

## “NEITHER ONE THING NOR THE OTHER”

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There can scarcely be a reader of the OITR who is not aware that American limited liability companies (LLCs) are fiscally transparent: i.e. for US tax purposes the profits of the LLC are not taxed on the LLC itself but on its members. Historically, LLCs arose in the State of Wyoming and are regulated by the Wyoming Limited Liability Company Act and because they have offered both limited liability with tax transparency they have spread to all other states of the USA (Delaware in particular) and beyond – including to jurisdictions such as Samoa, Nevis, the Isle of Man and (as we shall see) the United Kingdom. Apart from the fact that it has limited liability status, what are the main characteristics of a Wyoming LLC?

- It may be organized “for any lawful purpose” (other than insurance and banking)
- Its right to exist is recognized by a Certificate of Organisation issued by the state and it must maintain in Wyoming a registered office and registered agent
- It must have at least two members and file its “Articles of Organisation”
- The Articles of Organisation set out basic information about the LLC such as its name, purpose, and the identity of its registered agent and of its managers (if no manager is appointed then the identity of its members) and
- It will have a limited life which is 30 years (unless any other period is specified in the Articles of Organisation).

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Details of capital contributed or to be contributed by members is also included in the Articles of Organisation. Capital can be repaid to members only if all external creditors have been repaid whereupon revised Articles of Organisation must be filed. Profits and losses (and net assets on dissolution) are to be divided in accordance with an “operating agreement” (otherwise by reference to capital contributions).

### **Don’t be deceived!**

In some ways the term “Limited Liability Company” is deceptive. Americans perversely use the term “company” much as we use the word “association”. So it is not surprising that an LLC is not akin to a conventional UK-incorporated limited company. Although it has its “capital” that capital is not divided into shares which can readily be sold or otherwise transferred. Instead it is pretty much locked in (to this extent the capital position resembles that of a UK partnership under the 1907 Limited Partnerships Act where a partner who withdraws capital nevertheless remains liable for the firm’s debts up to the amount so withdrawn), although a member’s interest may be transferable if the operating agreement permits. The LLC does not have directors – instead its members can commit the firm (unless a manager is appointed to act in their stead). Furthermore the Wyoming LLC is not specified as being incorporated. It does however require a Certificate of Organisation which is perhaps parallel to a UK company’s incorporation certificate.

### **The Revenue line**

So is an LLC a company (UK-style) or, if not, what is it? In this connection the Inland Revenue Tax Bulletin (June 1997 at page 404) stated that:

*“..... for the purposes of United Kingdom tax we have taken the view in relation to those LLCs that we have so far considered that they should be regarded as taxable entities and not as fiscally transparent”*

It went on to say that a UK-resident member of such an LLC would not be taxed on his share of the LLC’s profits but on actual distributions therefrom, presumably just as if they were overseas dividends. This approach of course gave rise to an immediate problem: if a UK member of a US LLC pays US tax on his profit share then he is merely – according to the Inland Revenue’s interpretation – paying the liability of the LLC, so in strictness he is not entitled to double tax relief when he is taxed in the UK on actual distributions. However

*“as a matter of practice”* the Revenue will allow US tax paid as a credit against UK tax on the distributions received.

Is the Revenue correct in its view of the status of a US-type LLC? Must it be regarded as a taxable entity or should it be treated as fiscally transparent?

## **Manx LLCs**

Of course, the UK company law does not allow incorporation of entities known as LLCs (although see below). The Isle of Man does, and they can be useful for international tax planning. The Manx legislation (Limited Liability Companies Act 1996) is based on the Wyoming model, although (i) it does not prescribe a limited life for a set period and (ii) it specifies in section 1 that the LLC *“has legal personality”* and that *“the liability of its members is limited to the extent of their contributions to capital”*. Notwithstanding that *“the profits of the company shall be treated as the income of the members for the purposes of income tax”*, it would seem that Manx LLCs will be treated by the UK Revenue in much the same way as their US counterparts.

However, the LLC (whether Wyoming or Manx) has many of the characteristics of a partnership. As we know *“partnership is the relationship which subsists between persons carrying on business in common with a view of profit”* (Section 1(1) Partnership Act 1890) although that Act excepted bodies registered as companies under the Companies Act 1862 and otherwise by legislation or royal charter etc. An LLC is similarly a body of persons carrying on business with a view to making and sharing profits; it requires capital contributions from members. All these are normal characteristics of a partnership. True, the liability of an LLC’s members is limited (but so are the liabilities of non-general members of limited partnerships) and an LLC has separate legal personality – but so do Scottish partnerships (who do not thereby cease to be partnerships).

## **A UK LLC?**

Furthermore, the UK has LLCs. Some readers may find this a little surprising but a UK Limited Liability Partnership (LLP) is in all but name an LLC. Surely if an LLP is a fiscally transparent partnership why not a US or Manx LLC? In fact, because an LLP is specified (unlike Wyoming or Manx LLCs) as *“being incorporated under this Act”* (Section 1(2) Limited Liability Partnership Act 2000) (my emphasis), it is arguably closer to a conventional limited company than is an LLC on the Wyoming model.

So is a UK LLP intrinsically a partnership? If it is, then so must be – for UK tax purposes – a Wyoming or Manx LLC. In fact, however, an LLP is not in reality a partnership at all. It is described in section 1(2) of the 2000 Act as being simply “a body corporate (with legal personality separate from that of its members) which is formed by being incorporated under this Act”. As for taxation, what is now section 118ZA Income and Corporation Taxes Act 1988 sets out the basic rule:

For corporation tax purposes, where a limited liability partnership carries on a trade, profession or other business with a view to profit–

- (a) all the activities of the partnership are *treated* as carried on in partnership by its members (and not by the partnership as such),
- (b) anything done by, to or in relation to the partnership for the purposes of, or in connection with, any of its activities is *treated* as done by, to or in relation to the members as partners, and
- (c) the property of the partnership is *treated* as held by the members as partnership property.

References in this subsection to the activities of the limited liability partnership are to anything that it does, whether or not in the course of carrying on a trade, profession or other business with a view to profit. (my emphasis).

Similarly with the equivalent rule for income tax in ITTOIA, section 863(1):

For income tax purposes, if a limited liability partnership carries on a trade, profession or business with a view to profit–

- (a) all the activities of the limited liability partnership are *treated* as carried on in partnership by its members (and not by the limited liability partnership as such),
- (b) anything done by, to or in relation to the limited liability partnership for the purposes of, or in connection with, any of its activities is *treated* as done by, to or in relation to the members as partners, and
- (c) the property of the limited liability partnership is *treated* as held by the members as partnership property.

References in this subsection to the activities of the limited liability partnership are to anything that it does, whether or not in the course of carrying on a trade, profession or business with a view to profit.

So, notwithstanding the name, an LLP is seemingly no more than an incorporated body deemed to be fiscally transparent for UK tax purposes.

Much though I am tempted to assert that the Revenue’s approach in its Tax Bulletin is misplaced, I do not think I should. Suffice it to say that a US or Manx LLC is a hybrid resembling both a partnership and a company, and a UK LLP is, if anything, less of a partnership, but which nevertheless is *deemed* to be a partnership for tax purposes. LLCs and LLPs can be summarised as bodies corporate which in practice function as partnerships. But if the UK authorities deem it appropriate for a UK LLP to be treated as a partnership why not extend that treatment to overseas entities which are virtually identical? Indeed should not the Limited Liability Partnerships Act 2000 allow a body corporate set up under the legislation be allowed to call itself an LLC if its members think it more commercially appropriate or desirable? After all, that is what it is. And the fact that an LLC/LLP functions rather differently from a conventional limited liability company and has some markedly different features (e.g. its capital is not divided into shares in the same way) should not hide the fact that both are different breeds of the same species – an incorporated body with legal personality and legal capacity.

These hermaphrodite entities may have significant tax-planning uses. Just as a conventional company’s capital can be divided into income and capital shares (a split-capital investment trust is an obvious example) so the members of an UK LLP can – if they wish – “stream” the income and capital benefits of membership by so stipulating in the members’ operating agreement. So, an offshore trust with a non-domiciled settlor ordinarily resident in the UK intending to acquire an UK investment property for rental income and capital growth could create a UK LLP in conjunction with an underlying UK limited company (“Newco”) whose shares would be owned by the trustees. The operating agreement of the LLP could stipulate that the trustee “partner” would receive and bear capital gains and losses and Newco would be entitled to the net rental income.

In this way the net rental income will accrue to Newco which may well pay corporation tax at the 19% small companies’ rate. When the property is in due course sold the capital gain will accrue to the non-resident trustees without capital gains tax, and Newco can be wound up (again no CGT).

This structure is of course superior to a conventional offshore company whose rental income would be attributed to the settlor under section 739 Income and Corporation taxes Act 1988, no doubt at the 40% rate. The difference can be particularly significant if the property was purchased with bank finance – it is easier to repay debt out of post-tax income if the tax rate is 19% and not 40%.

The flexibility of LLP/LLCs gives opportunities for tax-planning; doubtless we shall be seeing rather more of them.