VIEWPOINT

U.K. Tax Treatment of U.S. LLCs Post-*Anson*

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In this article, the authors discuss whether U.S. limited liability companies are to be treated as opaque or transparent entities for U.K. tax purposes following the U.K. Supreme Court's decision in the *Anson* case.

It's a confusing time for those advising U.K. clients with interests in U.S. limited liability companies. The key question of the moment is whether a U.S. LLC is to be treated as a corporation or transparent for U.K. tax purposes. The answer is of crucial importance, since it will determine how, where, and at what rate profits are taxed, whether losses can be used, and whether a range of reliefs are available.

Since June 1997, HM Revenue & Customs has taken the public position that U.S. LLCs are to be considered opaque (that is, as corporations) for tax purposes. Whether LLCs are treated as transparent for U.S. tax purposes is considered irrelevant.

Rightly or wrongly, most U.K. taxpayers have followed HMRC guidance and treated their U.S. LLCs as corporations — that is, income is taxable in the U.K. only when withdrawn from the LLC, but is, at that time, treated as dividend income with no double tax credit for U.S. tax already suffered.

Enter George Anson, a U.K. tax resident individual with an interest in a U.S. LLC. Anson challenged the generally accepted view that U.S. LLCs are opaque and took HMRC to court. What followed was a roller-coaster ride of decisions as the case worked its way through the British judicial system until it reached the U.K. Supreme Court. The Court's decision in *Anson v. HM Revenue and Customs*, [2015] UKSC 44, was directly at odds with HMRC's longstanding view that LLCs are almost always opaque in nature.

The Supreme Court ultimately ruled that the automatic allocation of LLCs' profits to the capital accounts of their members indicated that the members were entitled to profits as they arose. Under the doctrine set out in *Memec PLC v. Commissioners of Inland Revenue*, [1998] STC 754, this entitlement indicated that the entity was transparent.

The *Anson* decision has caused great uncertainty among various types of taxpayers as they seek to determine what the decision could mean for them. Individual members of U.S. LLCs who have not withdrawn profits were particularly concerned that HMRC would suddenly seek back payment of taxes, while those who withdrew profits and reported them as dividends were interested in claiming refunds for taxes paid. Similarly, U.K. groups and parents with U.S. LLCs that had claimed reliefs in reliance on the position that U.S. LLCs were corporations were worried that the benefit of those reliefs would be revoked. Mild panic ensued.

In late September 2015, under pressure from the business and tax advisory community, HMRC published a brief clarifying its position on U.S. LLCs. This short document was undoubtedly something of a fudge, given the history, although it broadly confirmed the following:

- when U.S. LLCs have already been treated as companies or corporations, HMRC will not challenge this view;
- the *Anson* ruling was specific to the facts and circumstances of that case, particularly Delaware law, and did not herald a wholesale shift in interpretation in this area;

- individual claims for double tax relief in reliance on *Anson* will be considered on a case-by-case basis; and
- HMRC proposes to continue in its existing approach to determining whether a foreign entity has ''ordinary share capital'' for the purpose of various important corporate tax reliefs (including the substantial shareholding exemption).

The announcement from HMRC undoubtedly provides relief for taxpayers who are unwilling to go through the trouble of reviewing historic returns. For those who would benefit from a change in treatment based on *Anson*, however, the brief provides no further clarity, nor does it assure taxpayers of how new interests in U.S. LLCs acquired after September 2015 will be treated for tax purposes.

U.K. tax advisers have become well aware that while HMRC guidance might be helpful, it is not legally binding, and neither taxpayers nor HMRC can rely on it in court. HMRC has disregarded its own guidance in many high-profile cases in which it successfully challenged taxpayers. It therefore remains to be seen whether this attempt by HMRC to restore some order to this situation is worth the paper it is written on.

Taxpayers and their advisers must now consider whether to challenge HMRC's generally accepted position on the treatment of U.S. LLCs and whether the constitution of their particular LLC can be changed in support of such a challenge. Due to the tax-free nature of dividends paid in corporate form, U.K. corporate taxpayers are likely to continue seeking the treatment specified in the HMRC brief and are unlikely to challenge that treatment based on *Anson*.

For U.K. individuals that own an interest in a U.S. LLC, however, distributions of profit will not be received free of U.K. tax. U.K. individuals are generally likely to follow the historic approach confirmed in the HMRC brief when the LLC in question has high annual profits and does not distribute funds regularly.

Those looking to accumulate profits in the U.S. LLC without paying U.K. tax on the amount until the time of withdrawal might seek to rely on the HMRC brief. This position allows the deferral of income from the LLC's profits earned in the U.S.; the income is not taxable until withdrawn through dividend distributions. The downside of this approach, however, is that U.K. resident individuals with an interest in a U.S. LLC face an additional 7.5 percent in U.K. income tax on receipt of dividend income from April 6. Taxpayers would be well advised to analyze the benefits of the deferral versus the additional tax on dividend income to determine the best way forward.

U.K. individuals could also request a ruling from HRMC to avoid the historic classification of U.S. LLCs as opaque. This approach would generally be advisable if the U.K. individual receives annual or regular profit distributions and is not seeking deferral of profits.

For those who regularly draw profits from their LLC, transparent treatment with access to double taxation relief is likely to be highly desirable. If the LLC were treated as transparent, the top tax rate on profits would be 47 percent (including U.K. National Insurance), compared with 58.77 percent if the profits were treated as dividends from an opaque entity (assuming a U.S. income tax rate of 35 percent) — a difference of almost 12 percent.

Whether taxpayers will want to challenge HMRC on the tax treatment of their U.S. LLC is another matter. Many taxpayers will understandably opt for the easier, nonconfrontational route — this is largely why it took 18 years for HMRC's guidance to be successfully challenged.

The HRMC classification guidelines outline specific matters that should be considered in assessing whether an LLC should be treated as transparent or opaque, including:

- whether the U.S. LLC has a legal existence separate from the owners;
- whether the entity issues share capital or something else that serves the same function as share capital;
- whether the business is carried on by the LLC itself or jointly by the persons who have an interest in it that is separate and distinct from the entity;
- whether the owners are entitled to share in profits as they arise or if the entity or its owners must decide when to make distributions;
- the responsible party for debts incurred in the course of business; and
- whether assets used in the course of business belong to the entity or the owners.

The particular facts and circumstances in each situation are key. Of course, there is no such thing as a ''U.S. LLC'' — each U.S. state has its own version. The taxpayer and their advisers must pay close attention to the rules at state level to ascertain whether the existing constitution and local corporate law applicable to the LLC permits a change in U.K. tax treatment in line with *Anson*.

Some taxpayers will also be faced with the matter of legacy ''blocker'' structures designed to protect U.K. taxpayers from U.S. capital gains tax on the sale of an interest in an LLC. Such blocker structures could involve having a U.S. corporation hold the U.K. taxpayer's LLC interest to ensure that the taxpayer would not be exposed to U.S. taxes on disposal of the interest (and if the purchaser did not want to acquire the U.S. corporation, a price adjustment could be sought). Such structures now seem expensive and may no longer be as attractive as they were when created.

HMRC is in a difficult position, but one that is arguably of its own making. For 18 years, HMRC publicly advised taxpayers to treat U.S. LLCs as opaque

but has only now discovered that the courts do not agree. To avoid a crisis (particularly for corporate groups), HMRC has fudged its position, leaving taxpayers some scope to challenge it, if they really want to.

It remains to be seen whether taxpayers will respect the contents of the HMRC brief or if they will bring such a challenge on the basis of *Anson*. U.K. taxpayers that have earned significant income through U.S. LLCs may wish to review their position. This will require detailed coordination with their U.S. advisory teams to understand local corporate law and the specifics relating to the entity's constitution. Even then, it remains to be seen how difficult it will be in practice to convince HMRC that U.S. LLCs are transparent. Only time will tell. ◆