

THE ISLE OF MAN LIMITED LIABILITY COMPANY OR "LLC": PART III

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Taxation of the LLC

(A) Taxation in the Isle of Man

In an earlier part of this article reference was made to the principle of the taxation of the LLC as being to exclude the LLC from taxation liability and to impute its taxable income/profits to its members.

The provisions giving effect to this principle are set forth in section 46 of the 1996 Act and are expanded upon in that section and also in section 47.

However, a review of the provisions of the 1996 Act shows that the position in regard to taxation is not quite that simple. It is appropriate to look at two kinds of case:

The LLC where one or more members are Isle of Man-resident

Section 46(1) provides that any LLC is to be treated as if it is a partnership and that each member of the LLC is to be treated as a partner. Section 46(2) provides that in consequence the LLC is not liable to pay Isle of Man income tax on its profits and each member is to be liable to pay Isle of Man income tax at the appropriate rate in respect of his whole income including his share of the profits of the LLC. Section 46(3) contains provisions for recovering tax from an attorney or agent of individual members, and related provisions are to be found in the ordinary Isle of Man Tax Acts. But there are two provisions that call for specific comment:

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Section 46(4) of the 1996 Act provides that no deductions, allowances or reliefs which can be taken into account in the calculation of the taxable income of a body corporate and which but for the deeming provisions (treating the LLC as a partnership and each member as a partner) could have been taken into account in calculating the taxable income of any LLC, shall be allowed or taken into account in the calculation of the profits of the LLC or the portion of the taxable income of a member arising from that member's share of the LLC.

This is a strangely worded provision. Looked at broadly, one would infer that it is an attempt to state that the profits of the LLC are to be divided amongst its members and apportioned rateably between them - presumably in proportion to their capital contributions. But the provisions themselves do not say this. What they appear to be saying is that no deductions, allowances or reliefs which could reduce the taxable profit is to be allowed or taken into account in calculating the profit of the LLC or the portion of taxable income of a member in respect of his share of those profits. This appears to be similar to the provisions applicable to the punitive legislation in the United Kingdom to be found in sections 739 to 745 Income and Corporation Taxes Act 1988 and by reference to which income payable to an overseas company which was sought to be attributed to United Kingdom resident individuals eligible to benefit from such income, was to be attributed without regard to any deductions other than those which could be made by the particular individual if the relevant attributed income had been received by him direct in the first place; and even then, the only reason that such deductions were permitted was because the Act said so (and it does not say so in the particular provisions now under review). It does not seem that this was the intended effect of the provisions and further clarification of their purport and meaning would seem to be desirable.

Section 47(1) of the 1996 Act provides for a return in the prescribed form in respect of the income of members of the LLC to be made and delivered by the registered agent and which return should state the names of the members and the proportion of profits to which they are severally entitled and for the registered agent to be deemed to be the agent of each member. Section 47(2) of the 1996 Act provides for the registered agent to have any necessary rights of access to the LLC records. Section 47 also provides for a member present in the Isle of Man (who has similar rights of access to records) or, if none, any attorney or agent for any member, to make such return if there happens to be no registered agent - see (3), (4) and (5) of section 47. Provisions in section 47(6) and (7) also stipulate that if the Assessor of Income Tax is not satisfied with the return, he can require the person making it to appear before him to verify on oath the statements contained in the return or to produce oral and documentary evidence in support of it as the Assessor may require. If he fails to attend or to produce, or the Assessor is not satisfied, the Assessor can make an assessment. Taken with the provisions

in the existing Isle of Man legislation for an attorney or agent to pay Isle of Man income tax as attorney or agent of the individual members of the LLC, this is potentially capable of abuse. In conventional cases returns have to be made in writing. If they are made the Assessor can require further information under ordinary powers but he cannot require a person making a return to appear before him or to produce oral or documentary information to support the return. In effect, the Assessor is endowed with the character of an inquisitor or examining magistrate in continental countries and appears to have a status analogous to that of a member of the Internal Revenue Service in the USA. This is going too far in enforcing tax liabilities and will need to be kept under review and limited in scope if, as is potentially likely, there proves to be scope for abuse.

The LLC where all members reside outside the Isle of Man

There are provisions contained in sections 37 to 45 of the 1996 Act which are expressed to apply to each LLC in which all the members reside outside the Island. For these provisions to apply the following conditions precedent have to be satisfied:

- (a) all members must be resident outside the Isle of Man;
- (b) the LLC must be duly registered;
- (c) the LLC must not carry on or transact "any trade or business which is prescribed". What trades or businesses are thus prescribed are specified in Treasury Regulations which came into force on 17th October 1996. These Regulations are the Limited Liability Companies (Income Tax) (General) Regulations 1996 and the prescribed trades and businesses are detailed in paragraph 3 of those Regulations. These consist of trades or businesses involving:
 - (1) the manufacture of goods in the Isle of Man;
 - (2) the offering for sale of goods in the Isle of Man or at or from any premises or place in the Isle of Man;
 - (3) the exploration for or extraction of minerals or petroleum in the Isle of Man;
 - (4) fishing operations in the Isle of Man;
 - (5) livestock breeding or agriculture or horticulture in the Isle of Man;

- (6) distribution in or transport to or from the Isle of Man of goods;
- (7) land development in the Isle of Man;
- (8) construction operations in the Isle of Man;
- (9) land trading or dealing in Isle of Man land;
- (10) trustee services in or from the Isle of Man or to persons in the Isle of Man;
- (11) custodian services in respect of Isle of Man property or for the benefit of any Isle of Man resident;
- (12) providing or offering corporate services in or from the Isle of Man or to Isle of Man residents;
- (13) providing or offering legal or accountancy services in or from the Isle of Man or to persons in the Isle of Man.

In general the prohibited activities strongly resemble those excluded from re-investment relief in the UK Finance Act 1994.

- (d) neither the LLC **nor any member in it** must be -

the holder of a banking licence;

authorised to carry on insurance business under section 6 of the Insurance Act 1986. This appears to indicate that the holder of a permit to transact insurance business (usually being a company not incorporated or not resident in the Isle of Man and regulated by the United Kingdom Department of Trade or other acceptable overseas insurance authority) may be outside this particular restriction;

the holder of a full licence under the Investment Business Act 1991; or

some other "prescribed.....class of person" - as yet unknown but presumably to be specified in regulations yet to be published.

- (e) the Assessor must be satisfied that the LLC will not carry on or transact any trade or business in the Isle of Man unless it is such that receipts and income arise outside the Isle of Man or from dealings with certain Isle of Man tax-exempt bodies such as exempt companies, international companies or

international partnerships, and in either case originate from persons not residing in the Isle of Man;

- (f) no person resident in the Isle of Man (other than an exempt organisation) will have an interest in the LLC other than as a member or creditor quoted on a Stock Exchange or is a public company complying with prescribed conditions and which is either a member or creditor of the LLC .

There are limitations on these conditions but these are not considered appropriate to detail in this article.

Any LLC which satisfies these conditions and in respect of which a status certificate is issued by the Assessor is hereafter referred to as an "International LLC"

It should be noted here that if any LLC has only one out of a large number of non-resident members who actually resides in the Island, then the LLC is disqualified from being an International LLC.

The importance of an International LLC is to be found in section 38 of the 1996 Act, which provides that a member of an International LLC "shall not be liable to pay income tax in respect of income received from" that LLC. This therefore exempts the member from the provisions about returns, accountability for Isle of Man tax and investigations by the Assessor which were outlined earlier in this section of the article.

Section 39(1) to (5) of the 1996 Act provides for applications for status certificates to be made within certain time limits and for these to consist of a completed application form, a declaration and undertaking executed by the registered agent and £300 or such other sum as may be prescribed. There are provisions for appealing this last-mentioned amount for part of a period.

Under section 39(6) the Assessor can require an International LLC or prospective such body to produce to him the Balance Sheet and Profit and Loss Account for each year of assessment, such other accounting records as he may require and a copy of the articles of organisation and operating agreement.

There are also provisions in section 40 of the 1996 Act whereby if in any particular case the Assessor is satisfied that provisions of relevance have been contravened, he can assess the income of the members of the International LLC subject to "de minimis" rules and subject to the right of an assessed member to appeal.

Section 41 of the 1996 Act provides that on failure to comply with section 39 in regard to the production of accounts, records etc., the usual fine (of £5,000) is leviable; and a similar fine or imprisonment is exigible if a false statement or declaration is made.

From the foregoing it is apparent that the LLC is of potential benefit to its would-be users but that it is hedged about with sanctions, prospective penalties and requirements which are potentially so capable of threatening the uses to which it may be put as being sufficiently daunting to discourage prospective applicants or users from taking advantage of its provisions. It may be that time will show that the authorities charged with its operation will demonstrate a degree of moderation in the enforcement of its provisions which will ultimately temper the fears of persons such as the writer in regard to the potential threats to use and liberty which are implicit in the foregoing. But the caveats mentioned above must be appreciated by any would-be LLC member or user and especially by anyone who would be a registered agent of any particular LLC.

The Isle of Man Government Treasury has published a Practice Note (Reference PN65/96) dated 4th November 1996 under the hand of the Isle of Man Assessor of Income Tax which deals with the 1996 Act. A perusal of its provisions indicates a general intention to provide help to would-be proponents of the LLC. The Practice Note nevertheless ends with these words:

“This Practice Note is intended only as a general guide and must be read in conjunction with the appropriate legislation. It does not have any binding force and does not affect a person’s right of appeal on points concerning their own liability to tax.”

This statement tends to be disingenuous. The provisions of the 1996 Act, which are in some measure at variance with the contents of the Practice Note, are all, where so at variance, more favourable to an Isle of Man taxpayer by reference to the provisions of the Practice Note than they are as set forth in the legislation.

The Note consists of seven numbered paragraphs. Of these, paragraph 1 is introductory, paragraphs 2, 3, 4 and 5 relate to International LLCs and paragraph 7, under the heading “Further Information” states where copies of the legislation and of the application form for International LLC status can be obtained, as well as inviting enquiries relating to the completion of forms and further taxation information to be obtained from the Income Tax Division or the Tax Exempt Companies (TEC) Officer. Paragraph 6 of the Practice Note, however, is worthy of specific note. It is headed “Resident LLCs” and is intended to be a reference to those LLCs which are not International LLCs. Quite how the LLC can be regarded as resident or non-resident when it is not a company incorporated under

the Companies Acts and when it is in consequence not subject to the general rules concerning management and control as dictating the liability of an Isle of Man LLC to Isle of Man income tax, is not clear. Paragraph 1.2 of the introductory paragraph describes the LLC as "a legal entity separate from its members" but certainly does not give any indication to show that it is to be equated with a conventional incorporated company - which would therefore regulate whether it had residential status and how that status was to be determined.

Paragraph 6 states that:

"A resident LLC comes within the normal provisions of the Income Tax Acts and is treated as a partnership."

In listing six consequences of this, the first three of which are unexceptional, it then states that:

"The share of profits of each member will be taxed in their hands in accordance with normal income tax principles as applicable to that person; the deductions, allowances and reliefs available to an LLC are those available to a partnership and therefore those specific to corporate entities do not apply to an LLC, e.g. dividends and group relief; where the Assessor is not satisfied with the return submitted by an LLC the application of the provisions of section 84 of the Income Tax Act 1970 (as amended) will be in respect of the assessments issued to the members."

These statements are at variance with the provisions of sections 46 and 47 of the 1996 Act, which have been outlined earlier in this section of this paper. What makes it particularly disturbing is that the second of the three points mentioned above indicates that only dividends and group relief are excluded from the categories of deductible items available in computing the profits of the LLC, whereas section 46(4) indicates in clear words the intention that no deductions, allowances or reliefs will be available in computing the assessable (to Manx income tax) profits of the LLC which are attributed under the 1996 Act to its members.

Although not to be commented upon at this time in this paper, it should be noted that the 1996 Act contains no reference to section 84 of the Isle of Man Income Tax Act 1970 as such. Indeed, the assessment provisions are those set forth in section 47 of the 1996 Act and referred to above and which provisions have no counterpart in the other provisions of the Isle of Man Income Tax Acts.

APPENDIX

Taxes (and like contributions) other than Isle of Man Income Tax

So far this paper has been concerned with the taxation of the LLC in respect of the taxation of its income/profits. As has already been explained, Isle of Man taxation in this context is a reference to Isle of Man income tax only as regards the income/profits, since there is no other Isle of Man taxation liability as regards these items.

The 1996 Act is totally silent about other taxes which are or could be of actual or potential relevance to the activities of the LLC. As the LLC is entirely a creature of statute having no common law nor even any statutory or regulatory provision governing its incidents apart from the 1996 Act and regulations made under the authorities conferred by it, the remarks following can only be, at best, educated guesses or opinions on the subject matter.

Value Added Tax ("VAT")

The status of the LLC in a VAT context has not so far been the subject of any evaluation. To date, the Customs and Excise Division of the Isle of Man Treasury has not expressed any opinion in regard to its position or in regard to the persons dealing with it or administering it. At the present time this is hardly surprising: the LLC only became capable of being created as of 17th October 1996, when the regulations ordaining the coming into force of the 1996 Act themselves came into operation.

As the 1996 Act provides that for Isle of Man income tax purposes the LLC is to be treated as a partnership and its members are to be treated as partners, it would appear that the LLC must be regarded for VAT purposes as if it was a partnership and as therefore being capable of registration for VAT purposes. However, whereas in the case of an ordinary partnership - whether general or limited - the registration is normally in the names of the partners and where the partnership is a limited partnership it is the general partner who is first-named in the registration, the LLC is regarded as having juristic personality as is provided in section 2 of the 1996 Act. Accordingly it would appear that the LLC can be registered in its own name as if it were a company.

It would also appear that although for the purposes of Isle of Man income tax liability the LLC is not liable to Isle of Man income tax and that the members will be treated as partners and therefore subject to that income tax in respect of the income/profits of the LLC, they ought not to be regarded as being the maker of

taxable supplies, nor as being entitled to recovery of input tax as being related to deductible expenses or outgoings in relation to the receipts or entitlements which are related to the activities of the LLC. Section 46(4) of the 1996 Act provides that no deductions, allowances or reliefs can be taken into account in calculating the taxable income and section 46 requires that the LLC must be treated as if it was a partnership and each member be treated as a partner and liable to pay income tax in consequence; such deductions, allowances or reliefs are precluded from being allowed or taken into account in calculating both the profits of the LLC and the portion of the taxable income of a member arising from the member's share of profits. It is considered that this provision, which appears at first sight to impose Manx income tax liability on gross receipts of the business activities of the LLC while precluding any reduction in the prospectively taxable profits by reference to normally allowed business deductions, cannot be the subject of corresponding difficulties in regard to taxable supplies or recoverable inputs as regards VAT. Accordingly, it would appear that the LLC is potentially subject to VAT accountability in the same way as is a conventional company incorporated under the Companies Acts.

The position of a member of the LLC who may be entitled to charge the LLC with VAT in respect of services provided to it by him, and the position of the LLC in regard to any possible claim to recover input tax in respect of the prospectively taxable supply claimed by the member as a result of rendering services to the LLC, the rendering being by the member in question, appears to be obscure. In principle there would appear to be no reason why the LLC cannot receive such input tax and the member cannot be assessable to VAT on supplies rendered by him to the LLC. This appears to be so in spite of the provisions in section 46 that the LLC is not subject to income tax on its profits which are to be imputed as being the profits of its members.

It would also appear that the foregoing remarks are equally applicable to an International LLC, the members of which are not subject to Manx income tax (under section 38 of the 1996 Act).

It is considered that the subject of VAT in the context of the LLC has not yet been qualified but presumably Customs and Excise will shortly issue guidelines or other opinions in regard to same.

National Insurance Contributions

In general law, National Insurance contributions are not taxation. The liabilities related to the paying of the contributions, however, are in many respects similar to taxation insofar as they relate to payments by individuals in respect of their

earnings, whether the earnings are from employment or as a result of being self-employed.

On the other hand it is equally clear that dividends which are paid to members of a conventional company incorporated under the Companies Acts are not earnings and are not subject to National Insurance contributions.

The status of monies or value which accrue to members of the LLC in respect of their membership of the LLC is unclear. On the one hand, the members of the LLC are members and their entitlements are in respect of their membership: but for being members the persons in question would not be entitled to receive any income or profits or parts of the same in respect of the LLC. On the other hand, it is equally clear that the member of the LLC, since he or she or it participates in the management of the LLC, is in that respect to be likened to a director-member of a conventional company incorporated under the Companies Acts, so that distributions in respect of profits, whether paid in respect of current income/profits or distributed out of accumulations of income or profits which have not previously been distributed, run the risk of being likened to profits belonging to the member and either related to his partner status (and therefore as being likened to receipts resulting from self-employment) or as being in the nature of remuneration payable to him as an employee of the juristic person of which the LLC is a species (so that the LLC is in the same relation to one of its members as an employer is in relation to employees in respect of the relevant employment).

At the present time it is not possible to pronounce on these matters on a finite basis. The National Insurance authorities have not yet had the opportunity to make definitive statements on the matter since the LLC has only become capable of being organised since 17th October 1996. In the absence of any definitive statement from the authorities it would seem on balance that the profits of the LLC, because they are related solely to membership and because they appear to be capable of distribution whether the member recipient actually engages in the management of the LLC and its business or not, but can only become payable once the member has contributed capital to the LLC, should be likened to distributions of dividend income from a conventional company or corporation to its members or shareholders. In consequence, the receipts relating to profit distributions can be regarded as not subject to NIC liability.

It may be that a distinction can be drawn between a member who is entitled to participate in management but does not actually do so, and a member who does not in fact engage in management on an active basis. But so far there is no guideline available to indicate whether this distinction is legitimately to be drawn.

PAYE/ITIP

The Isle of Man does not have PAYE as a basis for collecting Isle of Man Income Tax in regard to emoluments of an employment which would if the employer was within the UK tax net be prospectively subject to PAYE obligations. However, Tynwald at the instigation of the Isle of Man Treasury has enacted the Isle of Man Income Tax (Instalment Payments) Act 1974 which creates a regime for the recovery of Isle of Man income tax by means of on-account payments by employers in relation to remuneration paid to employees. The regime, the shorthand title of which is "Income Tax Instalment Payments" or "ITIP" has a substantive effect equivalent to PAYE. There is a difference, however: whereas PAYE does not apply to employment emoluments which are paid to companies, ITIP appears to be capable of being applied to payments to companies provided the recipient company is in receipt of remuneration which is referable to employment-type emoluments. It should also be noted that a company cannot be a director of an Isle of Man incorporated conventional company incorporated under the Companies Acts, whereas in the United Kingdom incorporated comparable a company can be a director of another company.

As regards the LLC, the position is very simple. Subsection (6) of section 46 of the 1996 Act provides that the section shall not affect the liability of the LLC to deduct and account for tax under the ITIP Act 1974.

Payments to Sub-Contractors in respect of construction contracts

Subsection (6) of section 46 provides that nothing in the section affects the liability of the LLC to deduct and account for tax under the legislation now in force in the Isle of Man relating to payments to sub-contractors under construction contracts. The legislation, which is similar to that in force in the United Kingdom, arises under Part 3 of the Income Tax Act 1989. It should be noted, however, that both liabilities for deducting and accounting for tax whether under the sub-contractor deductions regime or under the ITIP regime, appear to be in respect of payments made or prospectively liable to be made by the LLC. It appears to be the case that this does not have an obvious impact on subsequent attribution of the income/profits of the LLC to its members. It is probably another reason why earlier provisions of the 1996 Act preclude deductions, allowances and reliefs as allowable deductions in computing the income tax-assessable profits of members of the LLC.

Capital Gains Tax

The Isle of Man does not levy any form of capital gains tax on gains of a capital nature. The only form of taxation on what are collectively described as "capital gains" is where the gain results from a trading activity or an adventure in the nature of trade when income tax liability is appropriate. It should, however, be noted that there is no provision in the 1996 Act which entitles the LLC to distinguish between profits of an income nature and profits of a capital nature: all profits - of whatever nature - will be regarded as profits of the LLC and are therefore subject to Isle of Man income tax. This has been referred to earlier in this section.

(B) Overseas Taxation

The point has already been made, and repeatedly made, that the LLC does not really have a counterpart in jurisdictions other than those which expressly permit it to be established. As already pointed out, these jurisdictions consist of various States comprising the United States of America, Nevis, the Turks & Caicos Islands, the Cayman Islands, a number of other Caribbean jurisdictions and most recently the Isle of Man. In the United States and in the Isle of Man the tax position in regard to the profits of the LLC is substantially similar - namely that the LLC is regarded as not being a corporation but as being a partnership for tax purposes with its members bearing the liability to taxation on the profits of the LLC. In jurisdictions other than the States making up the USA and the Isle of Man, the LLC appears to have been substantially exempted by local legislation from everyday conventional profit-related tax liabilities. Certainly there is no tax incidence in the Cayman Islands or in the Turks & Caicos Islands which already boast LLC legislation within their range of statutes. In the case of Nevis, although that jurisdiction has local taxation, the LLC is effectively exempted from it. No other jurisdictions in the Caribbean are known to the writer as having LLC legislation. But new techniques are infectious and no doubt in time there will be other Caribbean jurisdictions which espouse the new concept. There are other jurisdictions further afield which may also adopt the concept - e.g. Western Samoa. But all these jurisdictions have the same lacuna in them - namely the failure to relate the provisions of the LLC to taxation considerations as they might affect the LLC in its dealings in other foreign jurisdictions and the nationals or residents of those jurisdictions.

It is altogether beyond the scope of this paper to essay an exhaustive classification of the manner in which the LLC will be treated in jurisdictions in which tax liabilities are created other than the United States and the Isle of Man. All that can be stated here at this stage is a number of possibilities:

- (1) In jurisdictions which attribute a statutory definition to the term "company", such as the United Kingdom and Ireland, it is likely that the LLC will be, initially at any rate, an entity which is outside any of the meanings compendiously within that term. For example, the LLC is not a body corporate. For another, the LLC is at least arguably not an unincorporated association. For a third, the LLC is probably not - but not inevitably - a partnership. And for a fourth, the LLC is not a trust. So what is it? If the entity is not within any of these categories then it is likely that it will not fall within a number of taxing provisions of either jurisdiction. For example, and as has already been touched upon earlier in this paper, if the LLC is not within the term "company" then it cannot be within the phrase "close company" since that phrase is defined in the relevant legislation to be a species of "company" as that latter term is defined in the relevant primary legislation - either the Income and Corporation Taxes Act 1988 section 832(1) or the Taxation of Chargeable Gains Act 1992 section 288(1). On the other hand, in legislation where the term "company" is a partial definition - using the term "includes" as distinct from the term "means" - it is possible for the LLC to be brought within the scope of such legislation as is expressed to relate to entities includible within the term "company" - e.g. section 709 Income and Corporation Taxes Act 1988.
- (2) If the LLC is not a partnership, then it will be outside the terms of sections 111 to 114 Income and Corporation Taxes Act 1988 which deal with the taxation of the profits of partnerships. This is because subsection (1) of section 111 says:

"Where a trade or profession is carried on by persons in partnership, the partnership shall not, unless the contrary intention appears, be treated for the purposes of the Tax Acts as an entity which is separate and distinct from those persons."

The wording in this provision is calculated to enable the partnership, which is a person separate and distinct from its partner members, from being excluded from partnership taxation. The obvious example of such an entity is the Scottish law-governed partnership where "the firm" is regarded as a person separate from the partnership members - see Partnership Act 1890 section 4(2). But it is questionable whether the "separate entity" concept goes outside Scotland, particularly where the entity is not - *a fortiori* where it is expressly stated not to be - a partnership, such as might be the case with a body carrying on investment activity.

- (3) The LLC, not being capable of being brought within the terms "company" or "close company", will probably be outside the scope of inheritance tax as regards activities affecting individual participants.
- (4) Since the LLC is not a body corporate it will be outside the term "company" as used in sections 739 to 745 Income and Corporation Taxes Act 1988. However, it is a person.
- (5) Because the last-mentioned sections apply to impose income tax liability on individuals ordinarily resident in the United Kingdom who can or do benefit from "income" which "becomes payable to persons resident or domiciled out of the United Kingdom" there may be difficulty in establishing the residency of the LLC since the LLC is not a conventional company so as necessarily to be affected by the ordinary tests of residency in the context of companies and corporations. However, in the end it may not matter because being established under Isle of Man law it is almost certain that the LLC will be regarded as having a domicile in the Isle of Man and outside the United Kingdom even though the latter has no concept of fiscal domicile in its law.

There are other numerous possibilities which have not been touched on in this paper but each of which must be evaluated on its own merits and non-applications to particular circumstances.

The LLC and its Possible Usage

This is a difficult subject and one in relation to which no amount of lateral thinking can be attempted in any depth.

Those who promoted the formulation of the LLC concept as being available for utilisation in the Isle of Man envisaged that when the LLC became capable of creation approaches would be made to the US Internal Revenue Service for rulings that the organisation would be regarded as having the status equivalent to that of the LLC as previously perceived to be operable by those who might otherwise prefer to use the LLC concept by reference to the laws of a State within the USA. It was no doubt thought likely that the Internal Revenue Service would concur in the view that any LLC established in the Isle of Man would be regarded as a partnership for US Federal tax purposes. However, as was explained in the second part of this paper² the US Internal Revenue Service must have had other

² See *The Offshore Tax Planning Review*, Volume 7, Issue 1 at pages 41-45, being Part II of this paper.

ideas; and, by reason of the regulations issued by the Service on 17th December 1996 and which acquired the force of the law on and from 1st January 1997, the status of foreign-established entities and organisations underwent a series of substantive changes in regard to their classification in the USA. Specifically, those regulations provided that an entity organised outside the United States and of which the Isle of Man LLC was and is an example, would be classed as a corporation if - as is the case under the Isle of Man LLC - all the members of the entity have limited liability **unless** the entity being one which came into existence on or after 1st January 1997³ elects for classification as a partnership either by filing the relevant form or by including a copy of the form with the entity's US tax return for the year in which the election was effective. Thus, the effect of this is that the Isle of Man LLC would now be classed as a corporation unless it elects for partnership status, in contrast to what was thought to be the law prior to the operation of the regulations and being that the Isle of Man LLC would be classed as a partnership whether there was an election or not.

It is was obviously thought likely that business would be attracted to the Isle of Man from USA sources if only because the costs of creating and managing the Isle of Man LLC would prove to be substantially less expensive than those applicable to the creation and management of LLC entities outside the UK.

In the event, it appears that there have been a substantial number of Isle of Man LLCs established since 17th October 1996; though just how many is not known to the writer of this paper at the present time. In deciding whether to establish an Isle of Man LLC today, the caveats referred to throughout the latter part of this paper have to be taken into account; but would-be users of the concept should not be daunted by their presence. The legitimate user has little to fear from these caveats. Persons who would use the concept for non-legitimate, perhaps unlawful, purposes, may well have much to fear and it is right that they should have. The Isle of Man LLC is not planned for use by the non-legitimate operator.

All this having been said, there are a number of angles which the existing legislation does not cover and which need to be the subject of either prescribed exclusions or limitations or perhaps amendments to legislation. Perhaps most important of all, it appears that whereas a conventional Isle of Man incorporated company cannot be managed or directed by someone who is bankrupt either in the Isle of Man or a part of the United Kingdom, an individual who is bankrupt in the

³ Of course an entity established as an Isle of Man LLC between 17th October 1996 and 1st January 1997 would be classed as a partnership under the new regulations whether there was an election or not. But such cases are thought to be rare. The significance of 17th October 1996 is that it was the earliest date upon which an Isle of Man LLC could be established under Isle of Man law.

United Kingdom but has not been made bankrupt in the Isle of Man, or an individual who is bankrupt in some other jurisdiction but who is not regarded as bankrupt in the Isle of Man, can manage or participate in an Isle of Man LLC. This alone may make the LLC a possible target for international bankrupts. This cannot be helpful to the Isle of Man and to its regulators who are desirous of promoting both the Island and its image as a base for legitimate international operations.

There are, however, a number of other aspects in relation to the LLC and in respect of which comments arise:

- (I) As has been pointed out earlier in this paper, the LLC is superior to a limited partnership because although it has characteristics which are in commercial terms identified with a partnership, nevertheless there is no partnership member who does not have the protection of limited liability. All those who carry on the business of the LLC are either members of the LLC or a manager conducting the LLC business at the instigation of its members. As such all have the protection of the limited liability which the establishment of the LLC creates.

Despite the fact that all members and their manager have the protection of limited liability, all can participate in the conduct and management of the LLC business. This is different from the position of a limited partner in a limited partnership, where the limited partner is not permitted to participate in the conduct or management of the partnership business. Therefore, to that extent, the LLC is superior to the limited partnership as being a vehicle for transacting business in a partnership style but with the protection of limited liability.

- (II) Unlike the United States and one or two of the other jurisdictions where the LLC can be created, the Isle of Man does not have a network of double taxation conventions with other jurisdictions where income tax is paid by its residents and by companies established in the jurisdictions - apart, that is, from companies having some special status like being an exempt company, an international company or a non-resident company. The Isle of Man has only one double taxation convention of substance, that being with the United Kingdom. In relation to that treaty, the principal relief from non-Isle of Man tax for Isle of Man residents is where the resident carries on a trade or business in relation to which it makes industrial or commercial profits in the United Kingdom otherwise than by reference to having a branch, agency or permanent establishment in the UK. It is a condition precedent to an Isle of Man resident claiming the benefit of the treaty in relation to its non-Isle of Man profits, that the Isle of Man resident in question must be "subject to

tax" - i.e. to income tax - in the Isle of Man. Since the terms of sections 46 and 47 of the 1996 Act provide that the LLC is not liable to Isle of Man tax on its income or profits, which are to be attributed to its members, it necessarily follows that the LLC cannot be regarded as subject to tax in the Isle of Man, so that it is disqualified from relief from tax on its non-Isle of Man profits insofar as these are prospectively within the ambit of UK corporation tax or income tax liability.

- (III) In an earlier section of this paper it was explained that the LLC has features which are at the very least tendentious of it having partnership characteristics, though it appears that there is an overriding legislative intention to endow the LLC with separate personality akin to its having corporate status though in fact not incorporated. These features are to some extent contradictory, so it may be helpful to contrast them. It is declared (in section 46 of the Act) that the LLC is to be treated as a partnership with its members being treated as partners. In contrast, section 1(1) of the 1996 Act describes the LLC as a body of persons, this expression not being qualified in a manner indicating an intent that it should have corporate status even though the 1996 Act provides that it is to be a separate legal person. In addition, a number of phrases which would have been appropriate to be used if the LLC had been intended to have corporate status are missing from the legislation.
- (IV) An incidental disability which accrues to a would-be user of an Isle of Man LLC is that, because Isle of Man tax does not fall to be imposed on the profits or income of the LLC, the LLC cannot claim any tax credit relief or unilateral relief on its profits since those profits are for Isle of Man tax purposes treated as belonging to, and liable to Isle of Man tax upon, the members of the LLC.

It would have been far better if there had been included within the LLC legislation provisions which would have enabled the LLC to claim the benefit of tax credit or unilateral relief from overseas taxes by being subject to Isle of Man taxation but with the ability to reduce that taxation liability by means of some dividend or profit distribution to its members which was fully deductible in computing the liability of the LLC to Isle of Man income tax. This system prevails under section 25(1) of the Isle of Man Income Tax Act 1970 where the taxpayer is a company which is resident in the Isle of Man for Isle of Man tax purposes. The provisions do not apply to a body which is resident outside the Isle of Man for Isle of Man tax purposes. But it would have been far better for the system to be applicable to the LLC whether residents of the Isle of Man are subject to Isle of Man taxes on its profits or whether that tax liability is prospectively referable to profits

accruing to non-residents who might nevertheless be exempted from liability on the dividend or distribution to them while nevertheless enabling the LLC to remain within the provisions for non-liability to Isle of Man income tax where none of the members of the LLC are Isle of Man residents.

- (V) The LLC is not a trust, nor is it a nominee. Is it therefore the beneficial owner of its assets? The issue is one of importance because the LLC is not at present an incorporated company. It is uncertain whether any, and if so what, parts of what one might term "common law company law" might apply to it.

One has to bear in mind that the LLC is not subject to Isle of Man income tax on its profits and that such profits are attributed for Isle of Man income tax purposes to its members. If the assets representing profits are attributed to its members for Isle of Man income tax purposes, it must surely be logical for the ordinary law relating to the LLC to have stated that such assets are held by the LLC as nominee or bare trustee for its members. In the case of an ordinary company, a member is regarded as owning shares in the company, these shares being related to the company's assets and the right to seek a division of profits resulting from the application of those assets in connection with the company's business. If in truth the profits are to be attributed directly to the members of the LLC, then one would have expected to find the attribution referable to some kind of trust or nominee concept, rather than to a shares- or securities-related concept. In fact the 1996 Act provides that:

- (a) any LLC can divide and allocate its business profits and losses amongst its members in accordance with its operating agreement (section 15(1));
- (b) profits and losses are to be allocated on the basis of the value of members' contributions received and not returned by the LLC, unless there is some different provision in the operating agreement (section 15(3), (5)); and
- (c) the operating agreement governs the allocation of distributions which may be of cash or other assets (section 15(4)).

These provisions are consistent with the proposition that the assets resulting from the making of profits belong beneficially to the LLC but can thereafter be attributed, indeed can belong (following division) to the members. The yardstick appears to be the relevant provisions on this subject set forth in the operating agreement. There appears to be no "common law" or "common

law company law" point involved. The only "common law"-type point is that resulting from the provision in section 15(2) of the 1996 Act that a distribution cannot be made if assuming a distribution is made, the LLC's, assets do not exceed its liabilities (apart from liabilities to members on account of capital contributions). This is a bankruptcy/solvency point.

The overall conclusion is that the assets of the LLC belong beneficially to the LLC and not to its members, but that those assets which represent profit can readily be attributed to the members of the LLC. It is not clear whether the "conversion" of such assets from company ownership to member ownership results from the existence of a quasi share (as in the share or stock or security of a company) or from a partnership-related connection. The position would be more clear if the status of the LLC was itself more clear, which brings us back to the point discussed at (I) of this part of this article.

- (VI) It would seem to be possible for the LLC to transact its activities on an investment basis as compared with a trading basis. However, for this to be possible it would seem that the LLC must be that species amounting to an International LLC. This is because sections 46 and 47 of the Act attribute Isle of Man income tax liability to the income and profits of the LLC and do not distinguish between profits of an income nature and profits of a capital nature. Nor is there any attempt, either by reference to commercial accountancy principles or to an accounting conduct, to distinguish between income and capital in the context of the LLC and its accounts.

Under Isle of Man law Isle of Man income tax is only payable in respect of income. This much is clear from the provisions of section 2 of the Income Tax Act 1970. But whereas it follows from section 2 that there can be receipts which do not amount to income or which do not fall within a computation of income, the provisions of the Act, by failing to distinguish between categories of profit, create the effect of equating capital profits with income profits and making both subject to Isle of Man income tax. This effectively limits the use of the LLC to the conduct of activities which can only result in the production of income-type profits.

- (VII) References have already been made to the potential draconian penalties which exist for trifling infringements of requirements of the various legislative provisions relating to LLCs. There have also been references to the draconian powers available to the Assessor in regard to the accounting for Isle of Man income tax where there is any Isle of Man membership or interest in the LLC. Taking these factors together and comparing them with the much lesser and potentially more relaxed approach of the legislators to

the conventional company - even one subject to Isle of Man tax as being a resident of the Isle of Man for the purposes of Isle of Man income tax - it is the conclusion of the writer of this paper that the attractions of the LLC - which are substantial - are greatly outweighed by the difficulties apparently attendant upon its adoption as a business organisation. Indeed, one wonders whether the penalties are virtually a carbon copy of those prevailing in relation to US established LLCs. These penalties may have their place in a high tax paying jurisdiction such as the United States. However, it is considered that, having regard to the position of the Isle of Man as an international financial centre, the undoubted probity which the Isle of Man regulators require for those who would use its facilities is not best served by the existence of penalties such as those recorded in the legislation.

- (VIII) Despite what may appear to be criticisms of the LLC, it has a number of possible tax planning uses. Some of these were identified from a U.S. standpoint in the article by James Barrett in *Offshore Red Alert* which was referred to earlier in this paper. Evaluating the advantages for US persons in the use of the non-US LLC in the context of the taxpayers of other jurisdictions, it would appear that payments to non-Isle of Man residents which derive from income made by any LLC are not subject to Isle of Man withholding tax, whether or not the recipients of the payments are members of the LLC. This is because the income of the LLC is the income of its members for Isle of Man tax purposes. If, therefore, the LLC receives income from a third party which it proceeds to distribute, then in effect the income is being paid from the LLC's source directly to the recipient. Further, if the LLC's receipt is from a non-Isle of Man source and is to be treated as received by a non-Isle of Man source, there can be no Isle of Man withholding tax. Further, if the LLC can be so organised so that it is not an International LLC, income which is from an Isle of Man source and which having accrued to the LLC is distributed to a non-Isle of Man resident by the LLC, can escape Isle of Man tax. As a further point, the LLC can be utilised to hold assets which may be the subject of separation from estates of third parties and may thus be useful in the context of international estate planning. There are also other uses to which the LLC can be put in an international context but in order to enable would-be users of the LLC to take advantage of its provisions as regards such other uses, the difficulties identified in earlier paragraphs of this section of this paper need to be addressed and coped with, perhaps by amending legislation.

Conclusion

As a concept, the LLC has much to recommend it. The adoption of the concept into the Isle of Man financial system is in itself extremely encouraging and carries potentially great advantages for those who would seek to utilise the Isle of Man's undoubted financial infrastructure for legitimate commercial or investment purposes. It is to be hoped that what are seen as present rough corners for the Isle of Man LLC will somehow be mitigated or smoothed out so as to make the LLC as fully efficacious in regard to international usage as its background would appear to encourage in both excitement for potential and interest for utilisation. Perhaps the writer's best accolade for the LLC is that he is the first person to apply to register any LLC, having caused there to be lodged with the Chief Registrar on 17th October 1996 papers to enable the first LLC to be registered, with himself as the first registered agent and the first registered Articles of Organisation (and unregistered operating agreement) and which papers led to the incorporation of the LLC on 17th October 1996 as Company No. 1L. What about that for a confirmation that the LLC can be recommended for use even by its current greatest critic?

Postscript: the LLC for Incorporation in Great Britain?

When those having the task of promoting the adoption of the LLC concept into Isle of Man law formulated their paper to put the case for the creation of the LLC in Manx law, it was claimed that the entity would "provide a much simplified and streamlined form of company suitable....for very small business enterprises". The claim was soundly based. The legislation governing the creation of LLCs in the Isle of Man is simple. The details of the provisions affecting the creation, operation and ultimate dissolution of the LLC are simple in terms yet efficacious. Indeed, the provisions of the legislation are not complicated by being hedged about with detailed qualifications or supplementary provisions.

The general scheme of the concept is simple, consisting as it does of the formulation of an unincorporated association which though not endowed with incorporated status, nevertheless has separate juristic personality - like a conventional company limited by shares - with limited liability for its members. Additionally, the regulations relating to the functions and operations of the company management and its managers are relatively straightforward, if only because they fail to distinguish between the position of the company's members on the one hand and its management on the other. For tax purposes, the association is treated as a partnership with the members/managers treated as partners. It necessarily follows from this that the accounting formalities for the association are correspondingly simple, especially as they can clearly embrace the partnership format rather than the much more complicated provisions which govern the

conventional limited company. The only extension which would be needed - which is missing from the scheme of the Isle of Man legislation and which could readily be brought within it, especially since it is a feature of the Wyoming legislation enabling the creation of similar enterprises in the particular State - is the need for a merger or re-registration concept that would readily enable the LLC to be re-registered as a conventional company - or, as it is described in Wyoming itself, to enable one to be merged with the other - and for a conventional limited company to be re-registered as a species of LLC.

It appears to the writer that the LLC concept could reasonably be adopted within Great Britain, if not the United Kingdom, and thus provide small businesses with a much simpler format than is the case at present. Would it not pay to at least think about it?