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Anson and UK Tax Transparency

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A review of the Anson decisions and practical implications following HMRC's recent Business Brief, by Morgan, Lewis & Bockius UK LLP.

Introduction

Delaware limited liability companies ("LLCs") are regularly seen in international corporate groups. Their treatment is flexible for US tax purposes, as by default they are treated in the same way as partnerships, although they are able to elect to be treated as a corporation for US tax purposes. No such elective regime exists in the UK, and the tax treatment of them and their members will turn on whether or not the LLC is opaque or transparent for UK tax purposes. Until now HMRC's practice (which was widely accepted as being correct) has been that they should normally be treated as opaque.

Mr Anson, a UK resident taxpayer, was a member of a Delaware LLC (treated as a partnership for US tax purposes) and was subject to US tax on his share of the LLC's profits as they arose. For UK tax purposes, however, HMRC denied Mr Anson a credit against his UK tax liability for the US tax, on the basis that the LLC was not transparent, so Mr Anson's income consisted of the LLC distributions and not the underlying profits themselves, with the result that the US tax was not imposed on the "same income". As a result he was liable to pay UK income tax on the income distributed (net of the US tax paid), with no credit for the US tax already paid, which produced an effective rate of taxation of around 67%. On 1 July 2015 the Supreme Court of England & Wales gave its judgment in **Anson v Revenue and Customs Commissioners [2015] UKSC 44**, a landmark ruling that allowed Mr Anson a credit for his US tax against his UK income tax liability.

The decision came as a surprise to many, as it represented a departure from HMRC's previous view that Delaware LLCs should be treated as opaque for UK tax purposes. The Supreme Court agreed with the decision of the court of first instance (the First Tier Tribunal or "FTT") that Mr Anson was in fact entitled to the profits as they arose – or in other words, that the LLC was transparent for income tax purposes. This decision created some uncertainty regarding how Delaware LLCs should be treated from a UK tax perspective, including whether all LLCs should be treated in the same way.

HMRC Practice and Recent Announcement

HMRC has a long and well-established practice of entity classification, for the purposes of determining whether a non-UK entity should be treated as opaque (like a UK company) or transparent (like an English partnership). There are several limbs to the test (developed following the decision in **Memec v IRC [1998] STC 754**), including:

(i) whether the entity has separate legal personality,

(ii) whether it issues share capital or something equivalent,

(iii) whether the business is carried on by the entity or by its members,

(iv) whether members are entitled to the profits of the business as they arise or only following distribution,

(v) who is responsible for debts of the business and

(vi) to whom do the assets used in the business belong

(i.e., the "**Memec** tests"). HMRC's view has always been that no one factor should be determinative.

On 25 September 2015, HMRC released its views on the case, and its implications for UK companies and individuals with interests in Delaware LLCs, in Revenue and Customs Brief 15 (2015). The statement is somewhat lacking in useful analysis and detail, and there is no comment on the continuing applicability of the **Memec** tests; the implication is that HMRC will continue to

apply them as before. With respect to Delaware LLCs in particular, HMRC has taken the view that the deciding factor was in fact the LLC agreement and not the Delaware law itself (despite the lack of express statement to this effect in the judgement), and as a result the case does not necessarily have wide relevance to other LLCs. With respect to companies, HMRC has said they will continue to treat as a company an LLC that has historically been treated as a company within a corporate group. For individuals, however, a case by case approach is to be adopted.

The First Tier Tribunal's Decision

The FTT focused on whether the taxpayer's UK income tax liability had been computed "by reference to the same profits or income" as the US tax, within the meaning of the relevant provisions of the UK-US treaty. To assess this, rather than considering the entire entity classification test referred to above, the FTT focused on whether Mr Anson (or the LLC) was entitled to the profits as they arose. It relied on evidence provided by Delaware law experts regarding the relevant provisions of Delaware statute and the LLC agreement. Emphasis was placed on both the LLC agreement and the provisions of Delaware law, including in particular section 18-101 of the IRS Code which defines an LLC interest as including the "member's share of profits or losses" of the LLC , section 18-503 which provides that "profits and losses shall be allocated among the members … in the manner provided in the LLC agreement", and section 18-601 which provides that "to the extent and at the times or upon the happening of the events specified in the LLC agreement, a member is entitled to receive from an LLC distributions before the member's resignation from the LLC". The LLC agreement provided for gross income and losses to be credited and debited to the members' capital accounts according to their profit sharing ratios. The fact that the LLC was not required to distribute profits immediately, but rather allocated them to the members' accounts, did not necessarily mean that the profits belonged to the LLC in the meantime.

Following their consideration of the joint effect of the law and the LLC agreement the FTT concluded that Mr Anson was entitled to

the profits as they arose, not dependent on the timing of a distribution. While they did not specify whether it was the law or the agreement that carried more weight, they did acknowledge that Delaware law allows "wide freedom to contract the terms of a Delaware LLC" and therefore their conclusions may not be of "general application", implying that the agreement itself was the final determining factor.

The Supreme Court Decision

On appeal from the FTT decisions, the Upper Tribunal and Court of Appeal each felt that the proper test was actually whether the LLC members had a proprietary right to the LLC's assets and business, which the parties agreed was not the case. This led those courts to conclude that the profits could not belong to Mr Anson as they arose and so he was not entitled to a tax credit (as the UK and US taxes were <u>not</u> computed by reference to the same profits).

The Supreme Court reversed those decisions and found that the income on which the taxpayer was liable to UK tax had the same source as the income on which he was liable to US tax, because Mr Anson was indeed entitled to his share of the profits of the LLC as they arose. They determined that the FTT was entitled to make the finding (as a matter of fact, based on the expert witnesses' evidence) that the profits did not belong to the LLC in the first instance, with the members becoming entitled to those profits only on a subsequent distribution of those profits, but rather that the profits belonged to the members of the LLC as they arose. It is well established in UK tax law that the UK tax treatment depends on the local non-tax law of the facts (see for example, **Baker v Archer-Shee [1927] AC 844**, and **Archer-Shee v Garland [1931] AC 212**), although it may sometimes be challenging to determine the local law analysis. The court commented that the FTT's "conclusion … was that, under the law of Delaware, the member automatically became entitled to their share of the profits generated by the business carried on by the LLC as they arose, prior to, and independently of, any subsequent distribution". They also acknowledged that the factual outcome was a combined question

of Delaware law and the LLC agreement, but it was not clear whether the law or the LLC agreement had more relevance.

The Supreme Court's decision did not specifically consider whether the LLC was opaque or transparent for UK tax purposes, which had historically been HMRC's focus, because it was not necessary to do so for foreign tax credit purposes, but only to determine whether Mr Anson was entitled to the profits as they arose. Arguably, it is no longer necessary to consider all aspects of the**Memec** tests to determine the opacity or transparency of a non-UK entity, as the entitlement to profits will now "trump" the other limbs of the test.

Practical Implications for Taxpayers

In some respects it appears that HMRC has taken a practical – or even fair – approach to the implications of the **Anson** case. Individuals who suffer a penal rate of tax if they hold an interest in a Delaware LLC may no longer need to suffer, but on the other hand companies that are members may still benefit from the dividend exemption (the availability of which is dependent on Delaware LLCs being opaque). However, this creates some uncertainty on the way Delaware LLCs – and potentially other non-UK entities – should be treated for UK tax purposes. UK companies may be able to continue to treat Delaware LLCs in their groups as opaque without analysing the LLC's terms. But for individuals, it may be necessary to examine the exact terms of the LLC agreement to ascertain whether or not the LLC should be treated as transparent. It is not clear on what basis HMRC draws this distinction between individual and corporate members - could a corporate member of a suitable LLC treat it as transparent? Perhaps more pertinently, what is the tax treatment where a UK company and a UK individual have interests in the same LLC? Is a different treatment between corporate members and individual members justified since only individuals would (generally) be claiming a foreign tax credit under the treaty, whereas UK companies would be relying on the domestic law exemptions for dividends?

Given that HMRC has determined that the real reason for the Supreme Court's decision was the terms of the LLC agreement, it may be that **Anson** will have no impact on HMRC's analysis of

other non-UK entities. But **Anson** is nevertheless authority for the focus to be more or less exclusively on the question of who is entitled to the profits as they arise, at least for foreign tax credit purposes. As the UK domestic law is substantially similar to the UK-US treaty provision, presumably HMRC should apply this decision to cases that do not involve the UK – US treaty, although it is not clear that is their intention.

What is now clear is that, in planning for use of a US LLC with UK members, careful attention to the terms of the documents is required with a view to conforming as closely as possible to the salient terms of the operating agreement in **Anson** where tax transparent treatment is desired. Care will need to be taken to recognise that there is a distinction between entitlement to profits as they arise, and an entitlement to call on an immediate distribution of available cash. Where tax transparent treatment in the UK is required, the safest path may still be to use a limited partnership, the accepted practice before the Supreme Court's decision in the **Anson** case.

On the plus side, HMRC has helpfully confirmed that it will continue its existing approach to determining whether a US LLC should be regarded as having share capital – an LLC will continue to be regarded as having share capital if it issues membership certificates. (There has always been uncertainty whether LLCs can join UK corporate tax groups, based on the risk that they may not have "share capital".)

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