



**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



Trading Trust



LLP



S.A.R.L. de famille





Outline

- 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

	Level	Profits	Losses	Preferences
Entity Taxation	Entity	Taxed	Trapped	Not necessarily passed through
	Owner	Taxed again	Losses of owner may not be set against profits at entity-level	Owner-level tax preferences not applicable
Transparent Taxation	Entity	--	--	--
	Owner	Profits taxed once in the hands of owner	Losses of entity may be set against profits of owner, and vice versa	Owner-level tax preferences applicable



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)

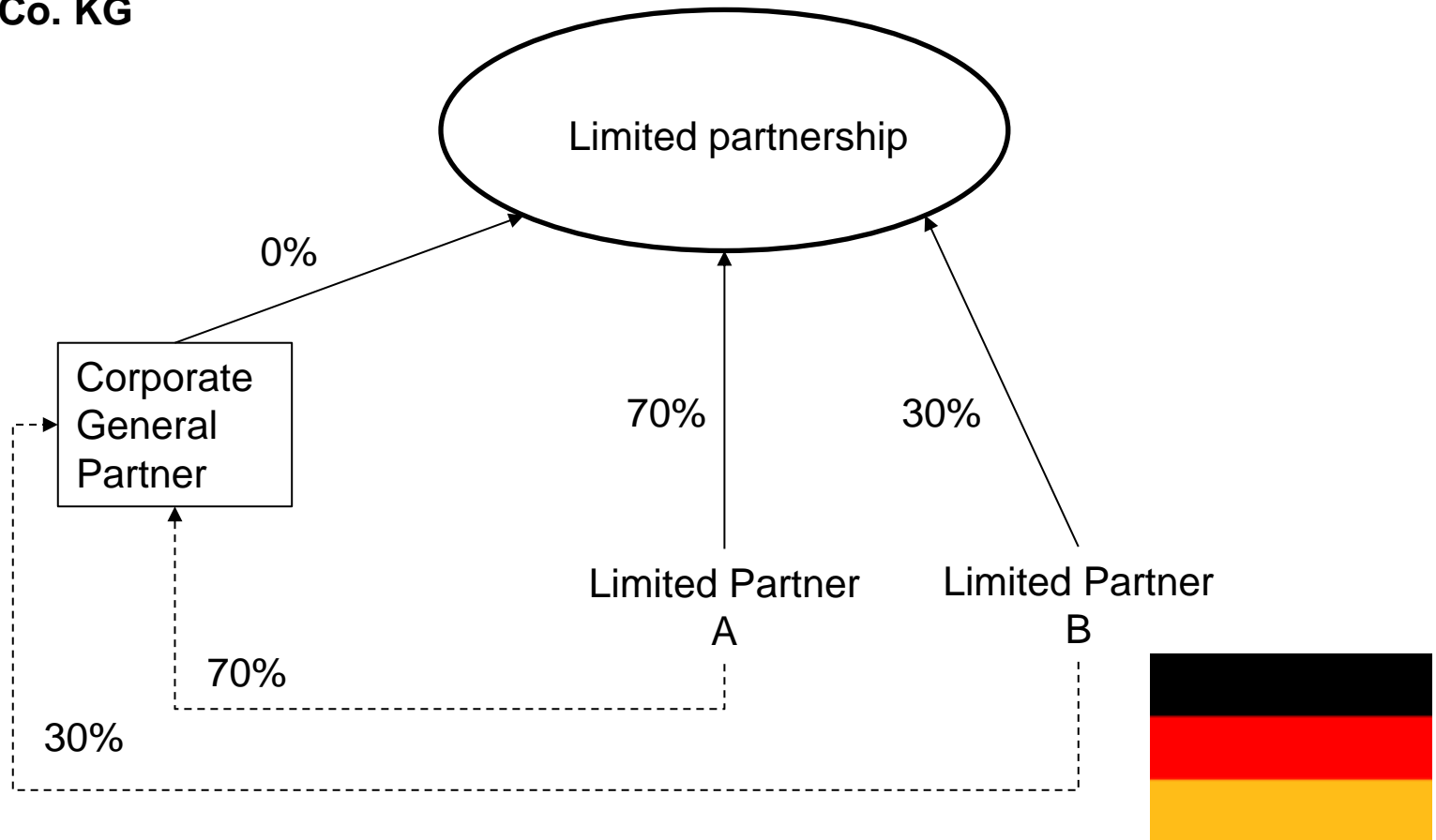
Path 1: combination of legal forms

- 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)



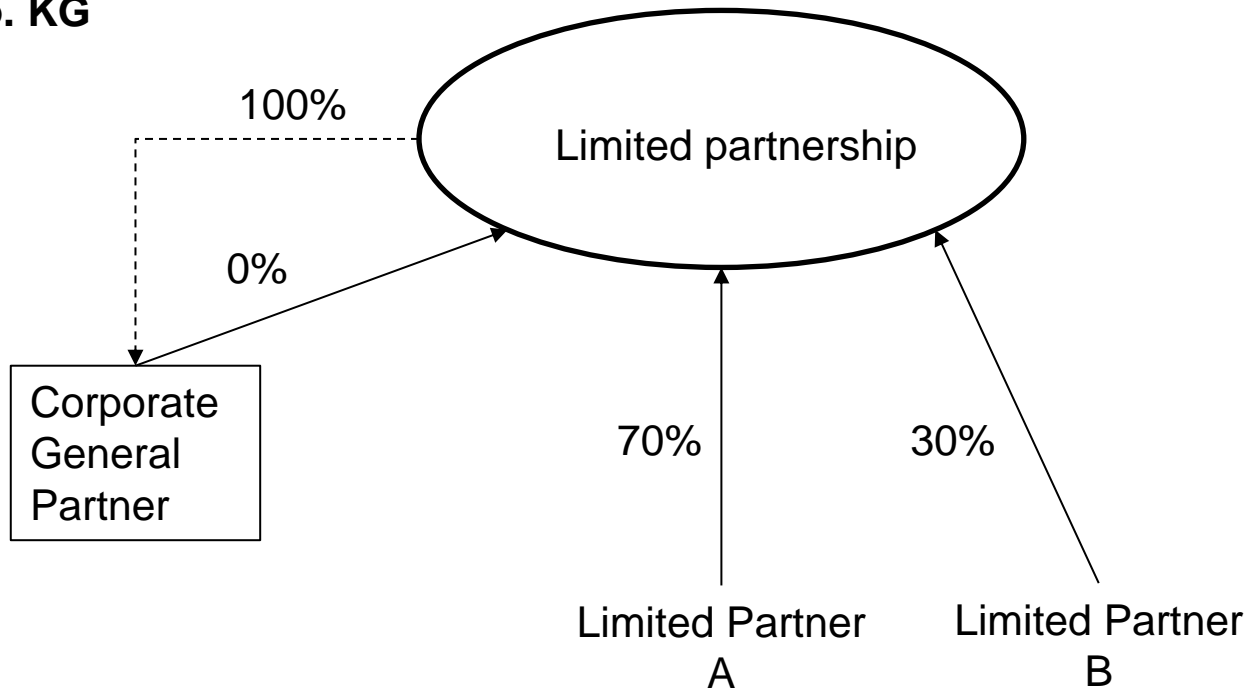
Path 1: combination of legal forms

GmbH & Co. KG



Path 1: combination of legal forms

GmbH & Co. KG



Path 1: combination of legal forms

Type of business entity		Net income 1 000 EUR	Net income percentage
Sole proprietorships		112.833.516	32 %
Partnerships		123.508.531	35 %
Thereof GmbH & Co. KG		65.568.874	19 %
Corporations		80.253.390	23 %
Other		36.202.905	10 %
Total		352.798.342	100 %

Year: 2011

Source:

German Personal, Partnership and Corporate Income tax statistic 2011



Path 1: combination of legal forms

Type of business entity	Number of taxpayers	Gross receipts 1 000 EUR	Gross receipts percentage
Sole proprietorships	2.182.130	567.636.578	10 %
Partnerships	428.751	1.508.069.560	26 %
Thereof GmbH & Co. KG	137.658	1.113.849.400	19 %
Corporations	553.390	3.295.206.784	56 %
Other	75.950	499.961.913	9 %
Total	3.240.221	5.870.874.835	100 %

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

Path 1: combination of legal forms

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.“

Path 1: combination of legal forms

- A brief history of the limited partnership:
 - FR: **1673** (Ordnnonance 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

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.“

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.”

Path 1: combination of legal forms

Germany (ADHGB, 1861)

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

US (Uniform Limited Partnership Act 2001, prefatory note):

[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



- *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

Trading Trust	Profits	Losses	Preferences
Entity-Level	--	<i>trapped</i>	--
Beneficiary-Level	Profits taxed once in the hands of beneficiaries	Profits of trust may be set against losses of beneficiaries	Beneficiary-level tax preferences applicable

Path 1: combination of legal forms

Type of business entity	Number of entities	Net business income 1 000 AUD	Net business income percentage
Companies	884.315	213.624.282	82,1 %
Partnerships	343.601	20.100.226	7,7 %
Trusts	802.645	26.303.393	10,1 %
Thereof Disrectionary Trust (Trading activities)	261.752	15.810.373	6,1 %
Total	2.030.561	260.027.901	100 %

Year: 2013-14

Source:
ATO, Taxation statistics 2013-14



Path 1: combination of legal forms

Type of business entity	Number of entities 1998-99	Number of entities 2013-14	Increase
Companies	646.405	884.315	37 %
Partnerships	530.860	343.601	-37 %
Trusts	502.665	802.645	60 %
Thereof Discretionary Trust (Trading activities)	139.680	261.752	87 %
Total	1.679.930	2.030.561	21 %

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 from passive investments < 25% (until 1982: < 20%)

Path 2: Optionality of transparent taxation

Type of business entity	Number of returns	Net income 1 000 USD	Net income percentage
Sole proprietorships	23.553.850	304.895.911	10 %
Partnerships	3.388.561	777.924.476	26 %
Corporations	5.840.821	1.871.914.319	63 %
Thereof S-Corps	4.205.452	475.998.050	16 %
Total	32.783.232	2.954.734.706	100 %

Year: 2012

Source:
SOI Tax Stats - Selected financial data on businesses 2012



Path 2: Optionality of transparent taxation

Type of business entity	Number of returns	Business receipts 1 000 USD	Business receipts percentage
Sole proprietorships	23.553.850	1.301.569.749	4 %
Partnerships	3.388.561	4.689.702.874	15 %
Corporations	5.840.821	26.029.143.463	81 %
Thereof S-Corps	4.205.452	6.427.057.090	20 %
Total	32.783.232	32.020.416.086	100 %

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 x
 - Free transferability of interests x
 - 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

Type of business entity	Number of returns	Net income 1 000 USD	Net income percentage
Sole proprietorships	23.553.850	304.895.911	10 %
Partnerships	3.388.561	777.924.476	26 %
Thereof LLCs	2.211.353	436.354.856	15 %
Corporations	5.840.821	1.871.914.319	63 %
Thereof S-Corps	4.205.452	475.998.050	16 %
Total	32.783.232	2.954.734.706	100 %

Year: 2012

Source:
SOI Tax Stats - Selected financial data on businesses 2012



Path 3: Creation of a bespoke entity

Type of business entity	Number of returns	Business receipts 1 000 USD	Business receipts percentage
Sole proprietorships	23.553.850	1.301.569.749	4 %
Partnerships	3.388.561	4.689.702.874	15 %
Thereof LLCs	2.211.353	2.775.065.589	9 %
Corporations	5.840.821	26.029.143.463	81 %
Thereof S-Corps	4.205.452	6.427.057.090	20 %
Total	32.783.232	32.020.416.086	100 %

Year: 2012

Source:
SOI Tax Stats - Selected financial data on businesses 2012





Lessons

- 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*

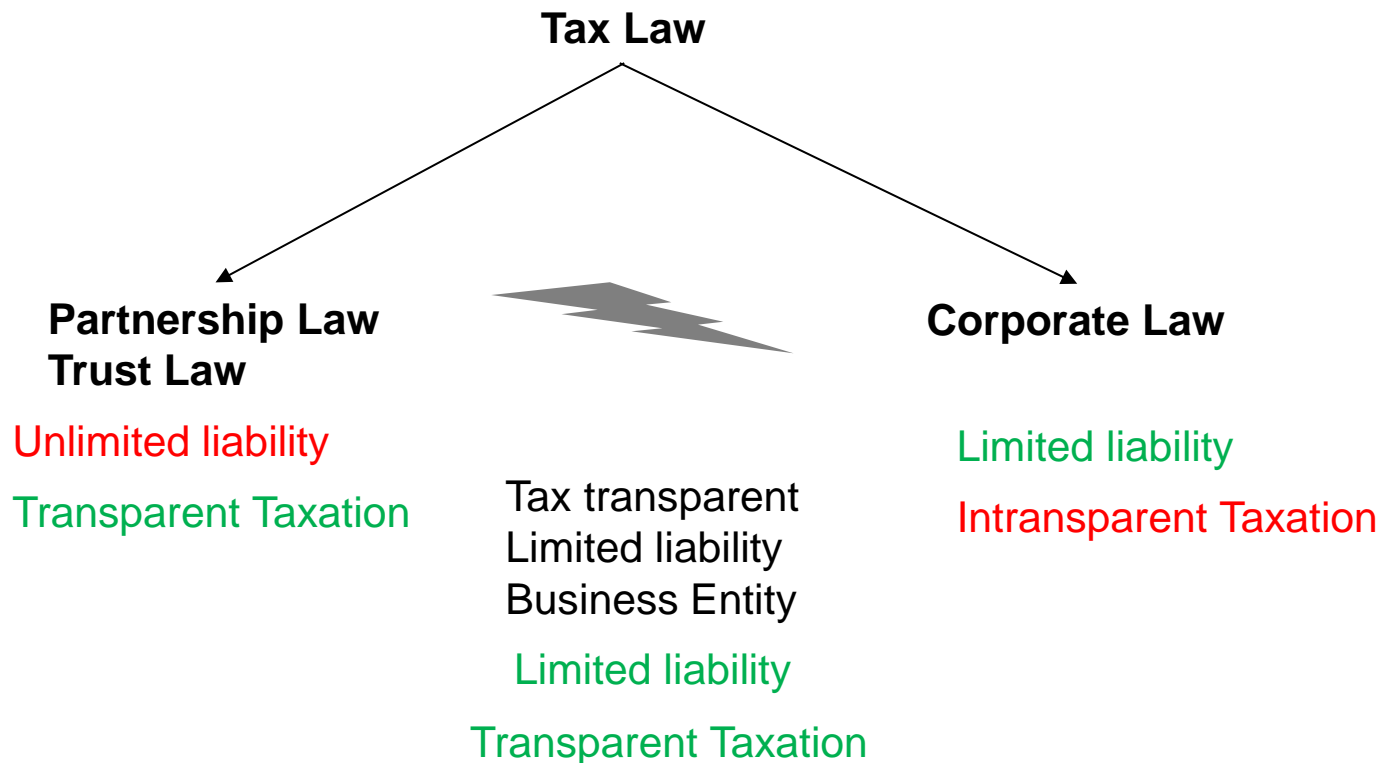


Lessons for a second best word

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

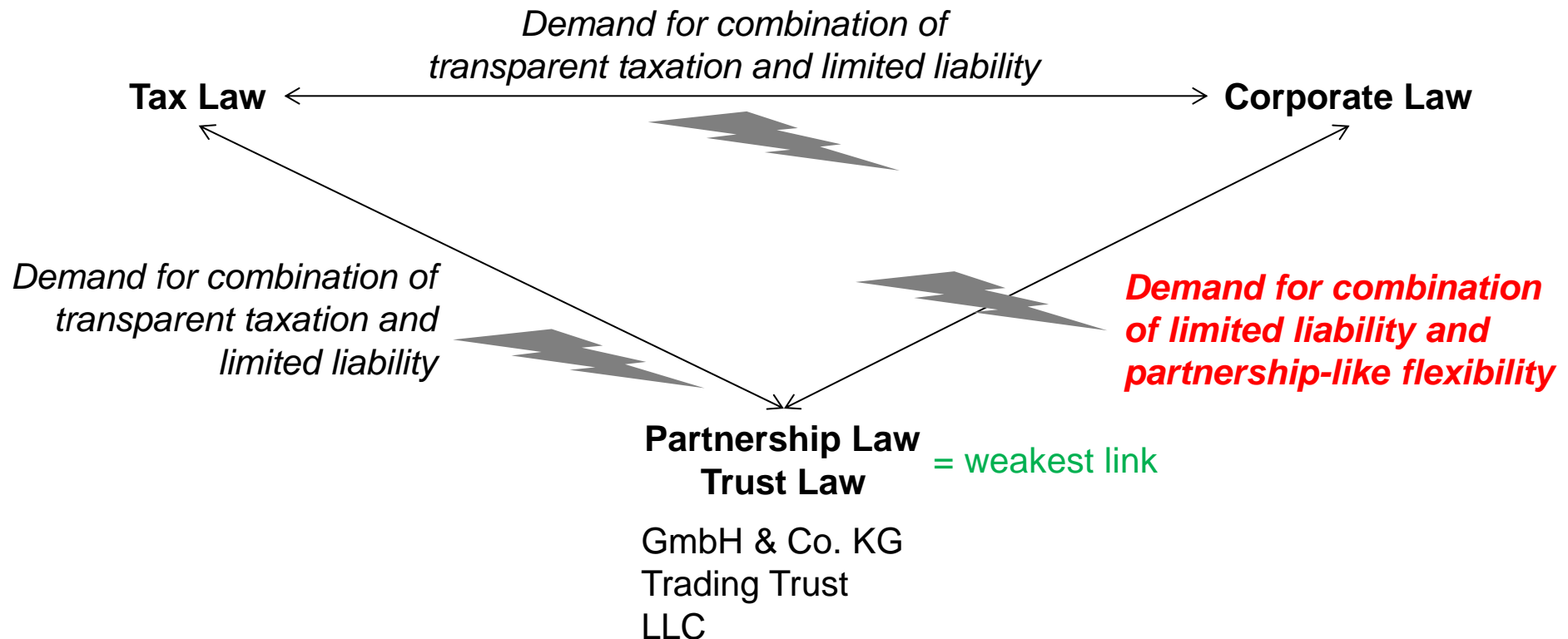
Lessons for a second best word

2. Availability of tax transparent limited liability entities enhances neutrality, irrespective of which path is followed



Lessons for a second best word

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

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



Lessons for a second best word

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