Delaware LLCs and UK Entity Classification: The Fallout From the Curious Case of George Anson

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Fundamental to any developed tax policy is knowing who the taxpayer is (or should be) with respect to any particular transaction. Although that can be relatively straightforward in purely domestic situations, a cross-border dimension can present different answers to this question in the jurisdictions involved and lead to issues over credit in one or the other jurisdiction, allocation of taxing rights, timing of the tax charge and the application of anti-deferral rules.

These and other issues underpinned the recent decision of the Supreme Court of the United Kingdom in the case of *Anson v. HMRC*. Put simply, in the years under consideration, George Anson was a U.K. resident member of a limited liability company formed under the laws of Delaware (referred to below as DLLC) and paid U.S. taxes on his allocated share of the profits of DLLC. Anson received distributions from DLLC, remitted those to the U.K. and — in the U.K. tax authority's (HMRC) view — was required to pay tax on those distributions as if they were dividends from DLLC. It followed that HMRC would not allow credit for U.S. taxes against this U.K. liability: Anson had not paid U.S. taxes on the distribution and so the profits subject to tax in the two jurisdictions were not the same.

Having considered the decisions of the three lower courts, the Supreme Court resolved the issue in Anson's favor: On the facts as found by the First-Tier Tribunal, the court ruled the profits subject to tax were the same for the purposes of the relevant double tax treaty between the U.S. and the U.K., and Anson was therefore entitled to credit against his U.K. tax liability for the taxes paid on those profits in the U.S.

Both the decision and the many questions it did not resolve leave significant uncertainty for taxpayers and HMRC alike (given HMRC's default classification of Delaware LLCs as "opaque" entities, capable of functioning as blockers for U.K. tax purposes) and, in the right context, planning opportunities.

One such opportunity is that the judgments give taxpayers a pathway to setting up a Delaware LLC in such a way that a U.K. taxpayer would be taxed on the same profits in the U.K. as in the U.S., at least for purposes of the double tax treaty. This provides a potentially significant layer of considerations when applying the analysis to the U.K. controlled foreign corporation (CFC) rules, the existing anti-arbitrage and proposed 2017 implementation of the base erosion and profit shifting (BEPS) anti-hybrid actions. It is possible to infer from the judgments that, if DLLC profits had not been automatically allocated to the members (while there is a clear distinction between allocation and distribution for these purposes, the lowest and highest courts held this to be irrelevant in this particular case) but instead DLLC or its managing member had been required to actively decide what the allocation to members should be and when the allocation should be made (akin to the process undertaken by the directors of an English company when considering the declaration of a dividend), the conclusion could have been substantially closer to the position taken by HMRC.

Additionally, the position taken by HMRC followed published guidance in its *International Manual*: Delaware LLCs have been seen as "opaque" since 1997. The guidance is, in fairness, general and subject to the specific facts of any particular case. Until *Anson*, the principal judgment of reference on the subject of classification of entities for U.K. tax purposes was *Memec plc v. Inland Revenue Commissioners*. From *Memec*, HMRC derived a list of questions by which it instructs its operators to assess non-U.K. entities. The list is largely drawn from the characteristics of an English company (assumed in *Memec* to be a prime example of an "opaque" entity) that the Court of Appeal considered relevant in *Memec*. In *Anson*, expert evidence on Delaware law has been framed

largely around those questions, and neither the taxpayer nor the courts appear to have disputed that those were the correct and relevant questions. This is of course helpful in establishing a framework and providing additional certainty to taxpayers and advisers.

One such question, which may require multinational groups to review the characteristics of Delaware LLCs within their own structures, is whether the LLC has issued "ordinary share capital." This is relevant to a number of specific regimes within the U.K. corporation tax code, including most forms of group relief, both for loss surrenders and for intra-U.K. transfers of assets, and the exemption for gains on sales of subsidiaries. The First-Tier Tribunal decided in *Anson* that DLLC's capital was closer to partnership capital than to the share capital of an English company. There is, however, no reference in the judgments to whether DLLC issued certificated membership interests (as permitted by Delaware law). The relevance to the application of *Anson* is that HMRC's published practice states that certificated membership interests issued by a Delaware LLC are accepted as ordinary share capital. It is not unreasonable to think that HMRC would have raised this point had certificated membership interests been issued by DLLC. Would this have led the First-Tier Tribunal to reach a different conclusion? On balance, probably not; but structures reliant on "ordinary share capital" and, in our view, on a nontransparent Delaware LLC should be considered against this background.

HMRC's formal response to the case was published on September 25, 2015. Business Brief 15 (2015) states that HMRC concluded that the decision in *Anson* is specific to the facts found in the case. HMRC confirms that the historic treatment of "US LLCs" (note, not just Delaware LLCs) will continue. HMRC's existing guidance is clear that entity classification is to be considered on a case-by-case basis. Business Brief 15 (2015) may give some comfort as to HMRC's approach to the past, especially for periods that are still open. However, taxpayers whose facts are close to those in *Anson* may still wish to consider — and be aware that HMRC may seek to consider — revisions or a change in approach to certain aspects of tax returns (for example, to claim credits for U.S. taxes or to submit a revised CFC or distribution exemption analysis) and a review of the analysis of current and future transactions reliant on grouping.

There was no obvious "one size fits all" answer here for HMRC: all potential reactions would have had both positive and negative consequences, and going with the status quo likely provides the lowest levels of uncertainty for past periods. Of course, the U.S. "solved" this question for U.S. federal income tax purposes some time ago by allowing certain entities not to be considered as per se taxpayers by checking a box. HMRC could have considered lobbying the government to introduce a U.S.-style "check the box" rule or a reverse deeming rule similar to Denmark. In practice, our view is that neither would have been likely to be implemented across the board, at least in a way that would give taxpayers the benefit of choice. In that context, it also is worth recalling that HMRC may be looking to introduce specific entity classification rules for reverse hybrids as part of the domestic implementation of the BEPS anti-hybrids actions.

A final word of warning: As reported, the *Anson* case did not involve any form of evasion or even aggressive avoidance. It was a clear case of unrelieved economic double taxation that resulted from the application of current U.K. tax laws. This happens most of the time when a U.K. individual taxpayer invests in a taxable corporation, of course. However, the Supreme Court, and the First-Tier Tribunal, concluded in this case that double taxation should be relieved. It is not inconceivable that different conclusions would have been reached (leaving aside *WT Ramsay v. Inland Revenue Commissioners* and the General Anti-Abuse Rule) in a case involving tax advantages that complicated otherwise very clean and apparent economic outcomes.