Appeal number: FTC/39/2010
[2011] UKUT 318 (TCC)

Income tax – double taxation – United Kingdom and United States – whether computation by reference to the same income or profits – whether taxpayer entitled to profits as they arise

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Appellant

- and -

GEORGE ANSON

Respondent

TRIBUNAL: MR JUSTICE MANN

Sitting in public in London on 12th & 13th April 2011

David Ewart QC, instructed by the Solicitor for HM Revenue and Customs, for the Appellant

Jonathan Peacock QC, instructed by Ernst & Young LLP, for the Respondent

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DECISION

Mr Justice Mann :

Introduction

1. This is an appeal from the First-Tier Tribunal (Judge John F Avery-Jones CBE and Ian Menzies-Conacher FCA) given on 22nd February 2010. In their decision they allowed an appeal against certain discovery assessments. The main issue before them was whether the appellant, Mr George Anson, was entitled to double taxation relief for US tax paid on the profits of a Delaware limited liability company.

2. The hearing below took place in private, on the application of Mr Anson. The tribunal prepared a full version of a decision which was apparently given to the parties. However, for public consumption they prepared what is described as an "anonymised decision". I was originally invited to hear this appeal in public, but on the basis of the anonymised version. That turned into an application that I should in fact sit in private, with the idea of sitting in public using an anonymised judgment as an alternative. When I enquired what the reason for all the privacy was, I was told by Mr Peacock QC, who appeared for the taxpayer, that it was feared that if the financial details of Mr Anson's tax affairs were married up with certain figures given at the hearing and in the original decision as to the affairs of the Delaware corporation, then by a process of "reverse engineering" competitors of that Delaware corporation might be able to piece together some information about the charging mechanism that that corporation adopted. The business of the company was that of managing a series of investments in which various wealthy individuals

had participated. Its charging structure involved a mixture of fixed fees and performance fees. The company was apparently concerned that competitors would be able to find out what the performance fees were and to use that to their competitive advantage.

3. In the event it was not necessary to go fully into the need for privacy or anonymisation because Mr Peacock accepted that, if we worked from the anonymised version of the judgment, which did not reveal any figures, then that removed the need for any privacy. Since the appeal did not turn on precise figures, that turned out to be possible. The hearing therefore proceeded on that basis. The identities of the parties were, however, no longer concealed and they have been used in this judgment.

4. I would nevertheless add two things in relation to privacy:

   i) I should not be taken as agreeing that any privacy regime was necessary. Although the point was not fully argued before me (because the point went away, for the purposes of the appeal before me, in the manner referred to above), it seemed to me that the need for privacy lacked plausibility. The tax years in question are some ten years or more ago, so even assuming that the information was once confidential, a lot of water has flowed under the commercial bridge since then, and it is not at all plain to me how present-day competitors could materially benefit from knowing the charging structures of this particular Delaware limited liability company ten years or more ago. Furthermore, it seems to me that the allegation that reverse engineering could take place in order to work out the charging structure lacked any

real degree of plausibility as well. It was not at all clear to me how a competitor could work from certain figures relating to the income and profits of the company (which would have been in evidence), back to its constituent parts in terms of fixed fee and performance fee without knowing what the fixed fee was, without knowing the base figures from which the performance fee was calculated. I suspect that other factors would need to be known as well. I very much doubt if that could have been done. I therefore think that the case for privacy was weak. However, I was not invited to undo the privacy regime relating to the previous decision, and in particular to allow the release of a non-anonymised judgment, and it is unnecessary for me to dwell further on the point.

ii) When the appeal was opened before me I was handed a copy of the original decision. It turned out that that decision was not only anonymised; it was also very significantly redacted. A lot of figures were removed and any cross-references to where those figures might appear were also removed. Those places of removal were in no way indicated on the face of the anonymised version of the judgment. Certain phrases or sentences containing references to figures were substituted by other more generalised phrases or sentences, again with no indication that had happened. It was therefore very much more than an anonymised version of the judgment. It seems to me that that is an inappropriate way of dealing with the need for privacy as it was perceived to be below. If a judgment is both anonymised and redacted, that should be made plain on the face of the publicly available version.

Otherwise a misleading impression is given. Of course, a reader is unlikely to be better off knowing that something has been removed that he cannot see than he would be if he has a version from which it is not apparent that anything has been removed. However, that is not the point. With all due respect to the First Tier Tribunal judges, the anonymised version which has been made public is actually a different decision from that which was delivered. The better course would, in my view, have been to indicate on the face of the document where any redactions had occurred. I cannot see there would have been any objection to that in this case; it would not have given the game away in relation to any allegedly private material.

5. With all that out of the way I can now turn to the substance of the appeal.

The decision below and the issues on this appeal

6. Mr Anson was, at the material time, a participant in a Delaware limited liability company known as HarbourVest Partners LLC ("LLC"). As a participant he was entitled to, and was paid, sums which as a matter of calculation at least amounted to a share of the profits of that entity (I formulate the matter in that way so as not to prejudge any of the issues arising on this appeal). He was taxed on those profits in the US on the footing that LLC was treated as transparent so that the profits fell to be taxed as income of the members. He was at the relevant time non-domiciled in this country, and so was taxed on remittances. He remitted his income from LLC. HMRC sought to tax him on the footing that the remitted income was treated as, or akin to, a

dividend. No credit was given for the tax paid in the US. The effect of this was summarised in paragraph 2 of the decision of the First Tier Tribunal:

> "… out of the Appellant's share of a profit of 100 roughly 45 has been paid in US Federal and State tax, 55 has been distributed to him and 22 tax has been charged in the UK."

7. HMRC contended that in English law the LLC fell to be treated as "opaque" so that there was no entitlement to double taxation relief. The issues before the First Tier Tribunal were, first, whether that contention was right; second, if it was, whether the taxpayer should have been taxed under section 739 of the Taxes Act 1988 (in which case what he said was his share of the profits of LLC was deemed to be his and he would be entitled to relief for the US tax), and third, whether the assessments were invalid.

8. The First Tier Tribunal decided that Mr Anson (the appellant before them) was entitled to double-taxation relief. In those circumstances the section 739 point did not arise, but the tribunal decided it anyway, and held against the appellant. It held that if it were wrong on the double-taxation relief point then the discovery assessments were good. On this appeal HMRC appealed the double-taxation point, and Mr Anson cross-appealed on the section 739 point. There was no appeal on the validity of the assessments point. At the outset of this appeal I ruled that the hearing would deal only with the double-taxation point, and the appeal on the section 739 point would be stood over, to be determined if it became necessary to do so. This judgment therefore deals only with the double taxation point.

The double-taxation provisions

9. Relief for double taxation is claimed under the UK/US Double Taxation Conventions of 31st December 1975 and 2001 (depending on the tax year in question), but since there is no material difference between their terms I can consider this question by reference to the terms of the implementation of the former (SI 1980/568). Article 23(2) provides:

> "(2) Subject to the provision of the law of the United Kingdom regarding the allowance as a credit against United Kingdom of tax payable in a territory outside the United Kingdom (as it may be amended from timeto time without changing the general principle hereof) –
>
> (a) United States tax payable under the laws of the United States and in accordance with the present Convention, whether directly or by deduction, on profits or income from sources within the United States (excluding in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid) shall be allowed as a credit against *any United Kingdom tax computed by reference to the same profits or income by reference to which the United States tax is computed*;
>
> (b) in the case of a dividend paid by a United States corporation to a corporation which is resident in the United Kingdom and which controls directly or indirectly at least ten percent of the voting powers of the United States corporation, the credit shall take into account (in addition to any United States tax creditable under (a)) the United States tax payable by the corporation in respect of the profits out of which such dividend is paid."

The most material words are those that I have italicised. The question in this case is whether or not income on which the two sets of tax has been charged falls within those words. The question is whether UK tax is computed by reference to the same profits or

income as the US tax. That depends on the basis of his distributions from LLC, which in turn depends on the terms of his participation. I therefore turn to that. Mr Anson was subjected to both federal and state (Massachusettts) tax, but for the purposes of this point in the appeal they can be considered as one.

The terms of participation in LLC

10. Delaware LLCs are flexible vehicles. Members are entitled to provide for the consequences of membership in a number of different ways. There was expert evidence in relation to the status of LLC and the experts were agreed on the following points:

    i) It is a separate legal entity.

    ii) The business of LLC was carried on by LLC itself and not by its members.

    iii) The assets used for carrying on the business belong beneficially to LLC and not to the members. The members have no interest in specific property of LLC.

    iv) LLC, and not its members, were liable for the debts incurred in carrying on its business. The members have no liability for the debts and liabilities of LLC.

The First Tier Tribunal also found certain other characterisitcs of the LLC, which are not challenged on this appeal:

v) A "limited liability company interest" is defined by statute as "a member's share of the profits and losses of a limited liability company and a member's right to receive distributions of the limited liability company's assets".

vi) S 18-503 of the relevant Delaware LLC Act provides that:

> "The profits and losses of a limited liability company shall be allocated among the members and among classes of members in the manner provided in a limited liability company agreement"

with a default rule they are allocated according to agreed values of contributions.

vii) That interest "is personal property. A member has no interest in specific limited liability company property" (section 18-701).

viii) The interest is in principle assignable as an economic interest but the assignee does not become a member.

ix) Subject to the LLC agreement (the internal agreement that governs the internal affairs of the LLC and the entitlement of members) the members manage the LLC and vote in proportion to their interest in profits.

11. Based on this and other material, the First Tier Tribunal found that the members interest in the LLC is not similar to share capital, but is more similar to a partnership interest under an English partnership.

12. The LLC agreement (in the case of LLC it was called "the LLC Operating Agreement") contained the following relevant provisions (abbreviating where appropriate):

i) Members made an initial capital contribution in the form of a note, and agreed to pay further contributions if required by the Managing Members.

ii) Financial statements were to be kept on an accruals basis (s 12.3).

iii) Members are entitled on request to access the books and records and to information about the business (s12.2).

iv) Article IV provided for the allocation of benefits among members. Capital accounts were kept for each member, being increased by capital contributions and decreased by distributions to the member, and to other adjustments (s 4.1). At least as often as annually, the capital accounts were adjusted as follows:

a) All gross income and gains appropriated in accordance with other arrangements (whose detail does not matter for present purposes) were credited, and all losses deductions and expenses were debited to members' accounts pro rata in accordance with their sharing amounts for each fund.

b) Gross income and losses were reallocated among the members in proportion to what were called "Adustment Amounts", which was a complicated formula with which I do not have to grapple.

c) Other reasonably complex adjustments to the allocations are also provided for.

d) For each calendar year items of income, gain, loss deduction and credit shall be allocated for income tax purposes among the members as nearly as possible in a manner that reflects equitably amounts credited or debited to each member's capital accounts for the current and prior fiscal years. Quite how that relates to the other allocation provisions is not clear to me, but neither side seemed to think that it affected the analysis in this case, or the result, so I shall not dwell on it.

e) Having looked at the presentation of figures to the US tax authorities, the First Tier Tribunal summarised the tax position as follows:

> "From this we find that the whole of the book profit for the year was allocated to the members' capital accounts, and that after making some tax adjustments the Appellant's share of that book profit was income for US Federal tax purposes."

Mr Peacock said that this was slightly inaccurate. It was gross income and expenses that were attributed, but that was not a material difference. Mr Ewart did not challenge it.

v) Article V of the LLC agreement provides for distributions:

> "5.1 Subject to the provisions of this Article V, to the extent cash is available, distributions of all of the excess of income and gains our losses,

deductions and expenses allocated in accordance with Section 4.2 with respect to any calendar year will be made by the Company at such time within seventy-five (75) days following the end of such calendar year and in such amounts as the Managing Members may determine in their sole discretion. The Managing Members may from time to time in their discretion make additional distributions in accordance with the provisions of this acticle V."

Distributions are made in a layered way depending on the balances on the member's account, and other matters. Yet again the detail does not matter.

vi) Article V also provides for set-off of sums due from a member, and also provides for reserves (s5.3):

> "The Company may withhold amounts otherwise distributable by the Company to the Members, pro rata from all members in accordance with the amounts otherwise distributable, in order to make such provision as the Company, in its discretion, deems necessary or advisable for any and all reasonably ancitipated liabilities, contingent or otherwise, of the Company and to maintain the Company's status as a qualified professional asset manager within the meaning of the [a statutory provision] …"

vii) On dissolution the assets are sold and the gains or losses are allocated to members in accordance with s4.2 and thereafter in a complicated fashion which, as the First Tier Tribunal observed, implied that there could be balances on capital account that were not yet distributable under Article V.

viii) Each member must devote at least 90% of his full business time to the advancement of the business and interests of the LLC.

The basis of taxation of Mr Anson and the LLC in the United States

13. The First Tier Tribunal found the position to be as follows:

> "3.2 Pursuant to the US entity classification rules … [LLC] did not make an election to be classified as a corporation and thus by default was classfied as a partnership for US tax purposes. Section 701 of the Code stated that the partners were liable to tax, rather than the partnership. As a result, each member, including the Appellant, was considered to be liable for US federal and Massachusetts state tax on his or her distributive share of LLC profits from [LLC].
>
> 3.3 As [LLC] was classified as a partnership for US tax purposes, the Appellant was subject to tax on his share of profits from the LLC irrespective of whether profits were actually distributed or retained."

14. Hence the US tax liability in this case. Those findings are actually derived from the wording of a statement of agreed facts, so there is no challenge to them.

The findings and determination of the First Tier Tribunal

15. The First Tier Tribunal found as follows.

16. The Tribunal summarised a lot of the expert evidence and made various findings in relation to it that I do not need to set out at this point. At paragraph 7 they dealt with two points on which the experts were not agreed, namely whether LLC had a share capital and whether the members had an interest in the profits as they arose. So far as the former is concerned they found:

> "Our finding of fact in the light of this evidence in relation to the membership interest in [LLC] is that it is not similar to share capital but something more similar to partnership capital of an English partnership, the transfer of which requires the consent of all the partners but the economic benefits can be transferred without consent and without the transferee becoming a partner (s 31 of the Partnership Act 1890)."

17. In paragraph 10 the tribunal indicated that it preferred the taxpayer's submission that Article IV allocated profit to the members as it arose, and rejected a submission by the Revenue that "profits did not belong to the

members". Having considered the definition of "limited liability company interest", the statutory provision for allocation of profits and losses in the manner provided in the LLC agreement and the US tax returns the tribunal analysed the situation a little and concluded (paragraph 7(1)):

> "Accordingly, our finding of fact in the light of the terms of the LLC Operating Agreement and the views of the experts is that the members of [LLC] have an interest in the profits as they arise."

They then went on to consider the mandatory or discretionary effects of s5.1 and concluded:

> "12. In summary, our conclusion in relation the LLC Operating Agreement is that the combined effect of s 18-503 of the Act and the terms of Article IV means that the profits must be allocated as they arise among the members. It follows that the profits belong as they arise to the members. Article V dealing with payment is irrelevant to this conclusion, but it provides that the distribution of the excess within 75 days is mandatory subject to the two matters set out at the beginning of s5.1."

18. The tribunal then turned to consider the effect of the double taxation treaty and in paragraph 18 identified the issues as being:

"whether the UK tax is 'computed by reference to the same profits of income' or whether he is taxable on the equivalent of a dividend."

19. In *Memec v IRC* [1998] STC 754 the court had referred to "opaque" and "transparent" entities, but the tribunal did not find that as helpful as concentrating on the words of the statute. They also rejected the submission of HMRC that it was useful to ask what the source of the income was. They preferred to concentrate on:

> "whether the income belongs to the Appellant as it arises, that is to say does the Appellant have a right to that income

> immediately it arises?, in which case it is not relevant when it is to be paid to him."

20. Having considered *Memec*, they then reverted to the statutory test and reflected on previous findings that LLC carried on the business, was liable for debts and obligation, owned the business and did not have anything which was the equivalent of share capital.

> "However, the members are entitled to the profits as they arose."

21. In paragraph 20 they reflected that:

> "[LLC] stands somewhere between a Scots partnership and a UK company, having the partnership characteristics of the members being entitled to the profits as they arise and owning an interest comparable to that of a partnership interest, and the corporate characteristics of carrying on its own business without liablility on the members … Since we have to put it on one side of that dividing line we consider that it is on the partnership side particularly in relation to its income."

They concluded:

> "21. The factor we are mainly concerned with in relation to the Treaty is whether the profits belong to the members as they arise. We have concluded that this is the effect of the LLC Operating Agreement and the Act. Accordingly the Appellant is taxed on the same income in both countries and is entitled to double taxation relief under the Treaty for the Federal tax. For the same reason he is entitled to unilateral relief for the Massachusetts State tax. "

The arguments of the parties on that decision

22. Mr Ewart QC, for HMRC, started by saying that the First Tier Tribunal had misanalysed the effect of the LLC agreement. The tribunal made a finding that Mr Anson was entitled to the profits in some sort of proprietary sense (in finding that the members of the LLC were entitled to the profits as they arose), which was conceptually wrong and not the effect of the LLC agreement (it

was the LLC which owned all the assets of the business). The only thing that was owned by them was a contractual right to an equivalent of the profits. He also criticised the apparent finding (in paragraph 10 of the decision) that the entitlement to profits arose without the intervention of any other determinative step such as the exercise of a discretion. He submitted that there was a 2 stage process – the figures to be credited to the capital account were ascertained under Article IV and then distributions were made under Article V, though in the end he said that it did not matter to his argument whether Article V gave a discretion or was, in effect, mandatory. As a matter of analysis there was no meaningful sense (proprietary or otherwise) in which Mr Anson was entitled to profits as they arose. The profits were at all times owned by LLC (so far as that concept had a meaning). All this meant that the analysis of the First Tier Tribunal was wrong. What was required was to identify the source of the taxed income. So far as US tax was concerned, the source was the trade of LLC – US taxation statutes had the effect of attributing the profits from that trade to the members for taxation purposes, but the source remained the same. So far as UK tax is concerned, the souce is the LLC agreement itself. That is a different source, with the effect that the two sets of tax are not computed by reference to the same profits or income.

23. For Mr Anson, Mr Peacock QC supported the First Tier Tribunal's decision and the broad thrust of its reasoning, though not always the precise formulation of some of its propositions. He submitted that the First Tier Tribunal had not found that the members of LLC had become entitled to profits in any proprietary sense. What they had found related to a contractual entitlement, not a proprietary entitlement, to profits. In that respect the

Tribunal had been correct to find that that entitlement to profit arose as the profits arose, in the sense that no third party act, or other event, was necessary to give rise to that entitlement (contrast the declaration of a dividend where there has to be a decision to distribute profits through a dividend) – see Article IV which procured the identification of the profit when the allocation procedure was conducted. Thus the members were entitled to the profits as they arose, which meant that the US and UK tax were computed by reference to the same profits or income. Mr Anson was therefore entitled to relief, as the First Tier Tribunal found.

24. As appears from the two preceding paragraphs, the parties did not agree about what the Tribunal should be taken as having found. Mr Ewart said that the Tribunal made findings about the ownership of profits in a proprietary sense, and was wrong about that; and Mr Peacock said that the Tribunal made findings about the time at which Mr Anson's entitlement to a contractual share in profits arose, and was right. I shall have to consider this dispute, but in his reply Mr Ewart shifted his ground and put forward another analysis which he said prevented Mr Anson from claiming double taxation relief. He said that even if Mr Peacock was right as to what the Tribunal found, the nature of Mr Anson's rights to have part of the profits credited to his capital account were not such as to trigger a charge to UK tax at all. UK tax was only payable on a distribution, not a crediting, and it followed from that that he would be taxed on different profits or income from the profits or income upon which he was charged in the US. The allocation would not be a taxable event in this jurisdiction. The source of the UK income would be different (it would be the LLC agreement).

What did the Tribunal decide about profits arising?

25. The passages from the decision that I have set out above demonstrate the importance to the decision of the question of the entitlement to profits as they arise. One only has to look at paragraph 21 to see that. The first question to be addressed is whether the Tribunal found that Mr Anson was entitled to the profits in some sort of proprietary sense, as Mr Ewart said they did; or whether they were referring to a contractual entitlement short of proprietary, as Mr Peacock said they did. If the former was the case, and if it was wrong to so find, then the apparent lynchpin of the decision would be removed, and the decision would have to be reconsidered.

26. Mr Peacock said it was not flawed in that way. While he accepted that some of the Tribunal's terminology seemed to reflect ownership of profits in a proprietary sense the Tribunal in fact asked itself, and then answered, a different question, namely:

> "(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?"

27. This question was one of 6 questions asked of the experts, and recorded as such in paragraph 5 of the decision. That was Mr Peacock's starting point. The 6 questions come from Tax Bulletin 39 (February 1999) which the Inland Revenue had promulgated as setting out some of the matters which they took into account in answering questions of "Entity Classification" of the kind that were thought to arise in this case. It is described as one of two factors to which particular attention is paid. That is doubtless why the experts were

asked to opine on it. As formulated, the question has both proprietary overtones (the first part) and purely mechanical overtones (the second part). I return to this below.

28. Following the point through from there, it is apparent that there are a number of different formulations in the decision. At paragraph 7(2) the Tribunal records that:

> "[The experts are not agreed on] Whether the members of the [LLC] have an interest in the profits of [the LLC] as they arise."

That is a different formulation with more proprietary overtones. However, when the judgment goes on to set out the two views of the experts it sets out their respective views on whether a distribution was mandatory (Mr Abrams, the taxpayer's expert) or whether it was not mandatory and depended on a discretion to be exercised under s 5.1 of the LLC agreement (Mr Talley, the Revenue's expert). That suggests that they were addressing the sort of mechanical point referred to above.

29. However, having said that, the Tribunal then immediately goes on to reflect on the definition of "limited liability company interest" referred to above and says that "This implies that the members have a share in the profits". That suggests a move into proprietorship territory.

30. At paragraph 5(7) the Tribunal takes a further step into proprietorship territory. The Tribunal observes:

> "The fact that the book profit is allocated (and the reallocations are made) 'at least as often as annually' might indicate that the profits must belong to the LLC until the allocation is carried

> out. We do not consider that this is the case in the light of s 18-503 of the Act which does not contemplate the possibility."

If this is taken on its face, it seems to me to be wrong. S 18-503 defines the interest of a member in an LLC. It does not speak to the ownership of profits; it refers to allocation, which is different. Mr Peacock sought to defend the apparent finding on the footing that the Tribunal really meant to refer to an entitlement to profits as they arose, citing a later paragraph in support of this. I do not think that works. The context and content of this paragraph suggests that the Tribunal means ownership in some sense – see in particular the use of the word "belong".

31. At paragraph 9 the Tribunal noted Mr Peacock's submission that the Article IV "allocated the profit to members as it arose and Article V required payment to be made within the 75 days…" and Mr Ewart's contention that "Article IV did not give the members a right to anything, it merely told one how much to pay to the member under Article V when the Managing Members exercised their discretionary power to pay it". That looks like a dispute as to mechanism or timing, not over whether there is ownership of the profits, though the Tribunal does go on to observe:

> "Mr Talley's reason for saying that the profits did not belong to the members was that the profits allocated to the capital accounts remain subject to the risks of the business and constitute part of the assets of the LLC."

which looks like a glance at ownership again.

32. Then in paragraph 10 the Tribunal states a preference for Mr Peacock's contention. The decision sets out some further statutory provisions and then states:

> "This means that the profits do not belong to the LLC in the first instance and then become the property of the members because there is no mechanism for any such change in ownership analogous to the declaration of a dividend."

Counsel accepted that the context made it apparent that what was really meant was:

> "This is not a case in which the profits belong to the LLC in the first place and then become the property of the members; and that is because in this case there is no mechanism for any such change of ownership …"

So the Tribunal was finding that the profits do belong to the members. The Tribunal immediately went on to acknowledge that the assets belonged to the LLC until a distribution was actually made:

> "but we do not consider that this means that the profits do not belong to the members; presumably the same is true for a Scots partnership."

33. After some further reasoning they say:

> "Accordingly, our finding of fact in the light of the LLC Operating Agreement and the views of the experts is that the members of [the LLC] have an interest in the profits of [the LLC] as they arise."

In the light of the preceding context this looks like a statement of some sort of proprietary entitlement, and not a statement about timing or mechanics of a right to receive money. Paragraph 12, set out above, reinforces this impression.

34. Paragraph 18 seems to revert to an inquiry about what I have called mechanism rather than ownership. It rejects the notion of inquiring into the source as being helpful, and states that they preferred to concentrate on whether:

> " … the income belongs to the Appellant as it arises, that is to say does the Appellant have a right to that income immediately it arises?, in which case it is not relevant when it is to be paid to him."

The parties before me both agreed that the word "income" in that sentence should really have been "profits". Then, having considered *Memec v IRC* [1998] STC 754 and a comparison with English and Scottish partnerships, where members were said to be entitled to the profits as they arose, and having said that the LLC stands on the partnership side of the line the Tribunal concluded in terms of paragraph 21 as set out above.

35. Having considered all that I think that there is a good case for saying that the Tribunal considered that the profits belonged to the members in a proprietary sense. It was not confining itself to a consideration of mechanics and timing of entitlement; it was basing itself on what it considered the nature of the entitlement to be. Without it, the comparison with partnerships is not nearly so relevant as they plainly thought it to be. I think that when the Tribunal said "belong" in paragraph 21 of the decision, it meant "belong".

Is that finding correct?

36. It seems to me that, on the facts as found by the Tribunal, it would be wrong to say that Mr Anson had any form of proprietary entitlement to profits at all. There is nothing in the findings, or in the evidence, which would justify such a conclusion, and I did not understand that Mr Peacock, for the taxpayer, would support such an averment. The LLC had its own corporate identity; it conducted the relevant business; it owned all the business assets; all the business liabilities were its own, not those of the members. The Delaware Act itself states that a member of an LLC has no interest in specific limited

liability company property – see s 18-701, which the Tribunal quoted as set out in paragraph 10(vii) above. Mr Anson got his entitlement to whatever he was entitled to (I do not want to prejudge any questions about that) as a result of various entries against his capital account. There is nothing in this legal construct, or in the analysis of the experts who gave evidence, which would suggest anything like a proprietary entitlement in something that would otherwise be the assets of the company.

37. So if the Tribunal's reasoning was based on a finding of such a proprietary interest in the assets of the company it would be flawed and the decision would fall to be reconsidered on that ground.

38. Furthermore, it seems to me that in the absence of a proprietary interest in the assets it is not possible to see how there can be any ownership, in a proprietary sense, of profits made by the LLC, because the "profits" is not something which one can own as an asset. The profits of an enterprise are an abstract notion, arrived at after a calculation. One cannot find an asset which represents them which one can own; one can only own the assets which, for the time being, reflect them. As Nourse J said at first instance in *Reed v Young*, as approved by Lord Oliver in the House of Lords ([1986] STC 285) in the same case at p 289:

> "Equally important is the distinction between the assets of a partnership and its profits for a given period. That distinction is self-evident, but I agree with counsel for the taxpayer that it is necessary to state it in order to detect the fundamental confusion which underlies the arguments of the Crown in this case. That confusion is between the losses of a partnership for a given period on the one hand and its liabilities or, as the statutory language has it, its debts and obligations on the other. The two things are entirely different. A loss, like a profit, is an

> accounting measure of the firm's performance over a given period. Liabilities, like assets, vary from day to day. Just as you do not make a profit by acquiring an asset, so you do not sustain a loss by incurring a liability."

Thus one cannot own "profits" as one can own other assets. There may be an entitlement to profits, that is to say a contractual entitlement to a sum which is to be calculated as profits are calculated; and there may be ownership of the underlying assets in respect of which it arose; but the profits are not something that can be owned, or in which one can have a proprietary interest, as one can in the assets. This is supported by the citations from *Memec* set out below. That is a further reason why, if the Tribunal had based its decision on the idea of the ownership of profits, its reasoning would be flawed.

39. The nature of the entitlement is an important factor, so taking ownership into account is not a consideration of an irrelevant factor. I consider that the Tribunal came to the wrong conclusion on the point, for the reasons appearing above. The profits could not "belong" to Mr Anson in the sense used by the Tribunal, and nothing in the expert evidence suggested that they could.

40. That means that the decision has to be reconsidered.

The significance of the "profits as they arise" question to this case

41. As will be apparent, the Tribunal vested this test with a lot of significance. So did the advocates at the hearing before me. In his closing remarks Mr Peacock emphasised his view of the importance of the point. Mr Peacock said that if Mr Anson was not entitled to the profits as they arose then he would not get the tax credit. He summarised Mr Ewart's position as being that if he were entitled to the profits as they arose then Mr Anson would get credit. It was

thus capable of determining the case, and that was because the answer to the question provided the answer to the question: Is it the same profits that are taxed in the UK as are taxed in the US.

42. The debate on this has some potential subtlety about it. That is apparent from Mr Peacock's submissions as to what the relevant question was. He said that Mr Ewart was wrong to say that the question was whether Mr Anson was taxed on his share of the LLC's profits. The correct statement was, he said, whether Mr Anson was charged on his share of the profits of the trade carried on by the LLC. The former builds in an assumption about ownership or proprietary interests of profits, which ought not to be built in. However, be that as it may, Mr Peacock seemed to accept that the question of whether Mr Anson fell within the convention depended on the status of the LLC – whether it was transparent or opaque, in the wording of cases, and whether Mr Anson could be said to be entitled to the profits of the trading as they arose in some meaningful sense. He did not seek to say that the opacity (or otherwise) of the LLC was irrelevant. In particular, he did not seek to say that the US method of taxation (treating the LLC as a partnership and then taxing Mr Anson accordingly) of itself, and without looking at the workings of the LLC, rendered the tax "computed by reference to the same profits or income" for the purposes of the convention. So it remained necessary to consider the quality of Mr Anson's interest in the company and his entitlement to profits. Hence his support for the finding of the Tribunal and his analysis of the determination that lay at the heart of the Tribunal's findings.

43. **The general significance of the "profits as they arise" test and transparency in this case.**

44. Before seeking to apply this test in the context of the present case its purpose, and then its meaning, must be borne in mind. Its purpose is that it is one factor that the Revenue will take into account in considering the status of an entity for double taxation treaty purposes. It is not the actual test itself, though both parties seemed in this case almost to give it that status.

45. It is also necessary to consider what it means and how it will assist in the debate. It has two halves, separated by a semi-colon. Its construction suggests an antithesis – is the first half true, or is the second half true. The second half seems clearly to relate to a mechanical test of the kind referred to above – is the entitlement dependent on a determination by a third party, or on a particular event, or does it exist independently of such a step? If that is what it is saying, and if the test represents an antithesis, then the emphasis in the first half would have to be on the words "as they arise". So the test would become, in effect: Is the person entitled to the profits automatically or is a further mechanism interposed. That says nothing about what is meant by "entitled to share in its profits". That is a question which still remains to be addressed, and is actually the more difficult point, since it is not so much a test as a re-statement of the problem – whose profits are they?

46. The answer to that question has been approached via various metaphors, which can be seen in *Memec* – independent vitality; transparency and opacity;

source; direct or indirect interest; and even the poetry of George Herbert (see the judgment of Sir Christopher Staughton at p 118). These metaphors are an attempt to get to the point, but are difficult to apply without any starting point and further guidance.

47. *Memec* demonstrates and contains both a helpful starting point and an element of further guidance. The starting point is an English partnership. That seems to be presented as a sort of paradigm of a transparent entity – one in which the profits of the entity can be seen to be those of the partners for double taxation purposes.

> "It is not difficult to see why an English partnership (including a limited partnership) is treated as transparent, the partners carrying on business (whether by themselves or by the other partners as their agents) in common and owning the business and having a beneficial interest in the partnership assets and profits. The justification for treating a Scottish partnership as transparent, though it may be less obvious because of the interposition of the partnership as a legal entity between the partners and the profits of the partnership, can be perceived in that in substance the position of the partners in relation to the profits is the same as in an English partnership: those profits are earned by the partners in carrying on business in common together and are shared in the same way and the partners, whilst not directly owning the business and assets, indirectly do so and have an indirect interest in them which is capable of being arrested by the creditor of a partner." (per Peter Gibson LJ at page 113).

He went on to emphasise the importance of a proprietary right in the underlying property, and said:

> "… even a Scottish partner has an (indirect) interest in the profits of the partnership as they accrue as well as in the assets of the partnership. In a real sense the profits and assets are the profits and assets of the partners, the firm, their collective alter ego, merely receiving those profits and holding those assets for the partners who are the firm. … In contrast, though a silent

> partner is indirectly interested in those profits, in that his entitlement to a share of the profits (or his obligation in respect of the losses) will be computed by reference to the profits of the owner at the end of the year, his interest is purely contractual."

He concluded:

> "The position of plc seems to me to be that of a purchaser who, for a consideration of the contribution of a capital sum and an undertaking to contribute to losses of the owner of a business up to the amount of the contribution, purchases a right to income of a fluctuating amount calculated as a share of the annual profits of the business. Neither in English or Scottish law would that leave plc a partner with GmbH. That in itself is not determinative of transparency, and I of course accept Mr Venables' submission that differences in the nature of rights should not cause cases which are in substance identical to receive different UK tax treatment. But I see insufficient justification present in the circumstances of the silent partnership for treating the share of the profits of the GmbH business received by plc as the same as the profits of the subsidiaries or the dividends which were paid to GmbH alone as shareholder and not to plc. … The agreement was, in my judgment, the source of plc's share of the profits of the GmbH business, not the trading operations of the subsidiaries or the shares owned by GmbH in the subsidiaries producing the dividends paid to GmbH. Accordingly I would reject the first basis advanced on behalf of plc."

48. That passage demonstrates the usefulness of taking a paradigm case to illustrate a concept, against which a different situation can be measured. It also demonstrates that ownership of underlying assets is also a very significant factor. This was emphasised by Robert Walker J below:

> "Whether or not the arrangement is called a partnership, the essential features (established by the evidence of German Law) are that there was a commercial arrangement under which plc, in consideration of a lump sum investment with a holding company, had the contractual right to an annual payment equal to a large share of the holding company's dividend income from it subsidiaries, less expenses. In my judgment, the decisive point, on this first main issue, must be the absence of any proprietary right, legal or equitable, enjoyed by plc in the

> shares of the trading subsidiaries, or in the dividends accruing on those shares … I conclude that plc's rights under the partnership agreement did have an independent vitality and were not mere incidental machinery. Without those rights under the partnership agreement, plc would have continued to receive dividends from Gmbh, and nothing from the trading subsidiaries.
>
> … Transparency is normally associated with a situation where the ultimate recipient of the income in question has a beneficial interest in it from the start, and moreover the income is not transmuted at some intermediate stage by the need for trustees to exercise a discretion or by its being packaged so as to reach the ultimate recipient in the form of a fixed annuity."

49. All this assists an approach to the question of whether Mr Anson has an entitlement to a share of profits as they arise in a relevant sense.

50. The first thing to get out of the way is that, on the findings of the Tribunal, the mechanical sort of test, or obstacle, to which I have referred above does not apply to him. There is no intermediate step in the form of a third party act which stands between him and whatever it is he is entitled to.

51. The much more difficult question is whether he has an entitlement to a share in profits in any relevant sense. In a very loose sense he does, but that is not the point. The purpose of the test is not to arrive at a loose answer. Nor is an indirect interest, as such, sufficient – in *Memec* Peter Gibson LJ recognised that GmbH could be said to have an indirect interest in the profits of its subsidiaries, but that was not enough to satisfy the double taxation test.

52. The relevant interest in profits for the purpose of the test in the relevant indicium seems to me to be one that makes the profits the same profits for the purposes of the double taxation test. That does not help much when stated like that. In order to gain assistance one needs to go into the questions, tests and conclusions illustrated by and contained in *Memec*. It is relevant to view the question as one of transparency, and like the courts in *Memec* to treat a partnership as a helpful illustration of transparency. It is the facts underlying transparency that bring about an equivalence of the profits for the purposes of the double taxation test.

53. When approached in that way it seems to me to be clear that what Mr Anson was taxed on was not the same profits that were taxed in the United States. What was taxed in the United States were in law, reality and substance the profits of LLC, albeit attributed to the members for taxation purposes (by election). Although the members were entitled to moneys which could be viewed as the monetary equivalent of the profits of the company (because that would be the result of the calculations and allocations in relation to their capital accounts) what they received was not the same thing. It was a contractual entitlement to money, like plc's interest in the silent partnership in *Memec*. Like Robert Walker J, a proprietary right in the underlying assets seems to me to be a crucial factor in the inquiry, and Mr Anson had none. I find it difficult to envisage any case of transparency where there is no such right, but whether or not that is possible, the absence in this case is fatal to the taxpayer's case. LLC owns everything; it pays out to its members an aggregate sum of money which can be seen to be the monetary equivalent of

its profits; and it will (on this footing) not retain any of its profits. But the profits were LLC's and the contractual obligation to credit and distribute did not make them the members', at least for English tax purposes. The position of the members is nothing like the position of an English partner, and I respectfully disagree with the Tribunal in its finding in paragraph 20 that the members have interests akin to the interests of a Scottish partner. The interest of the members is not comparable to the interests of Scottish partners because they do not have an interest in the assets of the LLC. They certainly do not have a direct interest (statute provides that) and in my view there is no case for saying they have an indirect interest either, in the sense in which Peter Gibson LJ held that Scottish partners have such an interest in the assets of their parthership. He said (see above):

> "In a real sense the profits and assets are the profits and assets of the partners, the firm, their collective alter ego, merely receiving those profits and holding those assets for the partners who are the firm."

That does not describe the interests of the members of the LLC.

54. I therefore find that the LLC is not transparent; the members (including Mr Anson) do not have an interest in the profits of the LLC in any meaningful sense; and that therefore the profits on which tax has been paid in the US are the profits of the LLC. Mr Anson is taxed on something different – his distributions from (or entitlement under) the LLC agreement. They are two different sources (and the importance of sources in the judgment of Robert Walker J in *Memec* should be noted). The double taxation treaty test is therefore not fulfilled.

55. In the circumstances the appeal in relation to the double taxation point succeeds, and it is necessary to move on to the section 739 point. The parties should arrange for the restoration of the appeal for that purpose.

MR JUSTICE MANN

UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)

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