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Combining Limited Liability and Transparent Taxation: Lessons from the Convergent Evolution of GmbH & Co. KGs, S Corporations, LLCs, and Other Functionally Equivalent Entities

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Combining Limited Liability and Transparent Taxation: Lessons From the Convergent Evolution of GmbH & Co. KGs, S Corporations, LLCs, and Other Functionally Equivalent Entities

by

*Erik Röder**

Abstract

Tax transparent limited liability entities (TTLLEs), such as the GmbH & Co. KG in Germany, the trading trust in Australia, or the S Corporation and the LLC in the United States, can be found in many developed economies. While these entities are to a large extent functionally equivalent, their underlying legal mechanics are very different. The Article traces the convergent evolution of six TTLLEs in five jurisdictions, along three different paths, and describes central determinants of path dependencies. It demonstrates that the demand for TTLLEs is universal and that their availability reduces distortions caused by a traditional tax system. Furthermore, the Article argues that the often reviled distortive influence of tax law on the choice of business entity, which drove the evolution of TTLLEs, sparked innovations in the law of business organizations that would probably not have occurred otherwise, or only much later. Finally, the Article recommends making transparent taxation and entity taxation optionally available to all types of business entities and suggests carefully rationalizing the organizational law of TTLLEs while maintaining the diversity of forms that has evolved.

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Introduction

From the middle of the twentieth century onwards, forms of business organization that combine limited liability and transparent taxation have proliferated among developed economies. Such tax transparent limited liability entities (TTLLEs) can nowadays be found, for instance, in all member states of the G7.[1] Important examples include the GmbH & Co. KG in Germany and the S corporation and the Limited Liability Company (LLC) in the United States. Businesses that are organized as TTLLEs are typically, though not necessarily, small or medium-sized enterprises (SMEs) and privately held.

The rise of TTLLEs is remarkable because they are essentially an anomaly. Traditionally, all major jurisdictions have been marked by a neat separation of limited liability and transparent taxation. Prior to the emergence of TTLLEs, only corporations featured a liability shield that protected *all* owners of a business from liability for business debt. Business profits of a corporation are—invariably—by default taxed at the entity level,[2] and not directly in the hands of its shareholders. To put it differently, a corporation is, as a matter of principle, non-transparent (or opaque) for income tax purposes. By contrast, forms of business organization that do not provide a liability shield, i.e., sole proprietorships and general partnerships, are—equally invariably—by default tax

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1. For France, Germany, the United Kingdom, and the United States, see *infra* Parts II.A, III, and IV. Japan introduced a transparently taxed Limited Liability Partnership (LLP) (*yugen-sekinin jigyo kumiai*) in 2005. *See* Zenichi Shishido, *Legislative Policy of Alternative Forms of Business Organization: The Case of Japanese LLCs*, *in* Research Handbook on Partnerships, LLCs and Alternative Forms of Business Organizations 374, 376 & n.7 (Robert W. Hillman & Mark J. Loewenstein eds., 2015). Canada also features transparently taxed LLPs. *See* Elizabeth J. Johnson & Geneviève C. Lille, *The Taxation of Partnerships in Canada*, 63 Bull. for Int'l Tax'n 381, 382 (2009). In Italy, companies can, if certain conditions are met, opt for transparent taxation. Decreto del Presidente della Repubblica 22 dicembre 1986, n.917, G.U. Dec. 31, 1986, n.302 (It.) (Articles 115–16 of Italian Income Tax Act); *see* Marco Rossi, *Italy's New Check-the-Box Rules*, 39 Tax Notes Int'l 329, 341–42 (2005).

2. *See, e.g.*, Code général des impôts art. 206 (Fr.); Körperschaftsteuergesetz [KStG], § 1 (Ger.); Corporation Tax Act 2009, c.4, § 2 (UK); I.R.C. § 11 (U.S.); *see also* Hugh J. Ault & Brian J. Arnold, Comparative Income Taxation: A Structural Analysis 331 (3d ed. 2010).

transparent in all major jurisdictions.[3] This means that business profits are taxed directly in the hands of the sole proprietor or of the individual partners.

If one takes a closer look and compares how limited liability and transparent taxation are combined in different jurisdictions, two striking facts about TTLLEs become apparent. First, while almost all jurisdictions feature TTLLEs, their practical importance as business vehicles differs widely. In Germany and the United States, a substantial share of total business activities is conducted through GmbH & Co. KGs, S corporations, and LLCs. However, in many other jurisdictions, such as Australia, Canada, and the United Kingdom, the relevance of TTLLEs as business vehicles ranges from limited to marginal.[4] Second, while TTLLEs are functionally equivalent to a large extent, their underlying "legal mechanics" or structure can be very different: A GmbH & Co. KG is a combination of two business entities—a corporation and a limited partnership. An S corporation is a plain-vanilla corporation that has opted for a special tax regime. An LLC can best be described as a hybrid business entity that combines elements of partnership and corporation.

The Article sets out to answer three main questions. First, what accounts for the difference in the prevalence of TTLLEs in different jurisdictions? Second, why are TTLLEs of different jurisdictions structurally so different, and which factors determined the type of TTLLE that would emerge in a given jurisdiction? Third, what can be inferred from the comparative analysis of TTLLEs about the interaction of organizational law and tax law and about how both areas of law could be enhanced?

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3. *See, e.g.*, CODE GÉNÉRAL DES IMPÔTS art. 8 (Fr.); Einkommensteuergesetz [EStG], § 15(1) (Ger.); Income Tax (Trading and Other Income) Act 2005, c. 5, § 848 (U.K.); I.R.C. § 701 (U.S.); *see also* AULT & ARNOLD, *supra* note 2, at 331, 415. A notable exception is Belgium, where all organizations that have legal personality are, in principle, subject to entity taxation, irrespective of the availability of a liability shield, such as commercial general partnerships (*sociétés en nom collectif*). *See* CODE DES IMPÔTS SUR LES REVENUES [C.I.R.] art. 179 (Belg.); ANDRÉ BAILLEUX, FISCALITÉ DE L'ENTREPRISE EN BELGIQUE 33 (2004).

4. *See infra* Parts II.B, IV.B; *see also* JOINT COMM. ON TAX'N, 113TH CONG., FOREIGN PASSTHROUGH ENTITY USE IN FIVE SELECTED COUNTRIES 11 (2013) (highlighting the limited relevance of transparent taxation in general in Australia, Canada, and the United Kingdom).

To answer the first question, the Article analyzes why entrepreneurs find combining limited liability and transparent taxation attractive. In all jurisdictions, protection from liability for business debt is of pivotal importance to the owners of a business, irrespective of its size. Variations in the prevalence of TTLLEs among jurisdictions can be accounted for, to a large extent, by differences in the design of income tax systems that influence the degree to which TTLLEs are attractive as business vehicles (Part I).

In order to explain the structural differences among TTLLEs, the Article examines six TTLLEs from five jurisdictions: Australia, France, Germany, the United Kingdom, and the United States (Parts II, III, and IV). Each jurisdiction is represented by the TTLLE that is most relevant as the organizational form for active[5] businesses: the GmbH & Co. KG for Germany, the trading trust for Australia, the SARL *de famille* for France, and the Limited Liability Partnership (LLP) for the United Kingdom. For the United States, two TTLLEs are examined: the LLC and the S corporation. The comparative analysis reveals that structural differences among TTLLEs are the result of convergent legal evolution.[6] Just as comparable evolutionary conditions caused dolphins (mammals) and sharks (fish) to develop a similar body form and coloration, the pressure exerted on different legal systems by the demand for combining limited liability and transparent taxation led to the emergence of functionally equivalent, but structurally different, TTLLEs. In total, there are three different "evolutionary paths" leading to a TTLLE: the combination of two legal forms (Path One), making transparent taxation optionally available for corporations (Path Two), and the creation of a bespoke new business entity (Path Three). Legal transplants play (almost) no role in the evolution of TTLLEs. This is not surprising if one considers that the creation of a TTLLE by means of a legal transplant would require

5. A combination of limited liability and transparent taxation is also the international standard for collective investment schemes. However, the particularities of collective investment activities, for instance, the protection of investors, require specific regulatory responses that can include specific legal forms and specific taxation regimes. Because of these particularities, the somewhat special world of investment vehicles is not covered in this Article. It merits a separate analysis.

6. The evolutionary analogy does not imply that the outcome of legal convergent evolution is necessarily positive or efficient.

substantial changes in two complex and distinct areas of law—the law of business organizations and tax law.

The six TTLLEs examined in this Article provide two examples for each of the three paths that lead to a TTLLE. Taken together, their history allows one to identify key parameters that determined which type of TTLLE would emerge in a given jurisdiction (Part V). As soon as the incentive of combining limited liability and transparent taxation is strong enough, entrepreneurs try to set up TTLLEs via Path One by combining a form of business organization that features a liability shield with another one that is taxed transparently. The result is a do-it-yourself TTLLE, such as the German GmbH & Co. KG. Path One TTLLEs do not require a deliberate policy decision, only tolerance or inaction by courts and legislators. From the perspective of entrepreneurs, this is a key advantage, as legislators are rather reluctant to meet entrepreneurs' demand for a combination of limited liability and transparent taxation. There are, however, high hurdles to overcome in order to create a Path One TTLLE. In some jurisdictions, it is simply not possible. If Path One is not available, entrepreneurs have to wait for the legislature to create a TTLLE via Path Two or Three. If legislators provide for a combination of limited liability and transparent taxation, they usually choose Path Two and allow corporations to opt for transparent taxation. Typically, legislators only want to grant the benefit of transparent taxation in a targeted way, which means that Path Two TTLLEs are only available to businesses that meet certain requirements—for instance, being not too large, being active in certain economic sectors, having not too many owners, etc. The creation of bespoke TTLLEs via Path Three becomes more likely if competences for the law of business organizations and tax law are split among different legislatures.

Finally, the Article draws lessons from the convergent evolution of TTLLEs about the interaction of organizational law and tax law and develops recommendations for the enhancement of both areas of law (Part VI). First, while the design of the tax system has a large influence on the attractiveness of TTLLEs, there is, under a traditional income tax system, always a substantial group of businesses for which combining limited liability and transparent taxation is beneficial. The demand for TTLLEs is thus universal. Second, the availability of TTLLEs of all types reduces tax-induced distortions as to the choice of business organization by eliminating the trade-off between limited liability and transparent taxation. TTLLEs have thus a useful role to play, and it is a positive development that more and more jurisdictions satisfy the demand for TTLLEs. Third, the often reviled distortive effect of tax considerations

on the choice of business entity, which drove the evolution of TTLLEs, has in fact positively influenced the law of business organizations. Distortive taxation has acted as a catalyst for its development and sparked innovations that would probably not have occurred otherwise, or only much later. Fourth, the Article recommends making transparent taxation and entity taxation optionally available to all types of business entities, as far as practically feasible. Apart from concerns about practicality, there are no sound reasons for linking the applicable tax regime to the legal form in which a business is operated. Finally, it is suggested to carefully rationalize the organizational law of TTLLEs while maintaining the diversity of forms that has evolved.

I. The Attractiveness of Combining Limited Liability and Transparent Taxation

In all jurisdictions in which TTLLEs are available, entrepreneurs face a choice between three ways in which to organize their business: (1) as a limited liability entity that is opaque for tax purposes, e.g., a business corporation, (2) as a transparently taxed entity that does not provide a liability shield, e.g., a general partnership, *or* (3) as a TTLLE. If the prevalence of TTLLEs across jurisdictions differs widely, this implies that combining limited liability and transparent taxation is not attractive to the same degree everywhere. While entrepreneurs invariably want to take advantage of a liability shield, the appeal of transparent taxation is much more changeable, depending on the design of the tax system.

A. Attractiveness of Limited Liability

The owners of a privately held SME, the main ambit of TTLLEs, opt for an organizational form that confers limited liability if its benefits outweigh its cost. The central benefit of limited liability for the owners of such a business is quite evident: it shields the owners' assets—non-business assets as well as assets invested in other businesses—from liability for business debt.[7] Against this must be weighed the cost

7. Other benefits of limited liability include, inter alia, the reduction/avoidance of monitoring costs, enhanced transferability of shares, and the enabling of risk diversification. *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89 (1985); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 Va. L. Rev. 259

of adopting a limited liability form. The direct costs associated with, for instance, incorporation include franchise taxes and the costs of complying with accounting requirements, disclosure obligations, etc. Incorporation might also lead to indirect costs caused by unsuitable mandatory rules of the corporate form.[8] In addition, adopting the form of a limited liability entity might result in a reduction of reputation and creditworthiness.

During much of the nineteenth century, the costs of incorporation, then the only way of obtaining a liability shield, were prohibitive for SMEs. However, this began to change from the end of the century. In 1892, Germany introduced a special type of corporation, the "GmbH,"[9] that combined limited liability with much of the flexibility of commercial partnerships and was thus particularly well-suited for family-owned SMEs. The famous *Salomon v. Salomon* case sanctioned the use of the corporate form for privately held firms in common law jurisdictions in 1897,[10] and the United Kingdom introduced legislation that provided for private limited companies in 1907.[11] As a result of World War I, France not only regained Alsace-Lorraine but also saw itself exposed to GmbHs formed there prior to 1919. As the local business community resisted the intended abolition of this popular business form, France replaced it instead with its own version, the *société à responsabilité limitée* (SARL) in 1925.[12] In the United States, the corporate form was relaxed in order

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(1967). While these benefits are of paramount importance for publicly traded corporations with widely dispersed share ownership, their relevance is limited in the case of privately held firms with a limited number of owners. *See* Judith Freedman, *Limited Liability: Large Company Theory and Small Firms*, 63 Mod. L. Rev. 317, 331 (2000).

8. *See* Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 Wash. U. L.Q. 417, 420 (1992).

9. Short for *Gesellschaft mit beschränkter Haftung*, German for "company with limited liability," a misnomer, as the liability of the company for its obligations is of course unlimited. It is the owners of the company who enjoy limited liability.

10. Salomon v. A. Salomon & Co. [1896] UKHL 1, [1897] 1 AC (HL) 22.

11. The relevant provisions were contained in the Companies Act 1907, 7 Edw. 7 c. 50. *See also* Ron Harris, *The Private Origins of the Private Company: Britain 1862-1907*, 33 Oxford J.L. Stud. 339 (2013).

12. Loi du 7 mars 1925 tendant à instituer des sociétés à responsabilité limitée, Journal Officiel de la République Française [J.O.], Mar. 7,

to accommodate privately held firms from the middle of the twentieth century onwards.[13] One of the first states to amend its corporate law was New York in 1948.[14] The corporate form has certainly remained more expensive than the default form of business organization, the general partnership.[15] Nevertheless, as a result of these developments, incorporation, and thus access to limited liability, has become widely available from the end of the nineteenth century onwards.

It is fair to say that privately held SMEs that are organized as limited liability entities generally score pretty low when it comes to creditworthiness.[16] This, however, has apparently been no serious impediment to their success. One would expect reputational effects to be greatest in countries such as France and Germany, where the distinct legal forms of GmbH and SARL render privately held corporations easily recognizable. However, while organizing as a GmbH or SARL originally might have had a relevant negative effect on a firm's reputation, any such effect has apparently long faded away. Both GmbH and SARL are very popular as business forms in their respective jurisdictions. In Germany, for instance, value-added tax (VAT) statistics[17] for 2014 show

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1925, p. 2382; *see* Philippe Merle & Anne Fauchon, Sociétés commerciales 213 (21st ed. 2017); *see also* Peter Koberg, Die Entstehung der GmbH in Deutschland und Frankreich 276 *et seq.*, 298 *et seq.* (1992).

13. *See* F. Hodge O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 Bus. Law. 873 (1978); Harwell Wells, *The Rise of the Close Corporation and the Making of Corporation Law*, 5 Berkeley Bus. L.J 263, 311–14 (2008).

14. Chapter 862 of the New York Laws of 1948 added a new section 9 to the Stock Corporation Law. 1948 N.Y. Laws 1704; *see* Carlos D. Israels, *The Close Corporation and the Law*, 33 Cornell L.Q. 488 (1948).

15. In civil law jurisdictions, which distinguish between private law partnerships and commercial partnerships, it is more accurate to regard the latter as the default form of business organization.

16. For the German GmbH, see Justus Meyer, Haftungsbeschränkung im Recht der Handelsgesellschaften 1065 *et seq.* (2000) [hereinafter Meyer, Haftungsbeschränkung]; Justus Meyer, *Die Insolvenzanfälligkeit der GmbH als rechtspolitisches Problem*, GmbH-Rundschau, no. 22, 2004, at 1417.

17. Statistisches Bundesamt, Umsatzsteuerstatistik (Voranmeldungen) 48 (2014), https://www.destatis.de/DE/Publikationen/Thematisch/FinanzenSteuern/Steuern/Umsatzsteuer/Umsatzsteuer2140810147004.pdf?__blob=publicationFile.

15,166 *Offene Handelsgesellschaften* (OHGs), i.e., commercial general partnerships, with a combined turnover of €45.7 billion. In an OHG, all partners are jointly and severally liable for business debt, which implies a high reputation among potential creditors. Nevertheless, the OHG as an organizational form is eclipsed by 522,573 GmbHs with a combined turnover of €2,252.6 billion. This success would not have been possible if GmbHs' access to credit were seriously restricted because of their legal form. In fact, it is not, in spite of GmbHs' generally low creditworthiness, because relevant contractual creditors simply secure their claims. Suppliers insist on concurrent performance or keep a lien over supplies until the purchase price has been paid. Banks routinely demand personal guarantees for business debt from the ultimate owners of GmbHs.[18] Essentially the same happens in other jurisdictions as well.[19]

The fact that access to credit frequently requires the owners of a business to accept personal liability for business debt considerably reduces the benefit of liability protection. The extent is subject to debate. As far as small businesses are concerned, it is not uncommon to cast the usefulness of limited liability entities entirely into doubt.[20] As banks insist on personal guarantees of the owners anyway, limited liability would be nothing more than a "placebo"[21] or might even amount to a "dangerous illusion."[22] However, this view underestimates the relevance of two groups of creditors that are typically at least partially unsecured: employees and customers. While customers, like suppliers, can insist on concurrent performance, they are normally unsecured with regard to claims for damages. This is important because entrepreneurs are not only concerned about liability for bank loans but also about unpredictable liabilities that can result from the conduct of the business. In fact, many substantial businesses do not rely on bank loans at all.[23] Even if

18. Meyer, Haftungsbeschränkung , *supra* note 16, at 1060.

19. For Australia, see Jennifer Hill, *Close Corporations in Australia—The Close Corporations Bill 1988*, 15 Can. Bus. L.J. 43, 57 (1989); for France, see Merle & Fauchon, *supra* note 12, at 214.

20. *See, e.g.*, Meyer, Haftungsbeschränkung, *supra* note 16, at 1106; Freedman, *supra* note 7, at 317; Hill, *supra* note 19, at 57.

21. Hill, *supra* note 19, at 57.

22. Judith Freedman, *Limited Liability Partnerships in the United Kingdom—Do They Have a Role For Small Firms?*, 26 J. Corp. L. 897, 904 (2001).

23. The largest German retailer, Aldi, famously evolved from a grocery store into a supermarket empire simply by relying on the financing effect

the owners have to subscribe loans on behalf of their business, their exposure is limited to the amount of the loan and is thus calculable. The same is not true of liability for damages. In order to appreciate the relevance of this kind of liability exposure, the background of the introduction of the limited liability partnership (LLP) in the United States is enlightening. In essence, the LLP owes its existence to the fact that large professional firms, which used to be organized as general partnerships, had been subject to "doomsday claims," i.e., substantial claims for damages for professional negligence.[24] Thus, personal guarantees for bank loans do not render limited liability forms redundant. Instead, they permit the fine-tuning of the liability shield, combining a maximum of protection for business owners with access to credit for the business. Against this background, it is doubtful whether "the partnership remains useful for situations where the firm's own assets might not constitute a credible bond and thus the firm's owners . . . must pledge all of their respective assets in support of the firm's obligations to make the firm creditworthy," as is argued by Hansmann, Kraakman, and Squire.[25]

The cost-benefit analysis of limited liability entities may also be affected by the existence of alternative routes towards limited liability. In their seminal article, *The Essential Role of Organizational Law*, Hansmann and Kraakman argue that limited liability is of "distinctly secondary importance"[26] as compared to "affirmative asset partitioning"[27]—or "entity shielding," as it was later rebranded.[28] Entity shielding means that business assets are protected from the business owners' personal creditors. According to Hansmann and Kraakman, entity shielding is essential while limited liability is not, because the former can be achieved only by means of organizational law, whereas the latter could be feasibly established by contract on an ad hoc basis with every individual creditor. It is certainly true that entity shielding is much harder to achieve without organizational law than limited liability.

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of being paid by its customers immediately while delaying paying its suppliers by a few weeks. *See* Hendrik Schröder, Handelsmarketing 131 (2d ed. 2012).

24. *See infra* notes 169–183 and accompanying text.

25. Henry Hansmann, Reinier Kraakman & Richard Squire, *The New Business Entities in Evolutionary Perspective*, 2005 U. Ill. L. Rev. 5, 9.

26. Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 Yale L.J. 387, 390 (2000).

27. *Id.* at 393.

28. Hansmann, Kraakman & Squire, *supra* note 25, at 5–6.

However, one should not be tempted to conclude that if a limited liability business form is available, limited liability by contract would be a viable alternative. Ad hoc limited liability by contract depends on the willingness of creditors to accept it, on the willingness of courts to enforce the relevant clauses, and in any event does not affect involuntary creditors. As late as 1999, for instance, a German court frustrated the attempt of achieving a general contractual limitation of liability for business debt by adding the German equivalent of "limited" to the name of a general partnership.[29] If compared to a fully-fledged limited liability entity, limited liability by contract is risky and unsatisfactory. Other factors that might reduce the attractiveness of a liability shield in a given jurisdiction include courts that are fast at piercing the corporate veil and insolvency procedures that allow failed entrepreneurs to rid themselves of business debt with relative ease.

It is not necessary to speculate about the outcome of the cost-benefit analysis of limited liability for SMEs. The data reveal that most entrepreneurs find adopting a limited liability form worthwhile. Business forms that do not shield the owners' assets from liability for business debt have been all but marginalized. In Germany, sole proprietorships and general partnerships combined accounted for less than 12% of turnover measured for VAT purposes in 2014.[30] In the United States, the share of total business receipts of sole proprietorships and general partnerships was approximately 6.5% in 2012.[31] Historically, the fate of French commercial partnerships provides a revealing illustration of the attractiveness of limited liability protection for privately held business. From the adoption of the *Code de commerce* in 1807 until 1925, French entrepreneurs could essentially choose between four organizational forms. There were two types of corporation, the *société anonyme* and the *société en commandite par actions*, whose legal regimes were suitable for large, publicly held companies. In addition, the *Code de commerce* provided for two types of commercial partnerships suitable for SMEs, the *société en nom collectif*, in which all partners are jointly and severally liable for business debt, and the *société en commandite simple,* the French version of the limited partnership. During this entire period,

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29. Bundesgerichtshof [BGH], Sept. 27, 1999, 142 BGHZ 315 (Ger.).

30. Statistisches Bundesamt, *supra* note 17.

31. *SOI Tax Stats - Integrated Business Data*, *Table 1: Selected Financial Data on Businesses 1980–2013*, IRS.gov, https://www.irs.gov/uac/soi-tax-stats-integrated-business-data (last updated Nov. 20, 2017).

both partnership forms were consistently popular. In 1840, 1,634 s*ociétés en nom collectif* and 328 *sociétés en commandite simple* were newly created.[32] In 1913, the respective numbers were 4,613 and 971.[33] However, in 1925, all traditional business forms experienced a marked decline, which in the case of the two commercial partnerships can only be described as collapse. By 1934, the number of newly created *sociétés en nom collectif* and *sociétés en commandite* was down to three- and two-digit numbers respectively, never to recover again. The upheaval was caused by the arrival on the scene, in 1925, of the SARL, which proved an immediate success. In 1926, 1,790 new SARLs were registered. Two years later, the number had risen to 11,971. In 1934, it stood at 6,769.[34]

Entrepreneurs apparently want and actively seek limited liability protection. If they have a choice, they conduct risky business activities through a limited liability entity. Even if limited liability were only a placebo, the placebo effect would be very powerful. Entities without a liability shield do subsist in some areas, in particular the professions, due to tradition and path dependencies. Otherwise, the main reason why businesses are still run as sole proprietorships or general partnerships is that they are too small or too short-lived to support even the modest costs of current limited liability business forms.[35]

B. Attractiveness of Transparent Taxation

Tax consequences are an important element of the cost-benefit analysis of different business entities. The most relevant type of taxation in that

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32. By comparison, only 18 *sociétés anoymes* and 176 *société en commandite par actions* were created that year. Claudine Alexandre*, Statistiques relatives aux sociétés en commandite en France et en Europe*, *in* La société en commandite entre son passé et son avenir 305, 309 (Centre de recherche sur le droit des affaires ed., 1983).

33. As well as 1,255 *sociétés anoymes* and 66 *société en commandite par actions.* From 1867 onwards, when general incorporation became available in France, the *société en commandite par actions* became marginalized by the *société anonyme,* see Merle & Fauchon, *supra* note 12, at 771; *infra* note 274. After World War I, catch-up effects resulted in a short-term boom in newly created businesses. 12,998 *sociétés en nom collectif*, 1,579 *sociétés en commandite*, and 3,040 *sociétés anoymes* were created in 1920 alone. *See* Alexandre, *supra* note 32, at 310.

34. Alexandre, *supra* note 32, at 310.

35. *See* Ribstein, *supra* note 8, at 417.

respect is income taxation. The income tax burden that a business's owners have to bear is, generally, substantive and, unlike tax liabilities resulting from other important taxes such as VAT, sensitive to the choice of organizational form. A substantive income tax has been in place in all examined jurisdictions for almost exactly one century. Prior to 1914, the burden of income taxation was generally very light by today's standards, if an income tax was levied at all. This changed dramatically and permanently in the context of World War I, when income taxation reached significant levels in all examined jurisdictions,[36] and has remained a substantial burden ever since.

Generally speaking, there are two regimes for the taxation of business profits: entity taxation and transparent taxation.[37] 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 when profits are distributed. Transparent taxation means that profits flow through to the owners where they are taxed only once. All income tax systems are marked by a divide between two types of business organization: those that are by default taxed transparently and those that are by default taxed at the entity level.[38] As already mentioned, sole proprietors invariably belong to the former category, corporations to the latter. All other forms of business organization are assigned to either of the two categories. Typically, partnerships are taxed transparently in order to put them on an equal footing with sole proprietorships. For limited liability business forms, entity taxation is the default[39] and thus also the benchmark against

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36. For Australia, see AH Slater, *Taxing Trust Income After Bamford's Case*, 40 Austl. Tax Rev. 69, 70 (2011); for Germany, see Rainer Hüttemann, *Das Steuerrecht der Aktiengesellschaft*, *in* 2 Aktienrecht im Wandel: Grundsatzfragen des Aktienrechts 1212, 1219 (Walter Bayer & Mathias Habersack eds., 2007); for France, see Thomas Piketty, Les hauts revenus en France au XXe siècle: Inégalités et redistributions, 1901–1998, at 233 (2001); for the United Kingdom and the United States, see Steven A. Bank, Anglo-American Corporate Taxation: Tracing the Common Roots of Divergent Approaches (2011).

37. Ault & Arnold, *supra* note 2, at 331.

38. *Id.* at 331 *et seq.*, 415 *et seq.*; Wolfgang Schön, *Die Personengesellschaft im Steuerrechtsvergleich*, *in* Die Personengesellschaft im Steuerrecht: Gedächtnissymposium für Brigitte Knobbe-Keuk 139, 142 *et seq.* (Franz Dötsch et al. eds., 2011).

39. *See, e.g.*, Code général des impôts art. 206 (Fr.); Körperschaftsteuergesetz [KStG], § 1 (Ger.); Corporation Tax Act 2009 c. 4, § 2 (UK); I.R.C. § 11 (U.S.).

which the potential benefits of transparent taxation have to be assessed. Ceteris paribus, an entrepreneur will only opt for a TTLLE if his tax burden under transparent taxation is lighter than under entity taxation.

It is often stated that transparent taxation is, from a taxpayer's perspective, superior to entity taxation because it features only one layer of tax as compared to two.[40] This, however, is an oversimplification. The number of tax layers is not necessarily correlated to the total tax burden. In fact, if a business runs a profit, it depends on a multitude of factors whether the tax burden under transparent taxation is lower than under entity taxation.[41] Obviously, the design of the tax system is of paramount importance. Under a classical system of entity taxation, profits distributed by a business entity are taxed again—as ordinary income at the applicable ordinary income tax rate—in the hands of the individuals receiving the distribution.[42] This was the way in which dividends were taxed in the United States prior to 2003.[43] By contrast, under an integrated system of entity taxation, the economic double taxation of distributed profits is either eliminated or at least alleviated. Design options for integrating entity- and owner-level taxation are manifold, ranging from a deduction of profit distributions from the tax base at entity level, to the full or partial exemption of profit distributions from tax at owner level, to the imputation of the entity-level tax against the tax payable on profit distributions at owner level.[44]

Apart from the basic design question of if and how corporate and individual income tax are to be integrated, the attractiveness of

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40. *See, e.g.*, Reuven S. Avi-Yonah & Amir C. Chenchinski, *The Case for Dividend Deduction*, 65 Tax Law. 3, 4 (2011); Mirit Eyal-Cohen*, When American Small Business Hit the Jackpot: Taxes, Politics and the History of Organizational Choice in the 1950s*, 6 Pitt. Tax Rev. 1 (2008); Susan Pace Hamill*, The Origins Behind the Limited Liability Company*, 59 Ohio St. L.J. 1459, 1461 (1998).

41. *See* Daniel N. Shaviro, Decoding the U.S. Corporate Tax 73–99 (2009).

42. *See* Ault & Arnold, *supra* note 2, at 333 *et seq.*

43. *Id.* at 335; Bank, *supra* note 36, at 99 *et seq.* As of 2003, qualifying dividends in the United States have been subject to a preferential rate. I.R.C. § 1(h)(11); Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302(a), 117 Stat. 752, 760–61.

44. For an overview of the basic options, see U.S. Treas. Dep't, Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (1992); Ault & Arnold, *supra* note 2, at 333 *et seq.*

transparent taxation depends in particular on the relative tax rates at entity and owner level and on how long profits are retained at entity level before being distributed. Even a classical system of entity taxation is more attractive than transparent taxation if the tax rate at entity level is sufficiently lower than that at the owner level and if profits are retained sufficiently long. If, for instance, profits are taxed at a rate of 20% at entity level and at a rate of 40% at owner level, and if future tax payments are discounted at a rate of 5%, profits need to be retained for 15 years until the net present value of entity- and owner-level tax combined falls below the tax burden of 40% under transparent taxation that is due immediately. Thus, with regard to the taxation of profits, it depends essentially on the design of the tax system and on idiosyncratic characteristics of businesses and their owners, in particular the leeway for profit retention, whether transparent taxation is advantageous. There is, however, one scenario in which transparent taxation of profits is unequivocally superior to entity taxation: if the tax rate faced by the owners of a transparently taxed business entity is lower than the entity-level tax under entity taxation.

When it comes to losses, the benefits of transparent taxation are clearer. While taxpayers who make a profit must pay part of it over to the state as income tax, no tax system in the world provides for the payout of a "negative" income tax to all taxpayers who incur losses. However, income generation is a continuous process that transcends the arbitrary temporary boundaries of taxation periods. Hence, it would be problematic to simply levy income tax in profitable periods and to ignore periods with losses completely. Instead, tax systems generally provide for some sort of inter-temporal loss compensation. In some jurisdictions, it is possible to carry losses back to profitable tax years in the past and to receive a refund for tax already paid, but generally only to a very limited extent.[45] If a loss carryback is not available or not possible due to a lack of past profits, a loss can generally be carried forward. As a result, it will only reduce a business's tax burden if and when the business generates profits in the future. In addition, the right to carry losses forward is frequently limited to a certain period of time and/or with regard to the amount of losses that can be set against profits of a future

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45. In Germany and France, for instance, losses can be carried back only to the previous tax year and only up to an amount of €1 million. *See* Einkommensteuergesetz [EStG], § 10d(1) (Ger.); Code général des impôts art. 220 *quinquies* (Fr.).

tax year.[46] As a result, taxpayers might forfeit all or part of their losses even if they generate future profits of the same amount. Against this background, it is obvious that taxpayers would find it very attractive if they could receive immediate relief for their losses instead of having to rely on the uncertain prospect of a loss carryforward. Absent a negative income tax, this is only possible if losses from one source can be set against profits from another source within the same taxation period. Unlike entity taxation, transparent taxation frequently enables precisely this outcome.[47] The owners may set losses generated at entity level against income from other sources. Vice versa, they may also set losses generated, for instance, in another business venture against their share of the profit of a transparently taxed business entity. Transparent taxation thus enables the immediate compensation of profits and losses, in both directions, between entity level and owner level. Under entity taxation, however, losses are generally 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.

Finally, transparent taxation might also be useful when only the owners of a business are entitled to preferential tax treatment with regard to certain items of the tax base. In Australia, for instance, individuals, but not companies, may benefit from a preferential tax rate on capital gains.[48] As profits and losses flow through to the owners under transparent taxation, such a preferential tax treatment may be applicable. This is generally not possible under entity taxation. Even if, for instance, a company that derives a capital gain distributed the same amount immediately to its shareholders, the latter would receive income in the form of a dividend and would thus not benefit from a more preferential treatment of capital gains.[49]

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46. In Germany and France, for instance, the loss carryforward exceeding 1 million euros is capped at 60% (Germany) or 50% (France) of the taxable profit of subsequent tax years. *See* Einkommensteuergesetz [EStG], § 10d(1) (Ger.); Code général des impôts art. 209 (Fr.). Prior to the adoption of the Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13302, 131 Stat. 2054 (2017), losses could be carried forward for only up to 20 years in the United States. I.R.C. § 172.

47. Jurisdictions do, however, enact restrictions to limit tax avoidance. *See infra* note 302 and accompanying text.

48. *Income Tax Assessment Act 1997* (Cth) div 115.

49. It is, of course, possible to align the taxation of dividends with, for instance, a preferential tax regime for capital gains. For example, the United

While the attractiveness of combining limited liability and transparent taxation explains why TTLLEs did emerge, it does not account for the structural differences that can be observed among TTLLEs of different jurisdictions. As will be described in the following, these differences reflect the fact that TTLLEs evolved convergently, along three different "evolutionary paths."

II. Path One Towards a TTLLE: Combination of Legal Forms

Historically, the first path towards a TTLLE consists of combining a form of business association that is taxed transparently with another one that features a liability shield.

A. The German Solution: GmbH & Co. KG

The beginnings of the convergent evolution of limited liability entities can be traced with some confidence to a decision in 1912 by the highest Bavarian Court, which—for the first time—accepted the registration of a GmbH & Co. KG in the public register for commercial partnerships and corporations.[50] A GmbH & Co. KG is a *Kommanditgesellschaft* (KG), i.e., a limited partnership, whose sole general partner is a corporation in the guise of a "GmbH."[51] The inception of the GmbH & Co. KG was tax driven. In 1910, the German state of Bavaria had extended income taxation to GmbHs. The GmbH & Co. KG was designed by a Munich law firm in order to avoid the resulting effective double taxation of profits.[52]

States, as discussed *supra* note 43 and accompanying text, has a preferential dividend rate that is set equal to the preferential capital gain rate.

50. Bayerisches Oberstes Landesgericht [BayObLG] Feb. 16, 1912, 27 OLGRspr 331 (Ger.); *see also* Karsten Schmidt, Gesellschaftsrecht § 56 I 2a (4th ed. 2002).

51. For the background of the "GmbH," see *supra* Part I.A.

52. *See* Brigitte Knobbe-Keuk, Das Steuerrecht—eine unerwünschte Rechtsquelle des Gesellschaftsrechts? 6 (1986); Gustav Zielinski, Grundtypvermischungen und Handelsgesellschaftsrecht 37 (1925); Bernhard Grossfeld, Zivilrecht als Gestaltungsaufgabe, 130 Schriftenreihe: Juristische Studiengesellschaft Karlsruhe 33 *et seq.* (1977); Manfred Groh, *Das Steuerrecht als unerwünschte Quelle des Gesellschaftsrechts*, Betriebs-Berater, no. 5, 1984, at 304, 305.

To intertwine a corporation and a limited partnership in such a way is 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. On the other hand, the limited partnership is a partnership—and as such is taxed transparently. In an archetypal GmbH & Co. KG structure, equity interests are held exclusively by the limited partners. The corporate general partner has no equity stake in the limited partnership. Correspondingly, limited partners are usually entitled to 100% of the profit of the limited partnership.[53] In a typical GmbH & Co. KG, the shares in the corporation that functions as sole general partner are owned by the limited partners, with each partner usually holding corresponding shares in both entities. Thus, a change in the ownership structure requires a double transfer of membership interest. In a more recent variant of the GmbH & Co. KG, the shares in the corporate general partner are held by the limited partnership itself.[54] Short of removing the corporate general partner entirely—which would require an intervention by the legislature—this structure can be seen as the conceptual culmination of the effort of integrating corporation and limited partnership.

Although it had been around since 1912, the GmbH & Co. KG became very popular only in the 1930s. At first, it was held back by legal uncertainty. The GmbH & Co. KG got its ultimate blessing as a legitimate form of business organization from the Reichsgericht, then the German Supreme Court for private and criminal law, only in 1922.[55] It took the Reichsfinanzhof, then the German Supreme Court for tax law, another eleven years to establish, in 1933, that GmbH & Co. KGs were to be taxed like ordinary partnerships, i.e., transparently, and not like

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53. Karsten Schmidt, *Zur Binnenverfassung der GmbH & Co. KG—Wer ist Herr im Haus: die GmbH oder die Kommanditisten?*, *in* Festschrift fur Volker Röhricht: Zum 65. Geburtstag 511 (Georg Crezelius et al. eds., 2005). Technically, the corporate general partner receives a nominal, fixed profit share that is meant to compensate it for absorbing unlimited liability for the limited partnership's debt. The residual, however, is typically assigned exclusively to the limited partners. *See* Schmidt, *supra* note 50, § 56 IV 1a.

54. Karsten Schmidt, *Die GmbH & Co. KG als Lehrmeisterin des Personengesellschaftsrechts: 18 Leitsätze zum gewandelten Rechtsbild der Kommanditgesellschaft*, 63 JuristenZeitung, no. 9, 2008, at 425, 435.

55. Reichsgericht [RG], July 4, 1922, Rep. II B 2/23, 105 RGZ 101.

corporations.[56] However, the GmbH & Co. KG was truly kick-started, inadvertently, only by Nazi economic policy.[57] According to Nazi ideology, a good German businessman should be personally liable. Limited liability was regarded as cowardly and immoral.[58] Therefore, the Nazi regime wanted to encourage the transformation of closely held corporations, in particular GmbHs, into general partnerships. In order to implement this policy, corporations were subjected to unrelieved and prohibitive corporate income taxation.[59] At the same time, corporations were given the opportunity to convert into partnerships without negative tax consequences. As a result, the owners of GmbHs suddenly faced a major trade-off between, on the one hand, protection from liability for business debt and, on the other hand, a much lower tax burden under the tax regime applicable to partnerships, i.e., transparent taxation. Many business owners decided to combine the best of both worlds by converting their GmbHs not into general partnerships but into limited partnerships.[60]

After World War II, of course this policy came to an end. Nevertheless, Germany operated a classical corporate income tax system until 1976.[61] Up to this point, transparent taxation remained more

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56. Reichsfinanzhof [RFH], Feb. 18, 1933, I A 422/30, RStBl 1933, 375 (377). In a previous decision, the Reichsfinanzhof had already stated that establishing a GmbH & Co. KG was not per se abusive and as such was not caught by the German general anti-avoidance rule (then section five of the *Reichsabgabenordnung*). *See* Reichsfinanzhof [RFH], Mar. 13, 1929, I A 174-176/28, RStBL 1929, 329.

57. In the 1920s, the low corporate income tax rate of 20% meant that entity taxation was more attractive than transparent taxation if profits were to be retained. *See* Zielinski, *supra* note 52, at 44 n.16; *supra* Part I.B.

58. Matthias Stupp, GmbH-Recht im Nationalsozialismus 98 *et seq.* (2002); Roman Seer, *Die Besteuerung der GmbH im Spiegel der Zeit*, GmbH-Rundschau, no. 19, 2009, at 1036, 1039.

59. *See* H. Großmann-Doerth, *Zur Reform der Kommanditgesellschaft*, 147 Archiv für die civilistische Praxis 1, 11 (1941) (stating that the increase of the corporate income tax burden was intended as punishment ("als Strafe gedacht")).

60. *Id.* at 12.

61. From 1953 onwards, the economic double taxation of distributed profits was mitigated by means of a preferential corporate income tax rate for

attractive than entity taxation. Consequently, its tax treatment gave the GmbH & Co. KG a competitive advantage over the GmbH. Interestingly, the GmbH & Co. KG has remained popular to the present day, although the benefits of transparent taxation have been considerably mitigated since 1977. From 1977 through 2000, Germany operated an imputation system that eliminated the economic double taxation of profits by imputing the corporate income tax on the personal income tax due on profit distributions,[62] and the current German system of business taxation does not discriminate against corporations either.[63] 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 some time. There is no sign of a decline of the GmbH & Co. KG.

distributed profits. *See* BRIGITTE KNOBBE-KEUK, BILANZ- UND UNTERNEHMENSSTEUERRECHT 560 *et seq.* (9th ed. 1993).

62. For the details, see KNOBBE-KEUK, *supra* note 61, at 561 *et seq.*

63. For the background of the abolishment of the imputation system, and for the details of the current system, see Johanna Hey, *Körperschaftsteuer*, *in* TIPKE/LANG, STEUERRECHT 741, 744 *et seq.* (Roman Seer et al. eds., 23rd ed. 2018).

Table 1

	Income tax statistics 2011[64]		VAT statistics 2014[65]		
Type of business entity	***Net income 1,000 EUR***	***Net income percentage***	***Number of taxpayers***	***Gross receipts 1,000 EUR***	***Gross receipts percentage***
Sole proprietorships	112,833,516	32%	2,182,130	567,636,578	10%
Partnerships	123,508,531	35%	428,751	1,508,069,560	26%
Thereof GmbH & Co. KG	**65,568,874**	**19%**	**137,658**	**1,113,849,400**	**19%**
Corporations	80,253,390	23%	553,390	3,295,206,784	56%
Other	36,202,905	10%	75,950	499,961,913	9%
Total	352,798,342		3,240,221	5,870,874,835	

64. Author's calculation, based on STATISTISCHES BUNDESAMT, LOHN- UND EINKOMMENSTEUER: STATISTIK ÜBER DIE PERSONENGESELLSCHAFTEN UND GEMEINSCHAFTEN (2011) and FINANZEN UND STEUERN: JÄHRLICHE KÖRPERSCHAFTSTEUERSTATISTIK (2011).

65. Author's calculation, based on STATISTISCHES BUNDESAMT, *supra* note 17.

The continuing relevance of limited partnerships as business vehicles, in the form of GmbH & Co. KGs, is unique to Germany. In France, limited partnerships are nowadays barely used at all; there are approximately 2,000 corporations for every limited partnership.[66] In Australia, the United Kingdom, and the United States, limited partnerships are used, but predominantly as investment vehicles. In the United Kingdom and Australia, there are 200[67] and in the United States, twenty corporations for every limited partnership.[68] 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 four to one.

B. The Australian Solution: Trading Trust

In Australia, legal practitioners created a do-it-yourself TTLLE in much the same way as their colleagues in Germany—by combining two different legal forms. However, Australian lawyers' toolbox of organizational forms had—and still has—a different content than that of their German counterparts. Most notably, it contains the trust, a legal concept deeply rooted in the conceptual world of common law systems but unfamiliar to civil law jurisdictions. This enabled Australian lawyers to come up with an original variant of the combination approach. In Australia, a corporation is combined not with a limited partnership but with a trust. If such a structure is used as an organizational form by active businesses, mostly SMEs, it is commonly referred to as a "trading trust."[69] In the panoply of Australian business organization forms, the trading trust

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66. Author's calculation, based on Jean-Paul Valuet et al., Code des sociétés: Annoté et commenté 284, 290 (33d ed. 2017); Pierre-Louis Périn, *Complémentarité et concurrence des formes des sociétés commerciales en France: une approche statistique,* Revue Trimestrielle de Droit Financier, no. 2, 2013, at 48.

67. Author's calculation, based on Austl. Tax'n Office, Taxation Statistics 2015–16 (2016), https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2015-16/.

68. Author's calculation, based on *SOI Tax Stats*, *supra* note 31 (LLCs were counted as corporations).

69. The usage of the term is not completely unambiguous. *See* Nuncio D'Angelo, Commercial Trusts 76 (2014).

acts effectively as a close substitute for the corporation.[70] The extent to which both organizational forms are regarded as equivalent is highlighted by the fact that it was contemplated in the state of Victoria to extend minority oppression remedy rules for privately held companies to trading trusts.[71]

In a trading trust structure, a close corporation with a small number of shareholders—or only one shareholder—and only a nominal amount of capital (usually two Australian dollars[72]) acts as trustee and holds legal title to the business assets.[73] The beneficiaries of the trust are entitled to the business profits. The directors of the corporate trustee are usually also beneficiaries of the trust.[74] A trust is not itself a legal entity and has no separate legal identity.[75] Thus, a trading trust can only operate through the corporate trustee, who conducts the business activities in its own name. As a result, it is also the corporate trustee who is primarily liable for business debt.[76] In return, the trustee has a right to be indemnified out of the trust's assets[77] but has no claim against the beneficiaries. In a properly designed trading trust structure, both the

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70. ROBERT BAXT ET AL., CORPORATIONS AND ASSOCIATIONS xxii (10th ed. 2009); PAMELA HANRAHAN ET AL., COMMERCIAL APPLICATIONS OF COMPANY LAW 72 (15th ed. 2014); Graeme S. Cooper, Comment, *Reforming the Taxation of Trusts: Piecing Together the Mosaic*, 35 SYDNEY L. REV. 187, 188 (2013); Brett Freudenberg, *Tax on My Mind: Advisors' Recommendations for Choice of Business Form,* 42 AUSTL. TAX REV. 33 (2013); Kevin Lindgren, *The Birth of the Trading Trust*, 5 J. EQUITY, no. 1, 2011, 2011 AJEQT LEXIS 33.

71. *See* VICTORIAN LAW REFORM COMM'N, TRADING TRUSTS—OPPRESSION REMEDIES: REPORT (2015).

72. *See, e.g.*, JULIE CASSIDY, CONCISE CORPORATIONS LAW 22 (5th ed. 2006); JASON HARRIS ET AL., AUSTRALIAN CORPORATE LAW 110 (1st ed. 2008); D.G. Gardiner, *Trading Trusts and Straw Trustees (Principles & Problems Reconsidered)*, 3 QUEENSL. INST. TECH. L.J. 17 (1987).

73. CASSIDY, *supra* note 72, at 22; HARRIS ET AL., *supra* note 72, at 110; Lindgren, *supra* note 70, at *4 (LEXIS).

74. VICTORIAN LAW REFORM COMM'N, *supra* note 71, at 213.

75. CASSIDY, *supra* note 72, at 19; HARRIS ET AL., *supra* note 72, at 59; Gardiner, *supra* note 72, at 17.

76. H.A.J. Ford, *Trading Trusts and Creditor's Rights*, 13 MELBOURNE U. L. REV. 1, 2 (1981); B.H. McPherson, *The Insolvent Trading Trust*, *in* ESSAYS IN EQUITY 142, 143 (P.D. Finn ed., 1985).

77. HARRIS ET AL., *supra* note 72, at 59 *et seq.*; Ford, *supra* note 76, at 4; McPherson, *supra* note 76, at 142, 144 *et seq.*

beneficiaries and the settlor of the trust, who may also be a beneficiary, are protected from liability for business debt.[78] 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 in the trust deed. If these requirements are satisfied, section 197 of the Corporations Act of 2001 provides that beneficiaries are held personally liable for business debt.[79]

In Australia, the modern trading trust became popular in the 1970s as an alternative to the corporation because it is taxed transparently.[80] It was born as a TTLLE.[81] At this time, Australia operated a classical corporate tax system and levied a penalty tax on undistributed profits of privately held companies.[82] Even if the special tax on undistributed profits was not applicable, the combined tax burden on corporate profits at entity and owner level amounted to 82.5%, whereas the top marginal rate of the personal income tax payable by individuals was "only" 67%.[83] Transparent taxation was thus clearly attractive. In 1987, Australia introduced an imputation system that did away with the economic double taxation of profits.[84] However, as in the case of the GmbH & Co. KG in Germany, this did not put an end to the popularity of the trading trust. This is remarkable, as trading trusts have always been only partially transparent.[85] While profits may flow through to the beneficiaries, losses are trapped at the level of the trust.[86] The trading trust thus lacks a vital benefit of a fully tax transparent TTLLE such as the GmbH & Co. KG.

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78. *See* Ford, *supra* note 76, at 5 *et seq.*; McPherson, *supra* note 76, at 142, 143. Beneficiaries are only liable if they have given specific instructions to the trustee who followed these instructions. Hanrahan et al., *supra* note 70, at 75.

79. *Corporations Act 2001* (Cth) s 197 (Austl.).

80. D'Angelo, *supra* note 69, at 77.

81. *See* Gardiner, *supra* note 72, at 17 ("The attractive combination of limited liability and taxation advantages resulted in an explosion in the 1970s of the trading trust, using a straw corporate trustee to carry on a business enterprise." (footnotes omitted)).

82. Austl. Commonwealth Tax'n Review Comm., Full Report January 31 1975, ch. 16.12 (1975) ("Asprey Report").

83. *Id.* chs. 14.3, 16.15.

84. 1 Australia's future tax system, Report to the Treasurer, pt. 2, at 192 *et seq.* [hereinafter Henry Report].

85. Cooper, *supra* note 70, at 188.

86. *Income Tax Assessment Act 1936* (Cth) ss 95, 97, 98, 100 (Austl.); *see* Graeme S. Cooper et al., Income Taxation, Commentary and Materials

Trading trusts continue to offer two main tax benefits. The first concerns the taxation of capital gains. Individuals, but not companies, are entitled to a 50% discount on long-term capital gains, i.e., gains that are made on the disposal of assets that have been held by the seller for at least twelve months.[87] An individual who is a beneficiary of a trust can receive the same discount with regard to capital gains realized at trust level.[88] The second tax benefit consists in the trading trust's potential for income splitting. Trading trusts used by SMEs are typically discretionary trusts.[89] In a discretionary trust, as opposed to a fixed trust, the trustee has wide discretion with regard to the allocation of income, and even of different types of income, among beneficiaries.[90] To the extent that these allocations are recognized for tax purposes, income can be split among beneficiaries in a tax-efficient way, taking into account differences in marginal tax rates or the availability of losses from other sources that can be set against trust profits.[91] A key non-tax benefit of trading trusts is asset protection. A trust is an effective tool for shielding assets from the beneficiaries' personal creditors because beneficiaries have no legal title over, but only a beneficial interest in, trust property.[92] By contrast, in the case of a company, personal creditors of one of the business owners might simply seize the owners' shares in the business.

According to tax data, the relevance of the trading trust as a business vehicle is much lower than that of the GmbH & Co. KG, but it is not negligible either. Corporations still reign supreme in the world of Australian business. However, in 2013–14, trusts in general were more important than partnerships, and trading trusts accounted for six percent of all net business profits, excluding sole proprietorships. Furthermore, over the past fifteen years, the trading trust has been the most dynamic form of business organization in terms of existing entities, with an increase of 87% (Table 2).

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732 *et seq.* (6th ed. 2009).

87. *Income Tax Assessment Act 1997* (Cth) div 115 (Austl.).

88. For the (complicated) details, see Cooper et al., *supra* note 86, at 737; Cooper, *supra* note 70, at 188.

89. *See* D'Angelo, *supra* note 69, at 77.

90. *Id.* at 70.

91. Brett Freudenberg, Tax Flow-Through Companies 177 (2011).

92. *See Chief Comm'r of Stamp Duties v. Buckle* [1998] 192 CLR 226 (23 January 1998) (Austl.); *Gartside v. Inland Revenue Comm'rs* [1968] AC 553 (HL) (UK); *see also* Freudenberg, *supra* note 70.

Table 2

	Taxation statistics[93]				
Type of business entity	*Number of entities 1998–99*	*Number of entities 2013–14*	*Change 1998–99 / 2013–14*	*Net business income 2013–14 1,000 AUD*	*Net business income 2013–14 percentage*
Companies	646,405	884,315	37%	213,624,282	82%
Partnerships	530,860	343,601	–37%	20,100,226	8%
Trusts	502,665	802,645	60%	26,303,393	10%
Thereof Discretionary Trusts (trading activities)	**139,680**	**261,752**	**87%**	**15,810,373**	**6%**
Total	1,679,930	2,030,561		260,027,901	

93. Author's calculation, based on Austl. Tax'n Office, *supra* note 67.

III. Path Two Towards a TTLLE: Optionality of Transparent Taxation

Apart from combining different legal forms, the creation of a TTLLE requires legislative intervention. The obvious solution is to make transparent taxation optionally available for corporations.

A. The U.S. Solution (1): S Corporation

In the United States, Subchapter S of the Internal Revenue Code (I.R.C.) allows "small business corporations" to opt for the status of "S Corporation."[94] An S corporation is not itself subject to income tax.[95] Instead, the corporation's items of "income . . . , loss, deduction, or credit" are passed through, pro rata, to its shareholders.[96] Transparent taxation under Subchapter S comes with considerable strings attached:[97] S corporations may have only one class of shares and a maximum shareholder number of 100. Apart from some narrowly defined exceptions, only individuals who are resident in the United States qualify as shareholders of an S corporation. Notably, corporations, partnerships, and LLCs are ineligible as shareholders.

Subchapter S was enacted in 1958 with the explicit aim of reducing tax-induced distortions of the choice of organizational form.[98] Since 1913, when a federal income tax was permanently introduced,[99] the United States has—most of the time—subjected income earned through a corporation to either unmitigated or only partially mitigated double

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94. I.R.C. § 1361 *et seq.* Note that an S corporation need not necessarily be organized as a corporation under state business organization law. The meaning of "small business corporation" is defined for federal tax purposes in the I.R.C. Since the introduction of "check-the-box," entities that are not corporations from a business law perspective can opt to be treated as corporations for tax purposes—including the status of S corporation if otherwise qualified. *See* Willard B. Taylor, *Can We Clean This Up? A Brief Journey Through the United States Rules for Taxing Business Entities*, 19 Fla. Tax Rev. 323, 327 (2016); *infra* Part IV.A.

95. I.R.C. § 1363.

96. I.R.C. § 1366(a)(1)(A).

97. I.R.C. § 1361(b).

98. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650.

99. For the details, see Bank, *supra* note 36, at 30, 70 *et seq.*

taxation.[100] According to the U.S. Senate Committee on Finance, allowing corporations to opt for flow-through taxation was "desirable because it permits businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence."[101] In that respect, Subchapter S was meant to complement a short-lived provision enacted in 1954, which allowed sole proprietorships and partnerships to opt to be taxed like corporations.[102] On this occasion, in 1954, the Senate suggested—in vain—to allow certain corporations to opt for the taxation regime applicable to partnerships (Subchapter K of the I.R.C.).[103] By contrast, the enactment of Subchapter S in 1958 created a special flow-through regime that differed considerably from the one applicable to partnerships. This new conceptual approach was motivated by the concern that allowing existing corporations to elect to be partnerships for tax purposes might result in a loss of tax revenue with regard to unrealized gains and undistributed profits.[104] In 1982, Subchapter S was reformed in order to align it more closely with the partnership model.[105] Nevertheless, important differences remain.[106] According to Eustice, Subchapters S and K, "which had formerly been merely kissing cousins, became in 1982 at least blood brothers—though not, as yet, identical twins."[107] Furthermore, it is worth mentioning that the eligibility criteria for S corporation status have been

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100. *Id.* at 70 *et seq.*

101. S. Rep. No. 85-1983, at 87 (1958) (report of the Committee on Finance, Technical Amendments Act of 1958).

102. *Id.* The relevant provision was abolished in 1966. *See* James S. Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals*), 39 Tax L. Rev. 345, 347 (1983).

103. S. Rep. No. 83-1622, at 452–53 (1954) (report of the Committee on Finance to accompany H. R. 8300, A Bill to Revise the Internal Revenue Laws of the United States); *see also* Eyal-Cohen, *supra* note 40, at 20 *et seq.*

104. Taylor, *supra* note 94, at 337.

105. Eustice, *supra* note 102, at 348.

106. For the details, see Paul R. McDaniel, Martin J. McMahon Jr. & Daniel L. Simmons, Federal Income Taxation of Partnerships and S Corporations 449 (5th ed. 2012).

107. Eustice, *supra* note 102, at 346.

constantly relaxed since 1958.[108] The most visible changes have occurred with regard to the maximum number of shareholders. It started at 10 in 1958 and was raised first to 15, then to 25, then to 35, then to 75, and finally, in 2004, to 100.[109] In reality, the number of shareholders can be considerably higher. Spouses have long been counted as just one shareholder.[110] In 2004, this rule was extended to all members of family, generously defined as any lineal descendant of a common ancestor not more than six generations removed from the youngest generation of shareholders, and their current or former spouses.[111] Other restrictions that were dropped or relaxed concerned the maximum amount of passive income that an S corporation is allowed to earn and an S corporation's ability to acquire interests in other business entities.[112]

The S corporation is quite popular. In 2012, more than 70% of all U.S. corporations were S corporations. They accounted for 16% of all business profits and for 20% of gross business receipts.

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108. *See* McDaniel, McMahon & Simmons, *supra* note 106, at 446–47; Eustice, *supra* note 102, at 345.

109. McDaniel, McMahon & Simmons, *supra* note 106, at 456; Roberta Mann, *Subchapter S: Vive le Difference!*, 18 Chap. L. Rev. 65, 67 n.19 (2014).

110. *See* Eustice, *supra* note 102, at 355.

111. I.R.C. § 1361(c)(1)(B); *see* McDaniel, McMahon & Simmons, *supra* note 106, at 451 *et seq.*

112. *See* McDaniel, McMahon & Simmons, *supra* note 106, at 445 *et seq.*; Eustice, *supra* note 102, at 345.

Table 3

	SOI, Business Tax Statistics, Integrated Business Data[113]				
Type of business entity	***Number of returns***	***Net income 1,000 USD***	***Percentage of total***	***Business receipts 1,000 USD***	***Percentage of total***
Sole proprietorships	23,553,850	304,895,911	10%	1,301,569,749	4%
Partnerships	3,388,561	777,924,476	26%	4,689,702,874	15%
Corporations	5,840,821	1,871,914,319	63%	26,029,143,463	81%
Thereof S Corps.	**4,205,452**	**475,998,050**	**16%**	**6,427,057,090**	**20%**
Total	32,783,232	2,954,734,706		32,020,416,086	

113. *SOI Tax Stats*, *supra* note 31.

The S corporation has not always been a success story. In the 1970s and in the first half of the 1980s, S corporations only accounted for about two percent of the net income earned by corporations.[114] By the middle of the 1980s, only 24% of corporations filed S corporation returns.[115] The fate of the S corporation changed in 1986 when, under the presidency of Ronald Reagan, the United States undertook a major overhaul of its tax system.[116] The Tax Reform Act of 1986[117] made flow-through taxation extremely attractive by reducing the top marginal rate for individuals to 28%, below the corporate tax rate of 34%.[118] As a result of the inverted rate structure, transparent taxation became attractive even for retained earnings.[119] Neither the increase of the top marginal income tax rate for individuals to 39.6% in 1993, above the corporate tax rate of then 35%,[120] nor competition from the LLC from 1988 onwards[121] have—so far—reversed the success of the S corporation.[122]

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114. Susan C. Nelson, *S Corporations Since the Tax Reform Act of 1986*, *in* Proc. 84 Ann. Conf. on Tax'n, Nat'l Tax Ass'n 18, 19 (1991).

115. Author's calculation, based on McDaniel, McMahon & Simmons, *supra* note 106, at 446 n.4.

116. *See id.,* at 446; Stephen Schwarz, Daniel J. Lathrope & Brant J. Hellwig, Fundamentals of Business Enterprise Taxation: Cases and Materials 990–91 (6th ed. 2016); Hamill, *supra* note 40, at 1459, 1517.

117. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

118. *SOI Tax Stats - Historical Table 23*, IRS.gov, https://www.irs.gov/statistics/soi-tax-stats-historical-table-23 (last updated Aug. 11, 2017); *SOI Tax Stats - Historical Table 24*, IRS.gov, https://www.irs.gov/statistics/soi-tax-stats-historical-table-24 (last updated Aug. 11, 2017); *see also* Karen C. Burke, *Passthrough Entities: The Missing Element in Business Tax Reform*, 40 Pepp. L. Rev. 1329, 1330 (2013); George A. Plesko & Eric J. Toder, *Changes in the Organization of Business Activity and Implications for Tax Reform*, 66 Nat'l Tax J. 855, 856 (2013); Deborah H. Schenk, *Reforming Entity Taxation: A Role for Subchapter S?*, 146 Tax Notes 1237, 1239 (Mar. 9, 2015).

119. Schwarz, Lathrope & Hellwig, *supra* note 116, at 990–91.

120. *SOI Tax Stats - Historical Table 23*, *supra* note 118; *SOI Tax Stats - Historical Table 24*, *supra* note 118.

121. *See infra* Part IV.A.

122. One reason for the unwaning popularity of S corporation status are advantages with regard to employment taxes. *See infra* note 166 and accompanying text. For an optimistic view on the future of S corporations, see David Branham, *Has the S-Corp Run Its Course? The Past Successes and Future Possibilities of the S Corporation*, 42 J. Legis. 101 (2016). *See infra*

B. The French Solution: SARL de Famille & Co.

Like the United States, France allows corporations to opt for transparent taxation if certain conditions are satisfied. The most time-revered regime is that of the *SARL de famille*. Nowadays, there are, however, no less than three ways of creating a TTLLE in France. Two regimes allow corporations to opt into transparent taxation. Under a third regime, transparent taxation is the default, requiring corporations to actively opt for entity taxation. What complicates matters further is that, in France, there are several types of business corporations.

Against this background, a brief introduction to French business forms is in order. In a nutshell, the universe of French business entities is dominated by a triumvirate of business corporations: *société anonyme* (SA), *société par actions simplifiée* (SAS), and SARL. Outside the professions, partnerships—and in particular commercial partnerships—are marginalized.[123] It was already mentioned that the SARL was an immediate success when it was introduced in 1925.[124] It has remained popular ever since.[125] In 2012, 84.5% of businesses organized as *sociétés commerciales,* i.e., business corporations or commercial partnerships,[126] were SARLs. If one takes into account firm size, however, it becomes evident that the SARL reigns supreme only among small businesses. In 2012, SARLs accounted for well over 80% of all *sociétés commerciales* with less than 50 employees, while SAs and SASs were equally

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notes 312–317 and accompanying text for a discussion of the potential impact of the recently enacted Tax Cuts and Jobs Act.

123. In 2012, there were only 28,980 *sociétés en nom collectif* and only 1,143 *sociétés en commandite* (*simple* and *par actions*) registered in France. Pierre-Louis Périn, *Complémentarité et concurrence des formes des sociétés commerciales en France: une approche statistique (chiffres 2012),* Revue Trimestrielle de Droit Financier, no. 3, 2013, at 65, 66. A notable exception consists of a few very large businesses that are organized as *sociétés en commandite par actions,* such as Michelin, Lagardère, and Hermès. Périn, *supra* note 66, at 48.

124. *See supra* Part I.A.

125. From 2000 to 2012, its numbers grew from 764,006 to 1,442,142. *See* Périn, *supra* note 123, at 66.

126. The French category of "*société commerciale"* includes, most notably, *société anonyme*, *société par actions simplifée,* SARL, *société en nom collectif*, *société en commandite*, and *société européenne*. *See* Code de commerce art. 210-1(2); Merle & Fauchon, *supra* note 12, at 15.

dominant among businesses with a workforce of more than 50.[127] Only very recently, this neat separation of spheres according to firm size has come under pressure as a result of the relentless rise of the SAS. As its name suggests, it was introduced as a simplified version of the SA in 1994.[128] Initially, it was a nonstarter.[129] A liberalizing reform in 1999,[130] however, put it on an entirely different trajectory. In 2006, SASs outnumbered SAs for the first time. Only six years later, in 2012, there were more than four times as many SASs than SAs.[131] For almost a decade, the SARL remained largely unaffected by this development. As late as 2008, it accounted for 91% of newly formed *sociétés commerciales*. However, the same year another reform increased the appeal of the SAS for smaller businesses,[132] and the SARL started to lose ground. In 2016, the SAS supplanted the SARL as the most popular business form for newly established *sociétés commerciales* with a share of 56%.[133]

For the purposes of income taxation, France draws a distinction between corporations (*sociétés de capitaux*) and partnerships (*sociétés de personnes*).[134] Corporations are, in principle, taxed at entity

127. SARLs account for 89% of *sociétés commerciales* with no employees, for 83% of those with 1 to 49 employees, for 16% of those with 50 to 999 employees, and for only 2% of those with more than 1000 employees. In the latter two categories, SA and SAS had a combined share of 82% and 90% respectively. Périn, *supra* note 123, at 69.

128. Loi 94-1 du 3 janvier 1994 instituant la société par actions simplifiée, Journal Officiel de la République Française [J.O.], Jan. 4, 1994, p. 129.

129. At the beginning of 1999, there were only approximately 2,600 *société par actions simplifiées,* as opposed to approximately 165,000 *sociétés anonymes*. *See* Périn, *supra* note 66, at 49.

130. Loi 99-587 du 12 juillet 1999 sur l'innovation et la recherche, art. 3, Journal Officiel de la République Française [J.O.], July 13, 1999, p. 10396; *see* Merle & Fauchon, *supra* note 12, at 779.

131. There were 188,735 SASs versus 44,629 SAs. *See* Périn, *supra* note 123, at 66.

132. Périn, *supra* note 66, at 52.

133. *Les créations d'entreprises en 2016,* NSEE Première, no. 1631, Jan. 24, 2017, https://www.insee.fr/fr/statistiques/2562977.

134. Assemblée Nationale (Treiziéme Législature), No. 905, Avis présenté au nom de la Commission des Finances, de l'économie générale et du plan sur les articles 1er, 9, 15, 16, 17, 25, 31, 36, 38, 39, 40, 42, et 43 du projet de loi, après déclaration d'urgence, de modernisation de l'économie (n° 842),

level, whereas profits and losses of partnerships flow through to the partners.[135] However, this seemingly clear-cut classification is subject to substantial qualifications, or complications.[136] France was, in fact, an early adopter with regard to the optionality of business taxation regimes. Already in 1948, during a major overhaul of the French income tax system,[137] partnerships were given the right to opt into—irrevocably—the tax regime applicable to corporations.[138] It took considerably longer until transparent taxation was reciprocally made available to some corporations.

Since 1981, SARLs can opt for the partnership tax regime if they carry on an industrial, commercial, or artisanal activity and if their members are only individuals who are either related in direct line of descent, siblings, or spouses.[139] Because of the kinship requirement, corporations that choose transparent taxation under this regime are commonly referred to as SARLs *de famille* or SARLs *familiales*.[140] Like S

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par M. Nicolas Forissier, Député, at 51 (May 20, 2008), http://www.assemblee-nationale.fr/13/pdf/rapports/r0905.pdf; Sénat (2007–08), No. 413, 1 Rapport fait au nom de la Commission spéciale, charger d'examiner le projet de loi après déclaration d'urgence, de modernisation de l'économie, par M. Laurent Béteille, Mme Élisabeth Lamure et M. Philippe Marinie, Sénateurs 140 *et seq.* (June 24, 2008), https://www.senat.fr/rap/l07-413-1/l07-413-11.pdf.

135. Code général des impôts art. 8, 206; *see also* Daniel Gutmann, Droit fiscal des affaires 152 (8th ed. 2017).

136. *See* Gutmann, *supra* note 135, at 152 *et seq.*, who dedicates only half a page to the principle but has no difficulty filling more than seven pages with "facteurs de complications."

137. By means of the Décret 48-1986 du 9 décembre 1948 portant réforme fiscale, Journal Officiel de la République Française [J.O.], Jan. 1, 1949, p. 60. For a description of the prior system, *see* Piketty, *supra* note 36, at 233 *et seq.*

138. Décret 48-1986, *supra* note 137, art. 93, 108 (now Code général des impôts art. 239); *see also* Gutmann, *supra* note 135, at 153–54.

139. Code général des impôts art. 239 *bis* AA, originally introduced by the Loi 80-1094 du 30 décembre 1980 de finances pour 1981, art. 52, Journal Officiel de la République Française [J.O.], Dec. 31, 1980, p. 3099.

140. Sénat (1980–81), No. 98, 3 Rapport général fait au nom de la Commission des Finances, du Contrôle budgétaire et des Comptes économiques de la Nation, sur le projet de loi de finances pour 1981, adopté par l'Assemblée Nationale, par M. Maurice Blin, Sénateur, Rapporteur général 29–30 (Nov. 19, 1980), https://www.senat.fr/rap/1980-1981/i1980_1981_0098_03.pdf; Gutmann, *supra* note 135, at 154.

corporations in the United States, SARLs *de famille* may not exceed a certain number of members. The cap is implicit in the restriction of eligible entities to SARLs. According to the *Code de commerce*, SARLs in general may have no more than 100 members.[141] If the legal maximum of members is exceeded, a SARL must be transformed into another type of business entity, for instance a *société anonyme,* within one year.[142] Otherwise, it will suffer dissolution. The introduction of the special tax regime for SARLs *de famille* was motivated by neutrality concerns. Sole proprietorships, partnerships, and SARLs formed exclusively among family members were regarded as factually so similar that putting them on an equal footing tax-wise appeared natural.[143]

In 1985, France introduced legislation that allowed for SARLs to be established with only one member.[144] Single-member SARLs are so routinely referred to as *entreprises unipersonnelles à responsabilité limitée* (EURL) that they might easily be mistaken for a distinct type of business entity. Still, they are technically plain-vanilla SARLs.[145] What makes them stand out is not their corporate law structure but their tax regime. Also in 1985, single-member SARLs whose only member is an individual were removed from the realm of the corporate income tax and instead subjected to the tax regime applicable to partnerships.[146] As a result, SARLs with only one individual as member are by default tax transparent. In order to be taxed like corporations, they have to actively

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141. Code de commerce art. L223-3 (Fr.). Prior to 2004, the number was 50. *See* Francis Lemeunier, SARL: Société à responsabilité limitée 90 (25th ed. 2006). When the SARL was introduced in 1925, however, there was no such requirement. *See* Loi du 7 mars 1925, *supra* note 12, art. 5. The limitation to 50 members was contained, however, in article 36 of Loi 66-537 du 24 juillet 1966 sur les sociétés commerciales, Journal Officiel de la République Française [J.O.], July 26, 1966, p. 6402.

142. Merle & Fauchon, *supra* note 12, at 217.

143. Sénat (1980–81), No. 98, *supra* note 140, at 30.

144. Loi 85-697 du 11 juillet 1985 relative à l'entreprise unipersonnelle à responsabilité limitée et à l'exploitation agricole à responsabilité limitée, Journal Officiel de la République Française [J.O.], July 12, 1985, p. 7862.

145. While Loi 85-697, *supra* note 144, refers to "entreprise unipersonnelle à responsabilité limitée" in its title, all it does is modify the legislation relevant to SARLs in order to accommodate single-member entities.

146. Loi 85-1403 du 30 décembre 1985 de finances pour 1986, art. 5, Journal Officiel de la République Française [J.O.], Dec. 31, 1985, p. 15448.

opt into entity taxation—which they are allowed to do like any other partnership. As in the case of the SARL *de famille*, the measure was meant to establish neutrality between different types of business organizations, in this case between sole proprietorships and EURLs.[147] It is noteworthy, in this regard, that when the *société par actions simplifiée unipersonnelle* (SASU) was introduced in 1999,[148] no such necessity was felt by the legislature: SASUs are, like any other corporation, taxed at the entity level.

Finally, in 2008, France introduced a special tax regime that was explicitly inspired by Subchapter S of the I.R.C.[149] but that turned out so much more restrictive that any kinship is barely recognizable. SARLs, *sociétés par actions simplifiées,* and *sociétés anonymes* were given the right to opt into transparent taxation, but only within five years of their creation and only for at most five years, if they satisfy all of the following conditions:[150] their membership interests must not be publicly traded; at least 50% of the capital must be held by individuals; at least 34% must be held by persons who are officers of the corporation; the corporation must carry on a primary activity that is industrial, commercial, artisanal, professional, or agricultural in nature and that does not consist in managing its own assets; for the entire period of transparent taxation, the corporation must have less than 50 employees and either a turnover of less than €10 million or a balance sheet total of less than €10 million. The explicit aim of the regime is to encourage the creation of new businesses by allowing its founders to set starting losses against positive income from other sources.[151]

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147. Sénat (1985–86), No. 96, 2 Rapport général fait au nom de la Commission des Finances, du Contrôle budgétaire et des Comptes économiques de la Nation, sur le projet de loi de finances pour 1986, adopté par l'Assemblée Nationale, par M. Maurice Blin, Sénateur, Rapporteur général 31 (Nov. 21, 1985), https://www.senat.fr/rap/1985-1986/i1985_1986_0096_02.pdf.

148. Loi 99-587, *supra* note 130, art. 3.

149. Assemblée Nationale (Treiziéme Législature), No. 905, *supra* note 134, at 52.

150. Code général des impôts art. 239 *bis* AB, introduced by Loi 2008-776 du 4 août 2008 de modernisation de l'économie, Journal Officiel de la République Française [J.O.], Aug. 5, 2008, p. 12471.

151. Assemblée Nationale (Treiziéme Législature), No. 905, *supra* note 134, at 55; Sénat (2007–08), No. 413, *supra* note 134, at 145.

IV. Path Three Towards a TTLLE: Creation of a Bespoke Entity

Making transparent taxation optionally available is not the only way of creating a TTLLE through legislative intervention. Alternatively, jurisdictions can introduce an entirely new, bespoke business form that combines limited liability and transparent taxation.

A. The U.S. Solution (2): LLC

In the United States, the S corporation was insufficient to satisfy the demand for TTLLEs. In 1977, nineteen years after the enactment of Subchapter S, Wyoming embarked on Path Three by introducing the first LLC statute, thus turning the United States into the only jurisdiction examined in this Article that has been using two paths towards TTLLEs simultaneously.

While it is certainly not surprising that some sort of lobbying from business groups is involved when a new form of business entity is introduced, the Wyoming LLC statute is special in that it goes back to the lobbying effort of a single enterprise: Hamilton Brothers Oil Company.[152] The company had been using the Panamanian *limitada* for some time for international oil and gas exploration ventures. The *limitada* is essentially an offshoot of the German GmbH, in the sense that many countries around the globe have followed the German precedent of creating a special type of corporation for closely held businesses, rather than simply relaxing the corporate form, as in the Anglo-Saxon world.[153] Although it provided a complete liability shield, the *limitada* was qualified as a partnership for federal tax purposes in the United States, which meant that the initial losses from the exploration ventures could be passed on to investors in the United States. *Hamilton Brothers* eventually concluded that it would come in handy if a domestic entity offered the same mix of features. First, the company approached Alaska unsuccessfully

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152. The following account is based on the detailed description of the emergence of the LLC provided by Hamill, *supra* note 40, at 1459 *et seq.*

153. For an overview of the way in which the GmbH has inspired the introduction of similar legislation around the globe, see Marcus Lutter, *Die Entwicklung der GmbH in Europa und in der Welt*, *in* Festschrift 100 Jahre GmbH-Gesetz 49 *et seq.* (Marcus Lutter et al. eds., 1992).

in 1975, and shortly afterwards, successfully, Wyoming with the explicit aim of convincing the legislature of creating a TTLLE.

At that time, entity qualification for federal tax purposes had been hinging on the *Kintner* regulations since 1960.[154] The *Kintner* regulations qualified an entity as a corporation for federal tax purposes if it showed a preponderance of four corporate characteristics. The first LLC statute was carefully drafted in such a way as to allow LLCs to be qualified as partnerships. It provided for limited liability (one) and centralized management (two), but not for continuity of life (three) and free transferability of interests (four). Both the continuation of an LLC upon the death or expulsion of any member and the transfer of an interest in the LLC by any member required the unanimous consent of all members, which considerably attenuated the attractiveness of the LLC as a form of business organization.[155] However, getting an LLC statute enacted proved to be the easy part. Despite the concessions made in order to secure partnership qualification for federal tax purposes, the tax status of the Wyoming LLC remained in limbo for several years. It took the Internal Revenue Service (IRS) until 1988 to confirm that a Wyoming LLC could indeed be classified as a partnership for federal income tax purposes.[156] At that point in time, there were only 26 LLCs in Wyoming, and only Florida had also enacted an LLC statute.[157] The year 1988 marked a modest breakthrough for the LLC. By 1991, six additional states had adopted LLC statutes. In the same year, 1,700 LLCs were established. However, it was not until 1992, when the IRS further relaxed its stance towards partnership qualification of LLCs,[158] that new LLC legislation swept quickly through the United States, and the number of LLCs began to skyrocket.[159] By the end of 1995, over 210,000 LLCs had been formed. By the end of 1996, all U.S. States plus the

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154. Reg. §§ 301.7701–1 to—11 (1960); T.D. 6503, 1960–2 C.B. 409. For an account of the background of the *Kintner* regulations, see Louis J. Andrew Jr., Comment, *Wisconsin Professional Service Corporations under the New "Kintner" Regulations*, 49 Marq. L. Rev. 564 *et seq.* (1966); *see also* Taylor, *supra* note 94, at 343.

155. Hamill, *supra* note 40, at 1459, 1470.

156. Rev. Rul. 88–76, 1988–2 C.B. 360.

157. Larry E. Ribstein & Jeffrey M. Lipshaw, Unincorporated Business Entities 426 (3d ed. 2004).

158. Hamill, *supra* note 40, at 1474.

159. *Id.* at 1475.

District of Columbia had adopted LLC statutes.[160] Also in 1996, the LLC got another boost with the introduction of the "check-the-box" regulations.[161] Against the backdrop of the rise of the LLC, the IRS finally came around to the view that further defending the time-honored partnership/corporation divide had become futile. As of January 1, 1997, business entities other than corporations have been by default taxed transparently, unless their shares or membership interests are publicly traded.[162] Eligible entities with at least two owners are classified as partnerships. Single-member entities are disregarded for tax purposes and are thus treated as sole proprietorships.[163] Alternatively, both single-member and multi-member entities may elect to be taxed as corporations. Any election is binding for a period of generally at least 60 months. In the event of a major change of ownership, the minimum period may be abridged.[164]

After the introduction of "check-the-box," it was no longer necessary to draft around the *Kintner* regulations. As a result, the default rules in LLC statutes that were meant to ensure partnership qualification were adapted in order to reflect business needs instead of tax considerations.[165] The LLC became more flexible and attractive, and its persistent popularity is clearly reflected in current tax data. From the early 1990s, the number of active LLCs being taxed as partnerships or disregarded for tax purposes grew from virtually nothing to more than 3.5 million in 2012. Collectively, these LLCs accounted for 16% of all business profits in the United States and for 10% of gross business receipts. In addition, there are a considerable number of LLCs that have opted for the status of S corporation, which combines transparent taxation with employment tax benefits that are unavailable to businesses treated as sole proprietorships or partnerships for tax purposes.[166]

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160. *Id.* at 1477.

161. Reg. § 301.7701–3; T.D. 8697, 1997–1 C.B. 215.

162. I.R.C. § 7704; Reg. §§ 301.7701–2(b),—3(a), (b).

163. Reg. § 301.7701–3(a).

164. Reg. § 301.7701–3(c)(1)(iv).

165. The Uniform Limited Liability Act of 1994, for instance, was amended in 1996, in anticipation of the "check the box" regulations. *See* Unif. Ltd. Liab. Co. Act prefatory note (Nat'l Conference of Comm'rs on Unif. State Laws 1996) ("Freed from the old tax classification restraints, the amendment modifies the [Act]. . . .").

166. For the benefits of S corporation status with regard to employment taxes, see Mark P. Keightley, Cong. Research Serv., R43104, A Brief Overview of Business Types and Their Tax Treatment (2013); Burke, *supra*

Table 4

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Thereof LLCs	**1,324,196**	**35,841,000**	**1%**	**291,350,500**	**1%**
Partnerships	3,388,561	777,924,476	26%	4,689,702,874	15%
Thereof LLCs	**2,211,353**	**436,354,856**	**15%**	**2,775,065,589**	**9%**
Corporations	5,840,821	1,871,914,319	63%	26,029,143,463	81%
Thereof S-Corps	**4,205,452**	**475,998,050**	**16%**	**6,427,057,090**	**20%**
Total	32,783.232	2,954,734,706		32,020,416,086	

note 118, at 1332; Mann, *supra* note 109, at 76 *et seq*. In 2006, 6.11% of LLCs were taxed as S corporations; 1.68% had C corporation status. Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Are Were Taxed for Tax Years 2002-2006*, FORDHAM J. CORP & FIN. L. 459, 486 (2010).

167. *SOI Tax Stats*, *supra* note 31. The number of single-member LLCs that are treated as sole proprietorships for tax purposes was drawn from Adrian Dungan, *Sole Proprietorship Returns, Tax Year 2014,* 36 SOI BULL., Fall 2016, at 2, 10.

B. The UK Solution: LLP

The UK LLP stands out among the TTLLEs discussed in this Article in two respects. First, it can be regarded as a partial legal transplant. The first jurisdiction to introduce a business entity by the name of LLP was Texas in 1991.[168] Second, whereas most TTLLEs resulted from pressure to extend transparent taxation to businesses that already enjoyed limited liability, the LLP is the product of a development that ran in the opposite direction: businesses that had traditionally been organized as general partnerships, and that had thus always been taxed transparently, wanted to enjoy liability protection without change to their tax regime.

In the 1980s, the United States experienced a wave of failures of savings and loan associations, with Texas being the epicenter. As part of the clean-up process, substantial claims for professional negligence and malpractice were brought against law and accountancy firms that had served the failed financial institutions.[169] These claims totaled billions of dollars and could easily exceed insurance coverage.[170] Professional firms had traditionally been organized as general partnerships. In a general partnership, all partners are jointly and severally liable for business debt.[171] Joint and several liability means that an act of professional negligence committed by one partner can potentially bankrupt all other partners. The vulnerability of partners in professional firms was further highlighted in 1990 by the spectacular collapse, not directly linked to the savings and loan associations crisis, of Laventhol & Horwath, then the seventh largest accountancy firm in the

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168. William H. Clark Jr., *Rationalizing Entity Laws*, 58 Bus. Law. 1005, 1005 (2003); Robert Hamilton, *Registered Limited Liability Law Partnerships: Present at the Birth (Nearly)*, 66 U. Colo. L. Rev. 1065, 1065 (1995); J.J. Henning, *Partnership Law Review: The Joint Consultation Papers and the Limited Liability Partnership Act in Brief Historical and Comparative Perspective*, 25 Company Law., no. 6, 2004, at 163, 167; *see also supra* Part I.A.

169. Clark, *supra* note 168, at 1005; Hamilton, *supra* note 168, at 1069 *et seq.*; Henning, *supra* note 168, at 163.

170. Hamilton, *supra* note 168, at 1076.

171. For the United States, see, for example, Del. Code Ann. tit. 6, § 15-306(a) (2011); for the United Kingdom, see Partnership Act, 1890, 53 & 54 Vict. c. 39, § 9.

United States.[172] Against this background, the LLP was introduced in the United States with the aim of allowing "innocent" partners in professional firms, who are not personally guilty of profession malpractice, to protect their personal assets.[173] Consequently, early LLP statutes provided only for an incomplete or partial liability shield: with regard to claims resulting from professional negligence, only the negligent partner and the LLP itself could be held liable.[174] Otherwise, the principle of joint and several liability remained intact. Gradually, however, full-shield LLPs have become the standard.[175]

Having obtained liability protection while keeping transparent taxation in the United States, the then "big six" accountancy firms wanted to extend this attractive regulatory mix to other jurisdictions, including the United Kingdom. Doomsday claims against accountancy firms were also a realistic threat in the United Kingdom. This was highlighted by the litigation in the *BDO Binder Hamlyn* case that culminated in the award of £65 million in damages in 1995.[176] However, had professional firms simply wanted to seek cover behind a liability shield, they would not have needed the LLP. Most regulated professions—including accountancy firms—were allowed to set up companies by the mid-1990s.[177] Apart from any potential reputational or nostalgic allure of the "partnership label," accountancy firms lobbied for the introduction of the LLP because they wanted to enjoy liability protection *and* the transparent taxation regime of partnerships at the same time.[178] In 1996,

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172. *See* Nancy Rivera Brooks, *Laventhol & Horwath to Seek Bankruptcy Shield, Dissolve Firm*, L.A. Times (Nov. 21, 1990), http://articles.latimes.com/1990-11-21/business/fi-4640_1_bankruptcy-law-firm.

173. Hamilton, *supra* note 168, at 1066.

174. *See, e.g.*, 1991 Tex. Gen. Laws 3234 *et seq.* (ch. 901 § 83 *et seq.*); *see also* Clark, *supra* note 168, at 1010; Hamilton, *supra* note 168, at 107.

175. *See, e.g.*, Del. Code Ann. tit. 6, § 15-306(c) (2011); *see also* Unif. P'ship Act (1997) prefatory note (Nat'l Conference of Comm'rs on Unif. State Laws 1997); Clark, *supra* note 168, at 1010; Hamilton, *supra* note 168, at 1087.

176. ADT Ltd v. BDO Binder Hamlyn [1996] BCC 808 (Queen's Bench Div.).

177. *See* Judith Freedman & Vanessa Finch, *Limited Liability Partnerships: Have Accountants Sewn Up the "Deep Pockets" Debate?*, J. Bus. L. 387, 389 n.10 (1997); Freedman, *supra* note 22, at 905.

178. Freedman, *supra* note 22, at 905.

Ernst & Young and Price Waterhouse succeeded in convincing the Bailiwick of Jersey (Jersey), a Crown dependency located in the Channel Islands, to introduce the LLP.[179] This put pressure on the United Kingdom, which was now confronted with the not entirely implausible threat of professional firms relocating offshore. In May 1997, the UK government gave in and announced its intention of adopting the LLP form.[180] Originally, it was intended to restrict access to the LLP to regulated professions. However, in the course of the legislative process it was decided to make the LLP available to all businesses in order to create a level playing field.[181] The LLP was finally introduced by means of the Limited Liability Partnerships Act of 2000,[182] which was complemented by the Limited Liability Partnerships Regulations in 2001,[183] both of which came into force on April 6, 2001.

While it is evident that the concept of the LLP was imported to the United Kingdom from the United States via Jersey, the UK LLP is far from being a clone of its U.S. counterpart.[184] In the United States, the LLP was introduced by adapting the provisions applicable to general partnerships in order to accommodate the liability shield of LLPs. The few provisions that are necessary to do this are woven into the relevant partnership acts.[185] As a result, a general partnership that turns itself into an LLP remains the same entity.[186] The United Kingdom followed a completely different approach, by modelling the LLP not on the

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179. *Id.*; Freedman & Finch, *supra* note 177, at 414.

180. *See* Select Committee on Trade & Industry, Fourth Report: Draft Limited Liability Partnership Bill, 1998–98, HC 59, pt. I.1; Freedman & Finch, *supra* note 177, at 398.

181. *See* Select Committee on Trade & Industry, *supra* note 180, pt. III.30; Jennifer Payne, *A New Legal Entity Poised to Enter onto the Commercial Stage*, 21 Company Law., no. 4, 2000, at 133.

182. Limited Liability Partnerships Act 2000, c. 12.

183. Limited Liability Partnership Regulations 2001, SI 2001/1090.

184. Vanessa Finch & Judith Freedman, *The Limited Liability Partnership: Pick and Mix or Mix-up?*, 2002 J. Bus. L. 475, 480; Henning, *supra* note 168, at 168.

185. *See, e.g.*, 1991 Tex. Gen. Laws 3234 *et seq.* (ch. 901 § 83 *et seq.*); Unif. P'ship Act (1997) §§ 1001, 1002, 1003 (Nat'l Conference of Comm'rs on Unif. State Laws 1997).

186. Del. Code Ann. tit. 6, § 15-201(b) (2009); Unif. P'ship Act (1997) § 201(b) (Nat'l Conference of Comm'rs on Unif. State Laws 1997);

partnership but on the company form. Paragraph 5 of section 1 of the Limited Liability Partnerships Act states that, "except as far as otherwise provided . . . , the law relating to partnerships does not apply to a limited liability partnership." Unlike an English general partnership, which is not a legal entity,[187] a UK LLP is a "body corporate" with "unlimited capacity" and comes into existence upon "incorporation."[188]

Apart from the somewhat strange requirement that it takes at least two persons to form an LLP,[189] there are two main aspects in which LLPs are partnership-like: internal affairs and taxation. With regard to the rules that govern their internal relations, LLPs offer total flexibility. The Limited Liability Partnerships Act starts from the assumption that the members of an LLP agree on a bespoke internal governance structure. However, if an agreement is lacking, elements of partnership law are brought back in by means of default provisions contained in the Limited Liability Partnerships Regulations. For instance, absent an agreement by its members, capital and profits are shared equally among the members, irrespective of assets contributed or hours worked.[190] With regard to the taxation of LLPs, the Limited Liability Partnerships Act makes sure that LLPs are taxed like partnerships, i.e., transparently.[191] The remainder of the LLP's regulatory regime consists essentially of references to the rules applicable to companies. In particular, LLPs have to comply with essentially the same auditing, filing, and disclosure requirements as companies.[192] As a result, and unlike their counterparts in the United States, UK LLPs have to file and disclose their financial accounts.[193] While U.S. LLPs are essentially modified U.S. general partnerships, the UK LLP is closer to a private limited company than to an

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see also Del. Code Ann. tit. 6, § 15-202(a) (2015) ("A limited liability partnership is for all purposes a partnership.").

187. *Contra* Partnership Act, 1890, 53 & 54 Vict. c. 39, § 4(2).

188. Limited Liability Partnerships Act 2000, c. 12, § 1(2)–(3).

189. *Id.* § 2(1)(a).

190. *Compare* Partnership Act, 1890, 53 & 54 Vict. c. 39, § 24(1), *with* Limited Liability Partnership Regulations 2001, SI 2001/1090, reg. 7(1).

191. Limited Liability Partnerships Act 2000, c. 12, § 10.

192. Limited Liability Partnership Regulations 2001, SI 2001/1090, regs. 3–4.

193. Freedman, *supra* note 22, at 903; Finch & Freedman, *supra* note 184, at 493.

English general partnership.[194] Instead of simply transplanting a foreign legal form, the concept of the LLP was transposed into the legal system of the United Kingdom in an original way, by combining elements of UK corporate law and English partnership law.

Although the UK LLP was in the end made available to all businesses, it was designed with large professional firms in mind. The government estimated in 1999 that the LLP would be taken up by more than 60% of all firms that were members of professional regulatory bodies at the time, and professional firms were predicted to be the dominant sector among LLPs, contributing 55,000 to an expected total of 90,000.[195] Things have not turned out quite as expected. The LLP had a slow start. By March 31, 2003, there were only approximately 4,500 LLPs.[196] Their number grew steadily to approximately 56,000 by March 31, 2015.[197] However, since 2014, the rise of the LLP has effectively stalled. In 2015–16, the number of newly formed LLPs exceeded the number of dissolved LLPs by only 13.[198] Unless this trend is reversed, 90,000 LLPs in the United Kingdom are a very distant prospect. Furthermore, there is

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194. The potential impact of these different starting points is considerably mitigated, in practice, by the fact that U.S. general partnerships are legal entities and thus show, from an English perspective, some corporate features. *See* Del. Code Ann. tit. 6, § 15-201(a) (2011); Unif. P'ship Act (1997) §201(a) (Nat'l Conference of Comm'rs on Unif. State Laws 1997).

195. *See* Dep't of Trade & Indus., Limited Liability Partnerships (LLP) Bill, Regulatory Impact Assessment (version 2, Dec. 10, 1999), http://webarchive.nationalarchives.gov.uk/20070603164510/http://www.dti.gov.uk/cld/llpbill/RIA.htm.

196. Denise Fletcher et al., *Understanding Limited Liability Partnerships in the Small and Medium-Sized Business Sector*, ICAEW 6 (2013), https://www.icaew.com/-/media/corporate/files/products/tax/understanding-limited-liability-partnerships-in-the-small-and-medium-sized-business-sector.ashx.

197. Via 24,555 at 31 March 2007, and 45,932 at 31 March 2011. Companies House, Statistical Tables on Companies Registration Activities 2010/11, tbl.E4 (2011); Companies House, *Companies Register Activities 2015–16 Spreadsheet*, Gov.uk tbl.D4, https://www.gov.uk/government/statistics/companies-register-activities-201516 (last visited May 28, 2018) [hereinafter Companies House 2015–16].

198. 8,453 versus 8,440. Companies House 2015–16, *supra* note 197, tbl.D4.

evidence that the body of existing LLPs is not dominated by professional firms to the degree expected. In fact, LLPs are used to a considerable degree by SMEs from a wide range of industries, including manufacturing, construction, healthcare, and financial services.[199]

V. Determinants of Path Dependencies in the Convergent Evolution of TTLLEs

The way in which legal systems evolve is to a large extent determined by idiosyncratic factors, and one must be very careful not to overrate apparent similarities. In the case of the convergent legal evolution of TTLLEs, it is nevertheless possible to recognize basic patterns and to describe some of the factors that determined and shaped the evolutionary path used by a given jurisdiction.

A. High Hurdles for Using Path One

The combination of two business forms is, as already mentioned, the only way in which a TTLLE can be created without purposive legislative intervention. Legal systems generally do not confer upon individuals the power to unilaterally establish a liability shield with effect vis-à-vis third parties.[200] Furthermore, individuals cannot unilaterally modify a jurisdiction's system of business taxation. There are, however, considerable hurdles to overcome on the way to a Path One TTLLE, which explains why Path One was used only in Germany and, to a much lesser extent, in Australia. Combining business forms in an unusual way results initially in legal uncertainty.[201] To overcome the uncertainty requires a strong incentive, typically in the form of substantial tax savings. Furthermore, combining two business forms attracts higher costs than using just one. As a result, Path One becomes unattractive if the legislature provides for an alternative TTLLE via Path Two or Three. Even if there is a strong incentive and no viable alternative, the creation of TTLLEs via Path One requires a coincidence of at least three factors: it must be possible to combine two entities in a way that (a) shields

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199. Fletcher et al., *supra* note 196, at 19 *et seq.*

200. *Supra* Part I.A.

201. In Germany, it took a decade until the GmbH & Co. KG was recognized as a legitimate business form by the courts, and 21 years until its tax transparency was finally confirmed. *See supra* Part II.A.

all individuals involved from liability for business debt; (b) results in flow-through taxation; and (c) allows the owners to control the business without putting liability protection or transparent taxation at risk.

1. Limited Liability

The creation of a TTLLE via Path One requires the availability of either limited partnerships or trusts. At least historically, only these organizational forms could be combined with a corporation in a way that provides a complete liability shield.

Non-statutory, equitable trusts are unique to common law jurisdictions and have thus been unavailable in France and Germany. Even within common law jurisdictions, a trust is, at first sight, an unlikely candidate as a business form. Originally, it was a device used for intra-family wealth transfers,[202] not for conducting business activities. However, trust law has a well-deserved reputation for being very flexible.[203] Both in the United Kingdom and in the United States, trusts have been put to commercial use for a long time.[204] Today, Australia stands out only with regard to the kind of economic activities that are conducted through trusts. While trusts are routinely used for passive investment activities across the Anglosphere, they play a significant role as vehicles for active businesses only in Australia.[205] Even in that respect, there are at least historical precedents: in the seventeenth and eighteenth centuries, trust law, together with partnership law, provided the conceptual underpinning for unincorporated joint stock companies in England that were organized as "deed of settlement companies," the shares of which were publicly traded.[206] Unincorporated joint stock companies were the product of a time when incorporation required either a royal

202. Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. Rev. 434, 436 (1998); John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 Yale L.J. 165 (1997).

203. Lindgren, *supra* note 70, at *62 (LEXIS).

204. For the United States, see Langbein, *supra* note 202, at 165; Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unravelling the Mystery*, 58 Bus. Law. 559 (2003).

205. D'Angelo, *supra* note 69, at 30.

206. *Id.* at 38; Lindgren, *supra* note 70, at *8–9 (LEXIS); John Morley, *The Common Law Corporation: The Power of the Trust in Anglo-American Business History*, 116 Colum. L. Rev. 2145, 2157 (2016).

charter or an Act of Parliament, which were both difficult to obtain. They became redundant after the passing of the Joint Stock Companies Act of 1844,[207] which provided for incorporation upon registration.[208] In the United States, the Massachusetts business trust became very popular in the course of the nineteenth century, and it is still used, mainly as an investment vehicle.[209] Statutory trusts, most notably the Delaware statutory trust,[210] are a conceptually different phenomenon.[211] As the name suggests, they are predominantly a creature of statute. Trust law, by contrast, is a non-statutory product of the law of equity.[212]

While trusts are an exotic concept from the perspective of civil law jurisdictions, common law jurisdictions struggled, conversely, with the limited partnership form. The concept of limiting the liability of certain partners to a commercial enterprise has very deep historical roots.[213] In its modern form, the limited partnership was born in France, where it was codified as *société en commandite* first in the famous *Ordonnance sur le commerce* of 1673,[214] and later, more comprehensively, in the *Code de commerce* of 1807.[215] From France, the limited partnership spread across the globe. It was the French *société en commandite* that

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207. Joint Stock Companies Act of 1844, 7 & 8 Vict. c. 110.

208. D'Angelo, *supra* note 69, at 39; Lindgren, *supra* note 70, at *3–4, 43 (LEXIS).

209. Sheldon A. Jones, Laura M. Moret & James M. Storey, *The Massachusetts Business Trust and Registered Investment Companies*, 13 Del. J. Corp. L. 421 (1988); Hansmann & Mattei, *supra* note 202, at 473; Jared W. Speier, *Clarifying the Business Trust in Bankruptcy: A Proposed Restatement Test*, 43 Pepp. L. Rev. 1065, 1067, 1074 (2016); *see also* D'Angelo, *supra* note 69, at 325.

210. Del. Code Ann. tit. 6, §§ 3801 *et seq.*

211. *See* Robert H. Sitkoff, *Trust as "Uncorporation": A Research Agenda*, 2005 U. Ill. L. Rev. 31, 33.

212. Hansmann & Mattei, *supra* note 202, at 435.

213. It evolved out of the *commenda* that can be traced in Europe back to tenth century Italy. The *commenda* was probably imported to Italy from the Arab peninsula were it had apparently been used since pre-Islamic times. *See* Ron Harris, *The Institutional Dynamics of Early Modern Eurasian Trade: The* Commenda *and the Corporation*, 71 J. Econ. Behav. & Org. 606, 611 (2009).

214. Ordonnance de 1673, Édit du roi servant de règlement pour le commerce des négociants et marchands tant en gros qu'en détail, Titre IV: Des sociétés (also known as Code Savary or Code Marchand).

215. Code de commerce de 1807 art. 23 *et seq.* (Fr.).

inspired, directly or indirectly, existing limited partnership legislation in other jurisdictions.[216] For instance, the *société en commandite* acted as role model for the German *Kommanditgesellschaft* provided for in the *Allgemeine Deutsche Handelsgesetzbuch* of 1861, the first German Commercial Code.[217] In Germany, which shares the civil law tradition with France, limiting the liability of partners was not an unfamiliar concept.[218] In common law jurisdictions, however, the adoption of the limited partnership form was hampered by the well-established principle that anyone who shares in the profits of a business becomes a partner and is, as such, jointly and severally liable for all business debt[219] "to his last shilling and his last acre."[220] It was even argued that this principle constituted "an unalterable rule of natural justice."[221] Nevertheless, New York introduced a French-style limited partnership already in 1822, as the first U.S. state to do so.[222] By the middle of the nineteenth century, most states had followed New York's lead.[223] However, as it ran afoul of

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216. Achilles Renaud, Das Recht der Commanditgesellschaften 27 *et seq.* (1881), http://dlib-pr.mpier.mpg.de/m/kleioc/0010/exec/books/%22198744%22; R. Saleilles*, Étude sur l'histoire des sociétés en commandite*, 9 Annales de droit com.: Français, Étranger et Int'l 10, 49*,* 53 (1895).

217. It was elaborated under the auspices of the German Confederation. The relevant provisions were carried over substantially unchanged in the *Handelsgesetzbuch* of 1897 that is still in force. For a detailed account, see Erik Röder, *Die Kommanditgesellschaft im Rechtsvergleich: Hintergründe der unterschiedlichen Karriere einer Rechtsform*, 78 Rabels Zeitschrift 109, 114 *et seq.* (2014).

218. *See* Röder, *supra* note 217, at 114 *et seq.*

219. Grace v. Smith (1775) 2 Wm. Bl. 998; Waugh v. Carver (1793) 2 Hy. Bl. 235, 126 ER 525; *see also* Amalia D. Kessler, *Limited Liability in Context: Lessons from the French Origins of the American Limited Partnership*, 32 J. Legal Stud. 511, 532 (2003).

220. Report from the Select Committee on the Law of Partnership, Together with the Proceedings of the Committee, Minutes of Evidence, Appendix, and Index vi (1851) (UK).

221. 27 June 1854, Parl Deb HC (3d ser.) (1854) cols. 752–800 (UK).

222. Neil Gow, A Practical Treatise on the Law of Partnership 18 (1830); *see* Unif. Ltd. P'ship Act official comment (Nat'l Conference of Comm'rs on Unif. State Laws 1916); Kessler, *supra* note 219, at 530; J.J. Henning, *The Cape and Natal Special Partnerships Limited Liability Acts. A Statutory History*, 21 Fundamina 251, 260 (2015).

223. Clement Bates, The Law of Limited Partnership 20 (1886); Joseph J. Basile Jr*., Limited Liability for Limited Partners: An Argument for*

common law tradition, U.S. courts remained hostile towards the limited partnership and were quick at withdrawing liability protection even in cases of only minor noncompliance with statutory requirements. The perceived need to promote the limited partnership form in the face of judicial hostility was in fact one of the reasons why, in 1916, the first Uniform Limited Partnership Act was adopted.[224] In the British Isles, Ireland rushed to introduce a version of the *société en commandite* immediately after it had, for a brief period, regained legislative independence in 1782.[225] The Anonymous Partnerships Act[226] was barely used in Ireland and barely known in England,[227] where a tormented debate about the merits of introducing a "partnership *en commandite*" simmered throughout the entire nineteenth century. In the very same period in which Parliament provided for general incorporation in 1844[228] and general limited liability for corporations in 1855,[229] it could not bring itself to override the common law tradition of joint and several liability of partners.[230] Only in 1907 did the Limited Partnerships Act[231] finally see the light of day.

In Australia, the legislative history of the limited partnership is even more complicated. New South Wales, Victoria, and Southern

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the Abolition of the Control Rule, 38 Vand. L. Rev. 1199, 1202 (1985); Henning, *supra* note 222, at 260.

224. Unif. Ltd. P'ship Act official comment (Nat'l Conference of Comm'rs on Unif. State Laws 1916).

225. E.A. French, *The Origin of General Limited Liability the United Kingdom*, 21 Acct. & Bus. Res. 15, 15 *et seq.* (1990).

226. Act to Promote Trade and Manufactures by Regulating and Encouraging Partnerships, 21 & 22 Geo. 3 c 46 (Ir.). The act was repealed by the Companies Act 1862, 25 & 26 Vict. c. 89, § 205 & 3d sched.

227. H. Bellenden Ker, Report on the Law of Partnership 21 (1838).

228. Joint Stock Companies Act of 1844, 7 & 8 Vict. c. 110.

229. Limited Liability Act of 1855, 18 & 19 Vict. c. 133.

230. Several parliamentary initiatives for the introduction of the limited partnership were defeated in the course of the nineteenth century. *See* French, *supra* note 225, at 15; Henning, *supra* note 168, at 165 *et seq.*; John Saville, *Sleeping Partnership and Limited Liability, 1850–56*, 8 Econ. Hist. Rev. 418 (1956); *see also* Christopher Anglim, Joined in Common Enterprise: A Bibliography on the Origins of Early Anglo-American Partnership Law 301 *et seq.* (2005).

231. Limited Partnerships Act of 1907, 7 Edw. 7 c. 24.

Australia introduced it simultaneously in 1853,[232] only to abolish it again within two decades.[233] The only state where this first wave of legislation survived was Queensland, which had inherited it from New South Wales upon separation in 1859 and which carried the relevant provisions over in the Mercantile Act of 1867.[234] Tasmania and Western Australia introduced Limited Partnerships Acts in 1908 and 1909 that were closely modelled on the UK Act of 1907.[235] Finally, New South Wales, Victoria, and Southern Australia reintroduced the limited partnership in a third wave of legislation only in the 1990s.[236] As a result, the limited partnership form was not available in the commercial heartland of Australia for much of the twentieth century.

2. Transparent Taxation

Apart from providing liability protection, the combination of a corporation and either a trust or a limited partnership must also be recognized

232. It is widely believed that the early legislation of Australian states was inspired by the Irish "Anonymous Partnerships Act." *See* Queensl. Law Reform Comm'n, *A Bill to Establish Limited Liability Partnerships* 6 *et seq.* (Working Paper 27, 1984), https://www.qlrc.qld.gov.au/__data/assets/pdf_file/0008/372887/wp27.pdf; P.F.P Higgins & K.L. Fletcher, The Law of Partnerships in Australia and New Zealand 19 (3d ed. 1975). However, its structure, content, and language suggest that it is more closely related to the nineteenth century U.S. tradition of limited partnership legislation. *See* Henning, *supra* note 222, at 263–64.

233. New South Wales: An Act to Legalise Partnerships with Limited Liability, 17 Vict. c. 9, repealed by the Companies Act 1874; South Australia: An Act to Legalize Partnerships with Limited Liabilities, 17 Vict c. 20, repealed by the Law of Partnership Act 1866; Victoria: An Act to Legalise Partnerships with Limited Liability, 17 Vict. c. 5, repealed by the Companies Statute 1864; *see also* Henning, *supra* note 222, at 263–64 (discussing these Acts).

234. *See* Queensl. Law Reform Comm'n, *supra* note 232, at 6; Higgins & Fletcher, *supra* note 232, at 70.

235. *Tasmania Limited Partnerships Act 1908* (No. 6 of 1908); *Western Australia Limited Partnerships Act 1909* (No. 17 of 1909); *see* Queensl. Law Reform Comm'n, *supra* note 232, at 8.

236. *New South Wales Partnership (Limited Partnership) Amendment Act 1991* (No. 48 of 1991); *Victoria Partnership (Limited Partnerships) Act 1992* (No. 43 of 1992); *South Australia Partnership (Limited Partnerships) Amendment Act 1997* (No. 54 of 1997).

as tax transparent. In that respect, it is precisely the liability shield that is problematic.

In France, limited partnerships are only partly tax transparent. While general partners are taxed on a flow-through basis, the profit share of limited partners is subject to corporate income tax at the level of the partnership, and distributions are taxed like corporate dividends in the hands of the limited partners.[237] This particularity even predates the introduction of a modern income tax in France. The first, isolated element of income taxation in France was a tax on certain types of capital income, the *impôt sur le revenu des valeurs mobilières* that was established in 1872.[238] Next to dividends and interest payments, the tax base originally included benefits derived from partnership interests in general.[239] However, already in 1875, general partners were exempted from the tax on the grounds that they put their "entire fortune, their credit, and even their honor," at risk.[240] When France finally set up a system of comprehensive income taxation in the context of World War I, it opted originally for a complicated two-tier structure, consisting of a general income tax, introduced in 1914,[241] and a schedular income tax, introduced in 1917.[242] Under the schedular tax, business profits were originally taxed at the entity level.[243] A few years later, in 1923, the system was changed. Partners in (commercial) general partnerships and general partners of

237. Code général des impôts art. 8, 206(4).

238. Impôt sur le revenu des valeurs mobilières (Loi du 29 juin 1872) appliqué aux warrants, http://gallica.bnf.fr/ark:/12148/bpt6k58606635.

239. *Id.* art. 1(3) ("[I]l est établi . . . une taxe annuelle et obligatoire . . . [s]ur les intérêts, produits et bénéfices annuels des parts d'intérêts et commandites dans les sociétés, compagnies et entreprises dont le capital n'est pas divisé en actions.").

240. *See* the excerpt from the legislative materials reproduced at Hélène Paerels, Le Dépassement de la personnalité morale 2, 84 n.332 (Thèse Université de Lille 2008) ("leur fortune tout entière, leur crédit et même leur honneur").

241. Loi du 15 juillet 1914 portant fixation du budget général des dépenses et des recettes de l'exercice 1914, art. 5 *et seq.*, Journal Officiel de la République Française [J.O.], July 18, 1914, p. 6448.

242. Loi du 31 juillet 1917 portant suppression des contributions personnelle-mobilière, des portes et fenêtres et des patents et établissement d'un impôt sur diverses catégories de revenus, Journal Officiel de la République Française [J.O.], Aug. 1, 1917, p. 5975.

243. Loi du 31 juillet 1917, *supra* note 242, art. 3 *et seq.*

limited partnerships—but not limited partners—were taxed personally on their profit share[244] in order to allow them to benefit from certain deductions that had been hitherto only available to sole proprietors.[245] The resulting dichotomy of limited partnerships' taxation has been a hallmark of French partnership taxation ever since. Hence, French limited partnerships have not been suitable building blocks for TTLLEs since the introduction of income taxation in France.

In the United States, the term "corporation" for federal taxation purposes includes, according to I.R.C. section 7701(a)(3), "associations, joint-stock companies, and insurance companies." Prior to the introduction of "check-the-box" in 1996,[246] any business organization that was classified as "association" was thus subject to entity taxation. In that respect, limited liability was regarded as a corporate characteristic. Originally, it was even the dominant criterion. From 1914 until 1921, limited partnerships were automatically classified as associations, simply because some of the partners enjoyed limited liability. From 1921 until 1940, there was still a strong presumption for association status of limited partnerships.[247] From 1940 onwards, limited liability was simply treated as one among four corporate characteristics,[248] and the *Kintner* regulations of 1960 specified that an entity only qualified as "association" if at least three of four corporate characteristics were satisfied.[249] If a corporation acted as sole general partner, the limited partnership satisfied the limited liability criterion if the corporate general partner was merely a "dummy" of the limited partners.[250] More importantly, in 1972, the IRS specified that partnership status could only be confirmed in advance by means of a ruling if the corporate general partner held at least 10% of the capital of the limited partnership, and if limited partners owned no more than 20% of the shares in the limited partner.[251] As

244. Loi du 30 juin 1923 portant fixation du budget général de l'exercice 1923, art. 11, Journal Officiel de la République Française [J.O.], July 1, 1923, p. 6166; *see also* Emmanuel Besson, Traité pratique des impôts cédulaires et de l'impôt général sur le revenu 100 (4th ed. 1927).

245. Loi du 31 juillet 1917, *supra* note 242, art. 52.

246. *Supra* Part IV.A.

247. Hamill, *supra* note 40, at 1504.

248. *Id.* at 1505.

249. *Supra* Part IV.A.

250. Reg. § 301.7701–2(d)(2).

251. Rev. Proc. 72–13, 1972–1 C.B. 735.

a result, there was no legal certainty that a typical GmbH-&-Co-like structure would be tax transparent as late as the 1970s in the United States.[252] Trusts were subject to the same classification rules.[253]

While the United States gradually relaxed its approach towards the transparent taxation of limited partnerships, Australia moved in the opposite direction. Limited partnerships were tax transparent for most of the twentieth century in Australia. Since 1992, they have been taxed like corporations, with the exception of some venture capital investment vehicles.[254] Thus, the existence of limited partnerships and their transparent taxation did not overlap in New South Wales, Victoria, and South Australia, ruling out any chance for TTLLEs based on limited partnerships to evolve there.

3. Control

As TTLLEs are typically closely held SMEs, it is essential that the (beneficial) owners can remain in control. Thus, a typical German GmbH & Co. KG is controlled by the limited partners.[255] Such a combination of limited liability *and* control in a limited partnership was impossible in the other examined jurisdictions for much of the twentieth century—and in three out of four cases it still is.[256]

Historically, the limited partnership evolved to serve one specific purpose: to allow passive investors to participate in business profits without being exposed to unlimited liability.[257] Conversely, passivity was regarded as a prerequisite for liability protection.[258] When the limited

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252. *See, e.g.*, P. Mike Allison, Comment, *The Limited Partnership with a Corporate General Partner—Federal Taxation—Partnership or Association?*, 24 Sw. L.J 285 (1970).

253. *See* Richard F. Barrett & Jean E. deValpine, *Taxation of Business Trusts and other Unincorporated Massachusetts Entities with Transferable Shares*, 40 B.U. L. Rev. 329, 334 (1960); Rosemary Alito Hall, *Tax Classification of Limited Partnerships: Opportunity for Reform*, 30 Rutgers L. Rev. 1260, 1261 (1977).

254. *See* Cooper et al., *supra* note 86, at 721.

255. *Supra* Part II.A.

256. In the United States, this was also true for business trusts until late into the twentieth century. *See* Robert Flannigan, *The Political Path to Limited Liability in Business Trusts*, 31 Advocates' Q. 257, 271 (2006).

257. *See* Röder, *supra* note 217, at 111 *et seq.*

258. *Id.* at 138 *et seq.*

partnership was codified in France in 1807, this principle was taken up in a particularly strict form because the *société en commandite* had been used for fraudulent investment schemes at a large scale in the aftermath of the French Revolution.[259] The *Code de commerce* of 1807 contained a provision that threatened any participation of a limited partner in the management with unlimited, joint and several liability for all business debt.[260] This rule, which is commonly referred to as "*défense d'immixtion,*" was later modified and relaxed several times. In particular, it was restricted to acts of management by which the limited partner represents the partnership vis-à-vis third parties, and to the liabilities resulting from such a concrete act of external management.[261] However, in its essence, the *défense d'immixtion* is still in force and would, on its own, reliably prevent the emergence of a typical GmbH-&-Co-KG-like structure in France.

Because the *Code de commerce* acted as role model for limited partnership legislation in so many other countries, the *defense d'immixtion* spread across the globe. Section five of the 1822 New York Act[262] read: "[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 revised version of 1829 that inspired the limited partnership legislation of most other U.S. states,[263] the actions that a limited partner may or may not undertake were laid out, in section 17, in more detail:

> A special partner may, from time to time, examine into the state and progress of the partnership concerns, and may advise as to their management; but he shall not transact any business on account of the partnership, nor be employed for that purpose as agent, attorney, or

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259. *Id*. at 139.

260. Code de commerce de 1807 art. 27–28 ("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.").

261. For a detailed account, see Röder, *supra* note 217, at 140 *et seq.*

262. An Act Relative to Partnerships, N.Y. Laws, 45th sess., ch. CCXLIV, p. 259 (Apr. 17, 1822).

263. Henning, *supra* note 222, at 260.

> otherwise. If he shall interfere, contrary to these provisions, he shall be deemed a general partner.[264]

This interference test was replaced, in section 7 of the Uniform Limited Partnership Act of 1916, by a control test that was deemed to be less strict and meant to enhance liability protection of limited partners: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business."[265]

In a slightly different form, as a management test, the French rule was also taken up by English law, in section 6(1) of the Limited Partnerships Act 1907: "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."[266]

In Australia, all three waves of limited partnership legislation[267] contained provisions that prevented limited partners from playing an active role in the management of the business. In Queensland, the relevant provision of the Mercantile Act of 1867 read: "[I]f . . . any special partner . . . shall personally make any contract respecting the concerns of the partnership every such special partner shall be deemed to be a general partner with respect to the contract . . . he shall have so contracted."[268]

The limited partnership legislation of Tasmania and Western Australia of 1908 and 1909 copied the English management test. As late as the 1990s, when New South Wales, Victoria, and Southern Australia finally reintroduced the limited partnership, they included the management test, together with a safe-harbor list of permitted activities, in the relevant legislation.[269]

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264. 1 Revised Statutes of the State of New-York, 1829, at 766, ch. IV, tit. 1, § 17.

265. Unif. Ltd. P'ship Act § 7 (Nat'l Conference of Comm'rs on Unif. State Laws 1916)

266. Limited Partnerships Act of 1907, 7 Edw. 7 c. 24.

267. *Supra* Part V.A.1.

268. The Mercantile Acts, 1867 to 1896, § 56 (compiled to July 31, 1968), https://digitalcollections.qut.edu.au/2694/1/qsr_mercantile_acts_1867-1896_31jul68.pdf.

269. *Partnership (Limited Partnerships) Act 1992* s 67(2) (No. 43 of 1992) ("If a limited partner takes part in the management of the business of

When the first German commercial code of 1861 was drafted, the example of the *Code de commerce* loomed particularly large, as it was at that time the law of the land in a considerable part of Germany.[270] Unsurprisingly therefore, the drafting committee considered the *défense d'immixtion* at length. In the end, however, the incorporation of such a provision into the *Allgemeine Deutsche Handelsgesetzbuch* was rejected with a clear majority of 14:1 because it was regarded as unnecessary.[271] With hindsight, this proved remarkably modern. Nowadays, the view that a *défense d'immixtion*–style provision is superfluous is shared by many in the United States, where the control test was relaxed in revisions of the Uniform Partnership Act in 1978 and 1985, and finally dropped in the new Uniform Limited Partnership Act of 2001.[272] On this occasion, the Uniform Law Commission stated that, "[i]n a world with LLPs, LLCs and, most importantly, LLLPs, the rule is an anachronism."[273]

However, this realization occurred too late to make a difference. Irrespective of other factors, the *défense d'immixtion* would have been sufficient to prevent the development of a GmbH & Co. KG–style structure in all examined jurisdictions, except Germany.

B. Default Character of Path Two

If the hurdles for using Path One prove too high, TTLLEs can only be created through legislative intervention. In that respect, Path Two—making transparent taxation optionally available—is the natural default

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the limited partnership, the limited partner is liable, as if the partner were a general partner, for the debts and obligations of the partnership incurred while the limited partner takes part in the management of that business.").

270. The *Code de commerce* was introduced by the French in the territories left of the Rhine that were temporarily annexed by France. Remarkably, it had remained in force even after these territories came back under the control of German states, in particular Prussia, after 1815. *See* Röder, *supra* note 217, at 115.

271. Protokolle der Kommission zur Berathung eines allgemeinen deutschen Handelgesetzbuches, I. Theil: Protokoll I-XLV (Johann von Lutz ed. 1858).

272. For a detailed account, see Röder, *supra* note 217, at 141 *et seq.*

273. Unif. Ltd. P'ship Act (2001), 2001 prefatory note (Nat'l Conference of Comm'rs on Unif. State Laws 2013); *see also* Hansmann, Kraakman & Squire, *supra* note 25, at 9. For the view in favor of linking control with unlimited liability, see Flannigan, *supra* note 256, at 259 *et seq.*

if the availability of limited liability entities predates concerns about transparent taxation. If flow-through taxation is to be added to limited liability, the obvious solution is to tackle the problem at its root, by changing tax law in order to make transparent taxation available to preexisting limited liability entities. In all examined jurisdictions, the corporate form became available through general incorporation statutes long before the introduction of an income tax, or at least before its rise to significant levels in the context of World War I.[274]

The above described examples of Path Two TTLLEs, the S corporation, and the three French regimes share one notable feature. The right to opt for transparent taxation is not available to all business corporations but only to those that meet certain requirements. These requirements reflect the specific tax policy goal that legislators want to foster by granting the privilege of transparent taxation. In the cases of the S corporation, the SARL *de famille*, and the EURL, the introduction of flow-through taxation regimes was motivated by the concern of putting SMEs on an equal footing irrespective of their organizational form.[275] Against this background, it is not surprising that the introduction of Subchapter S coincided with the process of adaptation of corporate law to the needs of closely held corporations by U.S. states in the 1950s.[276] Because small businesses organized as sole proprietorships or general partnerships are taxed on a flow-through basis, it makes sense to extend transparent taxation to corporations that are designed to cater to the same audience. The aim of creating a level playing field for SMEs warrants, in particular, restrictions relating to the size of the business operation of an eligible corporation and to the number and legal nature of its shareholders. By contrast, if legislators want, for instance, to encourage the creation of new incorporated businesses, the availability of transparent taxation might be limited to a certain period of time after incorporation, as in the case of the French regime that was established in 2008.[277]

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274. For instance, in the United Kingdom in 1844 (*supra* note 207); in France in 1867 (Loi du 24 Juillet 1867 sur les sociétés commerciales); in Germany in 1870 (Gesetz betreffend die Kommandit-Gesellschaften auf Aktien und die Aktien-Gesellschaften vom 11.6.1870, Bundesgesetzblatt des Norddeutschen Bundes 1870, at 375). For the United States, see Morley, *supra* note 206, at 2163; *see also supra* Part I.B, in particular note 36.

275. *Supra* Part III.

276. *Supra* Part I.A.

277. *Supra* Part III.B.

Put differently, as long as the availability of transparent taxation is used as a tool to foster specific tax policy goals, the right of corporations to opt out of entity taxation will come with strings attached, with different policy goals resulting in different requirements.[278] The only policy goal that would require no restrictions to the availability of transparent taxation would be a general concern to mitigate tax-induced distortions to the choice of business entity.[279]

C. Split Competences as Catalyst for Path Three

If Path Two is the default, there has to be an additional factor that accounts for the evolution of bespoke TTLLEs via Path Three. If one looks at the examples of the U.S. LLC and the UK LLP, one might—at first—be tempted to conclude that competitive pressure is the driving force behind the evolution of TTLLEs via Path Three. In the United States, the rapid spread of the LLC was obviously the result of competition among states.[280] In the United Kingdom, the introduction of the LLP was prompted by the threat of professional firms relocating to Jersey.[281]

This, however, would be an oversimplification. At closer inspection, one realizes that competitive pressure is only part of the picture. The regulatory regime of TTLLEs consists of two components, one relating to the law of business organizations, and one relating to tax law. The market for business forms is highly competitive among U.S. states and also, albeit to a lesser degree, among EU member states. Both inside the United States and the European Union, the jurisdiction under which a business entity is formed can, in principle, be decoupled from the place(s) where it conducts its business activities.[282] By contrast, entrepreneurs do not enjoy the same degree of freedom with regard to the applicable tax regime. In the United States, the federal income tax system overarches all fifty states. In the European Union, which member

278. *Supra* Part V.

279. *See infra* Part VI.D.

280. *Supra* Part IV.A.

281. *Supra* Part IV.B.

282. *See* Erik M. Vermeulen, The Evolution of Legal Business Forms in Europe and the United States 71, 141 *et seq.* (2003); Wolfgang Schön, *The Mobility of Companies in Europe and the Organizational Freedom of Company Founders*, Eur. Company & Fin. L. Rev. 122, 123 *et seq.* (2006).

state's tax law applies is determined, as a general rule, by the place of effective management of an entity and, if applicable, in addition by the places where an entity has permanent establishments.[283] Thus, a German law firm that only operates inside Germany is perfectly free to organize as a UK LLP, but it will still be subject to German tax law. If Germany did not classify it as a tax transparent entity under its domestic entity classification rules, it could not operate as a TTLLE.

If competitive pressure is essentially limited to the component of a TTLLE's legal regime that belongs to the law of business organizations, something else must have caused the emergence of bespoke TTLLEs in the United States and the United Kingdom. In the case of the U.S. LLC, the additional factor was a split in the legislative competence for the law of business organizations and tax law. While competition among U.S. states caused the LLC to be introduced by all 50 states within a short period of time, it was the split of competences between the federal government and the individual U.S. states that led to the adoption of the first LLC statute by Wyoming. If organizational law also fell within the federal state's competence, there would have been only one addressee for Hamilton Brothers' lobbying effort. If Hamilton Brothers had succeeded at the federal level, the most likely result would have been a tweak to Subchapter S in order to make the S corporation a viable business form for its oil exploration ventures. Instead, Hamilton Brothers could approach states and ask them to introduce a new business form that stood a chance of being classified as a partnership under federal entity classification rules. At this point, the federal government could have thwarted the LLC by classifying it as a corporation for tax purposes,

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283. With the notable exception of the United States, most states use the place of effective management as a tiebreaker for corporate residence in their bilateral Double Tax Conventions. *See* OECD Model Tax Convention on Income and on Capital, art. 4(3), July 15, 2014, http://dx.doi.org/10.1787/mtc_cond-2014-en art. 4(3); U.N. Model Double Taxation Convention between Developed and Developing Countries, art. 4(3), 2011, http://www.un.org/esa/ffd/wp-content/uploads/2014/09/UN_Model_2011_Update.pdf. The United States uses the place of incorporation as a tiebreaker. *See* U.S. Model Income Tax Convention, art. 4(1), Feb. 17, 2016, https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf. Apart from the state where a company is resident for tax purposes, only states where the same company has a permanent establishment are allowed to tax its business profits. *See* OECD Model Tax Convention, *supra*, art. 7(1); U.N. Model Double Tax Convention, *supra*, art. 7(1).

if necessary by tightening the relevant regulations. That this did not happen was a deliberate decision not forced by competitive pressure of any kind. The LLC only turned from a nonstarter into a success story when its partnership classification was confirmed for federal tax purposes.[284]

In an international context, a similar split of competences exists to the extent that a jurisdiction accepts that foreign business entities operate on its territory. While the law of business organizations applicable to such an entity is foreign, it is nevertheless taxed according to domestic tax law. In the case of the UK LLP, the relevant split of competences occurred between the United Kingdom and Jersey. In order to determine which jurisdiction's law of business organizations applies to a given business entity in a cross-border context, the United Kingdom follows the "incorporation approach." If an entity is lawfully established in a foreign jurisdiction, the United Kingdom applies the foreign legal regime to it.[285] As a result, a Jersey LLP can operate in the United Kingdom even if it maintains only a mailbox on Jersey. For this reason, it made sense for UK accountancy firms to lobby Jersey for the introduction of a new organizational form that they intended to use for their UK operations. By contrast, Germany follows the "real seat approach," which broadly speaking means that a business entity that is headquartered in Germany must comply with the German law of business organizations.[286] However, inside the EU, all member states, including those that follow the "real seat approach," are bound by the freedom of establishment[287] to recognize business forms established in other member states.[288] The EU thus certainly provides a competitive environment with regard to the choice of organizational form. When it comes to taxing a business entity's profits, however, every member state applies its domestic

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284. *Supra* Part IV.A.

285. *See* VERMEULEN, *supra* note 282, at 142 n.6; Wolfgang Schön, *Das System der gesellschaftsrechtlichen Niederlassungsfreiheit nach VALE*, 42 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT 333, 351 (2013).

286. *See* Schön, *supra* note 282, at 132; *see also* VERMEULEN, *supra* note 282, at 142. Nevertheless, Germany also needs to classify companies headquartered abroad that operate inside Germany into its domestic tax categories—for instance, a company that has its "real seat" in Switzerland and a permanent establishment in Germany. To this extent, there is also a split of competences under the real seat approach.

287. Treaty on the Functioning of the European Union art. 49, Dec. 13, 2007.

288. *See* Schön, *supra* note. 282, at 122 *et seq.*

tax law. If a business entity uses a foreign organizational form, it normally has to be classified according to the relevant categories of the domestic business taxation regime. While this process must not involve discrimination vis-à-vis domestic business forms, there is no need to take foreign tax regimes into account. In particular, if a member state generally taxes domestic limited liability entities at entity level, it is under no obligation to recognize a foreign limited liability entity as transparent for tax purposes. In the case of the Jersey LLP, the United Kingdom could probably have reacted by classifying it as a corporation for tax purposes, as originally indicated by the competent authority,[289] and this would have been the end of it. Instead, the United Kingdom created its own version of the LLP as a domestic alternative to the Jersey LLP.

To summarize, it was not primarily competition among different jurisdictions but a split in competences with regard to organizational and tax law that acted as a catalyst for the evolution of the U.S. LLC and the UK LLP. In the absence of competitive pressure, states retain much room for maneuvering. They are free to decide whether to recognize foreign limited liability entities as tax transparent, whether to make transparent taxation optionally available to domestic entities, and whether to create a bespoke TTLLE.

VI. Lessons From the Convergent Evolution of TTLLEs

If one starts from first principles and looks only for first-best solutions, the lessons to draw from the convergent evolution of TTLLEs are straightforward. First, the legislature should provide for a set of legal forms that corresponds exactly to different commercial demands and could thus be regarded as optimal in a non-tax world. Second, the legislature should introduce a tax system that is completely neutral and does not, inter alia, distort the choice of business entity. It is, however, for a reason that the real world is very different from this ideal state. Both aims are genuinely difficult—or maybe even impossible—to achieve under real world conditions. If one accepts that a perfect law of business organizations and a truly neutral tax system are both utopias, and that utopia is not a destination but a direction,[290] it is worthwhile to

289. *See* Freedman, *supra* note 22, at 905; Freedman & Finch, *supra* 177, at 414.

290. "Eine Utopie ist aber kein Ziel, sondern eine Richtung." Robert Musil, The Man Without Qualities; *see* Jane Smiley, *Nowhere Man*, Guardian

draw more nuanced lessons for a second-best world from the history of TTLLEs.

A. Demand for TTLLEs Is Universal

The convergent evolution of TTLLEs in Australia, France, Germany, the United Kingdom, and the United States confirms the attractiveness of combining limited liability and transparent taxation described above.[291] The GmbH & Co. KG and the LLC are the most powerful examples. In both cases, limited liability entities taxed at entity level were available,[292] as well as transparently taxed entities without a liability shield. Nevertheless, entrepreneurs in Germany were willing to accept more than twenty years of legal uncertainty,[293] and in some cases legal struggles, in order to obtain what they considered the best of both worlds: a TTLLE in the form of the GmbH & Co. KG. In the United States, interested parties were willing to invest in lobbying efforts for more than a decade, first at the state level in order to get the first LLC statute enacted, and then at the IRS to ensure its classification as a partnership for federal income tax purposes.[294]

The evolution of both the GmbH & Co. KG and the LLC occurred against the backdrop of a classical tax system—in the case of Germany, at times, even of a tax system designed to punish the use of the corporate form. Although it was explained above that a classical system does not necessarily favor transparent taxation,[295] it is certainly true that unmitigated double taxation feeds demand for TTLLEs. It is thus noteworthy that the examples of Australia, France, the United Kingdom, and—again—Germany show that demand for TTLLEs persists even if income taxes at the entity level and owner level are highly integrated. In Australia, double taxation of corporate profits has been avoided since 1987 by means of an imputation system.[296] France, Germany, and

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(June 16, 2006), https://www.theguardian.com/books/2006/jun/17/features reviews.guardianreview28 (describing Robert Musil's unfinished novel).

291. *Supra* Part I.

292. In the case of the United States, there was even a TTLLE available, in the form of the S corporation, see *supra* Part III.A.

293. *Supra* Part II.A.

294. *Supra* Part IV.A.

295. *Supra* Part I.B.

296. Henry Report, *supra* note 84, at 192 *et seq.*

the United Kingdom operated imputation systems from 1965–2003, 1977–2000, and 1973–1999 respectively.[297] In all three jurisdictions, the imputation systems were replaced by systems that mitigate economic double taxation either by a reduced income tax rate for, or a partial exemption of, profit distributions at the owner level.[298] Nevertheless, the GmbH & Co. KG has remained a popular organizational form to the present day; the trading trust has grown in importance over the past 15 years; France has introduced three different regimes for the transparent taxation of corporations since the 1980s; and the United Kingdom created a bespoke TTLLE in 2001.[299] In Australia, there is even lobbying pressure for the introduction of an entirely new flow-through taxation regime.[300]

The fact that a TTLLE such as the GmbH & Co. KG, which is more expensive than a plain-vanilla corporation, can persist for decades after the double taxation of profits under entity taxation has been removed, illustrates that, as described above,[301] the attractiveness of transparent taxation is indeed multifaceted. Most notably, even an imputation system does not take away the benefits of transparent taxation with regard to losses. The ability to let losses flow through to the owners is of particular interest to newly founded businesses with starting losses and to businesses with volatile business cycles. Many jurisdictions limit the amount of losses that can be deducted by taxpayers who enjoy limited liability, in order to prevent the use of TTLLEs as

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297. For France, see Gutmann, *supra* note 135, at 192 *et seq.*; for Germany, see Hey, *supra* note 63, at 744; for the United Kingdom, see Bank, *supra* note 36, at 49 *et seq.*

298. For France see Gutmann, *supra* note 135, at 196 *et seq.*; for Germany see Hey, *supra* note 63, at 744 *et seq.*; the United Kingdom, see Bank, *supra* note 36, at 68 *et seq.*

299. *Supra* Parts II.A–B, III.B, IV.B.

300. *See* Inst. of Chartered Accountants & Deloitte, Entity Flow-Through (EFT) Submission (2008), http://www.gaaaccounting.com/entity-flow-through-for-smes-icaa-government-submission/ (full report on file with author). For a critical review of this proposal, see Brett Freudenberg, *A Model Idea: Is the ICAA proposal for a Tax Transparent Company the Ideal Model for Australia?*, 38 Austl. Tax Rev. 161 (2009).

301. *Supra* Part I.B.

tax shelters.[302] However, an active[303] entrepreneur is generally able to deduct losses at least up to the amount invested in the business.[304] In addition, transparent taxation might give access to tax preferences that are idiosyncratic to each tax system. It was already mentioned that the trading trust in Australia is not transparent with regard to losses. Instead, it may be attractive from a tax perspective because it allows for income-splitting and grants access to a capital gains tax discount for individuals.[305] In the United Kingdom, one of the factors that make the LLP attractive to some businesses relates to National Insurance contributions. Members of an LLP might be treated as self-employed, which results in a lower National Insurance contributions burden as compared to traditional employees.[306]

The example of the UK LLP also illustrates the degree to which the attractiveness of TTLLEs depends on idiosyncratic properties of a given tax system. In the United Kingdom, transparent taxation has almost always been of limited appeal.[307] Apart from a brief period between 1965 and 1973, when the United Kingdom experimented with a classical system,[308] income taxation of companies and their shareholders has always been highly integrated. Since the introduction of the LLP, the corporate income tax rate has been consistently much lower than the top marginal income tax rate, which means that entity taxation is much more attractive than transparent taxation with regard to retained profits.[309] Furthermore, as TTLLEs have never been popular in the United Kingdom, there are also no path-dependencies that could prop up the flow-through sector there. When an imputation system was introduced

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302. *See, e.g.*, Einkommensteuergesetz [EStG], § 15a (Ger.); Income Tax Act 2007 s. 104 (UK); I.R.C. §§ 465, 469 (U.S.).

303. For a comparative review of restrictions to loss compensation for "passive" investors, see Schön, *supra* note 38, at 158 *et seq.*

304. See, however, the new limitation on "excess business losses" in I.R.C. § 461(l), introduced by Pub. L. No. 115-97, § 11012, 131 Stat. 2054 (2017) [hereinafter Tax Cuts and Jobs Act]. *See also* Samuel A. Donaldson, *Understanding the Tax Cuts and Jobs Act*, at 26 *et seq.* (Jan. 3, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3096078.

305. *Supra* Part II.B.

306. Freedman, *supra* note 22, at 904.

307. *Id.*

308. Finance Act 1965, c. 25; *see also* Bank, *supra* note 36, at 67.

309. *Supra* Part I.B.

in Germany, the GmbH & Co. KG had been around for decades. Practitioners were well accustomed to it, and it was thus easy to put it to new use. By contrast, the LLP was only introduced in 2001, in a business taxation environment that was dominated by entity-level taxation. This probably explains why the LLP, with less than 60,000 entities, has remained a decidedly marginal phenomenon compared to the more than 3,000,000 companies registered in the United Kingdom.[310]

As the attractiveness of transparent taxation depends to a large extent on the design of the tax system, changes to the relevant features may cause the fate of TTLLEs in a given jurisdiction to turn. In the United States, for instance, the tax reform of 2017 certainly has the potential for halting the rise of S Corporations and transparently taxed LLCs as vehicles for active businesses operations.[311] It might even put it into reverse. As of 2018, the Tax Cuts and Jobs Act[312] widens the gap between the top marginal income tax rates of C corporations and individuals at the federal level from 4.6% to 16%.[313] As a result, it has become much more attractive to earn profits through a C corporation than it used to be, in particular if profits can be retained for a prolonged period of time, and/or if distributions are taxed preferentially as qualified dividends in the hands of the recipient.[314] The Tax Cuts and Jobs Act also lowers the tax burden of flow-through entities by means of a deduction of 20% for "qualified business income."[315] If applicable, the deduction brings the top marginal personal income tax rate down from 37% to 29.6%.[316] While there are—probably justified—concerns that wage earners might start using flow-through entities in order to

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310. Companies House 2015–16, *supra* note 197, tbl.A1.

311. *See* Burke, *supra* note 118, at 1335; Karen C. Burke, *Unified Passthrough Reform Misses the Mark*, 146 Tax Notes 1371, 1377 (2015); Schenk, *supra* note 118, at 1240.

312. Tax Cuts and Jobs Act, *supra* note 304.

313. 35 %/39.6 % versus 21%/37 %.

314. James R. Repetti, *The Impact of the 2017 Act's Tax Rate Changes on Choice of Entity*, 21 Fla. Tax Rev. 686 (2018); Shawn Bayern, *An Unintended Consequence of Reducing the Corporate Tax Rate*, 157 Tax Notes 1137 (Nov. 20, 2017); Donaldson, *supra* note 304, at 13.

315. *See* Donaldson, *supra* note 304, at 14 *et seq.*

316. David Kamin et al., *The Games They Will Play: An Update on the Conference Committee Tax Bill* (Dec. 28, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423.

convert part of their labor income into qualified business income,[317] the deduction might not be sufficient to maintain the attractiveness of flow-through taxation for many closely held businesses—in particular if a significant part of the profits is to be reinvested at entity level. However, even if a tax system strongly favors entity taxation of profits, more generous loss compensation opportunities mean that at least a subgroup of entrepreneurs will generally find it attractive to combine limited liability with transparent taxation. Thus, the demand for TTLLEs is indeed universal.

B. Availability of TTLLEs Reduces Tax-Induced Distortions

In a traditional income tax system, the availability of TTLLEs mitigates tax-induced distortions to the choice of business entity. A traditional income tax system can, under realistic assumptions, never be completely neutral with regard to the choice of business entity. As already mentioned above,[318] all major tax systems are marked by a divide between two types of business organization: those that are by default taxed transparently and those that are by default taxed at the entity level. The reason for the universality of this divide is that there is simply no obvious one-size-fits-all tax regime that would be suitable for the full range of business organizations from the sole proprietor with a micro-business to the large public corporation with widely dispersed share ownership.[319] The standard approach is to tax the sole proprietor transparently and the public corporation at the entity level, and to assign all other forms of business organization to one of the two models. The line is commonly drawn between partnerships and close corporations, i.e., according to the legal form.[320] Alternative criteria that are applied, or at least suggested,

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317. *See* David S. Miller, *Tax Planning Under the Tax Cuts and Jobs Act: Flow-Throughs Are the Answer to Everything* (Dec. 13, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3070662; Kamin et al., *supra* note 316, at 8; see Scott Greenberg, *Pass-Through Businesses: Data and Policy* (Tax Found. Fiscal Fact No. 536, 2017), https://files.taxfoundation.org/20170124162950/Tax-Foundation-FF5361.pdf.

318. *Supra* Part I.B.

319. Schön, *supra* note 38, at 144 *et seq.*

320. Ault & Arnold, *supra* note 2, at 416.

include limited liability,[321] legal personality,[322] and quotation of shares or other membership interests on a stock market.[323]

However, apart from it being practically unfeasible to apply the same tax regime to all kinds of businesses, there is no sound reason why business income should be taxed differently subject to the organizational form of the business. In particular, neither the availability of legal personality[324] nor of a liability shield[325] mandates a differential tax treatment.[326] The base of the income tax is net income. Income is not of a different quality depending on the organizational form in which it is earned. There is in particular no direct link between limited liability or legal personality on the one hand and income on the other. Whether the owners of a business are liable for the business's debt or not is irrelevant from a tax perspective in the standard case of the business being profitable.[327] Losses of limited liability entities need not necessarily be trapped at entity level either. As long as losses do not exceed the

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321. As in the cases of France and Australia, *supra* Part V.A.2; *see also* Jeffrey A. Maine, *Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises*, 62 U. Pitt. L. Rev. 223 (2000).

322. In Belgium, all organizations that have legal personality are, in principle, subject to entity taxation, irrespective of the availability of a liability shield, such as commercial general partnerships ("sociétés en nom collectif"). *See* Code des impôts sur les revenues [C.I.R.] art. 179 (Belg.); Bailleux, *supra* note 3, at 33 *et seq.*

323. Eric J. Toder & Allan Viard, *Major Surgery Needed: A Call for Structural Reform of the US Corporate Income Tax*, Tax Pol'y Ctr. (Apr. 3, 2014), https://www.taxpolicycenter.org/publications/major-surgery-needed-call-structural-reform-us-corporate-income-tax/full.

324. For an illustration of this view, see Motivation of the Körperschaftsteuergesetz of 1920 (reproduced at Knobbe-Keuk, *supra* note 61, at 560).

325. For an illustration of this view, see Maine, *supra* note 321, at 250 *et seq.* ("The Entity Tax: A Statutory Price for the Statutory Benefit of Limited Liability").

326. Wolfgang Schön, *Die Funktion des Unternehmenssteuerrechts im Einkommensteuerrecht, in* Erneuerung des Steuerrechts, 37 DStJG 217, 230, 237 (Monika Jachmann ed., 2014); Schön, *supra* note 38, at 145 *et seq.*; *see also* Yariv Brauner, *Whither Choice of Entity?* (Aug. 31, 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2318825.

327. Schön, *supra* note 38, at 147. If a profitable business were not the standard or default scenario, there would be little point, fiscally, in levying an income tax on business profits.

investment into the business, owners of entities with and without a liability shield are in a comparable situation.[328] If a jurisdiction wants to attach a price tag to an organizational form that offers the benefits of legal personality and/or of a liability shield, the appropriate way would be the levying of a franchise tax.[329]

The line-drawing exercise between entity taxation and transparent taxation could only be avoided if either public corporations were mandatorily taxed transparently, or if all businesses, including microbusinesses, were taxed at entity level. Traditionally, transparent taxation of publicly traded corporations with widely dispersed share ownership has been regarded as unfeasible.[330] Whether this might change in the future with the progress of information technology remains to be seen. In any event, there seems to be no momentum for comprehensive flow-through taxation. All major concepts for fundamental tax reform, such as the Allowance for Corporate Equity,[331] the Comprehensive Business Income Tax (CBIT),[332] and the Destination-Based Income Tax,[333] are based on entity taxation. At the other side of the spectrum, the ambit of entity taxation could, in theory, be extended until the compliance costs associated with entity taxation would become untenable for small businesses. In the case of the CBIT proposal, for instance, it was envisaged—in 1992—to spare all businesses with a turnover of less than $100,000 from entity taxation.[334]

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328. *See* Schön, *supra* note 326, at 237; Schön, *supra* note 38, at 147; Joachim Hennrichs, *Besteuerung von Personengesellschaften—Transparenz- oder Trennungsprinzip?*, 92 Finanz-Rundschau 721, 727 (2010).

329. *See, e.g.*, Schön, *supra* note 326, at 230 *et seq.*; Schön, *supra* note 38, at 147.

330. *See* Knobbe-Keuk, *supra* note 61, at 563; Schön, *supra* note 38, at 145.

331. *See* Inst. for Fiscal Studies, Capital Taxes Group, Equity for Companies: A Corporation Tax for the 1990s (1991), https://www.ifs.org.uk/comms/comm26.pdf.

332. *See* U.S. Treas. Dep't, Integration of the Individual and Corporate Tax Systems—Taxing Business Income Once 39 *et seq.* (1992).

333. *See* Alan J. Auerbach, Michael P. Devereux & Helen Simpson, *Taxing Corporate Income*, *in* Dimensions of Tax Design: The Mirrlees Review 837 *et seq.* (Inst. for Fiscal Studies ed., 2010).

334. U.S. Treas. Dep't, *supra* note 332, at 42. For a proposal that aims at including all sole proprietorships into a unified entity tax regime, see

Until now, however, no major jurisdiction has put general limits on the size or nature of businesses that can be organized as transparently taxed sole proprietorships or general partnerships. As a result, entrepreneurs might face a trade-off between limited liability and transparent taxation. If transparent taxation is more attractive than entity taxation, the tax incentive might cause them to organize their business as a sole proprietorship or general partnership although, from a business perspective, a corporation or another form of limited liability entity would be more suitable. The emergence of tax transparent limited liability entities means that this gap can, at least to some extent, be bridged, and the trade-off between limited liability and transparent taxation disappears. In the cases of the most prominent examples of Path Two TTLLEs, the U.S. S corporation and the French SARL *de famille* and EURL, this was the explicit aim of the legislature.[335] TTLLEs that evolved on Paths One and Three fulfill the same purpose. At first sight, this might appear counterintuitive. Entrepreneurs who use a GmbH & Co. KG, a trading trust, an LLC, or an LLP opt neither for a plain-vanilla partnership nor for a plain-vanilla corporation but instead for something else. However, because such an *aliud* combines elements of both worlds, its availability has a mitigating effect on tax-induced distortions. Had the German GmbH & Co. KG not been available in the 1930s, for instance, entrepreneurs would have faced the choice of either punitive corporate income taxation or unlimited personal liability, both of which had the potential of driving many of them out of business.

If a jurisdiction meets the universal demand from entrepreneurs for combining limited liability and transparent taxation, by either tolerating Path One TTLLEs or by actively creating Path Two or Path Three TTLLEs, taxation becomes less distortive. TTLLEs thus have a useful role to play in any traditional income tax system.

C. Evolution of TTLLEs Advanced the Law of Business Organizations

The evolution of TTLLEs advanced the law of business organizations by driving innovation. It is common among lawyers who specialize in the law of business organizations to complain about the "negative"

Martin J. McMahon Jr., *Rethinking Taxation of Privately Held Businesses*, 69 Tax Law. 345, 389 (2016).

335. *Supra* Part III.

influence of tax law.[336] According to this narrative, the distortive force of tax law wreaks havoc on the otherwise serene universe of business organization law. For instance, the GmbH & Co. KG was referred to in Germany as a "legal monster."[337] Similarly, the Australian trading trust was described as a "commercial monstrosity."[338] However, a closer analysis of the convergent evolution of TTLLEs reveals that by distorting the choice of business entity, tax law acted as a catalyst for the development of the law of business organizations, bringing about positive change.[339]

The relationship between corporate law, partnership law,[340] and tax law can be described as a 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. Up to a point, demand for a flexible limited liability entity was on its own sufficient to provoke change in the law of business organizations, such as the introduction of the GmbH and the SARL in France, or the relaxation of some of the rigidities for close corporations in the Anglosphere.[341] However, the additional pressure of the demand for transparent taxation was necessary in order to bring about the GmbH & Co. KG, the trading trust, the LLC, and the LLP. Thus, tax law contributed towards making limited liability entities more flexible. In that respect, it is not surprising that the GmbH & Co. KG and the trading trust emerged from partnership and trust law, because this is the weakest link in the regulatory triangle

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336. For the Australian trading trust, see, for example, Slater, *supra* note 36, at 78. For the German GmbH & Co. KG, see 1 HERBERT WIEDEMANN, GESELLSCHAFTSRECHT 23 (1980). For the U.S. limited partnership, see, for example, Larry E. Ribstein*, An Applied Theory of Limited Partnership*, 37 EMORY L.J. 835, 874 (1988) ("[P]erversely influenced").

337. SCHMIDT, *supra* note 50, § 56 I 2a (quoting 1 HOLDHEIMS WOCHENSCHRIFT FÜR AKTIENRECHT UND BANKWESEN 195 (1892): "juristisches Monstrum"); *see also* GROSSFELD, *supra* note 52 ("strange hybrid" ("eigenartiges Mischgebilde")).

338. Ford, *supra* note 76.

339. For Germany, see Groh, *supra* note 52, at 308.

340. For the sake of simplicity, partnership law shall be understood, in the following, also to encompass trust law.

341. *Supra* Part I.A.

with the highest degree of freedom for individuals to shape business forms according to their needs.

It is argued that the original rigidity of the corporate form was necessary for making a firm creditworthy and that its liberalization was made possible by the emergence of alternative ways of protecting creditors from the opportunistic withdrawal of assets by a firm's owners—such as more sophisticated financial contracting, stricter accounting and disclosure requirements, etc.[342] On the one hand, it is certainly plausible that this aspect played an important role in the evolution of the law of business organizations. On the other hand, some doubt is cast on the relevance of these factors given that banks still insist on personal guarantees by the owners of SMEs.[343] In any event, it is undeniable that legislators were, at least historically, quite reluctant to change the law of business organizations in a proactive way in order to reflect new developments. All major innovations were either the result of intensive lobbying efforts, such as the GmbH, the SARL, the LLC, and the LLP, or did not involve the legislature at all, as in the case of the GmbH & Co. KG or the trading trust. Apart from the first wave of liberalization that adapted the corporate form to the needs of closely held firms, these innovations were driven by tax considerations.[344]

The tax-induced evolution of TTLLEs thus created spillover effects in the law of business organizations. Whether these individual effects are positive or negative is, of course, open to debate in each single case. With regard to TTLLEs resulting from Path One, the combination of two legal forms that were not intended to be combined can have problematic effects. For instance, a GmbH is subject to capital maintenance requirements, while a *Kommanditgesellschaft* is not. As a result, the GmbH & Co. KG could, in principle, hollow out creditor protection standards, as there is no individual who is personally liable and the limited partners could withdraw assets without being bound by the mechanisms of GmbH law that are meant to protect creditors. German courts have solved this problem by effectively extending the capital maintenance requirements of the GmbH to the GmbH & Co KG.[345] In Australia, the equivalence of close corporations and trading trusts resulted in pressure to extend the oppression remedies available to

342. Hansmann, Kraakman & Squire, *supra* note 25, at 5 *et seq.*
343. *Supra* notes 16–25 and accompanying text.
344. Hansmann, Kraakman & Squire, *supra* note 25, at 9.
345. Bundesgerichtshof [BGH], Mar. 29, 1973, 60 BGHZ 324 (Ger.).

minority shareholders to trading trusts. Furthermore, one might question the legitimacy of the way in which trading trusts can be used for sheltering assets from personal creditors of beneficiaries.[346] These, however, are specific problems that can be remedied by means of targeted solutions. It is sometimes argued that the availability of limited liability entities to small business is problematic per se because it would result in an unwarranted advantage for sophisticated contractual creditors.[347] Banks would not be affected by it, as they could access the business owners' assets via personal guarantees. Only unsophisticated and involuntary creditors would run up against the liability shield. This argument would also affect the assessment of TTLLEs, as they have contributed towards making limited liability entities more readily available. Its persuasiveness is, however, mitigated to a considerable extent by the fact that sophisticated contractual creditors always have an advantage over unsophisticated or involuntary creditors. For instance, even in the absence of a liability shield, banks would insist on some form of collateral that gives them priority over other creditors.

In the case of Path Three TTLLEs, which are created by the legislature, there is—as always with new legislation—the risk of bad drafting. For instance, the UK LLP was criticized because it did not provide for appropriate default rules for SMEs.[348] Well-intentioned but badly designed legislation is, sadly, not a phenomenon that is specific to TTLLEs. According to a more fundamental critique, it is not only the lack of appropriate default rules that renders new entity forms like the LLC problematic, but the very fact that these provisions can be altered by contractual agreement.[349] This critique is motivated mainly by an apparent lack of standardization in the agreements of U.S. investment vehicles organized as limited partnerships or LLCs. This issue might be more appropriately addressed by means of capital market regulation and does not necessarily require a revival of rigid mandatory rules. In any event, it is hardly relevant for TTLLEs used by SMEs as their organizational form.

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346. *Supra* Part II.B.

347. Freedman, *supra* note 7, at 317 *et seq.*

348. Freedman, *supra* note 22, at 897 *et seq.*

349. Leo E. Strine Jr. & J. Travis Laster*, The Siren Song of Unlimited Contractual Freedom*, *in* Research Handbook on Partnerships, *supra* note 1, at 11 *et seq.*

Tax-induced innovations in the law of business organizations are, of course, no panacea. They are, however, no unmitigated disaster either. Problematic aspects should be addressed by the courts or the legislature. On balance, the spillover effects in the law of business organizations are unequivocally positive, as TTLLEs resulting from Paths One and Three have demonstrated that limited liability entities can be rendered more flexible without putting legitimate interests of members, creditors, or the general public at risk. The costs associated with adopting a limited liability business form were lowered, and the realm of businesses with access to a liability shield was thus extended. Put differently, this means that fewer potential entrepreneurs are discouraged from starting a business by the risk of unlimited personal liability.

D. Availability of Transparent Taxation and Entity Taxation Should Be Liberalized

In order to further reduce the distortive influence of tax law on the choice of business entity, both transparent taxation *and* entity taxation should be made optionally available to all business entities, with as few strings attached as practically feasible.[350] The fact that the distortive effect of taxation sparked innovation in the law of business organizations is no justification for intentionally perpetuating existing distortions. As far as intentional policy is concerned, it is preferable to keep tax law and the law of business organizations neatly separated. While tax law is frequently used to influence behavior, this obviously makes little sense when the primary addressee is the legislature itself, albeit in another field of legislation, the law of business organizations.

The availability of TTLLEs resulting from Path One or Path Three is not equivalent to a liberalization of Path Two. If transparent taxation is linked to a certain organizational form, a change of tax legislation that results in entity taxation becoming more attractive than flow-through taxation would require a Path One TTLLE or a Path Three TTLLE to change its legal form. If, however, transparent taxation and entity taxation are both optionally available, businesses can simply change the applicable tax regime.

Among the five examined jurisdictions, the United States has liberalized the availability of transparent taxation and entity taxation the

350. Schön, *supra* note 38, at 148.

most, with the adoption of the "check-the-box" regulations in 1996.[351] Even in the United States, however, there is potential for further liberalization and rationalization. There is no obvious reason why the United States should maintain two separate regimes for transparent taxation, in the form of Subchapter S and Subchapter K, which are not equally available to all types of business entities. Unification, or at least harmonization, of both regimes has long been suggested.[352] Proponents of the status quo argue that the continued coexistence of Subchapters S and K is justified because the former is considerably less complex than the latter. Thus, small businesses could achieve flow-through taxation at a lower cost under Subchapter S than under Subchapter K.[353] Even if one assumes that Subchapter K could not be simplified in a meaningful way in the process of harmonization, or that there are other benefits in having more than one flow-through taxation regime, there is, from a neutrality perspective, no sound reason for most of the existing restrictions to the scope of Subchapters K and S.[354] It is, for instance, not obvious why privately held corporations should be barred from opting for Subchapter K.

In the interest of neutrality, there should be as few preconditions as possible for opting for either transparent taxation or entity taxation. Among the necessary restrictions are provisions that reduce the scope for tax arbitrage, for instance by providing that the choice of regime is valid for a certain minimum period. Furthermore, feasibility justifies the exclusion of publicly traded entities from transparent taxation. At the other end of the spectrum, sole proprietorships can probably only be subject to entity taxation if the pool of business assets is separated from the personal assets of the entrepreneur in a meaningful way, in order to allow for the monitoring of asset transfers from one sphere to the other.

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351. *Supra* Part IV.A.

352. Eustice, *supra* note 102, at 347 ("[S]ubchapters S and K should be harmonized as completely as is practicable."); *see also* McDaniel, McMahon & Simmons, *supra* note 106, at 523–25; Taylor, *supra* note 94, at 352 *et seq.*; Burke, *supra* note 311, at 1374 *et seq.* For an overview and evaluation of current reform proposals, see David R. Sicular, *Subchapter S at 55—Has Time Passed This Passthrough By? Maybe Not*, 68 Tax Law. 185 (2014).

353. Mann, *supra* note 109, at 65; Schenk, *supra* note 118, at 1242 *et seq.*

354. *See* Burke, *supra* note 311, at 1377 (arguing for "expanding subchapter S to include as many privately held businesses as feasible").

This aspect is even more important if the sole proprietor is to be granted the right to take advantage of a liability shield. In that respect, the French regime of *entreprise individuelle à responsabilité limitée* (EIRL) provides an illustrative example. Introduced in 2011,[355] it allows a sole proprietor—on an optional basis—to limit his or her liability to a designated pool of business assets,[356] and to opt for entity taxation.[357] This, however, requires the sole proprietor to file an account of assets used in the business with a public register and to update it every year.[358] Beyond that, additional hurdles should only be introduced if there is a clear justification. The U.S. example of the S corporation illustrates that conditions for flow-through taxation result invariably in new distortions and in tax planning activities. There is, for instance, no sound reason for limiting S corporations' maximum number of shareholders to 100.[359] If an upper limit to the number of shareholders were mandated by the requirements of a simplified flow-through regime, which is doubtful, the number would probably have to be much lower. Similarly, France should consider reducing the number of regimes under which corporations can be taxed transparently and relaxing the requirements. Furthermore, it does not make sense that a SARL can opt for transparent taxation but a *société en commandite* cannot.[360]

Suggesting that transparent taxation and entity taxation should be made optionally available might potentially provoke opposition from tax lawyers who blame the U.S. "check-the-box" regulations for allowing U.S. multinationals to implement aggressive international tax avoidance strategies.[361] While it is certainly true that "check-the-box" plays a role in structures such as the "double Irish sandwich,"[362] it would be wrong to regard it as the sole, or even the main, culprit. Rather, it is the

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355. Loi 2010-658 du 15 juin 2010 relative à l'entrepreneur individuel à responsabilité limitée, JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE [J.O.], June 16, 2010, p. 10984.

356. CODE DE COMMERCE art. 526-6 *et seq.*

357. CODE GÉNÉRAL DES IMPÔTS art. 1655 *sexies*.

358. CODE DE COMMERCE art. 526-7, 526-13.

359. MCDANIEL, MCMAHON & SIMMONS, *supra* note 106, at 456; Eustice, *supra* note 102, at 356.

360. *Supra* Part III.B.

361. *See, e.g.*, Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, 62 NAT'L TAX J. 727, 734 (2009).

362. *See* Stephen C. Loomis, *The Double Irish Sandwich: Reforming Overseas Tax Havens*, 43 ST. MARY'S L.J. 825 (2012).

combination of several idiosyncrasies of the U.S. international tax system that aggravates the more general problem of international tax planning—not least the peculiarity of using the place of incorporation instead of the place of effective management as the tiebreaker for determining the country where a corporation is a tax resident.[363]

E. TTLLEs Resulting from Paths One and Three Should Be Carefully Rationalized

TTLLEs resulting from Paths One and Three should be carefully rationalized. In the United States, the proliferation of new business entities has led to a controversial debate about entity rationalization.[364] The most radical proposal consists in replacing all existing limited liability entities with a single, unified business entity.[365] Such a sweeping consolidation of legal forms would only be sensible if the coexistence of different organizational forms were indeed associated with significant costs that exceed its benefits. This, however, is highly unlikely.

Organizational forms are, in essence, property rights.[366] With regard to both property rights in general and forms of business organizations in particular, it is argued that each new variant increases marginal information processing costs of the public.[367] As the marginal

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363. *Supra* note 283.

364. *See* Clark, *supra* note 168, at 1005; Robert R. Keatinge, *Universal Business Organization Legislation: Will It Happen? Why and When*, 23 Del. J. Corp. L. 29 (1998); John H. Matheson & Brent A. Olson, *A Call for a Unified Business Organization Law*, 65 Geo. Wash. L. Rev. 1 (1996); Dale A. Oesterle & Wayne M. Gazur, *What's in a Name: An Argument for a Small Business "Limited Liability Entity" Statute (with Three Subsets of Default Rules)*, 32 Wake Forest L. Rev. 101 (1997); Larry E. Ribstein, *Making Sense of Entity Rationalization*, 58 Bus. Law. 1023 (2003).

365. Oesterle & Gazur, *supra* note 364, at 131. The degree of uniformity that would be achieved under this proposal, is, however, doubtful, as the authors suggest three sets of default rules for their "unified" limited liability entity. *See* Matheson & Olson, *supra* note 364, at 1.

366. Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The* Numerus Clausus *Problem and the Divisibility of Rights*, 31 J. Legal Stud. S373, S405 (2002).

367. Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The* Numerus Clausus *Principle*, 110 Yale L.J. 1, 47 (2000); Ribstein, *supra* note 364, at 1029.

utility of each new variant declines, the optimal number of variants would be limited.[368] To put it differently, it is argued that a plethora of business forms "produces too much choice" and confuses potential users, thus resulting in "costs of confusion."[369] It was, however, argued convincingly that this theory is actually false, as it is not plausible that additional property rights—or business entities—result in significant additional "costs of verification."[370] Instead, while high costs are generally associated with establishing the first property right of a certain kind, the cost of creating additional rights of the same kind is actually quite limited. For instance, in the hypothetical case that the concept of a limited liability entity had just been conceived, it would be very expensive to provide the necessary infrastructure for the first type of entity. In particular, a new public register would have to be created, as creditor protection requires a certain degree of transparency about limited liability entities, and the public as well as legal practitioners would have to familiarize themselves with the very concept of a registered limited liability entity. However, for additional types of limited liability entities, the same register, or at least the same infrastructure, in the form of personnel and IT resources, could be used at negligible additional cost.[371] The interested public would have to understand only the particularities of the new entity type. Furthermore, an important part of these costs would have to be incurred only to the extent that a certain entity is actually used, which means that it provides benefits that make its adoption worthwhile. If the legislature introduced a new business form that offers no apparent benefit over existing forms, it would simply be ignored. The fact that it is in the statute book would cause no significant cost or do any other harm. At the same time, there is a clear benefit in the availability of additional business forms with distinct sets of default rules.

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368. Merrill & Smith, *supra* note 367, at 39.

369. *See* Ribstein, *supra* note 364, at 1029; *see also* Susan P. Hamill*, The Story of the Limited Liability Company: Combining the Best Features of a Flawed Business Structure, in* Business Tax Stories 295, 313 (Steven A. Bank & Kirk J. Stark eds., 2005); Maine, *supra* note 321, at 254; Matheson & Olson, *supra* note 364, at 3 ("morass").

370. Hansmann & Kraakman*, supra* note 366, at S399.

371. This holds true if one assumes that the availability of additional organizational forms does not significantly increase the total number of entities that need to be registered. If that were indeed the case, additional costs for increased capacity could be covered with fees.

It increases the number of businesses for which available default rules are suitable and which thus do not need to rely on customized agreements.[372]

Against this background, the proliferation of business forms in the United States is not problematic per se. Instead of relying on just one business form with one set of default rules, it appears to be generally preferable[373] to create as many sets of default rules as might potentially be in demand in practice and to add new forms as soon as additional demand materializes. This is not to say that TTLLEs resulting from Path Three should not be carefully rationalized where appropriate. In the case of the United States, it might be sensible, for instance, to harmonize equivalent provisions across business forms, either by means of references or by creating general provisions that apply to several business forms.[374]

The case for rationalizing TTLLEs resulting from Path One is clearer. It was originally undoubtedly a boon to entrepreneurs if a legal system was flexible enough to allow for the creation of TTLLEs via the combination of two legal forms. Through the GmbH & Co. KG, German entrepreneurs have had a transparently taxed limited liability entity with partnership-like flexibility at their disposal since the 1920s, 70 years before the LLC became generally available in the United States.[375] 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 partnership. This creates an additional entry barrier for small businesses for which the costs of using these legal forms are too high. In Australia, a prominent proposal for the introduction of an optional flow-through taxation regime for companies was, inter alia, motived by the desire to spare SMEs from having to rely on trust law and its complexities to achieve transparent taxation.[376]

If the availability of transparent taxation were to be liberalized in the way suggested above,[377] combined legal forms that are only useful

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372. Ribstein, *supra* note 364, at 1030.

373. It is even necessary if default rules have to be mandatory. *See* Larry E. Ribstein, *Possible Futures for Unincorporated Firms*, 64 U. Cin. L. Rev. 319, 334 (1996).

374. *See* Clark, *supra* note 168, at 1019; Ribstein, *supra* note 364, at 1035.

375. *Supra* Parts II.A, IV.A.

376. Inst. of Chartered Accountants & Deloitte, *supra* note 300, at 8.

377. *Supra* Part VI.D.

because they grant access to transparent taxation would eventually be wiped out. Their additional costs as compared to a plain-vanilla limited liability entity would render them uncompetitive.[378] However, if a Path One TTLLE serves a useful purpose beyond tax planning, its essential features should be consolidated into a new legal form. There is no sound reason to prevent small businesses from adopting a certain entity form because of *unnecessarily* high compliance costs. There is, of course, a lower bound to the size of a business that can be usefully organized as a limited liability entity. Ideally, the lower bound should be determined exclusively by such costs that are necessary to guarantee adequate creditor protection. In that respect, the cost of operating a single-member limited liability entity is probably a good proxy. At least, this is what the limited success of the French EIRL[379] suggests. Since its introduction in 2011, the EIRL has proved fairly unpopular, probably because the compliance costs for separating business assets from personal assets are comparable to those for establishing a SARL.[380] Another factor that might prevent small businesses from organizing as a limited liability entity is access to credit. It has been suggested that general partnerships still have a role to play in situations where access to credit requires that a firm's owners pledge all their personal assets.[381] As already discussed above, this is not really an issue as long as banks can insist on personal guarantees and suppliers can secure their claims effectively.[382]

If one takes the German GmbH & Co. KG as an example, rationalization would require a modification of two aspects. First, the requirement of a general partner with unlimited personal liability would have to be replaced by an adequate creditor protection regime. Second, limited partners would have to be, by default, managers and agents of the firm. Currently, the default rules of the German limited partnership are

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378. They would thus be more severely affected than TTLLEs resulting from Path Three.

379. *Supra* Part VI.D.

380. *See* Sénat (2013–14), No. 162, avis présenté au nom de la Commission des lois constitutionnelles, de législation, du suffrage universel, du Règlement et d'administration générale dur le projet de loi de finances pour 2014, adopté par l'Assemblée Nationale, Vol. VIII, par M. Antoine Lefèvre 22 *et seq.* (Nov. 21, 2013)

381. Hansmann, Kraakman & Squire, *supra* note 25, at 9.

382. *Supra* Parts I.A, VI.C.

incoherent.[383] In the vast majority of cases, a limited partnership is controlled by the limited partners. However, according to the statutory default provisions of the *Kommanditgesellschaft*, limited partners are no more than passive investors, with no say in the management of the firm, no power to bind the firm, and limited information rights.[384] Thus, these provisions have to be modified, as far as possible, contractually in every partnership agreement of a standard GmbH & Co. KG. However, there are certainly cases in which limited partners are indeed passive investors. There might also be cases in which it proves useful that an individual as general partner assumes statutory unlimited liability. Therefore, the limited partnership form should not simply be replaced. Instead, the German commercial code should provide appropriate default rules for all relevant scenarios.

Conclusion

The convergent evolution of six tax transparent limited liability entities in five jurisdictions along three different paths illustrates that the demand for TTLLEs is universal. While entrepreneurs have a very strong preference for liability protection, the degree to which transparent taxation is attractive to them depends to a large extent on the design of the applicable tax system. The evolution of TTLLEs was sparked by the dichotomy of transparent taxation and entity taxation that is a hallmark of all real world tax systems. Traditionally, limited liability coincided with entity taxation, while transparent taxation was only available to forms of business organizations that do not offer a liability shield. The emergence of TTLLEs mitigates the resulting tax-induced distortion of the choice of business entity. Furthermore, TTLLEs have advanced the law of business organizations by rendering limited liability entities more flexible. In order to further reduce tax-induced distortions, transparent taxation and entity taxation should be made optionally available to all business entities without preconditions, as far as this is practically feasible. TTLLEs that result from a combination of two legal forms and serve a useful purpose beyond granting access to transparent taxation should be consolidated into a new legal form in order to avoid unnecessary costs.

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383. For the concept of incoherent default rules, see Ribstein, *supra* note 373, at 334; Ribstein, *supra* note 364, at 1030.

384. Handelsgesetzbuch of 1897 §§ 164, 166, 170.