Analysis

# US limited liability corporations: updated HMRC guidance

Speed read

**HMRC has issued updated guidance on the treatment of profits arising within, and distributions from, US LLCs. In a number of respects the updated guidance is unsatisfactory, coming in the midst of tax return preparation season, seeking to re-argue points that many will have considered settled by the Supreme Court's decision in *Anson v HMRC* and raising the prospect of true double taxation as between the US and the UK.**

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## The *Anson* decision

On 12 December 2023, HMRC issued updated guidance on the treatment of profits arising within, and distributions from, US limited liability corporations (LLCs) (see *International Manual* at INTM180000–180050). The guidance replaces the interim guidance which was issued in light of the Supreme Court decision in *Anson v HMRC* [2015] UKSC 44 (*Revenue & Customs Brief 15/2015*). We refer to the updated guidance as the 12 December guidance in the analysis below.

The *Anson* case had ramifications in a number of areas, but at its heart turned on two questions: first, under the terms of Delaware law and the relevant LLC agreement (which set out the key operating terms of the LLC), did the profits of the LLC arise directly to the member; and second, under the predecessor to the 2001 US/UK Double Taxation Convention was 'United Kingdom tax computed by reference to the same profits or income by reference to which the United States tax is computed'?

The First-tier Tribunal (FTT) in the *Anson* litigation heard competing expert evidence on the provisions of the LLC agreement and Delaware law. There was common ground that an LLC is a legal entity, the business of the LLC is carried on by the LLC itself and not by its members, the assets used for carrying on the business belong beneficially to the LLC and not to the members, with the members having no interest in specific property of the LLC; and the LLC is liable for the debts incurred in carrying on its business, with the members having no liability. However, the experts disputed whether the profits of the LLC arose to the members independently of the LLC's distribution mechanisms.

Ultimately, the FTT supported the taxpayer's contentions that allocation of profits to members' capital accounts in the LLC was sufficient for the profits to arise directly to the members.

Underpinning this decision was the drafting of the LLC agreement but also the provisions of Delaware law (specifically the Delaware LLC Act (6 Del C) ('the Act')). As a finding of fact, the FTT concluded that:

> 'In relation to the LLC Operating Agreement … the combined effect of section 18-503 of the Act and the terms of Article IV [of the Operating Agreement] means that the profits must be allocated as they arise among the members. It follows that the profits belong as they arise to the members.'

A further issue which the FTT had to consider was whether it was important that there was a requirement to distribute the profits under the terms of the LLC operating agreement. Ultimately the FTT decided that the distribution mechanism was not germane to the analysis of whether profit arose to the members.

Having established that the profit arose to the members for the purposes of the LLC operating agreement as underpinned by Delaware law, it followed that double tax treaty relief should be available because the sums in question were the same sums taxable in the US and the UK.

Ultimately, the decision of the Supreme Court was based on the FTT's findings of fact. As the FTT was entitled to make such findings based on the evidence before it (and had not erred, as the Upper Tribunal had found), it followed that the taxpayer won.

## HMRC's reaction

HMRC's initial reaction, published on 25 September 2015, was nuanced. They stated that, after careful consideration, the decision is specific to the facts found in the case. However, and critically, reference is made to the fact that 'individuals claiming double tax relief and relying on the *Anson v HMRC* decision will be considered on a case-by-case basis'. In other words, there was no outright denial of the logic underpinning the *Anson* decision, and there was balance in the September 2015 publication in that there were helpful statements from HMRC that 'where LLCs have been treated as companies within a group structure, HMRC will continue to treat the US LLCs as companies' (potentially aimed at preserving the availability of group reliefs in certain scenarios). In other words, there was an effort to weigh the fact that the decision was to some extent problematic in terms of its treatment of share capital and that individual LLCs needed to be considered separately.

Over time, however, HMRC have been persuaded on a number of occasions that the decision in *Anson* should be applied more widely and not constrained to its own facts. Specifically, HMRC are understood to have agreed in a number of instances that the profits of members of Delaware LLCs with similar operating terms to those of the LLC in *Anson* (and LLCs established under the laws of other US states whose LLC legislation maps onto the Delaware LLC Act) should be treated as arising to the members for the purposes of the 2001 Convention. We are aware of many taxpayers who filed on this basis.

### The 12 December guidance

In their 12 December guidance (at INTM180050), HMRC advanced two principal contentions. The first is that the FTT was incorrect in its interpretation of Delaware law. The second is that, because the finding of Delaware law is a finding of fact, it is not binding in subsequent cases. In effect, therefore, HMRC are giving notice that they wish to re-litigate the issues raised in *Anson*.

In reaching this conclusion, HMRC state that they believe that the profits of an LLC will generally belong to the LLC in the first instance and that members will not generally be treated as receiving or entitled to the profits of an LLC as they arise. The LLC will carry on the business. LLCs are separate legal entities. LLCs own the assets which are used in the business. The LLC will be responsible for the debts, obligations and liabilities of the LLC. Members only achieve the status of a creditor to the LLC with regard to their economic interest in the LLC when they become entitled to a distribution. A member is only entitled to receive an interim distribution to the extent provided by the LLC agreement and a distribution may not be made if the LLC is insolvent or would make the LLC insolvent. Creditors of members have no rights to the property of the LLC. On a winding up of the LLC, assets have to be distributed to the creditors of the LLC ahead of the members.

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HMRC make the statement that they do not believe that the two Delaware law provisions which were of critical importance to the FTT in reaching its decision (s 18–101(10) and s 18–503 of the Act) 'are significantly relevant'. HMRC advance a contention that:

> 'A member of a Delaware LLC will not … usually receive or be entitled to the profits of the LLC for the purposes of [ITTOIA 2005 s 8] because the LLC would normally carry on the business on its own behalf and owns the profits which belong to the LLC in the first instance.'

HMRC refer to the FTT's finding that the provisions of Delaware law, combined with the terms of the relevant LLC operating agreement, resulted in a liability to the LLC member in respect of the profits. The 12 December guidance then states:

> 'Contrary to the FTT's view, HMRC understands that an allocation of profits to a member's capital account does not evidence a liability to the member. Capital accounts are an equity concept and therefore appear in the equity, rather than the liabilities section of the LLC balance sheet.'

HMRC contend that a positive balance on a member's capital account does not provide a member with the right to a distribution. The LLC agreement gives rise to that right. Member creditors 'cannot seek recovery out of LLC assets merely by virtue of profits being allocated to a capital account'.

### Discussion

There are a number of striking features of HMRC's position.

First, in large measure HMRC's contentions amount to a re-statement of positions which they have already advanced in the earlier *Anson* litigation. Underpinning HMRC's contentions is the argument that the profits of an LLC belong to the LLC and do not therefore belong to the member as they arise.

This was specifically dealt with by the FTT, which referred to HMRC's evidence, and dismissed it in the following terms:

> 'It is true, as Mr Talley [HMRC's expert] said, that the assets representing those profits do belong to the LLC until the distribution is actually made but we do not consider that this means that the profits do not belong to the members.'

HMRC's statement that 'an allocation of profits to a member's capital account does not evidence a liability to the member' appears to be drawn from the FTT's statement that:

> 'There is a corresponding liability to the members evidenced by the allocation to their capital accounts rather than a balance of undistributed profits.'

However, this reference to a liability must be read in the broader context. Profits can belong to the members without creating a debt. The point being made by the FTT was that there is a distinction to be drawn between profits and assets – the profits belong to the members whereas the assets belong to the LLC. HMRC accept this distinction in the 12 December guidance but do not reach the same conclusion that profits belong to the members.

The repetition of various aspects of Delaware law which had already been considered by the FTT is somewhat curious. Although the 12 December guidance suggests (but does not confirm) that HMRC may have taken new advice on Delaware law, HMRC seem to advance no new information which would cause the FTT's findings of fact to be flawed.

Second, HMRC make no reference to the usual terms of LLC agreements. Indeed, other than a passing reference to the LLC agreement providing the mechanism for the transfer of profits from the LLC to members, HMRC ignore the terms of LLC agreements. But these are frequently very clear as to the allocation of profits. A typical example is below:

> 'Except as otherwise provided in this Agreement, the items of Company Profit and Loss for each fiscal quarter (or shorter period selected by the Managing Member) shall be allocated among the Members in proportion to their respective Membership Interests.'

As can be seen, the inference of this wording is that profits do in fact belong to the members as they arise. The position is straightforward. Our view is that the FTT in *Anson* would have had little difficulty in reaching the same conclusion, possibly more simply, with this wording. HMRC's statement that the most relevant provisions of Delaware law (sections 18-101(10)) and 18-503 of the Act), which were key to the FTT's decision-making, are not 'significantly relevant' seems odd. This is no doubt a matter that would have to be reconsidered by a court if HMRC were to seek to advance the same arguments. In particular, seeking to ignore s 18-503 on the basis that it is unlikely ever to apply in practice and that s 18-503 itself states 'that the profits and losses are' of the LLC which would then have to be allocated amongst the members seems odd given the focus on these provisions by the FTT. The authors are not experts in Delaware law, but these provisions are in our understanding critical to the understanding of the Delaware law underpinnings for the ecosystem of LLCs and s 18-503 in particular seems to support profits belonging to the members.

There is then the question of the tax paid in the UK and the US. HMRC's position is that tax paid in the US is neither creditable nor deductible. The 12 December guidance is explicit about this. However, the impact could be startling, and advisers and taxpayers will rightly query HMRC's position. Take the following example, assuming trading profits in the US of $100 which are allocated to a UK resident US citizen deemed domiciliary member of an LLC. Assume that the rate of tax payable is 50% in the US (counting federal, state and city taxes, a fair approximation for many states such as New York) and assume that the entire $100 is distributed to the member as their profit share, with the US citizen paying $50 of US tax personally. On HMRC's view, it appears that the entirety of the $100 distribution is taxable as a dividend, at an assumed rate of 39.35% (with no credit or deduction for the $50 of US tax), meaning the total effective tax rate is 89.35%. There are a number of other examples that can be readily identified that produce similar outcomes.

There is also the question as to whether member tax that is required under US law to be withheld and paid to the IRS by the LLC itself (as was the case in *Anson*) is in HMRC's view a form of deemed distribution. Even if HMRC ultimately take the position that the withholding is deductible (contrary to what they appear to say in the 12 December guidance), the impact is still an effective rate of close to 70%.

These effective rates and the lack of clarity surrounding them will be of significant concern to taxpayers and advisers alike, but they are an inevitable consequence of HMRC's rejection of the US legal position underpinning *Anson*, namely that the profits arise to the members and so does the US tax liability.

In this context, HMRC's failure to address issues arising from the 2001 Convention is noteworthy. In a number of respects the 2001 Convention simply repeats aspects of earlier double tax treaties, but the Exchange of Notes accompanying Article 24 (the relief from double taxation provision) is important. Whilst drafted in somewhat opaque language, this contains the following provision:

> 'It is understood that, under paragraph 4 or 8 of Article 1 (General Scope), the provisions of the Convention may permit the Contracting State of which a person is a resident [the UK] (or, in the case of the United States, a citizen) to tax an item of income, profit or gain derived through another person (the entity) which is fiscally transparent under the laws of either Contracting State, and may permit the other Contracting State [the US] to tax (a) the same person; (b) the entity; or (c) a third person with respect to that item. Under such circumstances, the tax paid or accrued by the entity shall be treated as if it were paid or accrued by the first-mentioned person for the purposes of determining the relief from double taxation to be allowed by the State of which that first-mentioned person is a resident [the UK].'

It is surprising that HMRC have not commented on the likelihood of double taxation other than to confirm that it exists because 'the same profits, income or gains would not be taxed in both countries' without referring to this provision. In our view, this provision could be read as giving rise to an ability to claim credit for US tax paid or accrued on the profits of a transparent US vehicle even if it is not treated as transparent in the UK, if the tax is paid by 'the same person' (i.e. the UK taxpayer) or 'the entity'. In both jurisdictions, the economic reality is that tax is levied on the LLC's 'profit', the difference being that in HMRC's view the profit manifests itself in the taxpayer's hands in the form of a dividend whereas in the US the profit arises independently of any distribution (distributions are instead a mechanical event, transferring to the member what is already theirs in fiscal terms). This gives rise to an argument that the UK should credit the US tax against UK tax on the subsequent dividend/distribution. It must be said that this argument is untested and HMRC may be hostile to it, but on a reasonable reading of the 2001 Convention it could allow a constructive route forward and a means of dealing with the UK treatment of LLCs without needing a re-run of the *Anson* litigation.

On a practical level, the timing of the 12 December guidance is also deeply unsatisfactory, leaving taxpayers and advisers in the difficult position of having to deal with a change in HMRC position in the middle of tax return preparation season. This appears to be becoming something of a recurring theme for HMRC, and is reminiscent of the 17 January 2022 change in HMRC's guidance on the crediting of foreign tax under the carried interest taxation regime, which resulted in significant disruption and uncertainty.

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The 12 December guidance offers taxpayers the opportunity to approach HMRC's Base Protection Team for confirmation of whether a particular US LLC will be treated as 'transparent or opaque' (INTM180050), but this offers little comfort as it is highly unlikely that proper consideration could be given to any situation before the 31 January deadline.

## Way forward

The 12 December guidance now leaves taxpayers with three choices. The first is to file in accordance with the guidance in which case the taxpayer's position is unlikely to be challenged by HMRC but they will end up paying in many cases double tax and potentially at very high effective rates. In the absence of clarification from HMRC on key points such as whether withholding imposed on non-US resident LLC members is in fact deductible, there is an open question as to how taxpayers can in fact know that they are compliant. Unless the sums in question are small, we suspect that comparatively few taxpayers will want to follow this option.

The second is to seek to reserve the taxpayer's position by filing in accordance with the 12 December guidance (so as to avoid penalties, if any), whilst attempting to retain an ability to amend their returns in the event that HMRC are wrong. There are doubts as to whether this position will be sustainable because it is unclear whether further litigation on this subject would be conclusive in the timeframe available to taxpayers to amend their returns. In addition, given the tone of the 12 December guidance, there must be an open question as to whether HMRC would permit this approach, or whether they would seek to close out the taxpayer's return and litigate.

The final approach is therefore to file in accordance with the *Anson* decision and take a position contrary to the 12 December guidance. This is never an easy position for any taxpayer to take, particularly as the 12 December guidance makes clear that HMRC will consider opening an enquiry where such a position is taken. However, in this case, we feel that in many instances it would be justified. The reasons for this are as follows.

First, irrespective of HMRC's revised position as set out in the 12 December guidance, taxpayers have the benefit of a Supreme Court decision behind them. This endorsed a finding of fact at FTT level, and this must be persuasive, not least in terms of any penalty situation. It would in our view be inappropriate for HMRC to seek to levy penalties on any taxpayer who took a position contrary to the 12 December guidance in this almost unique situation. HMRC are arguing against a decided decision, and though they are correct that a finding as to foreign law is a finding of fact, the broader concept is important. We suspect that in a contrary situation HMRC would be aggressive in countering arguments of the type now put forward by HMRC in the 12 December guidance.

Second, HMRC's position as set out in the 12 December guidance, whilst containing some novel aspects, appears to be in large measure a re-treading of ground already gone over by the FTT. If that is a correct interpretation of HMRC's revised guidance, then what has changed, and why can taxpayers expect that a finding of fact at FTT level would be different this time around?

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Third, in most cases, taxpayers filing in accordance with the *Anson* decision are not engaged in avoidance in any sense. This was found by all levels in the court process in the attitude to the Transfer of Assets Abroad Regime, and in this instance most taxpayers would be facing genuine (and unattractive) double taxation. Taking a position which is in reality consistent with a Supreme Court decision in order to avoid double taxation should on any basis in our judgment be seen to be reasonable.

Fourth, and as explained above, there are surprising absences from HMRC's discussion of the issues particularly as regards the impact of their revised position on those subject to genuine double taxation. There is no attempt to engage HMRC's revised view of Delaware law with the provisions of the 2001 Convention. As a result, it might be felt that the 12 December guidance is at best interim, incomplete, and therefore of somewhat uncertain validity.

For these reasons, we suspect that a number of taxpayers will continue to file in accordance with the *Anson* decision and take a position contrary to the 12 December guidance. In the authors' opinion, based on the arguments outlined in the 12 December guidance, in many cases taxpayers would be justified in doing so. ■

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