TAXING THE PARTNER OF A FOREIGN PARTNERSHIP

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The recent 2007 tax case ITC 1819 (2007) 69 SATC 159 is noteworthy on two grounds. First, it is one of only a few South African tax cases dealing with the application and interpretation of double taxation agreements (DTAs), in this instance an agreement concluded between Lesotho and South Africa. Secondly, it highlights two crucial issues in such cases, namely the importance of determining the correct tax-paying entity and the interaction between DTAs and domestic tax legislation.

The facts of the case are quite straightforward. The taxpayer, an attorney resident in South Africa, was a partner in a law firm established in Lesotho. In the relevant tax year the Lesotho authorities levied tax on the taxpayer's share of the partnership profits for that year in accordance with the tax treatment of partnerships in Lesotho. This treatment is much the same as in South Africa, namely that, although a partnership is required to file a partnership return, the income from the partnership is attributed to the partners according to their respective shares of the partnership income, and tax is levied on that income in the hands of the partner and not the partnership.

Since the taxpayer was a resident of South Africa, his share of the partnership profits was subject to tax in South Africa and included in his 'gross income' in terms of the South African Income Tax Act 58 of 1962 (the Act). As the same income was subject to tax in both Lesotho and South Africa, the taxpayer sought relief in South Africa for this double taxation. There were two possible bases for such relief, and he had an election as to which to rely on.

The first was s 6*quat* of the Act. Section 6*quat* provides relief to South African residents from international juridical double taxation if, inter alia, the

source of the income on which the tax is levied is not in South Africa. (Section 6*quat* has since been amended by the Revenue Laws Amendment Act 35 of 2007, but the amendment is not relevant for the present discussion.) The relief provided by s 6*quat* is in the form of a rebate (a credit) for the taxes paid to a foreign government, and is granted against the taxpayer's South African tax liability. The disadvantage to the taxpayer of relying on this form of relief is twofold: first, the credit is limited to the amount of tax he would have paid on that income in South Africa; and secondly, the income is taken into account in the calculation of his South African tax liability. There is, therefore, no advantage to the taxpayer: he pays the same amount of tax that he would have paid if the income had been earned in South Africa. In contrast, if income earned in a foreign country is exempt from tax in South Africa as a result of the right to tax being allocated exclusively to that foreign country, this exempt income is not taken into account at all in the calculation of the taxpayer's taxable income.

The alternative basis of relief was the application of the DTA entered into between South Africa and Lesotho (the Lesotho DTA, published in GN 607 *GG* 17948 of 22 April 1997). On the taxpayer's interpretation of the relevant provisions of the Lesotho DTA, the income earned in Lesotho was exempt from tax in South Africa because Lesotho was allocated the exclusive right to tax. If this were correct, the income would not be taken into account at all in the calculation of his South Africa taxable income.

The taxpayer exercised his right to elect, confirmed by s 6*quat*(2), and relied on the Lesotho DTA rather than on the provisions of s 6*quat*.

The Commissioner of the South African Revenue Service had a different interpretation of the Lesotho DTA, however. On its interpretation the taxpayer was entitled only to a credit for the tax paid in Lesotho, the end result being the same as that under s 6*quat*. The taxpayer objected to the Commissioner's form of relief, contending that he was entitled, under the Lesotho DTA, to relief in the form of an exemption. The dispute centred on the interpretation of the relevant provisions of the Lesotho DTA.

The taxpayer's interpretation of the relief to be afforded to him hinged on the first sentence of art 7 of the Lesotho DTA, which states that '[t]he profits of an enterprise of a Contracting State shall be taxable only in that State'. This sentence in effect allocates the exclusive right to tax to the country in which the enterprise is resident, with the country of source having to exempt that profit from tax. According to the taxpayer, this sentence was to be interpreted to mean the right to tax was allocated exclusively to Lesotho, being the country where the enterprise, in this case the partnership, was resident.

In rejecting the taxpayer's argument, Van der Merwe J pointed out that art 7 must be read together with arts 3 and 4 of the Lesotho DTA (see paras 5 and 6 of his judgment). In particular, art 3*(f)* defines 'an enterprise of a Contracting State' as 'an enterprise carried on by a resident of a Contracting State', and art 4 defines the term 'resident'. To rely on art 7 and be subject to tax in Lesotho only, the taxpayer would have to be an enterprise resident and

liable to tax in Lesotho. As the taxpayer was not resident in Lesotho, this interpretation had to fail.

In rejecting the taxpayer's argument, Van der Merwe J stated that the taxpayer's proposition 'is dependent on whether C [the partnership] is liable to tax in Lesotho' (para 8). Although correct in identifying tax residence as a prerequisite for relying on art 7, this statement does, with respect, appear to blur the distinction between the identity of the taxpayer and that of the partnership. Even if the partnership itself were liable to tax in Lesotho for the purposes of art 7, it is the partnership's income that would be exempt from tax in South Africa.

Since South African law does not recognize a partnership as a person and does not levy tax on the partnership itself, the partner who is resident in South Africa will still be taxed in South Africa on his portion of the partnership income. This is simply because a DTA relieves juridical double taxation, namely the taxation of the same person and the same income. In the case of a partnership, although the income may be the same, the same person is not being taxed. Of importance here is the recognition that the correct application of a DTA and the relief it offers depends on correctly determining the resident seeking relief in the application of the DTA. This is particularly so when dealing with partnership income.

When a DTA applies to partnership income, whether it is the partner or the partnership that is the resident depends on whether a partnership is treated as a person or a transparent entity. The different treatment of partnerships by countries has been discussed extensively by the Organization for Economic Co-operation and Development (OECD) (see the OECD's *Report on Partnerships* (1999); 'The application of the OECD Model Tax Convention to partnerships' in (2000) 6 *Issues in International Taxation*; and see the commentary on art 1 in *OECD Model Tax Convention on Income and Capital* (2005) paras 2–6.6). The need for this report and commentary arose because the different treatment of partnerships in different jurisdictions could result either in different relief, or none at all, being granted to the taxpayer. This is clearly seen in the current case where the taxpayer would not have been entitled to relief in terms of the Lesotho DTA if Lesotho had treated a partnership as a person. As neither South Africa nor Lesotho treats a partnership as a person for tax purposes, this problem does not arise in respect of the application of the Lesotho DTA.

There is, however, a view stated in the OECD partnership report (at 13–14) that if a partnership is treated and taxed like a company, the partnership should be able to qualify as a resident for the purposes of a DTA. In this regard, s 66(15) of the Act and s 75 of the Lesotho Income Tax Act 9 of 1993, which provides that a partnership must render a joint return, could potentially be seen as treating a partnership as a legal entity. Van der Merwe J rejected this view by stating (para 8) that

> 'although registered as a tax entity, [the partnership] is not liable to tax in Lesotho. The position in respect of partnerships in Lesotho would appear to be similar to the position provided for in respect of partnerships by the [Income

> Tax] Act. The Act provides in s 66(15) that persons carrying on any business in partnership shall make a joint return of partners in respect of such business but in terms of s 77(7) that separate assessments shall notwithstanding be made upon partners.'

That it is the partner and not the partnership upon which tax is levied has been confirmed by the Supreme Court of Appeal in *Chipkin (Natal) (Pty) Ltd v Commissioner, South African Revenue Service* 2005 (5) SA 566 (SCA). In this case Cloete JA stated that the Act recognizes only income — being gross income less applicable exemptions — that accrues to the partners in common, and then attributes that income to each partner proportionally (para 11). In relation to the allowable deductions and allowances, Cloete JA stated that these are attributed to the partners in proportion, resulting in the taxable income of each partner, with each partner taxed on his or her partnership income (para 12).

Notwithstanding the use of the partnership in Lesotho, it is the partner, a South African resident, who is the taxpayer. The double taxation is as a result of a resident of South Africa deriving income from Lesotho, with both countries having the right to levy tax, the former on the basis of residence and the latter on the basis of source.

The second issue highlighted by this case is the interaction between DTAs and domestic tax legislation. As part of the enquiry to determine whether the income from the taxpayer was to be categorized as 'business income' under art 7 of the Lesotho DTA or 'income from independent personal services' under art 14, Van der Merwe J considered s 24H(2) of the Act (para 11). In doing this he placed reliance on a deeming provision found in domestic law to interpret a DTA.

Section 24H(2) provides that where any trade or business is carried on in a partnership, each member of such partnership shall, notwithstanding that he may be a limited partner, be deemed for the purposes of the Act to be carrying on such trade or business. On the assumption that a law firm is a trade or business, applying this subsection means that the South African resident taxpayer is deemed to be carrying on the trade or business of the Lesotho partnership in South Africa. The use of a deeming provision of South African domestic law to interpret a provision of a DTA raises a question, not discussed in the judgment, about the interaction between domestic legislation and a DTA.

In terms of the Lesotho DTA, if a term is not defined, reference may be made to the domestic laws of the relevant country to determine its meaning. Article 3(2) provides that a term shall, 'unless the context otherwise requires, have the meaning which it has under the laws of that State concerning the taxes which are the subject of this Agreement'. Article 3(2) thus allows, in this limited sense, domestic law to be used. However, art 3(2) does not appear to include references to deeming provisions. In addition, although the provisions of a DTA and the Act should be read together (s 108 of the Act has the effect that a DTA becomes part of the Act), consideration needs to be given to the possibility that deeming provisions could potentially undermine or affect the application of a DTA.

In the absence of s 24H(2), the partnership in Lesotho is not necessarily a business or trade carried on by the taxpayer. For instance, the partnership might be carrying on a business in Lesotho but the partner might not necessarily be carrying on the business of the partnership. The partner's contribution to the partnership could merely be in the form of capital or an intangible good, or the rendering of services from South Africa. The latter possibility in relation to a foreign partnership is illustrated by *Commissioner for Inland Revenue v Epstein* 19 SATC 221; 1954 (3) SA 689 (A), where Centlivres CJ stated (at 699D–E in the SALR):

> 'It may be said that when there is a partnership the members of which carry on their business activities in two different countries, the income of the partnership is derived from two sources and that when one of the partners carries on his business activities in the Union his income from the partnership is derived from a source within the Union while the income of the other partner is derived from a source in a foreign country. For the income which the partner, who carries on his business activities in the Union receives is the *quid pro quo* for the services he renders in the Union to the partnership.'

By contrast, the use of the deeming provision has the result that the income is categorized as business income in South Africa. It may be that without the deeming provision, the income would have been categorized as being income from independent personal services. The other contracting state, in this case Lesotho, may, on the application of its domestic laws, classify the income as falling under the latter. This mismatch between the articles of the DTA could potentially result in the taxpayer's not being granted any relief.

This case illustrates precisely this possibility. The income is classified in South Africa as business income, and accordingly the allocation of the taxing rights between South Africa and Lesotho is to be determined by art 7. On the application of this article, South Africa as the resident country of the taxpayer is allocated the exclusive right to tax the income. South Africa will only recognize Lesotho's right to tax income that is attributable to a permanent establishment of the taxpayer in Lesotho and in this event, provide relief in the form of a credit by applying art 22.

If Lesotho classifies the income as arising from independent personal services, it may, in terms of art 14, tax the income to the extent that services are rendered in Lesotho, and if the taxpayer has a fixed base regularly available to him in Lesotho for the purpose of performing his activities, the income attributable to that fixed base.

In the event that the taxpayer does not have a permanent establishment in Lesotho, South Africa will tax the income on the basis of the residence of the taxpayer in accordance with art 7. As South Africa will be applying its domestic law as allowed by art 3(2) and by the incorporation of the treaty into the Act in terms of s 108(2), South Africa has no obligation to recognize the basis on which Lesotho is levying the source taxation. From the South African perspective, it will have an exclusive right to tax the income. As pointed out by Skaar, 'mainstream opinion seems to be that both countries

are entitled to use their own definition of terms that are not defined in the treaty itself' under art 3(2) (Juris Skaar 'The concept of permanent establishment: Commentary on article 5 of the OECD Model Treaty' *IBFD Database*, available at *http://ip-online2.ibfd.org/pe/* at para 2.6.2 of ch 2, last accessed on 10 May 2008). The disadvantage pointed out by him, that 'income may . . . be classified as business profits [in one country] and subject to residence taxation, and the same income may be classified as income from personal services subject to source taxation [in the other country]', could potentially result owing to the use of the s 24H(2) deeming provision. The potential mismatch of categories would always exist as a result of the application of each country's domestic law.

A possible solution, as indicated by Skaar loc cit, is for both states party to the treaty to use the concept of business profits as determined by the source state's domestic law. On the basis of this approach, Van der Merwe J should not have embarked on an analysis to determine the category of the income but should merely have referred to the category used by Lesotho. Whether or not Skaar's approach is seen as undermining the sovereignty of a country in enacting its own domestic tax legislation, it offers a solution to a problem created by the use of domestic legislation in the application and interpretation of DTAs, particularly in the use of deeming provisions.

More pertinent, however, in my opinion, is that the s 24H(2) deeming provision is used out of its intended context. Section 24H deals with the treatment of partnership income. In particular, it provides a method for ensuring that partnership income is not kept in the partnership, as was decided in *Sacks v Commissioner for Inland Revenue* 1946 AD 31. In the context of the present case, it is not the partnership income that is being taxed in South Africa but the profit that the partner receives as a result of his business activities in Lesotho. In the judgment of Van der Merwe J there is no reference to the calculation of this profit in accordance with s 24H. The only reference to the calculation of the taxpayer's profit states that the taxpayer was entitled to a share of the profits of the partnership, being '[a]n equal share in the total profit (*ie* total income not consisting only of fees less total expenses)' of the partnership.

The purpose of s 24H(2) in particular is to allow a partner to be able to deduct the proportionate share of the expenses and losses of the partnership by deeming the partner to carry on the trade or business of the partnership. Without s 24H(2), a partner would not necessarily be able to deduct the expenses successfully as the partner would not necessarily be carrying on a trade or business.

In addition, the calculation of partnership income in Lesotho might be different to that under s 24H. In terms of s 24H, as stated in *Chipkin* (supra) by Cloete JA (paras 11–12), income (being gross income less exemptions) accrues to the partners in common and is then attributed to them proportionately. Similarly, in terms of s 24H(2) deductions and allowances are attributed to the partners proportionately. An alternative method of calculating the profit of a partner was rejected in *Chipkin* (para 12) in

applying s 24H. This alternative method calculated the partnership income as if the partnership were a separate legal person. In this calculation the income of a partnership would be determined separately, with the Act attributing to each individual partner a proportionate share of the partnership's taxable income. That this different method can lead to a different amount being taxed in the hands of the partner is clearly illustrated by *Chipkin*. The portion of the income of the taxpayer as partner may therefore be different depending on which method of calculation is used.

Thus the interpretation of terms in a DTA in accordance with domestic law has consequences not only for the categorization of the income under the DTA but also for the amount that would form part of gross income if s 24H were to be applied.

Although it is likely that the same result would have been reached in the present case irrespective of whether the issues dealt with in this note had been raised, the case nevertheless serves to illustrate the importance of the correct application of DTAs: first, in ensuring that the resident of the contracting state seeking relief has been correctly identified, and secondly, that the income is dealt with under the correct category. More pertinently, however, it highlights the potential problems that arise in the interaction between a DTA and deeming provisions in the Act.