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UK Supreme Court Forces HMRC to Rethink its Tax Treatment of Delaware LLCs

Supreme Court rules in favour of taxpayer in landmark case regarding UK tax treatment of Delaware LLCs.

On 1 July 2015, the UK Supreme Court handed down a long-awaited ruling in the case of *Anson v Commissioners for Her Majesty's Revenue & Customs* [2015] UKSC 44. *Anson* is arguably one of the most important cases on double tax treaties in recent years.

Background

Double tax treaties offer vital protection for taxpayers, as they can provide relief to taxpayers who face paying tax on the same profits or income in more than one jurisdiction. In order to benefit from such relief, it needs to be demonstrated that the profits or income being taxed in each jurisdiction are, in fact, the “same profits or income”. The relevant treaty in *Anson* was the UK/US double taxation treaty (the **Treaty**).

Mr. Anson was a member of a Delaware LLC (the **LLC**) which managed a number of venture capital funds. Since a Delaware LLC is generally treated as transparent for US tax purposes (unless an election is made to the contrary), Mr. Anson was liable to US federal and state taxes on his allocable share of the LLC's profits.

Mr. Anson was resident, but non-domiciled, in the UK for tax purposes, meaning he was subject to UK income tax on both any UK-source income and any non-UK source income remitted to the UK. After paying tax in the US on his share of the LLC's profits, Mr. Anson remitted the balance of his profit share to the UK, and was therefore liable to UK income tax on that balance (subject to any relief available under the Treaty).

The key question for the Supreme Court was whether Mr. Anson was entitled to relief for double taxation under the Treaty.

First Tier Tribunal

In the initial hearing before the First Tier Tribunal (the **FTT**) in 2010, the FTT followed the approach taken by the UK Court of Appeal in *Memec plc v Inland Revenue Commissioners* [1998] STC 754.

A key part of the analysis in *Memec* involved examining the characteristics of the foreign entity in question under the relevant local law. In that context, a comparison can be made between a spectrum of entities ranging from UK companies (which are treated as fiscally opaque), Scottish partnerships (which are treated as fiscally transparent, albeit that they have a separate legal personality) and English partnerships (which are treated as fiscally transparent without a separate legal personality). Accordingly, the FTT in *Anson* considered the following characteristics of the LLC:

- Whether the LLC has a separate legal personality
- Whether the LLC has issued share capital (or something which serves an analogous function)
- Whether the business is carried on by the LLC itself or by its members
- Whether the members are entitled to a share of the profits in the LLC as they arise or only when those profits are distributed by the LLC to its members
- Whether the LLC or its members are responsible for debts incurred by the business
- Whether the assets of the LLC belong beneficially to the entity or to its members

Hearing expert testimony on Delaware law, the FTT agreed with HMRC that the LLC had carried on the business, was liable for debts incurred, owned the assets of the business and had a beneficial interest in the profits of the business.

However, the FTT also found that the LLC had nothing equivalent to share capital. Critically, the FTT agreed with Mr. Anson's expert witness that certain Delaware statutory provisions, when combined with the terms of the agreement constituting the LLC, meant that the members were entitled to the profits as they arose — prior to, and independently of, any subsequent distribution of the LLC. The FTT viewed the latter characteristic as being of central importance and, on that basis, held that Mr. Anson had indeed been taxed on the same income in both the US and the UK and was accordingly entitled to relief under the Treaty.

Upper Tribunal and Court of Appeal

The Upper Tribunal and the Court of Appeal both, in 2011 and 2013 respectively, rejected the FTT's decision. Broadly, both the Upper Tribunal and the Court of Appeal decided to focus on a different aspect of the analysis, holding that the source of the profits of the LLC and Mr. Anson were not the same as (in particular) the expert testimony had not demonstrated that Mr. Anson had a proprietary interest in the LLC's profits.

Supreme Court

The Supreme Court has now overturned the decisions of the Upper Tribunal and the Court of Appeal, in favour of Mr. Anson. The Supreme Court's decision is final and non-appealable.

In his decision, Lord Reed, amidst giving a fairly lengthy analysis on the history of international tax treaties, supported the FTT's original decision, concluding that the fundamental factor in this particular case (based on the ordinary meaning of the provisions of the Treaty and UK domestic law) was that Mr. Anson was entitled to a share of the profits of the LLC as they arose. The Supreme Court therefore concluded that Mr. Anson was entitled to relief under the Treaty on the basis that the income on which Mr. Anson paid US tax was the same as the income on which he was liable to pay UK income tax.

Comment

Good news for UK members of LLCs?

The Supreme Court based its decision on an analysis of the interaction between certain provisions of Delaware law and the agreement constituting the Delaware LLC in question. It is far from clear, therefore, whether relief will be available to other UK tax resident members of other US (non-Delaware) LLCs or even other Delaware LLCs. However, the decision could potentially be good news for UK tax resident members in a similar position to Mr. Anson and facing what might amount to a significant double tax liability (prior to the Supreme Court ruling, Mr. Anson was facing a tax charge on his share of the LLC's profits at an effective tax rate of 67% — *i.e.*, £45 in US taxes for every £100 of income, plus £22 in UK tax, calculated as 40% of the £55 remitted after payment of US taxes).

It is not entirely clear which of, on the one hand, the provisions of Delaware law or, on the other, the terms of the agreement constituting the LLC, the Supreme Court viewed as more important when reaching its decision. If the latter, there may be the potential in the future for taxpayers to draft their LLC agreements in a certain way in order to achieve the desired tax treatment.

A new approach?

The case marks a departure from long-established HMRC practice, with the scope of the Supreme Court's decision intentionally narrow. Until now, HMRC have viewed Delaware LLCs as simply being fiscally opaque and accordingly treated in the same way as an overseas company. In *Anson*, the FTT and the Supreme Court focused on the particular question of whether members are entitled to a share of the profits as they arise. The decision did not go further: for example, the Supreme Court did not opine on whether an LLC should be treated as a partnership for UK tax purposes. Indeed, the FTT and the Supreme Court both largely steered clear of the traditional analysis of whether an entity is "opaque" or "transparent".

As of the date of this *Client Alert*, HMRC have not published any response to the Supreme Court's decision. Therefore, how the Supreme Court's ruling might affect the general UK tax treatment of UK resident members of Delaware and other US LLCs (for example, the UK capital gains tax position of such members) remains unclear. Moreover, the case of *Anson* does not extend to the area of general entity classification. Accordingly, UK taxpayers who hold interests in US LLCs may wish to seek professional advice as to the impact of the Supreme Court's ruling on their position.

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