Entity Classification Election Rules in Germany and Beyond: Necessary Tools to Achieve Neutrality of Legal Form or Invitation to Engage in Tax Avoidance?

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Tax systems worldwide differentiate between pass-through income taxation of transparent entities (especially partnerships) and corporate income taxation of opaque entities (corporations). Very recently, Germany introduced the possibility of certain pass-through entities being able to opt for taxation under the corporate tax regime. This form of breaking the dividing line between business tax regimes is already known, the US "check-the-box" regulations in particular being a prominent example of entity classification election rules. In Germany the election is presented as ensuring neutrality of legal form, but the US regulations are often portrayed as a tool for international tax avoidance.

This article evaluates the policy implications of entity classification election rules in light of the German example and identifies whether the German design can be a model for other jurisdictions. The analysis focuses on the pivotal points of the discussion on entity classification election, specifically neutrality of legal form and robustness to avoidance, together with their dimensions of fairness, efficiency, and simplicity. The analysis identifies entity classification election as a measure that has conceptual advantages over fundamental reforms and (other) small-scale means of aligning the business tax regimes. It is a legislative tool with distinct policy goals and its own scope of application in which it achieves necessary improvements provided its use is confined and coordinated domestically to prevent avoidance.

I. Introduction

More than 25 years ago the US introduced the "check-the-box" entity classification election regulations, which give many businesses a choice between pass-through taxation or the corporate tax regime.[1] In the words of Lawrence Lokken this "revolutionized the U.S. international tax practice".[2] The US entity classification election rules are infamous for furthering international tax avoidance and attracted public attention for instance through US Senate Subcommittee[3] hearings on offshore profit shifting by US multinationals. Empirical analyses suggest that the check-the-box regulations did indeed foster tax planning, namely through the use of hybrid entities;[4] and in the literature these issues were even linked to the recent disagreements between the EU and the US over the state aid decisions of the European Commission[5] concerning Ireland and Apple.[6] Despite all this Germany has introduced very recently the possibility of certain pass-through entities being able to opt for opaque taxation under the corporate tax

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[1] 61 Fed.Reg. 66,584 (18 December 1996).

[2] Lawrence Lokken, "Whatever Happened to Subpart F? U.S. CFC Legislation after the Check-the-Box Regulations" (2005) 7 *Florida Tax Review* 185, 196.

[3] See Senate Hearing 112-781 (2012); Senate Hearing 113-90 (2013).

[4] See, e.g. Rosanne Altshuler and Harry Grubert, "The Three Parties in the Race to the Bottom: Host Governments, Home Governments and Multinational Companies" (2005) 7 *Florida Tax Review* 153. See below Pts IV.A., IV.B.1., with further references. See also Michael P. Devereux and John Vella, "Are We Heading towards a Corporate Tax System Fit for the 21st Century?" (2014) 35 *Fiscal Studies* 449, 459–460.

[5] Commission Decision (EU) 2017/1283 of 30 August 2016 on State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) implemented by Ireland to Apple [2017] OJ L187/1. For further discussion, see below Pt IV.D.1.

[6] See Daniel Shaviro, "The EU-US Relationship in the Field of Income Taxation as Viewed from a US Perspective" (Ch.4) in Pasquale Pistone and Dennis Weber (eds), *The Implementation of Anti-BEPS Rules in the EU* (Amsterdam: IBFD, 2018). See below Pt IV.D.1.

regime from 2022 onwards and by doing so has created rules that were instantly labelled German "check-the-box" rules.[7] The German Government sees this as a means to strengthen medium-sized businesses (especially internationally) and argues that the option can achieve a "real neutrality of legal form".[8] But what is right? Are entity classification election rules a necessary tool to achieve neutrality of legal form or an invitation to engage in tax avoidance? This article approaches this question by conducting a policy examination of entity classification election rules, based on a catalogue of principles, with a focus on neutrality of legal form and robustness to tax avoidance. The article's starting point is the new German legislation, but it also draws general conclusions from the German example.

II. Subject of the analysis

A. Company law and company tax starting points

Tax systems worldwide often differentiate between pass-through income taxation of transparent entities (especially partnerships) and corporate income taxation of opaque entities (corporations).[9] Germany also follows this "dualism".[10] In German company law, a distinction can be made between partnerships and capital companies.[11] Capital companies are juridical persons; here the assets of the company are to be strictly distinguished from the assets of the members of these companies, and the members are not liable for company obligations.[12] Examples of capital companies are the limited liability company (*Gesellschaft mit beschränkter Haftung*) and the stock company (*Aktiengesellschaft*).[13] Partnerships, in contrast, are not juridical persons, even though they generally have the ability to bear rights and obligations.[14] Relevant examples of partnerships are the general partnership (*Offene Handelsgesellschaft*) and the limited partnership (*Kommanditgesellschaft*).[15] The basic form of partnership is the civil law partnership (*Gesellschaft bürgerlichen Rechts*).[16] One relevant conceptual difference between capital companies and partnerships is that the members of partnerships in principle are personally liable for company obligations; but this is limited for certain (limited) partners of limited

[7] See, e.g. Manuel Brühl and Martin Weiss, "'Check the Box' from good old Germany: Die Option zur Besteuerung als Körperschaft nach dem Entwurf des KöMoG" [2021] *Deutsches Steuerrecht* 889.

[8] See German Federal Ministry of Finance (BMF), press release, *Scholz will Wettbewerbsfähigkeit von Familienunternehmen stärken* (24 March 2021), *https://www.bundesfinanzministerium.de/Content/DE/Pressemitteilungen/Finanzpolitik/2021/03/2021-03-24-modernisierung-der-koerperschaftsteuer.html* [Accessed 27 November 2023]; Bundestagsdrucksache 19/28656 (2021), 15 (*"echte rechtsformneutrale Besteuerung"*).

[9] For an overview of different systems, see Hugh J. Ault, Brian J. Arnold and Graeme S. Cooper, *Comparative Income Taxation: A Structural Analysis*, 4th edn (Alphen aan den Rijn: Wolters Kluwer, 2020), pp.443–557. For the UK and the US as important examples, see Wooje Choi, "United States – Corporate Taxation" in IBFD, *Country Tax Guides* (1 October 2023), paras 1.1.3., 11.2.; Irene Martinez Curra, "United Kingdom – Corporate Taxation" in IBFD, Country Tax Guides (22 September 2023), paras 1.1., 11.2.

[10] Frank Balmes, "Rechtsformneutralität der Unternehmensbesteuerung" in Jürgen Pelka (ed.), *Unternehmenssteuerreform: DStJG Sonderband* (Cologne: Otto Schmidt, 2001), pp.26–28; Michael Fischer, "Der Regierungsentwurf eines Gesetzes zur Modernisierung des Körperschaftsteuerrechts" [2021] *Zeitschrift für Gesellschafts-, Unternehmens- und Steuerrecht* R144.

[11] For an overview of the German company law structure, see Holger Fleischer, "A Guide to German Company Law for International Lawyers" in Holger Fleischer, Jesper Lau Hansen and Wolf-Georg Ringe (eds), *German and Nordic Perspectives on Company Law and Capital Markets Law* (Tübingen: Mohr Siebeck, 2015), p.3. See also Ulrich Eisenhardt and Ulrich Wackerbarth, *Gesellschaftsrecht I. Recht der Personengesellschaften*, 17th edn (Heidelberg: CF Müller, 2022), paras 19–43.

[12] Eisenhardt and Wackerbarth, *Gesellschaftsrecht I. Recht der Personengesellschaften* (2022), para.33.

[13] See German Act on Limited Liability Companies (Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG) s.1; German Stock Corporation Act (Aktiengesetz, AktG) s.1.

[14] For an overview of differences of the types of companies, see Eisenhardt and Wackerbarth, *Gesellschaftsrecht I. Recht der Personengesellschaften* (2022), paras 19–43.

[15] See German Commercial Code (Handelsgesetzbuch, HGB) ss.105, 161.

[16] See German Civil Code (Bürgerliches Gesetzbuch, BGB) s.705. See also Eisenhardt and Wackerbarth, *Gesellschaftsrecht I. Recht der Personengesellschaften* (2022), para.21.

partnerships, and by installing a capital company as a fully liable (general) partner the personal liability can be minimised in such an organisation.[17]

German tax law builds on this company law differentiation.[18] Consequently, the general partnership, the limited partnership and other partnerships are taxed on a pass-through basis. The partnership itself is not subject to (corporate) income tax,[19] instead the partners are taxed on the profits within the income tax system (individual income taxation, or corporate income taxation for corporations as partners).[20] Individual partners, therefore, are treated similarly to sole proprietors.[21] Companies like the limited liability company and the stock company, on the other hand, are (in accordance with the company law principle of separation of assets) opaque for tax purposes and subject to corporate income tax; and the shareholders are subject to (corporate) income tax (only) when profits are distributed.[22] Currently, in light of developments especially through the Law to Modernise the Partnership Law (*Gesetz zur Modernisierung des Personengesellschaftsrechts*),[23] partnership law in Germany is in flux.[24] Nevertheless, in practice, the conceptual differentiation between partnerships and capital companies and the distinction between transparent and opaque taxation remains in place, notwithstanding theoretical discussions about the legal classification of partnerships.[25]

As in many other jurisdictions, however, rules exist to align the two regimes of business taxation.[26] On the one hand, efforts have been made to compensate for the economic double taxation in the corporate tax regime that arises from entity and shareholder level taxes and has been identified as a problem worldwide.[27] Relevant measures that have been taken in Germany include a relatively low corporate tax rate (compared to individual income tax rates) and lower shareholder taxes.[28] Corporate income taxation in Germany overall typically amounts to circa 30 per cent of the profits, taking into

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[17] See Eisenhardt and Wackerbarth, *Gesellschaftsrecht I. Recht der Personengesellschaften* (2022), paras 19–43, 508–522, 875–892.

[18] See Johanna Hey, "Rechtsformabhängige Unternehmensbesteuerung" (Ch.13) in Roman Seer et al (eds), *Tipke/Lang: Steuerrecht*, 24th edn (Cologne: Otto Schmidt, 2021), para.13.1.

[19] The partnership, however, is subject to trade tax; see German Trade Tax Law (Gewerbesteuergesetz, GewStG) s.5(1)(3). For further discussion in this context, see below fn.29.

[20] See especially German Income Tax Law (Einkommensteuergesetz, EStG) ss.1, 15(1)(1)(No.2); German Corporate Income Tax Law (Körperschaftsteuergesetz, KStG) ss.1, 8. For details, see Joachim Hennrichs, "Besteuerung von Mitunternehmerschaften" (Ch.10) in Roman Seer et al (eds), *Tipke/Lang: Steuerrecht*, 24th edn (Cologne: Otto Schmidt, 2021). See also Andreas Perdelwitz, "Germany – Individual Taxation" in IBFD, *Country Tax Guides* (1 October 2023), para.1.4.3.

[21] See Hey, "Rechtsformabhängige Unternehmensbesteuerung" (Ch.13) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), para.13.168.

[22] See EStG ss.1, 15, 20; KStG ss.1, 8. For details, see Johanna Hey, "Körperschaftsteuer" (Ch.11) in Roman Seer et al, (eds), *Tipke/Lang: Steuerrecht*, 24th edn (Cologne: Otto Schmidt, 2021). See also Andreas Perdelwitz, "Germany – Corporate Taxation" in IBFD, *Country Tax Guides* (1 October 2023), para.1.1.3.

[23] MoPeG, BGBl I 2021, 3436.

[24] For the objective of the law, see Bundestagsdrucksache 19/27635 (2021), 1–3.

[25] For an overview of respective discussions, see Hennrichs, "Besteuerung von Mitunternehmerschaften" (Ch.10) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), para.10.4. See also Sebastian Benz, "Mögliche steuerliche Auswirkungen des Gesetzes zur Modernisierung des Personengesellschaftsrechts (MoPeG)" in Thomas Rödder and Marcel Krumm (eds), *Steuerberater-Jahrbuch 2021/2022* (Cologne: Otto Schmidt, 2022), p.637; Roman Seer, "Mitunternehmerschaft im Einkommensteuerrecht – Bestandsaufnahme und Zukunft" [2023] *Steuer und Wirtschaft* 30.

[26] For a comparison of concepts internationally, see Johanna Hey and Heide Bauersfeld, "Die Besteuerung der Personen(handels)gesellschaften in den Mitgliedstaaten der Europäischen Union, der Schweiz und den USA" [2005] *Internationales Steuerrecht* 649.

[27] For the issue of economic double taxation, see Peter Harris, *Corporate Tax Law: Structure, Policy and Practice* (Cambridge: CUP, 2013), pp.230–250. See also below Pt III.B.1.

[28] For an overview, see Perdelwitz, "Germany – Individual Taxation" in IBFD, *Country Tax Guides* (1 October 2023), paras 1.7., 1.10; Perdelwitz, Germany – Corporate Taxation" in IBFD, *Country Tax Guides* (1 October 2023), para.6.1. For a comparative context, see Ault, Arnold and Cooper, *Comparative Income Taxation: A Structural Analysis* (2020), pp.445–453, 468–490, 528–539.

account corporate tax (*Körperschaftsteuer*), trade tax (*Gewerbesteuer*)[29] and solidarity surcharge (*Solidaritätszuschlag*).[30] Shareholders are taxed on the dividends within the income tax system (*Einkommensteuer*), either with a low flat tax of 25 per cent (generally for shares held privately; so-called *Abgeltungsteuer*),[31] or with the regular (progressive) income tax rate, applied to only 60 per cent of the dividends (especially for shares held in a business; so-called *Teileinkünfteverfahren*).[32] If applicable, the solidarity surcharge is added.[33] Corporations as shareholders are largely exempt from dividend taxation.[34]

On the other hand, profits are generally immediately attributed to partners (and sole proprietors) and in this context are subject to an income taxation of up to 45 per cent (top marginal individual income tax rate; plus solidarity surcharge if applicable).[35] Therefore disadvantages can be seen when a comparison is made with the accumulated profits of corporations; but here, too, certain accumulation rules try to equalise the effects.[36] Certain partners (and sole proprietors) can elect to be taxed under a special regime for retained profits with an initial income tax rate of only 28.25 per cent; later distributions then lead to an additional income tax of 25 per cent.[37] The details of the taxation of accumulated profits are complex, and, because of the limitations and special effects of the rules,[38] the special accumulation tax regime, which aims at equalising the tax burden of partnerships and capital companies,[39] has been criticised.[40] It is difficult to compare the tax burdens under different tax regimes

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[29] Corporations and partnerships are subject to trade tax; but partners are relieved (to a certain extent) from trade tax; see EStG s.35. The actual trade tax depends on the specific trade tax base and on the trade tax rate, which is determined by a combination of a uniform tax rate of 3.5% (*Steuermesszahl*) and a local trade tax rate set by the municipality (*Hebesatz*); see GewStG ss.7, 11, 14. At a local trade tax rate of 400% (the average lies in fact at 403% lately) the trade tax burden amounts to 14% and the overall corporate taxation in that case is close to 30%; see Destatis, press release, *Trade tax revenue at record high in 2021* (29 August 2022), *https://www.destatis.de/EN/Press/2022/08/PE21_362_713.html* [Accessed 27 November 2023]; Oliver Rode, "KStG § 23" in Peter Brandis and Bernd Heuermann (eds), *Ertragsteuerrecht*, 168th edn (Munich: Vahlen, 2023), para.46.

[30] See Rode, "KStG § 23" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), para.46. For the current discussion on the solidarity surcharge, see Klaus Lindberg, "SolZG § 1" in Peter Brandis and Bernd Heuermann (eds), *Ertragsteuerrecht*, 168th edn (Munich: Vahlen, 2023), paras 1a, 10–15. See also German Federal Fiscal Court (BFH), 17 January 2023, IX R 15/20, BFH/NV 2023, 339.

[31] EStG s.32d.

[32] EStG ss.3(No.40), 3c(2).

[33] For calculations of the tax burden, see Rode, "KStG § 23" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), paras 48–52.

[34] See KStG s.8b. See also GewStG ss.8(No.5), 9(No.2a), 9(No.7). For the remaining tax burden, see Rode, "KStG § 23" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), para.47.

[35] See EStG s.32a. For effects of trade tax not credited under EStG s.35, see Sebastian Benz and Tim Hannig, "Das Optionsmodell versus § 34a EStG" in Thomas Rödder and Marcel Krumm (eds), *Steuerberater-Jahrbuch 2020/2021* (Cologne: Otto Schmidt, 2021), pp.49, 56–57. For further discussion in this context, see above fn.29.

[36] For an overview, see Perdelwitz, "Germany – Individual Taxation" in IBFD, *Country Tax Guides* (1 October 2023), paras 1.4.1. For a comparative context, see Ault, Arnold and Cooper, *Comparative Income Taxation: A Structural Analysis* (2020), p.542.

[37] See EStG s.34a.

[38] See Eckart Ratschow, "EStG § 34a" in Peter Brandis and Bernd Heuermann (eds), *Ertragsteuerrecht*, 168th edn (Munich: Vahlen, 2023), para.5. See also Ulrich Niehus and Helmuth Wilke, "EStG § 34a" in Johanna Hey, Martin Klein and Michael Wendt (eds), *Herrmann/Heuer/Raupach: EStG/KStG*, 321st edn (Cologne: Otto Schmidt, 2023), para.3; Roland Wacker et al, "Zum Optionsmodell nach dem Gesetz zur Modernisierung des Körperschaftsteuerrechts: oder: eventus varios res nova semper habet" [2021] *Deutsches Steuerrecht DStR-Beihefter* 3, 4–5.

[39] See Bundestagsdrucksache 16/4841 (2007), 62.

[40] See Hennrichs, "Besteuerung von Mitunternehmerschaften" (Ch.10) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), para.10.224; Matthias Wackerbeck, "KStG § 1a" in Peter Brandis and Bernd Heuermann (eds), *Ertragsteuerrecht*, 168th edn (Munich: Vahlen, 2023), para.5. See also Benz and Hannig, "Das Optionsmodell versus § 34a EStG" in Rödder and Krumm (eds), *Steuerberater-Jahrbuch 2020/2021* (2021), pp.52–74; Niehus and Wilke, "EStG § 34a" in Hey, Klein and Wendt (eds), *Herrmann/Heuer/Raupach: EStG/KStG* (2023), para.3. Currently, developments are underway to make adjustments to this particular tax regime through the Growth Opportunities Act (*Wachstumschancengesetz*). For the legislative process, see Deutscher Bundestag, Vorgang,

because these burdens will depend on the various factors pertaining to individual cases;[41] but overall, the criticism of the dualism in business taxation remains.[42]

B. Introduction of the entity classification election rules in Germany

The creation of the new entity classification election rules in Germany must be considered in the context outlined above. These entity classification election rules have been introduced by the Law to Modernise the Corporate Tax Law (*Gesetz zur Modernisierung des Körperschaftsteuerrechts*)[43] and apply to tax years from 2022 onwards.[44] The way the new rules operate is that certain non-corporate entities can apply to be taxed under the corporate tax regime.[45]

Technically under the entity classification election rules in Germany, a change of legal form from a partnership to a corporation is assumed for income tax purposes, without the change of legal form actually taking effect for company law purposes.[46] Re-opting for partnership treatment is possible.[47] With recourse to the reorganisation rules on changes of legal form, the Law to Modernise the Corporate Tax Law allowed only certain partnerships (but not sole proprietors)[48] to exercise the option.[49] By electing to exercise this option, the partnership is treated as a corporation for income tax purposes (and is subject especially to corporate income tax and trade tax under the above-mentioned corporate tax regime)[50] and the partners are taxed as shareholders.[51] The election only has effect for income tax

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Wachstumschancengesetz, *https://dip.bundestag.de/vorgang/gesetz-zur-stärkung-von-wachstumschancen-investitionen-und-innovation-sowie-steuervereinfachung/303318* [Accessed 27 November 2023]; Bundestagsdrucksache 20/8628 (2023), 21–23, 125–126; Bundesratsdrucksache 588/23 (2023), 13–16. This does, however, not address all issues that are deemed problematic in practice; see Paul Forst and Joachim Schiffers, "Beratungspraxis Familienunternehmen – Neue Koordinaten zur Rechtsformwahl durch das Wachstumschancengesetz?" [2023] *Zeitschrift für Gesellschafts-, Unternehmens- und Steuerrecht* 966; Ursula Ley, "§ 34a EStG idF des Regierungsentwurfs eines Wachstumschancengesetzes" [2023] *Deutsches Steuerrecht* 2025. See also Martin Cordes and Marc Glatthar, "Reform der Thesaurierungsbegünstigung nach § 34a EStG und Anpassung des Optionsmodells – Entwurf eines Wachstumschancengesetzes" [2023] *FinanzRundschau* 681, 682–685; Ratschow, "EStG § 34a" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), para.6.

[41] Hey, "Rechtsformabhängige Unternehmensbesteuerung" (Ch.13) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), paras 13.19–13.23; Joachim Schiffers, Finanzausschuss Testimony (29 April 2021), 3, *www.bundestag.de/resource/blob/838324/8a0ea4b1e8ed0b6e7d2ff57666052be7/07-Schiffers-data.pdf* [Accessed 27 November 2023].

[42] For details, see Hey, "Rechtsformabhängige Unternehmensbesteuerung" (Ch.13) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), paras 13.1–13.187.

[43] KöMoG, BGBl I 2021, 2050.

[44] See KStG ss.1a, 34(1a).

[45] KStG s.1a(1).

[46] KStG s.1a(2).

[47] KStG s.1a(4).

[48] See René Feldgen, "KStG § 1a" in Harald Bott and Wolfgang Walter (eds), *Körperschaftsteuergesetz*, 172nd edn (Bonn: Stollfuß, 2023), para.28; Kai Tiede, "KStG § 1a" in Johanna Hey, Martin Klein and Michael Wendt (eds), *Herrmann/Heuer/Raupach: EStG/KStG*, 321st edn (Cologne: Otto Schmidt, 2023), para.20; Wackerbeck, "KStG § 1a" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), para.12.

[49] See German Transformation Tax Act (Umwandlungssteuergesetz, UmwStG) s.25; German Transformation Act (Umwandlungsgesetz, UmwG) ss.190, 191. For the recourse to reorganisation law, see Bundestagsdrucksache 19/28656 (2021), 21. For eligible partnerships and for current developments in that regard, see below Pt III.B.2.

[50] See KStG s.1(1)(No.1), GewStG s.2(8). See also Klaus-Dieter Drüen, "GewStG § 2" in Peter Brandis and Bernd Heuermann (eds), *Ertragsteuerrecht*, 168th edn (Munich: Vahlen, 2023), paras 370–372; Wackerbeck, "KStG § 1a" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), para.25.

[51] KStG ss.1a(1), 1a(3). See also GewStG s.2(8). For an overview, see Perdelwitz, "Germany – Corporate Taxation" in IBFD, *Country Tax Guides* (1 October 2023), paras 1.1.4., 11.2. For details, see, e.g. Christian Bochmann and Jan Bron, "Die nächste Stufe der Modernisierung des Personengesellschaftsrechts: Vom MoPeG zum KöMoG: Steuerliche Skizze und gesellschaftsrechtliche Einordnung" [2021] *Neue Zeitschrift für Gesellschaftsrecht* 613; Manuel Brühl and Martin Weiss, "Die Option zur Körperschaftsbesteuerung nach der endgültigen Fassung des KöMoG" [2021] *Deutsches Steuerrecht* 1617; Daniel Dreßler and Patrick Kompolsek, "Das Optionsmodell zur Besteuerung als Kapitalgesellschaft nach dem vom Bundestag beschlossenen KöMoG: Überblick, Einordnung, Vorteilhaftigkeitsüberlegungen" [2021] *Die Unternehmensbesteuerung* 301; Sebastian

purposes, but certain repercussions and complications have emerged in other tax fields in the context of the election, namely complications that concern real estate transfer tax (*Grunderwerbsteuer*) and inheritance and gift tax (*Erbschaft- und Schenkungsteuer*).[52]

C. Research question and research framework

This article takes the recent introduction of the entity classification election rules in Germany as its starting point for a policy analysis. The objective is to evaluate the entity classification election rules in light of the German example, and to understand whether aspects of the German design can be a model for other jurisdictions. Furthermore, the analysis extends the view to the US check-the-box regulations,[53] which are the prominent international blueprint for entity classification election rules.[54] Conceptual differences between the narrow German rules (which allow only certain partnerships to switch to the corporate tax regime)[55] and the wider US check-the-box regulations (which allow entity classification election more generally, excluding certain per se corporations),[56] make a comprehensive comparison between Germany and the US less useful.[57] In contrast, the comparative approach taken in this article is based upon the combination of the pivotal points of the German and the US debate on entity classification election.

In light of the foregoing, the analysis is divided into two main parts, oriented towards the two main headings under which entity classification election rules are discussed. The first part focuses on neutrality of legal form, which is the central point in the German discussion on the dualism of business taxation and the explicit reason for the recent introduction of the entity classification election rules (see III.). The second part focuses on "robustness to avoidance",[58] which relates to concerns arising from the experience with the US check-the-box rules and their (mis)use to achieve (inappropriate) tax advantages (see IV.). The article is structured to account for these two main concerns in the debate in Germany and the US, but the analysis must substantiate these elements to ensure the universal relevance of the findings. The introduction of the entity classification election is only a relatively small change to the overall tax system, but since this article is concerned with the general effects on the business tax system, the election as a legislative tool must be measured against fundamental principles of good tax design. For this purpose, the article draws on evaluative standards, which have been developed in tax scholarship, in particular based on the work of Adam Smith.[59] Recently, these criteria were concretised by Michael Devereux et al[60] for the business tax context. Broadly speaking, the relevant standards

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Leitsch, "Einführung eines Optionsmodells – Zur Möglichkeit der Körperschaftsbesteuerung für Personengesellschaften" [2021] *Betriebs-Berater* 1943; Rolf Möhlenbrock and Ingo Stangl, "Die Option zur Körperschaftsteuer" in Thomas Rödder and Marcel Krumm (eds), *Steuerberater-Jahrbuch 2021/2022* (Cologne: Otto Schmidt, 2022), pp.123, 139–147. See also Petra Eckl and Felix Schill, "The Corporate Tax Option for Partnerships" (2022) 62 *European Taxation* 187.

[52] For an overview, see Tiede, "KStG § 1a" in Hey, Klein and Wendt, (eds), *Herrmann/Heuer/Raupach: EStG/KStG* (2023), para.39; Wackerbeck, "KStG § 1a" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), paras 27–37.

[53] See Code of Federal Regulations (CFR) Title 26 ss.301.7701-1, 301.7701-2, 301.7701-3. See also Internal Revenue Service (IRS), Form 8832 (2013).

[54] Other countries, too, have entity classification election rules in place, which, however, are less prominent internationally. France is an example; see Pierre Burg, "France – Corporate Taxation" in IBFD, *Country Tax Guides* (1 July 2023), para.1.1.5.1.

[55] See below Pt III.B.2.

[56] See Choi, "United States – Corporate Taxation" in IBFD, *Country Tax Guides* (1 October 2023), para.1.1.4.4.

[57] On the lack of comparability, see Alexander Linn and Andreas Maywald, "Der Rechtstypenvergleich nach MoPeG und KöMoG" [2021] *Internationales Steuerrecht* 825. See also Erik Röder, "Ein frischer Blick auf den Typenvergleich: Gestiegene gesellschaftsrechtliche Komplexität erfordert radikale Vereinfachung" [2021] *Internationales Steuerrecht* 795, 805.

[58] For this concept, see Michael P. Devereux et al, *Taxing Profit in a Global Economy* (Oxford: OUP, 2021), pp.50–53.

[59] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (London: W. Strahan and T. Cadell, 1776), Vol.2, pp.423–426.

[60] Devereux et al, *Taxing Profit in a Global Economy* (2021), pp.33–56.

demand fairness (equity), efficiency, and simplicity in taxation.[61] Accordingly, this is the evaluative framework, which is used in this article to explore whether entity classification election rules are necessary tools to achieve neutrality of legal form or an invitation to engage in tax avoidance.

This analysis takes the recent introduction of entity classification election rules in Germany as its reference point, but the policy considerations discussed in this article are relevant in principle for all jurisdictions which differentiate between opaque and transparent taxation of business profits, and which therefore need to address the questions of fairness, efficiency, and simplicity of the dualism of company taxation posed in this article. Even though the dichotomy of business taxation is widespread, systems exist in which partnerships and corporations are taxed under the same regime.[62] In relation to those jurisdictions where the differentiation does exist (like Germany), however, conflicts may still arise, so that the considerations discussed in this article have a certain significance in this context as well.[63]

III. Entity classification election and neutrality of legal form

A. Neutrality of legal form as the first pivotal point of the discussion

In this first main section of the article, in accordance with the first element of the research question, the analysis is concerned with entity classification election rules as a tax policy instrument to ensure neutrality of legal form. In the course of introducing the German rules, reference was made to this policy goal.[64] This reflects that neutrality of legal form has long been at the forefront of discussions on business taxation in Germany.[65] Internationally, however, the concept of neutrality of legal form is not always as visible in the debate.[66] To meet the article's objective of providing general insights into the benefits of entity classification election rules by evaluating the German design choices, the following considerations relate the requirement of neutrality of legal form to the established fundamental principles of good tax design (fairness, efficiency, and simplicity).[67]

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[61] These criteria are widely applied in standard tax literature; for Germany and the US, see, e.g. Michael J. Graetz, Deborah H. Schenk and Anne L. Alstott, *Federal Income Taxation: Principles and Policies*, 8th edn (St Paul: Foundation Press, 2018), p.28; Johanna Hey, "Einführung in das besondere Steuerschuldrecht" (Ch.7) in Roman Seer et al, (eds), *Tipke/Lang: Steuerrecht*, 24th edn (Cologne: Otto Schmidt, 2021), paras 7.1–7.17. See also Glen Loutzenhiser, *Tiley's Revenue Law*, 10th edn (Oxford: Hart Publishing, 2022), para.1.3.

[62] Hungary and Spain are examples; see Álvaro de la Cueva González-Cotera and Esther Quintana Ortiz, "Spain – Corporate Taxation" in IBFD, *Country Tax Guides* (25 September 2023), paras 1.1.3., 11.2.; Gabriella Erdős, "Hungary – Corporate Taxation" in IBFD, *Country Tax Guides* (1 October 2023), paras 1.1.3., 11.2.

[63] For mismatches in German case law regarding Hungary and Spain, see BFH, 25 May 2011, I R 95/10, BStBl II 2014, 760; BFH, 21 January 2016, I R 49/14, BStBl II 2017, 107. See also Brühl and Weiss, "'Check the Box' from good old Germany: Die Option zur Besteuerung als Körperschaft nach dem Entwurf des KöMoG" [2021] *Deutsches Steuerrecht* 889, 890; Wackerbeck, "KStG § 1a" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), para.6.

[64] See Bundestagsdrucksache 19/28656 (2021), 15. See also Schiffers, Finanzausschuss Testimony (29 April 2021).

[65] See, e.g. Klaus-Dieter Drüen, "Rechtsformneutralität der Unternehmensbesteuerung als Verfassungsrechtlicher Imperativ?" [2008] *Zeitschrift für Gesellschafts-, Unternehmens- und Steuerrecht* 393; Johanna Hey, "Besteuerung von Unternehmensgewinnen und Rechtsformneutralität" in Iris Ebling (ed.), *Besteuerung von Einkommen* (Cologne: Otto Schmidt, 2001), DStJG Vol.24, p.155; Franz W. Wagner, "Was bedeutet und wozu dient die Rechtsformneutralität der Unternehmensbesteuerung?" [2006] *Steuer und Wirtschaft* 101.

[66] For discussions on neutrality of legal form as a German peculiarity, see Wagner, "Was bedeutet und wozu dient die Rechtsformneutralität der Unternehmensbesteuerung?" [2006] *Steuer und Wirtschaft* 101. For requests not to discriminate between legal forms, see Claire Crawford and Judith Freedman, "Small Business Taxation" (Ch.11) in Stuart Adam et al (eds), *Dimensions of Tax Design: The Mirrlees Review* (Oxford: OUP, 2010), p.1028. See also James Mirrlees et al, *Tax by Design: The Mirrlees Review* (Oxford: OUP, 2011), p.452. For the European context, see, e.g. Werner Haslehner, "'Avoir Fiscal' and Its Legacy after Thirty Years of Direct Tax Jurisprudence of the Court of Justice" (2016) 44 *Intertax* 374.

[67] See above Pt II.C.

B. Fairness dimensions of neutrality of legal form

1. Lack of neutrality of legal form as a fairness issue and entity classification election as a solution

Fairness as a policy goal needs to be specified;[68] and in the context of business taxation based on legal form specifically, the question arises how "notions of fairness"[69] can be linked to business entities.[70] Different stakeholders (owners, employees, customers, etc.)[71] potentially carry the burden of a business tax economically, and identifying the incidence of a business tax on a company is particularly complex.[72] It is clear, however, that for a comparison, from which fairness conclusions are to be drawn, it is not appropriate to look (only) at the taxation on the company level.[73] Instead, as a universal (albeit imperfect)[74] yardstick, in the German literature on the entity classification election rules a comparison between the nominal tax burden of shareholders and partners (considering all levels of taxation) usually provides the practical basis for a comparison between tax burdens.[75] The underlying assumption of course has to be that at least a part of the burden falls on (certain) individuals that own the company.[76]

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[68] For dimensions of fairness, see Richard Collier, Michael P. Devereux and John Vella, "Comparing Proposals to Tax Some Profit in the Market Country" (2021) 13 *World Tax Journal* 405, 415; Liam Murphy and Thomas Nagel, *The Myth of Ownership: Taxes and Justice* (Oxford: OUP, 2002).

[69] Devereux et al, *Taxing Profit in a Global Economy* (2021), pp.34–35.

[70] For businesses and ability to pay, see Monika Jachmann, "Besteuerung von Unternehmen als Gleichheitsproblem: Unterschiedliche Behandlung von Rechtsformen, Einkunftsarten, Werten und Steuersubjekten im Ertrag- und Erbschaftsteuerrecht" in Jürgen Pelka (ed.), *Europa- und Verfassungsrechtliche Grenzen der Unternehmensbesteuerung* (Cologne: Otto Schmidt, 2000), DStJG Vol.23, pp.9, 16–19.

[71] For an overview, see Devereux et al, *Taxing Profit in a Global Economy* (2021), p.35; Harris, *Corporate Tax Law: Structure, Policy and Practice* (2013), p.245; Mirrlees et al, *Tax by Design: The Mirrlees Review* (2011), pp.406–412.

[72] See, e.g. Alan J. Auerbach, "Who Bears the Corporate Tax? A Review of What We Know" (2006) 20 *Tax Policy and the Economy* 1; Clemens Fuest, Andreas Peichl and Sebastian Siegloch, "Do Higher Corporate Taxes Reduce Wages? Micro Evidence from Germany" (2018) 108 *American Economic Review* 393; Jennifer Gravelle, "Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis" (2013) 66 *National Tax Journal* 185; Suresh Nallareddy, Ethan Rouen and Juan Carlos Suárez Serrato, "Do Corporate Tax Cuts Increase Income Inequality?" (2022) 36 *Tax Policy and the Economy* 35. See recently also Patrick J. Kennedy, Christine L. Dobridge, Paul Landefeld and Jacob Mortenson, "The Efficiency-Equity Tradeoff of the Corporate Income Tax: Evidence from the Tax Cuts and Jobs Act" (2023), *https://patrick-kennedy.github.io/files/TCJA_KDLM_2023.pdf* [Accessed 27 November 2023].

[73] Devereux et al, *Taxing Profit in a Global Economy* (2021), p.35; Michael Devereux and John Vella, "Issues of Fairness in Taxing Corporate Profit" (2022) 2(4):10 *LSE Public Policy Review* 1, 2–8; Harris, *Corporate Tax Law: Structure, Policy and Practice* (2013), p.8; Mirrlees et al, *Tax by Design: The Mirrlees Review* (2011), p.408; Dieter Schneider, "Steuervereinfachung durch Rechtsformneutralität?" [2004] *Der Betrieb* 1517, 1518–1519.

[74] See Devereux and Vella, "Issues of Fairness in Taxing Corporate Profit" (2022) 2(4):10 *LSE Public Policy Review* 4–5.

[75] For comparative calculations regarding partnerships and corporations, see, e.g. Martin Cordes and Marvin Kraft, "Regierungsentwurf zum Optionsmodell – Körperschaftsteuer ab 2022 auch für Personengesellschaften?" [2021] *FinanzRundschau* 401, 402–404; Wacker et al, "Zum Optionsmodell nach dem Gesetz zur Modernisierung des Körperschaftsteuerrechts: oder: eventus varios res nova semper habet" [2021] *Deutsches Steuerrecht DStR-Beihefter* 3, 4–5. For different shareholders, see Rode, "KStG § 23" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), paras 46–52. For perspectives on the burden of taxation, see Balmes, "Rechtsformneutralität der Unternehmensbesteuerung" in Pelka (ed.), *Unternehmenssteuerreform: DStJG Sonderband* (2001), p.34; Hey, "Besteuerung von Unternehmensgewinnen und Rechtsformneutralität" in Ebling (ed.), *Besteuerung von Einkommen* (2001), DStJG Vol.24, pp.170–171; Jachmann, "Besteuerung von Unternehmen als Gleichheitsproblem: Unterschiedliche Behandlung von Rechtsformen, Einkunftsarten, Werten und Steuersubjekten im Ertrag- und Erbschaftsteuerrecht" in Pelka (ed.), *Europa- und Verfassungsrechtliche Grenzen der Unternehmensbesteuerung* (2000), DStJG Vol.23, p.28. With regard to current developments, see also Forst and Schiffers, "Beratungspraxis Familienunternehmen – Neue Koordinaten zur Rechtsformwahl durch das Wachstumschancengesetz?" [2023] *Zeitschrift für Gesellschafts-, Unternehmens- und Steuerrecht* 966, 970–971.

[76] See Harris, *Corporate Tax Law: Structure, Policy and Practice* (2013), p.245. For the burden of past, present, or future owners, see Harris, *Corporate Tax Law: Structure, Policy and Practice* (2013), p.246.

The ability to pay principle and the principles of horizontal and vertical equity are constitutional doctrines in Germany.[77] Neutrality of legal form conversely, according to the German Federal Constitutional Court,[78] is not generally mandated by the constitution. Rather, the court allows a differentiation based on legal form in light of differences in legal autonomy and economic independence of different entities.[79] In the literature, however, it is emphasised that these non-tax factors only justify a different taxation if they have an effect on the ability to pay (of the owners, from the perspective adopted in this article).[80] In this sense, neutrality of legal form is an element of a fair business tax system.[81] In the European context of freedom of establishment the freedom of choice of legal form plays a role.[82] A binding EU law imperative of neutrality of legal form, however, can hardly be deduced from this.[83]

By allowing a choice of tax regime and thus preventing tax differences based on legal form, which are not routed in the individual ability to pay of shareholders or partners, entity classification election rules can lead to a more equitable taxation. Compared to a comprehensive transformation of the system (achieved by eliminating the dualism of business taxation),[84] entity classification election rules are a moderate reform, which only symptomatically addresses the problems of a taxation based on legal form. Compared to regulations which compensate for issues arising from a taxation based on legal form through specific adjustments of the business tax system (for example by offsetting economic double taxation for corporations, or by enabling accumulation of profits for pass-through entities) the entity classification election has a more general effect, because it does not alter the specifics of the different

[77] See German Basic Law (Grundgesetz für die Bundesrepublik Deutschland, GG) art.3(1). See, e.g. German Federal Constitutional Court (BVerfG), 21 June 2006, 2 BvL 2/99, BVerfGE 116, 164, para.C.I.2.; BVerfG, 29 March 2017, 2 BvL 6/11, BVerfGE 145, 106, para.C.I.1. See also BVerfG, 5 November 2014, 1 BvF 3/11, BVerfGE 137, 350, paras B.III.1.a)–B.III.1.c).

[78] See, e.g. BVerfG, 18 June 1975, 1 BvR 528/72, BVerfGE 40, 109, para.C.II.; BVerfG, 21 June 2006, 2 BvL 2/99, 116, 164, para.C.III.; BVerfG, 24 March 2010, 1 BvR 2130/09, NJW 2010, 2116, para.III.

[79] See BVerfG, 21 June 2006, 2 BvL 2/99, BVerfGE 116, 164, para.C.III.; BVerfG, 12 October 2010, 1 BvL 12/07, BVerfGE 127, 224, para.D.III.1.b)aa); BVerfG, 29 March 2017, 2 BvL 6/11, BVerfGE 145, 106, para.C.II.1.b).

[80] See Joachim Hennrichs, "Dualismus der Unternehmensbesteuerung aus gesellschaftsrechtlicher und steuersystematischer Sicht: Oder: Die nach wie vor unvollendete Unternehmenssteuerreform" [2002] *Steuer und Wirtschaft* 201, 202; Hey, "Rechtsformabhängige Unternehmensbesteuerung" (Ch.13) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), paras 13.172–13.175. See also Joachim Hennrichs and Ulrike Lehmann, "Rechtsformneutralität der Unternehmensbesteuerung" [2007] *Steuer und Wirtschaft* 16, 17; Jachmann, "Besteuerung von Unternehmen als Gleichheitsproblem: Unterschiedliche Behandlung von Rechtsformen, Einkunftsarten, Werten und Steuersubjekten im Ertrag- und Erbschaftsteuerrecht" in Pelka (ed.), *Europa- und Verfassungsrechtliche Grenzen der Unternehmensbesteuerung* (2000), DStJG Vol.23, p.20.

[81] For a need for neutrality of legal form following from GG art.3(1), see Balmes, "Rechtsformneutralität der Unternehmensbesteuerung" in Pelka (ed.), *Unternehmenssteuerreform: DStJG Sonderband* (2001), pp.33–35; Hey, "Besteuerung von Unternehmensgewinnen und Rechtsformneutralität" in Ebling (ed.), *Besteuerung von Einkommen* (2001), DStJG Vol.24, pp.166–171. For recent legal developments, see Alexander Schall, "Erzwingt das MoPeG die rechtsformneutrale Unternehmensbesteuerung?" [2021] *Neue Zeitschrift für Gesellschaftsrecht* 494.

[82] See Treaty on the Functioning of the European Union (TFEU) art.49. See, e.g. *Commission v France (Avoir Fiscal)* (Case C-270/83) EU:C:1986:37; *Saint-Gobain ZN* (Case C-307/97) EU:C:1999:438; *CLT-UFA* (Case C-253/03) EU:C:2006:129.

[83] See Johanna Hey, "Perspektiven der Unternehmensbesteuerung in Europa" [2004] *Steuer und Wirtschaft* 193, 209; Michael Lang, "Gemeinschaftsrechtliche Verpflichtung zur Rechtsformneutralität im Steuerrecht?" [2006] *Internationales Steuerrecht* 397; Wolfgang Schön, "The Free Choice between the Right to Establish a Branch and to Set-Up a Subsidiary – a Principle of European Business Law" (2001) 2 *European Business Organization Law Review* 339, 359–362. See also David Stein, "Die verfassungsrechtliche Zulässigkeit einer Option zur Körperschaftsbesteuerung von Personengesellschaften" [2020] *Betriebs-Berater* 1879, 1886–1887.

[84] For an overview of proposals to achieve neutrality of legal form, see Hey, Rechtsformabhängige Unternehmensbesteuerung" (Ch.13) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), paras 13.177–13.187. For the proposal to include partnerships in corporate taxation, see, e.g. Hennrichs, "Besteuerung von Mitunternehmerschaften" (Ch.10) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), para.10.8, with further references.

business tax regimes (that is, the rules regarding income, tax rate, and tax payable on the different levels of taxation),[85] but only makes it possible to choose between regimes.[86]

Entity classification election rules, which as a measure come between a comprehensive reform and specific adjustments, have a conceptual advantage which relates to the uncertainties of the policy implications of business taxation. How an ideal business tax should look is highly controversial;[87] and in the traditional dualism of the taxation of business profits (pass-through or separate entity taxation) arguments exist for and against the different regimes.[88] Even the traditionally postulated compensation for economic double taxation is not unchallenged, and most recently, Michael Devereux et al[89] argued for a comparison of business ownership (as an investment) with other investments, assuming that the incidence of entity and shareholder level taxes differs. A view beyond business taxation in a narrow sense also resonates in the Mirrlees Review,[90] which extends the question of neutrality of legal form in the context of small business taxation to self-employed taxpayers and employees. But regardless of the perspective adopted, the different viewpoints do not contradict the entity classification election rules if they are not seen as an instrument for the adoption of a certain business tax regime (for example the corporate tax regime with compensation of economic double taxation), but as a tool for the possible harmonisation of the taxation of business profits (or investments). Because, irrespective of the "right" taxation in absolute terms, there is a fairness advantage to be seen in supporting the equal treatment of comparable pairs of businesses under the same tax regime.[91]

2. Insights from the German example

Under the German rules, only the transition from pass-through to corporate taxation (and back) for certain partnerships is possible.[92] Comparisons considering all levels of taxation after the distribution of profits show significant alignments of the two business tax regimes in Germany, due to the existing adjustments, especially in light of economic double taxation.[93] The German entity classification election

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[85] For relief of economic double taxation by way of interventions on these levels, see Harris, *Corporate Tax Law: Structure, Policy and Practice* (2013), pp.251–311.

[86] For the paradigm shift, from mitigating different tax burdens to allowing to opt for a change of the tax regime, see Fischer, "Der Regierungsentwurf eines Gesetzes zur Modernisierung des Körperschaftsteuerrechts" [2021] *Zeitschrift für Gesellschafts-, Unternehmens- und Steuerrecht* R144, R145. See also Jan Böttcher, "Körperschaftsteuer: Das neue KöMoG: Optionsmodell ein 'Großer Wurf'?" [2021] *Gestaltende Steuerberatung* 168.

[87] The discussion has different dimensions; for general considerations, see Mirrlees et al, *Tax by Design: The Mirrlees Review* (2011), pp.406–469; for the international context, see Devereux et al, *Taxing Profit in a Global Economy* (2021).

[88] In the context of check-the-box, see George K. Yin, "The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the 'Check-the-Box' Regulations" (1997) 51 *SMU Law Review* 125, 131–145, 499–522. More generally see, e.g. Jennifer Arlen and Deborah M. Weiss, "A Political Theory of Corporate Taxation" (1995) 105 *Yale Law Journal* 325, 331; Terrence R. Chorvat, "Apologia for the Double Taxation of Corporate Income" (2003) 38 *Wake Forest Law Review* 239; Hennrichs, "Dualismus der Unternehmensbesteuerung aus gesellschaftsrechtlicher und steuersystematischer Sicht: Oder: Die nach wie vor unvollendete Unternehmenssteuerreform" [2002] *Steuer und Wirtschaft* 201.

[89] Devereux et al, *Taxing Profit in a Global Economy* (2021), pp.77–82. See also Devereux and Vella, "Issues of Fairness in Taxing Corporate Profit" (2022) 2(4):10 *LSE Public Policy Review* 4–8.

[90] Mirrlees et al, *Tax by Design: The Mirrlees Review* (2011), pp.452–469. See especially Crawford and Freedman, "Small Business Taxation" (Ch.11) in Adam et al (eds), *Dimensions of Tax Design: The Mirrlees Review* (2010).

[91] But see Heather M. Field, "Checking in on Check-the-Box" (2009) 42 *Loyola of Los Angeles Law Review* 451, 497 (submitting that entity classification elections are only justified if a policy rationale exists for the different optional regimes).

[92] KStG ss.1a(1), 1a(4). For more far-reaching ideas, see Linn and Maywald, "Der Rechtstypenvergleich nach MoPeG und KöMoG" [2021] *Internationales Steuerrecht* 825, 831; Röder, "Ein frischer Blick auf den Typenvergleich: Gestiegene gesellschaftsrechtliche Komplexität erfordert radikale Vereinfachung" [2021] *Internationales Steuerrecht* 795, 805.

[93] For a current comparison, see Wacker et al, "Zum Optionsmodell nach dem Gesetz zur Modernisierung des Körperschaftsteuerrechts: oder: eventus varios res nova semper habet" [2021] *Deutsches Steuerrecht DStR-Beihefter* 3, 5. See also Cordes and Kraft, "Regierungsentwurf zum Optionsmodell – Körperschaftsteuer ab 2022

rules, therefore, should not be seen primarily as a reaction to broad disparities in the nominal overall tax burden of owners of different business forms.[94] The rationale, instead, is to address in particular the specific differences that are considered to be disadvantageous for larger profitable partnerships, particularly those operating internationally.[95] These businesses are subject to a higher tax on accumulated profits (when compared to the non-distributed profits of corporations), and together with certain administrative issues it is feared that this has a negative impact on market competitiveness.[96] The optional rules that were intended to compensate for the accumulation disadvantages of the pass-through regime, which exist independently of the entity classification election, have been criticised for certain shortcomings;[97] and empirical data shows that these optional rules have been scarcely utilised.[98] The German situation therefore demonstrates how specific issues, that are deemed problematic despite a general alignment of tax rates, can be addressed by entity classification election rules.[99] The difficulties concerning large partnerships may be less relevant in other countries in which larger businesses may generally incorporate, while the question whether or not to incorporate may be a planning subject mainly for smaller businesses in such countries.[100] The general finding that specific problems relating to the aligning of the business tax regimes can be addressed with the election, however, is an insight that is valid beyond the German situation.

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auch für Personengesellschaften?" [2021] *FinanzRundschau* 401, 402–404; Leitsch, "Einführung eines Optionsmodells – Zur Möglichkeit der Körperschaftsbesteuerung für Personengesellschaften" [2021] *Betriebs-Berater* 1943, 1946–1947.

[94] See Bundestagsdrucksache 19/28656 (2021), 14. For an emphasis on this overall tax burden and the rejection of the election, see Bundesrechtsanwaltskammer (BRAK), Growth Opportunities Act Referentenentwurf Statement (July 2023), 8, *https://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetze_Gesetzesvorhaben/Abteilungen/Abteilung_IV/20_Legislaturperiode/2023-09-08-WtChancenG/Stellungnahme-09-Bundesrechtsanwaltskammer.pdf?__blob=publicationFile&v=2* [Accessed 27 November 2023].

[95] See BMF, press release, *Scholz will Wettbewerbsfähigkeit von Familienunternehmen stärken* (24 March 2021).

[96] See Bundestagsdrucksache 19/28656 (2021), 14, 21; BMF, press release, *Scholz will Wettbewerbsfähigkeit von Familienunternehmen stärken* (24 March 2021). For competitiveness, see also, e.g. Monika Wünnemann, "Aktuelle Steuerpolitik" [2021] *Die Unternehmensbesteuerung* 234. For accumulated profits, see, e.g. Dreßler and Kompolsek, "Das Optionsmodell zur Besteuerung als Kapitalgesellschaft nach dem vom Bundestag beschlossenen KöMoG: Überblick, Einordnung, Vorteilhaftigkeitsüberlegungen" [2021] *Die Unternehmensbesteuerung* 301, 309. For situations where pass-through taxation can be lower than corporate taxation on accumulated profits, cf., however, Stein, "Die verfassungsrechtliche Zulässigkeit einer Option zur Körperschaftsbesteuerung von Personengesellschaften" [2020] *Betriebs-Berater* 1879, 1881.

[97] See EStG s.34a. For an evaluation of these rules in the context of neutrality of legal form, see Hey, "Rechtsformabhängige Unternehmensbesteuerung" (Ch.13) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), paras 13.182–13.184. For the respective rules, see above Pt II.A.; and for further discussion on current developments, see above fn.40. See also Forst and Schiffers, "Beratungspraxis Familienunternehmen – Neue Koordinaten zur Rechtsformwahl durch das Wachstumschancengesetz?" [2023] *Zeitschrift für Gesellschafts-, Unternehmens- und Steuerrecht* 966; Ley, "§ 34a EStG idF des Regierungsentwurfs eines Wachstumschancengesetzes" [2023] *Deutsches Steuerrecht* 2025.

[98] See Bundestagsdrucksache 19/6308 (2021), 7. See also Bundesverband der Deutschen Industrie (BDI) et al, Finanzausschuss Testimony (29 April 2021), *www.bundestag.de/resource/blob/838812/a97f884f4e732576dfa4662f9a574586/01-BDI-data.pdf* [Accessed 27 November 2023]; Wackerbeck, "KStG § 1a" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), para.5. It should be noted that in the early days of KStG s.1a, the election has not been exercised very often either; however, this observation is based on early figures, and the election is only aimed at a specific target group (certain profitable partnerships); see Bundestagsdrucksache 20/1231 (2022), 6; Ulrich Prinz, "Internationale Personengesellschaften: Option gem. § 1a KStG bei ausländischen Mitunternehmern" [2023] *FinanzRundschau* 1, 2.

[99] For economic analyses of the benefits of the election (only) for certain (large) partnerships, see Melanie Frieling and Dieter Schneeloch, "Zur Vorteilhaftigkeit einer Option zur Körperschaftsteuer" [2022] *FinanzRundschau* 743; Stephan Kudert and Rebekka Rein, "Eine ökonomische Analyse der steuerlichen Vorteilhaftigkeit der Option nach § 1a KStG" [2022] *FinanzRundschau* 976.

[100] See Crawford and Freedman, "Small Business Taxation" (Ch.11) in Adam et al (eds), *Dimensions of Tax Design: The Mirrlees Review* (2010), p.1029.

Taxpayer elections as such pose a risk of a "taxation at will".[101] Consequently, critical voices have been raised in the context of entity classification election rules from the standpoint of equity.[102] On the other hand, especially in the US context, it is argued that drawing the line between different tax regimes is difficult and can be facilitated by the election.[103] In Germany, at the outset, distinguishing between partnerships and corporations for tax purposes is relatively unproblematic, because the differentiation follows clear company law qualifications.[104] However, this article has established that aligning the two business tax regimes is problematic in light of certain larger and profitable partnerships, and this results in demarcation issues, because size and profits are factors that are difficult to apply in this context. A feasible way to ensure that businesses, for which a switch of tax regime is seen as a matter of equitable taxation, are included in a rule of transition, is to define eligible companies in broad and clear terms, for example by extending the transition to all partnerships or all commercial partnerships.[105] Then, the option, and not a mandatory transition, is a sensible way of allowing larger profitable partnerships to make the election, while not forcing other partnerships out of pass-through taxation.[106]

In Germany, the entity classification election is only possible for partnerships, and in particular for commercial partnerships,[107] but the Law to Modernise the Corporate Tax Law did not provide an option for civil law partnerships, and also not for sole proprietors.[108] This created new differences, since partnerships were subject to a uniform concept of income taxation before the introduction of the election rules;[109] and this is a departure from the alignment of partners and sole proprietors, which is an established principle in the German tax system (and internationally, too).[110] If the German rules are not understood as a means of implementing the same tax treatment universally, but as a tool that aims at compensating for specific disadvantages of certain partnerships, it is generally logical to ascertain the scope of the entity classification election rules by setting them against the issues to be solved.[111]

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[101] Johanna Hey, "Steuersystem und Steuerverfassungsrecht" (Ch.3) in Roman Seer et al (eds), *Tipke/Lang: Steuerrecht*, 24th edn (Cologne: Otto Schmidt, 2021), para.3.236 (*"Besteuerung 'nach Wahl'"*). See also H. David Rosenbloom, "Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt" (2004) 26 *Sydney Law Review* 17, 22–27.

[102] See Benz and Hannig, "Das Optionsmodell versus § 34a EStG" in Rödder and Krumm (eds), *Steuerberater-Jahrbuch 2020/2021* (2021), p.107; Roland Wacker, "Aktuelle Überlegungen zur Unternehmensteuerreform – Aspekte aus rechtspraktischer Sicht" [2019] *Deutsches Steuerrecht* 585, 589; Yin, "The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the 'Check-the-Box' Regulations" (1997) 51 *SMU Law Review* 125, 129–131.

[103] David A. Weisbach, "Line Drawing Doctrine and Efficiency in the Tax Law" (1998-1999) 84 *Cornell Law Review* 1627, 1630. See also below Pt III.D.1.

[104] For the international context, see below Pt III.D.2.

[105] For disadvantages of referring to sub-categories of businesses, see Crawford and Freedman, "Small Business Taxation" (Ch.11) in Adam et al (eds), *Dimensions of Tax Design: The Mirrlees Review* (2010), p.1060.

[106] For advantages of pass-through taxation generally, see Bundestagsdrucksache 19/28656 (2021), 2. See also Benz and Hannig, "Das Optionsmodell versus § 34a EStG" in Rödder and Krumm (eds), *Steuerberater-Jahrbuch 2020/2021* (2021), p.89; Cornelius Link, "Das Optionsmodell – Nach dem BMF-Schreiben ist vor der Evaluierung" [2022] *Deutsches Steuerrecht* 1599, 1600; Wacker, "Aktuelle Überlegungen zur Unternehmensteuerreform – Aspekte aus rechtspraktischer Sicht" [2019] *Deutsches Steuerrecht* 585, 588.

[107] The professional partnership (*Partnerschaftsgesellschaft*) can also make the election; see KStG s.1a(1)(1).

[108] For a more far-reaching draft bill, see Bundestagsdrucksache 14/2683 (2000). Conversely limited liability companies or stock companies can also not opt for pass-through taxation.

[109] For the constitutional justification, see Wacker et al, "Zum Optionsmodell nach dem Gesetz zur Modernisierung des Körperschaftsteuerrechts: oder: eventus varios res nova semper habet" [2021] *Deutsches Steuerrecht DStR-Beihefter* 3, 41–42. See also Tiede, "KStG § 1a" in Hey, Klein and Wendt, (eds), *Herrmann/Heuer/Raupach: EStG/KStG* (2023), para.5.

[110] See Gero Burwitz, "Neuere Entwicklungen im Steuerrecht: Gesetz zur Modernisierung des Körperschaftsteuergesetzes" [2021] *Neue Zeitschrift für Gesellschaftsrecht* 869; Wacker, "Aktuelle Überlegungen zur Unternehmensteuerreform – Aspekte aus rechtspraktischer Sicht" [2019] *Deutsches Steuerrecht* 585, 588. For the comparative context, see Ault, Arnold and Cooper, *Comparative Income Taxation: A Structural Analysis* (2020), p.541.

[111] For the call for a comprehensive election for everyone (and in every direction, which would then go beyond the goal of compensating for accumulation disadvantages, for example if capital companies could choose to be taxed on a pass-through basis), however, see Stein, "Die verfassungsrechtliche Zulässigkeit einer Option zur

However, even though civil law partnerships usually are small and may often not belong to the targeted businesses,[112] it is doubtful that a general exclusion of civil law partnerships is appropriate, especially since the legislative tool as discussed above is intended only to give taxpayers an option.[113] From the legislative perspective the exclusion of civil law partnerships also followed on from technical considerations of the deemed change of legal form in light of the scope of application of reorganisation rules.[114] This argument, however, cannot be generalised beyond Germany. Furthermore, the Law to Modernise the Partnership Law brings about a certain alignment of the (reorganisation law) treatment of (certain) civil law partnerships and commercial partnerships in Germany,[115] and current legal developments aim to extend the option to be taxed under the corporate tax regime explicitly to these civil law partnerships.[116]

On the other hand, it is sensible not to include sole proprietors in the election, because corporate taxation for individuals would require difficult adjustments under the German system.[117] It depends on the specific situation in the particular jurisdiction whether and to what extent neutrality of legal form can be established via entity classification election rules. Naturally, rules which are limited in scope are no panacea for all issues relating to business taxation, and the alignment of the taxation of only certain company owners only results in a neutrality of certain legal forms. Nevertheless, a general lesson that can be learned from the German example is that if the respective rules achieve a balance in certain comparative pairs, they can be a sensible and necessary way in which to compensate incrementally for shortcomings in the alignment of business tax regimes through other means, even if they do not achieve a comprehensive equalisation.

Körperschaftsbesteuerung von Personengesellschaften" [2020] *Betriebs-Berater* 1879, 1881–1882. See also Benz and Hannig, "Das Optionsmodell versus § 34a EStG" in Rödder and Krumm (eds), *Steuerberater-Jahrbuch 2020/2021* (2021), p.106.

[112] See Bundestagsdrucksache 19/28656 (2021), 21.

[113] See BDI et al, Finanzausschuss Testimony (29 April 2021), 1; Johanna Hey, Finanzausschuss Testimony (2 May 2021), 4, *www.bundestag.de/resource/blob/838856/2f6ecb96c25456b83261533072d7c174/03-Hey-data.pdf* [Accessed 27 November 2023]. For criticism regarding the government's argument to save civil law partnerships from complex tax considerations, see Hans-Joachim Kanzler, "Verfassungswidrige Benachteiligung Steuerpflichtiger durch die Exklusivoption zur Körperschaftsbesteuerung für Personenhandels- und Partnerschaftsgesellschaften" [2021] *FinanzRundschau* 1049, 1054–1055; Sarah Lauer, "Der persönliche Anwendungsbereich der Körperschaftsteueroption – Ist eine Erweiterung geboten?" [2021] *Die Unternehmensbesteuerung* 548, 552.

[114] See Bundestagsdrucksache 19/28656 (2021), 21. For criticism, see Kanzler, "Verfassungswidrige Benachteiligung Steuerpflichtiger durch die Exklusivoption zur Körperschaftsbesteuerung für Personenhandels- und Partnerschaftsgesellschaften" [2021] *FinanzRundschau* 1049, 1054.

[115] See Feldgen, "KStG § 1a" in Bott and Walter (eds), *Körperschaftsteuergesetz* (2023), para.30; Tiede, "KStG § 1a" in Hey, Klein and Wendt, (eds), *Herrmann/Heuer/Raupach: EStG/KStG* (2023), para.20; Wackerbeck, "KStG § 1a" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), para.12. See also Bundestagsdrucksache 19/28656 (2021), 21.

[116] For a discussion on the legislative process of the Growth Opportunities Act, see above fn.40; and in this context, see particularly Bundestagsdrucksache 20/8628 (2023), 54, 191; Bundestagsdrucksache 20/9341 (2023), 116; Bundestagsdrucksache 20/9396 (2023), 30; Bundesratsdrucksache 588/23 (2023), 48. See also Cordes and Glatthar, "Reform der Thesaurierungsbegünstigung nach § 34a EStG und Anpassung des Optionsmodells – Entwurf eines Wachstumschancengesetzes" [2023] *FinanzRundschau* 681, 686.

[117] See Hey, Finanzausschuss Testimony (2 May 2021), 4; Lauer, "Der persönliche Anwendungsbereich der Körperschaftsteueroption – Ist eine Erweiterung geboten?" [2021] *Die Unternehmensbesteuerung* 548, 552–553; Wacker et al, "Zum Optionsmodell nach dem Gesetz zur Modernisierung des Körperschaftsteuerrechts: oder: eventus varios res nova semper habet" [2021] *Deutsches Steuerrecht DStR-Beihefter* 3, 42. See generally Hennrichs, "Dualismus der Unternehmensbesteuerung aus gesellschaftsrechtlicher und steuersystematischer Sicht: Oder: Die nach wie vor unvollendete Unternehmenssteuerreform" [2002] *Steuer und Wirtschaft* 201, 214–215; Hey, "Rechtsformabhängige Unternehmensbesteuerung" (Ch.13) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), para.13.185. But see Kanzler, "Verfassungswidrige Benachteiligung Steuerpflichtiger durch die Exklusivoption zur Körperschaftsbesteuerung für Personenhandels- und Partnerschaftsgesellschaften" [2021] *FinanzRundschau* 1049 (for the unconstitutionality of the exclusion of civil law partnerships and also of sole proprietors).

C. *Efficiency dimensions of neutrality of legal form*

1. Lack of neutrality of legal form as an efficiency issue and entity classification election as a solution

Under the criterion of economic efficiency taxes should be neutral and avoid economic distortions and "excess burden".[118] Neutrality of legal form is a specific expression of neutrality.[119] If similar business activities are taxed differently based on legal form, and the choice of legal form is free, taxation creates a distortion with regard to the use of legal forms.[120] The extent of distortions based on legal form also depends on non-tax conditions (for example on the access to financial markets),[121] but empirical evidence shows that tax differences between unincorporated and incorporated businesses can affect economic decisions.[122]

The German literature links the taxation based on legal form not only to (constitutional demands for) equity, but also to constitutional freedoms,[123] which builds a bridge to the neutrality requirement.[124] From the German perspective, not different layers of taxation in the corporate setting, but the less favourable taxation of certain partnerships is problematic, and in the efficiency context, the German entity classification election rules therefore aim to prevent the tax motivated pressing for the corporate form.[125] From the European perspective, neutrality is relevant for the direct tax context (only) to the aforementioned extent in light of freedom of establishment.[126]

The issues of neutrality regarding a taxation based on legal form are to be solved within the tax system. Possibilities to choose and change the legal form of a business are important, and these possibilities exist under German law (and have also been proposed as a way of mitigating the limited scope of application of the entity classification election rules regarding civil law partnerships and sole

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[118] See Devereux et al, *Taxing Profit in a Global Economy* (2021), pp.41–42; Mirrlees et al, *Tax by Design: The Mirrlees Review* (2011), pp.40–41. For details, see Alan J. Auerbach and James R. Hines, "Taxation and Economic Efficiency" (Ch.21) in Alan J. Auerbach and Martin Feldstein (eds), *Handbook of Public Economics* (Amsterdam: Elsevier, 2002), Vol.3, p.1347.

[119] See Marc Desens, "Einführung zum KStG" in Johanna Hey, Martin Klein and Michael Wendt (eds), *Herrmann/Heuer/Raupach: EStG/KStG*, 321st edn (Cologne: Otto Schmidt, 2023), paras 55, 57; Hey, "Besteuerung von Unternehmensgewinnen und Rechtsformneutralität" in Ebling (ed.), *Besteuerung von Einkommen* (2001), DStJG Vol.24, pp.157–158; Wagner, "Was bedeutet und wozu dient die Rechtsformneutralität der Unternehmensbesteuerung?" [2006] *Steuer und Wirtschaft* 101, 102–106.

[120] See Harris, *Corporate Tax Law: Structure, Policy and Practice* (2013), p.22. For details, see Crawford and Freedman, "Small Business Taxation" (Ch.11) in Adam et al (eds), *Dimensions of Tax Design: The Mirrlees Review* (2010), pp.1046–1060.

[121] See Harris, *Corporate Tax Law: Structure, Policy and Practice* (2013), pp.242–243. See also Wagner, "Was bedeutet und wozu dient die Rechtsformneutralität der Unternehmensbesteuerung?" [2006] *Steuer und Wirtschaft* 101, 113.

[122] See Ruud A. de Mooij and Gaëtan Nicodème, "Corporate tax policy and incorporation in the EU" (2008) 15 *International Tax and Public Finance* 478; Michael P. Devereux and Li Liu, "Stimulating investment through incorporation" (2016) Oxford University Centre for Business Taxation Working Paper 16/07, *https://oxfordtax.sbs.ox.ac.uk/files/wp16-07pdf* [Accessed 24 July 2023]; Li Liu, "Income Taxes and Business Incorporation: Evidence from the Early Twentieth Century" (2014) 67 *National Tax Journal* 387. See also Devereux et al, *Taxing Profit in a Global Economy* (2021), p.43.

[123] See GG arts 2(1), 9(1), 12, 14.

[124] For constitutional freedoms, see Hey, "Besteuerung von Unternehmensgewinnen und Rechtsformneutralität" in Ebling (ed.), *Besteuerung von Einkommen* (2001), DStJG Vol.24, pp.171–173. For neutrality, see Johanna Hey, "Einführung zum KStG" in Arndt Raupach (ed.), *Herrmann/Heuer/Raupach: EStG/KStG*, 196th edn (Cologne: Otto Schmidt, 1999), para.32.

[125] See above Pts II.A., III.B.2.

[126] See above Pt III.B.1.

proprietors),[127] but these real economic decisions should not be distorted by tax implications only.[128] It is not necessary for tax rules to be perfectly identical for all legal forms;[129] and if the entity classification election replicates the change of legal form without the associated inefficient consequences, this is a sensible reaction to the problems of a lack of neutrality of legal form.[130]

2. Insights from the German example

The German entity classification election rules are a measure taken to ensure "competitive neutrality".[131] In particular the rules aim to mitigate issues concerning the accumulation of profits for certain larger pass-through businesses and they are therefore concerned with the interplay of different perspectives of neutrality of legal form in relation to companies (neutrality regarding accumulation) and owners (neutrality regarding transfers).[132] Since the German rules, according to their political goal, are also concerned with the international competitiveness of German businesses, the prevention of tax motivated relocations also resonates.[133]

In Germany the already existing rules to compensate for disadvantages regarding accumulation of profits for pass-through businesses have been considered unsatisfactory;[134] but it has to be conceded that it is difficult to align two tax regimes by using specific interventions, which can only aim for an

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[127] See, e.g. Wackerbeck, "KStG § 1a" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), para.12. See also Bundestagsdrucksache 19/28656 (2021), 21. For criticism, see Kanzler, "Verfassungswidrige Benachteiligung Steuerpflichtiger durch die Exklusivoption zur Körperschaftsbesteuerung für Personenhandels- und Partnerschaftsgesellschaften" [2021] *FinanzRundschau* 1049. For eligible partnerships and for current developments in that regard, see above Pt III.B.2.

[128] See Hey, "Rechtsformabhängige Unternehmensbesteuerung" (Ch.13) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), para.13.178. See also Lauer, "Der persönliche Anwendungsbereich der Körperschaftsteueroption – Ist eine Erweiterung geboten?" [2021] *Die Unternehmensbesteuerung* 548, 550.

[129] Balmes, "Rechtsformneutralität der Unternehmensbesteuerung" in Pelka (ed.), *Unternehmenssteuerreform: DStJG Sonderband* (2001), p.34; Drüen, "Rechtsformneutralität der Unternehmensbesteuerung als Verfassungsrechtlicher Imperativ?" [2008] *Zeitschrift für Gesellschafts-, Unternehmens- und Steuerrecht* 393, 401; Hey, "Besteuerung von Unternehmensgewinnen und Rechtsformneutralität" in Ebling (ed.), *Besteuerung von Einkommen* (2001), DStJG Vol.24, pp.167–168.

[130] See Joachim Schiffers, Finanzausschuss Hearing 19/138 (2021), 7, 15–16. For check-the-box enabling organisation according to business needs and not tax needs, see Field, "Checking in on Check-the-Box" (2009) 42 *Loyola of Los Angeles Law Review* 451, 472, 480, 482.

[131] For neutrality of legal form and competitive neutrality, see Hey, "Besteuerung von Unternehmensgewinnen und Rechtsformneutralität" in Ebling (ed.), *Besteuerung von Einkommen* (2001), pp.157–161. See also Jachmann, "Besteuerung von Unternehmen als Gleichheitsproblem: Unterschiedliche Behandlung von Rechtsformen, Einkunftsarten, Werten und Steuersubjekten im Ertrag- und Erbschaftsteuerrecht" in Pelka (ed.), *Europa- und Verfassungsrechtliche Grenzen der Unternehmensbesteuerung* (2000), DStJG Vol.23, p.18.

[132] For perspectives on the comparison, see above Pt III.B.1. For neutrality regarding accumulation and transfers, see Desens, "Einführung zum KStG" in Hey, Klein and Wendt (eds), *Herrmann/Heuer/Raupach: EStG/KStG* (2023), para.57; Franz W. Wagner, "Unternehmenssteuerreform und Corporate Governance" [2000] *Steuer und Wirtschaft* 109, 116. For criticism on the perspective of the reform, see Deutsche Steuer-Gewerkschaft (DSTG), Finanzausschuss Testimony (29 April 2021), 2, *www.bundestag.de/resource/blob/838294/81b2c7af4346b377716034f4d52c53f4/02-DSTG-data.pdf* [Accessed 27 November 2023].

[133] For the political goal of international competitiveness, see above Pt III.B.2. See also Felix Haug, "Entwurf eines Gesetz zur Modernisierung des Körperschaftsteuerrechts (KöMoG): Folgen aus dem Optionsmodell für die Investmentbesteuerung" [2021] *FinanzRundschau* 410; Daniela Kelm, Finanzausschuss Hearing 19/138 (2021), 13; Leitsch, "Einführung eines Optionsmodells – Zur Möglichkeit der Körperschaftsbesteuerung für Personengesellschaften" [2021] *Betriebs-Berater* 1943; Jochen Lüdicke and Astrid Eiling, "Erste Überlegungen zum Entwurf eines Gesetzes zur Modernisierung des Körperschaftsteuerrechts" [2021] *Betriebs-Berater* 1439, 1440; Wünnemann, "Aktuelle Steuerpolitik" [2021] *Die Unternehmensbesteuerung* 234, 234. For calculations of the effects of the election in cross border cases, see Clemens Wangler and Michael Wernsberger, "Das Optionsmodell für Personengesellschaften: Überlegungen zur Steuerbelastung von optierenden Gesellschaften mit Investitionen im Ausland" [2023] *Internationales Steuerrecht* 62.

[134] See above Pts II.A., III.B.2.

approximation of the tax burden, but not for an equalisation.[135] Entity classification election, in contrast, enables the switch of the tax regime, and by this it can achieve a full equalisation while still being specific (through the limitation of the scope of the application of the election).[136] Whether the German rules are a model for other countries depends on the conditions in the given jurisdiction, but a general conclusion that can be drawn from the German situation is that entity classification election has strengths in addressing particular inefficiencies. Entity classification election avoids the weaknesses of specific corrective regulations, but without the need to fundamentally revise the system. Of course, it must be acknowledged in the efficiency context, too, that the German entity classification election rules only align the taxation of (certain)[137] partnerships and corporations, and beyond this specific neutrality the German implementation does not bring about a further neutrality to the business or income tax system in a broader sense.[138]

D. Simplicity dimensions of neutrality of legal form

1. Lack of neutrality of legal form as a simplicity issue and entity classification election as a solution

Simplicity of the tax system is a policy goal worldwide,[139] but it is, again, a broad concept.[140] Relevant dimensions for this analysis are the costs of the tax collection for taxpayers (ease of compliance) and for the government (ease of administration).[141] A lack of neutrality of legal form can lead to complications in the system (especially if it leads to tax planning)[142] resulting in not only economic distortions but also enforcement costs.[143] In Germany, academics and politicians see a need, and a constitutional mandate, for tax simplification;[144] and business tax unification is seen as a measure for

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[135] See below Pt III.D.2. For the approximation of the income tax burden as a goal of the accumulation rules under EStG s.34a, cf. also Wacker et al, "Zum Optionsmodell nach dem Gesetz zur Modernisierung des Körperschaftsteuerrechts: oder: eventus varios res nova semper habet" [2021] *Deutsches Steuerrecht DStR-Beihefter* 3, 4. Nevertheless, the specific interventions under EStG s.34a are sometimes seen as superior to the election under KStG s.1a; see Benz and Hannig, "Das Optionsmodell versus § 34a EStG" in Rödder and Krumm (eds), *Steuerberater-Jahrbuch 2020/2021* (2021).

[136] See above Pt III.B.2. For the conceptional strength of the election, see Schiffers, Finanzausschuss Hearing 19/138 (2021), 7.

[137] For eligible partnerships and for current developments in that regard, see above Pt III.B.2.

[138] Cf. above Pt III.B.

[139] See Hugh J. Ault, "Steuervereinfachung im internationalen Vergleich" in Peter Fischer (ed.), *Steuervereinfachung* (Cologne: Otto Schmidt, 1998), DStJG Vol.21, p.107.

[140] For economic and legal approaches of defining complexity (as a counterpart of simplicity), see Robert Helbig, *Steuerkomplexität: Ein systemtheoretischer Ansatz* (Wiesbaden: Springer Gabler, 2017), pp.1–2, 5–10. For details, see, e.g. Louis Kaplow, "How Tax Complexity and Enforcement Affect the Equity and Efficiency of the Income Tax" (1996) 49 *National Tax Journal* 135; Louis Kaplow, "Accuracy, Complexity, and the Income Tax" (1998) 14 *Journal of Law, Economics & Organization* 61.

[141] For an overview, see Devereux et al, *Taxing Profit in a Global Economy* (2021), pp.53–55. See also Mirrlees et al, *Tax by Design: The Mirrlees Review* (2011), pp.42–44. For details on compliance and administrative costs, see, e.g. Chris Evans, "Studying the Studies: An overview of recent research into taxation operating costs" (2003) 1 *eJournal of Tax Research* 64; Michael J. Graetz and Louis L. Wilde, "The Economics of Tax Compliance: Fact and Fantasy" (1985) 38 *National Tax Journal* 355; Joram Mayshar, "Taxation with Costly Administration" (1991) 93 *Scandinavian Journal of Economics* 75.

[142] For the (limited) elimination of planning costs through neutrality of legal form, see Wagner, "Was bedeutet und wozu dient die Rechtsformneutralität der Unternehmensbesteuerung?" [2006] *Steuer und Wirtschaft* 101, 110.

[143] For economic distortions, see above Pt III.C. For simplicity and neutrality, see Franz W. Wagner, "Steuervereinfachung und Entscheidungsneutralität – konkurrierende oder komplementäre Leitbilder für Steuerreformen?" [2005] *Steuer und Wirtschaft* 93. See also Devereux et al, *Taxing Profit in a Global Economy* (2021), p.54.

[144] See Paul Kirchhof, "Steuergleichheit durch Steuervereinfachung", in Peter Fischer (ed.), *Steuervereinfachung* (Cologne: Otto Schmidt, 1998), DStJG Vol.21, p.9; Joachim Lang, "Steuergerechtigkeit durch Steuervereinfachung" in Wilhelm Bühler, Paul Kirchhof and Franz Klein (eds), *Steuervereinfachung: Festschrift für Dietrich Meyding zum 65. Geburtstag* (Heidelberg: CF Müller, 1994) 33. See also Friedrich Merz, "Ein gutes Steuersystem muss einfach sein" (2004) 57(1) *ifo Schnelldienst* 8–9.

simplification in the German discussion, closing the circle to neutrality of legal form.[145] At the European level, in the context of simplicity, the focus is more on international harmonisation.[146]

One complication that follows from a taxation based on legal form is that the application of different tax regimes to different legal forms requires demarcation. In the US, for example, the classification of business entities for tax purposes, before the introduction of the check-the-box regulations, was considered particularly complex,[147] and also prone to planning.[148] The check-the-box regulations were therefore received as a significant simplification.[149] But even beyond the elimination of demarcation difficulties, entity classification election rules can promote simplification, by making tax planning in reaction to a taxation based on legal form obsolete. However, entity classification election rules themselves, especially if they require sophisticated considerations, may in turn lead to compliance difficulties;[150] and planning with entity classification election is a problem of its own.[151] It is necessary, therefore, to balance the complexity with the election against the complexity without the election.[152]

2. Insights from the German example

Determining the business tax treatment is closely linked to legal form in Germany. This has a certain advantage in terms of legal certainty, and it also results in a degree of simplicity, because the standards are clear.[153] This is true nationally, and to a certain extent also in relation to foreign entities, where the *Rechtstypenvergleich* (a form of corporate resemblance test)[154] is an established instrument to determine pass-through or corporate tax treatment. However, aside from this, the German business tax system is

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[145] Hey, "Rechtsformabhängige Unternehmensbesteuerung" (Ch.13) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), para.13.169; Thomas Stapperfend, "Die Unternehmensbesteuerung in den Entwürfen zur Reform des Einkommensteuerrechts" [2005] *FinanzRundschau* 74, 77.

[146] For tax simplification and European law, see Michael Lang, "Steuervereinfachung und Europarecht" in Peter Fischer (ed.), *Steuervereinfachung* (Cologne: Otto Schmidt, 1998), DStJG Vol.21, p.145.

[147] For explanations on the earlier "Kintner Regulations", see Choi, "United States – Corporate Taxation" in IBFD, *Country Tax Guides* (1 October 2023), para.1.1.4.4.5. See also *United States v Kintner* 216 F.2d 418 (9th Cir. 1954). For demarcation before, see *Morrissey v Commissioner* 296 U.S. 344, 357–359 (1935).

[148] For an overview, see Field, "Checking in on Check-the-Box" (2009) 42 *Loyola of Los Angeles Law Review* 451, 467–468; Joni L. Walser and Robert E. Culbertson, "Encore Une Fois: Check-the-Box on the International Stage" (1997) 15 *Tax Notes International* 53, 54. For planning under check-the-box, see below Pt IV.

[149] See, e.g. Victor E. Fleischer, "If It Looks Like a Duck: Corporate Resemblance and Check-the-Box Elective Tax Classification" (1996) 96 *Columbia Law Review* 518, 556; Monica Gianni, "International Tax Planning After Check-the-Box" (1999) 2 *Journal of Passthrough Entities* 9, 9–11; Daniel Shefter, "Check the Box Partnership Classification: A Legitimate Exercise in Tax Simplification" (1995) 67 *Tax Notes* 279, 281–282.

[150] For elections in general and considering the US regulations, see Steven A. Dean, "Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification" (2005) 34 *Hofstra Law Review* 405, 451–461; Field, "Checking in on Check-the-Box" (2009) 42 *Loyola of Los Angeles Law Review* 451, 474; Yin, "The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the 'Check-the-Box' Regulations" (1997) 51 *SMU Law Review* 125, 130.

[151] See below Pt IV.

[152] For the US rules, see Field, "Checking in on Check-the-Box" (2009) 42 *Loyola of Los Angeles Law Review* 451, 471–481. For Germany, see below Pt III.D.2. For the trade-off of compliance costs more generally, see Wagner, "Steuervereinfachung und Entscheidungsneutralität – konkurrierende oder komplementäre Leitbilder für Steuerreformen?" [2005] *Steuer und Wirtschaft* 93, 95.

[153] Hey, "Rechtsformabhängige Unternehmensbesteuerung" (Ch.13) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), para.13.169; Wagner, "Was bedeutet und wozu dient die Rechtsformneutralität der Unternehmensbesteuerung?" [2006] *Steuer und Wirtschaft* 101, 112. See also above Pt III.B.2. For legal certainty and neutrality of legal form, see Joachim Englisch, "Rechtsformneutralität der Unternehmensbesteuerung bei Ertragsteuern" [1997] *Deutsche Steuer-Zeitung* 778, 780.

[154] For an overview, see Christian Kahlenberg, "Classification of Foreign Entities for German Tax Purposes" (2014) 54 *European Taxation* 152. See also BMF, 24 December 1999, BStBl I 1999, 1076, Tables 1, 2; BMF, 19 March 2004, BStBl I 2004, 411. For details, see Sophia Schwemmer, "Der Rechtstypenvergleich im Internationalen Steuerrecht" [2023] *Steuer und Wirtschaft* 82. For a comparative view, see Agnieszka Kopec and Katarzyna Mroz, "Steuersubjektqualität ausländischer Rechtsträger im internationalen Vergleich" [2014] *Die Unternehmensbesteuerung* 164.

not particularly simple, and the situation is complicated by the rules aiming to align the tax burden in the different business tax regimes. In particular, the rules governing the accumulation of profits of partnerships (or sole proprietors) modify and complicate the system, in a way that causes the legal framework to sometimes be described as a "trialism"[155] and not as a dualism of business taxation.[156]

The entity classification election rules can simplify compliance and administration; not in the sense that the complex rules would no longer exist, but insofar as the election does not complicate the different business tax regimes further in order to address the specific issues of accumulation.[157] In addition, the election removes the complexities arising from arrangements to change the legal form, and avoids associated planning costs.[158] The election is also convenient from a legislative viewpoint, because the introduction is fairly easy when compared to a comprehensive reform;[159] and it has respective advantages over specific compensation rules,[160] which require a concrete analysis of the differences in the tax burden that can generate higher planning costs.[161]

However, since the election rules only aim at the (selective) equalisation of tax differences and not at the elimination of conceptual differences of pass-through and corporate taxation,[162] these rules cannot provide a fundamental simplification through a structural overhaul.[163] Like any election, the German rules cause costs.[164] Potential related fairness implications are perhaps less relevant in this context,[165] since the German rules aim at larger and profitable partnerships, which have the means to make the decision and which should differ less in sophistication.[166] Still, the concrete implementation of the election is not trivial.[167] This is demonstrated by various specific issues discussed and criticised in

[155] Wacker, "Aktuelle Überlegungen zur Unternehmensteuerreform – Aspekte aus rechtspraktischer Sicht" [2019] *Deutsches Steuerrecht* 585, 586 (*"Trialismus"*).

[156] For criticism on the complexity, see Hey, "Rechtsformabhängige Unternehmensbesteuerung" (Ch.13) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), para.13.184.

[157] See Schiffers, Finanzausschuss Testimony (29 April 2021), 3–4. The accumulation rules for pass-through entities remain in place in Germany; but calls for further reform have been expressed; see, e.g. BDI et al, Finanzausschuss Testimony (29 April 2021), 11–13; Schiffers, Finanzausschuss Hearing 19/138 (2021), 7; Monika Wünnemann, Finanzausschuss Hearing 19/138 (2021), 6; and legislative changes have been initiated recently; for a discussion on this issue, see above fn.40.

[158] See Institut der Wirtschaftsprüfer (IDW), *Positionspapier zum Einstieg in eine rechtsformneutrale Besteuerung ("Optionsmodel")*, 2nd edn (2019), 4, *www.idw.de/blob/121002/fe6a7902b85e470b96e8d0e30461712c/down-positionspapier-optionsmodell-data.pdf* [Accessed 27 November 2023].

[159] For the simplicity of smaller reforms generally, see Devereux et al, *Taxing Profit in a Global Economy* (2021), pp.54–55.

[160] For specific compensation rules in this sense, see above Pt III.B.1.

[161] For the (moderate) costs of the introduction of the Law to Modernise the Corporate Tax Law estimated by the government, see Bundestagsdrucksache 19/28656 (2021), 17–20.

[162] See Wacker et al, "Zum Optionsmodell nach dem Gesetz zur Modernisierung des Körperschaftsteuerrechts: oder: eventus varios res nova semper habet" [2021] *Deutsches Steuerrecht DStR-Beihefter* 3, 43.

[163] For the need of structural reform, see Hey, "Rechtsformabhängige Unternehmensbesteuerung" (Ch.13) in Seer et al (eds), *Tipke/Lang: Steuerrecht* (2021), para.13.184.

[164] For concerns over costs, see Thomas Eigenthaler, Finanzausschuss Hearing 19/138 (2021), 12; Lorenz J. Jarass, Finanzausschuss Hearing 19/138 (2021), 11; Wünnemann, Finanzausschuss Hearing 19/138 (2021), 6. See generally Franz W. Wagner, "Was bedeutet Steuervereinfachung Wirklich?" [2006] *Perspektiven der Wirtschaftspolitik* 19, 22. For arising legal uncertainty and complexity, see Benz and Hannig, "Das Optionsmodell versus § 34a EStG" in Rödder and Krumm (eds), *Steuerberater-Jahrbuch 2020/2021* (2021), pp.87–88.

[165] For repercussions on fairness (and efficiency), see Field, "Checking in on Check-the-Box" (2009) 42 *Loyola of Los Angeles Law Review* 451, 486, 480, 522.

[166] For disadvantages of smaller businesses regarding compliance costs, see Crawford and Freedman, "Small Business Taxation" (Ch.11) in Adam et al (eds), *Dimensions of Tax Design: The Mirrlees Review* (2010), pp.1080–1081. See also Chris Evans et al, "Small business and tax compliance costs: A cross-country study of managerial benefits and tax concessions" (2014) 12 *eJournal of Tax Research* 453.

[167] For an emphasis on this issue, see Benz and Hannig, "Das Optionsmodell versus § 34a EStG" in Rödder and Krumm (eds), *Steuerberater-Jahrbuch 2020/2021* (2021).

practice.[168] Most of these issues are inherent in the broader German system, but it is characteristic of the election that these issues are difficult to overcome and may be transferred to new situations. And this must be kept in mind as a general lesson beyond Germany when implementing entity classification elections.

E. Findings

In this first part of the analysis, issues of entity classification election rules have been tested against the principle of neutrality of legal form and its links to fairness, efficiency, and simplicity. On the one hand, the election maintains (and transfers to new situations) problems inherent in the existing legal framework, and it causes its own complications in relation to the exercise of the election. On the other hand, entity classification election rules are easier to implement than large-scale fundamental reforms, which aim to overcome the dualism of business taxation, and can have fewer side-effects while being more effective than specific measures to compensate for the disadvantages of certain tax regimes. By not interfering with the (corporate and pass-through) regimes as such, and by merely establishing a way to overcome the dividing line, entity classification election rules are also less dependent on different perspectives, which can be adopted when comparing the tax burdens of different business stakeholders, and foster (relative) fairness and (specific) neutrality between legal forms. The goal of entity classification election rules cannot be the ideal business tax system; but the German rules are an example of how the election can overcome specific problems of a business tax system that focuses on legal form. Overall, in light of the insights from the German case study, it can be concluded that entity classification election rules can improve the fairness, efficiency, and simplicity of the business tax system.

IV. Entity classification election and robustness to avoidance

A. Robustness to avoidance as the second pivotal point of the discussion

In this second main section, the article addresses the second part of the research question, specifically, whether entity classification election rules ensure robustness to avoidance and whether the specific German rules can provide insight for other jurisdictions in this regard. Robustness to avoidance is recognised as a criterion for good tax design,[169] and the elimination of avoidance is one of the most

[168] For an overview, see Dreßler and Kompolsek, "Das Optionsmodell zur Besteuerung als Kapitalgesellschaft nach dem vom Bundestag beschlossenen KöMoG: Überblick, Einordnung, Vorteilhaftigkeitsüberlegungen" [2021] *Die Unternehmensbesteuerung* 301; Susanne Kölbl and Anna Luce, "Optionsmodell nach dem KöMoG-E – eine erste Analyse ausgewählter Fragestellungen" [2021] *Die Unternehmensbesteuerung* 264; Prinz, "Internationale Personengesellschaften: Option gem. § 1a KStG bei ausländischen Mitunternehmern" [2023] *FinanzRundschau* 1. For a summary of proposed changes in the context of an evaluation of the election initiated by the BMF, see Thomas Brinkmeier, "Evaluierung der KSt-Option (§1a KStG)" [2023] *GmbH-Steuerberater* 33. For a discussion on the legislative process of the Growth Opportunities Act, see above fn.40; and in this context, see particularly Bundestagsdrucksache 20/8628 (2023), 54, 191–192; Bundesratsdrucksache 588/23 (2023), 48. Against this background, see, e.g. Deutsche Industrie- und Handelskammer (DIHK) et al, Growth Opportunities Act Referentenentwurf Statement (25 July 2023), 31–32, *https://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetze_Gesetzesvorhaben/Abteilungen/Abteilung_IV/20_Legislaturperiode/2023-09-08-WtChancenG/Stellungnahme-01-Spitzenverbaende-der-Deutschen-Wirtschaft.pdf?__blob=publicationFile&v=2* [Accessed 27 November 2023]; and for strong criticism of the option in this context, see BRAK, Growth Opportunities Act Referentenentwurf Statement (July 2023), 8.

[169] See Collier, Devereux and Vella, "Comparing Proposals to Tax Some Profit in the Market Country" (2021) 13 *World Tax Journal* 405, 415.

discussed topics in taxation in Germany,[170] in the EU,[171] and on the broader international stage.[172] Avoidance of course is an ambiguous term.[173] For this article, an examination of the phenomenon by looking at tax planning activities, which aim to exploit differences between and the lack of alignment of tax systems internationally ("tax arbitrage"), is helpful.[174] Namely, entity classification election rules pose a risk of the formation of hybrid entities, which have been identified in the US and in the broader international context (not least in the BEPS process) as a vehicle for tax avoidance.[175] Robustness to avoidance, like neutrality of legal form, has implications for fairness, efficiency, and simplicity;[176] and, parallel to the first part of this article, the article therefore examines the issues of (robustness to) avoidance by having recourse to these fundamental policy standards.

B. Fairness dimensions of robustness to avoidance

1. Lack of robustness to avoidance as a fairness issue and entity classification election as a cause of problems

In political discussions, tax avoidance is perceived to be a fairness problem.[177] And indeed, the tax burden can be unequally distributed as a result of planning activities.[178] If, based on entity classification

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[170] See, e.g. Paul Kirchhof, "Legalität, Gestaltungsfreiheit und Belastungsgleichheit als Grundlagen der Besteuerung" in Rainer Hüttemann (ed.), *Gestaltungsfreiheit und Gestaltungsmissbrauch im Steuerrecht* (Cologne: Otto Schmidt, 2010), DStJG Vol.33, p.9; Wolfgang Schön, "Legalität, Gestaltungsfreiheit und Belastungsgleichheit als Grundlagen des Steuerrechts" in Rainer Hüttemann (ed.), *Gestaltungsfreiheit und Gestaltungsmissbrauch im Steuerrecht* (Cologne: Otto Schmidt, 2010), DStJG Vol.33, p.29.

[171] See, e.g. Rita de la Feria, "EU General Anti-(Tax) Avoidance Mechanisms" (Ch.8) in Glen Loutzenhiser and Rita de la Feria (eds), *The Dynamics of Taxation: Essays in Honour of Judith Freedman* (Oxford: Hart Publishing, 2020), p.155. See also Wolfgang Schön, "The Concept of Abuse of Law in European Taxation" (Ch.9) in Glen Loutzenhiser and Rita de la Feria (eds), *The Dynamics of Taxation: Essays in Honour of Judith Freedman* (Oxford: Hart Publishing, 2020), p.185.

[172] Especially the BEPS and "BEPS 2.0" discussions are to be seen in this context. For an evaluation of BEPS regarding robustness to avoidance, see Devereux et al, *Taxing Profit in a Global Economy* (2021), pp.120–122, 126–127; Devereux and Vella, "Are We Heading towards a Corporate Tax System Fit for the 21st Century?" (2014) 35 *Fiscal Studies* 449. For recent reflections on international tax avoidance and evasion, see Annette Alstadsæter, Sarah Godar, Panayiotis Nicolaides and Gabriel Zucman, "Global Tax Evasion Report 2024" (2023) EU Tax Observatory Report, *https://www.taxobservatory.eu//www-site/uploads/2023/10/global_tax_evasion_report_24.pdf* [Accessed 27 November 2023].

[173] See Michael P. Devereux, Judith Freedman and John Vella, "Tax Avoidance" (2012) Oxford University Centre for Business Taxation Report, *https://ssrn.com/abstract=3754562* [Accessed 27 November 2023]. See also Leonard Hoffmann, "Tax Avoidance" [2005] B.T.R. 197.

[174] See Devereux et al, *Taxing Profit in a Global Economy* (2021), pp.1–52. For details on tax arbitrage, see Mitchell A. Kane, "Strategy and Cooperation in National Responses to International Tax Arbitrage" (2004) 53 *Emory Law Journal* 89; Diane M. Ring, "One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage" (2002) 44 *Boston College Law Review* 79; H. David Rosenbloom, "The David R. Tillinghast Lecture: International Tax Arbitrage and the 'International Tax System'" (2000) 53 *Tax Law Review* 137; Joseph E. Stiglitz, "The General Theory of Tax Avoidance" (1985) 38 *National Tax Journal* 325, 325.

[175] For hybrid mismatches, see, e.g. OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2015), *http://dx.doi.org/10.1787/9789264241138-en* [Accessed 27 November 2023]. For the US context, see IRS, Notice 98-11, 1998-1 CB 433; Peter H. Blessing, "Final §894(c)(2) Regulations" (2000) 29 *Tax Management International Journal* 499, 501; Office of Tax Policy, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations* (2000), 68–70, *https://home.treasury.gov/system/files/131/Report-SubpartF-2000.pdf* [Accessed 27 November 2023]. See also Andriy Krahmal, "International Hybrid Instruments: Jurisdiction Dependent Characterization" (2005) 5 *Houston Business and Tax Law Journal* 98, 100; Kenan Mullis, "Check-the-Box and Hybrids: A Second Look at Elective U.S. Tax Classification for Foreign Entities" (2011) 64 *Tax Notes International* 371, 377–378.

[176] See Collier, Devereux and Vella, "Comparing Proposals to Tax Some Profit in the Market Country" (2021) 13 *World Tax Journal* 405, 415; Devereux et al, *Taxing Profit in a Global Economy* (2021), p.50.

[177] For numerous references to fairness, see, e.g. Senate Hearing 113-90 (2013).

[178] Joel Slemrod and Shlomo Yitzhaki, "Tax Avoidance, Evasion, and Administration" (Ch.22) in Alan J. Auerbach and Martin Feldstein (eds), *Handbook of Public Economics* (Amsterdam: Elsevier, 2002), Vol.3,

election rules, businesses can choose a tax regime (nationally), this is the intended result and no objectional tax planning. The question is, however, whether there are side effects that can be regarded as avoidance. One important consideration in this context is international profit shifting;[179] and without going into the technical details of the US rules, it can be observed that the check-the-box regulations were used for cross border tax arbitrage by creating hybrid entities, which are inconsistently characterised in different jurisdictions.[180] Profit shifting relates to fairness between businesses, which reduce their tax burden by exploiting the rules, and businesses (and also taxpayers with non-business income),[181] which cannot or will not shift profits.[182] However, questions also arise about the fairness between (and in relation to) countries.[183] In this context, the discussion on profit shifting revolves around the problem that internationally operating businesses ultimately decide which country can (or cannot)[184] tax profits and by so doing influence tax burdens and revenues.[185]

2. Insights from the German example

In the German context the entity classification election was introduced to compensate certain partnerships for specific disadvantages.[186] The election's international dimension, however, is demonstrated by the fact that the rules also aim to strengthen the international competitiveness of certain German companies.[187] The risk of creating hybrid entities through the US check-the-box rules was a result of the extension of the election to foreign entities.[188] The German rules by contrast entail

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pp.1423, 1445–1446. See also OECD, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD Publishing, 1998), 14-15, *https://doi.org/10.1787/9789264162945-en* [Accessed 27 November 2023]; Ring, "One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage" (2002) 44 *Boston College Law Review* 79, 120–121, 124.

[179] See Devereux et al, *Taxing Profit in a Global Economy* (2021), p.52.

[180] For details especially in the context of circumventing Subpart F, see, e.g. Ring, "One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage" (2002) 44 *Boston College Law Review* 79, 96–100; Cynthia Ram Sweitzer, "Analyzing Subpart F in Light of Check-the-Box" (2005) 20 *Akron Tax Journal* 1. For the "Double Irish Dutch Sandwich", see Edward D. Kleinbard, "Stateless Income" (2011) 11 *Florida Tax Review* 699. For empirical data on check-the-box and US multinationals' tax planning, see again Altshuler and Grubert, "The Three Parties in the Race to the Bottom: Host Governments, Home Governments and Multinational Companies" (2005) 7 *Florida Tax Review* 153. See also Field, "Checking in on Check-the-Box" (2009) 42 *Loyola of Los Angeles Law Review* 451, 489 (pointing to data indicating that about 70% of the elections by foreign entities aim for classifying the entity as disregarded).

[181] See Ring, "One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage" (2002) 44 *Boston College Law Review* 79, 120–121, 124. See also Reuven S. Avi-Yonah, "Globalization, Tax Competition and the Fiscal Crisis of the Welfare State" (2000) 113 *Harvard Law Review* 1573, 1575–1576.

[182] OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (Paris: OECD Publishing, 2012), 11, *www.oecd.org/ctp/aggressive/hybrid-mismatch-arrangements-tax-policy-and-compliance-issues.pdf* [Accessed 27 November 2023]. See also Devereux et al, *Taxing Profit in a Global Economy* (2021), p.40.

[183] For this aspect, see Devereux et al, *Taxing Profit in a Global Economy* (2021), pp.38–39. See also Devereux and Vella, "Issues of Fairness in Taxing Corporate Profit" (2022) 2(4):10 *LSE Public Policy Review* 8–10.

[184] Two big questions resonate: whether (single tax) and where (residence, source, value creation, etc.) to tax; for the broader discussion, see Reuven S. Avi-Yonah, "International Taxation of Electronic Commerce" (1997) 52 *Tax Law Review* 507, 517–523; Wolfgang Schön, "Is There Finally an International Tax System?" (2021) 13 *World Tax Journal* 357.

[185] For evidence on the impact of check-the-box on foreign (and domestic) tax rates of US multinationals, see Amy Dunbar and Andrew Duxbury, "The Effect of 'Check the Box' on U.S. Multinational Tax Rates" (2015) *https://ssrn.com/abstract=2630738* [Accessed 27 November 2023]; Harry Grubert, "Foreign Taxes and the Growing Share of US Multinational Company Income Abroad: Profits, Not Sales, are Being Globalized" (2012) 65 *National Tax Journal* 247. See also again Altshuler and Grubert, "The Three Parties in the Race to the Bottom: Host Governments, Home Governments and Multinational Companies" (2005) 7 *Florida Tax Review* 153.

[186] See above Pt III.B.2.

[187] See above Pts III.B.2., III.C.2.

[188] For the anticipation of issues with foreign entities, see Albertina M. Fernandez, "Eighth Annual GWU International Tax Conference" (1996) 12 *Tax Notes International* 21 (citing Joni L. Walser). See also Kathleen Matthews, "IRS Official Discusses Check-The-Box Proposal for Foreign Entities" (1996) 12 *Tax Notes International* 541, 542. For failed efforts to counteract respective tax structures shortly after introducing the check-the-box rules, see Paul W. Oosterhuis, Committee on Ways and Means Testimony (13 June 2013), 5,

provisions that aim explicitly at limiting base erosion and profit shifting.[189] The rules generally enable foreign partnerships to make the election;[190] but they disallow an election for foreign entities, which qualify as partnerships from a German perspective (under the corporate resemblance test),[191] but would not be subject to corporate taxation in their country of management after the election.[192] In addition, the German rules address issues of tax treaties, which (under certain circumstances)[193] can arise if Germany in light of the election treats a German partnership as being liable to corporate tax and entitled to treaty benefits, but a partner's foreign country of residence continues to assume pass-through treatment.[194]

In principle, the prevention of the emergence of hybrid mismatches is an approach that is to be recommend beyond Germany. Limiting the scope of application for certain foreign companies is, therefore, the right approach, if it is clear that conflicts in the qualification of the entities will arise in relation to the foreign country of management and Germany.[195] For German companies however, where the domestic qualification (after the election) may conflict with the qualification in a number of other jurisdictions, only the effects of a mismatch in the qualification of companies, and not the emergence of hybrid entities as such, can be offset. This is more difficult conceptually though, and the German rules aiming at the prevention of double non-taxation in the treaty context were introduced in the form of a treaty override which ensures taxation.[196] Specific regulations to tackle problems of hybrid mismatches already exist as a result of the BEPS project (BEPS Action 2)[197] at the international (treaty)[198] level, and

https://waysandmeans.house.gov/wp-content/uploads/2017/07/20130613FC.pdf [Accessed 27 November 2023]. See also Field, "Checking in on Check-the-Box" (2009) 42 *Loyola of Los Angeles Law Review* 451, 487–491. For check-the-box and BEPS, see Ruth Mason, "The Transformation of International Tax" (2020) 114 *American Journal of International Law* 353, 372, 376–377. For check-the-box and the 2017 tax reform in the US, see J. Clifton Fleming Jr., Robert J. Peroni and Stephen E. Shay, "Expanded Worldwide Versus Territorial Taxation After the TCJA" (2018) 161 *Tax Notes* 1173. See also Daniel Shaviro, "NYU Tax Policy Colloquium on Blouin-Krull, Part 2" (13 October 2021), *http://danshaviro.blogspot.com/2021/10/nyu-tax-policy-colloquium-on-blouin.html* [Accessed 27 November 2023].

[189] See Bundestagsdrucksache 19/28656 (2021) 22. See also Bundesratsdrucksache 244/21(B) (2021), 13–14.

[190] For details and notes on EU law, see Tiede, "KStG § 1a" in Hey, Klein and Wendt, (eds), *Herrmann/Heuer/Raupach: EStG/KStG* (2023), para.21.

[191] See above Pt III.D.2. For issues regarding entity classification election, see Florian Haase, "Internationalsteuerliche Aspekte des geplanten KöMoG" [2021] *Die Unternehmensbesteuerung* 193, 195–196.

[192] See KStG s.1a(1)(6)(No.2). For explanations, see Tiede, "KStG § 1a" in Hey, Klein and Wendt, (eds), *Herrmann/Heuer/Raupach: EStG/KStG* (2023), para.40; Wacker et al, "Zum Optionsmodell nach dem Gesetz zur Modernisierung des Körperschaftsteuerrechts: oder: eventus varios res nova semper habet" [2021] *Deutsches Steuerrecht DStR-Beihefter* 3, 37.

[193] See Wacker et al, "Zum Optionsmodell nach dem Gesetz zur Modernisierung des Körperschaftsteuerrechts: oder: eventus varios res nova semper habet" [2021] *Deutsches Steuerrecht DStR-Beihefter* 3, 38.

[194] See EStG s.50d(14). For explanations, see Wacker et al, "Zum Optionsmodell nach dem Gesetz zur Modernisierung des Körperschaftsteuerrechts: oder: eventus varios res nova semper habet" [2021] *Deutsches Steuerrecht DStR-Beihefter* 3, 38–39; Klaus J. Wagner, "EStG § 50d" in Peter Brandis and Bernd Heuermann (eds), *Ertragsteuerrecht*, 168th edn (Munich: Vahlen, 2023), paras 206–210.

[195] Cf. Schwemmer, "Der Rechtstypenvergleich im Internationalen Steuerrecht" [2023] *Steuer und Wirtschaft* 82, 91 (pointing to potential qualification conflicts as a result of an unlimited election).

[196] See Wacker et al, "Zum Optionsmodell nach dem Gesetz zur Modernisierung des Körperschaftsteuerrechts: oder: eventus varios res nova semper habet" [2021] *Deutsches Steuerrecht DStR-Beihefter* 3, 38–39; Wagner, "EStG § 50d" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), paras 206–210.

[197] OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (2015). For a US perspective, see Reuven S. Avi-Yonah "Constructive Dialogue: BEPS and the TCJA" (2020) 46 *International Tax Journal* 25.

[198] OECD, Model Tax Convention on Income and on Capital 2017 (Full Version) (OECD Model 2017) (OECD Publishing, 2019), art.1(2), https://doi.org/10.1787/g2g972ee-en [Accessed 27 November 2023]; Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), art.3, *https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm* [Accessed 27 November 2023]. But see OECD Model 2017 Commentary on Article 1, para.114. For details and policy assessments, see Leopoldo Parada, "Hybrid Entity Mismatches and the MLI: A Tax Policy Assessment" (2021) 49 *Intertax* 786.

also at the EU level (Anti-Tax Avoidance Directives, ATAD).[199] However, Germany was reluctant to implement these BEPS results in the tax treaty context,[200] and the German implementation of the respective European directives again involves treaty override.[201] At all events, unless uniform qualifications exist internationally, there will always be a problem inherent in the election in the cross-border case.[202] The purest solution is to restrict the election in order to prevent the emergence of hybrids; but from the German perspective, it was also possible to tackle additional avoidance issues by prioritising the prevention of double non-taxation over the (potential)[203] issues of treaty override, because the Federal Constitutional Court[204] accepts treaty overrides as a matter of German constitutional law. Nevertheless, it is a breach of the international law principle of *pacta sunt servanda* and conflicts with fairness between countries;[205] and this may therefore not be an option for other countries under national (constitutional) law.[206]

C. Efficiency dimensions of robustness to avoidance

1. Lack of robustness to avoidance as an efficiency issue and entity classification election as a cause of problems

Another dimension of robustness to avoidance is efficiency. Efficiency improvements through entity classification election rules have already been identified in this article.[207] On the other hand, the avoidance tactics already described, which exploit entity classification election rules, lead to distortions.[208] The question can be raised whether cross-border tax arbitrage through the US check-the-

[199] See Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market [2016] OJ L193/1; Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries [2017] OJ L144/1.

[200] For details, see Philip Nürnberg, "Multilaterales Instrument (MLI)" in Matthias Alber et al (eds), *Beck'sches Steuer- und Bilanzrechtslexikon*, 64th edn (Munich: CH Beck, 2023), paras 14–29; Hans Weggemann and Daniela Nehls, "OECD-MA Art. 1" in Roland Ismer (ed.), *Vogel/Lehner: Doppelbesteuerungsabkommen*, 7th edn (Munich: CH Beck, 2021), paras 79–80n.

[201] See EStG s.4k. See also Daniel Fehling, "Addressing Base Erosion and Profit Shifting: The Implementation of the ATAD in Germany" (2022) 50 *Intertax* 721, 727–729; Carsten Pohl, "EStG § 4k" in Peter Brandis and Bernd Heuermann (eds), *Ertragsteuerrecht*, 168th edn (Munich: Vahlen, 2023), paras 16, 22, 189; Tim Zinowsky, "Die Vernunft als Maßstab findet Eingang in das Einkommensteuerrecht: Erläuterung der Bestimmungen zur Abwehr hybrider Gestaltungen nach § 4k EStG" [2021] *Internationales Steuerrecht* 500.

[202] See Wacker, "Aktuelle Überlegungen zur Unternehmensteuerreform – Aspekte aus rechtspraktischer Sicht" [2019] *Deutsches Steuerrecht* 585, 589. For the relation of anti-hybrid rules to "BEPS 2.0", see Stefan Köhler, "§ 4k EStG und andere Neuregelungen zu hybriden Strukturen" in Thomas Rödder and Marcel Krumm (eds), *Steuerberater-Jahrbuch 2021/2022* (Cologne: Otto Schmidt, 2022), pp.479, 497.

[203] For unwritten rules against abuse relevant for tax treaties, see, e.g. Rebecca M. Kysar, "Interpreting Tax Treaties" (2016) 101 *Iowa Law Review* 1387, 1423; Klaus Vogel, "Double Tax Treaties and Their Interpretation" (1986) 4 *International Tax & Business Lawyer* 1, 82–83.

[204] BVerfG, 15 December 2015, 2 BvL 1/12, BVerfGE 141, 1. But see BFH, 10 January 2021, I R 66/09, BFHE 234, 304. See also GG arts 25, 49; German Fiscal Code (Abgabenordnung, AO) s.2. For the generalisation of the Federal Constitutional Court decision, see, e.g. Ralf Haendel, "Treaty Override – verfassungsrechtlich zulässig, aber im Einzelfall nicht anwendbar?" [2017] *Internationales Steuerrecht* 436; Wolfgang Mitschke, "Anmerkung" [2016] *Deutsches Steuerrecht* 376; Pohl, "EStG § 4k" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), para.22.

[205] See Vienna Convention on the Law of Treaties (VCLT) art.26.

[206] For the German and US perspectives, see Reuven S. Avi-Yonah, "Pacta Sunt Servanda? The Problem of Treaty Overrides" [2022] B.T.R. 25; Georg Kofler, "Legislative Tax Treaty Overrides in Austrian, German, and EU Law" [2022] B.T.R. 64; Nicolas M. Traut, "Tax Treaty Overrides and Friendliness Towards International Law: A Comparative Approach to Put the Later-in-Time-Rule to the Test" (2020) 48 *Capital University Law Review* 403.

[207] See above Pt III.C.

[208] For effects of hybrid mismatches on competition, see OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (Paris: OECD Publishing, 2012), 11. For wasted resources and neutrality issues regarding check-the-box, see Field, "Checking in on Check-the-Box" (2009) 42 *Loyola of Los Angeles Law Review* 451, 486.

box regulations fostered "national efficiency"[209] by facilitating US companies' saving of foreign taxes; and in this context interesting reflections exist in the literature on whether the US, through check-the-box, unconsciously or consciously (as a form of tax competition)[210] permitted "foreign-to-foreign tax planning" and profit shifting.[211] The wider effects of the reduction of the tax burden of "domestic"[212] US companies, however, are unclear.[213] What is clear is that the US regulations brought about distortions in the choice of investments, by favouring investment in certain foreign countries over investment in other foreign countries, but also over investment in the US.[214]

2. Insights from the German example

The first main section of this article showed that the German entity classification election rules counteract a potential move away from the partnership as a legal form.[215] One could ask, whether corporate taxation should be tied to the treatment as a corporation outside of the tax law, and whether it should go hand in hand with non-tax regulations for corporations (for example regarding corporate codetermination for larger companies).[216] This then raises the question whether the election now pushes more businesses into the partnership form, leading to inefficient structuring by businesses trying to achieve the best of both worlds (that is, corporate taxation and partnership treatment under private and company law).[217] However, as already indicated in this article, non-tax aspects that do not have an effect on the ability to pay should not influence the tax treatment,[218] and for the partnerships for which the option to be taxed under corporate tax rules is required in light of neutrality of legal form, the tax advantages (or rather the compensation of disadvantages) previously mentioned regarding accumulated

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[209] For an overview of perspectives of efficiency in international taxation, see Ring, "One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage" (2002) 44 *Boston College Law Review* 79, 102–109. For details, see Tsilly Dagan, "The Costs of International Tax Cooperation" in Eyal Benvenisti and Georg Nolte (eds), *The Welfare State, Globalization, and International Law* (Berlin: Springer, 2004) p.49; Michael J. Graetz, "The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies" (2001) 54 *Tax Law Review* 261, 269–294.

[210] For the connection of avoidance and competition, see Collier, Devereux and Vella, "Comparing Proposals to Tax Some Profit in the Market Country" (2021) 13 *World Tax Journal* 405, 423. For check-the-box as a competitive tax policy, see Devereux and Vella, "Are We Heading towards a Corporate Tax System Fit for the 21st Century?" (2014) 35 *Fiscal Studies* 449, 459–461.

[211] See Shaviro, "The EU-US Relationship in the Field of Income Taxation as Viewed from a US Perspective" (Ch.4) in Pistone and Weber (eds), *The Implementation of Anti-BEPS Rules in the EU* (2018), para.4.2. See also Mason, "The Transformation of International Tax" (2020) 114 *American Journal of International Law* 353, 360.

[212] For the question to what extent foreign investors benefit, see Devereux and Vella, "Are We Heading towards a Corporate Tax System Fit for the 21st Century?" (2014) 35 *Fiscal Studies* 449, 460–461.

[213] Ring, "One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage" (2002) 44 *Boston College Law Review* 79, 121–122, 156. For different perspectives, see Shaviro, "The EU-US Relationship in the Field of Income Taxation as Viewed from a US Perspective" (Ch.4) in Pistone and Weber (eds), *The Implementation of Anti-BEPS Rules in the EU* (2018), para.4.2.

[214] See generally Ring, "One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage" (2002) 44 *Boston College Law Review* 79, 117–118. For statements from within the IRS comparing this to capital export subsidies, see Lee A. Sheppard, "IRS Talks About Foreign Hybrid Notice" (1998) 78 *Tax Notes* 402 (citing Phyllis Marcus). For effects of hybrid mismatches on capital import and export neutrality, see OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (Paris: OECD Publishing, 2012), 11.

[215] See above Pt III.C.

[216] For this aspect, see, e.g. Jarass, Finanzausschuss Hearing 19/138 (2021), 11. See also Prinz, "Internationale Personengesellschaften: Option gem. § 1a KStG bei ausländischen Mitunternehmern" [2023] *FinanzRundschau* 1, 3.

[217] For the invitation to cherry-pick through the election, see DSTG, Finanzausschuss Testimony (29 April 2021), 1, 4. See also Stephan Meyering and Sandra Müller-Thomczik, "Große Familienpersonengesellschaften: Glückspilze dank KöMoG" [2021] *Der Betrieb* M4. For reservations against additional planning opportunities with legal form, see Crawford and Freedman, "Small Business Taxation" (Ch.11) in Adam et al (eds), *Dimensions of Tax Design: The Mirrlees Review* (2010), p.1062. For "the best of both worlds" through US check-the-box, see Thomas M. Hayes, "Checkmate, the Treasury Finally Surrenders: The Check-the-Box Treasury Regulations and Their Effect on Entity Classification" (1997) 54 *Washington and Lee Law Review* 1147, 1182.

[218] See above Pt III.B.1.

profits are the aim of the election.[219] Since the option would have no real advantages (and in any case no disproportionate advantage) for other (smaller) partnerships, which could theoretically elect corporate taxation under the German rules, there is not a high risk of unintended spill-over effects in the German domestic setting.[220] This underlines the general finding (beyond the German context) that the election can address specific issues of neutrality of legal form without creating relevant new distortions domestically; and regarding the concerns about international inefficiency arising from the US example, the relevant German rules to counteract the emergence of hybrid entities have already been discussed.[221]

D. Simplicity dimensions of robustness to avoidance

1. Lack of robustness to avoidance as a simplicity issue and entity classification election as a cause of problems

Robustness to avoidance has simplicity implications.[222] The literature points to a cat-and-mouse game between taxpayers and tax authorities in the context of avoidance schemes and anti-avoidance measures, which is not only inefficient but which also complicates the system.[223] The compliance and administrative issues of tax planning have already been addressed in this article, and how tax planning can be triggered by entity classification election rules has also been described.[224] Observations in the literature, linking the check-the-box regulations and their incentives for international tax planning to more recent international disputes in tax and related economic questions, and drawing a connection with the controversial state aid decisions of the European Commission[225] regarding Ireland and Apple, indicate the far reaching effect of internationally uncoordinated regulations.[226] And there are also the more immediate effects of unlimited and uncoordinated entity classification election rules. Other countries and the international tax system generally must deal with the check-the-box rules, and this, in the global view, is an increase in administrative burdens.[227]

2. Insights from the German example

Anti-avoidance rules, and special anti-avoidance regulations in particular, can generally lead to complex attempts by taxpayers to circumvent the rules.[228] The elements of the German regulations on the

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[219] See above Pts III.B.2., III.C.2.

[220] See above Pt III.B.2.

[221] See above Pts IV.B.2., IV.C.1. Anti-avoidance rules can also cause distortions, especially if they result in real activity to be shifted; see Devereux et al, *Taxing Profit in a Global Economy* (2021), pp.116–117. In this light, the German rules to counteract tax planning with hybrid entities in the context of the entity classification election could influence real business decisions internationally; this, however, should be secondary to the advantages in this context.

[222] Mirrlees et al, *Tax by Design: The Mirrlees Review* (2011), p.42.

[223] Devereux et al, *Taxing Profit in a Global Economy* (2021), p.120; Mirrlees et al, *Tax by Design: The Mirrlees Review* (2011), p.42.

[224] See above Pts III.D., IV.B.

[225] Commission Decision (EU) 2017/1283 [2017] OJ L187/1. See also *Ireland v Commission* (Joined Cases T-778/16 and T-892/16) EU:T:2020:338; and see recently Opinion of Advocate General Pitruzzella in *Commission v Ireland and others* (C-465/20 P) ECLI:EU:C:2023:840.

[226] See Shaviro, "The EU-US Relationship in the Field of Income Taxation as Viewed from a US Perspective" (Ch.4) in Pistone and Weber (eds), *The Implementation of Anti-BEPS Rules in the EU* (2018). See also David D. Steward, "BEPS Seen as Area of Both Consensus and Conflict" 140 *Tax Notes* 1387 (quoting Robert Stack: "U.S. check-the-box rules, which allow for the shifting of earnings, have 'incensed' U.S. trading partners"). For Apple's tax planning and check-the-box, see Antony Ting, "iTax: Apple's International Tax Structure and the Double Non-Taxation Issue" [2014] B.T.R. 40. See also Senate Hearing 113-90 (2013).

[227] For the international reactions to hybrid mismatches, see above Pt IV.B.2.

[228] For the effects of different kinds of anti-avoidance rules, see Richard Krever, "General Report: GAARs" in Michael Lang et al (eds), *GAARs* – A Key Element of Tax Systems in the Post-BEPS World (Amsterdam: IBFD, 2016), p.1. See also Paulo Rosenblatt and Manuel E. Tron, "General Report Subject 1: Anti-avoidance measures of general nature and scope – GAAR and other rules" in IFA, *Cahiers de droit fiscal international* (2018), Vol.103A, p.5. For line-drawing issues in the context of anti-arbitrage measures, see Ring, "One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage" (2002) 44 *Boston College Law Review* 79, 125–128.

prevention of arrangements with foreign hybrid entities (foreign corporate taxation), however, are not particularly open to circumvention.[229] The problem lies more in verifying the foreign tax treatment, but this is simplified for the domestic authorities in that foreign entities have to provide evidence of their eligibility for the election.[230] The treaty override, as a unilateral measure to address issues of domestic hybrid entities, is also relatively easy to handle administratively, and is not prone to litigation under the Federal Constitutional Court's case law.[231] The latter does not necessarily translate to other countries though, and the trade-off of administrative simplification through taxpayer participation is that compliance becomes more burdensome.[232]

So far, the article has addressed issues of mismatches due to entity classification elections, but hybrid mismatches are an issue even without entity classification elections. The foreign qualification of the partnerships in question may already differ from the domestic classification, and these conflicts can be avoided by the entity classification election, which thus fosters simplification.[233] This therefore is another perspective to be added to the simplicity evaluation.[234] Furthermore, issues of potential tax arrangements regarding entity classification elections have emerged at the national level beyond (corporate) income taxation. The details (of the German real estate transfer tax for example)[235] are not relevant for this article. The need for coordination of a moderate reform within an existing system, however, is also a general lesson to be learned beyond Germany.

E. Findings

In this second part of the analysis, entity classification election rules have been examined in light of the principle of robustness to avoidance and its relationship with fairness, efficiency, and simplicity. From a policy perspective the main risk of entity classification election rules in this context is the emergence of hybrid entities in the international context. This became apparent in the US check-the-box discussion. Since the problems of entity classification election rules lie in the cross-border situation, it is appropriate to confine the impact of the election to the domestic context. This, together with the necessary domestic coordination might complicate the domestic entity classification election rules, and relying on treaty overrides may not be a model for all countries; overall, however, the German example shows that domestically confined and coordinated entity classification election rules can play out their strengths in furthering fairness, efficiency, and simplicity.

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[229] To be sure, using foreign entity classification election rules to achieve foreign corporate taxation is not objectionable in this context; see Bundestagsdrucksache 19/28656 (2021), 22.

[230] See Wacker et al, "Zum Optionsmodell nach dem Gesetz zur Modernisierung des Körperschaftsteuerrechts: oder: eventus varios res nova semper habet" [2021] *Deutsches Steuerrecht DStR-Beihefter* 3, 37. For the requirement of proving the eligibility for the election generally, see BMF, 10 November 2021, BStBl I 2021, 2212, para.6.

[231] See above Pt IV.B.2.

[232] For the trade-off in light of cooperation obligations, see Helbig, *Steuerkomplexität: Ein systemtheoretischer Ansatz* (2017), p.26.

[233] See Brühl and Weiss, "'Check the Box' from good old Germany: Die Option zur Besteuerung als Körperschaft nach dem Entwurf des KöMoG" [2021] *Deutsches Steuerrecht* 889, 890; Johanna Hey, Finanzausschuss Hearing 19/138 (2021), 8; Wackerbeck, "KStG § 1a" in Brandis and Heuermann (eds), *Ertragsteuerrecht* (2023), para.6. See also Benz and Hannig, "Das Optionsmodell versus § 34a EStG" in Rödder and Krumm (eds), *Steuerberater-Jahrbuch 2020/2021* (2021), p.100.

[234] See generally above Pt III.D.

[235] For an overview of amendments to German Real Estate Transfer Tax Law (Grunderwerbsteuergesetz, GrEStG) ss.5, 6 in the context of the Law to Modernise the Corporate Tax Law, see, e.g. Stefan Behrens and Marcel Seemaier, "Änderung der §§ 5, 6 Abs. 3 GrEStG durch das KöMoG und das StAbwG" [2021] *Deutsches Steuerrecht* 1673; Feldgen, "KStG § 1a" in Bott and Walter (eds), *Körperschaftsteuergesetz* (2023), paras 130–135. For further current issues in the context of GrEStG ss.5, 6, see Maximilian Freiherr v. Proff and Sören Steuber, "Handlungsbedarf wegen drohender Abschaffung der Gesamthand-Steuervergünstigungen (§§ 5–7 GrEStG) ab 1.1.2024 durch das Wachstumschancengesetz" [2023] *Deutsches Steuerrecht* 2465.

V. Conclusion

In answer to the research question posed at the beginning of this article, the truth lies in the middle. Entity classification election rules can be both sensible tools to achieve neutrality of legal form but also an invitation to engage in tax avoidance. Regarding the first part of the question, the article showed conceptual advantages of entity classification election rules over fundamental reforms under consideration of the three standards of fairness, efficiency, and simplicity; and the German rules demonstrate that the election can indeed be necessary to achieve full equity and neutrality in certain comparative pairs of taxpayers, which may not be attainable with justifiable effort by specific adjustments to align the different business tax regimes. The analysis of the second part of the question, by examining the US check-the-box regulations, highlighted that entity classification election rules can endorse international tax avoidance, which has negative implications on fairness, efficiency, and simplicity. However, although the German treaty override approach is not a model of international cooperation, it shows that entity classification election rules are not inevitably a means of tax competition.

On a final note, it is necessary to reconfirm what entity classification election rules can and cannot achieve, by revisiting the aforementioned political statements from Germany. First, if the German Government believes the election leads to "real neutrality of legal form",[236] this is only partly correct. It is true that entity classification election rules can achieve a full tax alignment. However, the election, in the way it is designed in Germany, is only effective in equalising differences in specific comparative pairs, and therefore does not lead to a comprehensive neutrality of legal form.[237] Secondly, the considerations of the German Government in relation to the strengthening of international competitiveness do not necessarily imply a competitive approach.[238] The German rules strengthen the businesses in question (nationally and internationally), but only by offsetting the differences in the domestic tax treatment of (larger) partnerships and corporations. Overall, the entity classification election is no substitute for a comprehensive reform, but instead is a separate legislative tool with distinct policy goals and its own scope of application in which necessary alignments can be achieved.

[236] See Bundestagsdrucksache 19/28656 (2021), 15.

[237] See above Pt III. See Wacker et al, "Zum Optionsmodell nach dem Gesetz zur Modernisierung des Körperschaftsteuerrechts: oder: eventus varios res nova semper habet" [2021] *Deutsches Steuerrecht DStR-Beihefter* 3, 43.

[238] See BMF, press release, *Scholz will Wettbewerbsfähigkeit von Familienunternehmen stärken* (24 March 2021).