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Is It All Now Transparent? UK Supreme Court Case on Delaware LLCs Leaves Open Questions on Entity Classification for UK Tax Purposes

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The UK Supreme Court delivered an unexpected final judgment on 1 July 2015 in the long-running case of *Anson v Commissioners for Her Majesty's Revenue & Customs* [2015] UKSC 44. Reversing the decisions of the Upper Tribunal and the Court of Appeal, the Supreme Court upheld the original 2010 ruling of the First Tier Tribunal ("FTT") in deciding that Mr Anson, a UK resident member of HarbourVest Partners LLC, a Delaware limited liability company ("LLC"), was entitled to credit against UK tax for US tax borne on the LLC's profits.

The decision raises questions over the status of HMRC's long-standing practice that Delaware LLCs are generally not fiscally transparent for UK tax purposes.

UK Entity Classification and the FTT Decision

Cases relating to foreign entity classification for UK tax purposes are few and far between. Long-standing UK tax authority ("HMRC") practice is based largely on the 1998 Court of Appeal decision in *Memec plc v Inland Revenue Commissioners* [1998] STC 754, another case concerning foreign tax credits. Broadly, this practice requires the evaluation of several characteristics of the entity in question (set out below) under local commercial law, and a comparison with the equivalent characteristics of English and Scottish partnerships (which are fiscally transparent, albeit that a Scottish partnership has separate legal personality) on the one hand and of a UK company (which is fiscally opaque) on the other. The need for a local commercial law analysis of often very fine points sharply contrasts with practice in other jurisdictions. For instance, the United States specifically provides that a Delaware LLC with more than one member is by default treated as a partnership for US federal income tax purposes, unless an election is made so that it is instead treated as an opaque corporation.

The UK courts establish relevant points of foreign law as a matter of fact, based on expert evidence heard before and evaluated by the initial fact-finding tribunal, in this case the FTT. Notably, this approach led the House of Lords to give contrasting decisions in the two *Archer-Shee* cases in the 1920s and '30s (two different cases, because each case covered different tax years), having had access to evidence on New York trust law in the second case that was not available in the first. Given the importance of the fact-finding exercise carried out by the FTT, and that the Supreme Court has now upheld its decision, a brief description follows of the relevant aspects of the FTT decision.

The FTT had heard evidence from expert witnesses on Delaware law for Mr Anson and HMRC as to the characteristics of HarbourVest Partners LLC under Delaware commercial law. The most significant characteristic for Mr Anson's case – on which the parties' experts disagreed – was whether an LLC member was entitled under Delaware law to the profits of the LLC as they arose. For completeness, other factors evaluated in accordance with the practice mandated by *Memec* included: the separate legal personality of the LLC; whether members' interests served a function analogous to share capital in a company; whether the business was carried on by the LLC or by its members; whether the LLC or its members were responsible for debts incurred in the business; and whether the LLC's assets belonged beneficially to the LLC or to its members.

The LLC received investment management fees from a number of venture capital funds. It was agreed that, under Delaware law, the fees when paid belonged beneficially to the LLC and not to the members. However, Delaware statute requires the allocation of the LLC's profits and losses to members, and includes the member's share of profits and losses within the definition of the member's LLC interest. The FTT agreed with Mr Anson's expert in finding that these Delaware statutory provisions, combined with the terms of the LLC agreement of HarbourVest Partners LLC meant that, notwithstanding the beneficial ownership by the LLC of its assets, the members were indeed automatically entitled to the profits of the LLC's business as they arose. The FTT did not regard the provisions set out in the LLC agreement for the allocation of profits to members and their subsequent distribution as amounting to a mechanism like a corporate dividend for effecting a change in ownership of the profits.

The requirement to consider local commercial law characteristics had been generally understood (including by HMRC) to mean that a typical Delaware LLC would be fiscally opaque for UK tax purposes and therefore that, in contrast to the equivalent US federal income tax position, an LLC member would be subject to UK tax on distributions as and when distributions were made by the LLC. But it followed from the FTT's decision on Delaware law, at least in relation to this particular LLC, that the United Kingdom and the United States both taxed Mr Anson on the same profits – on his share of the profits as they arose to the LLC, rather than on a subsequent distribution from the LLC. This, in turn, meant that he was entitled to credit the US federal and state income tax paid on his share of the LLC's profits against his UK tax bill (under the UK/US tax treaty in respect of US federal income tax, and under similar UK domestic law provisions on foreign tax credits for US state income taxes).

Upper Tribunal and Court of Appeal Decisions

The FTT decision was good news for Mr Anson (and for other UK resident individuals in his position). The effective tax rate on his return from the LLC was reduced by virtue of the decision from 67% (taking into account both US federal and state income tax on the LLC's profits and UK tax on the distribution of Mr Anson's share of the post-US tax profits) to the applicable combined US federal and state income tax rate with no incremental UK tax cost.

The news was perhaps far less good for the settled UK treatment of foreign entities; for instance, where UK resident corporate or tax exempt investors would expect to be treated for UK tax purposes as receiving exempt distributions from an LLC, and – consistent with an investment in an opaque entity – should not recognise any taxable income at all unless and until there was a distribution. Separately, the finding of the FTT that the LLC interests in *Anson* were more similar to partnership capital than share capital raised questions about the application of the grouping rules for UK tax purposes (where it is important that interests in affiliates take the form of ordinary share capital) to LLCs within corporate groups.

HMRC swiftly published a release stating that the FTT's decision was being appealed and that its previous practice would continue to be applied pending the outcome of the appeal process.

On appeal, the Upper Tribunal (in 2011) and the Court of Appeal (in 2013) both disagreed with the FTT's decision. Broadly, they held that, for Mr Anson's case to succeed, he needed to show that his profits and the LLC's profits had the same source and that, following *Memec*, unless Mr Anson could demonstrate that he had a proprietary interest in the LLC's profits, his profits must be of a different source to those arising to the LLC. Since the FTT's findings on Delaware law did not disclose any such proprietary interest, his case failed.

Whilst there were some difficulties with this – for example, it is difficult to locate a proprietary interest that a member of a Scottish partnership has in the partnership's assets or profits – these decisions were generally welcomed as confirming the previous practice in this area.

The Supreme Court Decision of 1 July

The Supreme Court has now unanimously overturned the Upper Tribunal and Court of Appeal decisions, and upheld the initial judgment of the FTT.

Lord Reed, with whom the four other Supreme Court judges agreed, based his decision on the terms of the UK/US tax treaty dealing with tax credits – 10 pages of the judgment are devoted to a magisterial exposition on the history of the relevant treaty provisions from 1945 onwards. The nub of the decision returns to the FTT's finding that, under Delaware law, the members of the LLC became entitled to their share of the profits generated by the business of the LLC automatically as the profits arose, prior to and independently of any subsequent distribution. The expert evidence on Delaware law entitled the FTT to make that finding, which could not be set aside through the arguments that had persuaded the intermediate courts otherwise. In particular, the weight given in *Memec* to proprietary rights only came about because of the particular terms of the treaty provisions with which that case was concerned (dealing with credit for underlying tax paid by subsidiaries owned by the German silent partnership of which Memec plc was a member, rather than credit for tax on the profits of the partnership itself). Accordingly, it was sufficient to hold, and the Supreme Court did hold, that Mr Anson's UK tax liability was computed by reference to the same income as was taxed in the United States, so that he qualified for credit. The Supreme Court's decision is the final step in the case, and no further appeal is available to HMRC.

Comment

In principle, the decision in Anson concerns the analysis of one particular foreign entity, and one particular consequence of that analysis for its UK resident members. This was also true of the *Memec* case, but the principles derived from that case as distilled by HMRC published practice have governed the UK approach to entity classification for the past 15 years or more. *Memec* required several local law characteristics of foreign entities to be evaluated and balanced, whereas the focus in Anson was almost exclusively on members' entitlements to profits as they arise. Therefore, there are open questions as to appropriate local law characteristics of an entity which must be established, in order to determine the UK tax treatment of that entity in various circumstances.

In practice, there are significant questions about the scope of the decision.

First, whether the decision applies to Delaware LLCs generally, or only where the LLC agreement contains provisions governing the allocation of profits to members' capital accounts which are similar to those in the HarbourVest Partners LLC agreement. This will likely depend on the weight accorded to the seemingly general Delaware statutory requirement that profits are included in members' interests and must be allocated to the members. Secondly, the impact on the treatment for UK tax purposes of other types of foreign entities and LLCs may well now depend on further analysis in the light of the *Anson* decision, particularly as to the nature of members' entitlements to the entity's profits. Thirdly, the effect on grouping for UK tax purposes of the FTT's decision that the members of HarbourVest Partners LLC did not have

interests similar to share capital could be clarified. Fourthly, while the argument in *Anson* before the various tribunals dealt with subtly different concepts of transparency/opacity, partnership/company, source and the 'same profits' condition, the Supreme Court decision in *Anson* was based on the 'same profits' condition in the UK/US treaty. It remains to be seen whether an LLC which does fall within *Anson* is now to be treated as a transparent partnership for all UK tax purposes, or if different factors apply for instance in relation to capital gains and to the distribution and substantial shareholding exemptions; it seems that *Memec* may still hold good for now in relation to underlying tax credits.

Taxpayers whose structures depend on UK entity classification prior to *Anson* should review their positions. It is to be hoped that HMRC will clarify their practice in this area as soon as possible.

Finally, it is noteworthy that the *Anson* case drew on the expertise of no fewer than 11 eminent UK judges (for the record, the final outcome was favoured by a combined 7-4 majority), together with numerous counsel for the parties. Yet, at bottom, the case turned on the contrasting factual evidence given by two Delaware law experts before the FTT, which the three higher courts have had to construe without further input. This is not the first time that foreign law points have been highly significant in recent important UK tax cases (see, for example, the *First Nationwide* case [2012] EWCA Civ 278 in relation to the local law nature of Cayman dividends paid out of share premium account, and the *HSBC Holdings* case [2012] UKFTT 163 (TC) in relation to the local law nature of American depositary receipts). Often, these points cover fine distinctions which have little or no practical relevance except to the UK tax position. Absent the second bite of the cherry that the multiple *Archer-Shee* cases afforded (as discussed above, in *Archer-Shee* a second case gave a chance for New York lawyers to weigh in), who knows what further insights Delaware lawyers would have been able to give to the higher courts, if only they had been able to ask?

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