Many paths to the same goal: Lessons from the convergent evolution of tax transparent limited liability entities

Erik Röder
MPI for Tax Law and Public Finance
Sydney-Munich-Conference on the Law and Economics of Taxation
28 November 2016
Convergent evolution

...in biology:
Convergent evolution

...in the law of business organisations:

- S-Corporation LLC
- GmbH & Co. KG
- S.A.R.L. de famille
- Trading Trust
- LLP
• Benefits of Transparent Taxation and Limited Liability

• Preconditions: Income Tax and Limited Liability Entities

• Three paths to the same goal:
  – Path 1: Combination of legal forms (Germany, Australia)
  – Path 2: Optionality of transparent taxation (US)
  – Path 3: Creation of a bespoke business entity (US)

• Lessons
### Benefits of transparent taxation

<table>
<thead>
<tr>
<th>Level</th>
<th>Profits</th>
<th>Losses</th>
<th>Preferences</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Entity Taxation</strong></td>
<td><strong>Entity</strong></td>
<td>Taxed</td>
<td>Trapped</td>
</tr>
<tr>
<td></td>
<td><strong>Owner</strong></td>
<td>Taxed again</td>
<td>Losses of owner may not be set against profits at entity-level</td>
</tr>
<tr>
<td><strong>Transparent Taxation</strong></td>
<td><strong>Entity</strong></td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td></td>
<td><strong>Owner</strong></td>
<td>Profits taxed once in the hands of owner</td>
<td>Losses of entity may be set against profits of owner, and vice versa</td>
</tr>
</tbody>
</table>
Benefits of limited liability

- Owners’ non-business assets are shielded from business debt

- Is limited liability a mere „placebo“ for SMEs?
  - Because banks insist on personal guarantees?
  - Probably not, for instance because of „doomsday claims“
  - Empirical fact: Entrepreneurs want and actively seek limited liability protection
Preconditions

• **Income taxation:**
  – Significant levels of income taxation since WWI
  – Partnership/corporation divide universal

• **Availability of limited liability entities:**
  – Limited partnership
  – Corporation
  – Trust
Three paths to the same goal

• Path 1: Combination of legal forms (Germany, Australia)
• Path 2: Optionality of transparent taxation (US)
• Path 3: Creation of a new business form (US)
Path 1: combination of legal forms

• Germany: GmbH & Co. KG:
  – Combination of corporation (GmbH) and limited partnership (KG)
  – Corporation is typically the sole general partner of limited partnership (limited liability)
  – Limited partners are typically entitled to 100 % of the profit of the limited partnership (transparent taxation)
Path 1: combination of legal forms

GmbH & Co. KG

Limited partnership

Corporate General Partner

Limited Partner A: 70%

Limited Partner B: 30%
Path 1: combination of legal forms

GmbH & Co. KG

- Corporate General Partner
- Limited partnership
  - Limited Partner A: 70%
  - Limited Partner B: 30%
Path 1: combination of legal forms

<table>
<thead>
<tr>
<th>Type of business entity</th>
<th>Net income 1 000 EUR</th>
<th>Net income percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole proprietorships</td>
<td>112.833.516</td>
<td>32 %</td>
</tr>
<tr>
<td>Partnerships</td>
<td>123.508.531</td>
<td>35 %</td>
</tr>
<tr>
<td><strong>Thereof GmbH &amp; Co. KG</strong></td>
<td><strong>65.568.874</strong></td>
<td><strong>19 %</strong></td>
</tr>
<tr>
<td>Corporations</td>
<td>80.253.390</td>
<td>23 %</td>
</tr>
<tr>
<td>Other</td>
<td>36.202.905</td>
<td>10 %</td>
</tr>
<tr>
<td>Total</td>
<td>352.798.342</td>
<td>100 %</td>
</tr>
</tbody>
</table>

Year: 2011

Source: German Personal, Partnership and Corporate Income tax statistic 2011
# Path 1: combination of legal forms

<table>
<thead>
<tr>
<th>Type of business entity</th>
<th>Number of taxpayers</th>
<th>Gross receipts 1 000 EUR</th>
<th>Gross receipts percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole proprietorships</td>
<td>2.182.130</td>
<td>567.636.578</td>
<td>10 %</td>
</tr>
<tr>
<td>Partnerships</td>
<td>428.751</td>
<td>1.508.069.560</td>
<td>26 %</td>
</tr>
<tr>
<td><strong>Thereof GmbH &amp; Co. KG</strong></td>
<td><strong>137.658</strong></td>
<td><strong>1.113.849.400</strong></td>
<td><strong>19 %</strong></td>
</tr>
<tr>
<td>Corporations</td>
<td>553.390</td>
<td>3.295.206.784</td>
<td>56 %</td>
</tr>
<tr>
<td>Other</td>
<td>75.950</td>
<td>499.961.913</td>
<td>9 %</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3.240.221</strong></td>
<td><strong>5.870.874.835</strong></td>
<td><strong>100 %</strong></td>
</tr>
</tbody>
</table>

**Year: 2014**

Source: German VAT statistic 2014
Path 1: combination of legal forms

- LPs in the France, the UK, the US and Germany
  - France:
    - LPs barely used at all
    - Corporation-LP-ratio = 2000 : 1
  - UK, US and Australia:
    - LPs predominantly used as investment vehicles
    - Corporation-LP-ratio = 200 : 1 (UK/AU) / 20 : 1 (US)
  - Germany:
    - LPs used as investment vehicles and as business entity
    - Corporation-LP-ratio = 4 : 1
Path 1: combination of legal forms

- What made the difference?
  - Limited liability?
  - Taxation?
    - FR: Profit share of limited partner subject to corporate income tax
    - AU: Limited partnerships treated as companies only since 1992
    - UK, US: Flow-through-taxation
  - Control
France (Code de Commerce, 1807, Art. 27 and 28):

„L’associé commanditaire ne peut faire aucun acte de gestion, ni être employé pour les affaires de la société, […]. En cas de contravention […] l’associé commanditaire est obligé solidairement, avec les associés en nom collectif, pour toutes les dettes et engagements de la société.“
• A brief history of the limited partnership:
  – FR: 1673 (Ordnonannce sur le commerce); 1807 (Code de Commerce)
  – US: From 1822 (State of New York); 1916 (Uniform Ltd Partnership Act)
  – DE: 1861 (ADHGB/German Commercial Code)
  – UK: 1907 (Limited Partnerships Act)
  – AU: 1867 (QSL); 1908/09 (TAS/WA); 1991/92 (NSW/VIC); 1997 (SA)
Path 1: combination of legal forms

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„L’associé commanditaire ne peut faire aucun acte de gestion, ni être employé pour les affaires de la société, […]. En cas de contravention […] l’associé commanditaire est obligé solidairement, avec les associes en nom collectif, pour toutes les dettes et engagements de la société.“

State of New York (An Act relative to Partnerships, 1822, sec. 5):  
„[N]o special partner shall transact any business on account of the partnership, nor be employed for that purpose, as agent, attorney or otherwise, under the penalty of being liable as a general partner.“
Path 1: combination of legal forms

UK (Limited Partnerships Act 1907, sec. 6(1)):

„If a limited partner takes part in the management of the partnership business he shall be liable for all debts and obligations of the firm incurred while he so takes part in the management as though he were a general partner.”

New South Wales (Partnership Act 1892, sec. 67(2) (1991)):

„If a limited partner takes part in the management of the business of the limited partnership, the limited partner is liable, as if the partner were a general partner, for the liabilities of the partnership incurred while the limited partner takes part in the management of that business.”
Germany (ADHGB, 1861)

Drafting committee rejected the adoption of a French-style “défense d`immixtion“ 14:1


[I]n a world with LLPs, LLCs and, most importantly, LLLPs, the rule is an anachronism.“
Path 1: combination of legal forms

- Australia: Trading Trust
  - (Typically) combination of a corporation and a discretionary trust
  - Corporation acts as trustee
    - Holds legal title to business assets
    - Conducts business activities
  - Beneficiaries of the trust are entitled to the profits of the business
Path 1: combination of legal forms

- **Trustee liable for business debt**
- **Right to be indemnified out of trust assets**

**Corporate Trustee**

**Trading Trust**

- **Beneficiaries not liable for business debt**
- **Unless they are directors of the trustee and the trustee’s right to indemnification is restricted**

**Beneficiary A**

**Beneficiary B**

100%
### Path 1: combination of legal forms

<table>
<thead>
<tr>
<th>Trading Trust</th>
<th>Profits</th>
<th>Losses</th>
<th>Preferences</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Entity-Level</strong></td>
<td>--</td>
<td><em>trapped</em></td>
<td>--</td>
</tr>
<tr>
<td><strong>Beneficiary-Level</strong></td>
<td>Profits taxed once in the hands of beneficiaries</td>
<td>Profits of trust may be set against losses of beneficiaries</td>
<td>Beneficiary-level tax preferences applicable</td>
</tr>
</tbody>
</table>
### Path 1: combination of legal forms

<table>
<thead>
<tr>
<th>Type of business entity</th>
<th>Number of entities</th>
<th>Net business income 1 000 AUD</th>
<th>Net business income percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies</td>
<td>884.315</td>
<td>213.624.282</td>
<td>82.1%</td>
</tr>
<tr>
<td>Partnerships</td>
<td>343.601</td>
<td>20.100.226</td>
<td>7.7%</td>
</tr>
<tr>
<td>Trusts</td>
<td>802.645</td>
<td>26.303.393</td>
<td>10.1%</td>
</tr>
<tr>
<td><strong>Thereof Disrectionary Trust (Trading activities)</strong></td>
<td><strong>261.752</strong></td>
<td><strong>15.810.373</strong></td>
<td><strong>6.1%</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2.030.561</strong></td>
<td><strong>260.027.901</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

**Source:**
ATO, Taxation statistics 2013-14
Path 1: combination of legal forms

<table>
<thead>
<tr>
<th>Type of business entity</th>
<th>Number of entities 1998-99</th>
<th>Number of entities 2013-14</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies</td>
<td>646.405</td>
<td>884.315</td>
<td>37 %</td>
</tr>
<tr>
<td>Partnerships</td>
<td>530.860</td>
<td>343.601</td>
<td>-37 %</td>
</tr>
<tr>
<td>Trusts</td>
<td>502.665</td>
<td>802.645</td>
<td>60 %</td>
</tr>
<tr>
<td>Thereof Discretionary Trust (Trading activities)</td>
<td>139.680</td>
<td>261.752</td>
<td>87 %</td>
</tr>
<tr>
<td>Total</td>
<td>1,679.930</td>
<td>2,030.561</td>
<td>21 %</td>
</tr>
</tbody>
</table>

Year: 2013-14

Source:
ATO, Taxation statistics 2013-14
Three paths to the same goal

- Path 1: Combination of legal forms (Germany, Australia)
- **Path 2: Optionality of transparent taxation (US)**
- Path 3: Creation of a new business form (US)
Path 2: Optionality of transparent taxation

• US: S-Corporation (Subchapter S of the Internal Revenue Code)
  – Enacted in 1958 to enhance neutrality
  – Conditions for availability of S-Corporation-status:
    ▪ Limited number of shareholders (1958: 10; later 35; 75; now: 100)
    ▪ Shareholders must not be nonresident alien individuals, LLCs, partnerships, or corporations
    ▪ Only on class of shares
    ▪ Gross receipts form passive investments < 25% (until 1982: < 20%)
Path 2: Optionality of transparent taxation

<table>
<thead>
<tr>
<th>Type of business entity</th>
<th>Number of returns</th>
<th>Net income 1 000 USD</th>
<th>Net income percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole proprietorships</td>
<td>23.553.850</td>
<td>304.895.911</td>
<td>10 %</td>
</tr>
<tr>
<td>Partnerships</td>
<td>3.388.561</td>
<td>777.924.476</td>
<td>26 %</td>
</tr>
<tr>
<td>Corporations</td>
<td>5.840.821</td>
<td>1.871.914.319</td>
<td>63 %</td>
</tr>
<tr>
<td><strong>Thereof S-Corps</strong></td>
<td><strong>4.205.452</strong></td>
<td><strong>475.998.050</strong></td>
<td><strong>16 %</strong></td>
</tr>
<tr>
<td>Total</td>
<td>32.783.232</td>
<td>2.954.734.706</td>
<td>100 %</td>
</tr>
</tbody>
</table>

Year: 2012

Source:
SOI Tax Stats - Selected financial data on businesses 2012
Path 2: Optionality of transparent taxation

<table>
<thead>
<tr>
<th>Type of business entity</th>
<th>Number of returns</th>
<th>Business receipts 1 000 USD</th>
<th>Business receipts percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole proprietorships</td>
<td>23.553.850</td>
<td>1.301.569.749</td>
<td>4 %</td>
</tr>
<tr>
<td>Partnerships</td>
<td>3.388.561</td>
<td>4.689.702.874</td>
<td>15 %</td>
</tr>
<tr>
<td>Corporations</td>
<td>5.840.821</td>
<td>26.029.143.463</td>
<td>81 %</td>
</tr>
<tr>
<td><strong>Thereof S-Corps</strong></td>
<td><strong>4.205.452</strong></td>
<td><strong>6.427.057.090</strong></td>
<td><strong>20 %</strong></td>
</tr>
<tr>
<td>Total</td>
<td>32.783.232</td>
<td>32.020.416.086</td>
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</tr>
</tbody>
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Year: 2012

Source: SOI Tax Stats - Selected financial data on businesses 2012
Three paths to the same goal

- Path 1: Combination of legal forms (Germany, Australia)
- Path 2: Optionality of transparent taxation (US)
- Path 3: Creation of a bespoke business entity (US)
Path 3: Creation of a bespoke entity

• US: Limited Liability Company (LLC)
  – First introduced in Wyoming in 1977
  – Background: Federal rules on entity qualification for tax purposes:
    ▪ „Preponderance of corporate characteristics“:
      – Centralization of management ⚬
      – Limited Liability ⚬
      – Continuity of live ❌
      – Free transferability of interests ❌
    ▪ Rev. Rul. 88-76: „classified as a partnership for federal tax purposes”
  – Introduction of „Check-the-box“ 1996 made LLC more flexible
### Path 3: Creation of a bespoke entity

<table>
<thead>
<tr>
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<td>777.924.476</td>
<td>26 %</td>
</tr>
<tr>
<td><strong>Thereof LLCs</strong></td>
<td><strong>2.211.353</strong></td>
<td><strong>436.354.856</strong></td>
<td><strong>15 %</strong></td>
</tr>
<tr>
<td>Corporations</td>
<td>5.840.821</td>
<td>1.871.914.319</td>
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<tr>
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<td><strong>100 %</strong></td>
</tr>
</tbody>
</table>

**Year: 2012**

**Source:**
SOI Tax Stats - Selected financial data on businesses 2012
## Path 3: Creation of a bespoke entity

<table>
<thead>
<tr>
<th>Type of business entity</th>
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<tr>
<td><strong>Thereof LLCs</strong></td>
<td><strong>2.211.353</strong></td>
<td><strong>2.775.065.589</strong></td>
<td>9 %</td>
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<tr>
<td>Corporations</td>
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</tr>
</tbody>
</table>

**Year: 2012**

**Source:**
SOI Tax Stats - Selected financial data on businesses 2012
Lesson for a first best world: legislator should:

– Provide the optimal set of business organisations
– Introduce a completely neutral tax system

But both propositions are unrealistic
1. Demand for transparent taxation persists even if corporate and personal income tax are integrated
   
   – Double taxation of profits increases attractiveness of flow-through taxation
   
   – Beneficial treatment of losses ensures that flow-through taxation remains relevant in the absence of double taxation of profits
2. Availability of tax transparent limited liability entities enhances neutrality, irrespective of which path is followed.
3. Tax induced distortions of choice of business entity were a catalyst for the development of the law of business organisations for SMEs

Lessons for a second best word

Demand for combination of transparent taxation and limited liability

Tax Law ← Partnership Law

Demand for combination of transparent taxation and limited liability

Corporate Law → Partnership Law

Demand for combination of limited liability and partnership-like flexibility

Trust Law

GmbH & Co. KG
Trading Trust
LLC

= weakest link
4. Tax transparent limited liability business entities that are the result of a combination of legal forms should be carefully rationalized

- Combination of legal forms creates additional costs
- These additional costs create an unnecessary entry barrier
5. While path 1 was useful in the past, the way forward should consist in a combination of path 2 and path 3:

- Transparent taxation should be made optionally available to all legal entities that are not publicly traded (path 2)

- The essential features of combined business forms that are not exclusively tax driven should be consolidated into a new legal form (path 3), or an existing legal form should be adapted accordingly.
Many paths to the same goal: Lessons from the convergent evolution of tax transparent limited liability entities

Erik Röder
28 November 2016