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To LLC or Not to LLC, That is the Question

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On 20 May 2010, HM Revenue and Customs ("HMRC") made an announcement on its treatment of US LLCs. The announcement confirms that HMRC will be appealing the recent decision in Swift v HMRC, in which the UK's First-Tier Tribunal (the "Tribunal") had decided that a UK resident individual ("Mr Swift") was entitled to double taxation relief ("DTR") by way of a UK tax credit for US tax he had paid on his share of profits from a Delaware limited liability company ("LLC") in which Mr Swift was a member. This decision went against the commonly held view that LLCs are considered to be opaque taxable entities for UK tax purposes, a view which had been enshrined in HMRC's guidance. The announcement confirmed that pending the outcome of its appeal HMRC will continue its current general practices in relation to US LLCs.

This client alert discusses the impact of this announcement as well as the original decision in Swift v HMRC, and certain other recent case law related to the tax treatment of US LLCs.

2 SWIFT AND HMRC'S ANNOUNCEMENT

2.1 Background

Opaque entities are typically companies whose profits and losses are treated as accruing to the entity itself and not its members for tax purposes. The members of an opaque entity are therefore generally not subject to tax on the entity's profits until they are distributed by the entity to the members. In contrast, the profits and losses of a transparent entity, such as a partnership, are treated as accruing as they arise to the members of the entity and not the entity itself. Therefore, the members of a transparent entity are subject to tax on the entity's profits whether or not the entity distributes them to the members.

2.2 Swift v HMRC

The Issue

Mr Swift was personally taxed in the US on his share of the profits of the LLC on the basis that the LLC was fiscally transparent for US tax purposes (the US tax was withheld and paid to the US Inland Revenue Service by the LLC). Mr Swift, being a UK-resident individual, therefore sought double taxation relief in the form of a UK tax credit for the US tax he paid on his share of the profits of the LLC.

However, HMRC challenged Mr Swift's claim for a UK credit on the basis that the LLC is "*… a corporate entity that has paid the equivalent of a dividend and so [Mr Swift] has not been taxed on the same income in the UK*".

The Tribunal's Decision

The Tribunal decided that Mr Swift was entitled to a UK tax credit for US tax he had paid on his share of profits from a LLC.

The Tribunal, in applying the approach taken by the Court of Appeal in *Memec plc v CIR*, ruled that the LLC was a transparent entity on the basis that the profits of the LLC belong to its members as they arose and were therefore taxable in the hands of its members as they arose. The Tribunal noted that the LLC's characteristics were more similar to that of a (Scottish) partnership than a UK company. The Tribunal considered that this treatment was consistent with the relevant Delaware legislation and, more notably, specifically provided for by the LLC's operating (constitutional) agreement.

It is also of interest that the Tribunal held that the membership interests in the LLC did not constitute "share capital" and instead were more like membership interests in an English partnership. Again, this is contrary to HMRC practice which, as noted above, provides that a Delaware LLC is capable of having "issued ordinary share capital" for certain UK tax purposes.

2.3 HMRC's Announcement

Not surprisingly, HMRC have announced that they will be appealing *Swift* and, pending the outcome of that appeal, have indicated that they will not change their 'current general practices' in relation to US LLCs. This means that UK members of a US LLC will continue to be taxed on the profits of that LLC only when they are distributed to that member and relief from UK tax on the basis of tax paid in the US by the LLC will only be available where the member is a UK company controlling 10% or more of the LLC.

HMRC's guidance states that they "have not yet seen any examples of US LLCs for which it has considered this general practice to be inappropriate". However, they go on to say that a member of an LLC is free to contact HMRC if they feel the general practices are inappropriate to their circumstances or should be reviewed in the light of the decision in *Swift.*

HMRC have also indicated that they will continue to accept that in certain circumstances an LLC may have ordinary share capital for the purposes of s.832 of the Income and Corporation Taxes Act 1988 ("ICTA") despite the decision in *Swift* that the interests in the LLC were "not similar to share capital but something more similar to partnership capital of an English partnership".

3. *BAYFINE v HMRC*

Another interesting case on the interpretation of the UK/US treaty, which has potential ramifications for the tax treatment of US LLCs, *Bayfine v HMRC,* was decided at a similar time to *Swift* and is discussed below.

3.1 The Issues

Two UK subsidiaries of a US parent ("BDE") entered into complex forward contract arrangements with a counterparty structured to be 'self-cancelling', that is one UK subsidiary produced a loss and the other UK subsidiary an equal and opposite profit ("BUK"). The UK subsidiaries were each UK incorporated limited companies while BDE was US incorporated and resident and an ultimate subsidiary of Morgan Stanley. BUK and its sister company were 'check the box' entities for US tax purposes, meaning that the US treated them as transparent entities and taxed the profit produced by BUK as profits of BDE (as far as HMRC is concerned 'checking the box' has no impact on an entity's UK tax treatment). On appeal from the Special Commissioners, the High Court had to

determine whether DTR was applicable in the UK to the profits of BUK as a result of the tax paid by BDE in the US.

HMRC had argued that BUK was a UK resident and so the UK had primary taxing rights. The Special Commissioners had agreed and had also decided that the profits subject to tax had a UK source on a 'common sense' approach. HMRC had also argued that even if there was DTR on the profits then the extent of the relief should be limited, as the taxpayers had not taken all reasonable steps to reduce the foreign tax burden.

If there was no DTR, then the taxpayers argued that they should be entitled to unilateral relief for the US tax already paid. The issue was whether this relief was available given that the tax in question had actually been paid by BDE and not the UK subsidiaries.

3.2 The Decision

In allowing the appeal, the High Court was critical of the 'common sense' approach followed by the Special Commissioners, on the basis that there was no principle allowing them to follow such an approach. The judge went on to say that, on the facts, he did not see how a 'common sense' view could allow the interpretation they had arrived at. The High Court was of the view that, following *National Bank of Greece*, the source of income was more material than the residency of the company. In determining this source they took into account the location of the operations giving rise to the profits, the location of the other party to the arrangements, the law which they were expressed to be governed by and the lex situs of the underlying assets. On this basis the profits of BUK were held to be US in origin and this gave the US primary taxing rights.

That said, the High Court felt that, given that either state was entitled to tax the profits, had the UK taxed BUK before the US had taxed BDE (the opposite order of events on the facts) then the US would have had to give credit rather than the other way around.

The High Court also looked at whether the taxpayers had taken reasonable steps to reduce the amount of tax payable in the US, as under s.795A ICTA double tax relief could be reduced where this is not done. However, it was held that steps suggested by HMRC which would have involved doing a fundamentally different transaction or no transaction at all went beyond what would be 'reasonable'. HRMC had also suggested measures which would have involved actions by other subsidiaries but the High Court held that, unless the taxpayer can reasonably compel a third party to take steps, it is not reasonable to take into account the failure to perform actions which would be beyond the taxpayer's control.

For good measure, the High Court also held that unilateral relief would have been available had DTR not been.

4. COMMENTARY

Delaware LLCs are commonplace in UK/US cross-border group structures and the decision of the Tribunal in *Swift* is in certain circumstances unhelpful as it casts doubt on (i) the tax status of Delaware LLCs (given the Tribunal went against what has been established HMRC practice on the treatment of Delaware LLCs) and (ii) the availability of group relief, capital gains tax grouping, the substantial shareholder exemption, and the foreign distribution exemption. It should however be noted that the Tribunal specifically noted that its decision in *Swift* was based on a particular set of facts.

It should not come as a surprise that HMRC has challenged the decision in Swift and confirmed that, pending the outcome of the appeal, it will continue to apply its 'current general practices' in relation to US LLCs. The indication that HMRC is willing to hear arguments from US LLC members

who feel that their treatment should be reviewed in the light of the case law is particularly welcome, although it remains to be seen how HMRC will actually respond to such arguments.

It is interesting to note that at around the time of the decisions in *Swift* and *Bayfine*, in Canada the Tax Court in the case of *TSD Securities (USA) LLC v The Queen* recently decided against the long-standing position of the Canada Revenue Agency that US LLCs are not entitled to protection of the Canada-UK tax treaty. The basis of this decision is not entirely clear, but it appears to have been that although the LLC was not liable for tax in the US (which was necessary for residence on a strict interpretation of the text of the treaty) its members were subject to tax there. This case has significant ramifications for US LLCs with Canadian income which has previously been subject to withholding taxes and which may now be entitled to a refund. It remains to be seen how other jurisdictions with similar legal principles to Canada (including England) would have regarded the argument raised by the taxpayers.

Finally, those employing structures including Delaware LLCs should review the structures to ensure that they are and will continue to receive the desired tax treatment from a UK tax perspective.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers:

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