

June 2, 2010

Delaware LLC Challenged By United Kingdom Tax Authority

Cross-border US/UK transactions and group or fund structures which make use of a US LLC as an "opaque" business vehicle for United Kingdom tax purposes may need to be re-examined in the light of the recent decision in *Swift v HM Revenue & Customs* ("HMRC"), a First-tier Tribunal tax case.

Background

A UK investor in a non-UK business vehicle will be taxed on its profits and on any gains on disposal according to whether the vehicle is "opaque" or "transparent" for UK tax purposes. UK members of a "transparent" entity are effectively taxed as partners. This means that their business profits are subject to tax as they arise and a disposal of an interest in the vehicle is treated as a disposal of the underlying business assets. By contrast, investors in an "opaque" vehicle are taxed on profits of the business only when distributed and are treated as holding transferable rights in the vehicle itself and not in its underlying assets.

The distinction between "opaque" and "transparent" entities is based on case law and longstanding HMRC guidance. Although HMRC has always emphasised the need to evaluate the tax status of any non-UK entity according to its facts, Delaware LLCs have generally been regarded as "opaque" and as issuing "share capital" in the form of certificates which evidence the members' interests. In reaching its decision that the US LLC should be treated as "transparent," the Tribunal gave detailed consideration to the factors recognised by HMRC as being significant to the distinction but appears to have given greater weight to the terms of the US/UK Double Tax Treaty ("Treaty").

Facts

The LLC in *Swift v HMRC* was effectively treated as a partnership for US tax purposes and, accordingly, the UK member ("Appellant") was subject to US Federal and State tax on his share of the profits irrespective of whether they were distributed or retained by the LLC. In the UK, the Appellant claimed a credit for the US tax against his UK income tax liability on profits from the LLC. HMRC challenged the

Appellant's claim to treat the US tax as creditable arguing that the LLC was "opaque", so that the Appellant was chargeable to UK tax on the LLC profits not as they arose but only when they were eventually distributed. In HMRC's view these distributions were not the same income as that on which the Appellant had been charged to US tax and, therefore, he was denied relief for the US tax.

The Tribunal's Approach

The Tribunal applied HMRC's published criteria for the categorisation of foreign entities on the basis of expert evidence about the nature of the LLC, and came to the following factual conclusions:

1. The LLC had a "legal existence" separate from that of its members.
2. The business of the LLC was carried on by the entity itself and not by the members jointly.
3. The LLC, and not its members, was responsible for debts incurred as a result of carrying on the business.
4. The assets used for carrying on the LLC's business were beneficially owned by the LLC and not by the members themselves.

These four conclusions all pointed towards the LLC being "opaque". However, the tribunal nevertheless found it to be "transparent" as the result of its findings in relation to two further factors.

First, the Tribunal found that the members' interests in the particular LLC were not issued share capital nor something else which served the same function as share capital.

Secondly, the Tribunal concluded that its members had an entitlement to the profits of the LLC as they arose and that their entitlement did not depend on a decision of the entity or its managing members to make a distribution of profits.

The Tribunal viewed the UK tax status of the LLC as standing somewhere between a Scots partnership and a UK company. The LLC had certain partnership characteristics in that its members were entitled to profits as they arose and their membership interests were comparable to partnership interests. However, it also displayed the corporate characteristics of carrying on its own business without liability on the members and of there being some separation between managing members and other members.

Ultimately, the Tribunal concluded that the LLC fell on the partnership side of the dividing line. Although the Tribunal considered the criteria set down by HMRC in detail it appears to have put particular emphasis on the terms of the Treaty under which the deciding question is whether the profits belong to the investors as they arise.

Significance of the Decision

The Tribunal made it clear that as its decision was not of general relevance to all non-UK LLCs, it should not be interpreted as meaning that all US LLC's are "transparent". However, it is significant that in applying HMRC's published criteria it gave the individual factors different weight from that proposed by HMRC. HMRC guidance expressly says that particular attention should be paid both to whether the business is carried on by the entity itself or jointly by its members and to the basis on which the investors are entitled to profits. However, the Tribunal's decision appears to turn on the second factor, the basis of profit recognition, and its conclusion that a member's interest in the LLC was not represented by something akin to share capital.

HMRC has announced its intention to appeal the decision and has indicated that for the time being it will not be changing its existing practice in relation to US LLCs.

Conclusion

Although HMRC guidance on entity classification has always emphasised the need to consider each entity according to its own facts, it is arguable that HMRC may itself have been guilty of ignoring this warning. In recent years both HMRC and tax practitioners may have too readily assumed that any US LLC would be "opaque" for UK tax purposes. The Tribunal's decision is a timely reminder that published HMRC guidance may not always be supported by the Courts and many taxpayers may think it appropriate to review existing LLC based UK/US structures in the light of the Tribunal's findings of fact.

Our client alerts are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions, please contact:

Principal Author

Paul White
+44 (0)20 7337 8039
pwhite@chadbourne.com

Contact for More Information

Stuart D. Baker
+1 (212) 408-5435
sbaker@chadbourne.com

William G. Cavanagh
+1 (212) 408-5388
wcavanagh@chadbourne.com

Eli M. Katz
+1 (212) 408-1013
ekatz@chadbourne.com

Lauren D. Kelly
+1 (212) 408-5520
lkelly@chadbourne.com

Richard M. Leder
+1 (212) 408-5128
rleder@chadbourne.com

Edouard S. Markson
+1 (212) 408-1084
emarkson@chadbourne.com

Lawrence Rosenberg
+1 (212) 408-5274
lrosenberg@chadbourne.com

Donald Schapiro
+1 (212) 408-5305
dschapiro@chadbourne.com

Leslie J. Schreyer
+1 (212) 408-5335
lschreyer@chadbourne.com

George E. Zeitlin
+1 (212) 408-5311
gzeitlin@chadbourne.com