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THE TAX-TRANSPARENT ENTITY IN THE INTERNATIONAL CONFLICT OF LAWS

*Richard M. Buxbaum**

TWO disputes of fairly recent vintage by a German individual subject and a U.S.-incorporated entity with their respective countries' tax authorities prompt this brief exploration of some current versions of partnership-like legal issues—issues in which Alan Bromberg long was interested. In the first case, a German resident asked to be taxed on a pass-through basis for the distribution booked to him in consequence of his membership in a U.S. (Delaware) limited liability company.[1] In the second, the German tax authority required a traditional German analogy to a limited liability company—a GmbH[2]—to apply a 15% withholding rate on a dividend distribution made to a U.S. S Corporation that held 50% of the membership units of the GmbH.[3] The German tax office claimed that not the S corporation but its shareholders were the (beneficial) owners of the company and, as individuals, could not benefit from the reduced withholding tax rate the treaty specified for distributions to U.S. *corporate* owners of these GmbH membership units.[4]

To discuss these disputes, I begin with a brief look at the origins and fate of the pass-through (or flow-through) concepts on the basis of which these disputes arose.

I. FROM *LARSON* TO "CHECK-THE-BOX"

Those of us who, like Alan Bromberg, taught the Partnership Law course out of necessity had to deal with the economic motivations determining the choice of organizational form, and that meant dealing with the dreaded subject of tax law.[5] Fortunately, the basic context was relatively

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1. *See* explanation *infra* notes 41–43 and accompanying text.

2. In the context of tax-transparent entities, a rough analogy to the LLC. *Id.*

3. *See* discussion *infra* note 42. This was, of course, an issue under the applicable bilateral Convention for the Avoidance of Double Taxation, and will be explored below.

4. *Id.*

5. If General Ulysses Grant knew only two pieces of music—one was Yankee Doodle and the other was not—then, at one time, law teachers knew only two fields of law—one was tax law and the other was not. Today's law curricula suggest more cross-fertilization.

straightforward[6]: the investor whose financial situation was such as to benefit from the start-up losses incurred by the investment vehicle (and eventually to exit a profitable venture at the lowest available rate of taxation) preferred, and indeed required, a tax-transparent vehicle. It had to be an entity whose profit and loss flows passed directly to its owners. The tax authorities permitted this transparency, but only on the condition that the entity did not evidence a majority of so-called "associational" characteristics. By 1970, those characteristics had been fixed as involving four criteria: limitation of owners' personal liability for the entity's debts; centralization of management of the entity; indefinite duration of the entity; and free transferability of units of ownership by its owners. If a majority of these attributes existed, the entity had associational status, and as such was itself the location of the incidents of direct taxation. *Larson* then set the parameters: If no more than two existed, the entity was transparent, and the incidents of direct taxation flowed through to its owners.

So far, so good. But two conflicting considerations increased in salience as these entities grew in size and thus in the number of owners. Not the general but the limited partnership was the arena of this conflict. It was the ideal vehicle to gather significant amounts of capital for increasingly significant types of investment activity, and it limited the right of the providers of this passive capital, the limited partners, to participate in the management and governance of the entity. The private conflicting consideration was the need for limited partners to be able to exit. The public consideration was the impact of state and federal securities regulation not only on the adequate disclosure of the conditions of investment but also—especially at the state level—on the provision of a minimal amount of "voice" to these limited partners.

The first difficulty under this new participatory regime of course was not specifically with the "centralization of management" associational attribute; on the contrary, the more voice allotted to limited partners, the less likely should have been the ascription of associational status as to that component. The conflict, rather, was with the traditional requirement of earlier state law that the limited liability of the limited partners came at the price of non-participation in management. This, in turn, did mean that the associational attribute of centralized management remained an issue of concern whenever the financial interests of some or all of the limited partners required them to get involved with the business decisions of the entity.

That traditional constraint was loosened by the 1970s through the introduction into the limited partnership statutes of so-called "safe harbor" participatory rights (and it is worth noting that California was most active

6. At least once the era launched by the seminal case of *Larson v. Commissioner*, 66 T.C. 159(A) (1976), arrived (acquiesced, 1979-2 C.B. 1 (IRS ACQ), 1979 WL 194005). I do not discuss here the earlier position of the Treasury, under the original *Kintner* regulations, which tried to impose partnership status on professional entities in order to control the use of tax-deferred income for qualified retirement plans by these entities that were prohibited under state law from incorporation.

in insisting on this change, even at the potential cost to the desirable uniform law approach that facilitated multi-state, public entities and thus economic growth).[7] The IRS, however, did not automatically find centralization of management lacking just because the safe harbor approach mitigated the risk that safe harbor-based behavior might lead to personal liability of these limited partners. And since the larger these entities, the more clearly some of the other three attributes—liquidity, duration, and liability—might be deemed to evince associational attributes, the fate of the limited partnership remained in contention.

In a way, the safe harbor provisions concerning limited partner participation in some aspects of management perversely heightened the risk that associational status would be attributed to (the lack of) personal liability. In earlier times, slight missteps into the minefield of control quickly brought personal liability in their wake. Now, between the safe harbor catalogue and the umbrella safeguard clauses requiring third parties to have known of a particular partner's behavior that went beyond the safe harbor—and to have formed a reasonable belief that this behavior equaled that of a general partner—personal liability became rare if not practically impossible to demonstrate.[8] And the growth of the large limited partnership with a large number of passive investors meant that the need of investors for liquidity and thus for transferability of ownership interests became more important, more prevalent, and more "associational." In addition, indefinite continuity of life of course also became a more desirable notion the larger the enterprise, and for essentially the same reasons that led to the need for the transferability of interests.[9]

Now the pressure was on and, as is well known, the IRS yielded. Check-the-box regulations arrived. They not only nurtured large-scale limited partnerships, but also became the starting gun for the limited liability company,[10] whose members enjoyed both the limited liability of the traditional corporation and the pass-through tax privilege, no matter their

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7. *See* CAL. CORP. CODE § 15903.03 (West 2015).

8. Indeed, some states (fortunately, not the leading jurisdictions) have enacted RULPA § 303 (2001), which eliminates any potential liability of a limited partner no matter the extent of that partner's participation in management and control activities.

9. Nothing new here. *See* M. Herberger, *Das Inhaberpapier als spirituelle Dampfmaschine [The Bearer Instrument as the Spiritual Steam Engine [of Capitalism]]*, 1 RECHTSHISTORISCHES JOURNAL 180 (1982).

10. While the first LLC statute, that of Wyoming, was enacted in 1977, only a decade later was such an entity's tax-transparent nature fully accepted by the IRS with the adoption of Revenue Ruling 88-76, 1988-2 C.B. 360. *See* Carol Goforth, *Why Limited Liability Company Membership Interests Should Not be Treated as Securities and Possible Steps to Encourage this Result*, 45 HASTINGS L.J. 1223, 1225 n.11 (1994). Goforth notes:

> This revenue ruling was issued only after a lengthy period of confusion about how the IRS would regard LLCs. The IRS had issued a private letter ruling in 1980 which concluded that a particular Wyoming LLC would be treated as a partnership for tax purposes, Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980), but had also issued a private letter ruling in 1982 finding that another Wyoming LLC would be taxed as a corporation, Priv. Ltr. Rul. 83-04-138 (Oct. 29, 1982).

Id.

number.[11]

II. THE FOREIGN LLC MEMBER OF A TAX-TRANSPARENT U.S. ENTITY AND THE U.S. MEMBER OF A GERMAN TAX-TRANSPARENT ENTITY

This short essay does not enter the field of tax-avoidance planning, which is where most of the professional literature (and regulatory treatment) of cross-border situations suggested by this title is found.[12] My aim is far more limited; namely to the international conflict of laws context that these two ideal types of situations create and on which, but only in a limited fashion, bilateral treaties for the avoidance of double taxation may bear. To further limit the discussion, I shall focus on only one cross-border context: that of Germany and the United States.

A. THE GERMAN MEMBER OF A TRANSPARENT U.S. ENTITY

It always has been and, even in the era of Double Tax Conventions, remains the case that the characterization of the nature of a foreign legal entity for the purpose of identifying the appropriate tax regime to impose on domestic subjects[13] who own equity interests[14] in that entity is for the local law of the domestic subject to determine. The first case discussed here is that of a German subject who holds an interest in a U.S. entity.[15] The canonical conflicts rule was firmly emplaced already in 1930 in a decision of the German Finance Supreme Court (*Reichsfinanzhof*).[16] The fact situation was complex and does not need description for present purposes.[17] Decisive was the question of whether a Venezuelan limited part-

11. Even if this involves its subjection to federal securities regulation regimes. For the SEC's advice to counsel for LLCs registering securities for public issuance, see SEC Staff Legal Bulletin No. 19 (CF) (Oct. 14, 2011), *available at* https://www.sec.gov.interps/legal/cfslb.19.htm. The income tax treatment of such public issuers of course is not uniform, as the use of the exemption of even publicly held entities not carrying on an active trade or business in certain "privileged" sectors demonstrates.

12. These issues are the subjects of current efforts of the Organisation for Economic Co-operation and Development (OECD) to recommend domestic law reforms preventing tax avoidance schemes that result in "DD" (Double Deduction) or "D/NI" (Deduction/No Income Tax) outcomes. *See* OECD (2014), *Neutralizing the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. For a current comprehensive and somewhat critical evaluation, see Graeme Cooper, *Some Thoughts on the OECD's Recommendations on Hybrid Mismatches*, 69 BULL. INT'L TAX'N 6/7 (2015).

13. The specifics of "domestic"—whether citizenship or domicile, and their internal distinctions depending on whether the domestic subject is a natural or legal person—are discussed below.

14. Or—though I do not discuss this form of investment here—debt instruments, though the debt-or-equity characterization under domestic law is an important subset of the "hybrid mismatch" tax avoidance problem. For a typical discussion, again using German law, see Marisa Lipp, *The German Silent Partnership*, 55 EUR. TAX'N 7 (2015).

15. *See* Federal Ministry of Finance Letter, *infra* note 24.

16. Reichsfinanzhof [RFH] [Finance Supreme Court] 73, Feb. 12, 1930 (Ger.).

17. The underlying issues in the case were timing matters (to which taxable year of the taxpayer the distribution should be ascribed) and characterization of distributions in income or capital terms.

nership, a legal entity under both Venezuelan and German law, should be subject to German corporate taxation or whether, "despite the fact that the company is clothed in the form of a legal person, it is the individual members that should be treated as co-venturers in the sense of [the German law], with the consequence that their shares of the profit are directly subject to the income-tax law."[18] A sophisticated functional approach to the issue followed:

> [Comparisons based on their respective purposes] can lead to a sensible result if one undertakes an evaluation of the Venezuelan company in its totality, paying attention to its economic position and its legal construction under Venezuelan law. If this results in a significant correspondence with the structure and economic role of the German commercial or limited partnership in the context of its treatment in the [German] income and corporate taxation system of these forms, then one has to treat the Venezuelan company in the same fashion. For this comparison one has, in particular, to determine whether the foreign company is closer to the type of a personal company or one based on shares . . . . In the first type, the person of the member is primary. The members normally manage its business, are personally liable, and cannot transfer their participation to third parties. In the case of the share company, the relation of its members to it is more impersonal. They are not personally liable to creditors, may transfer their shares, and in their capacity as members, do not normally participate in the company's management.[19]

Applying these criteria to the specific case, the court found that the personal attributes predominated, and thus called for pass-through income tax treatment of the German member of the entity, even if Venezuelan law called for the incidence of taxation to fall on the company.

This so-called functional approach has remained the basis of the conflict of laws treatment of the first of these two case studies, the tax treatment of the German member of a foreign entity. A fair number of cases of essentially similar import have been decided under the laws of the Federal Republic; thus, a few secondary references will suffice.[20] Interesting for our purposes, of course, is the consequence of this form of the German local-law rule to the modern context of the public limited partnership and especially of the public limited liability company that now dominates the United States scene. A recent German discussion illustrates today's context within the traditional local law approach.

The specific question is how the limited liability company is characterized for the purpose of the difference between the German treatment of the "corporation" (*Körperschaft*) and the partnership (*Personengesell-*

18. 27 RFHE 73, 77 (Ger.) [author's translation].

19. *Id.*

20. *See, e.g.*, Friedrich Hey, *Stellung der US (Delaware) Limited Liability Company im internationalen Steuerrecht*, *in* FESTSCHRIFT FÜR HELMUT DEBATIN 121 (Munich 1997).

schaft),[21] as this characterization determines the availability of pass-through treatment of its profits and losses. A preliminary issue, beyond those involved in the 1930 decision, is consideration of the possibility that the tax treatment may depend on the role of the (in this regard, typical) Germany-United States Treaty for the Avoidance of Double Taxation. The Treaty, however, focuses on the right of a legal person incorporated in State A to bring a Treaty-based suit in State B to challenge its tax treatment there.[22] This Treaty-based right does not carry its home jurisdiction's characterization of the entity into the host jurisdiction for the purpose of determining its local tax treatment.[23] As an official bulletin of the German Ministry of Finance (technically only a "Letter" for the guidance of the tax authorities) makes clear, this depends on the domestic law of the taxing jurisdiction.[24] Within this framework pursuant to the private international law of the Federal Republic, however, only the first step has been taken. The interesting question concerns the German substantive law.

And with this we come to the revival of the abandoned IRS Regulations abroad. Based on the jurisprudence concerning comparison of legal typologies, the Letter specifies the following criteria as determinative:

1) Centralization of Management (and of Representation):

> An associational attribute is found whenever one or more persons—but not all members—are permanently ["*auf Dauer*"] exclusively authorized to make all decisions necessary to accomplish the purposes of the entity without the agreement of all (or the other) members.[25]

The document goes into considerable detail on this point. For example, it specifies that the (non-associational) attribute is not lost even if some portion of the members is excluded from participating in management, so long as the company—"*as in the case of a [German] limited partner-*

21. For the same purpose, the discussion also treats the German branch establishment (*Betriebsstätte*) as a U.S. LLC.

22. As applied to a Florida corporation bringing suit in Germany pursuant to Art. XXV(5) of the Double Tax Convention (in its 1954 version), see Bundesgerichtshof [BGH] [Federal Court of Justice] Jan. 29, 2003 (Ger.), *available at* http://juris.bundesgerichtshof.de/cgi-bin/rechtsprechung/document.py?Gericht=bgh&Art=en&sid=0c7ece0e68ea05e22474f04c3582d9ee&nr=25663&pos=0&anz=1.

23. Though the Department of the Treasury early and appropriately accepted that the local law of the foreign jurisdiction "must be applied in determining the legal relationships of the members of the organization among themselves . . . ." Rev. Rul. 73-254, 1973-1 C.B. 613.

24. Steuerliche Einordnung der nach dem Recht der Bundesstaaten der USA gegründeten Limited Liability Company [The Tax Characterization of a Limited Liability Company Founded Pursuant to the Law[s] of the Federal States of the USA], BMF Schreiben 19.3.2004, IV B 4 –S 1301 USA – 22/04 [Federal Ministry of Finance, Letter of March 19, 2004], *available at* https://beck-online.beck.de/Default [hereinafter Federal Ministry of Finance Letter].

These Letters derive from the complex legal system concerning the division of fiscal receipts among the Federal and Länder governments pursuant to Articles 85 and 108 of the German Basic Law ["Constitution"]. They are primarily intended to assure uniform administration of these laws by the Länder, but are instructive to the private sector.

25. *Id.*

ship"—is run by managing members only in their capacity as members and not in their capacity as appointed or elected managers.[26]

2) Limited Liability

This was the simplest criterion to state and utilize. The Letter found this attribute present when none of the members were personally liable for the debts of or claims against the entity.

3) Transferability of Membership Interests

Putting aside this straightforward issue of members' personal liability, the second major discussion of the availability of flow-through treatment under the German law concerns the transferability of membership units. Interesting for present purposes was the fact-specific view of the Finance Ministry:

> The free transferability of the units exists if the applicable statutory rules *or on the basis of the membership agreement* the financial *and* membership rights[27] arising out of participation can be transferred to third parties without the consent of the other partners, so that the acquirer enters into the partner position of the transferor. Free transferability, on the contrary, does not exist if the agreement of all or specified partners is needed for the transfer.[28]

4) Continuity of Life

The characteristic of continuity of life causes the German "ruling" some difficulties, principally because in the case of the closest analogous organization of the German law, the Commercial Partnership [*Personenhandelsgesellschaft*], whose members enjoy the pass-through privilege, the death, resignation, or insolvency of a member since a 1998 reform no longer leads to the dissolution of the entity.[29] "This criterion therefore is only of limited use in the characterization; that is, only when either under the foreign law or the partnership agreement its life continuation is limited . . . ."[30]

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26. *Id.* A difficult concept to track onto the U.S. approach, although the treatment of the limited partner who in her capacity as the owner or director of a corporate general partner manages the limited partnership is a classic issue. *Compare* Frigidaire Sales Corp. v. Union Properties, 562 P.2d 244 (Wash. 1977), *with* Delaney v. Fidelity Lease Ltd., 526 S.W.2d 543 (Tex. 1975).

27. Emphasis added. "Membership rights" basically involve voting rights.

28. Federal Ministry of Finance Letter, *supra* note 24, at 4. The differences from the original *Kintner* language are not major but still worth noting:

> [The corporate characteristic exists] if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute [a third party]. In order for this power of substitution to exist . . . the member must be able, without the consent of other members, to confer upon his substitute all the attributes of his interest . . . .

26 C.F.R. § 301.7701-2(e)(1) (1983). Thus, an assignment of the right to profits does not create associational status as to this element.

29. Federal Ministry of Finance Letter, *supra* note 24, at 4 (citing § 131 of the German Commercial Code).

30. *Id.* The Letter goes on to state:

> The unlimited life of the entity is present if, though the foreign statute provides for its dissolution on these or similar grounds, the members may de-

The Letter, however, does not give any weight to the existence or non-existence of the legal personality of the entity under its (foreign) law of organization, nor does the number of members matter.[31]

A Commentary to the Letter, appended to its publication,[32] suggests a number of difficulties with this fact-specific approach. Above all, its application to the LLC requires individualized review on the basis of the specified criteria.[33] This may not be the case if other organizational forms are at issue, since these are resolved on the level of that specific form alone and do not give rise to this particularized treatment. On the other hand, the Commentary suggests, the ability of the home entity to choose the availability of flow-through treatment through choosing the organizational form may in time create the problem that the German tax authorities will prefer a similar individualized analysis with all its practical consequences in all cases.[34]

B. THE U.S. MEMBER OF A GERMAN TAX-TRANSPARENT ENTITY

The Commentary also provides a helpful guide to the often-raised issue of whether the Double Tax Convention has a role to play. The Ministry Letter itself briefly speaks to this question in dicta that concern the reverse situation; namely, the case of a U.S. LLC receiving German source income, where the typical issue, of course, is the question of who is the U.S. subject—the organizational entity or its individual owners. The Convention, so the Finance Ministry, requires that the LLC be domiciled in the United States [*"eine in den USA ansässige Person"*] if it is to have access to the benefits of the Convention.[35] However, the LLC's "citizenship" or domicile is not the basis of its access to the Convention's benefits if—though in the U.S. treated as a taxable entity—under German law it

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> spite these grounds agree to its continuation and this continuation already is provided for in its agreement from the start and without further considerations. The condition of limited life assumes that in the case of a [statutory] basis for dissolution the continuation of the entity depends on a separately [i.e., ex post] reached agreement of the remaining members. It suffices for this assumption [of limited life] if the foreign law or the membership agreement specifies only a single event as the ground for dissolution. If realistically, however, such an event is not expectable, it is not to be recognized as a ground for dissolution.

Id.

31. The second point, concerning the number of members, is the consequence of an en banc judgment of the Federal Supreme Financial Court, see *Bundesfinanzhof* [BFH] [Federal Tax Court] June 25, 1984, SAMMLUNG DER ENTSCHEIDUNGEN UND GUTACHTEN DES BUNDESFINANZHOFS [BFHE] 405, 1985 (Ger.). This leading case distinguishes the securities-regulation aspects of a public entity with many passive members from its tax aspects and grants flow-through status even to these members. It does so on formal organizational structure grounds that in this context resemble the U.S. flow-through treatment for mass/public limited partnerships and limited liability companies. The differences in the respective rationales of the two situations, despite similar outcomes, are worth comparative treatment, but not here.

32. "Commentary" to Letter, *supra* note 24, at 8.

33. *Id.*

34. *Id.*

35. Federal Ministry of Finance Letter, *supra* note 24.

would be treated as a *Personengesellschaft*; i.e., one whose members, rather than itself, are subject to income taxation.[36] The Letter, surprisingly, suggests that in this case it is the domicile of the LLC's members that determines the availability of Convention treatment.[37] The Commentary convincingly argues that this seems to contradict the purpose of the Convention, since it is clear that U.S. law taxes the entity on its distributions based on its membership in the tax-transparent German entity.[38] It therefore should follow that it itself is a U.S.-based person and as such should enjoy the benefits of the Convention.

In any event, as it happens, a number of higher and lower German tax courts since then have agreed with this criticism and treated the U.S. entity as the U.S. subject with standing to claim these Convention benefits. Most significantly, since the mutual acceptance of the 2006 Protocol to the U.S.-German Double Tax Convention,[39] the new Article 1(7) has been used in conjunction with Article 10 in the case of a U.S. S corporation to reduce the German withholding tax on the dividend received by that entity to five percent (a rate not available to individuals).[40] It follows that any entity permitted to choose transparent status conveys the benefits of pass-through status to its members so far as the German withholding tax is concerned, possibly whether or not they themselves are U.S. subjects.

C. U.S. Tax Treatment of the U.S. Member of a Tax-Transparent German Entity

With this, we reach the relevant regulation under IRC § 7701, which I approach in the context of the evolution from the *Kintner* Regulations to the check-the-box approach.

As it happens, the German entity that provides the best case study, the company with limited liability, the *Gesellschaft mit beschränkter Haftung* or *GmbH*, tracks that evolution. In 1977 the Internal Revenue Commission issued a Revenue Ruling that considered the transparency of a Ger-

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36. *Id.*

37. *Id.* In any event, this statement presumably is no longer operative in light of the Treaty changes referenced *infra* note 40.

38. "Commentary" to Letter, *supra* note 24, at 8.

39. J. Comm. on Taxation, JCX-47-07, Explanation of Proposed to the Income Tax Treaty Between the United States and Germany (2007).

40. *See* Bundesfinanzhof [BFH] [Federal Tax Court] June 26, 2013, (Ger.), *available at* http://www.bundesfinanzhof.de/entscheidungen/entscheidungen-online. In this case, the German Supreme Finance Court (*BFH*) ordered the application of this reduced rate because under German law this entity was characterized as a corporation and, as such, assumed (again under the law) to be the taxable entity. The fact that in the United States it is a transparent entity whose individual owners bear the incidents of income taxation did not concern the court, so long as someone subject to U.S. law was taxed. In other words, the unavailability of the low rate to individuals, under the Treaty, could be legitimately circumvented. *See* Friedhelm Jacob & Martin Klein, *S-Corporation die Zweite – Kernaussagen und Folgewirkungen des BFH-Urteils vom 26.6.2013, I R 48/12*, Internationales Steuerrecht [IStR] no. 4, 121 (2014) (Ger.).

man *GmbH* owned by two subsidiaries of a U.S. corporation.[41] That Ruling first accepted that limited owner liability was a given under the German statute.[42] It then examined the particular company's Memorandum of Association, which purported to limit transferability of interests, but then used the reality of the ownership division of the two members—90%/10%—to conclude that whatever the Memorandum provided, the majority member had the power to arrange that free transferability.[43] It took a similar approach to the continuity of life criterion.[44] The Memorandum provided a boilerplate list of events that would cause dissolution of the company,[45] but again the ruling looked to economic reality:

> [The dissolution provision] has significance only if there exist separate interests that could compel dissolution . . . upon the occurrence of one of the listed events . . . . If, as in the instant case, both quotaholders are wholly owned by the same corporate parent, there are no separate interests that could compel dissolution . . . . Thus, the statement in the memorandum . . . has no substantive effect and will be disregarded.[46]

The *GmbH* reappeared in a 1993 ruling,[47] which still used the *Kintner* Regulations as the metric to evaluate the entity's associational attributes but specifically retreated from the "economic reality" gloss of the earlier ruling. The only consequence, however, was to remove the associational attribute of continuity of life:

> It subsequently has been determined that the presence or absence of separate interests is not relevant to the determination of whether an entity possesses continuity of life. Because the memorandum of association requires dissolution upon the bankruptcy of either quotaholder, without further action, the GmbH lacks continuity of life.[48]

With this we reach the relevant regulation under IRC § 7701, which I approach in the context of the evolution from the *Kintner* Regulations to the check-the-box approach. I begin with the purely domestic context, and then turn to the transnational context.

§ 301.7701-2 Business entities; definitions.

(a) Business entities. For purposes of this section and § 301.7701-3, a business entity is any entity recognized for federal tax purposes (in-

41. Rev. Rul. 77-214, 1977-1 C.B. 408.
42. *Id.*
43. *Id.*
44. *Id.*
45. *Id.* Dropping standard clauses into an agreement can have its own pleasures. In this case, insanity of a corporate owner was listed as one ground of dissolution.
46. *Id.*
47. Rev. Rul. 93-4, 1993-1 C.B. 225.
48. *Id.* This focus on the member's bankruptcy of course is a major element in U.S. partnership law provisions concerning dissolution, though not in the case of the LLC; nor even in the former case is it more than a default provision. Since the GmbH Memorandum at issue, however, mandated dissolution in that event, the characterization of this attribute as non-associational is appropriate.

> cluding an entity with a single owner that may be disregarded as an entity separate from its owner) . . . . A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.
>
> . . .
>
> (b) Corporations. For federal tax purposes, the term *corporation* means—
>
> (1) A business entity organized under a Federal or State statute . . . .
>
> . . .
>
> (8) Certain foreign entities—
>
> (i) In general. . . . [T]he following business entities formed in the following jurisdictions:
>
> . . .
>
> Germany, Aktiengesellschaft [stock corporation]
>
> . . .
>
> (c) Other business entities. For federal tax purposes—
>
> (1) The term partnership means a business entity that is not a corporation under paragraph (b) of this section and that has at least two members.
>
> (2) Wholly owned entities—
>
> (i) In general. . . . [A] business entity that has a single owner and is not a corporation under paragraph (b) of this section is disregarded as an entity separate from its owner.[49]

The international conflict of laws principle underlying this substantive statement is the same as in the discussed reverse case: the local law of the taxing jurisdiction determines the entity's—or its owners'—taxable status. It is that substantive law that differs. Unlike—totally unlike—the German tax treatment already discussed,[50] this section provides a categorical exemption from associational status and its tax consequences. The exemption is not based on contractual or other factual specificities; the label alone suffices to grant its owners flow-through status.

In the context of the present discussion, the upshot of this complex phrasing is that not only a German *Personengesellschaft*—including a limited partnership (as the term is used in the German Letter paraphrased above) or other formal type—is characterized under U.S. tax law as tax-transparent.[51] The flow-through status also applies to a standard (Ger-

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49. Treas. Reg. § 301.7701-2 (2014) (emphasis added). The many elisions are of material not relevant to this discussion.

50. Recall the introductory statement of the Letter:

> For the purposes of its German tax treatment, the limited liability company may be characterized either as an independent structure subject to the corporate income tax or as a partnership.

"Commentary" to Letter, *supra* note 24.

51. The German terminology typically speaks of three types of *Personengesellschaften* (in addition to the already mentioned *Personenhandelsgesellschaft*, *supra* text accompanying note 21); namely, the general partnership not necessarily for profit (*Gesellschaft bürgerlichen Rechts*), the commercial general partnership (*offene Handelsgesellschaft*), and

man) limited partnership, a *Kommanditgesellschaft*.[52] It even applies to a *Kommanditgesellschaft auf Aktien*—essentially a corporation but one with an individual or corporate[53] general partner, who, pursuant to a special provision in the German tax law, enjoys flow-through status (though the *KGaA* shareholders do not) despite the fact that depending on the entity's charter those shares may be sold or otherwise transferred. Most significantly, it applies to the traditional *GmbH*.

The *GmbH* often has been understood in the United States as the functional equivalent of the so-called "close corporation" (whether in its common law or statutory form), but that equivalency is misleading.[54] For many of these entities—even though in the aggregate they constitute only a small percentage of all so organized—centralized management, continuity of enterprise, and limited liability are the norm; only transferability of interests remains difficult to achieve. While in formal terms that characteristic is the default option under the German statute, it is there hedged with some significant constraints.[55] In practical terms, it usually is contractually limited at least in the case of the equivalent of the close corporation. Whether such limitations are absent or relaxed for the *GmbH* with large numbers of members, however, is an empirical question on which to the best of my knowledge reliable data are not available.[56] And be that as it may, this, in any event, is the only one of the four critical attributes whose associational status might be questionable.

In conclusion, it is the U.S. characterization that is categorical; the German characterization remains fact-intensive (albeit within a formal taxonomy of entity structures). That should not be a surprise. Federal law has completely abandoned the effort to hold the line on some ideal-typical basis of deserving versus undeserving flow-through benefits to passive in-

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the limited partnership, which, depending on the preferred typology, may include the limited partnership proper (the *Kommanditgesellschaft*), the special German entity known as the *Kommanditgesellschaft auf Aktien* [*KGaA*]) described immediately below, and the participation as silent partner in another's ownership of a commercial enterprise (*stille Gesellschaft/er*, *see* Lipp, *supra* note 14). Despite the partnership-like characterization of the *GmbH* created by negative inference in the cited IRC regulation, the German typology does not consider it to be part of this non-corporate set.

52. Since this is a type of *Personengesellschaft*.

53. That a corporation may be the general partner of a *KGaA* is a relatively recent concession, now embodied in Einkommensteuergesetz [Income Tax Statute], § 15(1), no. 3 (Ger.), *available at* http://www.gesetze-im-internet.de/.

54. For a succinct and clear overview of the German GmbH law, including a translation of its text, see MEISTER ET AL., THE GERMAN LIMITED LIABILITY COMPANY (7th ed. 2010).

55. *See* Act on companies with limited liability (Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG) of 20 April 1892 (Federal Law Gazette III 4123-1), as last amended by Article 27 of the Act of 23 July 2013 (Federal Law Gazette I p. 2586), § 15 (Ger.), *available at* http://www.gesetze-im-internet.de. This Act requires notarial confirmation of transfers. That, as well as the nature of the ownership instrument, makes both access to the primary capital markets and trading on the secondary markets infeasible.

56. The standard student text, CHRISTINE WINDBICHLER, GESELLSCHAFTSRECHT 202 (22d ed. 2009), reports that more than 1,000,000 exist. Thus, even if only as few as two percent of these are substantial and centrally managed enterprises, *see id.* at 206, that still represents a significant occupancy of the economy.

vestors in enterprises, whether these be classic holding companies or active operating companies. Some of the momentum for this sea of change came from policy considerations favoring certain sector-specific investments; some from political pressure barely hidden under policy arguments; some from the drag on stock market performance caused by the double taxation of corporate profits and dividends (though that itself has been reduced significantly in recent years); and some from difficulties of administration of rules increasingly out of sync with investment practices.

The fact that German, indeed general European, tax policy has not (yet) converged on the U.S. system also has underlying economic reasons.[57] German individual as well as institutional investors have not yet generated the high (i.e., U.S.) level of surplus savings prepared to enter these channels of investment directly through the second and especially the third pillar of retirement-driven investment vehicles. That was the case a quarter of a century ago[58] and remains, though to a diminishing extent, the case today. As a result, whatever other policy grounds may have existed to move the U.S. authorities away from the *Kintner* approach, the investor-driven demand for pass-through treatment has not reached the level at which German tax policy in this field needs reconsideration.

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57. This statement, and indeed this paragraph, need some qualification. Some states, largely of the UK and Commonwealth cohort, accept the U.S. grant of tax transparency to domestic entity forms other than the corporate one without recharacterizing these in the German manner. The following quotation illustrates this point:

> Australian domestic law starts with the presumption that corporate limited partnerships are the proper taxpayer rather than the partners in the partnership and that all "companies" are taxpayers in their own right. However, being aware that the United Kingdom treats the partners in limited partnerships as the taxpayer, Australia defers to the UK classification. Similarly, aware that the United States treats a company created as a limited liability company (LLC) as a partnership rather than as a company, Australia defers to the US classification.

Cooper, *supra* note 12 (citations omitted).

58. *See* Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1 (1991).