Ask an expert

The taxation of distribution from Washington LLC

Q My client has a 50% interest in a Washington LLC (which I have assumed behaves like a Delaware LLC). The LLC receives rental income from commercial properties of around $200,000 pa, with total profits of $100,000. There is an unrealised capital gain of $500,000. Tax returns have been filed in the US. Following *Anson* [2013] EWCA Civ 63, I am assuming that there will be no UK tax until a distribution is made and that there will be no UK tax on dividends within the basic rate of tax. If the dividend exceeds the basic rate tax, presumably there will be no credit for the US tax paid? If so, would it be worth restructuring as an LP? Would deferral relief apply?

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The US tax position

Because it has two owners, the LLC will be treated as a partnership for US tax purposes *unless* it has filed a US tax election to be treated as a corporation, which we assume has not occurred. We are not sure which ‘Washington’ you refer to (whether Washington DC or Washington state), but we agree it is reasonable to assume that the relevant LLC legislation is broadly similar to that of Delaware.

US tax will consider your client as earning his allocable share of the LLC’s profits as they arise, whether or not distributed. The LLC is likely to be considered as conducting the US trade or business of commercial property rental, whose net profits are subject to regular graduated rates of federal tax in the hands of the owners. The LLC will be obliged to withhold on your client’s share of profits as they arise at federal rates of up to 39.6% (ordinary income, e.g. rentals) and 20% (capital gain on the sale of property held more than one year). Your client may also be liable for state income tax, which also may be withheld by the LLC. Even if fully withheld, your client will be required to file US self-assessment returns. These US taxes are unlikely to be reduced by a claim under the US/UK double taxation treaty (‘the treaty’).

The UK tax position

We agree that, following *Anson*, the UK will tax any distribution made by the LLC, because the UK does not see your client as owning the LLC’s profits as they arise. Foreign tax credit will not be available for the US taxes, because the UK does not see the distributions (considered to be dividends) received by your client as the ‘same profits, income or chargeable gains by reference to which the United States tax is computed’ in accordance with the treaty (article 24(4)).

A dividend received by a UK individual from a foreign company is imputed with an additional tax already paid of one ninth, plus an amount of relief for any foreign tax paid on that *same* income (none in this case).

Mitigating double taxation

It is uncertain that the LLC could obtain fiscal transparency (as in a Scottish partnership model) merely by ensuring that its membership agreement requires all profits be distributed as they arise, without the possibility of reserve being made. Mr Anson’s LLC was reported to have converted to a limited partnership before the case came to court, and you wisely raise that option. Under Delaware law, this conversion can occur simply by filing a certificate of conversion; a more complicated transaction may be required under Washington law.

A restructuring could take place involving the merger of the LLC with a new LP, or the contribution of the LLC into a new LP followed by the LLC’s liquidation. Restructuring in this way would be considered to cause a capital distribution for UK tax purposes. Relief is not available through TCGA 1992 s 136 because, although HMRC may deem an LLC to be a ‘company’ for these purposes (RI 224), an LP is not one.

With no rollover relief available, your client will have a capital gain taxable at 28% on the LLC’s built-in gain of $500,000 (it may be larger if annual rental income has been rolled up). Bear in mind though that base costs in the LLC membership interest are to be applied. Nevertheless, compared to the double taxation arising if the LLC is maintained, it may be preferable to pay the one-off CGT.

However, if it were possible for the US to see a unit trust as a business entity, then an alternative solution becomes available. Instead of an LP, an unauthorised unit trust scheme (with non-UK resident trustees) issues units in return for interests in the LLC. Section 136 relief is available because the unit trust is deemed a company (TCGA 1992 s 99). The trust could be a fiscally transparent partnership from a US perspective and the problem of double taxation falls away. Non-UK resident trustees are outside the scope of UK tax and the UK-resident unit holders receive income from the unit trust as it arises and are entitled to foreign tax credit. This position is not due to change under the draft Unauthorised Unit Trust (Tax) Regulations, anticipated to come into force in 2013. Accordingly, provided that the unauthorised unit trust scheme is a business entity for US tax purposes, this is a scheme that will mitigate the nominal 54.7% rate of double taxation from which the LLC currently suffers, without tax on the conversion. ■

The author thanks Mark Annear for his contribution. For guidance on the decision in Anson, see ‘Anson: the latest in tax transparency’ (Philip Harle), Tax Journal, dated 1 March 2013.

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Example: LLC has profits of 100, distributed to X (UK higher rate taxpayer):

Ordinary income profit	100			
US federal tax (ignoring any state tax)	(39.6)			
Distribution to X	60.4	60.4		60.4
X’s imputed credit (one ninth)		6.7		
X’s total imputed dividend		67.1		
UK tax payable on dividend (32.5%)			(21.8)	
Less imputed credit			6.7	
Additional UK tax payable by X			(15.1)	(15.1)
Net received by X:				45.3
The combined tax rate (ignoring state taxes) is 54.7%				