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US LLC’s – transparent or not: another struggle continues

Jonathan Schwarz (Temple Tax Chambers; King’s College London) · Tuesday, August 22nd, 2017

Limited Liability Companies have become one of the most common forms of business organisation in the United States. Their main attraction is a combination of limited liability for LLC members and structural flexibility that can be adapted to almost any business requirement.

US federal income tax seeks to eliminate double taxation of profits in the hands of the LLC and then in the hands of its members by treating an LLC, by default, as a “pass-through entity”. Thus a single member LLC is disregarded and multi-member LLC is treated as a partnership.

Foreign Tax Consequences

The tax consequences for non-US persons investing in, or through, Limited Liability Companies has posed challenges in many countries. This arises from the principle that the general law rights and obligations must be considered and not the foreign tax treatment, when classifying LLC for non-US tax purposes. In the UK, for example, the seminal decision of the Supreme Court in *Anson v Revenue and Customs,* [2015] UKSC 44 on the question whether a UK resident individual investor was entitled to credit for US income taxes paid on the profits of a Delaware LLC, upset the longstanding of HMRC that an LLC was “opaque” and that therefore there was no credit. The Court did not find the terms “opaque” and “transparent” informed on the question. Instead, the Court focussed on the requirements expressed in Article 23 of the US-UK double tax treaty.

US Tax Treatment

Although the classification of US LLCs has primarily been an issue for non-US tax systems the same issue has come before the US Tax Court in *Grecian Magnesite Mining, Industrial & Shipping Co., SA v Commissioner,* 149 T.C. No. 3 . Like the UK Supreme Court in Anson, the US Tax Court upset the long-standing view of the IRS set out in Revenue Ruling 91-32, 1991-1 C.B. 107. In *Grecian Magnesite*, a Greek resident invested in a Delaware LLC whose business included mining, producing, and selling magnesia and magnesite. The investor subsequently redeemed its interest in the LLC. The investor accepted that part of the gain related to the sale of underlying US real property interests and was therefore liable to US tax on that part. The balance of the gain was in dispute. On the one hand, the IRS argued that, since the LLC was taxed as a partnership, the aggregate gain in respect of partnership assets is treated as that of the members. The partnership itself is not taxed. On the other hand, the investor argued that in the case of an LLC, the transfer of members’ interests is a transfer of interests in a separate entity.

“Aggregate” v “Entity” Theories

As in *Anson*, the US Tax Court focussed on the statutory requirements rather than the "aggregate" v "entity" theories of partnership taxation to conclude that the asset that is treated as sold on the redemption is the interest in the LLC and not a notional sale of the underlying assets of the LLC. The result was that the sale of the LLC interest was not effectively connected with the trade or business of the LLC. The US Tax Court also rejected an argument that the sale ought to be attributed to an office or fixed place of business in the US which the investor had. The Court assumed that the office of fixed place of business of the LLC could be treated as that of the investor, but decided that the gain on the sale of the investor's interest in the LLC was not attributable to that office or fixed place. Since the gain was not taxable in the US under US domestic law, the US Tax Court declined to consider the effect of the Greece-US double tax treaty on the transaction.

Attribution

By comparison, in *X LLP US v the German Tax Administration*, (No. I R 50.14) of 15 November 2015, the German Supreme Finance Court ruled that an office in Germany of a US LLC that carried on a legal practice was the office of its members, and thus a fixed base within Article 14(1)(Independent Personal Services)of the Germany-US double tax treaty. In that case, attribution of profits to individual members was only permitted by that article in respect of the work performed at that fixed base by the member in question. This US Tax Court conclusion in *Grecian Magnesite* is entirely consistent with this decision.

These cases illustrate the limitations of generic classification of entities for tax purposes. In each case, the courts have focussed on the specific legislative or treaty requirements rather than a broad characterisation.

BEPS Action 2

BEPS Action 2 does not concern itself with characterisation which is at the heart of hybrid mismatches. The Action plan notes that "Country rules that allow taxpayers to choose the tax treatment of certain domestic and foreign entities could facilitate hybrid mismatches." In doing so, the OECD hinted at one source of the difficulties, that is, US rules that treat (or allow to be treated) what is a separate legal person, as a partnership or disregarding it.

The BEPS Action is, however, more concerned with outcomes than with the root cause. Thus Action 2,in calling for the neutralisation of the effects of hybrid mismatch arrangements, proposes changes to the OECD Model Tax Convention to ensure that hybrid… entities … are not used to obtain the benefits of treaties unduly. These are embodied in Article 1(2) of the proposed 2017 OECD Model Convention and Article 3 of the BEPS MLI.

Whether co-ordination of rules or mutual recognition of treatment for tax purposes would produce a simpler, more manageable system is tomorrow's question.

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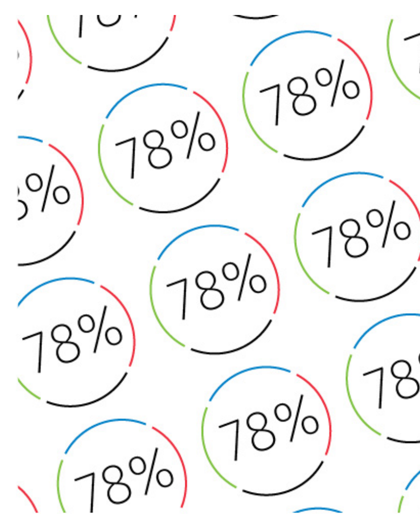

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