UK Tax Authorities address tax treatment of Delaware LLCs

Executive summary

On 25 September 2015, the UK Tax Authorities (HMRC) issued Revenue and Customs Brief 15, setting out its practice following the recent decision of the UK Supreme Court in Anson v HMRC [2015] UKSC 44.

It is extremely brief and states that, after careful consideration, HMRC has concluded that the decision is specific to the facts as found in the instant case. As a result, where US LLCs have been treated as companies within a group, HMRC will continue to treat the US LLCs as companies and, where a US LLC has itself been treated as carrying on a trade or business, HMRC will continue to treat the US LLCs as carrying on a trade or business. Furthermore, HMRC proposes to continue its existing approach to determining whether a US LLC should be regarded as issuing share capital.

Individuals claiming double tax relief and relying on the Anson decision will have their claims considered on a case by case basis and this Alert considers the implications for corporate groups with LLCs within the group structure.

Detailed discussion

Relevance of the case

Ever since the Supreme Court ruled that Mr. Anson's liability to UK tax was computed by reference to the profits of an LLC which were taxed in the US, this has led to considerable uncertainty for international group structures in answering three key questions:

- Whether UK resident members of Delaware LLCs (and other entities with similar characteristics) may now be subject to UK tax on the profits of the LLC as they are earned, as opposed to when they are distributed by the LLC.
- Whether a Delaware LLC can be a member of a “group” for UK tax purposes on the basis that the First-tier Tribunal (FTT) in Anson held that members’ interests in the LLC were not akin to share capital, but were more like interests in a partnership.
Whether double tax relief is available in all circumstances. If the decision in Anson is limited to its particular facts, as HMRC argues, this would not assist taxpayers in similar circumstances in applying the same treatment, and obtaining double tax relief for UK tax imposed on profits derived through a similar foreign entity.

On the face of it, the HMRC practice note considers the first two of these questions. However the brevity of the note leaves taxpayers in a potentially difficult position. HMRC states that the decision is specific to the facts found in the case and we understand that HMRC believes that a future First-tier Tribunal should, if necessary, be given the opportunity to consider any apparently similar cases involving these issues on their own facts and make their own findings, given the possibility that those findings might be different. There also remains the broader question as to what comfort taxpayers can take from the statement issued today given the limitations on HMRC practice established in Wilkinson [2006] 1 All ER 529.

Although not entirely clear from the announcement, we understand that HMRC expects to apply its announcement both historically and going forward in respect both of the transparency of an LLC and in determining whether an LLC has issued share capital.

In considering HMRC’s position, it is worth recapping the facts of Anson.

**Facts of Anson v. HMRC**

The taxpayer, Mr. Anson, was a UK tax resident, but non-domiciled. He was a member of a Delaware LLC that carried on an investment management business in the US, managing various venture capital funds. Mr. Anson was assessed to US tax on his share of the profits of the LLC. The balance of the profits were distributed to him, and in computing his UK tax liability on those profits he claimed credit relief for the US tax under Article 23(2) of the UK/US double tax treaty. Article 23(2) allows relief from UK tax for US tax “computed by reference to the same profits or income.” HMRC challenged his claim for double tax relief on the basis that the income which had been taxed in the US was not his income, but that of the LLC.

The key clauses of the LLC Operating Agreement were fairly standard. The agreement contained a section providing for the profits of the LLC to be allocated among the members in accordance with their profit shares. It also contained a section providing for distributions of all of the profits of the LLC to be made to the members each year “in such amounts as the managing members may determine in their sole discretion.”

The FTT found in favor of the taxpayer, on the basis that as a matter of fact that, on a proper construction of Delaware law and the LLC Operating Agreement, the members of the LLC had an interest in the profits of the LLC as they arose. In other words, the FTT found as a matter of Delaware law that the profits (as opposed to the assets) of the LLC did not belong to the LLC in the first instance and that they did not then become the profits of the members as a result of some mechanism (e.g., the declaration of a dividend). Rather, the profits of the LLC belonged to the members as they arose. The Supreme Court made it clear that further analysis would have been needed if the UK taxpayer had been a UK resident company holding at least 10% of the voting power in the LLC.

The decision of the FTT was overturned in the Upper Tribunal and then, on appeal by the taxpayer, in the Court of Appeal, in each case on the basis that the FTT had erred in its application of UK tax law to the facts. The Supreme Court, by contrast, found that the taxpayer had an interest in the LLCs profits as they arose, and was therefore entitled to double tax relief, thus reinstating the decision of the FTT.

**Interpreting Anson**

It is possible to read the Supreme Court’s decision either broadly or narrowly. The broad view is that Anson is authority for the position that under UK tax law the key factor in determining the treatment of any foreign entity is whether the members of the entity have an interest in the profits as they arise. This broad view potentially has a number of UK tax implications, including the two issues noted above. The narrow view is that the Supreme Court merely decided that the FTT’s findings of Delaware law were findings of fact and not
law. As a result they could not be overturned on appeal and the decision is arguably limited to the particular Delaware LLC in question and the specific treaty provisions providing for double tax relief. In this context the Supreme Court noted that “the issue in this case is not whether the receipts of the LLC from third parties are to be regarded as having been paid to the members of the LLC, but whether the income on which Mr. Anson paid tax in the US is the same as the income on which he is liable to tax in the UK.”

From today’s announcement, it would appear that HMRC are taking the narrow view. However in the absence of more detail, the question arises as to how taxpayers can satisfy themselves that their facts are distinct from those in Anson and thus that the different UK tax consequences should follow. While it provides some comfort regarding the focus of any HMRC enquiry, the guidance issued today cannot overturn the Supreme Court ruling in Anson. The key concern is that, as noted above, the LLC Operating Agreement appeared fairly standard and it is possible that many taxpayers wishing corporate treatment for an LLC will find themselves having to decide between a pragmatic approach in following HMRC’s practice announcement or seeking comfort that their facts can be differentiated from those in Anson.

Implications of HMRC’s position
It is clear from the Brief that, if corporate treatment is sought for an LLC, it will be necessary to continue to take particular care when drafting LLC agreements to ensure that the constitutional documents of the LLC resemble as closely as possible those of a UK company. In particular, groups may wish to pay attention to the terms relating to the allocation and entitlement of profit, among other clauses, with amendments potentially being made to clarify that profits are not allocated to the members but instead belong to the company until such time as there is a distribution to the members.

For additional information with respect to this Alert, please contact the following:

**Ernst & Young LLP (UK), London**
- Matthew Mealey +44 20 7951 0739 mmealey@uk.ey.com
- Fiona Thomson +44 20 7951 3913 fthomson@uk.ey.com
- Claire Hooper +44 20 7951 2486 chooper@uk.ey.com
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2015 EYGM Limited.
All Rights Reserved.

EYG No. CMS797

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com