition cost and any improvement expenses. However, when a share of a partnership is disposed of, the actual acquisition cost must in some cases

¹¹⁵ ITA, Chapter 14, Section 13.

¹¹⁶ This is clarified in ITA, Chapter 5, Section 3, paragraph 2.

¹¹⁷ Income can however be exempt from taxation according to tax treaties.

¹¹⁸ ITA, Chapter 3, Section 18; and Chapter 6, Section 11.

¹¹⁹ ITA, Chapter 10, Section 4. The rule is formulated somewhat unclearly, but the established interpretation is that salaries are assigned to the same income category as the partnership's income. The previous wording in Municipal Tax Act (1928:370) Section 32 was clearer in this regard: "If partners in a general partnership [...] received income from the partnership [...] in the form of payment, such income is not considered as employment income but as the same type of income as the classification of the partnership's [...] income". See also Mattsson (1974, 192 ff.)

¹²⁰ ITA, Chapter 14, Section 14.

¹²¹ Lodin et al. (2015, 508).

¹²² ITA, Chapter 13, Section 7.

¹²³ ITA, Chapter 41, Section 1, Chapter 42, Section 1, and Chapter 44, Section 3, ITA. Chapter 50, Section 1, clarifies that the basic regulations on capital gain and loss is applied for disposal of shares in a general partnership.

¹²⁴ ITA, Chapter 13, Section 2, and Chapter 25, Sections 2-3.

¹²⁵ ITA, Chapter 44, Sections 13-14.

be adjusted. These regulations apply in the same way to limited partnerships.

The purpose of the regulations on adjusted acquisition cost is to ally the fiscal transparency of partnerships regarding current taxation with the taxation of the partner when shares are disposed of. On the one hand, the intention is to not tax the revenue from a partnership twice, as is the case with a limited liability company. On the other hand, the inconsistency between current taxation and capital gain tax of shares should not lead to partners being able to utilize losses twice.

It is in this light that the adjustment regulations should be understood.¹²⁶ Adjusted acquisition costs are increased especially with two amounts.¹²⁷ First, contributions made by the partner to the partnership are considered an improvement expense. Therefore, the acquisition costs increase by the amount in question. Second, the acquisition costs increase by the amount claimed as the partner's share of the income of the partnership. A partner has already been currently taxed for such amounts, and thus there is no reason to tax them again when disposal takes place.

Inversely, the acquisition costs are reduced according to distributions to the partner by the partnership. A partner is not specially taxed on a distribution, but it should in any case be seen as something that has enriched the recipient at the expense of the partnership. Therefore, the amount should increase the capital gain when disposal takes place. Acquisition costs must also be reduced with those parts of a partnership's deficit that have been deducted by the partner. Here, the partner has already been able to deduct a negative result in the partnership, which can be expected to influence the value of the partnership negatively. Not reducing the acquisition costs would risk creating situations where a partner could first currently deduct a deficit in a partnership, and later dispose of the share in the partnership at a capital loss.

If the adjusted acquisition cost is negative, the cost amount is set to zero, at the same time as the remuneration is increased with the negative amount.¹²⁸ In this way, earlier deficit deductions are, for example, reversed when disposal takes place even if the real acquisition cost is not adequate to absorb the deficit. This solution is also applied to gratuitous transfers, which means a deviation from the otherwise applicable principle of continuity in these sit-

uations. Gratuitous transfers – through inheritance, will, gift, and division of property – is regarded as a disposal if the previous owner's adjusted acquisition cost is negative.¹²⁹ Since the negative amount is considered as remuneration, in this situation the gratuitous transfer is taxed. In such situations, the acquirer's acquisition cost is set to zero.

To carry out current taxation of revenue from partnerships in the income category of business income while disposal of shares in a partnership are taxed in the income category of capital income has previously created special opportunities for tax evasion. For business activities, a progressive tax scale of between about 30 and 57 percent applies to natural persons, while capital income is proportionally taxed at 30 percent. It was therefore advantageous to dispose of a share in a partnership at the end of the year to a fully owned limited liability company and thus achieve taxation of the year's profit as capital income instead of as business income. There are now regulations in ITA, Chapter 51 to counteract this type of arrangement. The regulations mainly mean that a capital gain created when a partner who has been active in a partnership sells a share in the partnership to a legal person is taxed in the income category of business income activity instead of in the income category of capital income.¹³⁰

In other cases, capital gains are included in the income category of employment income instead of the category of capital income. This applies if a partner disposes of shares in a partnership, which, in turn, owns shares that would have been covered by the regulations for qualified shares for closed companies in ITA, Chapter 57 if they had been owned directly by the natural person.¹³¹ A closed corporation is a limited liability company or cooperative association owned by a few individuals. If any of these individuals have been active to a significant extent in the company, distributions and capital gains are taxed to a certain extent as employment income instead of as capital income. The purpose of regulations to in some cases redirect profits when disposing of a partnership is to counteract evasion of the regulations on taxation of closed companies.¹³²

¹²⁶ These are also found in ITA, Chapter 50, Section 5.

¹²⁷ In addition to what is said below, expansion fund deposits and share transfers can also affect the adjusted acquisition cost.

¹²⁸ ITA, Chapter 50, Section 3, paragraph 2.

¹²⁹ ITA, Chapter 50, Section 2, paragraph 2.

¹³⁰ See ITA, Chapter 50, Sections 1-5.

¹³¹ ITA, Chapter 50, Section 7 and Chapter 10, Section 3.

¹³² See also section 3.6 regarding closed corporations.

5.3.4 Taxation of Foreign Partnerships

Foreign partnerships, meaning partnerships not registered in Sweden, are limited liable to tax in Sweden if they are considered as *foreign legal persons*. The definition of a foreign legal person is defined in ITA, Chapter 6, Section 8. The meaning of the concept has been much discussed.¹³³ For a foreign partnership to be a foreign legal person, it must according to the law of its own country be able to acquire rights and take on obligations as well as be able to plead a cause in court and other government agencies. These two requirements are normally relatively easy to determine. It can be noted that Swedish tax law, in principle, does not set any of its own criteria for foreign entities to be considered legal persons, but rather in this respect complies with the classification in foreign law.

There is, however, an independent criterion that must be fulfilled according to Swedish law in order for a foreign entity to be a foreign legal person. This criterion, which is more difficult to interpret than the above, states that individual partners should not be able to freely control the association's assets. Something that distinguishes a legal person is naturally that it is an independent subject. If one of the partners, without the agreement of the others, can withdraw or transfer assets that belong to the partnership, it is not possible to speak about any independent property that distinguishes an independent legal entity. It is unclear if the requirement means that there must be regulations for capital protection in relation to third parties, which means that partners cannot freely control the property of the partnership even if they are in agreement. Alternatively, it could be that the requirement aims toward an individual partner not being able to freely control property, while it can be seen as a legal person if the control is possible when there is unanimous agreement among the partners.

Some interpretation arguments advocate that the regulation requires mandatory capital protection regulations in the home country of the partnership. There is a leading case in this respect, namely *RÅ 1997 ref. 36*. The case concerns a German *GmbH & Co KG*, which is a special form of limited partnership ("*Kommanditgesellschaft, KG*" in German) whose general partner always consists of a limited liability company (*Gesellschaft mit beschränkter Haftung, GmbH*" in German). This last named type of company is distinguished by the limited liability of the partners for the

company's obligations, whereby there are special regulations on capital protection and minimum capital is available to protect the company's creditors. A limited partnership of the type *GmbH & Co KG* was regarded as a foreign legal person. It can be discussed how the case should be interpreted in relation to other types of partnerships. My view, which I have explained elsewhere in more detail,¹³⁴ is that the case does not require mandatory capital protection regulations outside of Sweden, but rather it is adequate that the partners individually, in relation to each other, are prevented from controlling the assets of the partnership. This means that the great majority of types of foreign partnerships are foreign legal persons for Swedish tax purposes.

A foreign partnership that is not recognized as a foreign legal person is completely ignored in Swedish tax law. Therefore, income and expenses flow continuously through to the partners to the degree in which they have participated in the transactions in question. It is then the partners' tax liability that determines the degree to which the income of such partnership is taxed in Sweden.

Even when a partnership is regarded as a foreign legal person, it is treated as transparent in Swedish tax law if the partnership is treated in that way for tax purposes by its home country.¹³⁵ Conversely, the partnership is treated as its own taxable person according to Swedish tax law if that is the case in the foreign home country of the partnership. The intention is, in other words, that the partnership should be treated symmetrically in the foreign country and in Sweden. The purpose is to avoid both international double taxation and double nontaxation to a greater degree.¹³⁶ Whether or not this purpose is achieved depends to a large degree on the interpretation of the abovementioned *RÅ 1997 ref. 36*. It also depends on how the foreign tax credit rules are designed (see the next section). If the foreign partnership is fiscally transparent outside of Sweden, the same tax rules apply for allocation of income as for Swedish partnerships (see Section 5.3.2). Here also, it is the extent of the partner's tax liability that determines what is taxed in Sweden. Thus, if one of the partners in the foreign partnership is a resident of Sweden, that partner is taxed for their share of the total income of the partnership, regardless of where in the world it originates.¹³⁷

¹³³ See also e.g. Dahlberg (2000, 132 ff.); Mattsson (2000, 100 ff.); Mattsson (2005, 112 ff.); Barenfeld (2005, 272 ff.); Berglund (2013, 245 ff.)

¹³⁴ Berglund (2013, 247 ff.)

¹³⁵ ITA, Chapter 5, Section 2a. The partnership is then referred to as "a foreign partner-taxed, legal person".

¹³⁶ Government bill 1989/90:47 p. 19. See also Swedish committee Skatteavräkningssakkunniga's report SOU 1988:45.

¹³⁷ ITA, Chapter 3, Sections 3 and 8.

If the foreign partnership is treated as its own taxable person in its home country, the partnership is thus also a taxable person in Swedish tax law. This means that only income covered by the regulations on limited tax liability for legal persons is taxed in Sweden. This applies especially with regards to income from Swedish permanent establishments and Swedish real property.¹³⁸ Partners with unlimited tax liability in Sweden are first taxed when they receive a distribution from the partnership.

5.3.5 Credit for Foreign Tax From Partnership Income

The extent to which a credit can be given for foreign taxes on income earned by fiscally transparent partnerships is now specifically regulated by law. Two rules in the Foreign Tax Credit Act (1986:468), Chapter 2, Section 3 and Chapter 1, Section 5, regulate who can be regarded as having had the income in such situations. The background is that SAC in case *RÅ 2001 ref. 46* declared that a tax credit could not be granted when foreign income had been earned by transparent partnerships. The court asserted that there was not adequate identity regarding the entity that earned the income and who was taxed for this revenue. Such a development was determined to be undesirable, which was why the new regulations were introduced.

These regulations mean, in principle, that foreign income earned by transparent partnerships are regarded as having been earned by the partner themselves. If the partnership has paid foreign taxes, these also must be viewed as having been paid by the partner himself. In this way, credit for foreign taxes is made possible even though there is a deficiency regarding the identity of the subject, which is normally required for the occurrence of such international double taxation that qualifies for credit.¹³⁹

5.3.6 Specific Regulations to Prevent Evasion

To prevent evasion in certain parts of the income tax system, there are in some cases special regulations for partnerships, which however do not directly concern taxation of income from partnerships.¹⁴⁰ An example is the

concept of *closed partnership* in the regulations described above on taxation of closed corporations. Partnerships are not covered by the regulations on closed corporations for re-allocation of income and capital gains to the income category of employment income. These regulations apply only to limited liability companies and cooperative associations. To prevent evasion from these regulations, there is, however, a need for regulations that qualify shares in closed corporations (limited liability companies or cooperative associations) if the partner is active to a significant degree in a closed partnership. A closed partnership is in principle a partnership that is owned by only a few physical persons.

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¹³⁸ ITA, Chapter 6, Section 11.

¹³⁹ See also Berglund (2013, Chapter 5). As mentioned in *ibid.*, there are however situations with general partnerships where it can be questioned if the new regulations in the The Foreign Tax Credit Act solve the double taxation issue.

¹⁴⁰ For the following see especially ITA, Chapter 56, Section 4 and Chapter 57, Section 4.