

Client Update

The Delaware LLC: now we see it, now we don't...or do we?

LONDON

Richard Ward
rward@debevoise.com

Ceinwen Rees
crees@debevoise.com

Much as it gladdens the heart to see the UK's Supreme Court hand down a decision that is a decisive victory for the taxpayer, the Supreme Court's decision in Anson v Commissioners for Her Majesty's Revenue and Customs [2015] UKSC 44 represents a double-edged sword for taxpayers as a whole. The case is of particular interest to those working in the fund sphere as it focusses on a typical private equity structure and has the potential to impact any fund with a UK nexus that has a Delaware LLC within its structure.

By way of reminder, this case has made its way up through the UK court system, starting out as the anonymised Swift v HMRC (TC00399) in the First Tier Tribunal. The facts and the issue to be determined are deceptively simple and are set out below.

FACTS

- Mr. Anson, a UK tax resident, non-domiciliary, was a member of a Delaware LLC.
- Under the LLC agreement which formed the entity, profits arising to the LLC were creditable to each member's capital account and expenses debited in the same way. Amounts were distributed quarterly in arrear.
- The Delaware LLC was treated as a partnership for US tax purposes, therefore, Mr. Anson was liable to pay US state and federal income tax on his share of the LLC's profits.
- As a UK tax resident who remitted all of his money to the UK, Mr. Anson was also liable to UK income tax on the LLC's profits (on top of the US tax paid, this would give rise to an effective tax rate of 67%).
- Mr. Anson claimed double taxation relief under the UK treaty (and also under a provision of UK domestic law).

- The UK-US treaty provides that “*United States tax payable...shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits or income by reference to which the United States tax is computed.*”

MATTER IN DISPUTE

Was the US tax payable by Mr. Anson computed by reference to the same profits as the UK income tax?

DECISION

Mr. Anson was entitled to the share of the profits allocated to him rather than receiving a transfer of profits previously vested in the LLC. Mr. Anson’s UK tax liability was computed by reference to the same income as was taxed in the US.

Therefore, Mr. Anson was entitled to benefit from double tax relief in the UK. The Supreme Court emphasised that a purposive approach should be taken to interpreting double tax treaties and that the stated purpose of the UK-US double tax treaty was to avoid double taxation.

WHY IS THIS DECISION SIGNIFICANT?

HMRC’s long-standing practice when it comes to considering an application for relief from double taxation is to determine whether the relevant foreign entity is opaque or transparent. The profits of an opaque entity are taxed in the UK only when they are distributed to the UK (for example, via a dividend), like with a UK company. In contrast, profits of a transparent entity are taxed in the UK when they arise, which is how profits of a UK partnership are treated.

There is no statutory test to determine whether an entity is transparent or opaque. Instead a set of principles are followed known as the Memec Principles after a Court of Appeal case of the same name. The Memec Principles seek to determine the main characteristics of the foreign entity and map them against a hypothetical “ideal” transparent/opaque entity. In addition to these principles, HMRC publishes an entity classification list with some of the more common entities pre-classified. A US limited liability company is included on this list as an opaque entity.

Turning to Mr. Anson’s case, if a Delaware LLC is an opaque entity, it follows that tax paid at the level of the Delaware LLC is not tax borne by Mr. Anson, and therefore, not available for double taxation relief purposes; the Delaware LLC’s profits are taxed in the US and then, separately, Mr. Anson’s profits are taxed in the UK.

The Supreme Court did not adopt this approach; instead, agreeing with the First Tier Tribunal's finding that "*[t]he profits do not belong to the LLC in the first instance and then become the property of the members...the members of [the LLC] have an interest in the profits of [the LLC] as they arise*". Although they did not use the terminology explicitly, the result is to treat the Delaware LLC as transparent for the purposes of Mr. Anson's income tax.

WHY IS THIS DECISION A DOUBLE-EDGED SWORD?

The position regarding Delaware LLCs and UK tax has been settled for many years and has been relied upon by a number of UK taxpayers when planning their affairs. This decision throws uncertainty back into the mix.

SO, IS A DELAWARE LLC NOW TRANSPARENT?

It depends.

This case involved a Delaware LLC and this particular Delaware LLC was classified by the Supreme Court as transparent for UK tax purposes. However, this does not mean that all Delaware LLCs will be treated as transparent for UK tax purposes or even that this specific Delaware LLC will be treated as transparent for all UK tax purposes. Counsel's submissions for Mr. Anson made it clear that a decision was sought only in respect of UK income tax and only in respect of the specific LLC. It therefore remains to be seen how the UK should treat a Delaware LLC that has checked the box to be treated as a corporate for US tax purposes or even how a Delaware LLC with different profit allocation provisions will be treated. Aside from the entity-characteristics, it is also unclear whether capital gains will be treated in the same way as income going forward. We expect HMRC to issue guidance regarding its approach to US limited liability companies. This guidance will hopefully provide clarity about some of these open issues.

HOW CAN I FIND OUT MORE?

The full text of the Supreme Court's decision and a recording of the hearing is accessible at www.supremecourt.uk/cases/uksc-2013-0068.html.

Richard Ward and Ceinwen Rees would be delighted to speak with you about how this decision may affect your existing or future arrangements.

* * *

Please do not hesitate to contact us with any questions.