Recent Developments Regarding Entity Classification for UK Tax Purposes

HMRC v. Anson – is a Delaware LLC “tax-transparent”?

SUMMARY

Whether a non-UK entity such as a Delaware limited liability company (“LLC”) is treated as transparent or opaque for UK tax purposes can make a significant difference to the amount and timing of tax incurred by a UK taxpayer investing in it. The UK Court of Appeal recently upheld the decision of the UK Upper Tribunal that a Delaware LLC should be treated as opaque for UK foreign tax credit purposes. The decision creates economic double taxation. The LLC in this case does not seem to have had any particularly unusual features.

The decision itself may be further appealed by the taxpayer but it further clarifies the income tax treatment of a UK investor in an LLC. There are also other long-standing questions on the UK treatment of non-UK entities, such as whether inserting an LLC in a corporate chain can disrupt a UK tax “group”, and the decision may be relevant to these.

This memorandum sets out some of the issues that a UK taxpayer considering an investment in an LLC will need to consider by reference to the decision in this case. UK taxpayers face similar issues when considering investment in other non-UK entities that are not clearly equivalent to companies formed under English law.

HMRC v. Anson

The recent decision by the Court of Appeal in HMRC v. Anson has underlined the risk of economic double taxation that will be faced by a UK investor in a Delaware LLC, especially if that investor is an individual relying on UK foreign tax credit relief to avoid double taxation. The UK does not have clear rules about whether to treat an investment in an LLC as equivalent to an investment in a partnership (tax transparent) or in a company (tax opaque) for tax purposes. The published guidance of the UK tax authority, HMRC, while recognising that the individual facts must be considered in each case,
indicates that the default position is that an LLC should be treated as opaque.\(^1\) The outcome of the case\(^2\) (which may be further appealed) was that the LLC in question was opaque. This is consistent with HMRC’s view, and upholds the decision of the Upper Tribunal in August 2011. However, it is contrary to the view of the First Tier Tribunal (when it ruled in the same case, anonymised as *Swift v. IRC*) in early 2010. For further detail on the decisions of the tax tribunals, please see our client memoranda of 31 March 2010 and 24 August 2011\(^3\).

The difference in treatment can significantly affect the amount of tax payable, as the facts of the case illustrate. Mr. Anson is a venture capitalist who, together with his US colleagues, set up HarbourVest Partners LLC (“HVLLC”), which acted as an investment manager to various venture capital funds, receiving fee income. All profits were distributed to the members. The key question in the case was whether Mr. Anson was able to credit US tax paid (at around 45%) on the LLC’s activities against his UK tax liability on the distributions made to him by the LLC. If he was entitled to a credit, he had no UK tax to pay (given UK tax rates at that time). If he was not entitled to a credit he was liable for further UK tax at 22%, on top of the US tax at 45%, as and when profits were distributed to him.

A UK foreign tax credit was available if the UK tax and the US tax were computed by reference to the same profits.\(^4\) The essential question for UK tax purposes was whether to treat Mr. Anson as being taxable on his share of the LLC’s underlying income (whether or not distributed) or whether to recognise the LLC as a separate corporate entity and treat Mr. Anson as receiving some form of distribution from the LLC (usually only taxable in the UK if distributions are actually received).

Mr. Anson was charged to tax in the US on his share of the profits of the LLC (distributed or undistributed) on the basis that HVLLC was treated as a partnership for US federal and state tax purposes. Mr. Anson argued that he was entitled to the profits of HVLLC as they arose because of his automatic entitlement to HVLLC’s profits under the LLC agreement. His UK income would therefore be the profits of HVLLC, accruing directly to him, and have the same source as his US income. Unfortunately for Mr. Anson, the Court of Appeal agreed with the Upper Tribunal that his automatic entitlement to HVLLC’s profits took effect through contract (i.e. the LLC agreement), and was not an entitlement to the underlying profits of HVLLC as they arose. It held that Mr. Anson’s interest was analogous to the “silent partner’s” interest in the *Memec* case\(^5\), in which a contractual right to receive a profit did not entitle the holder to a credit for non-UK tax in respect of underlying profits.

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\(^1\) HMRC International Manual ("INTM") at 180030.


\(^5\) [1998] STC 754.
Mr. Anson’s share of the distributed profits of HVLLC represented income received from his investment in the LLC, distinct from the profits that HVLLC made. UK tax was therefore levied on the equivalent of a dividend from the LLC, being a separate income source which did not constitute the same profits as those subject to US tax. Therefore, no foreign tax credit was available.

Counsel for Mr. Anson raised a new argument before the Court of Appeal based on an exchange of notes between the US and the UK in 2001. The exchange of notes clarified the right of a contracting state under Article 24 of the Treaty to levy tax “with respect to” an item of income, profit or gain derived by a resident of that state (or a US citizen) from an entity that is fiscally transparent in either state. Mr. Anson’s case was that this wording meant it was unnecessary to show that tax was paid on the same profits in order to benefit from Article 24 of the Treaty. The Court of Appeal refused leave to appeal on this further point. While there was doubt as to the factual situation which the exchange of notes sought to address, the Court of Appeal was sceptical of Mr. Anson’s argument that the exchange of notes was sufficient to alter the wording of the Treaty, which makes double tax relief conditional on the same profits being taxed in each jurisdiction.

ENTITY CLASSIFICATION

HMRC has published a list of relevant factors for the purposes of classifying non-UK entities. These factors have no statutory force but represent HMRC’s distillation of the limited guidance provided by the courts prior to Anson. The HMRC list was referred to in Anson. The factors mentioned in that list, none of which is conclusive, are, in summary:

- whether the entity has a legal existence separate from that of the persons that have an interest in it (in other words, whether it has legal personality);
- whether members of the entity are “entitled to profits as they arise”;
- whether the entity carries on business on its own behalf or via its members;
- whether the entity issues share capital or something similar;
- whether business assets belong beneficially to the entity or to its members; and
- whether the entity or its members is responsible for the debts of the business.

HMRC attaches particular importance to (b) and (c) but it is unclear following the Court of Appeal decision in Anson what the status of this list now is. This point is discussed further below.

Anson illustrates the unsatisfactory nature of UK tax law in its approach to entity classification: unless all factors point in the same direction, there is always going to be some scope for argument and therefore some uncertainty for the taxpayer. That uncertainty is compounded by the need for detailed review of non-UK legal documents (often not in English) and the need to obtain expert evidence on non-UK, and often esoteric, legal questions. Evidence of the relevant non-UK law is essential and, so far as a UK court is concerned, is a matter of fact. However, the ultimate question of entity

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6 INTM 180010.
classification is a UK legal question, which may well turn on fine, indeed commercially immaterial, distinctions.

It was common ground in Anson that a Delaware LLC is an entity separate from its members and holds its assets independently of its members. The First Tier Tribunal equated the capital of an LLC to the capital of an English limited partnership (transparent for tax purposes) in which the partners have a proprietary interest. However, the Upper Tribunal and the Court of Appeal found that the profits of an LLC as they arise belong to the LLC itself, and not to its members. Although an LLC may have a contractual obligation to distribute the LLC’s profits to its members, this gives the members the right to the distribution, not a right to those profits as such. Members of a Delaware LLC have no proprietary interest in the profits of the LLC. This was crucial in determining that Mr. Anson was not entitled to a UK tax credit.

By the time the case came to court, HVLLC, presumably because Mr. Anson had become aware of his tax exposure, had restructured to become a limited partnership. HMRC has historically tended to accept that a Delaware limited partnership is “transparent” even though it has legal personality.

While the Court of Appeal’s determination in Anson was not unexpected, some of the reasoning in the judgment is unhelpful. In particular, the court placed great emphasis on whether the taxpayer had a proprietary interest in the LLC’s income as it arose. Not only does this ignore the other factors in the HMRC list (see above) but as the judges themselves seem to have recognised, it is also a hard test for most entities with legal personality to satisfy. This might not matter were it not for the fact that very many partnership entities worldwide have legal personality, especially limited liability partnerships. The same is true much closer to home in the case of a Scottish partnership which, because of its civil law roots, has legal personality too, whether it is a general partnership or a limited partnership. While the courts (including the Court of Appeal in Anson) have recognised that a Scottish partnership is nonetheless tax-transparent in the UK, they have never clearly articulated why. (In relation to capital gains tax, however, the UK position is made clear in legislation.) So taxpayers investing in non-UK partnerships (but not Scottish partnerships) are left with uncertainty about their UK foreign tax credit position, purely because, typically, the entity has legal personality. It had been hoped that this narrow focus on legal personality had been left behind when HMRC stated that the old Court of Appeal decision in Dreyfus v. IRC7 was wrongly decided. The Court of Appeal in Anson did not refer to Dreyfus at all but in effect seems to have resurrected some of the concerns raised by that earlier decision which HMRC had tried to allay. It would be helpful if HMRC were now to confirm that its stance has not been altered by the Court of Appeal decision in Anson.

A further concern arising from the reasoning in Anson is that the court stressed that although the LLC’s governing documents provided for automatic allocation of profits to members, this was only after, in particular, necessary reserves had been made at the level of the LLC. This was seen as a further indication that the profits of the LLC did not belong to the members as they arose and that only

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7 Dreyfus v. IRC 14 TC 560
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A residual amount was in fact being distributed. However, the court’s discussion does not address certain decisions in relation to life interest trusts where the courts have held that underlying income of the trust can belong to the life interest holder as it arises even if certain expenses are first deducted by the trustees. Secondly, it also ignores the reality of a modern professional partnership, which will almost certainly be run on the basis that a management committee has considerable powers to adjust partner profit entitlements and to withhold money at the level of the partnership itself in order to cover expenses, provide for contingencies or make capital calls.

It is worth noting that none of these issues arises in respect of a UK limited liability partnership. This entity is in fact a UK corporate body (with separate legal personality) but which is explicitly treated as a partnership for UK tax purposes by a statutory fiction. Therefore, the UK tax treatment of it and its members is unaffected by Anson.

TAX GROUPING

In order to be part of a group for most UK tax purposes (including capital gains, group relief and stamp duty), an entity must be a “body corporate” having “ordinary share capital”. Not only will an entity without ordinary share capital (e.g. a company limited by guarantee) typically not form part of the group but HMRC may also take the view that it is not possible to trace a wider group through it, with the possible exception of where all the members of the entity are also part of the group. The inclusion of an entity without ordinary share capital can therefore cause the unexpected loss of the various group reliefs which would otherwise be available. Indeed, avoiding the creation of groups or splitting them by inserting companies limited by guarantee is a standard tax-planning technique.

The UK approaches this question by asking whether a member’s interest is analogous to a holding of ordinary share capital in an English company. Again this is not a bright line test but a question of fact and degree to be determined by reference to the relevant non-UK corporate law and a number of factors set out in HMRC guidance.

Since 2007, HMRC has taken the view that it is not necessary for a member to have availed itself of the possibility provided under s. 18-702c of the Delaware LLC Act (which allows for a member’s interest to be evidenced by a certificate issued by the LLC) in order for the LLC to be regarded as having ordinary share capital. Neither the tax tribunal nor the Court of Appeal discussed this issue, because corporate grouping was not directly in point.

Nonetheless, an LLC which issues certificates and has transfer provisions similar to those of an English company, where transfers are registered (whether or not subject to approval by the other members), is in our view likely to be considered as having ordinary share capital. This is separate

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8 Defined in Section 1119 Corporation Tax Act 2010 to include all share capital other than fixed-rate preference shares.

9 HMRC Business Brief 87/09: this is another non-statutory distillation of the few relevant judicial decisions.
from the question of whether an LLC should be treated as opaque for the purposes of taxing its members in the UK.

**OTHER INVESTOR CONSIDERATIONS**

While the *Anson* case related to a Delaware LLC, the same principles are applicable to other non-UK entities. Other entities which give rise to particular uncertainty include Dutch CVs, LLCs established under the laws of other US states and German silent partnerships.

For UK-resident individuals, the availability of a credit under the Treaty means that in most circumstances they are likely to prefer transparent entities. However, there are a number of other factors to consider if a choice of entity is available. If an entity is transparent for income purposes, it may also be transparent for the purposes of UK tax on capital gains on the basis that it is a “partnership” within section 59 Taxation of Chargeable Gains Act 1992.\(^\text{10}\) This means that a member will be treated as disposing of his fractional share of any capital asset disposed of by the entity (a credit for any non-UK tax should be available). The amount and timing of the income inclusion will also be different if an entity is transparent. This will be particularly significant if the entity rolls up its income rather than distributing it.

The rules are similar for UK corporation taxpayers but they are likely to have a different perspective, particularly as distributions from opaque vehicles will be tax-exempt in most cases. As a result, they are less likely to be concerned about the availability of credit under a double taxation agreement. They will also want to have regard to the tax grouping issues mentioned above.

**WIDER IMPLICATIONS**

The overall result remains highly unsatisfactory. The law and HMRC guidance are unclear and arguably in conflict but there is also a lack of guiding principle as to when entities should be treated as “transparent” for UK tax purposes and what this means. Key classification questions can turn on very fine, and commercially immaterial, distinctions requiring detailed examination of non-UK law and the constitutional documents of non-UK entities. It was the cost, complexity and uncertainty of such an approach which led the US to adopt the “check-the-box” rules in 1997. Unfortunately, the UK still seems a long way from adopting a similarly practical solution, despite HM Treasury’s general focus on making the UK corporate tax system more user-friendly for international investors.

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\(^{10}\) That said, there are now situations where partnership-type arrangements for collective investment are required by section 103A Taxation of Chargeable Gains Act 1992 to be treated as opaque, but only for the purposes of UK tax on capital gains, not income. Furthermore, non-UK unit trusts (e.g. Jersey property unit trusts) are typically treated as opaque for the purposes of UK tax on capital gains, but not income.
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