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Square Wheels: U.S. Pass-Through Taxation of Privately Held Enterprises in a Comparative Law Context

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I. INTRODUCTION

To an observer of current trends in the taxation of business enterprises in the United States, this symposium's consideration of enterprise structures in a comparative law context is particularly provocative. The United States is in the midst of a quiet revolution in the taxation of privately held businesses.¹ For decades, the United States has maintained a classical, two-tier tax system for corporations while much of the rest of the world moved toward integrated taxation of corporate distributions. Now, U.S. tax policy is promoting a much more radical alternative to the double tax:

¹ The term "privately held" as used in this article means a business that is not publicly traded within the meaning of Section 7704 of the Internal Revenue Code of 1986, as amended [hereinafter the Code or the I.R.C.]. Section 7704 defines a publicly traded interest as one that is traded on an established securities exchange or is readily tradeable on a secondary market. The term "privately held" as used in this article encompasses both businesses in which the principal equity owners are actively involved in management (conventionally referred to as closely held businesses) as well as businesses in which passive investors are a significant feature and management is centralized. See ROBERT W. HAMILTON, FUNDAMENTALS OF MODERN BUSINESS 342-43 (Little Brown and Co. 1989); HARM-JAN DE KLUVIER, Europe and the Private Company, An Introduction, in THE EUROPEAN PRIVATE COMPANY? 21, 23-24 (Harm-Jan De Kluvier & Walter Van Gerven eds., 1995).
pass-through taxation for all privately held enterprises, regardless of business form.

Changes in Treasury regulations and amendments to the Internal Revenue Code\(^2\) made in 1996 went very far toward establishing pass-through taxation as the norm for U.S. business entities that are not publicly traded, including most corporations and the new U.S. limited liability companies. The pass-through model treats the entity as transparent for tax purposes and taxes the equity owners directly on the income (and losses) of the enterprise.\(^3\) A survey of tax classification patterns in six of the transitional and emerging market countries represented in the symposium (Argentina, Hungary, Mexico, Romania, South Africa and South Korea) and in four major trading partner countries (France, Germany, Japan and the United Kingdom) suggests that the new emphasis in the United States on this business tax model is an unusual choice.

This article is a preliminary effort to locate the new norms in U.S. business taxation in the comparative law context. It focuses on the structural issue of entity classification, which is the traditional form in which the question of taxation of privately held businesses has been framed in the United States. While preliminary in nature, the findings from this comparative law survey are rather striking in light of the current trends in U.S. tax law.

In all but one of the countries surveyed, the pass-through model is seen to have quite a minor role structurally in the taxation of privately held business entities. Among the transitional and emerging market countries included in the symposium, pass-through taxation is only applied to business forms of marginal importance or narrowly restricted ownership, if it is used at all in the taxation of entities. In the four trading partner countries also surveyed, whose industrialized economies and mature tax systems are more comparable to the circumstances of the United States, a similar pattern is seen. With the exception of Germany, which does give pass-through taxation a broader role, in the other three mature tax systems pass-through taxation is again found to apply to a narrow range of business forms or on a restricted basis. In all ten of the countries, privately held limited liability companies and limited stock companies are treated as corporate taxpayers. The prevailing pattern in the taxation of privately held business entities in all the countries surveyed is not pass-through but corporate taxation. In most instances, the corporate tax is not a full double

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2. All references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

3. For a fuller description of pass-through taxation, see infra note 21 and accompanying text.
tax as it is in the United States, but is substantially integrated with shareholder taxation by one method or another.

The suggestion that the United States should look to other countries for models of law or economic policy may seem unusual. More typically, in recent years influence has flowed in the opposite direction, as transitional and emerging market countries have been presented with the experience of the United States (and other mature tax systems) and the advice and demands of the international monetary funds. But it is precisely because these countries are in the process of building tax systems and need to focus on the most fundamental questions of tax administration that their choices in entity taxation are interesting and instructive. The United Kingdom and Germany historically have been important reference points in the development of U.S. tax law. Along with Japan and France, they now are among the most significant participants in the global economy, within which the United States and its tax system function. Hence, even a limited comparative law survey of mature and developing tax systems can offer valuable insights for U.S. tax policy. It should give us some pause to find that on the question of the taxation of privately held entities, the systemic choices of all these countries converge on a model of entity taxation very different than our own.

For the past 35 years, U.S. business taxation has been marked by an expansion in the number and kinds of business forms classified and taxed on a pass-through model. In particular, the proliferation of partnership taxation (one of the methods of pass-through taxation used in the United States) to more business forms has been the result of self-help strategies by taxpayers rather than positive legislation. Yet, pass-through taxation has not been easy to manage within the federal income tax. Public and private tax shelter partnerships have been a persistent problem. Despite the

5. See discussion of integrated taxation infra notes 79-85 and accompanying text.
burgeoning of statutes and regulations intended to contain these excesses, concerns about compliance, tax avoidance and audit management have not abated. A staggering amount of complexity has followed pass-through taxation into U.S. tax law, burdening taxpayers and tax administrators to such an extent that it may impede compliance. Nevertheless, Congress has yet to revisit the fundamental premises of pass-through taxation and has permitted taxpayers to develop new business forms intended to extend its application. The Treasury regulations issued in 1996 at once consolidate and expand the reach of pass-through taxation.

The choices made in the tax systems of the countries surveyed here remind us that pass-through taxation is not the only alternative to a two-tier tax for privately held business entities. Integrated corporate tax systems are seen to fill much of the role that the United States now gives to pass-through taxation. While it may be heresy to question the expansion of pass-through taxation in view of the high regard in which it is held in income tax theory and its traditional place in U.S. tax law, the findings reported here suggest that an examination of the systemic value of its implementation in the United States is needed. Indeed, as the U.S. shift toward more universal utilization of pass-through tax models by privately held enterprises accelerates, more concerns about the partnership tax method of pass-through taxation are being raised. A reassessment of what pass-through taxation adds to the fairness and efficiency of the income tax is clearly overdue. The comparative law context poses both the question of the value of pass-through taxation and offers a different, perhaps simpler, and more balanced design as a possible answer.

This article is divided into three parts. The first section explores the question of how Heavy Duty II, the enterprise described in the symposium's Master Hypothetical, is likely to be taxed in the U.S. context. The second section presents the results of a brief survey of tax classification patterns in six of the countries represented in the symposium and four of the major trading partners of the United States. The third section offers some preliminary observations that can be drawn from this comparative law context.

II. THE U.S. CONTEXT

The case of Heavy Duty II arises at an important juncture in the evolution of U.S. business tax policy. Recent changes in tax law have pushed the federal income tax quite far down the road to making pass-through taxation the standard method of taxing privately held enterprises in all business forms. Business structure is no longer the primary factor in determining how a given enterprise will be taxed. The controlling issue
now is whether the equity ownership interests in the enterprise are publicly traded. If Heavy Duty II becomes a publicly traded entity at any point, it will be taxed as a corporation. If it remains privately held, Heavy Duty II and its owners are likely to be able to elect the generally more favorable pass-through method of taxation for the enterprise in whatever business form it may take.\(^8\)

For purposes of the analysis of U.S. taxation that follows, it is assumed that Heavy Duty II is a U.S. family owned and operated manufacturer of farm and construction equipment with gross revenues of $20 million per year and annual pre-tax earnings of $1 million, after paying appropriate salaries to all family members. Three generations of the family work in the business.\(^9\)

**A. Publicly Traded Enterprises**

With few exceptions, U.S. business entities that are publicly traded are treated as corporations in the federal income tax. The business form of the enterprise does not affect this tax classification. Business corporations, partnerships and limited liability companies alike are subject to the

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8. All unincorporated entities that have not made an election to be taxed as a corporation are classified as partnerships in accordance with Treasury Regulation sections 301.7701-2 and -3(a), issued in 1996. Treas. Reg. § 301.7701-2, -3(a). See infra notes 53-54 and accompanying text for the history of these regulations. Internal Revenue Code section 7704 (a) provides that partnerships that are publicly traded are to be treated as corporations. (This 1987 provision grandfather certain pre-existing partnerships and carves out an exception for passive investment vehicles). I.R.C. § 7704(a). Ordinary business corporations organized in the U.S. are classified as corporate taxpayers unless they elect Subchapter S treatment. Corporate taxpayers that have not made the S election are sometimes referred to as C corporations, the reference being to the Internal Revenue Code subchapter that generally governs their taxation. However, S corporations are also subject to subchapter C to the extent it is not inconsistent with Subchapter S. I.R.C. § 1371(a)(1). A corporation with more than 75 shareholders may not make or maintain a Subchapter S election. I.R.C. § 1361(b)(1)(A). It is assumed here that an entity whose equity interests are traded on an established securities exchange or readily tradable on a secondary market would have more than 75 equity owners. See Treas. Reg. § 301.7701-2; I.R.C. § 1361. A more extensive discussion of the limitations on the Subchapter S election can be found infra text accompanying notes 48-50, 55.

9. The discussion in this article of the taxation of Heavy Duty II and business entities in general is confined to the domestic context of each of the countries examined. Thus in describing the U.S. tax outcomes, it is assumed that Heavy Duty II is an enterprise organized in the U.S. and owned by U.S. persons. Questions of international tax law are beyond the scope of this article. In the U.S., the domestic tax context includes state and local taxation and a variety of federal taxes. The discussion of U.S. tax law in this article is limited to the federal income tax except as noted.
corporate tax if they are publicly traded. There are a handful of important exceptions to this general rule for some passive investment vehicles, including mutual funds and real estate investment trusts, but none of them will apply to a manufacturer such as Heavy Duty II.10 Public trading of equity interests in Heavy Duty II at any time will result in its classification as a corporate taxpayer. Public trading, for these purposes, means that equity interests in the business are traded on an established securities exchange or are readily tradable on a secondary market.11

Corporate taxation in the United States follows the classical corporate model.12 It is a two-tier tax. One level of tax is imposed on profits as they are earned at the enterprise level. When profits are distributed to equity owners who are individuals, the amount distributed is generally treated as ordinary income that is fully subject to tax in their hands.13 Economically, this tax on dividends is in effect a second tax on the earnings of the enterprise. But in the classical corporate tax model, the enterprise and its owners are regarded as separate taxpayers and hence each is seen as realizing income with respect to these earnings. The entity has income from its profits and the equity owner also realizes income from the distribution that she receives.

10. Specifically, these vehicles are the REITs (I.R.C. § 851), RICs (I.R.C. § 856) and REMICs (I.R.C. § 860 (A)-(G)). In general, their corporate level tax is eliminated to the extent they distribute profits to their investors. Although a narrow class of entities, they are significant participants in the capital markets. See Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 1.06, 1.08 [3] (6th ed. 1997). Analytically, the tax model applied to the RICs, REITs and REMICs is a form of integrated corporate taxation. Other exceptions to normal corporate taxation are made for cooperatives of different kinds under subchapter T of the Internal Revenue Code. See I.R.C. § 7704(c) for the general exception for publicly traded partnerships that are passive investment vehicles.


12. See Bittker & Eustice, supra note 10, ¶ 1.05 [1], 1.07 [2].

13. I.R.C. § 301; Bittker & Eustice, supra note 10. Tax on intercorporate dividends is reduced or eliminated depending on the percentage ownership in the shares of the distributing corporation. See I.R.C. § 243 and the consolidated return regulations.
The financial impact of the double tax on owners and enterprise can be seen in the following example. If Heavy Duty II were taxed as a corporation and it had $1,000 in profits available to distribute to its owners, it first would have to pay a tax of $350 on those profits, assuming the highest marginal corporate tax rate (35%) applied. After the enterprise level tax, $650 would remain available for distribution to the equity owners as a dividend. When they received this $650 distribution, they would include it in their individual incomes and an additional $257.40 in tax would be due from them, assuming the highest individual marginal tax rate (39.6%) applies. After tax, the equity owners would get to keep $392.60 of the $1,000 profit earned. Thus, in this example, an amount equal to 61% of the profits available for distribution to the owners is extracted by the federal income tax.

Many other tax consequences flow from the concept that the enterprise and its owners are separate taxpayers. Some of those consequences are discussed below in the comparisons of corporate and pass-through taxation. But the double tax on distributed profits is at once the central feature of the U.S. corporate tax and its primary flaw in the eyes of many economists, tax theorists, and business owners.

B. Privately Held Enterprises

If Heavy Duty II remains a privately held business, its owners will almost certainly choose for it to be taxed on a pass-through basis. New Treasury regulations issued in 1996 classify all unincorporated business entities as pass-throughs for tax purposes. Incorporated businesses that qualify may elect pass-through tax treatment in accordance with Subchapter

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14. For current tax rates, see I.R.C. §§ 1(individual), 11(corporate).

15. One issue not discussed below is the distinction between corporate and pass-through taxation in bankruptcy. Bankruptcy does not alter the status of the corporation as a taxpayer separate and apart from its owners, who remain insulated from tax liability at the entity level. Similarly, owners of pass-through taxpayers continue to be responsible for the income of the entity during bankruptcy as they are outside bankruptcy. See Gordon D. Henderson and Stuart J. Goldring, Failing and Failed Businesses § 1003 (1996).


17. See Treas. Reg. § 301.7701-3(a) and discussion supra note 8. The development of these regulations and prior law are discussed infra notes 52-59.
Thus, with very few constraints, pass-through taxation is applicable in one form or another to all types of business entities. As long as it is not publicly traded, Heavy Duty II should be able to claim pass-through tax status whether it incorporates, is organized as a partnership, or makes use of the new limited liability company business form.

Pass-through taxation is a fundamentally different conceptual model than the classical corporate tax regime and it can lead to dramatically different financial results for both enterprise and owners. In pass-through taxation, the entity is not regarded as a separate taxpayer. The income, gain and loss of the enterprise are taxed directly to the persons who own the entity. Most simply put, pass-through taxation is a one level tax, whereas corporate taxation is a two level tax.

One important distinction between the single tax and the corporate double tax in terms of financial outcome can be seen by comparing the tax treatment of distributed profits in both models. Assume Heavy Duty II earns the same profit of $1,000 as in the corporate tax example above but this time is taxed on a pass-through basis. If again the highest marginal individual tax rates apply, these profits would bear a tax of $396 and it would be paid directly by the owners of Heavy Duty II. No more tax is due on these profits even after they are distributed to the owners. After

19. The tax classification of trusts continues to be governed by Treasury Regulation section 301.7701-4. The taxation of trusts is a large subject that is outside the scope of this article.
21. Although the entity does not itself pay tax, in both partnership and Subchapter S forms of pass-through taxation, the existence of the entity is not entirely disregarded. Various tax elections must be made at the entity level and certain transactions between owners and enterprise will be respected for tax purposes, including loans and employment relationships. See Stephen Utz, Federal Income Taxation of Partners and Partnerships §§ 4.01-07, 7.19-20 (A.L.I. 3d ed. 1995). See also John K. McNulty, Federal Income Taxation of S Corporations ¶¶ 6.20-21 (1992).
22. Allocation of income to the owner increases the owner’s outside basis and losses, distribution of cash or other property reduces that basis. Distributions result in income only when they exceed outside basis. See I.R.C. §§ 1367, 1368 (concerning S corps), 705, 731 (concerning partnerships).
receiving the $1,000, a total of $604 would remain at the disposal of the owners. In the corporate tax example above, only $392.60 was left after federal income taxes were paid. The same $1,000 profit earned and distributed by a pass-through taxpayer yields about one-third more after tax funds than it did under the classical corporate tax regime.23

The flow through of losses is an equally important feature of pass-through taxation. When the owners of a pass-through entity are actively engaged in its trade or business as the Heavy Duty II owner/employees would be, they generally are permitted to use the net losses of the enterprise to offset their income from other sources. Passive investors are restricted by numerous matching and timing rules in their use of losses.24 The U.S. corporate income tax, which regards the corporate entity as a separate taxpayer, treats the losses of the enterprise as an asset or attribute of the entity and not of the equity holders.25 The corporate taxpayer can carry its losses forward or backward to reduce its own tax liability in other years, but the losses of the business as a general matter have no direct impact on the individual tax liability of the owners.26 Thus the owners of Heavy Duty II will find that there are significant differences between pass-through taxation and corporate taxation in both profit and loss years.

C. Some Fine Points

1. Partnership Taxation or Subchapter S

Putting tax consequences to one side, the two business forms that the owners of Heavy Duty II are most likely to consider for their enterprise are

23. However, it should be noted that in a pass-through system, the owner is liable for tax on the earnings whether or not they are distributed. The owners of a corporate taxpayer have tax liability for its earnings only when they are distributed. See infra note 40-47 and accompanying text, for a discussion of retained earnings.

24. In any given year, the flow through of losses to owners is limited by the tax basis that the owner has for his or her ownership interest in the entity. I.R.C. §§ 704(d) (basis limitation for pass-through of partnership losses), 1366(d) (Subchapter S loss limitations), 163(d) (limitation on deduction of investment interest), 465 (at risk limitations), 469 (passive activity loss limitations). See also McNulty, supra note 21, ¶ 6.10 - 6.18; TZ, supra note 21, § 6.01.


26. However, NOLS can have an impact on earnings and profits thereby reducing current taxable income from dividend distributions. See I.R.C. §§ 301, 312; see also BITTKER & EUSTICE, supra note 10, ¶ 5.03[4], 8.02.
the traditional business corporation and the new limited liability company.\textsuperscript{27}

Although both types of entities can be tax pass-throughs, incorporated and unincorporated entities ordinarily are taxed under two different sets of rules. If Heavy Duty II is organized as a limited liability company, it will be classified as a partnership and taxed in accordance with the Internal Revenue Code’s partnership tax rules.\textsuperscript{28} If instead Heavy Duty II takes the corporate business form, the Subchapter S pass-through tax regime will be applicable to it, assuming that it is qualified. A corporation engaged in manufacturing as Heavy Duty II is, would be eligible to elect Subchapter S treatment as long as it has 75 or fewer shareholders, only one class of stock, and its shares are not owned by any C corporations or nonresident aliens.\textsuperscript{29}

The partnership and Subchapter S versions of pass-through taxation are the same in concept but can be quite different in the details. Partnership tax rules are both more liberal and more complex in their treatment of losses, contributions, and distributions. In general, a partner can move assets in and out of a partnership without incurring a current tax, while for an S corporation, distribution of appreciated assets are taxable events and contributions can also be taxable.\textsuperscript{30} Also, within certain boundaries, the Internal Revenue Code permits partnerships to make special allocations of income and loss to achieve tax results that are at variance with the economic or non-tax financial sharing between partners. It is possible, for example, to allocate all of the depreciation deductions from a partnership’s real estate investment to one partner even when the partners share rental income on a pro rata basis.\textsuperscript{31}

\textsuperscript{27.} See generally Estreicher & Green, supra note 20.

\textsuperscript{28.} Treas. Reg. § 301.7701-3. The regulations permit unincorporated entities to elect to be treated as corporations, therefore, it is possible for a limited liability company to elect to be a corporate taxpayer and then elect Subchapter S treatment. When the corporate business form is used, the entity does not now have the option of electing partnership taxation without liquidating and changing business form. But see supra note 33.

\textsuperscript{29.} I.R.C. § 1361. Certain types of corporations not relevant to a discussion of Heavy Duty II’s options are ineligible as well. See infra notes 30, 32, 33.

\textsuperscript{30.} For an overall discussion of the tax characteristics of an S corporation, see McNulty, supra note 21, ¶¶ 3.01-.02, 4.01,6.01-.24. For the differences between S corporation taxation and partnership taxation, see id. ¶¶ 10.01-.20. The greater liberality of partnership taxation in the flow through of losses rests largely on the treatment of entity level debt. For a discussion of the partnership basis adjustment provisions, see Utz supra note 21, §§ 5.01-.07.

\textsuperscript{31.} Internal Revenue Code section 704(b) imposes the requirement that special allocations have substantial economic effect but permits temporal shifting and item allocation as in the depreciation example so long as the rules for keeping the partners’
2. Earnings Stripping

If Heavy Duty II must use the corporate business form and cannot hold itself to the pared-down capital structure of Subchapter S, it still may be able to mitigate the impact of the corporate double tax. Two different techniques are used in practice to reduce the tax on distributed profits to a single level.

To the extent that a corporate taxpayer can distribute profits to its owners as salary and reduce its taxable income by the amount of the salary distribution, it can eliminate one level of tax on these earnings. This practice is known as zeroing-out. It is commonly used by owner-operated capital accounts are followed and there is some risk that partners will have to make up capital account deficits on liquidation. I.R.C. § 704(b). See, e.g., Treas.Reg. § 1.704-1(b)(5) Ex.(2); UTZ, supra note 21, §§ 6.01-.09 (Professor Utz points out that the requirement that special allocations have “substantial economic effect” by implication permits allocations that do not have “full economic effect” and indeed only satisfy the technical requirements of the regulations. Taxpayers typically see special allocations of losses as a means of obtaining an early return on their investment). See also Larson v. Commissioner, 66 T.C. 159, 163 (1976) (description of calculation of limited partners’ return on investment as including after tax value of losses).

32. Although Internal Revenue Code section 1361(b)(1)(D) restricts S corporations to pro rata distributions to shareholders, a limited amount of disproportionate allocation and variations in timing can be achieved through use of shareholder loans.

33. The possibility of extending partnership taxation to privately held corporations eligible to make the subchapter S election was raised by Assistant Secretary of Treasury Leslie Samuels in a letter to the House Ways and Means Committee in 1995 and has been proposed a number of times since then. In its study of the entity classification issue, the Joint Committee Staff report of April 8, 1997, suggested extending elective partnership taxation to business corporations as one of the responses that Congress might make to the 1996 entity classification regulations (the so-called “Check-the-Box” Regulations). See Joint Committee on Taxation, Review of Selected Entity Classification and Partnership Tax Issues 3, 27 (JCS-6-97) (Apr. 8, 1997).

34. See, e.g., BITTKER & EUSTICE, supra note 10, ¶ 1.03.
service businesses, such as lawyers or business consultants, which tend to distribute all profits at the end of each year in any event. The technique is also utilized by smaller family owned and operated enterprises. However, it does not work well when the shareholders include investors who do not perform services for the entity. When compensation is not reasonable in relation to services rendered and industry standards, the corporate tax deduction that eliminates the entity level tax is not assured. Industrial enterprises like Heavy Duty II that are capital intensive are constrained by this standard as well; when profits exceed reasonable salaries, it is not possible to treat the entire amount as compensation for personal services.

However, if the corporation's capital structure includes debt, earnings can be distributed as interest payments and hence removed from the corporate level tax. Interest paid by the corporate taxpayer on its notes or debentures is deductible by it. Dividend payments are not. If the Heavy Duty II family shareholders and any passive investors structure their investments in the new entity to include debt in the mix, they will have the necessary mechanism for this technique. However, for the payments to be treated as interest for tax purposes, the note holder generally must enforce its terms, including payment obligations for interest and principal and otherwise act in a commercially reasonable manner.

3. Retained Earnings

For an industrial enterprise like Heavy Duty II or a commercial business, earnings stripping of either kind can be problematic. Going concerns like these have capital plants and workforces that create ongoing

35. See Treas. Reg. § 162-7(a) (reasonableness standard for deduction for salaries paid).
36. Recent increases in social welfare payroll taxes in the U.S. that have added to the tax burden on salaries may be making this technique less attractive. In particular, effective January 1, 1994, the ceiling on Medicare contributions was removed and all earned income is now subject to a payroll tax of 2.9%. See I.R.C. §§ 3101(b), 3111(b), 3121(a); Omnibus Budget Reconciliation Act of 1993, § 13207(a)(1)(A)-(C), Pub. L. No. 103-66, 107 Stat. 312 (1993).
37. See I.R.C. §§ 163(a), (h)(1).
38. See BITTKER & EUSTICE, supra note 10, ¶ 4.01, for a discussion of the tax impact of debt and equity for the corporate issuer. See also TREASURY 1992, supra note 16, at 5-11, for a discussion of the distortions in investment behavior seen to be caused by the disparate treatment of debt and equity in corporate taxation.
39. See I.R.C. §§ 385, 163(i), (e)(5) (regarding limits on the use of high yield discount notes). See also BITTKER & EUSTICE, supra note 10, ¶¶ 4.01, 4.26.
needs for working capital and capital reinvestment. Retained earnings are an important source of this capital and for this reason it is unlikely that all of the net profits of Heavy Duty II would be available for distribution each year in any event. However, for a corporate taxpayer in the current federal income tax rate environment, deferring distributions of earnings can mitigate the impact of the double tax. But while retaining earnings to finance growth can have a beneficial impact on a corporate taxpayer, for a pass-through, retained earnings can be a problem.

In corporate taxation, as long as the profits are not distributed, the second or shareholder level of tax is deferred and only the entity level tax is imposed. Moreover, by retaining earnings instead of distributing them, the corporate taxpayer can transform dividends into capital gains which typically are taxed more lightly than ordinary income in the United States. Moreover, in some circumstances the capital gains tax on the appreciation in value arising from reinvestment within the entity can be further reduced or even eliminated.

If, for example, the family patriarch holds an equity interest in Heavy Duty II that has appreciated in value at

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40. The bias in favor of retained earnings is one of the flaws that economists traditionally have pointed to in the classical corporate two-tier tax. See discussion in TREASURY 1992, supra note 16. But Professor Warren has demonstrated that this bias is present only when corporate and capital gains rates are lower than individual rates. Warren, REPORTER'S STUDY, supra note 16, at 28-40. The corollary of this conclusion is that when corporate rates are higher than individual rates, there is an incentive to distribute earnings so that reinvestment will be taxed at a lower rate. Thus Heavy Duty II family members in lower tax brackets may prefer current distributions.

41. Publicly traded companies in the U.S. generally payout only a small fraction of their earnings as dividends and hence, are not as adverse to the classical corporate tax as one might expect. Part of the explanation for this reaction may be that managers prefer other types of tax preferences that reduce their effective corporate tax rates. See, e.g., Jennifer Arlen & Deborah M. Weiss, A Political Theory of Corporate Taxation, 105 YALE L.J. 325, 328 (1995). The corporate taxpayer that is most burdened by the double tax is the one that must distribute earnings in the form of dividends. For a privately held corporation, there is also the risk that earnings that are retained merely to defer tax and not for reinvestment in the business, may become subject to penalty taxes. See I.R.C. § 531. If earnings are retained and invested in passive assets like real estate, passive income can make the family owned corporation subject to the undistributed personal holding company income tax. I.R.C. § 541.

42. The Internal Revenue Code favors retained earnings of corporate taxpayers in other ways as well. For example, Internal Revenue Code section 1202 gives the shareholders of qualifying privately held C corporations a partial exemption from the already more favorable capital gains tax rates and the Heavy Duty II family may be able to take advantage of this provision. I.R.C. § 1202. Both C corporations and S corporations can make use of the corporate reorganization provision to defer gain recognition on disposition and hence defer tax on retained earnings even after disposition. I.R.C. § 368.
the time of his death, the capital gain for his heirs will be eliminated by operation of law when the basis for his equity interest is reset at fair market value as of the date of his death.\footnote{43. \textit{I.R.C.} § 1014.}

In both forms of pass-through taxation, the equity owners are directly taxed on retained earnings. For tax purposes, the income is theirs in the year earned even when distributions of profits are deferred.\footnote{44. However, retained earnings do not result in a subsequent capital gains tax for the owners of the pass-through as they do for the shareholders of a corporate taxpayers. The owner's basis for his equity interests is increased by the amount of current profit includable in his income and through this mechanism, a second (capital gains) tax on the retained earnings of the pass-through entity is eliminated. \textit{I.R.C.} §§ 705, 1367.}

The direct taxation of undistributed profits can be troublesome for two reasons. Typically in the United States, the highest corporate tax rate is lower than the higher range of individual tax rates. The individual owners pay tax on retained earnings of the pass-through at their higher individual tax rates. Currently, while the top individual rate is 39.6\%, the corporate tax rate on the first $10,000,000 of ordinary taxable income is only 34\%.\footnote{45. \textit{Compare I.R.C.} § 1, \textit{with I.R.C.} § 11. \textit{See supra} note 14.} At this level of income, the corporate taxpayer owes fifteen percent less than the individual does.

In addition to the unfavorable rate differential at the high end of the tables, the direct taxation of retained earnings in pass-through taxation presents another kind of problem. Having no direct obligation to the government to pay the tax on retained earnings, the pass-through entity will only become involved in funding this liability to the extent that its owners agree that its resources should be used for that purpose. The larger and more diverse the ownership and the more centralized the management, the more of a problem this decision can become. Even in a family group like that of Heavy Duty II, an identity of investment goals and tax profiles may not be found. The older generation may prefer to take nothing out of the business while younger family members prefer to see the enterprise fund their tax liabilities fully even if it must borrow to do so, or vice versa. The corporate tax structure creates an identity of tax liability with respect to retained earnings but it is an expensive solution because of the potential double tax on distributions.\footnote{46. Owners with different tax postures will have different views on the decision to retain earnings for reinvestment within the corporate taxpayer or to distribute profits, with lower bracket owners probably preferring more distributions which they can reinvest at their lower rates. But once the decision to reinvest rather than distribute has been made, only the corporate taxpayer has any liability for the tax on the retained earnings. \textit{See} Hideki Kanda & Saul Levmore, \textit{Taxes, Agency Costs, and the Price of Incorporation}, 77} On the other hand, pass-through taxation can...
result in a continuing need to reinvest in the business by using other financial resources to fund the tax on the profits of the enterprise if sufficient cash is not distributed.

Corporate tax is not always more burdensome than pass-through taxation as the discussion of earnings stripping and retained earnings demonstrates. But it is substantially more costly when earnings are to be distributed as dividends or the effective capital gains rate is substantial. On balance, Heavy Duty II and its owners will consider themselves fortunate to have been able to choose pass-through taxation for their business and avoid the corporate double tax.

D. U.S. Business Tax Policy

Prior to 1996, Heavy Duty II would have been much more constrained in its ability to make use of pass-through taxation. That year marked a watershed in the development of U.S. income tax policy toward business. The combined effects of the actions taken by Congress and Treasury in 1996 contributed very substantially to the establishment of pass-through taxation as the norm for privately held enterprises in all business forms in the United States. The opportunity that businesses like Heavy Duty II now have to avoid the two-tier corporate tax without giving up the features of business form and operating structure that they prefer is in large measure the result of the consolidation and expansion of pass-through taxation that occurred during 1996.

In the Tax Reform Act of 1996, Congress significantly reduced the operating restrictions and some of the ownership limitations on the use of Subchapter S, making the election for privately held business corporations more attractive and more widely available than ever before. The number of shareholders permitted was increased from 35 to 75.48 For the first

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47. Again the confluence of tax rates is critical to this conclusion but in the U.S. the corporate rates generally have been lower than the individual tax rates and capital gains have been taxed at even lower rates. Warren, REPORTER'S STUDY, supra note 16, at 30 & 39. The deferral of tax payments inherent in the realization requirement for capital gains taxation reduces the cost of the capital gains tax with the result that later realization means a lower effective tax rate and earlier realization results in a higher effective rate.

time, S corporations were permitted to have wholly-owned corporate subsidiaries and to be owned by other Subchapter S corporations.\footnote{I.R.C. § 1361(b)(3).} Restrictions on the issuance of debt to financial institutions were lifted and intergenerational transfers of ownership were made easier.\footnote{I.R.C. § 1361(c)(5) (institutional debt). See the discussion of intergenerational transfer issues in Sharp & Shaw, \textit{supra} note 48, at 21-24.}


These regulations have changed both the method and substance of tax classification for privately held U.S. business entities. The changes that these regulations effected give the pass-through model a more central role in the structure of business taxation than had been possible in the past. Although presented as an election, the new regulations classify all privately held business entities that do not use the nomenclature of incorporation (and have more than one equity holder) as partnerships for tax purposes. Unincorporated entities with a sole owner are treated as completely transparent for tax purposes.\footnote{Treas. Reg. §301.7701-3(a). The popular name “Check-the-Box regulations” derived from the Treasury proposal to make tax classification of unincorporated privately held entities an actual election for taxpayers rather than a choice implemented by drafting organizational documents to include or exclude the test attributes. \textit{I.R.S. Notice 95-14, supra} note 51. The regulations do not in fact require an election but instead by means of the default rule, classify all U.S. unincorporated entities with two or more owners as partnerships for tax purposes and at the same time permit them to elect corporate taxation if they choose. Sole owner unincorporated entities are treated as a “nothing” for tax purposes unless the owner elects corporate tax treatment. \textit{Treas. Reg. § 301.7701-3(a).}} The old classification regulations required that the business structure of each unincorporated entity be analyzed to determine whether it should be taxed as a corporation or as a partnership. When more corporate characteristics than partnership features were found,
the entity was classified as a corporate taxpayer. This result was thought to have been required by the Internal Revenue Code.

Businesses typically want to have some if not all of the structural features of the corporate business form—limited liability, continuity of entity life, free transferability of interests and centralized management—but do not want to be subject to the corporate double tax. The old regulations compelled taxpayers to compromise some of the corporate business form features that they wanted in order to obtain pass-through tax classification. But over the past twenty-five years, sophisticated taxpayers became increasingly adept and aggressive in crafting business structures that expanded partnership classification to entities that were functionally

53. The old entity classification regulations tested for four corporate characteristics: limited liability, continuity of life of the entity, free transferability of ownership interests, and centralized management. The regulations were weighted toward partnership classification because when they were issued in 1960, the IRS was trying to prevent doctors and lawyers from obtaining corporate tax status for the entities through which they conducted their professional practices. At that time, employees of corporations could participate in very generous tax-deferred pension plans while partners could not. Called the Kintner Plan regulations, they were issued on November 15, 1960 in the midst of this controversy. T.D.6503, 1960-2 C.B. 409. See William S. McKee, et al., Federal Income Taxation of Partnerships and Partners, ¶ 3.06 (2d abr. stud. ed. Supp. 1993).


55. The Subchapter S election has existed since 1958 but prior to the 1982 Subchapter S reforms, much more limiting operating and eligibility criteria applied. Only 10 shareholders were permitted, it was risky to issue debt, the pass-through rules were complex and there were line of business restrictions as well. See Bittker & Eustice, supra note 10, ¶ 6.01; Senate Comm. on Finance, Report on H.R. 6055 (September 29, 1982), excerpted in Subchapter S Revision Act of 1982, Law and Explanation ¶ 315 (CCH 1982). Even with the 1996 expansion of Subchapter S, there is a 75 shareholder limit. Tax law imposes no limit on the number of owners an entity classified as a partnership may have. Apparently it is not uncommon for entities classified as partnerships to have more than 250 members. Treasury has recently been working on legislation to allow it to better manage the audits of such large partnerships. Moreover, although since the 1996 amendments Subchapter S corporations may own C corporations, they still may not have C corporations as shareholders. Corporations of any kind may be members of partnerships as far as the Internal Revenue Code is concerned. See also the discussion of the differences between Subchapter S and partnership taxation supra notes 30-33 and accompanying text.
similar to corporations.\textsuperscript{56} The limited liability company was designed to manipulate the classification regulations in just that fashion.\textsuperscript{57}

Despite its general success, the process of drafting business structures around the restrictions in the old regulations was costly and uncertain.\textsuperscript{58} Moreover, some compromises in the design of business structures were still necessary. The 1996 entity classification regulations have resolved all of these tensions in favor of taxpayer choice on all issues. With very little qualification, the new regulations make pass-through taxation the standard method of taxing privately held enterprises. All partnerships, limited partnerships, limited liability companies, joint ventures, limited liability partnerships and co-partnerships are now classified as pass-through taxpayers without regard to the particular features of their individual business structures.

Indeed, if taxpayers and state legislatures were to create a new business form that exactly replicated the traditional corporate form but did not use the words "incorporate" or "corporation," under the new regulations these entities would be classified as partnerships.\textsuperscript{59} The idea

\textsuperscript{56} N.Y. S. B.A. Tax Sec., \textit{Report on the "Check-the-Box" Entity Classification System Proposed in Notice 95-14}, \textit{95 Tax Notes Today} 173-64 (Sept. 5, 1995) [hereinafter NYS Bar Report 1995]. The holding in the \textit{Larson} case that presence or absence of limited liability was no more weighty a factor than any of the other three, closely preceded the enactment of the first limited liability company statute in Wyoming. \textit{Larson}, 66 T.C. at 180.

\textsuperscript{57} The new U.S. LLC business form in large measure was the precipitating factor in the abandonment of traditional entity classification jurisprudence. The Internal Revenue Service (IRS) and Treasury took cognizance of the LLC in their 1995 proposal to transform entity classification policy, citing the IRS's own 1988 ruling on LLC classification as evidence of the ease with which LLCs and other entities it described as being "designed to provide limited liability protection to all members and to otherwise resemble corporations" were able to qualify for partnership classification. Notice 95-14, supra note 51, para. 4. In what can be described as a biofeedback loop, the U.S. LLC which was specifically designed to exploit the biases of the old entity classification regulations has undermined the entire system of entity classification in the eyes of many and led to its demise.

\textsuperscript{58} Notice 95-14 adverts to the time and resources that taxpayers and IRS expended in classifying entities under the old regulations. Mention is also made of the possible disadvantage that the old regulations imposed upon small unincorporated organizations that lacked "sufficient resources and expertise to apply the current classification regulations to achieve the tax classification they desire." Notice 95-14, 1995-2 C.B. 297. The extent of uncertainty, and hence the hurdle that the old regulations posed for selecting tax classification can be gauged to some extent by the list of unresolved issues included in the NYS Bar 1995 Report. NYS Bar Report 1995, supra note 56, at 20-21.

\textsuperscript{59} The report of the New York State Bar Association Tax Section, submitted to the Treasury on August 23, 1996, noted that the determination of whether an entity was
that state legislatures might reinvent the business corporation under another name to give constituents a tax advantage is not without precedent. Within less than ten years of the first ruling from the Internal Revenue Service confirming that the limited liability company had the potential to be a pass-through taxpayer, all 50 states had adopted limited liability company statutes. But even without a new corporate clone business form, it seems likely that partnership taxation will increasingly dominate the taxation of privately held entities as the U.S. limited liability company develops and its use spreads.

The authority of the Treasury to change entity classification law in this manner has been questioned by the staff of the Congressional Joint Committee on Taxation. Self-described as a "Simplification of Entity Classification Rules," these regulations clearly have a significant

incorporated now will depend entirely upon the language used in the statute authorizing it, seeming to leave to state legislatures the choice of which domestic entities will be classified as corporations in all events. N.Y. S. B.A. Tax Sec., Report on the Proposed "Check-the-Box" Regulation, 96 TAX NOTES TODAY 169-22 (Aug. 23, 1996) [hereinafter NYS Bar Report 1996]. The regulations state that the term corporation means a business entity organized under a statute (federal or state) that "describes or refers to the entity as incorporated or as a corporation, body corporate or joint stock company." Insurance companies and certain banks and state owned bodies are also denied the privilege of elective classification. Treas. Reg. § 301.7701-2(b). A switch to English corporate law nomenclature, which might be readily made, apparently would change the tax classification result. English corporations are called "limited companies." See infra note 111.

60. See RIBSTEIN & KEATINGE, supra note 20, § 1.06.

61. The U.S. LLC was rapidly gaining a wide following even before the "Check-the-Box" regulations were proposed. The Internal Revenue Service reports that for the 1994 tax year, there was an increase of 176% in the number of LLCs filing tax returns as compared to 1993. Only 17,335 LLC returns were reported for 1993, while 47,816 were filed in 1994. In the same year, there was an increase of 272.6% in the number of taxpayers reported as members of LLCs. SOI reports 84,000 members of LLCs in 1993 and 313,000 for 1994. Timothy D. Wheeler, Partnership Returns, 1994, I.R.S. STAT. OF INCOME BULL.76, 77, Fig. E. (1996). Since Treasury made its "Check-the-Box" proposal in January 1995, the use of LLCs has grown even more rapidly. New York did not have an LLC statute until October 24, 1994, but 17,623 new LLCs were registered in the first 26 months after enactment. The Commonwealth of Massachusetts, one of the last states to adopt an LLC statute, registered 2,587 LLCs in the first 13 months after its January 1, 1996 effective date. (The information on LLC registration was obtained in telephone calls to the Offices of the Secretary of State of New York and of Massachusetts on February 17, 1997.)

62. Letter to practitioners from Joint Committee on Taxation Chief of Staff, Kenneth J. Kies. Kies Invites Experts to Discuss "Check-the-Box" Regs., 96 TAX NOTES TODAY 223-27 (Nov. 15, 1996); Joint Committee on Taxation Staff, supra note 33. See also Philip F. Postlewaite and John S. Pennell, JCT's Partnership Tax Proposals: "Houston, We Have a Problem," 97 TAX NOTES TODAY 144-66 (July 28, 1997).
substantive impact as well as a methodological one. Congress has yet to respond to the new regulations and did not move to counter them during the almost two years of public discussion of the proposal. Moreover, in view of the long history of Congressional acquiescence to the expansion of partnership taxation to new business forms, it is not very likely that Congress would reverse the trend at this point. The only alternative to pass-through taxation in current U.S. tax law is the two-tier corporate tax. It seems unlikely that Congress would want to be seen to be pushing privately held businesses back toward what they regard as an unpopular, burdensome, and economically irrational system.

Nonetheless, in the U.S. experience, partnership taxation at best has had only mixed results as a method of taxation. Despite endless discussion and voluminous regulations, it is complex to apply and troublesome to administer. In the era of public tax shelters in the 1970's and 1980's, abuses of partnership taxation became so notorious that they threatened the integrity of the income tax. Some of the more obvious problems have been addressed but at a cost of considerable systemic complexity. A whole host of provisions limiting the use of losses flowing through to passive investors were added to the Internal Revenue Code to try to contain the public tax shelter abuses. Currently, there is widespread concern about

63. Treas. Reg. § 301-7701-1. The check the box idea was widely discussed as a simplification of the method of entity classification because it eliminated the requirement of analyzing the characteristics of each unincorporated entity to test for corporate resemblance under the old four factor test. See, e.g., Susan Pace Hamill, The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classification Regulations, 73 WASH. U.L.Q. 565, 598-601 (1995). But the proposal was also understood to represent a more fundamental change. See Kurtz, supra note 11.


65. See id. at 215-22 (passive activity limitations), 255-57 (extension of at-risk rules to real estate), 262-70 (investment interest limitation), 1290-94 (tax shelter registration, penalties and interest), describing provisions added by the Tax Reform Act of 1986 and at-risk limitations added in 1976, 1978 and 1984. The present regulations governing special allocations of income and loss, which were another response to the era of public tax shelters, are absurdly complicated and difficult for taxpayers and the IRS to apply when faced with the endless variety of partnership interests that can be designed and negotiated. The ALI partnership treatise calls the Internal Revenue Code section 704(b) regulations “monstrously complex.” Utz, supra note 21, at 107-152 for overall description of the regulations. There are also inconsistencies with other provisions concerning special allocations. One instance of both inconsistency and continuing uncertainty is the application of these regulations to partnerships between tax exempt and non-tax exempt persons. Compare I.R.C. § 514(c)(9)(E), with Treas. Reg. § 704 -1.
the use of private tax shelters by corporations and very wealthy individuals to disguise sales of assets in which tens of millions of dollars in tax can be at stake in a given transaction. 66 These abuses apparently still flourish despite the adoption of an anti-abuse regulation in 1994, aimed at preventing the use of partnership tax rules to reach tax results so much at odds with economic results. 67

Some of the traditional outcomes of partnership taxation in the United States are also being criticized in the current round of partnership tax reform proposals. For example, both Treasury and academic tax policy theorists have suggested restricting the special allocation rules that permit partners to transfer tax losses among themselves as they choose. Nor is it clear what tax policy goals are served by this time honored practice, which largely survived the recently adopted anti-abuse regulations. 68 The

66. See, e.g., Allan Sloan, Sloan Looks at New Chandler Family Partnership with Times Mirror, 97 TAX NOTES TODAY 165-16 (Aug. 26, 1997) (press watch report of Washington Post story of swap of $475 million of Times Mirror stock for $249 million in cash and $226 million in real estate through a partnership resulting in the elimination or deferral of an estimated $75 million in tax). The discussion of the proposed partnership anti-abuse regulation, now Treasury Regulation section 1.701-2, focused on this problem to some extent. N.Y. S. B.A. Tax Sec., Report on Proposed Anti-Abuse Regulation, 94 TAX NOTES TODAY 130-34 (July 6, 1994). See Utz, supra note 21, at 164-72, 177-83, for a description of the range of planning choices for asset basis adjustment that can be used to defer gain when assets are exchanged through partnerships. The debate between Mark P. Gergen and John P. Steines, Jr. at the 1991 NYU Colloquium on Partnership Taxation over the need for changes in the regulations that govern some of the more basic issues in the taxation of partnership asset contribution and distribution indicates some of the problems of applying the already complex statutory rules and interpretive regulations. Mark P. Gergen, Reforming Subchapter K: Contributions and Distributions, 47 TAX L. REV. 173; John P. Steines, Jr., Unneeded Reform, 47 TAX L. REV. 239 (1991). See also the discussion of the "hot asset" or "mixing bowl" problem in William D. Andrews, Inside Basis Allocations and Hot Asset Exchanges in Partnership Distributions, 47 TAX L. REV. 3 (1991); Noel B. Cunningham, Needed Reform: Tending the Sick Rose, 47 TAX L. REV. 77 (1991). More recently, Joint Committee Staff included proposals to alter the statutory scheme that allows the mixing bowl result. Joint Committee on Taxation, supra note 33.

67. In the course of the debate over the adoption of the anti-abuse regulations, a number of partnership tax experts, including the principal author of the special allocation regulations, maintained on the basis on the legislative history of subchapter K of the I.R.C., that U.S. partnership tax rules historically were not intended to keep tax results consistent with economic results. Lee A. Shepard, Partnership Anti-Abuse Rule—Dirty Minds Meet Mrs. Gregory, 94 TAX NOTES TODAY 141-5 (July 21, 1994). This is anomalous with the view of tax theory that pass-through taxation most accurately reflects economic income and illustrates how important the actual implementation of any model of taxation is in assessing its systemic value.

68. Professor Berger raises fundamental questions about the benefits of special allocations and current rules enhancing loss flow through, suggesting that partnership
problems of compliance and administration of partnership taxation seem to be becoming more burdensome as the size of entities taxed as partnerships increases again. Congress is now considering proposals to redesign and simplify the pass-through of income to partners in entities with more than 100 members. New audit rules for large partnership are also proposed to give the Internal Revenue Service more control in managing the collection problems inherent in pass-through taxation: all of the partners must be pursued to collect the tax on the profits of an enterprise that is taxed on a pass-through basis.69

The staff of the Joint Committee on Taxation in Congress recently expressed the concern that partnership tax law has not kept pace with the increasing sophistication of taxpayers and is not equal to the task of dealing appropriately with the growing numbers of entities expected to choose partnership taxation in the wake of the new entity classification regulations.70 These fears seem to be well founded. Although the model of pass-through taxation in theory should result in a more accurate measure of income, in practice in the United States, it seems to be very distant from this ideal. It is difficult to view the beginning of this new era of business taxation—in which pass-through taxation is to have such a central role—without concern.

III. The Comparative Law Context

The new norms in the taxation of privately held businesses in the federal income tax represent a significant structural shift toward pass-through taxation in general and partnership taxation in particular in the United States. The symposium presented an unusual opportunity to think about these developments in United States business tax policy in a comparative law context.

69. These proposals were enacted in July 1997 as part of Taxpayer Relief Act of 1997, P.L. 105-34, § 1061, 1062(b)(3), 1063 & 1221(a). There are now different rules for large partnerships as well as small partnerships. I.R.C. § 6231. Distinctions are also made based upon line of business and owner involvement in the activity of the entity.

70. Kies Letter, supra note 62; Joint Committee on Taxation, supra note 33.
The symposium's corporate law panel discussions included a consideration of the future of Heavy Duty II as a privately held enterprise as well as its prospects as a publicly traded entity. For all of the panel countries with domestic public capital markets, it was noted that a publicly traded Heavy Duty II would be classified as a corporation for income tax purposes. For all four of these countries it was also reported that Heavy Duty II would be a corporate taxpayer in a system that followed an integrated corporate tax model of some kind with respect to dividends instead of imposing the full double tax on distributions seen in the classical two-tier corporate tax model used in the United States. The prevalence of integrated taxation among the panel countries was not surprising. The continued adherence of the United States to the classical corporate tax in the face of the movement toward integration in the taxation of corporations in many other tax systems has been the subject of much discussion and criticism in this country.

However, the reports of the panelists on the taxation of Heavy Duty II as a privately held business were unexpected. Panelists indicated that even as a privately held limited liability company, in their countries, Heavy Duty II would be treated as a corporation for income tax purposes. This was particularly surprising because the conventional view that the new U.S.

71. The panel presentation on the Peoples Republic of China focused primarily on structures for in-bound foreign investment. Detailed information concerning business forms and taxation entirely within the domestic sphere (which operates under a different set of laws than those applicable to foreign investors) in China was not available to the author. For this reason it has not been possible to include the PRC domestic tax system in this discussion.


73. Argentina adopted a tax reform measure that changed its tax law on this point a few months after the symposium. See infra notes 101-102 and accompanying text.
limited liability company was to some degree modeled on the limitada might be thought to imply that such entities are also pass-through taxpayers within their own systems. This turned out not to be the case. Moreover, pass-through taxation did not seem to be a possibility for a privately held industrial or commercial enterprise like Heavy Duty II in any of the business forms that were suitable for it. From the perspective of U.S. taxation, these comments raised intriguing questions about structural choices in business tax policy. The first issue was to try to determine what role the pass-through model, now so strongly favored in the United States, has in the taxation of privately held entities in the other countries.

Using the reports of both the bankruptcy and corporate law panels on taxation of Heavy Duty I and II in their respective countries as the starting point and secondary research for further elucidation, a brief survey has been compiled of tax classification of business entities in ten countries. The core group in the survey was made up of the six panel countries: Argentina, Hungary, Mexico, Romania, South Africa, and South Korea. Four other countries with mature tax systems—Germany, France, Japan and the United Kingdom—were added to the core group of developing and transitional market countries to provide an additional reference point. These four countries were chosen for two reasons. All four are fully

74. See, e.g., UTZ, supra note 21; Sanford J. Liebschutz, Introduction to Limited Liability Companies and Limited Liability Partnerships, in THE NEW LIMITED LIABILITY COMPANY AND LIMITED LIABILITY PARTNERSHIP LAW, N.Y. S. Bar Ass'n CLE program (Oct. 1995). Professor Carney argues that the English joint stock company is the pre-existing business form closest to the U.S. LLC. William J. Carney, Limited Liability Companies: Origins and Antecedents, 66 COLO. L. REV. 855, 857 (1995). If he is correct, the U.S. LLC may be a corporation within the meaning of Internal Revenue Code section 7704(a)(3). However, it is widely reported that the first U.S. LLC statute, adopted in Wyoming, was proposed at the request of the Hamilton Brothers Oil Company and was to some extent modeled on the Panamanian sociedad de responsabilidad limitada, a business form with which they were familiar from prior use. See Dale A. Osterle, Subcurrents in LLC Statutes: Limiting the Discretion of State Courts to Restructure the Internal Affairs of Small Business, 66 COLO. L. REV. 881, 882 (1995). At least currently, the limitada business form is taxed as a corporation in Panama. DELOITTE AND TOUCHE LLP, TAXES IN CENTRAL AND SOUTH AMERICA § 10.10, available in LEXIS, albeit within an integrated corporate tax system, as it is throughout Latin and South America. See Syllas Tozzini & José Luis de Salles Freire, Business Operations In Brazil, 954 Tax Mgmt. (BNA) A-8 to -9 (1992); Nicasio Del Castillo et al., Business Operations In Venezuela, 993 Tax Mgmt. (BNA) A-52 (1995); DELOITTE AND TOUCHE LLP, supra, §§ 4.01 (Chile), 5.01 (Colombia), 6.01 (Costa Rica), 7.01 (Ecuador), 11.01 (Peru), 12.01 (Uruguay). Argentina and Mexico are discussed infra notes 76, 90-92, 98-104 and accompanying text.

75. It was assumed that Heavy Duty II would require such features as limited liability and centralized management in its business structure. See Estreicher & Green, supra note 20.
industrialized, major trading partners of the United States and are influential in both regional and global markets. Further, the French and German commercial and civil codes historically have been important sources of business law in Mexico, Argentina, Hungary, and Romania, and through Japan, for South Korea as well. The United Kingdom has been one of the major sources of law for South Africa as well as for the United States.

A. The Survey

The survey looked at a number of issues in connection with entity classification. The central problem was to identify the models of income taxation—classical corporate, pass-through, integrated corporate and variations—that apply to privately held businesses in the various countries and then to explore the structural patterns of taxation that result.


77. South African law is typically described as having preserved its Roman-Dutch character while being influenced by common law. SCHLESINGER, supra note 76, at 247, 317, 320.

78. The focus of this survey is somewhat narrow: income tax classification of business entities. To some extent this focus on income tax by itself, removes the question from the broader economic and policy context that gives it the most meaning. All businesses in all countries are subject to a broad array of taxes. Income tax is typically only one among a host of taxes including the various turnover taxes, VAT and other consumption taxes, asset and wealth taxes, payroll and social security taxes and ultimately, death taxes. The presence or absence of a capital gains tax is a key feature of business taxation and must be considered with the income tax to achieve a full understanding of the impact of a given method of business taxation. Although important to a complete understanding of the implications of any income tax problem, the impact of other taxes is beyond the scope of this inquiry.
The classical corporate tax model and pass-through taxation have been described and contrasted in the preceding discussion of the U.S. taxation of Heavy Duty II. But it is necessary to understand how integrated corporate taxation differs from both these models of business taxation to evaluate the significance of the findings of the survey. In all ten of the countries surveyed, the corporate tax regime is integrated at least to some extent.

In its broadest definition, an integrated corporate tax is a system in which one of the two levels of tax imposed on distributed corporate profits in the classical corporate tax model is eliminated or moderated. Generally, corporate and individual taxation are coordinated or integrated so that either the entity or the individual equity owner, but not both, pay tax on the profits that are distributed. In some instances, a lesser degree of integration is achieved by reducing one of the two tiers of tax rather than eliminating it completely.

Although a number of approaches are discussed in the tax literature, two methods of integration are actually seen in practice: the shareholder credit and the dividend exclusion. Among the countries in the survey, Argentina, Hungary, Mexico, Romania, and South Africa, all use a dividend exclusion approach or, with similar effect, provide reduced tax rates on distributions from corporate taxpayers. In France, Germany, Japan, South Korea, and the United Kingdom, a shareholder credit system is used to integrate corporate and individual taxation. The impact of the shareholder credit method is very different from that of the dividend exclusion approach.

These two methods of integration have a common starting point. In both, the entity pays a corporate income tax on its profits on a current basis. If tax has not been paid at the entity level, a compensatory tax is typically imposed before the shareholder credit is given or the dividend is excluded. But this is not always the case. In Canada, the integrated tax for privately held companies that are Canadian

79. See Warren, supra note 72, for an authoritative source on the theory and methodology of integrated taxation. The view expressed in TREASURY 1992, that integration should be broadly understood as taxing business income once represents a somewhat different conceptual starting point than that generally seen in the economic and tax policy literature that urges the taxing of capital to its (individual) owners. TREASURY 1992, supra note 16, at 1. See, e.g., Deborah H. Schenk, Complete Integration in a Partial Integration World, 47 TAX L. REV. 697, 698-700 (1992).

80. Professor Warren notes seven different methods, including at least two in the first numbered item in his list. Warren, REPORTER'S STUDY, supra note 16, at 47-48; TREASURY 1992, supra note 16, introduction at x, develops two additional models, CBIT and the modified shareholder allocation method.

81. If tax has not been paid at the entity level, a compensatory tax is typically imposed before the shareholder credit is given or the dividend is excluded. But this is not always the case. In Canada, the integrated tax for privately held companies that are Canadian
equity owners, the tax burden on these profits shifts to the owners and the entity level tax previously paid becomes in effect a withholding tax on the distribution. 82 The equity owner will owe additional tax on the dividend if her individual tax rate is higher than the rate at which the entity paid tax and will likely get a refund if her personal rate is lower. 83

In contrast, in the dividend exclusion method of integration, the dividend is simply not included in the income of the equity holder. The dividend exclusion method leaves the liability for tax on distributed profits at the entity level where it is imposed at a uniform rate without reference to the marginal tax rate of the shareholder who receives the income distribution. 84 The same amount of tax is paid on the dividend (by the entity) whether the equity holder's other income is $10 or $10,000,000. The shareholder credit method reaches a different result. It is the equity owner's marginal tax rate or ability to pay that ultimately determines the amount of tax that will be due on the profits of the enterprise.

Thus the integrated corporate tax is similar to pass-through taxation in that it is a one-tier tax on distributed profits of the enterprise. Depending on the method chosen, an integrated corporate tax may resemble pass-through taxation even more closely. The shareholder credit method of integration generally taxes distributed profits at the individual tax rates of the equity owners, in much the same way they would be taxed on those profits on the pass-through model. But integrated corporate taxation differs from pass-through in important respects. In an integrated corporate tax, the entity is still generally regarded as a separate taxpayer and neither losses owned, extends the shareholder credit even when no corporate level tax is due on the distributed profits. See AULT, supra note 72, at 289.

82. Warren, REPORTER'S STUDY, supra note 16, at 50.

83. Comparing this result to the example in the preceding section of the impact of the classical corporate tax, a total of $396 would be payable upon the $1,000 of corporate profits available for distribution using a shareholder credit approach instead of the $604 due in the two tier tax. The $396 would be collected as follows. The $350 initially paid by the entity would be credited against the equity holders' individual tax liability. But, assuming the equity holder pays tax at the (highest) 39.6% marginal tax rate, she would owe more tax. She receives $650 in cash but would be regarded as having received a dividend of $1,000 much as a wage earner is treated as having income equal to the sum of his take-home pay and the amount of tax withheld from the paycheck. Hence the equity owner owes an additional $46 in tax on the distribution.

84. Warren, supra note 79, at 741-44. The use of a flat rate final withholding tax to reduce the shareholder level tax on dividends produces a similar outcome since the dividend income is not taxed at the equity holder's individual marginal rate but at an independently chosen fixed rate. For this reason, the flat rate final withholding systems of Hungary and Romania are treated as variants of the dividend exclusion method in the discussion infra notes 96-97, 105-06 and accompanying text.
nor retained earnings flow through to the equity owners as these items do in pass-through taxation. Losses generally remain with the enterprise in integrated corporate taxation.  

B. Summary

Overall, pass-through taxation has a very limited structural role in most of the tax systems surveyed. In five of the six symposium countries, virtually all business forms that a privately held enterprise may use are classified as corporate taxpayers. The few business structures that are taxed on a pass-through basis appear to be of limited application. In South Africa, the one panel country in which a broad range of partnership business forms are taxed on a pass-through basis, these entities generally are restricted to a rather small number of owners. The four trading partner countries present a more mixed picture. Japan follows the dominant pattern of tax classification seen in the panel countries. In France and the United Kingdom, pass-through taxation is applicable to a range of partnership forms but with substantial restrictions of different sorts. In the fourth of the trading partners, Germany, pass-through taxation has a larger structural role and there is one business form that provides both limited liability and pass-through taxation to all owners and can be publicly traded to some extent. Yet this pass-through entity does not appear to be the dominant business form even among privately held enterprises.

C. Findings

1. Public Trading as a Criteria for Tax Classification

In contrast to the current mode in tax law in the United States, public trading and private holding of ownership interests is not a direct criteria in
the tax classification process in any of the countries surveyed. In all the tax systems examined, tax classification of businesses ordinarily is based upon the business form used. The issue is determined on a generic basis for all taxpayers using a particular business form, without regard to individual characteristics of capital structure, ownership, or optional features of organizational structure.  

Typically, in the countries in the survey, authorizing statutes designate which business forms may be publicly traded and which are reserved for private ownership. This is sometimes accomplished by a direct authorization or a ban on issuing shares to the public and sometimes by means of a limit on the number of owners that is permitted. For the few business forms that may be used with both kinds of capital structures, public trading does not alter the normal tax classification. For example, whether an S.A. in Mexico is publicly traded or privately held, it will still be treated as a corporation for tax purposes. 

87. See AULT, supra note 72, at 289-92, for discussion of methods of tax classification outside the U.S. In some instances, the nature of activities carried on by the entity can lead to what amounts to a redesignation of the entity for tax and business law purposes. An example of this is seen in France where civil companies which by form would be classified as partnerships will be designated as corporate taxpayers if they engage in certain commercial activities. C.Gen.Imp.Art.206(1) (Editions Dalloz 1993). This is a classification based on activities, not attributes. See SIMÉON MOQUET BORDE, DOING BUSINESS IN FRANCE § 5.07 [1][c][ii] (Matthew Bender 1985). Similarly, in France, as in other countries, use of a business form for an activity that is not a business enterprise, such as a residential real estate cooperative, can result in reclassification by special exception. See Business Operations in France, 961 Tax Mgmt. (BNA) A-1, A-66 (1995); See infra note 124, for discussion of the role of limited liability in tax outcome.

88. South Africa authorizes a public limited company to issue shares to the public. Ch. V of Companies Act 61 of 1973 JSRA. English company law takes the same approach.

89. See DOING BUSINESS IN HUNGARY, supra note 76, at 87; see also Katherine Ashton & Dr. Zsuzsa Kovács, Corporate Development in Emerging Nations: Hungary, 17 N.Y.L. SCH. J. INT'L & COMP. L 329 (1997). Hungary prohibits the limited liability company form, the Kft from issuing interests to the public.

90. The limitada in Argentina is restricted to 50 owners. Dobson, supra note 76; see also Atchabahain, Business Operations in Argentina, 950 Tax Mgmt. (BNA) A-23 (1997).

91. Generally the joint stock company business form can be used either as a publicly traded company or as a privately held one. Another form that can be used either way is the limited partnership form that issues shares, called the societe en commandite par actions (KGaA in Germany) in the civil law countries. This entity is classified as a corporate taxpayer in Germany to the extent of the limited partnership interests and as a corporation in France. The form is reported to be rarely used. See BORDE, supra note 87, § 5.05[2][b]; STROBL, KILLIUS & VORBRUGG, BUSINESS LAW GUIDE TO GERMANY § 421 (CCH 1988).

92. The Sociedade Anonima (S.A.) is required to have at least two shareholders. PRICE
Similarly, the German limited partnership form known as the GmbH & Co. KG is taxed on a partnership basis whether it is privately held or publicly traded. This business form is the only one found in the survey that combined pass-through taxation with the potential for being publicly traded. All the other business forms noted in the survey that are classified as pass-through taxpayers appear to be ineligible to be publicly traded to any extent.

Only one example was found of an alternative tax classification becoming applicable on an elective basis to a particular business form as a result of voluntarily restricting the identity of owners, as is the case in the United States with the S corporation. In France, the SARL, which is one of the limited liability company business forms, may elect pass-through taxation if it engages in certain specified industrial activities and is owned by a family group.

2. Business Forms and Tax Classification

Having found that business form is the determinant of tax classification in the countries covered by the survey, the next question was which tax models applied to which business forms. The findings on this question are grouped as follows:

Group 1: Countries in which general partnerships are classified as corporate taxpayers.

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WATERHOUSE, DOING BUSINESS IN MEXICO 77 (1993). Minimum shareholder requirements are typical for joint stock companies. South Africa and South Korea both require at least seven shareholders. PRICE WATERHOUSE, DOING BUSINESS IN SOUTH AFRICA 85 (1990); PRICE WATERHOUSE, DOING BUSINESS IN SOUTH KOREA 66-67 (1992).


94. See supra note 91 and infra note 112 and accompanying text for a discussion of the KGaA and SCA which may be publicly traded and are pass-throughs as far as the general partner is concerned but not for the limited partners.

95. Société à Responsabilité Limitée. The French family SARL is only eligible for the partnership classification election so long as ownership remains within the family. However, reclassification back to the normal corporate taxpayer status in such a case is not a question of public trading because all SARLs are restricted to 50 shareholders. Business Operations in France, supra note 87, at A-15 to 16. The EURL (Entreprise Unipersonnelle à Responsabilité Limitée) which is the one owner limited liability company, is classified as a "nothing" or direct taxpayer and is permitted to elect corporate taxation. C.Gen.Imp. Art. 206(3), 239.
Group 2: Countries that classify general partnerships as pass-throughs and also tax some limited liability structures on a pass-through basis.

Group 3: A category of one country that does not fit either of these patterns.

Group 1

In five of the six symposium countries, Hungary, Romania, Argentina, Mexico, and South Korea, all of the major business forms are classified as corporate taxpayers. Included within this category are general and limited partnerships, joint ventures, joint stock companies, and limited liability companies. Sole proprietors are an important exception and are taxed directly. In these countries, the pass-through model is either not a feature of the business tax system at all or is applied only to business entities and arrangements with limited commercial usage.

Specifically, in Hungary all the recognized business forms are classified as corporate taxpayers. Romania takes almost as extreme an approach but recognizes a number of silent partnership business forms that are classified as pass-throughs. The only business form that is not taxed as a corporation in Mexico is the A. en P. or contract joint venture. The A. en P. is not recognized as a separate taxpayer and income and losses pass through to the managing venturer as well as the silent partners. Similarly, in South Korea all business forms except the contractual partnership (chop) are taxed as corporate taxpayers.

96. Ashton & Kovács, supra note 89. Gabriella Erods & Maria Veghelyi, Taxation and Investment in Hungary, § 5.1 (IBFD Eur. Tax’n, June 30, 1997). Sole proprietors are taxed directly and their activity seems to be referred to as “small private ventures” in the literature. See Ildiko Ekes, Hungary Plans to Introduce Amendments to Tax System, 12 TAX NOTES INT’L 2020, (June 24, 1996). The current tax rate structures in Hungary results in a lower overall tax on business profits of corporations than of sole proprietors even after distribution. See Daniel Deak & Richard Krever, Company and Shareholder Tax Reform in Hungary, 13 TAX NOTES INT’L 1811 (Nov. 25, 1996). It is on the basis of this outcome that the Hungarian corporate tax is included within the expansive definition of integration as a less than double tax.

97. Drd Ioan Condor, Taxation and Investment in Romania, §§ 4.2, 4.3.2 (IBFD Eur. Tax’n, June 16, 1997). See id. §§ 2.8.1, 2.8.2 for a discussion of the silent partnership and civil law business forms in Romania.

98. Although the A. en P. (association en participation) is not a juridical person, the silent partners (asociados) do not have general liability. Only the managing joint venturer (asociante) has liability to third parties. DOING BUSINESS IN MEXICO, supra note 92, at 84. Prior to the income tax regulations issued on January 31, 1997, the managing venturer was the only party with direct liability for the tax and had to look to contractual rights for reimbursement from the co-venturers. Mexico’s Income Tax Regulation, 97 TAX NOTES INT’L 21-25 (Jan. 31, 1997).
are corporate taxpayers. The _chap_ is a pass-through taxpayer like the A. en P.\textsuperscript{99} These various silent partnerships are more akin to financing arrangements than to active enterprises.\textsuperscript{100}

Although Argentina now follows the pattern seen in Mexico, Hungary, Romania and South Korea of treating all major business forms including partnerships and limited liability companies as corporate taxpayers, this is a very recent development. Until the tax reform enacted in September 1996, partnerships and the _limitada_ or limited liability company in Argentina were taxed on a pass-through basis. Argentina’s business tax policy was an exception to the prevailing pattern of taxation of limited liability companies in South America.\textsuperscript{101} The 1996 tax reforms reclassified a wide range of business forms, including general partnerships, as corporate taxpayers.\textsuperscript{102}

But, while all five of these countries classify their partnerships and limited liability companies as corporations, in none of them are the profits of corporate taxpayers subject to the full double tax of the classical corporate tax model. In each of the countries, a form of corporate tax integration eliminates or moderates one of the two levels of tax seen in the classical corporate tax regime. In Mexico\textsuperscript{103} and Argentina,\textsuperscript{104} the shareholder level tax is eliminated fully through the dividend exclusion method. In Romania\textsuperscript{105} and Hungary,\textsuperscript{106} the shareholders are taxed on

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\textsuperscript{99} Baskerville & Kim, _supra_ note 76, at A-9.

\textsuperscript{100} For example, the statutory definition of the A. en P. is “a contract whereby a person grants others that render him goods or services, a participation in the profits and losses of a mercantile business or in one of several commercial transactions.” _Mexico’s Income Tax Regulation, supra_ note 98.

\textsuperscript{101} See _supra_ note 74.

\textsuperscript{102} Dobson, _supra_ note 76. The category of business forms described as _sociedades de personas_ was reclassified as corporate taxpayers with effect for the tax years ending from September 27, 1996. Nicasio Del Castillo et al., _Tax Reform Law Approved in Argentina, 14 Tax Notes Int’l_ 269 (Jan. 27, 1997). See also _supra_ note 73.

\textsuperscript{103} If the amount distributed exceeds the distributing entity’s after tax net earnings, an equalization tax is imposed at the company level. _Doing Business In Mexico, supra_ note 92, at 139; Nicasio Del Castillo & Manuel F. Solano, _Business Operations In Mexico, 972 Tax Mgmt. (BNA) A6-A8_ (1995). From 1983 through 1988, a deduction for dividends paid was allowed the distributing entity and the dividends were taxed to the shareholder. But effective in 1989, the entity level tax relief for dividends paid was ended and the shareholder or owner level relief was substituted. _Id._

\textsuperscript{104} Del Castillo, _supra_ note 102, at 270; see also Atchabahian, _supra_ note 90, at A-37.

\textsuperscript{105} At present Romania provides some profits integration for distributions to individual shareholders in the form of a withholding tax at a flat (and reduced rate) on corporate dividends. The withholding tax is a final withholding tax, which means shareholders owe
dividends but at a reduced rate through the mechanism of a flat rate final withholding tax and a moderate amount of integration is achieved. Starting in 1991, South Korea began implementing an integrated tax using the shareholder credit method and since 1994 has kept the credit at the level necessary to achieve fully integrated taxation of dividends.107

Of the four trading partner countries, only Japan replicates the tax classification patterns seen in the symposium countries. In Japan, general partnerships, joint stock companies, limited partnerships and all other business entities recognized in the Japanese Commercial Code are taxed as corporations. There are some silent partnerships and contractual relationships that are not based upon the Commercial Code and these business forms are taxed on a pass-through basis. In practice, these pass-through structures are reported to be little used in Japan.108 The Japanese corporate tax is no longer a fully integrated tax but does provide some relief from the full burden of a double tax.109

Group 2
Two of the trading partner countries, Germany and the United Kingdom, and one of the panel countries, South Africa, fall into this group.

106. Hungary is in the midst of a corporate tax revision to try to make its corporate tax system more compatible with investment goals and tax credit concerns of foreign investors. If revised as recently proposed, the Hungarian corporate tax system would continue to favor incorporated as compared with sole proprietor status. Corporate taxpayers in Hungary pay lower taxes on distributed as well as undistributed profits than do sole traders. Deak & Krever, supra note 96. In Hungary, dividends paid to individual shareholders are subject to a flat, reduced rate final withholding tax that is creditable against other tax liability up to a fixed amount. DOING BUSINESS IN HUNGARY, supra note 76, at 140; Erods & Veghelyi, supra note 96, § 6.3(b). Since 1995 the corporate tax has been a split rate tax imposing a basic tax on profits when earned and a supplementary tax when profits are distributed. Erods & Veghelyi, supra note 96, §§ 5, 5.1; Maria Veghelyi, Moving Toward a New Corporate Tax System, (IBFD Eur. Tax’n., Apr. 1, 1995).

107. Baskerville & Kim, supra note 76, § VII. B.


109. Japan uses a shareholder credit and provides tax relief in the form of elective application of a final, reduced rate withholding tax. AULT, supra note 72, at 289; DELO ITTE AND TOUCHE LLP, supra note 108, §§ 15.03, 15.06. Prior to the 1987 tax reforms, Japan had a full shareholder credit system of corporate tax integration.
Of the three, pass-through taxation has the greatest structural role in the German system.

In South Africa, all of the company business forms are classified as corporate taxpayers, including unlimited liability companies. On the other hand, partnerships of all types, including general partnerships, joint ventures and three kinds of limited partnerships, are classified for taxation on a pass-through basis. However, the use of the various partnership forms is substantially restricted by the limitation on the number of partners that each may have. Commercial partnerships are restricted to a maximum of 20 partners. 110

This pattern is seen in the United Kingdom as well. There, the limited company form—both with and without the public trading election—is classified as a corporate taxpayer while general and limited partnerships are taxed on a pass-through basis. As in South Africa, the number of partners for both general and limited partnerships is held to 20. An exception is made in both countries for partnerships practicing law and other learned professions. Limited partnerships are not widely used. Only 3,600 limited partnerships were reported to be registered in the United Kingdom in recent years. 111

German tax law follows the classification pattern seen in the United Kingdom and South Africa but German business law does not impose the same stringent limitations on the use of partnership business forms. One of the limited partnership forms, discussed below, is particularly important and silent partnership arrangements of two different kinds are prevalent both as financing and tax shelter vehicles. All are treated as tax pass-throughs. 112

In Germany, the limited partnership with sole corporate general partner, called the GmbH & Co. KG, is a highly developed and widely used business form. 113 It has been accepted as a business form at least since 1922. 114 To a great extent it is viewed as the legal equivalent of the

110. DOING BUSINESS IN SOUTH AFRICA, supra note 92, at 136, 159, 199, 201.
111. DELOITE AND Touche, LLP, UNITED KINGDOM §§ 7.02, 8.04, available in LEXIS.
112. Business Operations in Germany, 962 Tax Mgmt. (BNA) A-12, A-13 to -38 (1995); Jorg-Ditrich Kramer, Taxation of Interest Paid By U.S. A typical Silent Partnership to a German Silent Partner, 12 TAX NOTES INT'L 385 (Feb. 5, 1996)(describing the typical and atypical silent partnerships structures); STROBL, supra note 91, at ¶ 421. But the KGaA, another limited partnership, is only taxed as a pass-through to the extent of the general partners' interests.
113. See infra note 116.
114. A 1922 decision of the German Supreme Court is cited as recognizing the GmbH
GmbH or limited liability company business form. The limited liability company is taxed as a corporation while the GmbH & Co. KG is a tax pass-through. Nonetheless, the GmbH & Co. KG runs very far behind the limited liability company in use.

All three countries have adopted an integrated corporate tax of some kind. South Africa gives shareholders a complete dividend exclusion. Germany achieves full integration through a shareholder credit. The United Kingdom provides a moderate amount of integration through its shareholder credit system, known as the ACT.

& Co KG as a business form in use. BUSINESS TRANSACTIONS IN GERMANY, supra note 93, § 22.05[1]. The limited partnership with sole corporate general partner is an adaptation that restricts general liability to whatever assets the corporation contains. This business form was used extensively in the United States in the tax shelters of the 1970's and 1980's. See, e.g., Larson, 66 T.C. 159.

115. For a discussion of the status of the GmbH & Co. KG in German commercial law, see Strobl, supra note 91, ¶ 420, (1988) referring to 1981 Commercial Code amendments. See also Heribert Hirte, The European Private Company: A German Perspective, in THE EUROPEAN PRIVATE COMPANY? 100 (Harm-Jan De Kluiver & Walter Van Gerven eds., 1995), discussing the German response to the extension of the Fourth Directive of the European Union, which established financial disclosure standards, in 90/605/EEC. There has been a protracted dispute with the European Union concerning the applicability of requirements for publication of financial accounts of businesses operating in the GmbH & Co. KG form on the grounds of its functional resemblance to the GmbH limited liability company form.

116. In 1991, the number of GmbH & Co. KG registered in Germany was approximately 93,000 as compared to about 372,000 regular GmbH's. For that year it is reported that there were 465,650 German GmbH's and 20% were sole general partners in a GmbH & Co KG. A total of 200,000 partnerships of all types, including GmbH & Co. KG were reported. Numerous commentators have referred to the GmbH & Co KG as a tax shelter vehicle and it is permitted to be publicly traded to some extent. Hirte, supra note 115, at 96-97, 100.

117. This exclusion in South Africa was extended to individual shareholders in 1990. DOING BUSINESS IN SOUTH AFRICA, supra note 92, at 130. The post-apartheid Katz Report recommended the continuation of this system and the split rate corporate tax which effectively reduces taxation on retained earnings as well. Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa, Commission of Inquiry Into Certain Aspects of the Tax Structure of South Africa Issues Intern Report, Dated December 9, 1994, 95 TAX NOTES INT'L 34-22 (Feb. 21, 1995) [hereinafter The Katz Report].

118. Business Operations in Germany, supra note 112, at A-24; The Taxation of Companies in Europe, ¶¶ 161, 662 (IBFD, October 1994). The Petersburg Tax Reform Proposal submitted by the German government's Tax Reform Committee would retain this system. See Eugen Bogenschütz, Germany Embarks on Sweeping Tax Reform Program, 14 TAX NOTES INT'L 655 (Feb. 24, 1997); See also AULT, supra note 72, at 287.

119. TREASURY 1992, supra note 16, app. B at 181. See also, AULT, supra note 72, at 288. Ault reports a residual corporate level tax of 16%. Id. at 353.
Group 3

France follows neither pattern. General partnerships are classified as pass-through taxpayers but most partnership forms are permitted to elect corporate tax status.120 Limited partnerships have a dual status, being treated as pass-throughs to the extent of the general partners' interests and as corporations to the extent of the interests of the limited partners. Silent partnerships also have this dual status.121 The joint stock company and all the limited liability company business forms are designated as corporate taxpayers.122 But family owned limited liability companies in certain industries are permitted to elect pass-through taxation.123

If there is a pattern in French entity classification, it is that corporate taxation follows limited liability through all business forms except when an alternative election is provided.124 In France, only general partners participate as pass-through taxpayers. Thus, structurally, the pass-through method of taxation should be regarded as available only on a very restricted basis. To complete the report on French entity classification, France has long had corporate tax integration through shareholder credits and currently has fully integrated the taxation of distributed profits.125

120. Business Operations in France, supra note 87, at A-33, -65, -66. Among the numerous business forms eligible to make this election are the general partnership (SNC), limited partnership (SCS), silent partnership (SP), civil companies and de facto companies. The EURL also is eligible to make this election. Other eligible entities include agricultural companies but real estate co-proprietors do not have this privilege. C.Gen.Imp., Arts. 206(3), 206(8), 239(modifie).

121. BORDE, supra note 87, § 5.10 [3][c].


123. An SARL that is engaged in industrial, commercial or crafts activities and is owned by a family group is eligible to make this election. Business Operations in France, supra note 87, at A-66; C.Gen.Imp. 239(3). This election became available in 1955 and seems similar in spirit to the S corporation election of similar vintage in the U.S. Both were added to a classical two-tier tax system to assist family owned businesses before corporate tax integration became the dominant trend that it is today. See JCS-16-95, II C. (Legislative Background); see also McNulty, supra note 21, at 1-2.

124. French tax law clearly has deviated from the classification method of treating juridical persons as separate taxpayers, which appears to be the approach in Germany, the United Kingdom and South Africa. Compare AULT, supra note 72, at 289 -92, with J. LE GALL, FRENCH COMPANY LAW 15, 18, 26, 28, 29 (Robert R. Pennington ed., 1974) (discussing separate legal personality of French business forms).

125. As of 1995, the French system of corporate tax integration through credits and imputation resulted in full integration, (i.e., no residual corporate tax on distributed profits). AULT, supra note 72, at 288. Only a moderate amount integration was found at the time of the Treasury study. TREASURY 1992, supra note 16, app. B at 167; Philippe Moisand & Frank Dierckx (revised by Gauthier Blanuet & M-A. Bouzoraa), The Taxation of
D. More Questions

This small survey does not provide enough data for broad statistical extrapolation nor enough detail to measure relative tax burdens. But if definitive conclusions cannot yet be drawn, some patterns seen in these findings merit comment and suggest further questions.

1. Patterns

The corporate tax model emerges as the dominant method of taxation of privately held entities in this structural survey, with pass-through taxation running a very distant second. There are clear indications that integrated corporate taxation serves as a substitute for pass-through taxation of privately held entities both in the group of emerging and transitional market countries and among the mature tax systems as well. Moreover, the pattern of limiting the structural role of pass-through taxation is seen both in countries with full corporate tax integration and countries with only partial integration.

Transitional and emerging market countries may be limiting the role of pass-through taxation because of the inherent complexity of implementation and the administrative burdens that it adds in comparison to entity level taxation. If tax on earnings of the enterprise must be collected from a myriad of owners rather than from the enterprise itself, more individual tax returns must be filed and more taxpayers pursued than if the entity were a corporate taxpayer. Building a culture of tax compliance is one of the central tasks faced by most transitional and emerging market countries in implementing their new tax systems and ease of collection and administration may be important priorities. For these reasons, one group of influential advisors suggests a tax code for transitional economies that both steers businesses away from pass-through taxation by keeping individual and integrated corporate tax rates in sync and limits the role of pass-through entities structurally by restricting it to enterprises owned by very small groups of natural persons. 126

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126. HUSSY & LUBICK, supra note 6, at vii-ix, 34-35 (section 12 of the Basic World Tax Code), 226, 264-65 (top individual tax rate of 30% and flat corporate tax rate of 30% with full advance corporate tax credit method of integration).
The limited use of pass-through taxation in the four trading partner countries may also reflect a decision to avoid the complexity and administrative burden of pass-through taxation.\textsuperscript{127} Yet the business tax systems of all four of these countries are highly developed and tolerate quite a lot of complexity. A perhaps more compelling explanation may be that when integrated corporate taxation is the alternative, there is little interest on the part of taxpayers in having a going concern taxed on a pass-through basis. Where pass-through taxation does not uniquely offer the advantage of a one-tier tax, it may have limited appeal.

The French corporate tax election for partnerships appears to support this hypothesis. At a minimum, the existence of this election suggests that when an integrated corporate tax is available, pass-through taxation is not always chosen by active businesses. The European Union (hereinafter "EU") advanced the idea of such an election a number of years ago and in 1994 recommended that its member states give sole proprietors and partnerships the choice of being treated as corporate taxpayers. In its program to develop small and medium sized businesses, the EU has concluded that the direct (or pass-through) taxation of retained earnings at progressive individual tax rates is a stumbling block for privately held businesses for which reinvested earnings are the principal source of capital.\textsuperscript{128} The implication of these elections seems to be that some businesses are willing to trade the possibility of a loss pass-through for the opportunity to defer a portion of the taxes on retained earnings.\textsuperscript{129}

\textsuperscript{127} To extent that pass-through taxation is used in these countries, the actual systems of pass-through taxation appear to be a good deal simpler than that seen in the U.S. at least in partnership taxation. \textit{See Ault, supra} note 72, at 354-66.


\textsuperscript{129} Germany, which has a fully integrated corporate tax system of long standing, also gives pass-through taxation the broadest role seen in any of the ten countries. This can perhaps be explained by history and chronology. The GmbH & Co. KG was already an entrenched business form for more than 40 years before Germany adopted an integrated corporate tax. It may have been difficult to dislodge it. But it is noteworthy that while it appears to be a well-used business form, the GmbH & Co. KG has not supplanted the GmbH, which is the corporate taxpayer business form that it so closely resembles. In the United States, there are nearly as many S corporations as there are C corporations. In Germany, the regular GmbH outnumbers the GmbH & Co. KG by four to one. The greater use of the GmbH in practice seems to support the theory advanced here that when a fully integrated corporate income tax is available, pass-through taxation is not necessarily preferred, especially by enterprises engaged in industrial and commercial businesses. As
Where the two-tier corporate tax is not a factor, entity taxation may also be preferred to pass-through by operating businesses in general because it simplifies decision making for the enterprise. Entity level taxation of retained earnings in effect insulates realization and reinvestment decisions from conflicts over taxation among the owners, who in pass-through regimes would be influenced by the impact of these decisions on their individual tax liabilities as well as the effect on the business. This separate tax identity thus reinforces the separate identity of the enterprise. From this point of view, the corporate models favored by the countries surveyed may appeal to business managers.130

2. Trends

The findings of this survey indicate that the structural role of pass-through taxation is much more limited in the tax systems surveyed than it now is in the United States and that it is not expanding in those other countries. There is some suggestion that its role may be shrinking.

The choices made in entity classification in the recently reconstructed tax systems in Hungary and Romania, two countries with transitional economies that were included in the symposium, are particularly interesting. In thinking about business law and business taxation, these countries have had the benefit of the advice and the examples of Western European systems as well as that of the United States. Their decision to avoid pass-through taxation for business entities is noteworthy. Likewise, the broad business tax reform enacted in Japan in 1987 did not enlarge the role of pass-through taxation in that country. The South African self-study of its business tax policy conducted in 1994 contained no indication that an expansion of pass-through taxation was even considered.131 Argentina, which put a business tax reform program in place in 1996, substituted its integrated corporate tax for the previous pass-through method applied to partnership and limited liability company business forms. The French creation of an election into corporate taxation for pass-through taxpayers suggests that there is interest in substituting an integrated corporate tax for pass-through taxation in French tax policy as well.
IV. SOME OBSERVATIONS

The emergence of pass-through taxation as the norm for privately held enterprises in the United States leaves U.S. business tax policy in a curious posture. From the point of view of avoiding the two-tier tax, U.S. treatment of privately held enterprises now more closely resembles taxation of such businesses in other countries. Most countries long ago moved away from the classical two-tier corporate tax model for businesses. The new entity classification regulations and expanded Subchapter S legislation of 1996 make it possible for virtually all privately held businesses to choose to be taxed on a single tier basis without resorting to the self-help techniques of the past. In this, the United States seems to have moved closer to its trading partners, new and old. Yet in the comparative law context, it is clear that the United States has chosen an unusual means to this end.

The United States is making a structural commitment to tax privately held businesses on the pass-through model at a time when other countries appear to be moving away from this approach to taxation. In September 1996, while the new regulations that classify the U.S. limited liability companies as partnerships were pending at the U.S. Treasury, Argentina enacted a tax reform that reclassified its partnerships and limited liability companies as corporate taxpayers. At least among the countries examined in the survey reported here, recent revisions and re-examinations of business taxation have produced systems in which pass-through taxation has a very minor structural role.

From a comparative law perspective, the structural choices made by the symposium and trading partner countries in their systems of business taxation demonstrate that the pass-through model is by no means the only answer to the question of how to design a one level tax for privately held entities. The integrated corporate tax model is the answer that many other countries have chosen. In recent years, the debate over an integrated corporate tax in the United States has focused on the question of whether it is preferable to the classical two-tier corporate tax. The economic inefficiencies and biases in the double tax have been well and thoroughly explored and the advantages of integration as a replacement for the classical system continue to be studied and weighed.132 The pattern of taxation of privately held entities reported in this survey suggests that integration should be re-examined from a different perspective: as a

132. For a discussion of these issues, see TREASURY 1992, supra note 16; Warren, REPORTER'S STUDY, supra note 16. See also Emil M. Sunley, Corporate Integration: An Economic Perspective, 47 TAX L. REV. 621 (1992).
potential solution to the widely observed problems with pass-through taxation in the U.S. experience.

U.S. business taxation has drifted toward the pass-through model in an unexamined way. For taxpayers the reasons seem plain enough. The existing partnership and Subchapter S tax methods have offered the only escape from the double tax of the traditional corporate tax regime. The lure of loss pass-through and tax shelters is clear as well. But from a systemic point of view, it is not such an obvious choice. Pass-through taxation clearly adds considerable complexity to U.S. tax law as well as multiplying collection issues. Some of the complexity comes from efforts to contain abuses, which still seem to flourish notwithstanding. Indeed, the thicket of regulatory responses to partnership tax problems is so dense that it may encourage further tax evasion; tax administrators cannot readily find even their own way through it.

But a great deal of the complexity of pass-through taxation is inherent in the idea of trying to equate the taxation of the many and varied participations in an entity with the tax treatment of direct ownership. U.S. partnership tax law may be an extreme example, but it illustrates the quandary of how far to take the concept of pass-through taxation once its premises are accepted, and how susceptible the pass-through model can be to tax avoidance schemes. While we may not be facing the task of creating a culture of tax compliance that transitional and emerging market countries have before them, the imperative to maintain an ethos of voluntary compliance remains central to U.S. tax policy goals. Any tax system that ignores the concerns of tax administration and compliance and tolerates abuses which undermine fairness, does so at its own peril.

The idea of an integrated corporate tax for privately held businesses in the United States is an attractive alternative for several reasons. Integration offers relief from the double tax on distributed profits, which seems to be the goal of much tax planning for entities. At the same

133. See AULT, supra note 72, at 355 for a discussion of partnership taxation in other mature tax systems.

134. Arguably, a defacto system of corporate tax integration for privately held corporations existed before the repeal of Internal Revenue Code section 337 in 1986. The earnings stripping techniques of distributing earnings to owner/operators as salary and interest payments eliminated the corporate level tax on current distributions and resulted in tax being paid by shareholders at their personal rates. Similarly, old section 337 allowed the sale of the business in liquidation to be taxed at the marginal rates of the shareholders and excused the corporation from tax on the transaction. For a discussion of the repeal of the General Utilities doctrine, see 1986 Blue Book, supra note 64, at 328-54. The same tax bill that ended this defacto integration also commissioned the review of corporate taxation that resulted in the 1992 Treasury study of formal integration.
time, an integrated corporate tax might well be simpler than the U.S. versions of pass-through taxation. 135 Difficult and contentious areas of U.S. tax law such as the inside and outside basis adjustment rules would no longer be necessary. 136 The need to regulate loss pass through would also be obviated. Losses do not flow through to owners in the typical integrated corporate tax. If loss pass through ceased to be a concern in U.S. tax law, numerous provisions of the Internal Revenue Code and voluminous regulations could be eliminated. With integrated taxation of privately held entities, substantial simplification of the Internal Revenue Code might become a more attainable goal. In this connection, one of the most interesting lessons from the comparative law survey is that so many business taxpayers in other countries are apparently willing to forgo loss pass-through in the taxation of privately held businesses.

The comparative law context suggests that U.S. tax policy toward privately held businesses is oddly configured. Pass-through taxation clearly was not chosen as the norm in the United States because it improves tax administration or, despite occasional protestations to the contrary, because of its perceived theoretical virtues. It represents instead a cumulative movement along a path of least political resistance. If pass-through taxation of closely held businesses has been permitted to grow to its present stature largely because it is popular with the taxpayers who directly benefit from it, a more considered justification should be required to raise it to the level of positive national tax policy. A thoughtful examination of its systemic benefits and costs is necessary. The Symposium has made clear that a consideration of the alternatives in use beyond our shores should form a part of this review.

Although it seems reluctant to do so, Congress should respond to the new entity classification regulations. The wiser course for Congress might well be for it to treat the new regulations as opening up the question of tax policy for privately held businesses rather than closing it off. An integrated corporate tax for privately held businesses is an alternative that should be given serious consideration. The reinvention of the taxation of

135. See Treasury 1992, supra note 16; Warren, Reporter's Study, supra note 16, on the issue of complexity of methods of integration and the host of issues, including streaming of dividends and preservation of corporate tax benefits that arise in an integrated system. See also Shuldiner, supra note 72, on the risks of adopting integration as a replacement for the classical corporate income tax.

136. The taxation of capital gains, which can be a deferred second-tier tax, is dealt with in the various integrated corporate tax systems in different ways, ranging from full taxation to complete exclusion. See supra note 68 for recent tax literature concerning various aspects of the basis issue.
privately held entities in the United States on the pass-through model may have left us with a square wheel and we could be in for an unnecessarily bumpy ride. Our neighbors in the global marketplace have shown us that there are other designs that we could be using.