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RESEARCH ARTICLE

A hybrid entity structure for tax optimization of foreign direct investment in the U.S.

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Abstract

This article develops a new strategy for the (tax) optimization of foreign direct investments in the U.S. This strategy is particularly favorable for natural persons. By using a foreign upstream hybrid partnership, a substantial tax optimization of the current taxation of profits as well as the taxation of capital gains can be achieved. In addition, current and final losses may also be offset cross-border to a certain extent in the case of an exemption under treaty law. This tax structuring idea is presented by way of example and explained on the basis of the country constellation U.S./Germany.

KEYWORDS

corporate structure, finance, international taxation, strategy, tax optimization

1 | INTRODUCTION

1.1 | Theoretical basis and research question

The U.S. is the world's most important destination for foreign direct investment.¹ Foreign direct investment (FDI) is an investment made by foreign companies or individuals in the United States (U.S. permanent establishment or subsidiary). Particularly for natural persons resident abroad, the question arises as to the legal form in which they should structure such a direct investment (e.g., production) in the United States that generates active business profits.

For example, a natural person resident in Germany (investor) can directly establish a permanent establishment (PE) in the USA. In this case, the profit (P) from the U.S. PE is taxed with income tax in the U.S. and is generally exempt from German income taxation in the country of residence, Germany, subject to progression.² In the event

of a profit, the individual's income tax burden amounts to up to 52% at the peak if a U.S. PE is directly chosen (see Equation 1). In the case of losses, final losses cannot be offset in Germany due to the exemption of the US PE under treaty law (DTA).³

$$\sum Tax_{PE} = P \cdot ITR_{U.S.} + (TB_{Germany} \cdot ITR_{Germany}) \quad (1)$$

$$\begin{aligned} Tax\ burden_{PE\%} &= \frac{\sum Tax_{PE}}{P} = ITR_{U.S.} \\ &+ \frac{(TB_{Germany} \cdot ITR_{Germany})}{P} \\ &= 52\% \max \end{aligned}$$

P reflects the annual profit of the U.S. permanent establishment. ITR stands for the applicable income tax rate regarding natural persons. TB represents the tax base in

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Germany, in the investor's state of residence, and takes into account the tax exemption of U.S. permanent establishment profits by tax treaties (DTA). Double taxation agreements have a significant impact on taxation in the investor's country of residence and on foreign direct investment decisions (Chandrasari, 2021; Janeba, 1995; Petkova et al., 2020). It becomes clear that for a natural person, a high-income tax burden arises regarding current profit taxation if he carries out his direct investment in the U.S. by means of a permanent establishment.

Another option is for the foreign individual to establish a U.S. corporation (subsidiary/Sub). In this case, the profit is initially taxed with U.S. corporate income tax (21%) and is subject to a reduced U.S. withholding tax of 15% upon distribution (Dyrenge & Gaertner, 2023).⁴ Taking into account the German final tax of 25% plus a 5.5% solidarity surcharge (Abgeltungsteuer) and crediting the US withholding tax in Germany, the total tax burden on the distributed profit is at least 41.18% (see Equation 2).^{5,6} Losses can only be offset at the level of the U.S. corporation (separation principle). Only indirectly through the sale of shares could the individual resident in Germany as a shareholder claim (final) losses to a limited extent, although there are significant limitations and, where applicable, restrictions on the amount.⁷

$$\begin{aligned} \sum Tax_{Sub} &= [P \cdot CITR_{U.S.} + (P \cdot (1 - CITR_{U.S.}) \cdot \beta \cdot WHTR_{U.S.})] \\ &+ [P \cdot (1 - CITR_{U.S.}) \cdot \beta \cdot (ITR_{Germany} - WHTR_{U.S.}) \\ &\cdot (1 + 0.055)] \end{aligned} \quad (2)$$

$$\begin{aligned} Tax\ burden_{Sub\%} &= \frac{\sum Tax_{Sub}}{P} \\ &= [CITR_{U.S.} + ((1 - CITR_{U.S.}) \cdot \beta \cdot WHTR_{U.S.})] \\ &+ [(1 - CITR_{U.S.}) \cdot \beta \cdot (ITR_{Germany} - WHTR_{U.S.}) \\ &\cdot (1 + 0.055)] \end{aligned}$$

P stands for the annual profit of the U.S. subsidiary (corporation). $CITR_{U.S.}$ is the U.S. corporate income tax rate (21%). $WHTR_{U.S.}$ is the U.S. withholding tax rate on dividend payments reduced by tax treaties to 15%. β reflects the share of the distributed profit for the relevant fiscal year. Here, β can assume values between 0 and 1. If $\beta = 1$, the full distribution of annual profit after tax is given. $\beta = 0$ means full retention of profit. In the present case,

β is set to 1, since a comparison is to be made with a U.S. permanent establishment. $ITR_{Germany}$ is the applicable income tax rate on dividend income regarding natural persons which is 25% (flat rate). The factor $(1 + 0.055)$ represents the German solidarity surcharge of 5.5% levied on the German income tax (flat tax) on dividends.

The total tax burden on the distributed profit is at least 41.18% if a U.S. subsidiary is chosen.⁸ The total tax burden is lower at its peak than if a foreign natural person selects a U.S. permanent establishment. Here, the total tax burden is 52% at the peak (see Equation 1). This is mainly due to the low U.S. corporate income tax rate (21%) and the flat tax in Germany of 25% on the dividend income of a natural person.

An optimal legal investment structure (choice of legal form) would result in the foreign individual being able to receive the profits from the U.S. permanent establishment at the U.S. corporate income tax rate of 21%, without any further subsequent taxation, either in the source state U.S. or in his state of residence Germany. Furthermore, capital gains should also be finally taxed at the U.S. corporate income tax rate. Capital losses or final losses, on the other hand, should be deductible as far as possible for tax purposes in the individual's state of residence (Germany). The question arises whether such an ideal legal structure is possible for the foreign individual. The entity structure is an important factor influencing the tax burden (Agarwal et al., 2021). Furthermore, the taxation system influences the choice of the corporate and capital structure and allows for structuring options (Faccio & Xu, 2015; Luna & Murray, 2010).

In response to this, this paper develops and discusses the strategy of the upstream foreign hybrid partnership (German KG) with a U.S. permanent establishment. This entity is treated transparently for German tax purposes. However, for U.S. taxation purposes, it is opted and taxed as a non-transparent corporation under the check-the-box election (§ 301.7701-3). See in general for the check-the-box election (Gianni, 1999; Mason, 2020). With this choice of legal form, it may be possible to achieve the aforementioned taxation objectives. Consequently, this legal structure can achieve a significant tax optimization of active permanent establishment investments with business profits in the U.S. by German individuals. In addition, final losses can be offset in Germany, the country of residence, in the case of an exemption under treaty law (DTA). As a result, this tax and investment structure is not only suitable for natural persons but also for German corporations wishing to invest in a U.S. PE. Furthermore, the aforementioned structure is of general relevance. It can be applied similarly to worldwide investors.

In the following, the legal structure of the upstream foreign hybrid partnership is developed and analyzed.

1.2 | Methodology and current status of research

This article is concerned with research on taxation. Since the issues under consideration are legal in nature, the methodological approach of using various research methods (theoretical analysis, legal analysis, quantitative analysis, experimental legal research) is suitable and appropriate. Methodologically, the research questions are traced with the theoretical and quantitative analysis, and the analysis of tax law (legal analysis). Since the relevant questions have not yet been examined in the literature, it is also necessary to transfer the existing case law and derive new findings. From a methodological point of view, for the purposes of tax research, case-related analysis, concrete modeling, and formal-analytical research are needed to work out the tax effects and consequences (Hechtner, 2010; Hundsdorfer et al., 2008; Meyering & Müller-Thomczik, 2020; Kußmaul, 2020).

Up to now, the literature has not developed a strategy for a foreign U.S. direct investment that results in significant tax optimization for individuals as investors (Brundage & Starchild, 1983; Endres & Spengel, 2015; Brähler, 2002). The use of hybrid entities for foreign direct investment in relations between the U.S. and Germany has not been extensively studied (Brähler, 2002; Bricker, 1998; Lendewig, 2014). In particular, upstream hybrid partnerships have not been considered so far. Therefore, this article breaks new ground. It extends the state of knowledge in international taxation and investment structuring and strategy. The upstream foreign hybrid partnership structure is a new strategy for a tax-optimized structuring of foreign direct investments in the U.S. This applies to both current taxation and capital gains. Moreover, this investment structure can be used similarly in other country constellations. Therefore, this finding has general relevance for foreign direct investment in the U.S., especially for natural persons.

The elaboration of the upstream foreign hybrid partnership structure is not a trivial analysis of tax law. The fact that an upstream foreign hybrid partnership can be used to tax-optimize foreign direct investment in the U.S. has not been examined before (see Figure 1). This approach has also not yet been discussed in the literature. In this article, this strategy is elaborated for the first time through legal experimental research and induction into a basic theory and decision-making tool. Thus, it is an unknown relationship (hypothesis or the use of a specific legal structure) that is worked out first (see Figure 1). For this purpose, a retrograde (theoretical) analysis including the tax law has been done, since it is not a matter of applying tax regulations to a known situation, but rather of searching for an unknown situation (the investment structure)

that leads to desired tax effects under the secondary condition of the applicable tax regulations. Taxpayers can only act within the framework of legal requirements in their planning and decision-making. Therefore, this article uses experimental legal research. Subsequently, the elaborated theory (upstream foreign hybrid partnership as a structuring instrument) is tested with regard to its legal stability and recognition in view of the intended objectives (tax optimization, stability, complexity) against the tax law. Furthermore, a general legal framework is elaborated by analyzing the case law, which gives companies planning security with regard to optimizing their tax payments.

Thus, this paper applies legal research methods, theoretical analysis, and legal experimental research. Decisions to optimize taxes are mandatorily linked with law and legal requirements. For the first time, an unknown fact is worked out by theoretical and experimental analysis (see Figure 1). It is not possible to use empirical analysis to work out new previously unknown facts for the first time. When investigating previously unknown facts and working out a theory for decision-making for the first time, only the theoretical analysis is suitable, and if the question is also law-based, as is the case here, a legal and legal-experimental investigation is needed. This already results from the object of investigation. If the issue of research is a legal one, the legal framework is of course the basis for the analysis. Empirical analysis can only find out what companies are doing, but not what companies could be doing that no company is doing yet, which would expand existing knowledge. Therefore, the methodological approach used in this paper is justified and well-founded.

1.3 | Literature review and contribution to the literature

The use of hybrid entities for optimizing the tax burden is a recognized instrument in both science and tax practice (Bricker, 1998; Finnerty, 2007; Hardeck & Wittenstein, 2018; Johansson et al., 2017; Nassy & Rahayu, 2018). However, in the case of hybrid entities and arrangements, the academic literature has mainly focused on double non-taxation situations and their avoidance (de Boer & Marres, 2015; Domingo, 2019; Harris, 2014; Lüdicke, 2014; Parada, 2018, 2019; Paulus, 2022; Surman, 2022). There is a lack of derivation in the literature on the use of hybrid entities outside of double non-taxation. Bricker et al. (1998) examine the use of hybrid entities in international tax planning. They do not analyze how hybrid entities can be used for tax structuring of foreign direct investment in the U.S. Lüdicke (2014) deals in general with the tax structuring potential of hybrid entities. However, he does not address how hybrid entities can be used to structure foreign direct

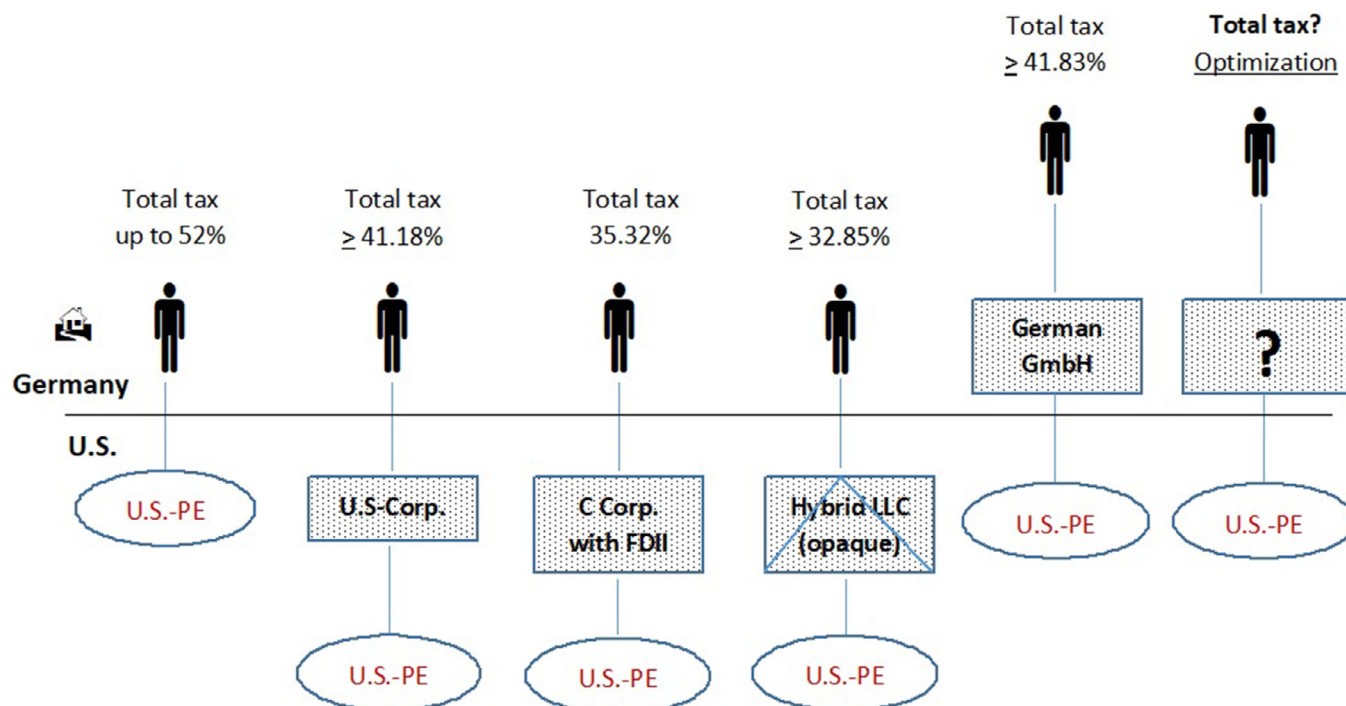


FIGURE 1 Searched investment structure (still unknown) under the secondary condition of tax optimization and reduction of complexity.

investment in the U.S. Robé (2011) focuses on the legal structure of firms. He does not elaborate on taxation and hybrid entities as well as the tax-induced choice of the legal form. Amberger and Kohlhasse (2022) deal with the benefits of flow-through entities in foreign direct investment and the tax burden. However, they do not analyze hybrid entities. They deal in general with international taxation and the organizational form of foreign direct investment. Eerola and Slangen (2022) provide an overview of international tax planning strategies. However, they do not specifically address hybrid entities in structuring foreign direct investment. Liotti (2020) deals with hybrid entities in the law of double taxation treaties but does not discuss structuring options. Qi and Schlagenhaut (2019) examine the choice of legal form against the background of taxation. They do not consider cross-border cases and hybrid entities between different states. Duhoon and Singh (2023) provide a systematic literature review and future research directions on tax planning and structuring. They do not specifically address the use of hybrid entities for foreign direct investment planning.

The results of my study expand the understanding of how foreign hybrid entities can be used to tax-optimize foreign direct investment in the U.S. This general strategy can also be transferred to other states. I contribute to the tax, accounting, and finance literature by developing a new strategy for structuring foreign direct investment

(upstream foreign hybrid partnerships structure). This extends the existing literature.

2 | UPSTREAM FOREIGN HYBRID PARTNERSHIP AS A LEGAL STRUCTURE FOR INVESTMENT INTO A U.S. PE

The natural person (A) resident in Germany (investor) does not “directly” establish the U.S. PE⁹. Rather, he first establishes a business partnership in Germany in the legal form of a limited partnership (KG)¹⁰ or is already a partner in such an entity (limited liability partner). The KG (business entity) is legally taxed as a transparent partnership for German tax purposes (flow-through entity)¹¹ and has at least two partners, with the general partner, in this case, a German GmbH¹². Then the German KG establishes the U.S. PE. For U.S. tax purposes, the KG opts to be taxed as a corporation under the check-the-box election (CTB): § 301.7701-3; Form 8832.¹³ The German KG or a foreign partnership is an eligible entity under the check-the-box election (Treas. Reg. § 301.7701-3; Lischer, 1998; Rosembuj, 2012). Thus, the German KG is a foreign hybrid entity that is taxed as a corporation in the U.S., but as a transparent partnership in Germany. This legal investment structure is illustrated by the figure below (Figure 2):

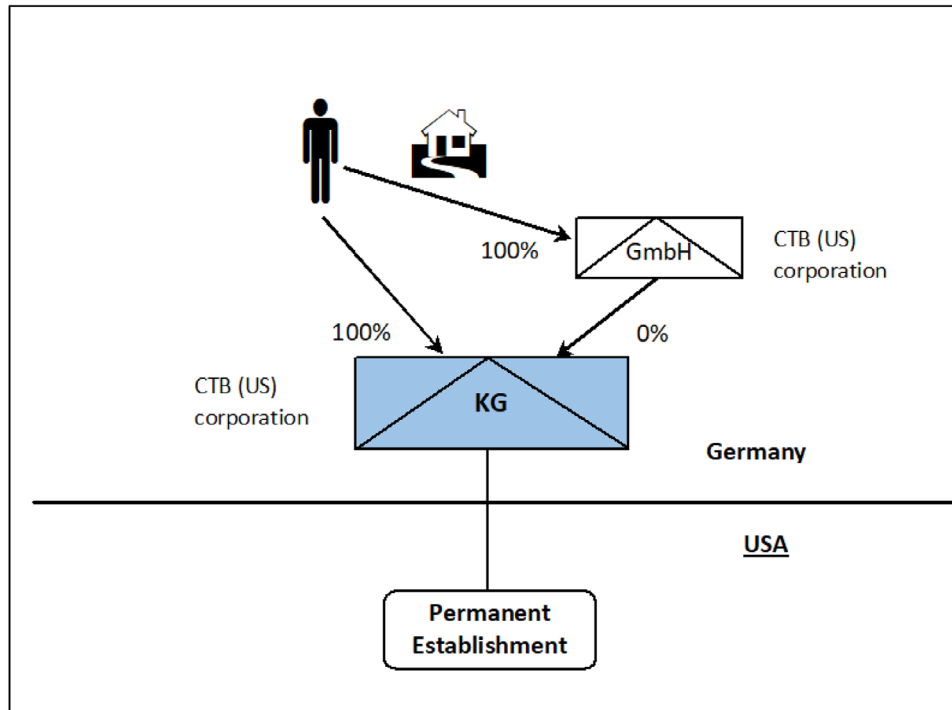


FIGURE 2 Hybrid KG structure.

3 | CURRENT TAXATION

3.1 | U.S. taxation

Since the German KG qualifies as a foreign corporation for U.S. tax purposes (CTB), it is subject to U.S. corporate income tax even on the profits from the U.S. PE under its limited tax liability. The applicable corporate income tax rate is generally 21% (federal level). If the U.S. PE is located in a state that does not levy corporate income tax (like South Dakota, Wyoming, and Texas), no further corporate income tax is due at the state level. As a result, current profits from the U.S. PE are subject to a 21% tax burden. This is the U.S. taxation in the context of current profits.

Withdrawals from the German limited partnership (KG), which from a U.S. perspective represent dividends, cannot be taxed in the U.S. under national tax law, as the limited partnership is cumulatively domiciled and managed abroad (Germany) and does not have a U.S. legal form. Moreover, the prohibition of extraterritorial taxation of dividends is likely to apply in this respect under DTA law.¹⁴

A starting point for U.S. taxation in connection with the distribution of profits can therefore only arise in connection with profit withdrawals of the limited partnership from the U.S. permanent establishment, which in principle can be taxed under a U.S. branch profits tax (BPT) under IRC §884(a) as a taxable dividend equivalent amount. See

for U.S. branch profits tax in general (Baldassari, 1988; Barsuk & Asembri, 2016). However, according to Art. 1 (7) DTA, Art. 3 (1) d) USA-Germany 2008, the German KG is a resident of Germany under treaty law since its income is attributed to German residents (A) for tax purposes by the State in which it is located.¹⁵ According to Art. 10 (9) a) DTA USA-Germany, the U.S. may only levy a BPT under treaty law if a company resident in a foreign treaty state has a PE in the U.S. concerning profit withdrawals from this U.S. PE. In line with Art. 10 (10) DTA USA-Germany, the BPT is limited to 5% of the profit withdrawals which are equivalent to a dividend distribution. In the present case, however, according to Art. 10 (10) b), Art. 28 (2) f), and (4) DTA USA-Germany, the BPT is not levied. Thus, in principle, no U.S. BPT is due.

Regarding current profit taxation, the German KG is thus subject to a tax burden of 21% (U.S. corporate income tax) with its profits from the U.S. PE.

3.2 | German taxation

For German income taxation, the German KG qualifies as a transparent partnership, so that the U.S. permanent establishment profits are attributed to the natural person (A) as a partner of the KG for taxation on a pro-rata basis at the time the profits are generated (Sec. 15 (1) No. 2 EStG). Under Art. 7 (1), (2), and Art. 23 (3) a) DTA

USA-Germany 2008, the U.S. PE profits of the natural person (A) are in principle fully tax-exempt under progression proviso. Consequently, there is no further income taxation of the U.S. permanent establishment profit itself in Germany.¹⁶

The exemption of the U.S. PE profits from German income taxation under treaty law is also not precluded by the qualification conflict at hand regarding the tax classification of the German limited partnership by Germany (transparent) and the U.S. (non-transparent). This is because the U.S. taxes the U.S. PE profits in full (U.S. corporate income tax of 21%). A situation of non-taxation or reduced taxation of the U.S. PE profit in the U.S. with a simultaneous exemption of the PE profit in Germany (double non-taxation or qualified reduced taxation) does not exist. Consequently, the German provisions of Sec. 50d (9) No. 1 to 3 EStG (anti-hybrid rules), which are intended to avoid double non-taxation or reduced taxation in the case of negative qualification conflicts with DTA exemption in Germany do not apply. Likewise, Art. 23 (4) b) DTA USA-Germany does not apply (switch over to the credit method in Germany), since the U.S. taxes the U.S. permanent establishment profits in full and precisely does not exempt them from U.S. taxation and also does not tax them under Art. 10 (2), (3) DTA USA-Germany only within the scope of limited source taxation. Furthermore, there is also no change to the imputation method in Germany concerning the U.S. PE profits under Sec. 20 (2) AStG (type of CFC taxation), since the U.S. PE, as already explained above, generates active income within the meaning of the AStG.¹⁷

Withdrawals from the U.S. PE and the KG are not taxable in Germany, as the KG qualifies as a transparent partnership and the profits are only attributed and taxed at the partner level of the KG at the time the profits are generated.

As a result, the foreign individual (A) can receive the U.S. PE profits at a final tax rate of 21% or the U.S. corporate income tax rate.

Current losses from the U.S. permanent establishment can, in principle, be offset by the individual (A) in Germany for income tax purposes by way of the negative progression proviso¹⁸ (indirect loss offset). This may reduce the applicable German income tax rate on domestic income.

3.3 | Overall effect concerning current taxation

In the overall view, the hybrid KG structure enables the final receipt of U.S. PE profits at the low U.S. corporate income tax rate of 21% (see Equation 3 below). This is

particularly favorable for individuals who are resident in Germany. Compared to this legal structure, the current tax burden for the direct establishment of a U.S. PE by the individual resident in Germany amounts to approx. 52% at the peak (see Equation 1). If the German resident individual uses a U.S. corporation (subsidiary) for its direct investment in the U.S., all other things being equal, the total tax burden upon distribution of profits is 41.18% (see Equation 2). If a U.S. C corporation is used as a subsidiary and FDII is applied, the current total tax burden upon full distribution of profits to the individual resident in Germany is 35.32% (see endnote 6).

$$\sum Tax_{Hybrid} = P \cdot CITR_{U.S.} + TProg_{Germany} \quad (3)$$

$$Tax\ burden_{Hybrid,\%} = \frac{\sum Tax_{Hybrid}}{P} = CITR_{U.S.} + \frac{TProg_{Germany}}{P} \rightarrow 0 \approx 21\%$$

P stands for the annual U.S. profit regarding the U.S. PE of the hybrid KG. $CITR_{U.S.}$ is the U.S. corporate income tax rate (21%). $TProg$ reflects income taxation under the progression proviso in Germany (§ 32b EStG). The taxation under the progression proviso does not mean that the U.S. profits itself were taxed in Germany or the profit share from the hybrid KG. Rather, these profits are completely tax-free by treaty exemption (DTA U.S./Germany) but get included in the calculation of the tax rate applicable to the remaining domestic income of the individual (A). Thus, the progression proviso may trigger indirect taxation. Provided that the individual (A) already has income in the upper tax bracket in Germany (>277,826 euros), the progression proviso in fact has very little effect. In the present case, it can therefore be set at 0.

Therefore, the hybrid KG structure as a legal formation can significantly optimize the current taxation of U.S. PE profits concerning investors resident in Germany (in particular individuals and corporations).

4 | CAPITAL GAINS TAXATION (EXIT)

Concerning the capital gains taxation or the abandonment of the U.S. permanent establishment (exit), two different options for the foreign investor (shareholder of the German KG) are given. The taxation of capital gains is an important factor influencing the return on investment and investment decisions (Hines & Schaffa, 2023; Huizinga et al., 2018; Kamin & Oh, 2019).

In the event of a profit, the German KG can sell the U.S. PE. A capital gain is only taxed in the U.S. with U.S. corporate income tax at 21% and is fully exempt from income taxation in Germany under the U.S.-Germany DTA.¹⁹ Similar to current profits from the U.S. PE, there is no harmful qualification conflict canceling the DTA exemption in Germany. Thus, the German resident investor can receive profits from the disposal of the U.S. PE with a tax burden at the low U.S. corporate income tax rate of 21%. In the event of a capital gain, the hybrid KG structure is also beneficial compared to the direct establishment of the U.S. PE or the establishment of a U.S. subsidiary (corporation) by the German investor.

In the event of a loss or a potential capital loss/loss on disposal, the U.S. permanent establishment is not sold by the limited partnership (KG). Instead, in this case, the German partner (A) of the KG sells his share in the KG. Since there is a harmful qualification conflict in this situation at hand, a change from the DTA exemption method to the unilateral imputation method under Sec. 50d (9) No. 2 or 1 EStG applies in Germany for the capital loss.²⁰ Germany assumes the disposal of the shares in the KG under Art. 13 (1), (3) DTA U.S.-Germany 2008 and generally grants the DTA exemption under Art. 23 (3) a) DTA U.S.-Germany 2008, whereas the U.S. would not tax the disposal of the shares under national law only for limited taxpayers or would apply Art. 13 (5) DTA U.S.-Germany 2008 to this loss on disposal of shares. Thus, final losses in the form of capital losses²¹ and the losses from the termination of the PE in the U.S. (year of abandonment) can in principle be offset for income tax purposes in Germany with full tax effect. Consequently, the hybrid KG structure is also favorable for German corporations to be able to deduct final losses in the form of abandonment and disposal losses of a U.S. PE for corporate income tax purposes in Germany despite the fundamental treaty exemption.

Also for capital gains taxation (exit), the hybrid KG structure is usually preferable compared to the direct establishment of a U.S. PE or a U.S. subsidiary regarding foreign direct investment in the U.S.

5 | TAX RECOGNITION AND SUSTAINABILITY

The structure of the hybrid partnership (KG) is fiscally stable and recognized. The taxpayer is free to choose its legal form. There is no scope for abuse of law (§ 42 AO).²² Nor is there any harmful conflict of qualification leading to a unilateral switch to the imputation method in Germany, as explicitly evidenced by the special provisions of § 50d (9) No. 1 to 3 EStG (anti-hybrid rules). Using the check-

the-box election in the U.S. for tax purposes is a statutory option abroad and is not abusive for tax purposes in any respect, not even from a German perspective.²³ Overall, the hybrid KG structure can be attested to tax stability and strong tax recognition. See for the recognition of tax planning (Brühne & Schanz, 2022; Finnerty, 2007; Kouroub & Oubdi, 2022).

Another significant benefit of the hybrid limited partnership structure is that the investor can operate with a legal form familiar to him in his state of residence and does not have to establish a hybrid company (e.g., a U.S. LLC) in the country of foreign direct investment. This significantly fosters the implementation of this legal structure and significantly reduces complexity and transaction costs. Via the check-the-box election, which is only effective for U.S. tax purposes, the German investor can achieve taxation with the upstream foreign hybrid limited partnership as with a hybrid U.S. LLC, but with greater legal certainty and significantly less complexity. A classification test is not necessary for German tax purposes, since a German legal form exists (KG). Furthermore, in the case of a foreign upstream hybrid entity, no withholding tax arises in the country of the direct investment.²⁴ Consequently, optimal profit repatriation is already taken into account regarding this legal investment structure.

The investment strategy developed in this paper—the upstream foreign hybrid partnership structure—is sustainable. The investor using that structure is in full compliance with the (tax) law. He pays exactly the taxes that the legislator determined. The investor does not behave ethically and morally reprehensible if he chooses from the range of investment options legally given the one that grants him favorable taxation by law. Here, the (ethical and moral) compass of the legislator is decisive. The taxpayer is not obliged to choose his circumstances or investment structure in such a way that the tax burden is as high as possible. According to settled case-law taxable persons are generally free to choose the organizational structures and the form of transactions that they consider to be most appropriate for their economic activities and for the purpose of optimizing their tax burdens (Court of Justice of the European Union, RBS Deutschland Holdings, C-277/09; EU:C:2010:810, para. 53; C-419/14; ECLI:EU:C:2015:832, para. 42; C-103/09; EU:C:2010:804, para. 27; C-255/02; EU:C:2006:121, para. 73).

Furthermore, the developed upstream foreign hybrid partnership structure is sustainable because the foreign investor can operate with a legal form of his state of residence. This significantly reduces complexity and compliance costs. A complicated legal classification of a foreign legal form is not required. This enables the investor to participate in business life on a sustainable

basis. The investment structure can be maintained in the long term and does not have to be continuously adjusted as in the case of a foreign legal form due to changes in the law abroad. The certainty and stability of the derived investment structure make it legally and economically sustainable for the investor and the foreign investment location. As a result, the foreign investor will keep his direct investment longer and more sustainably and thus participate more intensively in the economic life of the target country (job creation, long-term investment).

6 | SUMMARY AND CONCLUSIONS

The hybrid KG structure developed in this paper allows for a tax-optimized structuring of foreign direct investments in the U.S. This concerns both current taxation and the sale or termination of the direct investment (exit). Final losses in the form of disposal and abandonment losses can also be offset in Germany with full income tax effect despite the exemption under treaty law. The legal structure of the upstream hybrid limited partnership is particularly favorable for a natural person resident in Germany, but also for German corporations wishing to establish a direct investment in the U.S. Further benefit of this legal structure is that the investor can operate with a familiar legal form of his state of residence, with a considerable reduction in complexity compared to the use of a foreign hybrid legal entity (e.g., U.S. LLC). Beyond the U.S.-Germany relationship, the legal structure is of fundamental relevance because it can be used similarly in other country constellations. In addition, the U.S. check-the-box election is generally available. Moreover, the strategy of using an upstream hybrid company in the investor's country of residence as a vehicle for foreign direct investment is sustainable and offers high legal acceptance and stability as well as investment certainty.

DATA AVAILABILITY STATEMENT

The data that supports the findings of this study are available in the text of this article.

ENDNOTES

- ¹International Monetary Fund, IMF Data, Coordinated Direct Investment Survey 2021.
- ²Art. 7 (1), (2), Art. 23 (3) a) DTA USA-Germany 2008; DTA = Double Tax Agreement.
- ³So-called symmetry thesis, see also CJEU, (Court of Justice of the European Union), Decision of Nov. 6, 2007, C-415/06, ECLI:EU:C:2007:651 (loss from a U.S. permanent establishment/partnership); German Supreme Tax Court

(BFH), Judgment of Feb. 22, 2023, I R 35/22 (I R 32/18), ECLI:EN:BFH:2023:U.220223.IR35.22.0; BFH, Decision of September 22, 2015, I B 83/14, BFH/NV 2016 p. 375 No. 3. The indirect offsetting of losses in the case of natural persons by way of and within the limits of the negative progression proviso is still possible.

⁴Art. 7 (1), (2), Art. 10 (2) b) DTA USA-Germany 2008.

⁵ $[0.21 + (1 - 0.21) \times 0.15] + [(1 - 0.21) \times (0.25 - 0.15) \times (1 + 0.055)] = 0.4118 = 41.18\%$.

⁶If the German resident individual elects a U.S. C corporation and FDII applies (IRC Section 250), the total charge at an effective U.S. corporate tax rate of 13.125% and full distribution to the individual is approximate: $[0.13125 + (1 - 0.13125) \times 0.15] + [(1 - 0.13125) \times (0.25 - 0.15) \times (1 + 0.055)] = 0.3532 = 35.32\%$.

⁷See, for example, in the context of the German income tax, Section 20 (6) EStG (basket limitation).

⁸See endnote 5.

⁹An active permanent establishment (business profits) within the meaning of the German AStG and the meaning of Art. 5, Art. 7 (1), (2) DTA USA-Germany 2008 is given.

¹⁰§ 161 et seq. HGB (Germany).

¹¹§ 15 (1) No. 2 EStG.

¹²According to the check-the-box election, the German GmbH can be opted as a corporation for U.S. tax purposes or is to be treated as a corporation for U.S. tax purposes according to the default classification. A German AG (stock corporation) could also be used as the general partner of the KG. In this case, as a per se corporation, the check-the-box election is not required.

¹³See also Section 3.02 of Rev. Proc. 2010-32.

¹⁴Art. 10 (8) DTA USA-Germany 2008.

¹⁵See accordingly on the interpretation of Art. 1 (7) DTA USA-Germany 2008: German Supreme Tax Court (BFH), ruling of June 26, 2013, I R 48/12, BStBl 2014 II p. 367.

¹⁶For German trade tax purposes, the U.S. permanent establishment as a foreign PE (Sec. 12 AO) is already not subject to taxation (not taxable). German trade tax only applies to domestic commercial permanent establishments (territoriality principle). See Sec. 2 (1), Sec. 9 No. 3 GewStG.

¹⁷Section 8 (1) AStG.

¹⁸Section 32b (1) sentence 1 no. 3, Section 2a (2), Section 15a EStG.

¹⁹Art. 7 (1), (2), Art. 23 (3) a) DTA U.S.-Germany 2008. In the case of a natural person resident in Germany and partners of the KG, the exemption is subject to progression.

²⁰See on the consideration of foreign losses under application of Section 50d (9) EStG in the case of DTA exemption: BFH, judgment of July 11, 2018, I R 52/16, ECLI:DE:BFH:2018:U.110718.IR52.16.0. A case of section 2a EStG does not exist in the constellation at hand.

²¹Something else is likely to apply to accumulated losses carried forward: BFH, judgment of April 12, 2023, I R 44/22, ECLI:DE:BFH:2023:U.120423.IR44.22.0. However, such losses have already been taken into account in principle for income tax purposes in the case of natural persons as shareholders of the KG within the framework of the negative progression proviso in Germany.

²²Settled case law: BFH, IX R 8/20, para. 27; BFH GrS 1/81, C.III; BFH IX R 56/03, II.1.a; BFH, IX R 40/09, para. 10; BFH, I R 2/18, para. 28; CJEU (Court of Justice of the European Union), C-419/14, para. 42 and CJEU, C-277/09, para. 53.

²³See also BFH, judgment of September 7, 2005, I R 118/04 BStBl 2006 II p. 537, at II. 2 (tax benefits abroad).

²⁴For a hybrid U.S. LLC, taxed as a corporation in the U.S. according to the check-the-box election and as a transparent partnership in Germany, a U.S. withholding tax of 15% would apply upon distribution, taking into account the U.S.-Germany tax treaty (DTA). The shareholder of the hybrid U.S. LLC is the German resident individual (A). The total tax burden when using a hybrid U.S. LLC is at least 32.85%. U.S. corporate income tax (21%) and withholding tax on distribution (15% considering the tax treaty) will apply. Calculation: $[0.21 + (1 - 0.21) \times 0.15] = 0.3285 = 32.85\%$. Provided that the individual (A) already has income in the upper tax bracket in Germany (> 277,826 euros), the progression proviso in fact has very little effect. In the present case, it can therefore be set at 0.

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