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

By: Michael W. Galligan

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This is the second part in a three-part series on an introduction to the cross-border tax treatment of U.S. limited liability companies. To view the first part published in the June TaxStringer, please click here. Please look for the final part in the August issue.

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

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

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

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

Let us first examine the case of a U.S. person who is investing abroad through a U.S. LLC. Foreign jurisdictions do not necessarily have an equivalent of IRC section 351, which makes contributions of appreciated property to a corporation a non-recognition event as long as the control of the corporation remains basically the same before and after the contribution. A contribution of appreciated property such as real property located in a foreign country to a U.S. LLC could trigger capital gains tax in the foreign country even though there might be no U.S. tax. Moreover, if a U.S. LLC is engaged in an overseas business and then terminates that business and liquidates, such liquidation could be treated as a corporate liquidation in the foreign country, giving rise to possible gains or other taxes in the foreign country (especially if appreciated property is involved), while there might be little or no tax due in the United States with respect to such liquidation.

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

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

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

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

We now consider issues about the global tax treatment of U.S. LLCs under income tax treaties between the United States and other countries. Keep in mind that income tax treaties offer many important benefits, such as (1) reduced rates of or exemption from withholding tax by the source country on certain types on income such as dividend, interest, and royalty payments; (2) reduced rates of or exemption from the branch profits tax; (3) exclusion of certain types of gain from taxation in a treaty-partner country; (4) exemption of profits from tax in a treaty-partner country that would not be considered income of a permanent establishment as defined by the treaty; and (5) the availability of credits for taxes paid to a treaty-partner country.

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

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

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

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Michael W. Galligan *is a partner in the trusts and estates, tax and immigration practice of Phillips Nizer LLP in New York, N.Y. Mr. Galligan is a member of the International Academy of Trusts and Estates Law, STEP, and ACTEC. He is a former chair of the International Section of the New York State Bar Association and recently served as an at-large member of the Association's executive committee.*