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Through the Smokey Looking Glass: Opaque or Transparent?

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This week, the United Kingdom Supreme Court, in a landmark decision, has ruled that a UK resident individual member of a Delaware limited liability company is entitled to credit in the UK for US tax on the profits of the LLC. *Anson v Commissioners for Her Majesty's Revenue and Customs* [2015] UKSC 44 has rejected the long held view of HMRC and many tax advisors, that a Delaware LLC is "opaque" and not "transparent" with the result that firstly, UK members are not taxed in the UK until profits are distributed and secondly, credit is not given for US tax on the partnership profits (except for corporate members with a 10% participation). US tax rules treat the LLC as a partnership unless it elects to be taxed as a corporation. The US tax treatment thus eliminates US economic double taxation as between the LLC and its members. The traditional UK view caused economic double taxation for UK resident individuals. UK resident members could benefit from deferral in relation to undistributed LLC profits. In most cases, the deferral is unavailable at least to the extent that the LLC makes distributions to enable its members to pay the US tax they owe on LLC profits.

The Supreme Court declined to apply the opaque /transparent dichotomy, and focussed instead on the language in article 23 (now 24) of the US-UK tax treaty, in terms of which the United Kingdom is required to give credit for "United States tax payable… on profits or income from sources within the United States… against any United Kingdom tax computed by reference to the same profits or income by reference to which the United States tax is computed." Whether the profits on which US tax was paid was the same profit on which UK tax was payable turned on evidence of the effect of the Delaware law and the agreement constituting the LLC. This turned on the narrow point of whether the profits belonged to the members as it arose even though the members did not have a proprietary right to the assets of the LLC.

The decision leaves open the possibility that Delaware LLCs may be different for different UK tax or treaty purposes depending upon the statutory or treaty provision concerned.

While those taxpayers who seek relief from economic double taxation will welcome the decision, those who seek to rely on corporate-like characterisation of US LLCs will be concerned by it.

The decision may be compared with that of the Tax Court of Canada in *TD Securities (USA) LLLC v The Queen* 2010 TCC 186 (CanLII), where the question was whether a Delaware LLC was entitled to the benefits of the Canada –US treaty as a resident of a contracting state within article 4. It would qualify if it was "liable to tax in" the US by reason of its domicile, residence, place of management, citizenship, place of incorporation or any other criterion of a similar nature". There the court decided that the US taxed the worldwide income of the LLC but the LLC was not taxed on that income. Instead its income was fully and comprehensively taxed to its sole member which in turn was included in a group consolidated US tax return. The LLC's share of that tax was charged back to the LLC. This was held to be sufficient to meet the "liable to tax" requirement. Both courts were moved by the purpose of the treaties to prevent double taxation.

The *Anson* decision takes place against a background where the tax character of entities (and instruments) is under close scrutiny in BEPS Action 2. (OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20) Base Erosion and Profit Shifting Project, OECD Publishing. It proposes to address transparent entities by including the following in article 1 of the Model Tax Convention:

> 1(2). For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State. [In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State's right to tax the residents of that State.]

These proposals will not help resolve the issues that were raised in *Anson*. The condition that the residence state treats the income as that of the resident simply restates the issue in different language. The effect of BEPS Action 2 seems likely to be that inconsistent characterisation of entities by source and residence states will be less likely to give rise to double non-taxation in the future, but will remain a potential source of double taxation.

Principles of treaty interpretation

The most enduring contribution of *Anson* will however be the clear guidance provided by the Supreme Court on the principles of treaty interpretation, firmly anchored in articles 31 and 32 of the Vienna Convention on the Law of Treaties. The detailed examination of the history of the foreign tax credit article from the first tax treaty between the two countries in 1945 and the case law of both states to consider the context, use of the jurisprudence of the International Court of Justice and the application of article 3(2) make this a landmark decision in the area. This is only the second time in the 21st Century that the highest UK court has heard a tax treaty case and the first time it has considered the principles of treaty interpretation to tax treaties. Its impact is likely to endure.

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