U.S. Taxation of U.S. Limited Liability Companies

By: Michael W. Galligan

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This is the first of a three-part series on an introduction to the cross-border tax treatment of U.S. limited liability companies. Please look for the next two parts in the July and August issues.

INTRODUCTION

For the last two decades, the limited liability company ("LLC") has been the "darling" of U.S. attorneys, accountants, and other professionals who organize entities for the purpose of business, investment, asset management, and related tax- and estate-planning purposes. The 2017 Tax Reform Act[1] has perhaps tarnished somewhat the redoubtable shine of the LLC, with the Act's introduction of a significantly reduced corporate income tax rate, which will enable corporations to compete tax-wise to a greater degree with generally tax-transparent entities like LLCs.

Nonetheless, the LLC is still attractive for business organization and related tax planning due to the remarkable flexibility it offers to U.S. advisors for organizing business and investment vehicles and for charting their tax characteristics. As entrepreneurs become ever more focused on business and investment opportunities outside the United States, the question of how U.S. LLCs fare outside the country inevitably arises. Does the flexibility afforded the LLC in the United States—especially in tax matters—also prevail in foreign countries and jurisdictions?

As this article will explain, the LLC in many cases does not enjoy the same level of flexibility it is afforded in the United States. As a result, substantial inconsistencies can develop between the tax treatment of U.S. LLCs in the United States and the treatment of U.S. LLCs in other countries and jurisdictions. These differences have to be given serious consideration when engaging in cross-border business, tax, and estate planning. Moreover, flexible structures like the LLC, which have become vehicles for so-called "hybrid" financial and business structures, have also become the target of both U.S. and international efforts to limit attempts to maximize tax savings by taking advantage of the inconsistencies between the tax and classification rules among different nations.

At the outset, let us remember that an LLC is a form of business and investment entity that can be established pursuant to the statutory law of any one of the fifty states of the United States and the District of Columbia, which permits owners ("members") to take advantage of limited personal liability, shielding them personally from the debts or obligations of the LLC—much

like the protection that is afforded to shareholders of a corporation. Unlike a corporation, an LLC does not issue stock but rather “membership interests,” which are generally represented as percentages of ownership of the LLC rather than as a number of shares or units from an aggregate of available shares or units. (Note, however, that LLCs may issue ownership units if they wish to do so.) Unlike a corporation, an LLC does not have to have a board of directors or corporate officers. The members can share in the management of the LLC or can grant management responsibilities to one or more managers. An LLC can have limited duration, as set forth in the operating agreement. Finally, an LLC, by the terms of its operating agreement, can limit or restrict the otherwise free transferability of ownership interests or units.

I. U.S. TAXATION OF U.S. LLCs

Perhaps the most notable feature of an LLC organized in the United States is that it need not be taxed as a separate legal entity under U.S. federal law as well as most state laws, including those of New York and Delaware. Income allocated or distributions made to members are taxed to the members at their individual income tax rates, and members report business profits and losses on their personal income tax returns.

A. U.S. Check-the-Box Regulations

The LLC truly came into its own as a powerful tool of U.S. business and investment planning when the IRS introduced, effective Jan. 1, 1997, new entity classification rules commonly referred to as the “check-the-box” regulations. (See Treasury Regulations section 301.7701-3.) Under these rules, a relatively narrow set of U.S. and non-U.S. business entities are required to be treated as corporations—generally, in the case of non-U.S. foreign corporations, corporations that are publicly traded. (See Treasury Regulations section 301.7701-2(b).) All other business entities (“Eligible Entities”) have the option to choose their U.S. federal tax classification among (1) associations (essentially, a separately taxed corporate entity), (2) partnerships (essentially, a flow-through entity), and (3) disregarded entities (essentially, a single member or owner proprietorship).

B. Tax Classification and Consequences for U.S. LLCs

Under the “check-the-box” regulations, a domestic LLC with at least two members is classified as a partnership for U.S. federal income tax purposes, unless it files IRS Form 8832 (“Entity Classification Election”) and affirmatively elects to be treated as a corporation. An LLC with only one member is treated as an entity disregarded as separate from its owner for U.S. federal income tax purposes (but as a separate entity for purposes of U.S. Federal employment tax and certain U.S. federal excise taxes), unless it files IRS Form 8832 and affirmatively elects to be treated as a corporation.

If an LLC is treated as a partnership, normal partnership tax rules will apply to the LLC, and it will file IRS Form 1065 (“U.S. Return of Partnership Income”) on an annual basis. Each owner will be responsible for reporting on their individual income tax returns their share of partnership income, credits, or deductions reflected on the Form Schedule K-1 (1065) (“Partner’s Share of Income, Deductions, Credits, etc.”) issued by the LLC. Generally, each owner of an LLC that is

treated as a partnership and who is an active participant in the LLC's business pays self-employment tax on their share of partnership earnings.

On the other hand, if the LLC has elected to be treated as a corporation, normal corporate tax rules will apply to the LLC. It will file IRS Form 1120 ("U.S. Corporation Income Tax Return") on an annual basis, and the income tax attributes of the corporation will not flow through to any shareholders on their IRS Form 1040 ("U.S. Individual Income Tax Return"), unless a qualifying LLC also elects to be treated as an S corporation. (See IRS Publication 3402, "Taxation of Limited Liability Companies," for further discussion.)

C. The Major "Drivers" Behind Preference for the U.S. LLC Form

On the one hand, from the corporate or non-tax perspective, the LLC offers the ability to obtain all the asset protection and creditor protection features of the corporate form due to the limited liability of the members, where no member (not even the managing member) has to have unlimited liability. At the same time, the LLC offers great flexibility for allocating member and manager rights and responsibilities and determining the duration of the entity, among other things.

On the other hand, U.S. tax rules offer LLCs and their owners the ability to avoid the "dual taxation" regime associated with C corporations, where the income of the corporation is taxed as if the corporation were a separate taxpayer and the earnings and profits of the corporation are taxed a second time to shareholders when dividends and other non-liquidating distributions are made. The LLC also offers the ability to avoid certain restrictions otherwise imposed on corporations that elect S corporation status, which includes (1) the inability to have non-U.S. shareholders, (2) the requirement that, on liquidation, shareholders pay tax on their share of the unrealized gain of assets distributed to the shareholders as part of the liquidation, and (3) the inability to make an IRC section 754 election to step-up the basis of the corporation's underlying assets on the death of a shareholder. For an S-corporation, losses passed through to a shareholder can also generally only be deducted against other income to the extent of the shareholder's contributions to the corporation—because borrowing by the corporation does not affect a shareholder's basis in the corporate stock.[2]

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[1] The official name assigned to the 2017 Tax Reform Act that was signed into law by President Donald Trump on Dec. 22, 2017 is an "Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." The act was formerly known as the Tax Cuts and Jobs Act of 2017.

[2] All that being said, the 2017 Tax Reform Act radically shifts the tax rate impact of choosing the LLC form over the corporate form, as the corporate income tax rate has been reduced to a flat rate of 21%. Assuming dividends paid to shareholders would be taxed at the favorable qualified dividend rate of 23.8%, the effective combined federal income tax rate for investing through the corporate form would be 39.8% instead of 37% (the highest rate for individuals picking up income from an LLC taxed as a partnership). The 2017 Tax Reform Act introduced a special deduction to try to restore some of the savings many had come to expect by operating as an LLC. A 20% deduction may be claimed on Qualified Business Income ("QBI") under new IRC section 199A, which has the potential of reducing the effective tax rate on QBI to 29.6%. Taxpayers, however, must qualify under the rather complex requirements and thresholds of the QBI deduction regime. The ability to benefit from the deduction is capped based on wages paid by the business or amounts invested in machinery, equipment, or real estate, among other things. The

extent of the deduction is also tied to an LLC member's allocable share of wages paid by an LLC to its employees, which might create a preference—at least for some U.S. taxpayers—to do business through S corporations rather than LLCs

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U.S. Taxation of U.S. LLCs: Major Considerations in the International Context

By: Michael W. Galligan

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Disparate Tax Classification of LLCs by the United States and Foreign Countries

Many countries make a strict distinction between corporations and partnerships for tax purposes and do not have a "check-the-box" election or, if they do, it does not necessarily follow the U.S. scheme. The typical U.S. LLC (where the LLC substitutes for a corporation but qualifies for partnership and "flow through" tax treatment) will in many cases very likely be viewed as a corporation in many non-U.S. jurisdictions. For example, in the United Kingdom, subject to the approach taken by the U.K. Supreme Court in the *Anson* decision discussed below, a U.S. LLC was and still is generally viewed as a corporation or "opaque" entity for U.K. tax purposes. Canada takes the same approach. One hears anecdotally that French tax inspectors have taken the position that U.S. LLCs should be taxed as SARLs under French law and therefore also taxed as separate "opaque" tax entities.

In most situations, Germany is more likely to view a U.S. LLC as a corporate rather than a transparent entity. Germany determines the status of U.S. LLCs by weighing the presence or absence of eight factors, some of which are similar to the *Kintner* factors that applied in the United States to determine the tax status of a business entity prior to the U.S. adoption of the "check-the-box" rules. These factors include (1) centralized management, (2) limited liability, (3) free transferability of interests, (4) discretion to access profits, (5) equity contributions, (6) continuity of life, (7) allocation of profits, and (8) formation requirements.

The fact that many important jurisdictions treat LLCs as separate taxable entities creates the potential for unexpected and costly inconsistencies in tax treatment. For U.S. taxpayers for whom an LLC is either disregarded (i.e., a single-member LLC) or taxed as a partnership (i.e., a multi-member LLC), the member(s) of the U.S. LLC might be able to claim a credit for foreign taxes paid by the LLC in a foreign jurisdiction that treats the LLC as a corporation. The United States will effectively disregard the foreign classification of the LLC as a corporation and treat the foreign taxes as being paid by either the U.S. LLC's single owner (in the case where the LLC is disregarded) or as being effectively paid by the LLC members (in the case where the LLC is treated as a partnership). But the foreign rules governing the taxation might be significantly inconsistent with the U.S. rules.

Let us first examine the case of a U.S. person who is investing abroad through a U.S. LLC. Foreign jurisdictions do not necessarily have an equivalent of IRC section 351, which makes contributions of appreciated property to a corporation a non-recognition event as long as

the control of the corporation remains basically the same before and after the contribution. A contribution of appreciated property such as real property located in a foreign country to a U.S. LLC could trigger capital gains tax in the foreign country even though there might be no U.S. tax. Moreover, if a U.S. LLC is engaged in an overseas business and then terminates that business and liquidates, such liquidation could be treated as a corporate liquidation in the foreign country, giving rise to possible gains or other taxes in the foreign country (especially if appreciated property is involved), while there might be little or no tax due in the United States with respect to such liquidation.

Let us next consider the case of foreign investors investing in U.S. business activities through a U.S. LLC. The benefit of avoiding U.S. double taxation because of the U.S. treatment of the LLC as a partnership might be entirely lost because the foreign investors' home jurisdictions might treat the LLC as a separate "opaque" or "corporate" taxable entity. For example, a foreign investor must pay U.S. tax on the investor's distributable share of the profits of the business of a U.S. LLC regardless of whether the investor has actually received a distribution. But if the foreign jurisdiction views the U.S. LLC as a corporation, the foreign jurisdiction might view a distribution by a U.S. LLC of its prior years' earnings to the foreign investor as a dividend or a taxable liquidation and deny any credit for the tax previously paid to the United States.

This was precisely the view that Her Majesty's Revenue and Customs ("HMRC," the U.K. equivalent of the IRS) took—and even now, at least to a certain extent, still takes—with respect to distributions to U.K. resident taxpayers from a U.S. LLC. In *Anson v. Commissioners for HMRC,* the U.K. Supreme Court, focusing on the terms of the operating agreement governing the LLC, overruled HMRC for the first time and held that the U.K. taxpayer member of a U.S. LLC effectively recognized his share of profits as they were earned in the LLC and not at the time of their distribution. HMRC, it should be noted, has not entirely acquiesced in the *Anson* decision, and so the degree to which the members of an LLC can be seen to have a right to receive profits as they arise is still not certain for U.K. tax purposes. For more details, see the discussion in Pietro Stuardi's "The Problematic Use of Transparent U.S. LLCs by Foreign Taxpayers."

A similar scenario could well play out in Germany. An August 2008 decision of the German Federal Fiscal Court (*Bundesfinanzhof*) addressed the taxability to German tax residents of distributions from a U.S. LLC, which was considered for German tax purposes to be classified as a corporation. The court determined that the German taxpayers incurred German income tax on distributions by the LLC because they were considered to be dividends paid by a corporation. Thus, in Germany (and many other countries like it), one has the same risk of double taxation as in the U.K. scenario—at least pre-*Anson*—because U.S. tax payments made by members on their distributive share of LLC profits will not be creditable against the German tax on LLC distributions.

Uneven Treatment of Tax Treaty Benefits for U.S. LLCs

We now consider issues about the global tax treatment of U.S. LLCs under income tax treaties between the United States and other countries. Keep in mind that income tax treaties offer many important benefits, such as (1) reduced rates of or exemption from withholding tax by the source country on certain types on income such as dividend, interest, and royalty payments; (2) reduced rates of or exemption from the branch profits tax; (3) exclusion of certain types of gain from

taxation in a treaty-partner country; (4) exemption of profits from tax in a treaty-partner country that would not be considered income of a permanent establishment as defined by the treaty; and (5) the availability of credits for taxes paid to a treaty-partner country.

Tax treaties generally do not address the tax characterization of business entities. Therefore, there is a possibility that treaty benefits one might expect to accrue to a member of a U.S. LLC might be lost because the foreign jurisdiction will treat the U.S. LLC as a corporation rather than as a "pass-through" entity. In that case, U.S. members might not be eligible for treaty benefits such as reduced levels of foreign withholding tax or other foreign tax on items of income on which they are taxable in the United States. There is also the possibility that U.S. corporate LLC members will lose the more favorable tax treaty treatment of "branch profits" earned in a foreign country.

One of the most well-known examples of this disparity occurred under the income tax treaty between the United States and Canada. As noted above, Canada, like Germany and the United Kingdom (at least pre-*Anson*), classifies U.S. LLCs as corporations. Before the ratification of the Fifth Protocol to the United States-Canada income tax treaty, Canada viewed a U.S. LLC doing business in Canada as not having a U.S. residence even when all the members of the U.S. LLC were U.S. residents, because the LLC did not pay tax in the United States.

Therefore, Canada would not accord U.S. LLC members with income arising in Canada the benefit of lower Canadian withholding tax rates under the treaty because Canada would not recognize the transparent nature of the U.S. LLC. Similarly, Canada would not accord U.S. corporations doing business with Canada through a U.S. LLC the benefits of lower branch profits tax rates provided for under the treaty. The Fifth Protocol, reflected in Article IV(6) of the treaty, now requires Canada to "look through" a U.S. LLC and grant tax benefits to the U.S. members or owners of the LLC as long as the income would have been treated in the United States as if the members or owners of the U.S. LLC had received the income directly (i.e., same amount, character, and timing) from Canada and not through the intervening LLC. [See Cadesky Tax, "LLCs for Canadians — Yes, No, Maybe?".)

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U.S. Taxation of U.S. LLCs: Concerns About 'Hybrid' Tax Planning

By: Michael Galligan

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An important concern in dealing with the tax treatment of U.S. LLCs in non-U.S. tax jurisdictions is the extent to which their treatment as "hybrid entities" will cause them to run afoul of a growing campaign against tax planning seeking to take advantage of the inconsistent treatment by different countries and jurisdictions of major types of income and tax offsets. Such a campaign has spurred on major international tax initiatives such as the Base Erosion and Profit Shifting ("BEPS") project of the Organisation for Economic Cooperation and Development (the "OECD").

It is of course important to first be clear about the meaning of the term "hybrid." A "hybrid entity," from the U.S. perspective, is an entity that is fiscally transparent for U.S. tax purposes but opaque for foreign tax purposes, such as a U.S. LLC that is treated as a corporation in other countries. A "reverse hybrid entity" from the U.S. perspective, on the other hand, is an entity that is a separate taxpayer or "opaque" for U.S. tax purposes but fiscally transparent for non-U.S. tax purposes, such as a foreign partnership that elects to be treated as a corporation for U.S. tax purposes under the "check-the-box" regulations.

A. U.S. 1997 Legislation: IRC section 894 and U.S. Tax Treaties

Interestingly, IRC section 894(c) was passed as part of the Tax Relief Act of 1997 (on Aug. 5, 1997) just a few months after the IRS adopted its "check-the-box" regulations. This provision was not primarily aimed at disqualifying hybrid entities from the ability to gain tax advantages as a result of inconsistent tax rules among countries and jurisdictions, but rather to ensure that the use of transparent entities did not become an opportunity for the same types of "treaty-shopping" that the "limitation of benefits" provisions of many treaties were designed to deny to corporations whose shareholders did not mainly reside in the treaty partner. IRC section 894

prohibits a foreign person from receiving, under any income tax treaty with the United States, any reduced rate of U.S. withholding tax on an item of income derived through an entity that is treated as a partnership (or is otherwise treated as fiscally transparent) "if (A) such item is not treated for purposes of the taxation law of such foreign country as an item of income of such person, (B) the treaty does not contain a provision addressing the applicability of the treaty in the case of an item of income derived through a partnership, and (C) the foreign country does not impose tax on a distribution of such item of income from such entity to such person."

The United States has achieved amendments to U.S. income tax treaties or entered into Competent Authority Agreements that follow the principle of IRC section 894(c). These largely track the United States 2016 Model Income Tax Convention, for which Article 1(6) provides: "[f]or the purposes of this Convention, an item of income, profit or gain derived by or through an entity that is treated as wholly or partly fiscally transparent under the taxation laws of either Contracting State shall be considered to be derived by a resident of a Contracting State, *but only to the extent that the item is treated for purposes of the taxation laws of such Contracting State as the income, profit or gain of a resident*" (emphasis added). Article 3(1)(c) also expressly defines the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" to also include "an enterprise carried on by a resident of a Contracting State through an entity that is treated as fiscally transparent in that Contracting State."

It is very important to note that the recent amendments to U.S. tax treaties and certain "competent authority" agreements that track the requirements of IRC section 894(c) do not compel the foreign jurisdiction to treat the U.S. LLC as a pass-through entity under its own legislation. They may still tax the U.S. LLC as a corporation under their own rules. Thus, the risk of unexpected adverse tax results resulting from the inconsistencies between U.S. rules and non-U.S. rules about the taxation of U.S. LLCs still remains.

B. BEPS Action Plan No. 2

The OECD has invested major resources into efforts to rationalize and harmonize international tax rules through its "Base Erosion and Profit Shifting" ("BEPS") Project. Action 2 of the BEPS Project is intended to develop "model treaty provisions and recommendations regarding the design of domestic rules to neutralize the tax effects of hybrid instruments and entities" (e.g., double non-taxation, double deduction, long term deferral). (See paragraph 3 in the "Introduction to Part I" of the OECD/G20 BEPS Project's "Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report.") The BEPS Project essentially assumes that the world has a "single tax system" and that tax credits or deductions conferred by one country should always correspond to tax imposition or inclusion in another country. It therefore seeks to decrease the incidence of "mismatches" in tax outcomes that arise in respect of payments made under a hybrid financial instrument or payments made to or by a hybrid entity.

Action 2 proposes a "Primary Rule" and a "Secondary Rule" for hybrid transactions and entities. Under the Primary Rule, a country should deny a taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction (so-called deduction/no inclusion" or "D/NI Outcome") or it is also deductible in the counterparty jurisdiction (so-called double deduction or "DD Outcome"). Under the Secondary

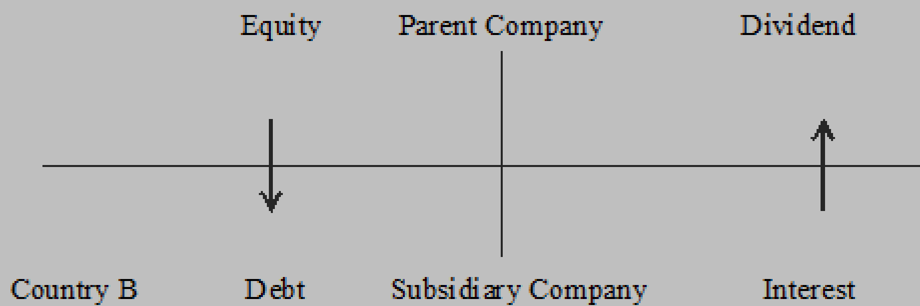
or "Defensive" Rule," if the Primary Rule is not applied, then the counterparty jurisdiction should require the deductible payment to be included in income or deny the duplicate deduction.

Thus, in the example below, the Parent Company in Country A transfers funds to its Subsidiary Company in Country B. Country A considers the transfer to be a contribution by the Parent Company to the Subsidiary Corporation while Country B considers the transfer to be a loan. Payments made by the Subsidiary Company to the Parent Company are treated by Country A as a dividend eligible for a participation exemption in Country A and therefore not subject to Country A tax. Country B considers the payments to be deductible interest payments. Under the Primary Rule, Country B should deny the interest deduction for the payments by the Subsidiary Company to the Parent Company and, failing that, Country A should deny the exemption and tax the payments.

Example*:

Debt/Equity Hybrid

Country A

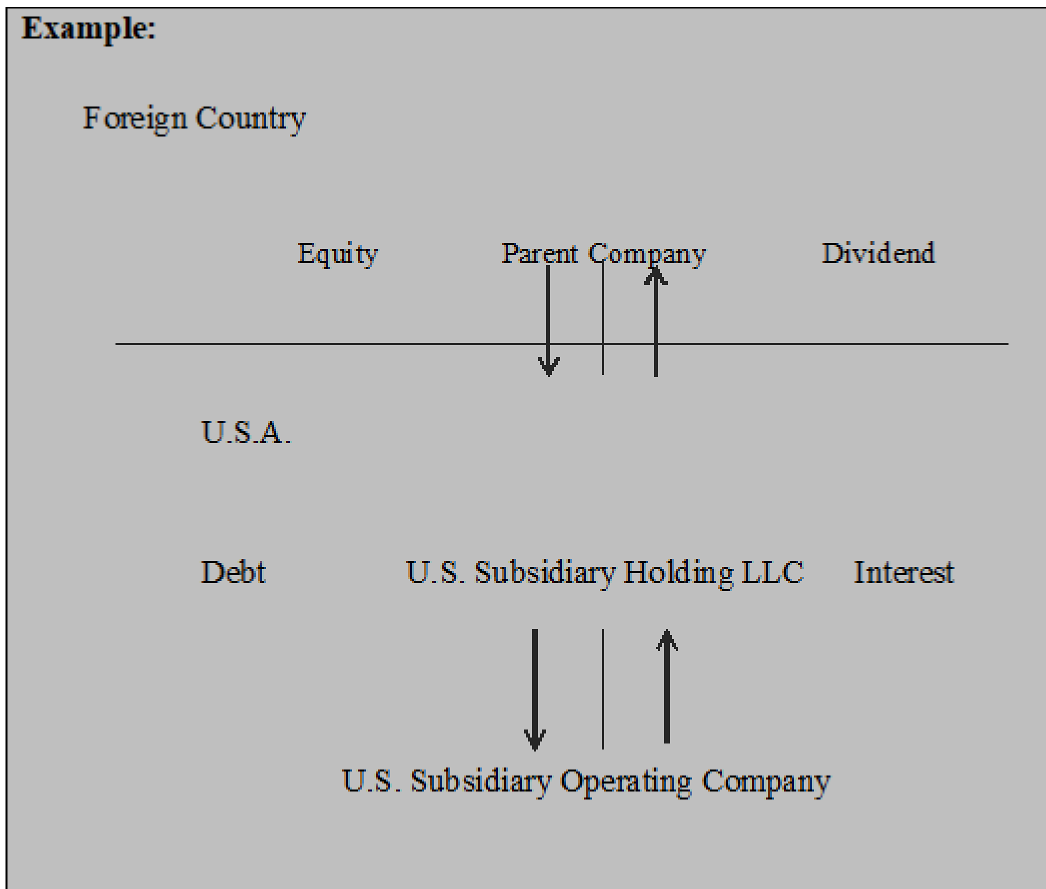


Country A considers a transfer of funds from Parent to Subsidiary as an equity investment but Country B considers it as a loan.

*Adapted from Example 1.1 of the BEPS' "Action 2: 2015 Final Report."

C. U.S. 2017 Tax Legislation – Introduction of New IRC section 267A

IRC section 267A is a new provision enacted as part of the 2017 Tax Reform Act, which is clearly inspired by BEPS Action Plan No. 2. This provision eliminates U.S. deductions for interest and royalty payments made to any foreign related party (including foreign hybrid entities) in a hybrid transaction, where the payments are not included in the income of the foreign recipient of the payment. It does not apply to payments taxed to a U.S. shareholder of a controlled foreign corporation. It applies to reverse hybrids" as well as to "hybrids" but does not appear to address payments made by foreign related parties to U.S. persons or entities not subject to U.S. taxation. Here is an example:



Suppose (1) a Foreign Parent Company contributes capital to a U.S. Subsidiary Holding LLC and (2) the U.S. Subsidiary Holding LLC in turn lends the same funds to its U.S. Subsidiary Operating Company. The U.S. Subsidiary Holding LLC is a hybrid entity because it is disregarded in the United States, even though the foreign country may consider it as a separate or "opaque" entity. From the U.S. tax perspective, the interest payments made by the U.S. Subsidiary Operating Company are treated as if they were made directly to the Foreign Parent Company and would, at least prior to the enactment of new IRC section 267A, be considered deductible. Assume, from the Foreign Parent Company's perspective, that the interest payments are treated as dividend payments from the U.S. Subsidiary Holding LLC to the Foreign Parent Company that are eligible for a participation exemption and therefore not subject to tax in the Foreign Parent Company's jurisdiction. Assume also that there is no U.S. withholding tax on interest payments by the U.S. Subsidiary Operating Company effectively to the Foreign Parent Company because of an exemption provision in the income tax treaty between the United States and the Foreign Parent's jurisdiction. Any deduction by the U.S. Subsidiary Operating Company for interest payments made effectively to the Foreign Parent Company should be denied pursuant to new IRC section 267A, because neither the U.S. Subsidiary Holding LLC nor the Foreign Parent Company are paying tax on these payments. (Even if the Foreign Parent Company were also to consider the U.S. Subsidiary Holding LLC as a pass-through, a deduction should still be

denied if the foreign country treats the interest payments as dividends eligible for a participation exemption.)

Conclusion

The use of U.S. LLCs for cross-border business and investment requires careful attention to the way foreign jurisdictions classify U.S. LLCs for tax purposes and tax them to avoid double taxation, denial of deductions, and other adverse tax results, especially in an international environment in which "tax arbitrage" based on inconsistent tax treatment among different countries and jurisdictions is increasingly coming under attack.

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