

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

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The topic of my presentation is the convergent evolution of what I have called somewhat unwieldily tax transparent limited liability entities. Actually, the name would have to be even longer, because I am focusing on entities that are used as business vehicles, and I am ignoring the somewhat special world of investment vehicles.

In biology convergent evolution means that unrelated organisms develop similar features. An obvious example is the similar body form and coloration of dolphins (mammals) and sharks (fish). But the shared features can also be more subtle, as in the case of humans and koalas who have both fingerprints that are so similar that even forensic experts cannot distinguish them.

Convergent evolution can also be observed among legal systems. Here it results in functionally equivalent legal institutions that do not share a common tradition and that are not the result of a legal transplant. A prime example are tax transparent limited liability business entities. Probably best known internationally are the S Corporation and the Limited Liability Company or LLC, both from the US. But nowadays, these entities can be found basically in all developed economies – so this list is far from being exclusive. While these entities are functionally equivalent to a large extent, the underlying legal mechanics can be very different.

In this presentation, I will focus, in addition to the US, on Australia and Germany. Both countries share the same pattern of convergent evolution, which differs from the patterns observable in the US and in most other countries, and which makes them an interesting object of study. In the following, I will first sum up why entrepreneurs might have an interest in combining transparent taxation and limited liability. Then I will talk briefly about two central preconditions for the evolution of tax transparent limited liability entities, the availability of limited liability entities and income taxation.

Against this background I will then describe the three major paths that lead to a business entity that combines limited liability and transparent taxation, namely

- First, the combination of two legal forms, as in Australia and Germany,
- Second, Making transparent taxation optionally available for corporations, as in the case of the US S Corporation,
- And, thirdly, the creation of a bespoke new business entity, as in the case of the US LLC.

Finally, I will derive some lessons from this development.

In order to assess the potential benefits of transparent taxation, it is necessary to compare it to the alternative model of entity taxation. Under entity taxation, profits are taxed first at the level of the entity and – in most cases – again in the hands of the owners of the entity. Transparent taxation means that profits flow through to the owners where they are taxed only once. But the fact that there is only one layer of tax is not necessarily beneficial. It depends on the relative tax rates at entity and owner-level and on the integration method. So, with regard to the taxation profits, it depends on the design of the tax system whether transparent taxation is advantageous. When it comes to losses, the benefits of transparent taxation are clearer. Under entity taxation, losses are trapped at entity level, and losses of the owners may not be set against profits of the entity as such, but at best against distributed profits. Transparent taxation generally results the immediate compensation of losses in both directions. Finally, transparent taxation might also be useful when it comes to tax preferences, for instance a preferential rate on capital gains. If profits flow through, tax preferences of the owners may be applicable to income derived at entity level. This is generally not possible under entity taxation, because the owners receive income earned by the entity in the form of dividends.

The benefit of limited liability is quite evident: it shields non-business assets of the owners of a business form liability for business debt. However, it is not uncommon to call its relevance into question, at least for small and medium sized enterprises, on the grounds that banks would insist on personal guarantees of the owners. So limited liability would be nothing more than a placebo. However, this view probably underestimates that entrepreneurs are not only concerned about liability for bank loans, but also about unpredictable liabilities that can result from the conduct of the business. For instance, the limited liability partnership, or LLP, was introduced both in the US and the UK because large professional firms had been subject to so called “doomsday claims”, i.e. substantial claims for damages for professional negligence.

Anyway, it is an empirical fact that entrepreneurs want and actively seek limited liability protection. This is a pattern that I have found in all jurisdictions that I have studied. If entrepreneurs have a choice, they conduct risky business activities through a limited liability entity. So even if it is a placebo, the placebo effect is very powerful.

To sum it up, entrepreneurs generally prefer limited liability, and – depending on the design of the tax system –, they might want to combine it with transparent taxation. This constitutes the incentive, or the evolutionary pressure that led to the emergence of tax transparent limited liability entities. But of course the evolution could only start as soon as two preconditions were met: there had to be income taxation, and there had to be limited liability entities available in a given jurisdiction.

With regard to income taxation, I will limit myself to some general remarks. Income taxation is essentially a child of war. For the purposes of this presentation it is sufficient to note that the

burden of the income tax reached substantial levels in the context of World War One in all relevant jurisdictions, and it has remained so ever since. Furthermore, I would like to note that all major tax systems are marked by a divide between sole traders and partnerships on the one hand, and corporations on the other hand. General Partnerships are taxed transparently in most countries. And, at least as a default, corporations are everywhere taxed as separate entities.

The second necessary precondition for tax transparent limited liability entities is the availability of liability entities. In the 19th century and for much of the 20th century, only two entities could provide its owners with a liability shield: the limited partnership and the corporation. In the case of the limited partnership, the shield is incomplete, however, as there has to be at least one general partner who assumes unlimited liability. Both limited partnership and corporation have been available in most developed economies since the beginning of the 20th century at the latest. Finally, as we are in Australia, I have also to mention the trust. At first sight, it is an unlikely candidate for a business entity. At least historically, it was a device for intra-family wealth transfers, not for conducting business. But, as we shall see, it also proved very flexible.

The bottom line is that the preconditions for the evolution of tax transparent limited liability entities were satisfied basically from the beginning of the 20th century, with income taxation in place and limited liability entities available.

Historically the first path to be used was the combination approach. This is not surprising as this is something that entrepreneurs can do on their own, without assistance from the legislator.

Our story begins in 1912, when a German court for the first time recognized a creature that we call GmbH & Co. KG. It is a combination of a corporation and a limited partnership. A GmbH is a special type of corporation for closely held companies that was introduced in 1892. The GmbH acts as general partner of the limited partnership and there is in most cases no other general partner. Limited partners are usually entitled to 100 % of the profit of the limited partnership. If you think about it, this quite an obvious solution if one wants to combine limited liability and transparent taxation. On the one hand, the corporate general partner closes the incomplete liability shield of the limited partnership. And on the other hand, the limited partnership is still a partnership after all and as such taxed transparently.

A typical GmbH & Co. KG structure looks as follows: The equity interests are typically held exclusively by the limited partners. The corporate general partner has no equity stake. The shares of the corporate General partner are either owned by the limited partner or by the limited partnership

Although it had been around since 1912, the GmbH & Co. KG became very popular only in the 1930s. According to Nazi ideology, the good German businessman should be personally liable. Limited liability was regarded as cowardly and immoral. Thus, the Nazi regime wanted to

encourage the transformation of closely held corporations into general partnerships. In order to implement this policy, corporations were subjected to unrelieved and prohibitive corporate income taxation. However, most enterprises did not convert into general partnerships, but into limited partnerships.

Interestingly, the limited partnership has remained popular to the present day, although Germany operated an imputation system from 1977 through 2000 and although our current system does not discriminate against corporations either. GmbH & Co KGs account for roughly a fifth of all business profits earned in Germany, and also for a fifth of turnover for VAT purposes.

This share has been pretty stable for quite a while. There is no sign of a decline of the GmbH & Co. KG. For a German, the combination a corporation and a limited partnership as business vehicle is so natural that I was at first genuinely puzzled and surprised when I realized a few years ago that it is not everywhere in the same way.

In fact, in France, limited partnerships are barely used at all. There are approximately 2000 corporations for every limited partnership. In Australia, the UK and the US, limited partnerships are used, but predominantly as investment vehicles. In the UK and Australia, there are 200 and in the US 20 corporations for every limited partnership. In Germany, however, limited partnerships are used for all kinds of purposes, as investment and as business vehicles. Furthermore, corporations do not hopelessly outnumber limited partnerships. The ratio is only 4 to 1. A substantial part of Germany's family owned small and medium-sized companies is organized as limited partnerships

So I wondered: What made the difference? I quickly realized that the limited liability shield was not the problem. All jurisdictions I looked at accept a corporation as sole general partner of a limited partnership. So the problem might be the tax system. And indeed, in France, limited partnerships have always been only partly tax transparent. The profit share of general partners flows through to the partners. But the profit share of limited partners is subject to corporate income tax at the level of the partnership and distributions are taxed again in the hands of the shareholders. However, Australia has been taxing limited partnerships like corporations only since 1992, and in the UK and the US, limited partnerships have been tax transparent to the present day.

So finally, I came to the conclusion that control might have played a major part in this story. As I have already mentioned, a GmbH & Co. KG is typically controlled by the limited partners.

This is certainly not possible in France, where the code de commerce prevents limited partners from participating in the management of the partnership, by withdrawing the liability shield if they do so. This rule, that is called "défense d'immixtion" in French, can be found in limited

partnership legislation across the globe. The reason for this is that the limited partnership is a legal transplant *par excellence*. It originated in its modern form in France, where it was first regulated in 1673 and codified in the Code de commerce in 1807. From there it spread first to US, probably aided by the exposure to French law after the purchase of Louisiana in 1803. In Germany, the limited partnership was **also** imported from France and codified in the First commercial code of 1861. Before I started working on this presentation, I thought that the UK had struggled most among major jurisdictions with adopting the limited partnership. Several parliamentary initiatives were defeated in the course of the 19th century, and it was only in 1907 that the Limited partnerships act finally saw the light of day. But then I found out about the interesting history of the limited partnership in Australia. Queensland introduced it already in 1867, as a legal transplant from the US. Tasmania and Western Australia followed the example of the UK in 1908 and 1909. But New South Wales, Victoria and Southern Australia adopted the limited partnership only in a third wave in the 1990s.

Because French law acted as role model, also the *défense d'immixtion* spread across the globe. So, if your French is a bit rusty, you can **instead** read section five of the 1822 New York statute, according to which “[N]o special partner shall transact any business on account of the partnership, under the penalty of being liable as a general partner.” In a slightly different form, as management test, the French rule was also taken up by English law, and, as late as 1991, by New South Wales.

However, when the first German commercial code of 1861 was drafted, the drafting committee rejected such a provision 14:1 because it found it unnecessary. Nowadays, this view is shared by many in the US, where the Uniform Law Commission stated in 2001 that, “[I]n a world with LLPs, LLCs and, most importantly, LLLPs, the rule is an anachronism.”

However, this realization occurred too late to make a difference. The bottom line is that, irrespective of other factors, the “*défense d'immixtion*” would have been enough to prevent the development of a GmbH & Co. KG.-style structure in all relevant jurisdictions.

But at least in Australia, lawyers were ingenious enough to find another way of combining legal forms in order to achieve limited liability and at least some degree of transparent taxation. In Australia, a corporation is combined not with a limited partnership, but with a discretionary trust. This structure is used by small and medium sized enterprises as a business vehicle, which is then called a trading trust.

In that respect I am particularly looking forward to the discussion because I must confess that the concept of a trading trust is somewhat unfamiliar to a lawyer from a civil law country. So I am setting out what I believe to have understood about the trading trust, but I am grateful for necessary corrections.

My understanding is that the corporation acts as trustee. The trustee holds legal title to the business assets and conducts the business activities. The beneficiaries are entitled to the business profits. So I imagine that a typical trading trust structure might look like this: As a trust is not an entity, only the trustee acts and conducts the business. As a result, only the corporate trustee is also primarily liable for the corporate debt. The trustee has a right to be indemnified out of the assets of the trust, but has no claim against the beneficiaries, who enjoy limited liability. A major exception applies if the beneficiaries act as directors of the corporate trustee and if the right of the trustee to be indemnified out of the trust's assets is restricted. Then they are personally liable. Another key non-tax benefit of trading trust is asset protection. Creditors of the beneficiaries have little a chance of getting hold of the trusts assets.

Tax-wise, a trading trust is only partially transparent. Losses are trapped at the level of the trust. But at least tax preferences of the beneficiaries are applicable, such as the 50 % Capital gains tax discount. Furthermore, the structure is very flexible and allows for the allocation of business profits to the beneficiary with the lowest marginal tax rate.

I have also tried to find some empirical data on the relevance of trading trusts. Corporations apparently still reign supreme in the world of Australian business, but Trusts in general are more important than partnerships and trading trusts account for 6 % of all net business profits after all. Furthermore, over the past 15 years, the trading trust has been the most dynamic form of business organization in terms of existing entities, with an increase of 87 %. So far, the data show no decline of the trading trust, although I understand that changes in the rules on the taxation of trust distributions mean that it has become less attractive form a tax perspective.

As we have seen, path 1, the combination model, requires a high degree of flexibility in the law of business organisations. If this flexibility is lacking, the legislator has to intervene in the evolutionary process, for instance by making transparent taxation optionally available to corporations. This is what happened in the United States in 1958, when subchapter S of the internal revenue code was enacted. If a corporation opts for the status of S corporation, it is taxed on a flow-through-basis. But transparent taxation comes with some strings attached. The number of shareholders is limited. Certain legal entities cannot be shareholders of an S corporation, such as other corporations or LLCs. S corporations may have only one class of shares and there is a limit to the share of passive income they are allowed to earn. These restrictions are, as you can imagine, the object of intensive tax planning activities. In particular there are ways to circumvent the maximum number of shareholders limitation. If on looks at the data, one realizes that the S corporation is quite successful. More than 70 % of all corporations are S corporations. They account for 16 % of all business profits, and for 20 % of gross business receipts. In spite of the great success of the S corporation, it was insufficient to satisfy the demand for tax transparent limited liability entities in the US.

That is why in the US also path 3 was used, the creation of a bespoke entity, in the form of the LLC. The LLC was first introduced in 1977 in Wyoming, with the explicit aim of creating a tax transparent limited liability entity. At the time, entity qualification for federal tax purposes hinged on the so-called Kintner regulations, which qualified an entity as a corporation if it showed a preponderance of four corporate characteristics. The first LLC statute was designed in such a way as to allow LLCs to be qualified as partnerships. It provided for limited liability and centralized management, but not for continuity of life and free transferability of interest. The breakthrough for the LLC came in 1988, when the IRS confirmed that a Wyoming LLC could indeed be qualified as a partnership for tax purposes. At this point in time, there were only 26 LLCs in Wyoming, and only Florida had also introduced the LLC. By the mid-1990s, all US States had adopted LLC statutes and the number of LLCs began to skyrocket. The LLC got another boost in 1996, with the introduction of check the box, which meant that it was no longer necessary to draft around the Kintner regulations. As a result, the LLC became even more flexible. So it is not surprising that it is quite successful.

From the early 1990s, the number of active LLCs grew from virtually nothing to more than 2 Million in 2012, and it is still growing. Collectively, these LLCs account for 15 % of all business profits in the US, and for 9 % of gross business receipts.

Now, what lessons can be drawn from this story. If one starts from first principles, and looks for a first best solution, the answer is straight forward: The legislator should first provide a set of legal forms that corresponds exactly to different commercial demands and could thus be regarded as optimal in a non-tax world. Secondly, the legislator should introduce a tax system that is completely neutral and that, *inter alia*, does not distort the choice of business entity. However, based on the assumption that both propositions are genuinely hard – or maybe impossible – to achieve under real world conditions, I will not stop here. Instead, I would like to draw some conclusions for the imperfect, second best world that we all live in.

First, the evolution of tax transparent limited liability shows that the demand for transparent taxation persists even if corporate and personal income taxation are perfectly integrated. It is certainly true that double taxation of profits increases the attractiveness of transparent taxation. But even integration does not take away the benefits of transparent taxation with regard to losses, at least if one of the usual methods is followed. This is an important factor that contributed to the persistence of the GmbH & Co. KG in Germany even under an imputation system. The ability of letting losses flow through to the owners is of particular interest to newly founded business and can thus be seen as an instrument that encourages entrepreneurial activity. So tax transparent limited liability entities are not made redundant by corporate integration.

Secondly, the availability of tax transparent limited liability entities enhances neutrality. A traditional income tax system can, under realistic assumptions, never be completely neutral with regard to the choice of business entity. There is simply no one-size-fits-all tax regime that would be suitable for the full range of business organizations – from the sole trader with a micro-business up to the public corporation with widely dispersed share ownership. The standard approach is to tax sole traders on a flow-through basis and public corporations as separate entities, and to assign all other forms of business organization to either of the two models. Commonly, the line is drawn between partnerships and close corporations. As a result, entrepreneurs might face a trade-off between limited liability and transparent taxation. The tax incentive might cause them to opt for a partnership, although, from a business perspective, a corporation would be more suitable. The emergence of tax transparent limited liability entities means that this gap can, at least to some extent be bridged. The trade-off between limited liability and transparent taxation disappears.

The third conclusion I would like to draw is that by distorting the choice of business entities, tax law has acted, in some cases, as a catalyst for the development of the law of business organisations, and has helped to bring about positive change. It is possible to describe the relationship between corporate law, partnership and trust law, and tax law as regulatory triangle: The demand for combining limited liability and transparent taxation results in tension between tax law on the one hand and both partnership law and corporate law on the other hand. But there is also tension between corporate law and partnership law, created by the demand for a combination of limited liability and partnership-like flexibility. In some cases, this demand was on its own sufficient to bring about change in the law of business organisations. One prominent example is the introduction of the GmbH as a special type of corporation for closely held companies. But these steps did not exhaust the full potential for flexibility that can be granted to limited liability entities. The additional pressure of the demand for transparent taxation was necessary in order to bring about the GmbH & Co. KG, the LLC and the trading trust. It is not surprising that the GmbH & Co. KG and the trading trust emerged from partnership law and trust law, because it is the weakest link in this regulatory triangle, with the highest degree of freedom for individuals of shaping business forms according to their needs.

Fourthly, I would like to observe that it was originally a good thing if a legal system was flexible enough to use path 1 and to combine legal forms in order to create tax transparent limited liability entities. After all, the German legal system produced a close substitute to the LLC seventy years before the LLC became generally available in the US. However, the combination of legal forms is complex and results in additional costs. For instance, a GmbH & Co. KG has to draw up two balance sheets, one for the corporate general partner and one for the limited partnerships. This creates an additional entry barrier for small businesses for which the

transactions costs of using these legal forms are too high. These costs can be avoided by carefully rationalizing these combined business forms through a combination of path 2 and 3.

This brings me to lesson number five: In order to enhance neutrality, transparent taxation should be made optionally available, with no strings attached. The example of the US S corporation shows that conditions for flow-through taxation only result in new distortions and in tax planning activities. Feasibility only requires tax transparent entities must not be publically traded. Vice versa, transparently taxed entities should be allowed to opt for entity taxation, as far as practically feasible. If a combined legal form is only useful because it grants access to transparent taxation, it will be wiped out as a result. However, if it serves a useful purpose beyond tax planning, its essential features should be consolidated either into a new legal form, or an existing legal form should be adapted accordingly. In this context, all legal systems that still adhere to the *défense d'immixtion* for limited partners should finally get rid of it. The rule has been redundant at the latest since the corporate form has become available to closely held companies.