The Anson decision — more (or less) clarity on UK treatment of US LLCs

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On 1 July 2015 the UK's Supreme Court issued an eagerly awaited decision about the UK tax treatment of UK-based members of US LLCs. Although the dispute related to one particular LLC formed in Delaware, the decision potentially applies far more broadly – to LLCs outside Delaware, to other types of US business entity and potentially to all non-US business entities created anywhere outside the UK.

The basic point at issue in the case of *Anson v HMRC* was, in principle, a very simple one. But different UK courts reached different conclusions on the point, and the true implications of the final decision are as yet far from clear. It is presumed that the UK tax authorities will eventually issue a general clarificatory statement of some kind but they have so far failed to do so.

The outcome of this dispute was favourable for the taxpayer involved, and it might also assist many other taxpayers. But the decision does not necessarily spell good news for all taxpayers affected by issues of the same kind, and in some situations it might not be clear whether this decision actually affects a particular taxpayer's affairs at all. In the absence of official guidance, taxpayers may wish to consider their position with their own tax advisers.

The taxpayer in the *Anson* case was an individual who was tax-resident in the UK but who was a member of a Delaware LLC. The LLC carried on business in Massachusetts as a manager of various venture capital funds, and it was treated as an effective partnership for the purposes of both US federal income tax and Massachusetts income tax.

This meant that the LLC's members (rather than the LLC itself) were directly taxable under US tax laws in respect of the LLC's profits. Therefore, the taxpayer wished to claim UK double tax relief so as to reduce his UK income tax exposure by the amount of any corresponding US federal and Massachusetts taxes levied on his share of the LLC's profits.

There was no doubt that UK double tax relief was available, in principle, to a UK tax-resident individual who was taxed overseas as a partner of a foreign partnership. But such relief could only be claimed if the amounts received in the UK by the taxpayer could properly be regarded as the same taxable subject matter under the applicable tax laws of both the UK and the USA. The UK tax authorities refused to grant double tax relief here, on the basis that the taxable subject matter was not in fact the same under the applicable laws of each country.

In their view, the profits generated within the LLC were realised by the LLC itself in the first instance and then separately distributed to the LLC's members afterwards. This meant that, viewing the matter from a UK-based member's perspective, the income of the member was akin to a distribution by way of dividend from a company, rather than a direct allocation of a share of partnership profits to a partner.

This, in turn, meant that the appellant's relevant UK income derived from a different 'source' from the LLC's own profits and so, in view of the US classification of the LLC as a partnership for US tax purposes, there was no taxation of the same subject matter in both the UK and the USA. Accordingly, UK double tax credit was refused, producing an effective tax rate for the taxpayer in the region of 67%.

The dispute was initially heard by a tribunal that found in the taxpayer's favour. This was because there was available evidence of Delaware law suggesting that profits were effectively distributed automatically to this particular LLC's members. The tribunal viewed this as tantamount to an allocation of partnership profits to partners, which is also how the matter was viewed under US tax law. But two higher UK courts then disagreed with this approach and so they overturned the original decision in favour of the taxpayer.

Those courts viewed the evidence differently, concluding that the original tribunal had made an error in its own interpretation and handling of the evidence of Delaware law. The higher courts placed considerable weight on the fact that an LLC could own business assets independently of its members and could conduct business activities in its own right. This suggested that any business profits belonged to the LLC itself in the first instance and were later distributed to members, like dividends paid to company shareholders.

However, as a result of a final appeal to the UK's highest civil court, the tribunal's original decision in favour of the taxpayer has now been reinstated. The Supreme Court took a rather different approach from the lower courts, where the emphasis had been placed on identification of the initial 'owner' of an LLC's income or profits. This was bound up with the general notion of 'tax-transparency,' which leads to some business entities being treated as taxable in their own right while others are treated as generating income that is only taxable in the hands of their members.

But the Supreme Court noted that what the relevant UK tax legislation (as modified by the UK- USA double tax treaty) actually required was that the taxable income should be the same in both the UK and the USA. An analysis of ownership was not necessarily conclusive, or even relevant, because the legislation was concerned with a person's 'entitlement' to certain receipts, not their ownership of such receipts or their source.

Although there were some complexities in the way that this particular LLC transmitted profits to members its governing document appeared, in substance, to require that profits be allocated automatically to members. The fact that the LLC might have a separate legal existence and a separate commercial identity did not negate this fundamental aspect of the relationship between the LLC and its members.

Delaware company law and the contents of the LLC's governing document permitted the LLC to allocate profits directly to its members, and the tribunal had correctly concluded that this was what in fact happened in the present case. Therefore, the income taxed in the UK was the same income as that taxed in the USA because each country treated the income as, in effect, a direct profit allocation to the members of a commercial entity, not as a distribution of a profit initially belonging separately to the entity itself.

Whilst this decision was a victory for the taxpayer who brought the case it is important to emphasise that the UK courts have not ruled that all Delaware LLCs are tax-transparent in the UK. The decision was based upon the particular evidence of law and fact presented to the tribunal. In principle, every case concerning the UK tax treatment of a foreign entity or its members will similarly require a detailed examination of the applicable foreign corporate laws and the terms of any agreements concluded amongst the members of a foreign entity, or between the entity and its members.

Along with favourable tax treatment available to members of LLCs treated as partnerships for income tax purposes, the flexibility to largely customize the terms of a LLC's governing document, particularly those provisions relating to profit allocations, has driven such entities to be amongst the most popular. There are both good tax driven and deal motivated reasons for LLC members to make use of sophisticated terms like special allocations, tracking mechanisms, and different classes or series of ownership interests to divide profits amongst themselves. That flexibility has promoted a diversity of bespoke governing documents that may complicate future analyses. UK courts charged with reviewing partnership agreements containing one or more aforementioned terms may find the line between direct profit allocations and dividends sufficiently blurred to rule differently from *Anson* with respect to certain types of income.

The outcome in this case was also affected by the terms of the double tax treaty between the UK and the USA. This means that some non-US cases might have different outcomes, either because a different treaty regime applies or because in some cases there is no applicable treaty regime (so that the matter is governed solely by UK internal tax law).

Similar concerns might also arise for taxpayers based in other countries outside the USA. For instance, a Canadian resident with an ownership interest in a US LLC may not entirely avoid double taxation because Canada regards US LLCs as corporations – opaque for tax purposes. In Germany, US LLCs are treated as tax-transparent if their governing documents adopt certain look-through provisions outlined in the relevant double tax treaty.

The type of taxpayer also needs to be considered; the outcome of this case was positive for an individual taxpayer but the position taken by the tax authorities would generally have been favourable for many corporate taxpayers because foreign dividend income of companies is often now tax-exempt in the UK.

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