Swift v Revenue and Customs Commissioners

[2010] UKFTT 88 (TC)

FIRST-TIER TRIBUNAL (TAX)
JUDGE AVERY JONES AND MR MENZIES-CONACHER
HEARING DATES: 25–27 JANUARY 2010, DECISION DATE: 22 FEBRUARY 2010

Double taxation – United Kingdom – Relief – Profits of trade – Taxpayer's share of profits of US limited liability company taxed in US on basis company was partnership – Whether taxpayer entitled to credit for US tax paid by him – Whether taxpayer entitled to profits as they arose – Whether partnership or corporate entity – Double Taxation Relief (Taxes on Income) (The United States of America) Order 1980, SI 1980/568, art 23(2) – Delaware LLC Act (6 Del C), ss 18–101(8), 18–503.

The taxpayer was United Kingdom resident and ordinarily resident but non-domiciled in the UK for tax purposes. He was an employee of a UK incorporated company and a founding member of SPLLC, a Delaware, United States limited liability company ('LLC'). During the relevant period, the business of SPLLC involved the management of various venture capital funds. SPLLC operated under a LLC operating agreement which set out, inter alia, the prescribed ownership of interests of each member, the process for determining the distribution of profits, admission and withdrawal of members, and the allocation of carried interests to members in the funds under management by SPLLC. All profits were distributed to members; they were credited to the relevant member's capital accounts against which distributions were charged. During the relevant period, SPLLC primarily carried out its business in the US. Since SPLLC was classified as a partnership (a transparent entity) for US tax purposes and partners rather than partnerships were liable to tax, the taxpayer was subject to US federal and state tax on his share of profits from the LCC irrespective of whether the profits were actually distributed or retained. During the relevant period, distributions by SPLLC to the taxpayer were received in the UK, after payment of US federal and state income tax. In the taxpayer's UK income tax returns, the gross figures for the taxpayer's share of SPLLC profits were reported as partnership income. The taxpayer

claimed double taxation relief under art 23(2)[a] of the Double Taxation Relief (Taxes on Income) (The United States of America) Order 1980 on the basis that he was liable to tax in the UK on his share of the profits of SPLLC which were the same profits that were taxed in the US. It was submitted that SPLLC was a transparent entity, the profits of which were taxable as they arose. The Revenue contended that the taxpayer was not entitled to double taxation relief for the US tax paid on the profits of SPLLC because SPLLC was a corporate (opaque) entity that had paid the equivalent of dividend and so the taxpayer had not been taxed on the same income in the UK. The taxpayer appealed against discovery assessments and amendments to his self-assessment income tax returns. In respect of the categorisation for UK tax purposes of a foreign entity as transparent or opaque in relation to SPLLC, it was agreed that SPLLC was a legal entity; that the business of SPLLC was carried on by SPLLC itself (not its members); that the assets used for carrying on the business belonged beneficially to SPLLC (not its members); and that SPLLC (and not its members) was liable for the debts incurred as a result of carrying on business. However, the answers to the following questions were not agreed on: (i) whether SPLLC had share capital or something which served the same function as share capital; and (ii) whether the members of SPLLC had an interest in the profits of SPLLC as they arose. Under s 18–101(8) of the Delaware LLC Act (6 Del C), a Delaware 'limited liability company interest' was defined to include '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', and s 18–503 provided that 'the profits and losses of a limited liability company [should] be allocated among the members, and among classes or groups of members, in the manner provided in a limited liability company agreement'.

Held

(1) The combined effect of s 18–503 of the Delaware LLC Act and the terms of the LLC operating agreement meant that the profits had to be allocated as they arose amongst members. It followed that the members of SPLLC had an interest in the profits of SPLLC as they arose (see [10], [12], below).

(2) SPLLC stood somewhere between a Scottish partnership and a UK company, having the partnership characteristics of the members being entitled to profits as they arose and owning an interest comparable to that of a partnership interest, and the corporate characteristics of carrying on its own business without the liability on the members and there being some separation between managing members and other members falling

a Article 23, so far as material, is set out at [13], below.

short of the distinction between members and directors. It was on the partnership side particularly in relation to its income. Accordingly, the taxpayer was taxed on the same income in both countries and accordingly was entitled to double taxation relief under the treaty (see [20], [21], below). *Memec plc v IRC* (1998) 1 ITLR 3 applied.

EDITOR'S NOTE

The Inland Revenue (now HMRC) has for some years had a published practice that a Delaware LLC will be treated as a corporate entity. The consequence is that a member of the LLP is not entitled to a foreign tax credit for US tax paid on profits derived by the LLC. This is applied even though the US treats the LLC as transparent, the income as derived by the member, and the US accordingly taxes the member on his share of the income of the LLC. The tribunal has decided against that practice.

It has to be emphasised that this decision is limited to the specific terms of the constituting documents of this particular LLC. On the basis of those documents, and the expert evidence given, the First-tier Tribunal held that the UK-resident member of the LLC was entitled to his share of the profits as those profits arose. Consequently, he was entitled to credit for the US tax imposed on those profits.

Regrettably, HMRC has announced its intention to appeal this decision. In the meantime, they do not intend to apply this decision in other cases. This seems unfortunate; the decision being an entirely reasonable one, which avoids a significant level of unrelieved international double taxation.

The taxpayer had a fall-back argument which deserved perhaps a better wind than it got. Under the 'transfer of assets abroad' legislation (formerly s 739 ICTA 1988), income of a non-resident person is attributed to the individual who transferred assets to that non-resident, unless the individual proves the absence of a tax avoidance motive. In effect, the legislation looks through the non-resident entity and attributes the income to the UK-resident transferor. The taxpayer sought to turn this anti-avoidance legislation into a sword by arguing that, if the income was attributed to him, he was entitled to the tax credit too. HMRC argued, however, that the taxpayer was entitled to the benefit of the 'bona fide commercial defence', even though he had never claimed it nor submitted evidence to support it. The tribunal accepted this argument. In other matters, however, HMRC has been adamant that a taxpayer must claim the defence and bring evidence in support. Even so, the tribunal accepted that HMRC could extend the defence to the taxpayer in this case. This means that a taxpayer who has tax avoidance motives, and cannot claim the defence, would receive the benefit of the foreign tax credit, while the taxpayer without such a motive would not (assuming the first argument

failed on appeal). This fall-back argument deserved a better hearing.

Again, it is interesting to compare this decision to the Canadian Tax Court decision in *TD Securities* reported elsewhere in this issue (12 ITLR 783) which deals also with the recognition of a US LLC for tax purposes by a country other than the US.

COMMENTARY

Swift is not a case about interpretation—it is a case about characterization—specifically, the characterization of the interest of a member of a Delaware limited liability company (an 'LLC'). Even more specifically, the United Kingdom First-tier Tribunal (Tax Chamber) decides the question of whether or not a member of a LLC is legally entitled to the profits of the LLC—as such, and as they arise—*versus* being legally entitled only to a payment or distribution from the LLC, that finds its own source and character in the contract or non-tax law governing the interest in the LLC. In this case, and while the matter may depend on the specific facts, the tribunal has held that the interest in the LLC was more similar to an interest in a partnership than to a share of a corporation, in the sense that the members of this LLC were the persons who were legally entitled to the profits of the LLC, and to whom those profits belonged, as such and as they arose.

The Context

Swift was a UK resident (non-domiciled) individual who was a member of an LLC that carried on a fund management business through offices in the United States. The LLC was 'fiscally transparent' for US tax purposes, being treated as a partnership. Accordingly, Swift was subjected to US federal and state direct income taxes, computed on his share of the LLC's profits, whether or not distributed. As the profits were in fact distributed and remitted to the UK annually, Swift was also taxable in the UK. For UK tax purposes, Swift computed his liability on the basis that the LLC should be treated as a partnership. Thus, he included in income his share of the LLC's profits, and claimed foreign tax credit relief for the US federal and state taxes that he had been subjected to.

If the credit was applicable, there would be no UK tax payable on these profits, since the rate of US taxes paid was higher (there was also an alternative argument which will not be discussed in this comment). However, the UK Revenue's position was that the LLC was a corporate-like entity, with corporate-like interests, and consequently that the profits of the LLC did not in law belong to its members as they arose, such that the US taxes paid by Swift were not computed by reference to the *same profits* as those on which the UK tax otherwise payable had been computed, and against which the credit was sought.

The specific context involved the application of art 23(2)(a) of the 1975 UK-US Double Tax Convention (and art 24(4) of the 2001 convention, depending on the year of assessment), which provided as follows:

> 'United States tax payable under the laws of 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;'

No material question of interpretation arose in the circumstances—in the sense that there was no dispute as to whether the reference to the 'same profits' could include profits derived indirectly by way of a payment or distribution from a company—for example, where computed by reference to those profits. But this, perhaps, would have been a difficult argument to make out, in the face of the specific exclusion for dividends, and the decision of the Court of Appeal in *Memec plc v IRC* (1998) 1 ITLR 3, as discussed below. Thus, what remained was the question of characterization.

The Decision

In reaching the conclusion that the profits of the LLC belonged in law to its members, and therefore that the US and UK taxes were computed by reference to the 'same profits', the tribunal emphasized (at [17], below) that this decision was to some extent fact-specific:

> 'We start by emphasising that we are concerned with whether relief applies in relation to the profits of this particular Delaware LLC, SPLLC, which, since there is wide freedom to contract the terms of a Delaware LLC, may not be of general application.'

Nevertheless, the implications of this decision may be broader, given the tribunal's reasoning, which focused considerably on the features of an LLC, and of an interest in an LLC, as determined in accordance with the governing law of Delaware.

In this regard, the tribunal had the benefit of expert testimony on both sides of the issue—in particular, with respect to the questions raised in HMRC's Tax Bulletin 29 (June 1997) and 39 (February 1999), concerning the categorisation of foreign entities. These questions were as follows:

> 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?

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?

The experts agreed on items 1, 3, 5 and 6, to the effect that the LLC was an entity distinct from its members, and that it and not its members carried on its business operations, was the beneficial owner of its assets and was responsible for all its debts. These were accepted by the tribunal as findings of fact.

However, there was disagreement on the remaining two questions—as to whether or not the LLC had share capital (or something which serves the same function as share capital), and whether or not Swift had an interest in the profits of the LLC as they arose. Accordingly, these were questions to be decided by the tribunal.

With respect to the 'share capital' question, the tribunal described the task at hand as requiring a comparison of the legal characteristics of a membership interest in a Delaware LLC with those in a UK company or partnership. Beginning with a review of the LLC's governing law, the tribunal noted that a 'limited liability company interest' is defined 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' (s 18–101(8) of the Delaware LLC statute (the 'DLLCA')). The tribunal also noted that '[a] limited liability company interest is personal property. A member has no interest in specific limited liability company property' (s 18–701 of the DLLCA). Moreover, the tribunal noted that, although interests in an LLC are transferable in principle, transfers may be (and, in this case, were) restricted by the operating agreement, and a distinction was drawn between economic interests and other membership rights such as those in relation to management—in that, for example, an assignee may benefit from economic interests but has no right to participate in the management or business except as provided in the operating agreement and on the approval of all the other members. With respect to matters of management, the tribunal noted that members in this case had voting entitlements that were disproportionate to their ownership

percentages, with the so-called 'Managing Members' having a majority of the votes between them. On this basis, the tribunal found (at [7](1), below) that the membership interests in the LLC were '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)', noting that '[n]ormally a share in a UK company is transferable and needs to be registered and if there are restrictions on transfer these are that the consent of the directors (not all the other shareholders) is required'.

With respect to the question of whether or not the members of the LLC had an interest in its profits as they arose, the discussion (at [7](2), below) turned on the proper effect to be given to the provisions of the DLLCA and of the operating agreement. In this regard, it was Swift's position that he was legally entitled to his share of the LLC's profits as they arose on the basis that the distribution of the profits credited to a member's capital accounts was *mandatory* (though subject to the availability of cash and to certain other restrictions in the operating agreement). In contrast, it was the Crown's position that Swift was not legally entitled to his share of SPLLC's profits as they arose on the basis that distributions of profit were at the *discretion* of the Managing Members. Thus, both parties focused on a member's distribution entitlements—with Swift taking the view that they were mandatory, and the Crown that they were discretionary.

In contrast, the tribunal took the view that the key to the determination lay not in the members' distribution entitlements but in their entitlements as to *profit allocations*. In this regard, the tribunal again turned first to the provisions of the DLLCA, noting that the definition of 'limited liability company interest' implies that the members have a share in the profits of an LLC, and distinguishes that from distribution entitlements, given the reference to '*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'. The tribunal then further distinguished a member's interest in the profits as they arise from a member's right to receive distributions:

> 'The fact that the right to receive distributions is dealt with separately from the allocation of the profit suggests that the second part [of the definition] is dealing with what in a partnership situation is called drawings (in addition to distributions on a winding-up).'

Moreover, the tribunal observed that the provisions of the DLLCA contemplated that '[t]he profits and losses of a limited liability company shall be allocated among the members, and among classes or groups of members, in the manner provided in a limited liability company

agreement', and included a default rule applicable where the LLC agreement does not so provide, allocating profits and losses on the basis of the members' contributions (s 18–503).

With respect to this particular LLC agreement, the tribunal found (at [8](4)–(6), below) that capital accounts would be maintained for each member and would be adjusted at least annually, with credits and debits determined based on a complicated allocation and sharing formula that took many factors into consideration, including different sharing ratios for different aspects of SPLLC's operations, but most importantly that 'the whole of the book profit for the year was allocated to the members' capital accounts'. The tribunal then considered (at [8](7), below) the question of whether or not the fact that the book profit had to be allocated (and could be reallocated) 'at least as often as annually' might indicate that the profits must belong to the LLC until the allocation is carried out, concluding that this language gave rise to no such inference, in that it was consistent with the view that allocations were mandatory (though could be done more frequently than annually). It was also found (at [8](11), below) that members could withdraw at any time, and would be entitled to allocations to the time of their withdrawal.

The tribunal then turned (at [8](8), below) to s 5.1 of the operating agreement, which provided for distributions. Despite some uncertainty and disagreement among the experts, the tribunal concluded (at [11], below) that distributions were indeed mandatory. However, as noted above, the tribunal's decision was not premised upon the finding that distributions were mandatory. Rather, the decision appears to be predicated upon the tribunal's characterization (at [10], below) of the provisions of the LLC's governing law and operating agreement that relate to *allocations* of profit and loss—and the finding that these allocations are mandatory:

> 'We regard it as important that "limited liability company interest" is defined to include "a member's share of the profits and losses of a limited liability company …" (s 18–101(8) of the Act), and that "The profits and losses of a limited liability company shall be allocated among the members, and among classes or groups of members, in the manner provided in a limited liability company agreement" (s 18–503 of the Act) with a default rule if the LLC agreement does not so provide. The US tax returns for 2000 (and we infer all other years) show that the whole of the book profits are allocated to the members' capital accounts. 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. It is true, as Mr Talley said, that the assets representing those profits do belong to the LLC until

the distribution is 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. Conceptually, profits and assets are different, as is demonstrated by the reference to both in the definition of "limited liability company interest" (see para [7](1)(a) above). There is a corresponding liability to the members evidenced by the allocation to their capital accounts rather than a balance of undistributed profits (even though that is what the audited accounts say, but they cannot override the terms of the LLC Operating Agreement in view of s 18–503 of the Act, which does not contemplate that profits can belong to the LLC as they must always be allocated to the members, and in any case they are consolidated accounts). 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 SPLLC have an interest in the profits of SPLLC as they arise.'

The implications of this finding of fact were then analyzed by the tribunal (at [20]) in accordance with the principles confirmed by the UK Court of Appeal in *Memec*:

'Although we have said that we prefer to concentrate on the words of the treaty rather than ask whether SPLLC in transparent or opaque, we shall apply the *Memec* approach to it. We have considered above the characteristics of SPLLC in accordance with Delaware law and concluded that it (and not the members) carries on its business as principal; it (and not the members) is liable for its debts and obligations; and it (and not the members) owns the business; and it does not have anything equivalent to share capital. However, the members are entitled to the profits as they arose. We can compare it with an English or Scottish partnership and a UK company. There is a spectrum running from—

(1) the English partnership: not a legal person, with the partners owning the assets jointly and incurring the liabilities, carrying on the business, and being entitled to the profits; through

(2) the Scots partnership: legal person (in consequence of an agreement) owning the assets and incurring the liabilities with a secondary liability on the partners, with the partners nevertheless carrying on the business (since that is the definition of partnership) and being entitled to the profits; to

(3) the UK company: legal person (in consequence of registration) owning the assets and incurring the liabilities with no liability on the members (or a liability only on winding-up for an unlimited company) and carrying on its business with the members holding shares and being entitled to profits only after either payment by the

directors or recommendation by the directors and a resolution to declare dividends by the members. (Mr Peacock pointed out that the articles of a UK company could provide for automatic dividends: see *Bond v Barrow Haematite Steel Co* [1902] 1 Ch 353, 71 LJ Ch 246, *Re Accrington Corpn Steam Tramways Co* [1909] 2 Ch 40, 78 LJ Ch 485, although it seems that in neither of these cases the articles did so.)

SPLLC stands somewhere between a Scots partnership and a UK company, having the partnership characteristics of the members being entitled to 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 liability on the members and there being some separation between managing members and other members falling short of the distinction between members and directors. 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.'

On this basis, Swift was entitled to UK foreign tax credits in respect of US taxes paid by him on his share of the LLC's profits, since the UK tax was computed by reference to the 'same profits' as those on which the US tax had been computed.

Comment

Swift, like *Memec*, was decided in the fascinating context of the UK Revenue attempting to impose what is unquestionably economic double taxation, in circumstances where it is clear that sufficient source country taxation has in fact been imposed on the underlying profits. In *Memec*, the Court of Appeal was not sympathetic to this observation, describing the matter as one involving 'a dry question of law unencumbered by the merits'. That seems fair—and it is certainly an approach to such matters that is often advocated to the benefit of taxpayers. A similar approach would seem to have been taken by the tribunal in *Swift*. In both cases, an important question of law (generally stated) was whether or not the legal features of the taxpayer's interest in the foreign legal entity or arrangement constituted or gave rise to a direct legal interest in the underlying profits. In *Memec*, this question was answered in the negative, in the context of a German 'silent partnership'. In *Swift*, a different conclusion was reached, on different facts.

But that is a question that remains, given that *Swift* has been appealed—how different really are these facts? In both contexts, the 'member' is not the legal owner of the assets, the latter being owned by a separate person. As to liability, the 'member' in both contexts has no direct

responsibility to third parties, and is responsible only for making agreed contributions. In both contexts, entitlements to a return on the contributions are computed by reference to underlying profits. Thus, the legal entitlements with respect to the assets, and the economic entitlements with respect to the profits, would seem to be very similar. However, there may be differences between the *legal* entitlements with respect to the profits, as opposed to the *economic* entitlements, and those types of differences are usually material for tax purposes. In *Memec*, it was found that the legal entitlement of the 'silent partner' may have been computed by reference to profits, but in law constituted no more than a personal right to be paid an amount—a right *in personam*, or *chose in action*—not a proprietary interest in the underlying profits. In *Swift*, it was found that the legal entitlement of the member constituted a proprietary interest in a share of the underlying profits, as such and as they arose. Both of these questions turn on the proper characterization of the effect of the foreign law governing the relevant interest.

It is always interesting to see the courts and others (including policy makers) struggle with such issues—such issues being those involving the proper significance for tax and other purposes to attribute to the interposition of a legal entity or arrangement between a particular source and a particular person. Ultimately, both sides have a point. From an economic perspective, every legal entity is no more than the representative or 'alter ego' of its members (and other stakeholders). However, from a legal perspective, distinct persons have distinct primary rights and obligations, and sometimes secondary rights and obligations that are derivative of, but nevertheless distinct from, the primary obligations of other persons. Tax law constantly struggles with this problem, being driven primarily by legal characterization. Although tax law normally recognizes these distinctions in the first instance, it often then goes about displacing them in a variety of contexts, such as by introducing regimes for corporate consolidated filing and group relief, or CFC provisions, or inter-corporate dividends-received deductions, and various other means of operating on an 'imputation' basis rather than on a 'classical' basis in terms of integrating entity-level and member-level taxation. We seem to want it both ways, but ultimately it would appear that most countries have settled on 'legal reality'—somewhere between 'economic reality' and 'legal form', but more on the side of the latter, in that 'legal form' coupled with an *adequate* (as opposed to *sufficient* or *unadulterated*) degree of 'substance' would seem usually to trump 'economic reality', subject to the many specific legal rules or principles to the contrary. And this sword cuts both ways.

But it is particularly interesting to see these issues play out in the context of reliefs for underlying taxes. In that context, the statutory framework

itself is premised on the recognition of this very paradox. As a matter of law, the taxes have not been imposed on the same person (they have been imposed at a level *below* the relevant taxpayer), but the economics are such that it is considered that it would be unfair to deny the relief, because the relevant taxpayer indirectly bears the burden of the taxes (subject to questions of *incidence* and *shifting*). Arguably, a similar observation could be made in situations involving taxes imposed at a level *above* the legal person technically earning the income (from the perspective of the relief-providing country), where the taxes are imposed in respect of that income. If the assets, the income, the taxes and the taxpayer are all in the same vertical line, then the overall context is similar, certainly from a policy perspective, regardless of which level each item occupies.

Nevertheless, the law is the law, and sometimes it is quite 'dry' and 'unencumbered by the merits', which is why the legal characterization question is so important. In the context of a traditional UK partnership, it is clear that the *allocation* of the profits is a key consideration, because the partnership is not regarded as a distinct person, such that by default it is only the partners to whom the profits can belong as a matter of law, and it is the allocation that assigns those primary legal entitlements. In other words, on the premise that a partnership is not a person, there is no possible choice for the legal entitlement to the profits as between the partners and the partnership, such that it must fall on the partners, as a primary legal entitlement, and such that the *allocation* serves the function of determining *as between the partners* who gets the entitlement. In the context of a traditional corporate entity, there is a possible choice as between the entity and its members, but the law is relatively settled that the members are not considered to have a proprietary interest in the underlying profits, thereby normally making that choice on primary entitlement in favour of the entity. Where is gets difficult is in the context of 'hybrid' entities or legal arrangements, such as 'silent partnerships', LLCs, and a variety of other legal constructs extant under the laws of many jurisdictions, often reflecting different legal histories and traditions.

And one need not necessarily look too far to find such animals. The Scottish partnership is a good example of this, as are many continental partnerships. In *Memec*, the Court of Appeal did struggle with this one—and came to what might best be described as a 'hybrid' characterization. That is, while it acknowledged that there is 'the interposition of the partnership as a legal entity between the partners and the profits', it found that 'in substance the position of the partners in relation to the profits is the same as in an English partnership' and that 'those profits are earned by the partners carrying on business in common together and are shared in the same way'. The court also found that 'the partners, whilst not directly owning the business and assets, indirectly do

so and have an indirect interest in them', and that '[i]n 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 profits for the partners who are the firm'. In a sense, the court seems to be characterizing a Scottish partnership as a form of agency arrangement—which is at the core of legal attribution in many contexts, including partnership law. It remains to be seen whether an appeal court will agree with the tribunal that, under the operating agreement and governing law of this particular LLC, the profits are the profits of the members as they arise, with the LLC merely receiving those profits and holding them as such for the members—in a 'real sense', given that the members were not considered to have any direct or indirect proprietary interest in the assets that give rise to those profits. Although there are many legal arrangements that have the effect of directly separating ownership of the assets from legal entitlement to the profits, the question is whether or not an interest in an LLC is one of these.

Angelo Nikolakakis

Cases referred to in decision

Accrington Corporation Steam Tramways Co, Re [1909] 2 Ch 40, 78 LJ Ch 485, Ch D.
Archer-Shee v Garland (*Inspector of Taxes*) (1929) 15 TC 693, KBD.
Bond v Barrow Haematite Steel Co [1902] 1 Ch 353, 71 LJ Ch 246, [1900–3] All ER Rep 484, Ch D.
Corbally-Stourton v Revenue and Customs Comrs [2008] STC (SCD) 907.
MacKinlay (*Inspector of Taxes*) *v Arthur Young McClelland Moores & Co* [1989] STC 898, [1990] 2 AC 239, [1990] 1 All ER 45, HL.
Memec plc v IRC (1998) 1 ITLR 3, [1998] STC 754, 71 TC 77, CA.
R (*on the application of Pattullo*) *v Revenue and Customs Comrs* [2009] CSOH 137, [2010] STC 107.
Veltema v Langham (*Inspector of Taxes*) [2004] EWCA Civ 193, [2004] STC 544, 76 TC 259.

Counsel:

Jonathan Peacock QC for the appellant.
David Ewart QC for the respondents.

Solicitors:

Ernst & Young LLP for the appellant.
Solicitor for Revenue and Customs for the respondents.

Cur adv vult

22 February 2010. The following anonymised decision was released.

JUDGE AVERY JONES AND MR MENZIES-CONACHER.

[1] This is an appeal against discovery assessments made on 15 January 2004 for the year 1997–98 and on 23 November 2004 for the years 1998–99 and 1999–2000, and amendments to the appellant's self-assessment income tax returns for 2000–01, 2001–02, 2002–03 and 2003–04 by closure notices dated 11 April 2007. The appellant was represented by Mr Jonathan Peacock QC, and the respondent ('HMRC') by Mr David Ewart QC.

[2] The main issue in this appeal is whether the appellant is entitled to double taxation relief for US tax paid on the profits of a Delaware limited liability company, Sandpiper Partners LLC, the appellant's share of which were taxed on him personally in the US on the basis that for US tax purposes it is a transparent entity, whereas in the UK HMRC contend that it is a corporate entity that has paid the equivalent of dividend and so the appellant has not been taxed on the same income in the UK. In round terms the financial effect is that 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. Two subsidiary issues are first, that if the LLC is opaque and HMRC are right that there is no entitlement to double taxation relief, the appellant contends that he should have been taxed under s 739 of the Income and Corporation Taxes Act 1988, in which case his share of the profits of the LLC are deemed to be his and he would be entitled to relief for the US tax. Secondly, the appellant contends that the discovery assessments are invalid.

FACTS

[3] We had seven ring binders of documents and heard evidence from two US experts, Mr Kevin G Abrams of Abrams & Laster LLP of Delaware (who adopted the report of J Travis Laster of the same firm on Mr Laster's appointment to the Delaware Court of Chancery) called on behalf of the appellant, and Mr Thomas N Talley of the New York Bar with 39 years' experience of dealing with Delaware entities called on behalf of HMRC; and Mr Graham Ronald Turner, senior technical adviser in relation to the transfer of assets legislation, HMRC.

[4] There was an agreed statement of facts as follows:

> '1. *The Appellant*
>
> 1.1 The Appellant is United Kingdom ("UK") resident and ordinarily resident and since the 1997/98 tax year he has filed his UK tax returns on a non-UK domiciled basis.
>
> 1.2 The Appellant at all material times was an employee of

Sandpiper (UK) Limited ("SUK"), a UK incorporated company.

1.3 The Appellant was a founding Member of Sandpiper Partners LLC ("SPLLC"), a limited liability company ("LLC") constituted under United States ("US") Delaware law. The relevant periods in question are the 1997/98 to 2003/04 UK tax years. The Appellant's interest in this LLC during this period is the subject of these proceedings.

1.4 The Appellant also indirectly participates in various venture capital funds sponsored by the Sandpiper Group via an interest in the entities (either limited partnerships or limited liability companies) which serve as the General Partners of those funds.

1.5 The Appellant is treated as a non-resident for US tax purposes and therefore only includes his US sourced income in his US Federal and Massachusetts State tax returns.

2. *The Sandpiper Group*

Sandpiper (UK) Limited

2.1 Since 1990, The Appellant has been an employee of SUK, a UK incorporated company and originally a wholly owned subsidiary of Cormorant Inc. ("CTUS"), a company incorporated in the United States ("US"). Upon its formation, SPLLC acquired CTUS's interest in SUK.

2.2 During the relevant period, SUK was wholly engaged by SPLLC as its representative in the UK, Continental Europe and the Pacific Rim countries through a consulting agreement under which it performed advisory and liaison functions for SPLLC. SUK was remunerated by SPLLC on a cost plus mark-up basis.

2.3 The Appellant is employed by SUK under a Contract of Employment dated 15 February 1991. Pursuant to clause 5(A) of the employment contract, the Appellant is entitled to a base salary, the level of which is reviewed annually. For the periods under review the base salary has been approximately four times the amount set at the time the original employment contract was entered into, with differences year to year attributed to exchange rate fluctuations between the US Dollar and Sterling. In addition, the Appellant is entitled to pension contributions by the UK company (clause 5(F) refers) and a discretionary bonus of up to sixty per cent of his base salary (clause 6 refers).

2.4 The Appellant included his total employment earnings from SUK in his UK income tax returns.

Sandpiper Partners LLC ("SPLLC")

2.5 The Appellant, along with a number of colleagues involved in Cormorant venture capital activities in the US, formed SPLLC as a Limited Liability Company, constituted under Delaware law. SPLLC'

place of business is and always has been located in Massachusetts, US. SPLLC has now changed into a limited partnership, however, for the periods under review, SPLLC was an LLC.

2.6 The members of SPLLC capitalised SPLLC by way of promissory notes created by the founders in favour of SPLLC. A proportion of these notes (the "Appellant's Proportion") were held by the Appellant. During the 1997 financial year the initial loan notes were cancelled and new notes were issued by the Members. The notes were paid to SPLLC by its members on 15 December 1998. The full amount of the promissory notes was returned to the members in 1999 by way of distribution.

2.7 Immediately after its formation, SPLLC became the sub-manager of the funds managed by CTUS and acquired the entire issued share capital of SUK from CTUS. It also employed all of the existing employees of CTUS under new contracts of employment.

2.8 During the relevant period, the business of SPLLC involved the management of various venture capital funds. It carried out a sub-advisory role on funds managed directly by CTUS and acted as an investment manager on new funds in return for fees. Apart from the fees, SPLLC had no economic interest in the funds and did not share in nor otherwise receive gains or losses of fund investments. However, the Appellant participated indirectly in various funds via his equity ownership in the limited partnerships and limited liability companies that served as the General Partners of various funds under management by SPLLC. In 2002 he set up an overseas trust in Jersey to hold the overseas carried interests.

2.9 SPLLC operated under a Limited Liability Company Agreement dated 28 January 1997 ("the LLC Operating Agreement"). This agreement set out inter alia the prescribed ownership interests of each member, the process for determining the distribution of profits, admission and withdrawal of members, and the allocation of carried interests to members in the funds under management by SPLLC. The parties wish to note that whilst the parties have agreed to the facts and matters as set out in this document, the parties reserve their right at the hearing to refer to the actual terms of agreements, documents and other evidence for the full meaning and effect of the transactions and agreements referred to therein.

2.10 Under the LLC Operating Agreement, where an Original Member (defined to include the Appellant) rendered services to SPLLC as an employee, he or she was entitled to an annual salary which was then allocated to the relevant member's Capital Account. The Appellant did not receive any salary payments from SPLLC during the years under review.

2.11 Article V of the LLC Operating Agreement set out the provisions relating to the distribution of profits. Section 5.1 provides:

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

The Managing Members are defined in Article II, Section 2.1.

2.12 Each calendar year, all profits were distributed to members on a quarterly basis in arrears, in accordance with section 5.1 of the LLC Operating Agreement. This means that the fourth quarter distribution was paid out after 31 December of the relevant US financial year. The consolidated equity balance at year end represented the undistributed quarterly profit from the fourth quarter, which was then wholly distributed in the first quarter of the following year.

2.13 The income generated by SPLLC was shared amongst the members of the LLC in accordance with prescribed profit sharing ratios as set out in the LLC Operating Agreement. The Appellant's profit share was made up of a number of different profit sharing interests which in aggregate were similar to the Appellant's Proportion. Not all members received a profit share in the same proportion to their ownership interest, for example Managing Members may have had a higher share as they were involved in earlier funds that helped start the business. Profit allocations were credited to the relevant member's capital accounts against which distributions were charged.

3. *US Tax Treatment*

3.1 During the relevant period, SPLLC primarily carried out its business in the US. Under the US Internal Revenue Code ("the Code") and Title IX (Taxation) of the General Laws of Massachusetts as the profits generated by SPLLC are connected with the conduct of a US trade or business they were subject to US federal and Massachusetts state taxes respectively, regardless of the residence or tax domicile of the recipient of such profits.

3.2 Pursuant to the US entity classification rules set out in section 301.7701–3 of the US Treasury Regulations ("the Regulations") SPLLC did not make an election to be classified as a corporation and thus by default was classified 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 SPLLC.

3.3 As SPLLC 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.

3.4 For the years ended 31 December 1998 to 2003, SPLLC filed US federal and Massachusetts state partnership income tax returns. Each member of the LLC was also required to file individual federal and Massachusetts state income tax returns.

Federal Income Tax

3.5 SPLLC was required to file an annual Federal partnership return (Form 1065 *US Partnership Return of Income*) reporting the taxable income of the partnership computed in accordance with Section 703 of the Code.

3.6 The Appellant was also required to file an annual federal income tax return, Form 1040NR, along with supplementary Schedule E, where his share of income from SPLLC was reported in Part II *Income or Loss from Partnerships and S Corporations*, Box 31.

3.7 For federal tax purposes, SPLLC was required to withhold US federal tax at the highest applicable tax rate on US sourced effectively connected income which was distributable to foreign partners pursuant to section 1446 *Withholding Tax on Foreign Partners' Share of Effectively Connected Income* of the US Internal Revenue Code. SPLLC withheld tax at the rate of 39.6 per cent. SPLLC then remitted quarterly withholding tax payments to the US Internal Revenue Service with respect to the Appellant's share of SPLLC' effectively connected income during each of the tax years in question.

3.8 Under Article 5.4 of the LLC Operating Agreement members of SPLLC authorised SPLLC to withhold and pay to the tax authority any withholding or other taxes payable by members. To the extent that tax was paid by SPLLC on behalf of a member, but not withheld from a distribution being made, the member was to be treated as having received a payment from SPLLC and that payment was to be treated as a loan from SPLLC to the member, repayable with interest on demand. In practice, SPLLC reduced distributions to the Appellant by the amount of withholding tax remitted on his behalf.

3.9 SPLLC was required to file Form 8804 *Annual Return for Partnership Withholding Tax* for each member and also complete Form 8805 *Foreign Partner's Information Statement of Section 1445 Withholding Tax* which foreign "partners" needed to furnish with

their US Federal income tax return to claim a withholding tax credit for the tax paid.

3.10 The US federal tax was reported on the Appellant's US federal income tax return and claimed as a credit of tax pursuant to section 1446(d) of the US Internal Revenue Code.

Massachusetts State Income Tax

3.11 SPLLC was required to file an annual State income tax return reporting the taxable income of the partnership, using Form 3 *Massachusetts Partnership Return of Income*. The LLC was also required to include for each partner a supplementary schedule, Schedule 3K-1 *Partner's Massachusetts Information* for each partner, which sets out each individual partner's distributive share of income for the year.

3.12 The Appellant is also required to file annually Massachusetts state income tax returns. For the tax years in question, the Appellant filed income tax returns using Form 1 *Non-resident / Part year Resident Income Tax Return* with the Massachusetts Department of Revenue. The Appellant reported his distributive share of income in accordance with Schedule K-1 as filed by SPLLC in its partnership return.

3.13 SPLLC was not required to withhold tax for state tax purposes. Instead, the Appellant remitted quarterly instalments of tax to the Massachusetts Department of Revenue, which were due on 15 April, 15 June, 15 September and 15 January in relation to the relevant US tax year. The Appellant paid state tax of approximately 6 per cent on his total reported income.

4. *UK Income Tax Returns*

4.1 The Appellant has been treated as resident, ordinarily resident, but non-domiciled for UK tax purposes since the 1997/98 tax year. Between 1997 and September 2003 distributions by SPLLC to the Appellant were received in the UK. The sums received in the UK were after the payment of US Federal Income Tax (see paragraph 3.7 et seq above) and Massachusetts State Income Tax (see paragraph 3.11 et seq).

4.2 For the tax years ended 5 April 1998 to 2004 the gross figures for the Appellant's share of SPLLC profits were, subject to the steps taken in paragraph 5.5, reported as partnership income in the partnership supplementary pages of the self-assessment tax return.

4.3 The LLC income figures reported in his UK tax return were taken from Line 18 of Schedule E of his US Federal income tax return (Form 1040NR). The US Dollar figures have been converted to Pounds Sterling using the annual average exchange rate for the applicable year. For the years in question, the Appellant remitted all of his profit

distributions and therefore the figure reported in his US tax return for the calendar year ending in the UK tax year was taken.

4.4 The total amount of Federal and State taxes during the relevant periods exceeded the highest UK personal tax rate of 40 per cent. Therefore, the foreign tax credit relief claimed by the Appellant in his UK income tax return was restricted to a maximum of 40 per cent of the LLC income reported.

5. *HMRC Enquiry*

5.1 The issues in these proceedings originated from Her Majesty's Revenue and Customs ("HMRC")'s enquiry into the Appellant's UK employment and US partnership activities in 2001 which was issued by a letter dated 25 November 2002.

5.2 By letter dated 1 December 2003 HMRC advised that they intended to enquire into the Appellant's tax return for the year ended 5 April 2002 and that a discovery assessment would be raised for the year ended 5 April 1998. HMRC issued a Notice of Assessment for the year ending 5 April 1998 on 15 January 2004. Ernst & Young LLP on behalf of the Appellant issued a formal appeal against the assessment by letter dated 20 January 2004.

5.3 HMRC advised the Appellant of their intention to issue further discovery assessments by letter dated 11 August 2004 in relation to the years ended 5 April 1999 and 2000. Notices of Assessments were issued on 23 November 2004 for the 1999 tax year and the 2000 tax year. Ernst & Young LLP lodged formal appeals against these assessments and elected to bring the appeal before the Special Commissioners under sections 31D and 46 of the Taxes Management Act 1970 by letter dated 3 December 2004.

5.4 HMRC issued amended self-assessments in relation to the tax years ended 5 April 2001, 2002, 2003 and 2004 by letters dated 11 April 2007. Formal appeals to these notices and election to bring the appeals before the Special Commissioners under sections 31D and 46 of the Taxes Management Act 1970 were lodged by Ernst & Young LLP on 27 April 2007.

5.5 The Appellant subsequently filed protective error and mistake claims under section 33(1) of the Taxes Management Act 1970 in relation to the years ended 5 April 1998, 1999, 2000, 2001, 2002, 2003 and 2004 advising that the foreign income arising from SPLLC should have been reported on the foreign pages of the tax return forms, as opposed to the partnership pages. The claims submitted by the Appellant were almost identical in their wording, and an example of the text adopted is set out below:

"On the assumption that Section 9A TMA 1970 enquiry raised in the [relevant] tax return on net foreign income of [£X] is finally determined as a result of the way CTUS US profits have been declared on the return, I am making a Protective Error and Mistake claim under Section 33(1) TMA 1970 that the foreign income so charged should strictly have been reported on the foreign pages of the tax return (F2) in box 6.4 as opposed to the Partnership pages (P1 & P2)."

5.6 Ernst & Young LLP on behalf of the Appellant requested listing of this case for hearing with the Special Commissioners in relation to the Self-Assessment Closure Notices for the tax years 2000/01 to 2003/04 and Discovery Assessments for the tax years 1997/98 to 1999/00 by letter dated 17 April 2008. Directions were issued in chambers by the Special Commissioners on 2 May 2008.'

[5] The experts were asked to answer the questions raised in HMRC's Tax Bulletin 29 (June 1997) and 39 (February 1999) for the categorisation of foreign entities as transparent or opaque in relation to SPLLC, which are:

(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?

(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?

[6] The experts were agreed on the following matters in relation to SPLLC and we find these as facts:

(1) It is a legal entity coming into existence by the execution of a certificate of formation, filing it with the Delaware Secretary of State and entering into a LLC agreement ('LLC agreement' when referring to such agreements in general, in contrast to 'the LLC Operating Agreement' in relation to SPLLC).

(2) The business of SPLLC is carried on by the SPLLC itself and not by its members (so long as the question is whether as an entity with separate legal existence is engaged in business as such, and not whether the members are themselves active in the business, which they are required to be, see para [8](12), below).

(3) The assets used for carrying on the business belong beneficially to SPLLC and not to the members. The members have no interest in specific property of the LLC (s 18–701 of the Delaware LLC Act (6 Del C) ('the Act')).

(4) SPLLC (and not the members) is liable for the debts incurred as a result of carrying on business. The members have no liability for the liabilities of SPLLC.

[7] The experts are not agreed on the answers to the questions:

(1) Whether SPLLC has share capital or something which serves the same function as share capital. We believe that their problem is that the expression 'share capital' is not being used in the US. Mr Abrams made some comparisons between the member's interest in an LLC and a Delaware corporation and a Delaware partnership (which is a legal person), particularly a limited partnership. We did not find this useful as the task for us will be to compare the membership interest in a Delaware LLC with a UK company or partnership, and particularly Delaware partnerships are not the same as partnerships in England (although general partnerships seem to be more similar to Scots partnerships). What was helpful was their description of the nature of the membership interest in a Delaware LLC from which we derive the following:

(a) A Delaware 'limited liability company interest' is defined 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' (s 18–101(8) of the Act).

(b) That interest is in principle assignable except as provided in the LLC agreement and the assignee has no right to participate in the management or business except as provided in the agreement and on the approval of all the other members. The assignee does not become a member but becomes entitled to the same economic interest as the assignor (s 18–702 of the Act). It follows that although the definition of 'limited liability company interest' is in terms of a member's share of the economic benefits, the same economic benefits can be held by a non-member (this is confirmed by *Symonds and O'Toole on Delaware Limited Liability Companies* at §1.04[C][2] of which we were given an extract). Conversely, according to the same authors at §1.04[C][1] 'A person may be admitted as a member without acquiring a limited

liability company interest (ie economic rights) in the limited liability company' (citing s 18–301(d) of the Act).

(c) The LLC Operating Agreement provides that a member's interest in it may not be transferred except for sales by a former member (i) under provisions giving SPLLC a right of first refusal before any such sale, (ii) to a person engaged in the full-time business of the LLC with the written consent of the managing members and two-thirds of the other original members, or (iii) on death.

(d) 'A limited liability company interest is personal property. A member has no interest in specific limited liability company property' (s 18–701 of the Act).

(e) Subject to the LLC agreement the members manage the LLC and vote in proportion to their interest in profits (s 18–402 of the Act). The LLC Operating Agreement provides that the operation and policy of SPLLC is vested in the managing members (the appellant not being a managing member) who have power to contract on its behalf, but certain matters, such as mergers and incurring liabilities of more than $500,000 in a year, require the consent of the members. The managing members have higher voting percentages (52% between them) than the other original members (including the appellant) who have 8% each, and members other than original members do not have any voting rights.

(f) The experts considered that the member's interest in an LLC is not 'issued,' although we notice that in three places the LLC Operating Agreement refers to its being issued. These are first, s 16.1(a) in connection with exemption from registration under the Securities Act 1933, where 'issued' may be used in connection with all corporate bodies, secondly, s 16(2)(a) containing a representation that SPLLC has 'all necessary power and authority under the Act to issue the interests in [SPLLC] to be acquired by the Members hereunder,' and thirdly, s 16(2)(b) containing a representation that when the interests in SPLLC are acquired by the members and the initial capital contributions made 'the interest in [SPLLC] acquired by the Member will be duly and validly issued'. (References in a similar form to 's 16.1(a)' are all to the LLC Operating Agreement.)

Our finding of fact in the light of this evidence in relation to the membership interest in SPLLC 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). Normally a share in a UK company is transferable and needs to be registered and if there are restrictions on transfer these are that the consent of the directors (not all the other shareholders) is required.

(2) Whether the members of SPLLC have an interest in the profits of SPLLC as they arise. In summary, Mr Abrams' view was that they did, on the basis that distribution of the profit credited to the partner's capital accounts was mandatory (subject to there being available cash and to the other provisions of art V of the LLC Operating Agreement). If s 5.1 were considered to be ambiguous a Delaware court would admit the extrinsic evidence that all the profit was distributed each quarter in reaching this decision. Mr Abrams was 100% confident that a Delaware court would in the light of such evidence reach the conclusion that distribution was mandatory. Mr Talley's view was the members did not have an interest in the profits as they arose on the basis that s 5.1 of the LLC Operating Agreement did not provide for mandatory distribution but distribution at the discretion of the managing members. The following provisions of the Act are relevant:

(a) A Delaware 'limited liability company interest' is defined 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' (s 18–101(8) of the Act). This implies that the members have a share in the profits. The fact that the right to receive distributions is dealt with separately from the allocation of the profit suggests that the second part is dealing with what in a partnership situation is called drawings (in addition to distributions on a winding-up).

(b) 'The profits and losses of a limited liability company shall be allocated among the members, and among classes or groups of members, in the manner provided in a limited liability company agreement' (s 18–503 of the Act). There is a default rule if the LLC agreement does not so provide, which allocates them in proportion to the agreed values of members' contributions to the LLC. Accordingly, a member's right to receive distributions depends solely on the LLC agreement. The terms of the LLC Operating Agreement in this respect were a matter of dispute between the experts and we consider this next.

[8] The LLC Operating Agreement is made under Delaware law and contains the following provisions which are relevant to the issue (in addition to the ones already mentioned):

(1) Members make an initial capital contribution in the form of a note (see para [4]2.6, above, for the initial capital). Members agree to pay additional capital contributions as requested by the managing members. Failure to pay results in legal proceedings to recover the amount plus interest and damages, and the member's right to further allocations and distributions from the LLC may be suspended.

(2) Financial statements are to be kept on an accrual basis in accordance with generally accepted accounting principles and audited (s 12.3). The audited financial statements, which are consolidated statements including SUK and Sandpiper (Asia) Ltd, show in the balance sheet an amount for 'retained earnings' corresponding to the amount of net income shown in the consolidated statement of income for the year less distributions to members.

(3) Members are entitled on request to access the books and records and to information about the business as is just and reasonable (subject to limitations for members who are not original members, which are not applicable to the appellant who was an original member) (s 12.2).

(4) Capital accounts are maintained for each member, being increased by capital contributions and decreased by distributions to the member and adjusted in accordance with the LLC Operating Agreement (s 4.1). At least as often as annually capital accounts are adjusted as follows:

(a) All gross income and gains attributable to the various funds (in which the appellant had different profit sharing percentages) realised during the period are initially credited, and all losses, deductions and expenses attributed to each of the three named business funds are initially debited to the member's capital accounts pro rata in accordance with their sharing amounts for each fund. Losses deductions and expenses are attributed to each of the funds pro rata to the aggregate income and gains of each fund.

(b) Gross income and losses are reallocated among the members in proportion to adjustment amounts (defined in accordance with a complicated formula).

(c) There is a provision dealing with mergers and assets sales.

(d) Other items of income or gain are allocated pro rata in accordance with the members' capital accounts after making the above adjustments.

(e) Gross income and gains are reallocated from those members having negative unrecouped adjustments (a defined expression) to

members having positive unrecouped adjustments and vice versa for gross losses, deductions and expenses.

(f) If any allocation of losses, deductions or expenses would cause or increase a negative balance in a member's capital account this is reallocated to other members in proportion to their positive capital account balances and thereafter to members in proportion to their ownership amounts (defined as the overall percentage applicable to each member).

(g) The managing members shall determine in their reasonable discretion the appropriate timing and the realisation of any income or gains or losses, deductions and expenses. This appears to be of general application but it is possible that it relates to the timing on a member becoming a former member for which a cross-reference is made to this provision (s 4.2).

(5) 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. The allocations are to be made in accordance with certain provisions of the Internal Revenue Code based on the sole determination of the managing members. No member is entitled to require any allocation of any item or to demand any distribution on the ground that such action is necessary to cause the provisions of the LLC Operating Agreement to conform to those requirements of the Code. Within 90 days of the end of the fiscal year the LLC is to transmit to each member a report indicating his share of the income or losses for federal income tax purposes (s 12.7). We deduce from this, although we did not have any evidence on US tax, that the allocations to members' capital accounts are amounts that, subject to tax adjustments, represent taxable income in the US. While it is strange that the timing of the realisation of the items of income and expenditure is in the managing members' reasonable discretion if that applies for tax purposes we assume that if the discretion relates to the timing of income and expenditure in general, rather than the split between former members and members, the difference is dealt with in the adjustment of the profits for tax purposes.

(6) The connection between the allocations to members' capital accounts and US tax is confirmed by the US tax return on Form 1065 for SPLLC for 2000 (we did not have copies of the returns for other years, but infer that this is typical of all years under appeal). This summarises the trade or business income and expenses, and in Sch K the 'Partners' Shares of Income, Credits, Deductions etc'; it

also summarises in Sch L the balance sheet in the books; reconciles in Sch M-1 the income in the books with the income in the tax return after adjustment for such matters as guaranteed payments, non-deductible expenses, tax-exempt interest, and depreciation; and in Sch M-2 analyses the capital accounts by listing the opening balance, the income according to the books, the distributions and the closing capital accounts. Over the year 2000 the appellant's capital account increased by the excess of his share of book profit over the amounts distributed to him during the year. Another form, Partner's Share of Income, Credits, Deductions etc (Sch K-1), for the appellant reconciles the taxable income on the form with the share of book profit in a supporting schedule. 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. The situation for Massachusetts state tax is similar, the appellant's share of the book profit for 2000 for Massachusetts purposes being a marginally lower sum than that shown on Sch M-2, the difference being because not all the income arose in that state. We could not reconcile these figures with the figures in the financial statements kept in accordance with s 12.3 but we deduce that this is because these are consolidated statements.

(7) 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. Since the accounts are drawn up annually the allocation must be made annually but it can be done more often, for example in this case quarterly in order to make quarterly distributions. Contractually allocation in accordance with art IV is required and so it does not matter when it is done (it would need to be done in time for the 75-day time limit after the end of the calendar year in art V (see (8) below) to be satisfied).

(8) Article V 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 over losses, deductions and expenses allocated in accordance with Section 4.2 [summarised in (4)(a) to (g) above] 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

a sole discretion. The Managing Members may from time to time in their discretion make additional distributions in accordance with the provisions of this article V.'

b Distributions are made first to members pro rata to their adjusted additional capital amounts (additional capital contributions less distributions under s 5.1) until these are reduced to zero; then in accordance with the excess of the positive balance on the member's capital account over the member's adjusted initial capital amount (the initial capital contribution less distributions under this heading);
c then pro rata to positive balances on each member's capital accounts until reduced to zero; then pro rata to vested ownership amounts [the percentage in (4)(f) above or, if less, 1/60 multiplied by the number of months of membership]. The managing members may
d provide for periodic distributions which will be applied against distributions which otherwise be made in accordance with the above order of distributions (s 5.1(e)).

(9) The other provisions of art V referred to the beginning of s 5.1 are:

e (a) Set off is provided for any amount due from the member to the LLC (s 5.2);

(b) Amounts may be held in reserve as follows (s 5.3):

f '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 anticipated liabilities, contingent or otherwise, of
g the Company and to maintain the Company's status as a qualified professional asset manager with the meaning of the Department of Labor's Prohibited Transaction Class Exemption 84–14, as amended from time to time. Any such amounts held in reserve may, but need not be, invested by the
h Company in such interest bearing investments as the Company may determine in its discretion.'

(c) Withholding and paying US federal tax on behalf of the member (s 5.4).

i (10) On dissolution the assets are sold and the gains or losses are allocated to members in accordance with s 4.2. Next payment is made to members with unrecouped adjustments. Thereafter the order of distribution is (a) to creditors other than for liabilities for distributions to members and former members under art V, (b) to

members and former members in satisfaction of liabilities under art V, (c) to members and former members pro rata to their positive balances on capital accounts, (d) to members and former members pro rata to their vested ownership amounts (see (8) above). This implies that there can be balances on capital account that are not yet distributable under art V.

(11) A member can withdraw on giving written notice. A former member is entitled to the same allocations of income, gains, losses, deductions and expenses which are determined by the managing members to be realised prior to the termination date (see (4)(g) above) as he had continued to be a member. Former members shall be allocated and report distributive shares of the income consistent with the allocation rules provided for in arts IV and V and payments made to former members are considered payment of a distributive shares.

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

[9] In summary, Mr Peacock, supported by Mr Abrams contended that art IV allocated the profit to the members as it arose and art V required payment to be made within the 75 days (subject to the factors mentioned at the beginning of s 5.1). Mr Ewart, supported by Mr Talley, contended that art IV did not give the members a right to anything, it merely told one how much to pay to the member under art V when the managing members exercised their discretionary power to pay it. Mr Ewart said that art IV was analogous to the rights of 'freezer shares' (shares which carry rights to the current value of the company and any excess belongs to other shares). 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.

[10] We prefer Mr Peacock's contention. We regard it as important that 'limited liability company interest' is defined to include 'a member's share of the profits and losses of a limited liability company …' (s 18–101(8) of the Act), and that 'The profits and losses of a limited liability company shall be allocated among the members, and among classes or groups of members, in the manner provided in a limited liability company agreement' (s 18–503 of the Act) with a default rule if the LLC agreement does not so provide. The US tax returns for 2000 (and we infer all other years) show that the whole of the book profits are allocated to the members' capital accounts. 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. It is true, as Mr Talley said,

that the assets representing those profits do belong to the LLC until the distribution is 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. Conceptually, profits and assets are different, as is demonstrated by the reference to both in the definition of 'limited liability company interest' (see para [7](1)(a) above). There is a corresponding liability to the members evidenced by the allocation to their capital accounts rather than a balance of undistributed profits (even though that is what the audited accounts say, but they cannot override the terms of the LLC Operating Agreement in view of s 18–503 of the Act, which does not contemplate that profits can belong to the LLC as they must always be allocated to the members, and in any case they are consolidated accounts). 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 SPLLC have an interest in the profits of SPLLC as they arise.

[11] On that basis, the main dispute about s 5.1 on whether distributions were mandatory (subject to the other provisions of art V, and cash being available) or discretionary, is not relevant to the question of whether the profits belong to the members as they arise. We set out again the provision for convenience:

> 'Subject to the provisions of this Article V, to the extent cash is available, distributions of all of the excess of income and gains over 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 Article V.'

The difficulty of interpretation is that if distribution of *all* the excess *will* be made within the 75 days of the end of the calendar year (subject to the two matters stated at the beginning), how can the distributions be in such amounts as the managing members may determine in their sole discretion? Conversely, if distributions are at the discretion of the managing members, and therefore that the statement that the distribution of *all* the excess *will* be made within 75 days is merely an expression of a hope of achieving this, would it not be drafted differently to make this clear; and why would one say *will* (in contrast to *may* in the next sentence)? It would be more natural to say something on the lines of:

> 'The Managing Members may from time to time make distributions in such amounts as they may determine in their sole discretion it being

> the expectation of the parties that subject to the provisions of this Article V, and to the extent cash is available, distributions of all of the excess of income and gains over losses, deductions and expenses allocated in accordance with Section 4.2 with respect to any calendar year will if possible be made by the Company within seventy-five (75) days following the end of such calendar year.'

Looking at the wider context the fact that there is provision for a set-off seems neutral. The fact that cash can be retained on account of contingent liabilities (which we do not read as impacting on the determination of the excess as this has already been computed under art IV, and art V is dealing with cash distributions) or for maintaining status as a qualified professional asset manager would not be necessary if distributions are discretionary, but we can understand that this is the type of matter that it is desirable to spell out in any event. The power of the managing members to make additional distributions (second sentence of s 5.1) and periodic distributions (s 5.1.(e)) (which Mr Talley considered was included for payment of taxes) would be unnecessary if distributions were discretionary. Distribution on dissolution 'in satisfaction of liabilities for distributions under Article V' (s 11.2(d)) also suggests an obligation to make such distributions. The best compromise we can come up with, which we put to both experts, is that the managing members' discretion as to amounts is solely a discretion as to the amounts of separate distributions made during the 75 days, in which case *time* should be read as *time or times*. On this basis, the provision is saying that the excess must be distributed within 75 days subject only to the right to set off, make additional reserves in s 5.2 and to withhold taxes, and to cash being available. Such an interpretation sticks closely to the wording and is to be preferred to one that changes the imperative of *all*, *will* and the 75 days into an expression of a hope of doing so. It also gives effect to the power to make additional and periodic distributions. On that basis there is no ambiguity and no need to resort to extrinsic evidence. This interpretation admittedly gives a slightly odd result if cash is not available within the 75 days, in that distribution thereafter become discretionary, but the cash flow statement in the accounts show little adjustment between net income and net cash which enabled full distributions to be made for all years, and so the possibility of the lack of cash by the end of the 75 days may be something that the LLC Operating Agreement covers for as a legal eventuality rather than practical likelihood.

[12] In summary, our conclusion in relation to the LLC Operating Agreement is that the combined effect of s 18–503 of the Act and the terms of art 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 s 5.1.

THE DOUBLE TAXATION RELIEF ISSUE

[13] The appellant claims relief under art 23(2) of the UK–US Double Tax Convention of 31 December 1975 (as set out in Sch 1 to the Double Taxation Relief (Taxes on Income) (The United States of America) Order 1980, SI 1980/568) for the years of assessment up to 2002–03. Article 23(2) provided as follows:

> '(2) Subject to the provisions of the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax of tax payable in a territory outside the United Kingdom (as it may be amended from time to time without changing the general principle hereof)—
>
> (a) United States tax payable under the laws of 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 10 percent of the voting powers in 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.'

For the year of assessment 2003–04, the appellant relies upon art 24(4) of the UK–US Double Tax Convention of 24 July 2001 (as set out in Sch 1 to the Double Taxation Relief (Taxes on Income) (The United States of America) Order 2002, SI 2002/2848). Article 24(4) of the 2001 treaty is in equivalent form to art 23(2) of the 1975 treaty.

[14] So far as Massachusetts state tax is concerned the issue is whether unilateral relief applies. Section 790(4) of the Income and Corporation Taxes Act 1988 ('ICTA 1988') provides:

> 'Credit for tax paid under the law of the territory outside the United Kingdom and computed by reference to income arising or any chargeable gain accruing in that territory shall be allowed against any

United Kingdom income tax or corporation tax computed by reference to that income or gain …'

[15] Mr Peacock, for the appellant, contends in outline:

(1) The appellant is liable to tax in the UK on his share of the profits of SPLLC which are the same profits that were taxed in the US and he is accordingly entitled to credit under the treaty.

(2) Applying the principles in *Memec plc v IRC* (1998) 1 ITLR 3, [1998] STC 754, SPLLC is a transparent entity, the profits of which are taxable as they arise.

[16] Mr Ewart, for HMRC, contends in outline:

(1) If SPLLC is transparent the appellant is entitled to relief for US tax; if it is opaque he is not.

(2) Applying the approach in *Memec* to SPLLC: it is a legal entity; it (and not the members) carries on its business; it carries on its business as principal; it (and not the members) is liable for its debts and obligations; and it (and not the members) owns the business and has a beneficial interest in all of the profits of that business. All these factors point to SPLLC being an opaque entity. The appellant was taxed in the UK on a separate source of income which derived from his rights as a member under the LLC Operating Agreement. Accordingly he is not entitled to relief.

[17] We start by emphasising that we are concerned with whether relief applies in relation to the profits of this particular Delaware LLC, SPLLC, which, since there is wide freedom to contract the terms of a Delaware LLC, may not be of general application.

[18] The appellant was charged to tax in the US on his share of the profits of SPLLC. The issue is whether the UK tax is 'computed by reference to the same profits or income' or whether he is taxable on the equivalent of a dividend. Asking whether SPLLC is transparent or opaque may be another way of asking the same question but we consider that it is preferable to apply the words of the treaty. We did not find helpful Mr Ewart's approach of asking what was the source of the income, to which his answer was that it was the LLC Operating Agreement rather than the business of SPLLC. For that reason we can 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.

[19] The most recent authority concerning the classification for UK tax purposes of a foreign organisation, a German typical silent partnership, is *Memec plc v IRC* in which Peter Gibson LJ's approach was ((1998) 1 ITLR 3 at 16–18, [1998] STC 754 at 764–765):

'What in my judgment we have to do in the present case is to

consider the characteristics of an English or Scottish partnership which make it transparent and then to see to what extent those characteristics are shared or not by the silent partnership in order to determine whether the silent partnership should be treated for corporation tax purposes in the same way. The judge aptly cited the remark of Rowlatt J in *Garland v Archer-Shee* (1929) 15 TC 693 at 711 in relation to an American trust:

> "The question of the American law is, what are exactly the rights and duties of the parties under an American trust, and when you find what those rights and duties are, you see what category they come in, and the place they fill in the scheme of the English Income Tax Acts which the Courts here must construe".

The relevant characteristics of an ordinary English partnership are these:

(1) the partnership is not a legal entity;

(2) the partners carry on the business of the partnership in common with a view to profit (s 1(1) Partnership Act 1890);

(3) each does so both as principal and (s 5 ibid) as agent for each other, binding the firm and his partners in all matters within his authority;

(4) every partner is liable jointly with the other partners for all debts and obligations of the firm (s 9 ibid); and

(5) the partners own the business, having a beneficial interest, in the form of an undivided share, in the partnership assets ([*MacKinlay* (*Inspector of Taxes*) *v Arthur Young McClelland Moores & Co* [1989] STC 898 at 900], [1990] 2 AC 239 at 249 per Lord Oliver), including any profits of the business.

A limited partnership differs relevantly only in the following respects:

(a) (2) and (3) above are modified in that the limited partner takes no part in the management of the partnership business (s 8(1) Limited Partnership Act 1907), the ordinary partners acting on his behalf as well as on their own behalf;

(b) the limited partner on entering the partnership is obliged to make a contribution of a sum or sums as capital or property of a stated amount and (4) above is modified in that the limited partner is only liable up to, not beyond, the amount so contributed.

No findings of fact were made by the Special Commissioner or agreed facts as agreed facts in relation to Scottish partnerships and the judge commented, at p 1352m, that there was, strictly speaking, no evidence before him as to Scottish law. There should of course have been such evidence if it was sought to be relied on by plc. But the

judge rightly said that it would be unrealistic to pretend to be unaware of s 4(2) of the 1890 Act or of the fact that in practice a Scottish partnership is taxed in the same way as an English partnership. Mr Venables and Mr Ghosh have taken us to statements in the leading Scottish textbooks. They and the provisions of the 1890 Act, most of which apply indifferently to English and Scottish partnerships, show that a Scottish partnership differs in the following respects:

(a) (1) above does not apply: the partnership is a legal entity distinct from the partner of whom it is composed, but an individual partner may be charged on a decree of diligence directed against the firm, and on payment of the firm's debts is entitled to relief pro rate from the firm and his other partners (s 4(2) of the 1890 Act;)

(b) (3) above is also modified in that the partner is not a principal but is an agent of the firm and his partners;

(c) (4) above is modified in that the partner is not only jointly but also severally liable;

(d) (5) above is modified in that the assets of the partnership are vested in the partnership legally and beneficially, the interest of each partner in the partnership property being described by Bell as "a *pro indiviso* right in the stock or common fund vested in the partners, firstly for payment of the company debts and then for the partners themselves" ([*Bell's Commentaries on the Law of Scotland*] 11, 501); of the consequences of this, as described by Bell, is "the peculiarity that heritable subjects belonging to and held by a company are considered not as heritable in succession but as movable, consisting of *jus crediti* only" (*Stair* (1995) Vol 16, para 1073). However the partner has an interest which may be arrested (or seized) by his separate creditors, but only in the hands of the firm, and specific property of the partnership cannot be arrested by such creditors (*Gloag & Henderson: Law of Scotland* 10th ed (1995) para 50.18).'

Perhaps because the emphasis in that case was directed to whether a German typical silent partnership was similar to an English or Scottish partnership, there is no reference to share capital, which is one of HMRC's tests.

[20] Although we have said that we prefer to concentrate on the words of the treaty rather than ask whether SPLLC is transparent or opaque, we shall apply the *Memec* approach to it. We have considered above the characteristics of SPLLC in accordance with Delaware law and concluded that it (and not the members) carries on its business as principal; it (and not the members) is liable for its debts and obligations; and it (and not the members) owns the business; and it does not have anything equivalent to

share capital. However, the members are entitled to the profits as they arose. We can compare it with an English or Scottish partnership and a UK company. There is a spectrum running from—

(1) the English partnership: not a legal person, with the partners owning the assets jointly and incurring the liabilities, carrying on the business, and being entitled to the profits; through

(2) the Scots partnership: legal person (in consequence of an agreement) owning the assets and incurring the liabilities with a secondary liability on the partners, with the partners nevertheless carrying on the business (since that is the definition of partnership) and being entitled to the profits; to

(3) the UK company: legal person (in consequence of registration) owning the assets and incurring the liabilities with no liability on the members (or a liability only on winding-up for an unlimited company) and carrying on its business with the members holding shares and being entitled to profits only after either payment by the directors or recommendation by the directors and a resolution to declare dividends by the members. (Mr Peacock pointed out that the articles of a UK company could provide for automatic dividends: see *Bond v Barrow Haematite Steel Co* [1902] 1 Ch 353, 71 LJ Ch 246, *Re Accrington Corpn Steam Tramways Co* [1909] 2 Ch 40, 78 LJ Ch 485, although it seems that in neither of these cases the articles did so.)

SPLLC stands somewhere between a Scots partnership and a UK company, having the partnership characteristics of the members being entitled to 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 liability on the members and there being some separation between managing members and other members falling short of the distinction between members and directors. 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.

[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.

SECTION 739

[22] Having decided the main issue in favour of the appellant the second issue does not arise but we shall deal with the arguments. It is common

ground that the conditions for s 739 ICTA 1988 applying are fulfilled and accordingly in principle a proportion of the income of SPLLC is deemed to be the appellant's by s 739(2):

> '(2) Where by virtue or in consequence of any such transfer, either alone or in conjunction with associated operations, such an individual has, within the meaning of this section, power to enjoy, whether forthwith or in the future, any income of a person resident or domiciled outside the United Kingdom which, if it were income of that individual received by him in the United Kingdom, would be chargeable to income tax by deduction or otherwise, that income shall, whether it would or would not have been chargeable to income tax apart from the provisions of this section, be deemed to be income of that individual for all purposes of the Income Tax Acts.'

The consequence is that he would be entitled to double taxation relief, either in principle or as specifically provided by s 743(2):

> '(2) In computing the liability to income tax of an individual chargeable by virtue of section 739, the same deductions and reliefs shall be allowed as would have been allowed if the income deemed to be his by virtue of that section had actually been received by him.'

The appellant is non-domiciled and so s 743(3) is potentially relevant but he has remitted all the income after payment of US tax (and if he remits income net of foreign tax this is grossed-up by the amount of foreign tax by s 795 and credit can be claimed):

> '(3) An individual who is domiciled outside the United Kingdom shall not be chargeable to tax in respect of any income deemed to be his by virtue of that section if he would not, by reason of his being so domiciled, have been chargeable to tax in respect of it if it had in fact been his income.'

[23] However the application of s 739 is subject to s 741:

> 'Sections 739 and 740 shall not apply if the individual shows in writing or otherwise to the satisfaction of the Board either—
>
> (a) that the purpose of avoiding liability to taxation was not the purpose or one of the purposes for which the transfer or associated operations or any of them were effected; or
>
> (b) that the transfer and any associated operations were bona fide commercial transactions and were not designed for the purpose of avoiding liability to taxation.
>
> The jurisdiction of the Special Commissioners on any appeal shall include jurisdiction to review any relevant decision taken by the Board

in exercise of their functions under this section.'

[24] Mr Graham Ronald Turner, senior technical adviser in relation to the transfer of assets legislation, gave evidence that he, as the delegate of the Board for this purpose, was satisfied that s 741 was applicable on the basis of the information provided by the appellant through his advisers even though that was not specifically directed as s 741 being satisfied.

[25] Mr Peacock made various criticisms of Mr Turner's approach as set out in his witness statement, suggesting that he could not have been satisfied that paying tax on 55 out of a share of profits of 100 did not avoid income tax.

[26] Mr Ewart contended that the appellant has shown in writing or otherwise to the satisfaction of the Board that the conditions in both paragraphs of s 741 were satisfied, and so s 739 cannot apply.

[27] As we have already stated, if HMRC were right on the main issue, the financial effect would be that out of the appellant's share of a profit of 100 roughly 45 has been paid in US tax, 55 has been distributed to him and 22 tax would be charged in the UK, for which no credit for US tax would be available. If s 739 applied his income would be 100 on which he would pay tax in the UK of 40 but the whole of the UK tax would be covered by double taxation relief for the US tax paid of 45. If s 741 is not satisfied so that s 739 applies, the effect would be that instead of his paying UK tax 22 he would pay no UK tax after double taxation relief. We cannot see that, on this basis, the appellant would have avoided any UK taxation and so we cannot see how he can have had the purpose of avoiding liability to taxation. We entirely agree with Mr Turner's conclusion that one or both of the conditions in s 741 is satisfied and whatever the scope of our review we would have come to the same conclusion.

[28] Accordingly, if we had decided the first issue in favour of HMRC, s 739 would not provide double taxation relief to the appellant.

DISCOVERY ASSESSMENT

[29] As we have decided the first issue in favour of the appellant this issue does not arise either but we will deal with it. Section 29 of the Taxes Management Act 1970 (as in force at the time of the discovery assessments) provides:

> '(1) If an officer of the Board or the Board discover, as regards any person (the taxpayer) and a year of assessment—
>
> (a) that any income which ought to have been assessed to income tax, or chargeable gains which ought to have been assessed to capital gains tax, have not been assessed, or
>
> (b) that an assessment to tax is or has become insufficient, or

(c) that any relief which has been given is or has become excessive, the officer or, as the case may be, the Board may, subject to subsections (2) and (3) below, make an assessment in the amount, or the further amount, which ought in his or their opinion to be charged in order to make good to the Crown the loss of tax.

(2) Where—

(a) the taxpayer has made and delivered a return under section 8 or 8A of this Act in respect of the relevant year of assessment, and

(b) the situation mentioned in subsection (1) above is attributable to an error or mistake in the return as to the basis on which his liability ought to have been computed,

the taxpayer shall not be assessed under that subsection in respect of the year of assessment there mentioned if the return was in fact made on the basis or in accordance with the practice generally prevailing at the time when it was made.

(3) Where the taxpayer has made and delivered a return under section 8 or 8A of this Act in respect of the relevant year of assessment, he shall not be assessed under subsection (1) above—

(a) in respect of the year of assessment mentioned in that subsection; and

(b) … in the same capacity as that in which he made and delivered the return,

unless one of the two conditions mentioned below is fulfilled.

(4) The first condition is that the situation mentioned in subsection (1) above is attributable to fraudulent or negligent conduct on the part of the taxpayer or a person acting on his behalf.

(5) The second condition is that at the time when an officer of the Board—

(a) ceased to be entitled to give notice of his intention to enquire into the taxpayer's return under section 8 or 8A of this Act in respect of the relevant year of assessment; or

(b) informed the taxpayer that he had completed his enquiries into that return,

the officer could not have been reasonably expected, on the basis of the information made available to him before that time, to be aware of the situation mentioned in subsection (1) above.

(6) For the purposes of subsection (5) above, information is made available to an officer of the Board if—

(a) it is contained in the taxpayer's return under section 8 or 8A of this Act in respect of the relevant year of assessment (the return), or in any accounts, statements or documents accompanying the return;

(b) it is contained in any claim made as regards the relevant year of assessment by the taxpayer acting in the same capacity as that in

which he made the return, or in any accounts, statements or documents accompanying any such claim;

(c) it is contained in any documents, accounts or particulars which, for the purposes of any enquiries into the return or any such claim by an officer of the Board, are produced or furnished by the taxpayer to the officer, whether in pursuance of a notice under section 19A of this Act or otherwise; or

(d) it is information the existence of which, and the relevance of which as regards the situation mentioned in subsection (1) above—

(i) could reasonably be expected to be inferred by an officer of the Board from information falling within paragraphs (a) to (c) above; or

(ii) are notified in writing by the taxpayer to an officer of the Board.

(7) In subsection (6) above—

(a) any reference to the taxpayer's return under section 8 or 8A of this Act in respect of the relevant year of assessment includes—

(i) a reference to any return of his under that section for either of the two immediately preceding chargeable periods; and

(ii) where the return is under section 8 and the taxpayer carries on a trade, profession or business in partnership, a reference to any partnership return with respect to the partnership for the relevant year of assessment or either of those periods; and

(b) any reference in paragraphs (b) to (d) to the taxpayer includes a reference to a person acting on his behalf.

(8) An objection to the making of an assessment under this section on the ground that neither of the two conditions mentioned above is fulfilled shall not be made otherwise than on an appeal against the assessment.

(9) Any reference in this section to the relevant year of assessment is a reference to—

(a) in the case of the situation mentioned in paragraph (a) or (b) of subsection (1) above, the year of assessment mentioned in that subsection; and

(b) in the case of the situation mentioned in paragraph (c) of that subsection, the year of assessment in respect of which the claim was made.'

[30] The appellant's UK tax returns for the years relevant to the discovery assessments contained the profit allocated to him on the partnership supplementary pages, and claimed double taxation relief for US tax on the foreign supplementary pages on the same profit figure but with the US tax limited to 40%. The partnership trade or profession (box

4.2) was stated to be 'Sandpiper Partners LLC.'

[31] In relation to an enquiry for 2000–01 (not a year covered by the discovery assessments) the inspector raised the issue of double taxation relief claims on the information in the return and before he had received a copy of the LLC Operating Agreement.

[32] Mr Peacock contended that as it was HMRC's published view since June 1997 that credit for what HMRC considered to be underlying tax paid by a LLC was not available for credit by an individual, and as the tax return stated that this was a LLC, HMRC could not make a discovery assessment.

[33] Mr Ewart contends that in accordance with the Court of Session decision in *R (on the application of Pattullo) v Revenue and Customs Comrs* [2009] CSOH 137, [2010] STC 107:

> '[101] In my view on a proper understanding of Auld LJ's position in *Veltema* the proper approach to the circumstances in which an assessment under s 29 can be made is a two-step process which is set forth in *Corbally-Stourton v Revenue and Customs Comrs* [2008] STC (SCD) 907, para 59:
>
> > "(i) he [the officer] newly comes to the conclusion that it is probable that there was an insufficiency; and
> >
> > (ii) at the relevant time an officer of the Board could not reasonably have been expected, taking into account the general knowledge and skill that might reasonably be attributed to him, and on the basis only of the s 29(6) information, to have concluded that it was probable that there was an insufficiency …"
>
> Applying a test in those terms would fit in with all the authorities to which I was referred.
>
> [102] In my opinion the test has to be a two-stage one to fit in with the underlying purpose of the scheme. The officer has to discover something new otherwise the underlying purpose of early finality of assessment would be defeated. His assertion of the newly discovered insufficiency is then tested against the adequacy of the disclosure by the taxpayer. It is only if the taxpayer has made a return which has clearly alerted the officer to the insufficiency that it will be considered adequate and will shut out a s 29 discovery assessment.'

In that case there had been the following disclosure:

> **'Capital Redemption Contract**
>
> 1. On 24 February 2004 I settled an interest in possession trust with £6,000.
>
> 2. The trust is called "The Pattullo 2004 Life Interest Settlement".
>
> 3. I had borrowed on commercial terms a sum of £2,665,000 from

Investec Bank UK Limited and settled this amount into the trust.

4. The trustees "Nexus Trustee Company Limited" used the funds to acquire a number of capital redemption contracts to me on 4 March 2004.

5. I surrendered the Capital redemption contracts on 8 March 2004 and received redemption proceeds of £2,600,000.

6. This has given rise to a capital loss as a consequence of Section 37(1) TCGA 1992 amounting to £2,665,000.'

This disclosure was insufficient to alert HMRC:

'[115] I do not believe for the foregoing reasons that Mr Johnston [for the taxpayer]'s position that the full factual and legal position is set forth in the white space is correct. The full factual position would have included a statement that the petitioner was part of such a scheme and a full statement of the legal position would have included a statement of doubt or a statement that a contrary position to the HMRC was being insisted upon together with a clearer picture of the operation of the scheme. I believe it is a fair conclusion to hold that the disclosure in the white space is a carefully crafted disclosure seeking to pass through the initial checks carried out by HMRC but in no way meeting the test of clearly alerting to an actual insufficiency.'

[34] We consider that the combination of using the partnership pages of the tax return together with name being Sandpiper *Partners* outweighed the addition of 'LLC' after the name and it would be unreasonable to assume that this would have been sufficient to have alerted HMRC. If the income had been reported, correctly we believe, on the foreign pages coupled with the double taxation relief claim on the same pages we consider that an ordinary competent inspector would have spotted the reference to 'LLC' and would have known of HMRC's published view that no double taxation relief was available even without a specific reference to the fact that the appellant was taking a different view. But coupled with the use of the partnership pages which led the inspector to believe that the entity was a partnership and, as can be deduced from the double taxation relief claim, a US partnership, we do not consider that a reasonable inspector could be expected to work out solely from the 'LLC' in the name that both it was not a partnership and no double taxation relief was available. Accordingly we do not consider that HMRC would have been prevented by s 29 from raising the discovery assessments.

[35] In summary our decision is:

(1) The appellant is entitled under the treaty to double taxation relief for the federal US tax paid on his share of the profits of SPLLC

and to unilateral relief for the Massachusetts state tax on such profits, and we allow the appeal in principle.

(2) If we are wrong on (1) s 739 of ICTA 1988 would not apply to entitle the appellant to such relief.

(3) If we are wrong on (1) HMRC would be entitled to make discovery assessments for the years 1997–98 to 1999–2000.

[36] The parties have a right to apply for permission to appeal against this decision pursuant to r 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009, SI 2009/273. The parties are referred to 'Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)' which accompanies and forms part of this decision notice.

Appeal allowed.