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Taxation of Partnerships - Economic general report for the Nordic Tax Research Council's annual meeting on 22 May 2015 in Aarhus

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Abstract: From an economic perspective a partnership is an odd construction. Generally, an economist will distinguish between physical persons and companies. However, partnerships are a combination of a person and a company. This report will attempt to give an overview of how the taxation of partnerships affects the organization of businesses and the role played by partnerships in the business structure in the Nordic countries.

The Economic General Report is based on the Economic National Reports from Denmark, Sweden, Norway, and Iceland. This report will include relevant information from the four reports. It is not an exhaustive study of the effects of the tax treatment of partnerships. However, it will examine how taxation of partnerships changes the incentive to choose a certain form of organization and it will give an illustration on how the different tax rules in the Nordic countries work. Particularly, it seeks to identify asymmetries in the taxation of different types of company structures, and the role of partnerships in the business structure.

1 Partnerships in general

In general, partnerships are companies, with the special characteristic that they are tax transparent. They are regarded as companies, but due to the tax transparency, it is the partners that are subject to taxation. The term “*transparency*” has different meaning in the Nordic countries, as described in The Legal General Report. The term “*partnership*” also has various meanings across the Nordic countries and the use of the term differs. The national rapporteurs focus on partnerships in their national reports un-

derlines the difference in the rules and the role of partnerships in the business structure.

A partnership can be a company, where all the partners have unlimited liability. It can also be a company, where some partners have unlimited liability and some partners have limited liability. Both types of partnerships exist in the four Nordic countries. Another characteristic is that both physical persons and companies with limited liability can be partners in a partnership. The legal framework of partnerships in the Nordic countries is described in the Legal General Report.

In section 1, this report discusses the typical partnership structures and the extent of those in the four Nordic countries. Section 2 covers the taxation of partners in partnerships. Section 3 describes the importance of taxation of partners in their choice of organization and tax planning. Section 4 describes the political focus on partnerships and their macro economic impact.

2 Partnerships in the Nordic countries

In all four Nordic countries, partnerships play a role in the business structure. However, the role is limited compared to other types of company structures. Due to tax transparency, there is limited access to data, which complicates a comparison of the effects of taxation of partnerships in the four countries.

One feature of partnerships is tax transparency. That is why it is the taxation of the partners, both the physical persons and the companies with limited liability that is relevant in order to assess the incentives of the partners. Taxation of partnerships is basically a question of how partners themselves are taxed in the different countries. This section will attempt to give an account of the consequences of the tax rules, and the impact of partnerships in the Nordic countries. Generally, there is a distinction between partnerships where the partners are jointly and unlimited li-

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able, and partnerships with more diverse patterns of liability.

2.1 The traditional partnership with joint and unlimited liability

A partnership where every partner has joint and unlimited liability, is known as *handelsbolag* in Sweden, *interessentskab* in Denmark, *sameignarfélag* in Iceland, and *ansvarligt selskab* in Norway. In Norway, the partnerships have a special feature to have an option among the partners to be uneven liable as long as the sum of all corresponds to the total liability of the partnership, cf. The Legal General Report. In this report, this type of partnership is called a partnership with joint and unlimited liability.

The Norwegian *ansvarligt selskap* has two models. Either every partner is liable to all the debt of the partnership or every partner is liable to a pre-determined share of the debt in the partnership. Sole proprietors are taxed based on *foretagsmodellen* while partners in a partnership are taxed based on *deltakermodellen* where the partners are taxed on the basis of a share of the partnership profit including dividends and income on capital which exceeds a risk-free interest.

In Sweden, the number of *handelsbolag* has decreased over the last decade, while the numbers of limited liability companies, *aktiebolag* has increased. In Sweden, the capital requirement for a company with limited liability, *aktiebolag* was halved in 2010 from SEK 100.000 to SEK 50.000, which increased the numbers of *aktiebolag* to more than 35.000 registered units in 2012. This means that *aktiebolag* represent a little more than half of the sole proprietorships, which by approx. 62.000 units and a share of 60 percent is the most widespread way that business is organized in Sweden. By comparison, *handelsbolag* represent only a small share with approx. 6.000 units.

In both Sweden and Denmark, sole proprietorships is the most common way to organize business, but when it comes to tax revenue, it is the (large) companies with limited liability that generates the majority of tax revenue. In Norway and Iceland, companies with limited liability are found more often than sole proprietorships.

In Iceland, the partners can choose whether the partnership is tax transparent or subject to taxation. This applies to partnerships with joint and unlimited liability and to partnerships with uneven and limited liability. Approximately 75 percent of the partnerships with joint and unlimited liability have registered to be subject to taxation. This indicates that the tax system has a determining effect on the choice. The tax rate for partnerships has increased

relatively more than the corporate tax rate and the capital income tax rate since the financial crisis in Iceland.

In Denmark, the partnership *interessentskab* is the most common type of partnership, but since the partnerships in Denmark are not obligated to register, there is not much information about the actual number.

In Denmark, the partnership *interessentskab* is comparable to a sole proprietorship with multiple owners who often are related. This type of partnership requires consensus among the partners on the operation of the partnership, but also on the distribution of profits, which depends on the share of ownership. This also means that the partners have to agree on how much of the profit that is used to consolidate the partnership. This challenge can under certain circumstances partly be solved if each of the partners deposits their share of the profit in a financial holding company that is not obligated to distribute dividends to the partners.

2.2 Partnerships with uneven and limited liability

Although access to comparable data is limited, a common characteristic is that partnerships are not the most predominant type of company in the Nordic countries among the different ways to organize a business. In Norway, Iceland, Sweden, and Denmark it is nonetheless possible to establish partnerships with limited liability alongside the partnerships with joint and unlimited liability.

The *kommanditselskap* in Norway, the *kommanditbolag* in Sweden, the *kommanditselskab* in Denmark, and the *samlagsfélag* in Iceland resemble each other. The Legal General Report provides a more detailed description of the differences in the taxation of partnerships with limited liability.

In Denmark, 3.700 partnerships with limited liability in the form of *kommanditselskab* are registered. Even though a partnership with joint and unlimited liability is most common, the tax treatment of partnerships with limited liability is attractive, because the partners can offset losses in the partnership in their personal income. In this way, participation in a partnership with limited liability can be a way to a significant reduction in the personal income tax for the partner.

This means that participation in a limited partnership – especially for partners with a high personal income – may be purely tax driven instead of being commercially driven. In Denmark, the partnership with limited liability has often been used to own real estate (often foreign) where the partner with unlimited liability is a company

with limited liability owned by the partners. In order to reduce the liability the partners, only invest the minimum capital in the company with the unlimited liability.

In Iceland, 1.760 partnerships with limited liability (*samlagsfélag*) are registered, which corresponds to a little more than 3 percent of the total number of companies. 97 percent of the 1.760 partnerships with limited liability are registered to be subject to taxation. The number of partnerships with limited liability has increased drastically since 2009, which is attributed to significant changes in the tax rules that apply to companies with limited liability. The Icelandic 20/50-rule states that distributed dividends that amount up to 20 percent of the equity capital are taxed as capital income. Amounts above this threshold, half is taxed as salary income and half as capital income. With the introduction of the 20/50-rule, the taxation of partnerships with limited liability will be much more attractive because dividends in partnerships are not taxed. Therefore, the majority of the profit can be paid to the partners free of taxation. This has led to a significant tax benefit of partnerships with limited liability compared to companies with limited liability.

The legislation was abolished in 2013. One of the consequences of the legislation was that the partner, who was unlimited liable, could avoid proper liability by letting a company with limited liability be the partner with unlimited liability, which meant that none of the partners were completely liable for the partnerships obligations.

2.3 Other types of partnerships

In Denmark and Iceland, another type of partnership exists alongside the partnerships with joint and unlimited liability and partnerships with uneven and limited liability. In Denmark exists a special type of partnership called *partnerselskab* (earlier called *kommanditaktieselskab*). Iceland has a special type of partnership called *partnership limited by shares*. However, only 53 of these exist, hence this type of partnership is rare compared to the total number of Icelandic companies.

The Danish *partnerselskab* is similar to a partnership with limited liability *kommanditselskabet*, but the use and spread of the two partnerships are different, which is due to tax rules and also to the stricter requirements that apply to *partnerselskabet*. In 2015 there is registered 632 *partnerselskaber* and approximately 3.700 partnerships with limited liability *kommanditselskaber*. Partnerships with limited liability have features, which makes this type of partnership suitable for businesses generating tax losses in the early stages because losses can be off-set in the part-

ners' other income. Conversely, *Partnerselskaber* are often used by businesses that generate profits and where the individual partners are an active part of the business.

Both the Icelandic partnership limited by shares and the Danish *Partnerselskab* require a minimum equity capital of respectively DKK 500.000 and ISK 4.000.000. This could explain why the Icelandic and the Danish version of this type of partnership despite the fiscal advantages are not more common.

3 Taxation of partners in partnerships

The taxation of partnerships – and transparent entities in general – should be considered in context with the overall tax system. Due to the principle of transparency, the taxation of partnerships is linked with the taxation of the different types of partners (physical persons or companies with limited liability).

The national economic reports by the four Nordic countries all emphasize that it is not only the tax treatment that is important when deciding how business is organized.

In all four countries the taxation of partnerships works as a total taxation, but with different taxation of personal income and capital income. Since the partnership is transparent the taxation takes place at the level of the partners, which means that the rules of personal income tax and the taxation of companies with limited liability are important to the partners of the partnership, depending on whether they are a physical person or a company with limited liability.

Partnerships in Norway and Denmark are tax transparent. An explanation of how these partnerships are taxed is not provided since the taxation of the partnerships is dependent on how the partners are taxed. The term transparency has another meaning in Sweden. As mentioned, it is optional in Iceland whether a partnership (including partnerships with joint and unlimited liability, partnerships with limited liability and partnerships limited by shares) is transparent or subject to tax.

3.1 Taxation of personally owned companies – division of earned income and capital income

The dual income tax system in Sweden entails that sole proprietorships and partnerships are taxed almost identi-

cally, except that the profit in a partnership is distributed to the partners depending on their share of ownership. Income is divided between capital income and salary income. Capital income is taxed at 30 percent. Salary income is taxed as personal income including social security, which in total can amount to 66,71 percent. The capital income is settled as a calculated return of the invested capital, *räntefördelning*. Compared to companies with limited liability, sole proprietorships and partnerships pays a little less in social security. Also, sole proprietorships and partnerships have no capital requirements. There is a capital requirement on 50.000 SEK for companies with limited liability.

During the last decades, Norway has focused on the taxation of sole proprietorships and partnerships. Variations of the dual income tax system do not only exist in Norway, but also in other Nordic countries. The main characteristics of the dual income tax system are a flat and low tax rate on capital income and a higher and progressive tax rate on salary income. This division of the income gives incentives for the owners to convert salary income to capital income.

In 1992, a version of the dual income tax system was introduced in Norway commonly known as the *split-model*. This regime sets up rules for the sole proprietor or the active partner in a partnership (or in companies with limited liability where the active owner holds two-thirds of the shares in the company) on how to split the income between salary income and capital income. One of the challenges with the regime was the strong incentives to convert income due to the significant differences in the taxation of salary income and dividends. The regime had an obvious behavioural effect since owners preferred to receive dividends from companies with limited liability due to the lower taxation.

Consequently, Norway changed the rules in 2006 in order to increase the symmetry in the taxation of the owners who have chosen different company structures for their business. Following the reform in 2006 the split-model was abolished for partners in partnerships and active shareholders in companies with limited liability and was replaced by *deltakermodellen* and *aktionærmodellen*. The changes, which, among other things, contributed to a more identical taxation of dividends and a lower marginal rate of tax on salary income, can be viewed as an attempt to counter income conversion from salary income to capital income.

In Iceland, the tax rate for partnerships that have chosen to be subject to taxation is 36 percent, but only 20 percent for companies with limited liability and for capital income. Despite this difference the rate of 36 percent is

still lower than the three different tax rates of personal income, which are 37,3 percent, 39,74 percent, and 46,24 percent. Given that the taxation of partnerships is lower than the lowest marginal tax rate, it can be tempting to register partnerships as subject to taxation in order to avoid being taxed at the level of the partner. This can be part of the reason why the vast majority of the partnerships in Iceland have chosen to be subject to taxation.

In Denmark, a sole proprietor is subject to the rules of either personal income tax or the rules in a tax regime called *virksomhedsskatteordningen*. It is optional to use *virksomhedsskatteordningen*. The tax regime allows a sole proprietor to be taxed almost the same way as a company with limited liability (subject to corporate income tax). There are a number of benefits linked to this tax regime. Among others, interest payments are fully deductible, a share of the profit is taxed as capital income instead of personal income and it is possible to set a side income that is subject to a provisional tax at the same rate as the corporate income tax (23.5 percent in 2015 and 22 percent in 2016).

An overall taxable income is calculated if the tax regime is used. Interest expenses and other capital expenses are a part of the income on the same terms as other expenditures. A capital return is calculated on the base of the assets and liabilities. The capital return, which amounts to 2 percent of the base, is taxed as capital income.

The rest of the income can be fully or partly set aside. This income is taxed at the corporate income tax rate. The income, which is not set aside is taxed as personal income, up to 55,8 percent is the maximum marginal tax rate in 2015. When income is withdrawn, it is taxed as personal income and the paid corporate tax is deducted from the personal income tax. This also means that if the income is not withdrawn, the same rate as for corporations is paid, which gives the incentive to keep the income in the regime as long as possible. Beside the possibility of tax deferral, *virksomhedsskatteordningen* has the advantage that losses can be deducted in other income. Additionally, the loss is deductible from previous savings, so that loss effectively is treated on the basis of a carry-back rule.

3.2 Taxation of a company with limited liability

In Denmark, companies with limited liability are taxed at a corporate income tax rate of 22 percent in 2016 (23.5 in 2015). The corporate income tax rate has been reduced a number of times in the last decades. In Norway the corpo-

rate income tax rate has only been changed once since 1992 from 28 percent to 27 percent in 2014.

In Sweden, companies with limited liabilities are taxed at a corporate income tax rate of 22 percent like in Denmark. The rate was reduced in 2013. Additionally, in Sweden The Corporate Income Tax Committee (*Selskabsskattekomiteen*) has proposed the introduction of a CBIT (comprehensive business income tax), which limits deductions, but supplemented by a significant reduction in the effective corporate income tax rate (from 22 percent to 16.5 percent). For *handelsbolag*, this means that the proposed limitation of deductions will affect partnerships, but they will not benefit from the corporate income tax rate reduction because the taxation happens at the level of the partner.

In Sweden, companies with limited liability are first taxed at the corporate income tax rate of 22 percent. Next, dividends are taxed as capital income with different rates depending on the type of company. As in other countries, this is a classic two-part taxation, where corporate income tax is first imposed and secondly dividends received by shareholders are taxed at a rate, which in Sweden varies between 20 percent and 57 percent.

As an example, dividends are taxed at either 30 percent or 25 percent, depending on whether the shares are publicly listed or not. If the company is a closely held corporation (*fåmansföretag*), dividends are taxed at 20 percent until a certain limit and the rest is taxed as salary income. The rules in Sweden gives minority shareholders incentives not to be employed in the company but instead to be classified as passive owners in order to avoid that part of a dividend is taxed up to 57 percent (not including social security contributions). Dividends received by a passive owner will be taxed at 25 percent, which, from a tax point of view, strongly incentivizes passive investments, while employees, who have a share in the company, are taxed at a substantially higher rate. However, the effect of this asymmetric taxation of shareholders is supplemented by the wage-based dividend allowance (*lönunderlagsreglen*), which means that minority shareholders, who pay the highest marginal tax, get a deduction so that dividends are taxed at 20 percent. The consequence of this rule is that owners with high salary income from a company still prefer to receive dividends as active owners rather than as passive owners in a company.

As the only country, Iceland has raised the corporate income tax in 2010 and 2011, from 15 to 18 percent at first and later to 20 percent. Despite the corporate income tax increase, Iceland is still the Nordic country with the lowest CIT rate. In the same period, the taxation of partnerships subject to tax was raised. However, with a raise from 24

to 33 percent and to the current level of 36 percent, it was substantially greater raise.

4 The significance of the taxation for partners choice of organisation

Different versions of the dual income tax system are seen in the Nordic countries, but the different taxation of salary income and capital income gives rise to challenges in relation to partners tax planning. Often, this is handled by specific rules that splits wage income and capital income, which is calculated as an imputed return. Nonetheless, differences in taxation of various types of income give rise to tax planning.

There is no doubt that a tax politician or a tax economist faces a challenge weighing tax policy considerations. One has to consider neutrality and the objective of minimizing excess burdens in the tax system and one also has to consider distribution and revenue. In a dual income tax system, diverse tax rates of capital income and personal income should not encourage conversion of the often highly taxed personal income into capital income in order to reduce the effective tax.

Partnerships play a role in relation to tax planning, because certain types of partnerships allow partners to deduct losses generated in the partnership in other income. This could be an incentive for some to choose partnerships for tax reasons only.

In general, the choice of organization depends on whether a person wants to be taxed as self-employed or as a salary earner. Several of Nordic countries have focused on harmonizing taxation of salary and profit. Still, self-employed persons – whether organized as a sole proprietor or in a partnership – have a list of possible ways to defer taxation or to convert the profit to capital income, which gives tax planning opportunities that is not possible for a salary earner.

Those that choose to organize themselves in a partnership also have to choose which type of partnership they want. The optimal type of partnership depends on several factors such as the number of partners in the partnership, their involvement in the management process, and whether they provide knowledge or capital. Similarly, it has importance whether profit is expected from year one or if losses are expected for a number of years, in which case it might be relevant that losses can be deducted in other income. Another aspect is whether there is to be joint

and unlimited liability or uneven liability for the partners. The different regulations of partners in partnerships in the Nordic countries described in the national reports display, that even though the the Nordic countries for decades have had focus on harmonizing the taxation of different types of income, there is still variations in which type of partnership that is suitable for a particular type of business and its owners.

From a tax expert point of view, it might seem discouraging, but the four Nordic reports indicate that it is not only the tax rules that have an effect on the choice of organization. Nonetheless, the Nordic reports display that the rules – particularly the rules that regulates the personal income tax system – has a significant impact on the choice of selecting partnerships.

5 Political focus

A favorable framework for business is high on the political agenda, especially in Sweden, Norway, and Denmark, where commissions and committees examine the business taxation system searching for ways to optimize the system in order to give the best possible incentives for investments and growth. Innovation and entrepreneurship are positive concepts in the public and in the political debate, which politicians – regardless of their political standpoint – endorse.

For example, in Denmark and Norway, there is political focus to attract more entrepreneurs and self-employed persons. However, the debate does not deal with why there have to be more people self-employed or if one form of organization is more preferable than others. The choice of organization is not part of the debate, and no one questions the premise that the more self-employment, the better.

Whether there exist sound economic arguments favoring that sole proprietorships and other partnerships should have more macro economic benefits than for example companies with limited liability is not part of the political debate to convince more people to start their own business. It is unclear for this rapporteur whether any studies have found this connection.

It is also unclear whether it has macro economic benefits that more persons switch from being wage-earner to self-employment. It might be related to the idea that self-employed generate a higher return than a person could have achieved as an employee. If the business creates new jobs it will have macro economic benefits but if it only means that employed persons change their job or business without a significant and economic profit, the effect of self-

employment is low. It is unclear to this rapporteur whether there are studies in the economic literature, which establish that self-employment has macro economic benefits compared to companies with limited liability and it is also unclear whether any studies show that it has a macro economic benefit that persons switch from being an employee to self-employment.

As mentioned, there is a political focus to create as favorable conditions as possible for self-employment, start-ups and alike in many of the Nordic countries. If the political debate leads to (frequent) regulatory changes, it could be seen as an effort to eliminate tax-avoidance for self-employed, but it could also be seen as an effort to lead a selective business policy.

Eliminating tax-avoidance is often part of the media coverage, when tax rules are being exploited for profit shifting or conversion of income. This often creates a debate to show consideration to self-employed versus consideration to protect the tax base. As mentioned, the four National Reports indicate that the tax rules are not the sole reason when deciding on the form of organization. This might give a little bit of comfort.