Doors and windows

SHIMON SHAW considers whether income from abroad emanates from a transparent or opaque entity.


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The gibe that "you'd make a better door than a window" has stuck with me over the years and as a result I almost never stand in front of the television.

While my transparency is not really in doubt, the same cannot be said for the array of companies, partnerships, foundations, and other foreign entities that exist in the world when one looks at them from a tax point of view. Transparency in this case is a question of whether the entity is "looked through".

In the first case, looking through the entity means that its profits are taxed directly on the beneficial owners as they arise in it. In the second case, the beneficial owners are taxed only when profits are distributed.

Opacity and transparency

The question of whether an entity should be looked through so that the beneficial owners are taxed on its income is a fundamental issue and, thankfully, it is fairly straightforward for most UK practitioners to grasp. This is done, usually, by drawing a parallel between the taxation of the owners of UK companies and partnerships.

Put simply, companies are taxed on their profits. The shareholders of those companies are not taxed on the companies' profits until these are distributed. Companies have separate legal personalities from their shareholders, who do not participate directly in the management of the company. HMRC cannot (in most circumstances) look through a company to apply tax on the shareholders. Companies are therefore "opaque".

English law partnerships, on the other hand, do not carry on a trade themselves, rather the partners themselves carry it on (*R v Income Tax General Commissioners, ex parte Gibbs* 24 TC 221). For most tax purposes, the individual partners are themselves taxed directly on the profits of the partnership. Partnerships are therefore "transparent".

At the risk of stating the obvious, it would be inaccurate to assume that all companies are opaque and that all partnerships are transparent, a point made in *Anson v CRC* [2015] STC 1777 (for a discussion on the implications of the decision see "Across the pond", *Taxation*, 6 August 2015, page 19).

In *Anson*, the Supreme Court considered the status of a limited liability company (LLC) formed in the US state of Delaware. HMRC argued (although in the end they lost) that the company should be treated as opaque, whereas the taxpayer argued that the LLC was transparent and in the nature of a partnership. Expert witnesses were called by both sides to back up the arguments.

In *Memec plc v CIR* [1998] STC 754, the Court of Appeal considered a German silent partnership (*stille gesellschaft*) which was ultimately considered "opaque" for the purposes of the UK-German tax treaty.

The *Memec* case introduced the concept of a transparent entity and was adopted by HMRC. Some tests for transparency were also set out and these form the basis of the questions in HMRC's *International Manual* at ***INTM180010*** and subsequent pages.

Not an academic question

While this all might seem quite academic, this issue arises (or should arise) frequently in practice, whenever any UK taxpayer has an interest in a foreign entity. Although it may be possible to dismiss the point quite easily in many cases, in my experience it is often only when the entity in question starts to distribute profits that questions are asked.

KEY POINTS

- Determining whether a foreign entity is transparent or opaque can be crucial to determining UK personal tax liabilities.
- HMRC's *International Manual* sets out the departmental tests for transparency.
- Ascertaining the status of a foreign entity and the nature of distributions from it in advance can avoid unexpected UK liabilities.
- Although HMRC do list foreign entities, this may not include recently created business bodies.
- The tax treatment of the distribution abroad may be critical to determining UK liability.

INTM180010

Foreign entity classification for UK tax purposes: Factors to consider in classifying a foreign entity for UK tax purposes

When considering the classification of a foreign entity (ie whether it is either opaque or transparent) for UK tax purposes, due regard is given to the approach of the Court of Appeal in the case of *Memec plc v CIR* (70 TC 77) and the line of case law that precedes it.

In particular, the following matters should be considered:

(1) Does the foreign entity have a legal existence separate from that of the persons who have an interest in it?
(2) Does the entity issue share capital or something else, which serves the same function as share capital?
(3) Is the business carried on by the entity itself or jointly by the persons who have an interest in it that is separate and distinct from the entity?
(4) Are the persons who have an interest in the entity entitled to share in its profits as they arise; or does the amount of profits to which they are entitled depend on a decision of the entity or its members, after the period in which the profits have arisen, to make a distribution of its profits?
(5) Who is responsible for debts incurred as a result of the carrying on of the business: the entity or the persons who have an interest in it?
(6) Do the assets used for carrying on the business belong beneficially to the entity or to the persons who have an interest in it?

Some of those factors may point in one direction; others may point in another. An overall conclusion is reached from looking at all the factors together, though some have more significance than others. Particular attention is paid to factors c and d [sic].

However, this may be rather too late if HMRC view the entity as transparent because UK tax on the underlying profits may be applied from a date before the first distributions. Further, because many clients with overseas investments also have resident but non-domiciled status, the remittance basis may also be in point.

In *Anson*, viewing the LLC as transparent would have led to relief under the double tax treaty being denied to the UK taxpayer. This was because HMRC considered the distributed profits of Anson's LLC investment as a dividend, whereas the US Internal Revenue Service (IRS) taxed him directly on the LLC's profits. This led to a mismatch in tax treatment and would have led to double taxation had the Supreme Court not found in his favour.

Foreign entity classification

In their *International Manual*, HMRC list entities, divided by country, and their view as to the transparency or opacity of that entity. I would encourage readers to have a look at this list, which can be found in INTM180030.

The list a good starting point when considering an offshore entity. That said, it is only a starting point if one agrees with HMRC but, having followed through the questions in ***INTM180010***, one should be able to take some comfort from the list. I would caution against viewing the list as definitive and there are several reasons why it should not be relied on.

- First, from a quick look at the list it is soon apparent that some of the analysis has not been updated for several years. Taking an example from the top of the list, the tax treatment of an Argentinian SRL – the equivalent of a UK limited company – does not seem to have been looked at since 1958. In that time, local laws may have changed. Following the *Anson* case, the status of Delaware LLCs has not yet been updated (at the time of writing).
- Second, the entity might not feature on the list. New entities are frequently dreamt up; for example, UK limited liability partnerships (LLPs) are a relatively recent invention. More exotic creatures, such as protected cell companies and foundations, can defy parallels with domestic entities.
- Third, HMRC's thinking might never have been challenged in the courts. Therefore, it can be worthwhile. Equally, HMRC's view does not always follow case law.
- Finally, individual entities may not lend themselves to convenient generalisation or follow a set pattern. For example, the rights of partners in a partnership are often as much a function of their governing documents as the governing local law.

Therefore, although the list in the manual is helpful (particularly as a starting point), it is important to go to back basic principles and look at the entity itself and, in particular, the rights attaching to the investment.

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Decision of the Supreme Court

This approach of looking at the facts and not necessarily relying on the *International Manual* (unless, perhaps, it supports your client's desired outcome) is supported by HMRC's response to the decision of the Supreme Court in *Anson*. This is contained in *Revenue and Customs Brief 15 (2015)*, published on 25 September 2015 (tinyurl.com/nq4zs6w).

HMRC have said that they will seek to distinguish the Supreme Court's decision on the particular facts in question: "The decision is specific to the facts found in the case. This means that where US LLCs have been treated as companies within a group structure HMRC will continue to treat the US

LLCs as companies, and where a US LLC has itself been treated as carrying on a trade or business, HMRC will continue to treat the US LLC as carrying on a trade or business. HMRC also proposes to continue its existing approach to determining whether a US LLC should be regarded as issuing share capital. Individuals claiming double tax relief and relying on the *Anson* decision will be considered on a case by case basis."

It seems, therefore, that not only will HMRC not change their general approach to LLCs, but they will not review cases where a decision has been already made. In such instances, it would fall on the taxpayer to review their LLC investment in light of those questions and to review the agreement taking into account local law.

Bear in mind, of course, that each state in the US has a different legal framework and that an LLC might have been formed in one state but trade in another. Because the LLC in *Anson* was a Delaware LLC it may be simpler to draw parallels when considering other Delaware LLCs. The decision would, however, apply to LLCs formed under the law of different states and indeed any foreign entity.

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Clearly, in a case where there is sufficient common ground with the analysis of the LLC relied on by the Supreme Court in reaching its conclusions, one would certainly have an argument to make to HMRC if a claim for treaty relief under the UK/US treaty needs to be made. The extent to which HMRC will insist on case matching the analysis in *Anson* remains to be tested in practice.

Particular attention will be required in relation to the questions of when the right to a share of the profits arises and the similarity between a member's interest in the LLC and "share capital". If sufficient parallels can be drawn with the facts in *Anson*, it will be hard to ignore the decision of the Supreme Court.

Distributions?

As was pointed out above, if an entity is classified as opaque this would seemingly lead to the conclusion that payments received from the company were distributions. However, there have been a number of cases in which the nature of distributions from overseas companies was unclear.

The distinction between the distribution of capital and income may be relevant for domestic tax purposes (for example, in determining whether this is taxed as a dividend or a part disposal) and for the purposes of double tax treaties or even the parent-subsidiary directive.

Over the years the nature of such payments has been considered by the courts. The case of *Archer-Shee v Garland* [1931] AC 212 established that the nature of a taxpayer's right to his foreign possession must be determined by the foreign law.

This approach was followed in *Rae (HMIT) v Lazard Investment Co Ltd* [1963] UKHL 7, in which the taxpayer had invested in a company incorporated under the law of the state of Maryland in the US. When one of the businesses operated by the company was hived off, by way of "a distribution in partial liquidation", it was sold to a new company with all the assets used in that business. The consideration for this transfer was the issue of shares in the new company "distributed" to the shareholders of the original company.

The inspector considered that this was a dividend from the original shareholding. However, the House of Lords, considering the evidence of a prominent Maryland corporate law expert, looked at whether the underlying asset (ie the shareholding in the original company) remained the same. Since it did not remain "intact", it followed that this was a distribution of capital. This was despite no parallel to the partial liquidation existing under English law at the time.

More recently, the Court of Appeal considered this issue in *First Nationwide v CRC* [2012] EWCA Civ 278. This involved a complex series of structured finance transactions. The question arose as to whether a payment out of a share premium account was income or capital. By Cayman Islands law, share premium was made distributable by dividend, although under UK company law this would have been treated as a payment of capital, and HMRC sought to argue on those lines.

As Lord Justice Moses said, rejecting HMRC's view: "The reality was the distribution of share premium as dividends, as [the Cayman Islands company] was free to do under Cayman Islands companies law. That mechanism establishes that the payments were income."

It was not relevant that a similar payment from a UK company would have been of capital.

Conclusion

The eagle-eyed will have noted a theme here: when determining the nature of an overseas investment – or, to use HMRC terminology, when classifying a foreign entity as transparent or opaque – the facts are key. It is not enough to rely on labels such as company or partnership or to draw too heavily on parallels with familiar UK legal and tax concepts.

Often, it will not be cost-effective to justify a detailed investigation of the overseas entity, and the client may be content to rely on the HMRC list in the *International Manual*. In those cases, proper health warnings should be given.

If it is cost effective, a review should start with an understanding of the nature of the overseas entity and any payments received under local law, and the principles set out in the above cases should be followed. In some cases, this can lead to interesting opportunities when entities are classified differently in different jurisdictions. But that is a story for another day.

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