The Offshore Tax Planning Review

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

Patrick Taylor[1]

The thrust of this article is to introduce the reader to the evolution of the Limited Liability Company - as the body concerned has been christened (somewhat erroneously in the view of the writer) - or "LLC" - into the legal systems operating within the British Isles, and to explain its possible advantages to would-be users and related tax aspects.

The LLC is the product of developments in partnership law with particular relevance to limited partnerships and their commercial, legal and taxation advantages (and disadvantages) as against the conventional body corporate whether with or without limited liability. It therefore seems appropriate to commence this paper with some comments about the medium known as "partnership" and the derivation from it known as "the limited partnership".

The Partnership in English and Isle of Man Law

Partnership law has evolved over the centuries until its equitable origins (in England and Wales) were consolidated into the Partnership Act 1890 and (in the Isle of Man) into the Partnership Act 1909. The 1890 Act also absorbed within it the partnership law of Scotland though the Scottish concept of partnership evolved from entirely different origins being based on concepts prevailing in Roman or Roman-Dutch law. As partnerships were evolved it became apparent that they were unwieldy if the business association implicit within it became composed of substantial numbers of persons. In effect, once the number of persons in a partnership became more than twenty, the concept itself became unwieldy and evolved into the joint stock company which took effect as a large partnership with a common transferable stock. The development of the incorporation concept languished from the enactment of the Bubble Act in 1720,

[1] T P D Taylor LLB, ATII, PO Box 2, Port St Mary, Isle of Man IM99 7PB.
Tel: (01624) 834903 Fax: (01624) 834921

passed as a result of the South Sea Bubble scandal, until it was revived in the Deed of Settlement company which made use of the trust concept. In such a body the joint stock might be vested in trustees and the management of the business in directors, some of whom - or two perhaps - might also be trustees. These nevertheless remained unincorporated partnerships in the eyes of the law. There were various attempts during the nineteenth century to consider the possibility of achieving the twin objectives of stock transferability and limited liability by adapting the partnership to meet these needs. There were possibilities of achieving the two objectives by borrowing from the commandite partnerships of continental law to provided limited liability for providers of capital but there was resistance in that century to such partnerships. In the end the objectives were achieved by permitting statutory incorporation with a limited liability share capital through a process of registration. In England this led to the first Companies Act of 1844 followed by later Companies Acts of 1855, 1856 and 1862 and much later Acts.

From this time onwards the references to "the company" were in terms of United Kingdom law references to "the incorporated company", shortened to "the company" by common usage. Such references were therefore to cases where incorporation was authorised by reference to the Companies Acts. This reference was in contrast to cases where bodies owed their incorporation status either to special Acts of Parliament, Royal Charter or ecclesiastical usage. These cases caused the bodies to be known as "corporations" under United Kingdom law.

A comprehension of this usage of terminology is fundamental to the later comprehension of the differences between the terms "corporation" and "company" as used in the United States of America and in countries which evolved concepts from the laws of individual States in the United States, such as the Isle of Man in relation to the LLC concept. These differences will be explained later in this article; but for the time being it is absolutely vital to appreciate that the term "company" has an entirely different meaning in the United States of America and in the individual States and their laws from its use in the United Kingdom and in jurisdictions deriving their laws from United Kingdom concepts. What comes to be explained later in this paper is the nature of the differences in the use of the word. For the remainder of this paper, and in the context of the United Kingdom and jurisdictions deriving their laws from it, the term "company", wherever used, is a reference to "the incorporated company".

It is not appropriate in this article to deal with the development of the incorporation concept as deriving from the partnership or the trust: this has been dealt with in an earlier paper by the same writer.[2] The Acts of 1844 and 1856 put

---

2 'Trusts or Companies : A Comparative Analysis & Related Tax & Tax Planning' *The Offshore Tax Planning Review* Volume 6, Issue 2, 1996.

statutory restrictions on the maximum number of persons who might form a company or partnership to carry on business. The legislation prohibited the number of persons capable of forming a partnership to twenty, though as time went on exceptions were made to the restrictions by enabling the maximum number to be increased. First banking, and later professional, partnerships became freed from this maximum number restriction. There were also a whole collection of associations, such as building societies, friendly societies, trustee savings banks, credit unions and cost book companies, each with their own peculiar legal status and characteristics. These associations are not considered in this article. But the partnership is distinguished from other associations by the following characteristics:

(1) The lack of any legal existence separate from its members. This is true of all forms of partnership existing in the British Isles, apart from Scotland where the partnership is treated as a person (known as a firm) separate from its members (see Partnership Act 1890 section 4(2)).

(2) As a by-product of this lack of incorporated status, the partnership (other than the limited partnership - referred to below) has always involved unlimited liability on the part of its members. Each partner is fully liable for the firm's debts whether the firm is separate from the partner members or not. In contrast, members of other unincorporated bodies, such as members' clubs, are as a general rule only liable to the extent of their agreed contributions - see Lord Lindley in *Wise v Perpetual Trustee Company Ltd* [1941] AC 139 at 149). The committee of a club does not have power to fix members with unlimited liability for its acts, whereas the essence of partnership is that a partner has such unlimited liability.

(3) The property of a partnership is held by all the partners in common, even though in a Scottish law governed partnership the property is held by the partnership person (or firm) on behalf of the partnership members. This therefore means that mortgages over partnership assets are charges against the assets and also against the partnership members. In contrast, a company, because it has a separate corporate personality, owns its property alone and the shareholders have no proprietary interest therein.

(4) The partnership has as its central feature the concept of agency - the power of the partner to bind the firm - i.e., his co-partners and himself. This is spelt out in section 5 Partnership Act 1890. The individual shareholder in a company has no equivalent power to bind the company, the management of which is normally put into directors who act as its agents. This separation of ownership and control in the company emerged in the nineteenth century and left shareholders with little direct say in the

management of the company. By contrast, the partnership continues to provide scope to the proprietor-entrepreneur, since section 24(5) Partnership Act 1890 confers upon every partner a prima facie right to participate in the management of the firm's business.

(5) The partnership is associated with the idea of a personal relationship founded on mutual confidence and trust, in contrast with the depersonalised relationship which now characterises the participants in companies.

(6) Subject to any agreement express or implied between the partners, a partner cannot transfer his share to a person so as to make him a partner without the consent of the other partners, though he can transfer his share (under section 23 Partnership Act 1890) without making the transferee into a partner. In the case of companies - at any rate public companies - shares are freely transferable, though in private companies there are usually restrictions on the right to transfer shares. These restrictions have to be in the constitution or they are not operative.

(7) The capital of the partnership is freely alterable, whereas in a company - unless an unlimited company - the capital can be increased or reduced only in accordance with the provisions of statutory company law - see sections 121, 135 Companies Act 1985.

(8) A partnership has power to engage in any business which it chooses, whereas a company is restricted in its activities by the objects clause in its Memorandum of Association (though an Isle of Man company can carry on any activity which is lawful without having to specify the activity in its Memorandum of Association).

(9) No disclosure of partnership accounts is necessary, whereas in the case of a limited company - and in some unlimited companies - the Accounts are made public by the requirement that a copy of the Accounts be sent to the Registrar of Companies - see Companies Act 1985 section 241(3)(a).

(10) The records of members, managers, capitalisation, etc, of a partnership do not have to be disclosed to the public, whereas these matters have to be disclosed as a matter of mandate under the Annual Return which company law requires to be filed annually with the Registrar of Companies.

(11) It is relatively easy to form a partnership and to keep it in being - in fact a partnership can be formed without any written document - whereas a company has to involve itself being registered with the Registrar of

management of the company. By contrast, the partnership continues to provide scope to the proprietor-entrepreneur, since section 24(5) Partnership Act 1890 confers upon every partner a prima facie right to participate in the management of the firm's business.

(5) The partnership is associated with the idea of a personal relationship founded on mutual confidence and trust, in contrast with the depersonalised relationship which now characterises the participants in companies.

(6) Subject to any agreement express or implied between the partners, a partner cannot transfer his share to a person so as to make him a partner without the consent of the other partners, though he can transfer his share (under section 23 Partnership Act 1890) without making the transferee into a partner. In the case of companies - at any rate public companies - shares are freely transferable, though in private companies there are usually restrictions on the right to transfer shares. These restrictions have to be in the constitution or they are not operative.

(7) The capital of the partnership is freely alterable, whereas in a company - unless an unlimited company - the capital can be increased or reduced only in accordance with the provisions of statutory company law - see sections 121, 135 Companies Act 1985.

(8) A partnership has power to engage in any business which it chooses, whereas a company is restricted in its activities by the objects clause in its Memorandum of Association (though an Isle of Man company can carry on any activity which is lawful without having to specify the activity in its Memorandum of Association).

(9) No disclosure of partnership accounts is necessary, whereas in the case of a limited company - and in some unlimited companies - the Accounts are made public by the requirement that a copy of the Accounts be sent to the Registrar of Companies - see Companies Act 1985 section 241(3)(a).

(10) The records of members, managers, capitalisation, etc, of a partnership do not have to be disclosed to the public, whereas these matters have to be disclosed as a matter of mandate under the Annual Return which company law requires to be filed annually with the Registrar of Companies.

(11) It is relatively easy to form a partnership and to keep it in being - in fact a partnership can be formed without any written document - whereas a company has to involve itself being registered with the Registrar of

management of the company. By contrast, the partnership continues to provide scope to the proprietor-entrepreneur, since section 24(5) Partnership Act 1890 confers upon every partner a prima facie right to participate in the management of the firm's business.

(5) The partnership is associated with the idea of a personal relationship founded on mutual confidence and trust, in contrast with the depersonalised relationship which now characterises the participants in companies.

(6) Subject to any agreement express or implied between the partners, a partner cannot transfer his share to a person so as to make him a partner without the consent of the other partners, though he can transfer his share (under section 23 Partnership Act 1890) without making the transferee into a partner. In the case of companies - at any rate public companies - shares are freely transferable, though in private companies there are usually restrictions on the right to transfer shares. These restrictions have to be in the constitution or they are not operative.

(7) The capital of the partnership is freely alterable, whereas in a company - unless an unlimited company - the capital can be increased or reduced only in accordance with the provisions of statutory company law - see sections 121, 135 Companies Act 1985.

(8) A partnership has power to engage in any business which it chooses, whereas a company is restricted in its activities by the objects clause in its Memorandum of Association (though an Isle of Man company can carry on any activity which is lawful without having to specify the activity in its Memorandum of Association).

(9) No disclosure of partnership accounts is necessary, whereas in the case of a limited company - and in some unlimited companies - the Accounts are made public by the requirement that a copy of the Accounts be sent to the Registrar of Companies - see Companies Act 1985 section 241(3)(a).

(10) The records of members, managers, capitalisation, etc, of a partnership do not have to be disclosed to the public, whereas these matters have to be disclosed as a matter of mandate under the Annual Return which company law requires to be filed annually with the Registrar of Companies.

(11) It is relatively easy to form a partnership and to keep it in being - in fact a partnership can be formed without any written document - whereas a company has to involve itself being registered with the Registrar of

Companies and in seeing that the constitution and the various details of its members, directors, registered office, shares, membership rights, etc, are filed with the Registrar of Companies prior to its creation and incorporation.

(12) Unless there is agreement to the contrary, the death or bankruptcy of a partner dissolves the partnership - Partnership Act 1890 section 33(1). The company, however, continues in being irrespective of the death or bankruptcy of any or all of its shareholders or any or all of its directors, though if there are no members at all this can be a ground for having the company wound up.

(13) As time has gone on, the taxation of a company in the United Kingdom has become very complicated. Inevitably taxation now arises on both the company's profits and on distributions of those profits to its members, though part of the tax payable in respect of the distributions can be credited against the company's own tax liability on its profits. In the case of partnerships on the other hand, the members are taxable on their individual profit shares and there is no separate taxation on the partnership firm.

From the foregoing it is apparent that the essence of partnership is simplicity and its dependence on personal relationships between the partners as well as on unity of interests between management and participatory rights. There is also unlimited liability on the individual partners. Over the years this has not been acceptable to everyone and this lack of acceptance led to the evolution of the limited partnership.

Development and Characteristics of Limited Partnerships in English and Scottish Law

The essence of limited partnership is the combination in a partnership firm of:

(A) one or more partners whose liabilities for the debts and obligations of the firm is unlimited and who alone are entitled to manage the firm's affairs; and

(B) one or more partners whose liability for such debts and obligations is limited in amount but who are excluded from all management functions.

The limited partnership is said to have had its origins in Italy during the Middle Ages and arose in Europe as being known as the *partnership en commandite*. It is said to have developed from a practice adopted by the nobility, for whom it was

at the time considered socially unacceptable - perhaps even illegal - to engage directly in trade. Nobles circumvented this inhibition by investing in commercial enterprises indirectly, through trusted merchants, on the understanding that they, whilst not in name parties, would receive a share of any profits without accepting any liability for losses beyond the amount of their contributions. Although of European origin, the concept gathered strength in the United States.[3]

Such partnerships were, however, unknown to the laws of England and Scotland prior to 1st January 1908, on which date the Limited Partnerships Act 1907 came into force.[4] Prior to that date there had been discussions fostered within the United Kingdom, though in 1837 the Ker Report to the Board of Trade advised against the introduction of these partnerships; and in 1851 a Parliamentary Select Committee expressed itself in favour of an easier means of borrowing capital without risk to the lender beyond the amount of the sum advanced, envisaging that such a method might involve the lender becoming involved in the business to which the money was being lent and thus becoming liable for its debts even though not participating in it. The Select Committee recommended a Royal Commission to consider the question but this was not established. In 1865 the Act generally known as "Bovill's Act" provided that in certain cases the receipt of a share of profits would not constitute the recipient a partner or render him liable as a partner, but conversely did not go so far as to enable such a person both to become a partner and yet avoid unlimited liability. This Act was popularly known as the Limited Partnership Act - see *Syers v Syers* [1876] 1 AC 174 in which the Act was so referred to both in the judgement in the case and the agreement under consideration in it. But the Act did not authorise the creation of limited partnerships. Indeed, the Partnership Act 1890 itself did not touch on the question, though it repealed and re-enacted the earlier 1865 Act.

The Limited Partnerships Act 1907 for the first time under English law enabled a partnership to be formed from which three of the essential characteristics of an ordinary partnership were missing, namely:

(a) the unlimited liability of every partner;

(b) the implied authority of each partner to bind the partnership in all matters within the ordinary scope of the partnership business; and

---

3 For greater detail on this one may refer to Troubat's "*Law of Commanditory and Limited Partnership in the United States*" (1853).

4 In the Isle of Man limited partnerships were governed by a part of the Partnership Act 1909.

(c) the right of each partner to take part in the management of the business subject to any contrary agreement.

The Act gave any number of persons not exceeding twenty (and the limit can now be exceeded in the case of certain professional firms) the freedom to enter into partnership on terms that the liability of some of them might be limited to the amount contributed by them in cash or property when the partnership is originally created. These partnerships are styled "limited partnerships". It is a requirement of the Act that a partnership in which one or more of the partners are limited partners must be registered: registration now takes place with the Registrar of Companies, though the partnership is not a company. But two fundamental and unalterable conditions affect the concept:

(1) the liability of at least one of the partners (described as the "general partner") must be unlimited; and

(2) during the partnership's continuance a limited partner has no implied authority to bind the firm and may neither be repaid any part of his capital contribution nor take part in the management of the firm, penalties being imposed for any breach (though apparently with no penalty if a limited partnership by agreement is given power to bind the firm). As a result the limited partner is forced to adopt an essentially passive role akin to that of the more traditionally dormant partner.

Limited partnerships under English law are within the ordinary partnership law rules laid down by the Partnership Act 1890 but because of the registration requirement a formal partnership agreement is usually indispensable.

The limited partnership has never been a vehicle attracting that much publicity or notoriety. At any given time there have been relatively few of these partnerships registered. In 1994 there were 1,962 registered in England and Wales and 2,075 in Scotland; but only 5 in Northern Ireland. They have been employed for tax planning purposes and are prominent in the field of venture capital.

The following points in favour of limited partnerships may be noted:

1. Although a limited partnership has to be registered, there is much less attendant publicity than in the case of a company formed under the Companies Acts.

2. Some return of capital is possible in the case of a limited partnership, whereas none is possible in the case of a company (unless it is an unlimited

company): returns of capital usually require a Court Order with considerable consequent expense.

3. Provided they have sufficiently wide powers of investment, trustees can participate in a partnership which is a limited partnership since they are not exposed to unlimited personal liability. Additionally, companies authorised to transact insurance business can, because they cannot participate in the conduct or management of the business, be limited partners in a partnership because their participation will be limited to receipt of profits and losses and thus be rendered acting lawfully without infringing section 16 of the Insurance Companies Act 1982 (activity not incidental to insurance business unlawful).

4. A limited company tends to be more expensive and complex as compared with forming a limited partnership, though some people take the view that because of the advent of ready-made companies this factor is no longer valid.

5. Most importantly, limited partnerships are taxed in the same way as ordinary partnerships: they are not taxed as companies and so are not subject to corporation tax or to the double liabilities to tax applicable to company profits and distributions of those profits, nor to the double liability to capital gains tax in relation to company gains and gains of members on their shares or other equity rights.

In the current edition of *Lindley on Partnerships* it is suggested that these factors are not of real significance, but in the opinion of the writer there is substantial benefit in the limited partnership enterprise taken in general. But there remain the twin principal disadvantages, already referred to above, that:

(A) there has to be at least one partner with unlimited liability; and

(B) no limited partner can participate in the conduct or management of the business in which he is a partner.

Partnerships and Limited Partnerships under Isle of Man Law

The laws of the Isle of Man are for the most part based on the laws of England. Although Isle of Man law with regard to land situated in the Isle of Man is reputed to be based on Nordic origins, most of the remainder of Isle of Man law is traceable in its origins to English sources and to English practices. What one might term "the non-statute law of the Isle of Man" is indeed of a customary

nature and draws on English common law and English equity. These sources are supplemented by Isle of Man statute law which is enacted by the Isle of Man Parliament, known as Tynwald, and which once passed through Tynwald is submitted to the Queen for Royal Assent whereupon it then binds the Isle of Man and its residents. This article is not concerned to embark upon a substantive discourse about Isle of Man law: there are reference books to which the interested reader can refer to deal with these matters.

In the case of the laws of partnership, the Isle of Man draws on English rules of equity and miscellaneous rules of English common law for its original sources of partnership law. However, whereas these English laws were ultimately consolidated into the Partnership Act 1890 in the context of general partnership law and the Limited Partnerships Act 1907 for limited partnerships, which had no common law or equitable counterpart until their creation was authorised by the 1907 Act, Isle of Man partnership law, both as regards partnerships and limited partnerships, was codified into the Isle of Man Partnership Act 1909. Section 3 of that Act (section 1 created its short title and section 2 was an interpretation section) provided that the rules of equity and common law applicable to partnerships were to continue in force except so far as inconsistent with express provisions of the Act. Thereafter, the Act was divided into two parts. Part I was concerned with partnerships generally and consisted of sections 4 to 46 while Part II was concerned with limited partnerships and consisted of sections 47 to 59.

There were no material differences between the laws on partnership in the Isle of Man and England apart from different section numbers of the different Acts. There is therefore no useful purpose served in this paper in providing a discourse on the differences in partnership law in general because there are no real differences of principle. However, in 1994 legislation was introduced into the Isle of Man which created, through the International Business Act 1994, a species of specially taxed limited company called the International Company. Sections 7 to 10 (Part 2) of that Act created special kinds of limited partnerships entitled "International Limited Partnerships". Section 7 of the 1994 Act provided details of characteristics of such limited partnerships. In brief:

(a) each limited partnership has to be registered under Part II of the Partnership Act 1909;

(b) each of the limited partners has to be either resident outside the Isle of Man or be an international company;

(c) the general partner has to be an Isle of Man-resident company with a place of business in the Island and has to comply with the local taxation provisions applicable to international companies as well as complying with certain

further requirements and must not be within certain stipulations, both of which were prescribed by Treasury regulations - in general these are activities which constitute activities from which International LLCs are similarly disqualified and which are referred to later on in this paper;

(d) the limited partnership:

(i) has to carry on business outside the Island; and

(ii) has to satisfy the Assessor of Income Tax that no-one resident in the Island is to have an interest in the partnership other than as a shareholder or debenture holder of one of the partners being a company either quoted on the Stock Exchange or a public company.

The non-resident members of such partnerships are then exempt from Isle of Man tax in respect of income received from the partnership.

In the course of the Limited Liability Companies Act 1996, referred to below, provisions were introduced which enabled the limited partner members of limited partnerships to bind the partnership and thus to participate in its conduct or management. In this respect the Isle of Man limited partnership carries with it greater flexibility for its limited partners than does its English counterpart. However, there still has to be at least one partner with unlimited liability. Both the ability of the person having the attributes of a limited partner to participate in business management and the desirability of excluding all partners from unlimited liability, nevertheless could be achieved provided an appropriate limited company was the general partner. The perceived desire to achieve these objectives was regarded as attainable through the evolution of the limited liability company, being that species of company not deriving its validity from ordinary Companies Acts but rather from special company legislation which originated in the United States and which is now in course of adoption in other non-US jurisdictions. The remainder of this paper is concerned to explain their evolution and their gradual adoption, first in the United States, then in other jurisdictions and most recently in the Isle of Man itself.

Evolution of the LLC Through the United States

Each of the fifty States making up the United States of America has its own system of law. In consequence, each State has (for example) its own real estate law, its own criminal law, its own partnership law and its own corporation law. In each of the States the word "corporation" is the noun used to describe an incorporated

body. In each State, in consequence, the law permitting the incorporation of a body corporate is often described as a species of corporation law: thus, for example, in the State of Wyoming the law enabling the creation of a body corporate for business activities is entitled "The Wyoming Business Corporation Act". There are, of course, other forms of organisation which can be created for particular business activities, some of which may have incorporated status and some of which may not. The partnership is one form of organisation not possessing incorporated status, but there are others. In the United States these forms of organisations are usually compendiously referred to as "associations".

Although most of the individual States possess a measure of purely State-related local taxation, the taxes payable throughout the United States are imposed on a uniform basis throughout the federal tax system. The system dates in origin from 1894 when income tax was first created, and is grounded in legislation described as the "Internal Revenue Code". From the earliest times the federal system imposed income tax liability upon the taxable income of "every corporation" without providing an exhaustive meaning of the word "corporation". A partial definition exists in the Code which provides that the term "includes associations, joint stock companies and insurance companies"; but nowhere does the Code define the terms "associations" or "joint stock company" though the latter term may date from a United States Supreme Court decision of 1911.

Although the term "associations" is wide enough to cover any group or body of persons banding together for some purpose or collection of purposes, whether the banding be through the creation of a body corporate, partnership or some other form of body lacking corporate status, in the United States the taxation of a corporate body or corporation differ materially from that attributed to an unincorporated body such as a partnership. Whereas in a corporate body or corporation (and the latter term is henceforth used in a USA context to refer to an incorporated body or body corporate) there was always the double liability to tax on corporation profits and distributions to corporation members, the partnership carried only one liability being that of the partnership members. Limited partnerships were popular in the US (see for instance the recent John Grisham book *The Firm* in which references are made to the use of the limited partnership as a tax shelter by one of the American clients of 'The Firm', using the Cayman Islands to provide foreign partners for his limited partnerships). But, in the United States as well as in the United Kingdom, the disadvantages of the limited partnership, already referred to at (A) and (B) above, were not only recognised but were looked upon as creating sizeable commercial disadvantages.

As between various forms of association which could be used for commercial or private purposes, the United States Supreme Court in 1935 in its decision in *Morrissey v CIR* 296 US 345, 356, laid down what it termed "the characteristics

ordinarily found in a pure corporation which, taken together, distinguish it from other organisations". These characteristics, which were seven in number, were, as to the first six, subsequently recorded in Internal Revenue Code Regulations dating from 1960. These Regulations created a mathematical standard: an association was to be classed as a corporation only if it possessed more corporate characteristics than non-corporate characteristics, the latter being as yet undefined. And features common to both corporations and partnerships were to be disregarded in evaluating whether an association was to be classed as a corporation or a partnership, though the absence of any one of such common features would disqualify the organisation from being either a corporation or a partnership.

The six characteristics defined in the *Morrissey* decision and confirmed by the Regulations as being required to be taken into consideration in determining whether an association possesses corporation or partnership status were:

(1) Associates;

(2) an intent to make profits and divide them (among the associates);

(3) continuity of life - i.e., perpetual existence;

(4) it has directors: its members do not provide the management;

(5) limited liability for its members;

(6) the rights of members must be freely transferable.

Of these, items (1) and (2) were identified as common to both corporations and partnerships, which left the remaining four - (3), (4), (5) and (6) - as needing to be satisfied if an organisation was to be classed as a corporation.

The later decision in *Larson v CIR* (1976) 66 TC 159,185 established the important weakness in the foregoing that if an organisation possessing features (1) and (2) nevertheless lacked two or more of the remaining four features, it could not be classed as a corporation and must then be classed as a partnership for federal income tax purposes. This decision appears to have been seized upon by certain advisers as providing a way of creating a business organisation which could have limited liability for its members while enabling them to participate in the business management of the organisation, yet retaining the taxation advantage of having the organisation profits taxed upon its members, without separate tax liabilities to the latter in relation to those profits or to any distribution of them to such members. The *Larson* decision was followed, relatively quickly one might say, by the enactment in 1977 in the State of Wyoming of what became known as The

Wyoming Limited Liability Company Act. This Statute created a new type of body or group, described in section 17-15-102 of the Statute as a "limited liability company" or "company" for short. Nowhere in the Statute was there any reference to this new body being described as a corporation or as having incorporated status or as being classed as a body corporate. The word "company" was thus used to distinguish this new kind of body from an organisation having corporate status.

A close perusal of the provisions of the Statute shows nothing which would indicate that the limited liability company (or company) was envisaged to be classed as having separate juristic personality. Although in its interpretation section (section 17-15-102 referred to above) the term "person" was the subject of a partial definition as including any of the following within the term, namely "individuals, general partnerships, limited partnerships, limited liability companies, corporations, trusts, business trusts, real estate investment trusts, estates and other associations", it is clear from the remainder of the terms of the Statute that the inclusion of each of these within the term "person" was merely a matter of partial definition of the word "person". There was no intent in the Statute thereby to accord any particular corporate status to any body or group within any of these categories.

The terms of the Statute contain nothing to indicate any intention to confer upon any limited liability company the status of a corporation or body corporate. Indeed, the intention appears to be to equate its status with that of a group of persons, called members, operating together as a single unit under a common name, and bound together by a document described as Articles of Organisation. But although not specifically stated, it appears to be the case that this group of persons takes effect as capable of standing on its own, independently of its members. That this appears to be the intention, arises out of the following specific provisions:

(a) There is a provision in section 17-15-113 of the Statute that neither the members of a limited liability company nor any of them nor anyone managing the company, are liable under any judgement, decree or Court Order or in any other manner, for a debt, obligation or other liability of the limited liability company. By itself that puts no member in a different position to that of a limited partner in a limited partnership;

(b) A subsequent provision in section 17-15-117 of the Statute declares that except as otherwise provided in the Act no debt shall be contracted or liability incurred by or on behalf of a limited liability company except by its managers or, if there is no management separate from the members, then by any member. The intention is clearly to enable the limited liability

company to take on debts or liabilities in its own name and not to commit any individual member or manager to liability in lieu;

(c) A third provision, this time in section 17-15-118 of the Statute, provides that real and personal property owned or purchased by a limited liability company is to be held and owned and conveyance made (and title taken) in the limited liability company name, in contrast to the name or names of one or more of its members as would be the case if the limited liability company was not intended to have separate juristic personality.

These provisions, taken as a whole, indicate it to be a reasonable inference that the limited liability company will be treated as having a personality separate from that of its members.

On the other hand, nothing in the Statute appears to contemplate that the company will have incorporated status. Indeed, not even the act of describing it as a "limited liability company" or "company" can give rise to that kind of inference. Indeed, the phrases "Company" "and Company", "Co." and "and Co." have historically been used in tandem with business names or groups which have formed themselves into partnerships without thereby implying that they might have been endowed with corporate status.

Nor is there an indication of an ascribing of corporate status in the provisions governing the creation or organising (or formation) of a limited liability company. Section 17-15-105 of the Statute contains provisions relating to the formulation of a name for the company and requires that the words "limited liability company" or some cognate abbreviations of the phrase or the letters "LLC" or "LC" must form part of the name of the organisation. Then, under the heading of "Formation", section 17-15-106 provides that:

> "any person may form a limited liability company which shall have two or more members by signing and delivering one original and one copy of the Articles of Organisation to the Secretary of State for filing."

After setting forth - in section 17-15-107 - the matters which must be contained in the Articles of Organisation, section 17-15-108, headed "Filing of Articles of Organisation", provides that (these copies having been delivered to the Secretary) if he finds that the Articles conform to law he shall endorse "Filed" and the date of filing on the original and copy, file the original in his office and issue a "Certificate of Organisation", to which he shall affix the copy. The Certificate and copy is then to be returned to the representative of the limited liability company. Section 17-15-109 then provides, under the heading "Effect of Issuance of Certificate of Organisation" that upon the issuance of the Certificate the limited

liability company shall be considered organised and the Certificate shall be conclusive evidence that the conditions precedent required to be performed by the members have been complied with and that the limited liability company has been legally organised under the Act. Not a word is said to indicate that formation gives rise to incorporation or that the Certificate is a Certificate of Incorporation or that the company is to be treated as having been incorporated. But it seems clear that there is nothing to interfere with the conclusion that the limited liability company has juristic personality. From a United Kingdom standpoint, the nearest parallel that one can find is the position of a Scottish firm under the Partnership Act 1890, section 4(2) of which accords to the firm a personality which is separate from the members of the partnership. But, differently to the Scottish partnership, the limited liability company is not either in terms or in fact a partnership. If anything at all, it is a species of unincorporated association lacking corporate status but not being a partnership from a private law standpoint.

The next matter which falls to be considered in the context of the limited liability company is its status for United States federal tax purposes. In this respect the limited liability company has the following specific features:

(i) It is not an incorporated body - as already explained above. This, however, has no relevance from the standpoint of US federal tax classification;

(ii) It has associates - namely its members - which must be two or more in number (as is provided in section 17-15-106 above);

(iii) It demonstrates an intention to carry on activities which are hoped to produce profits and to divide its profits amongst its members - this is apparent from the scheme of the Statute taken as a whole;

(iv) It has a duration which is not perpetual - which is the case with a normal corporation. The period of its duration (which has to be specified in its Articles of Organisation - section 17-15-107(a)(ii)) has to be thirty years from the date of filing of the Articles with the Secretary of State if no other period of duration is specifically set forth;

(v) The management of the limited liability company is reserved to its members or to a manager or managers appointed by them - as specifically provided in section 17-15-107(a)(ix) as having to be included within the Articles of Organisation. The limited liability company does not have directors which have separate status to its members;

(vi) Liability of the members of the limited liability company is limited - as is provided by section 17-15-113 of the Statute referred to above

(vii) Members' interests are not freely transferable - as is provided in section 17-15-122 of the Statute - in that members' rights cannot be transferred if all the other members of the limited liability company so resolve.

Features (ii) to (vii) above bear comparison with the six items ordained by the *Morrissey* decision and confirmed by the Internal Revenue Code Regulations as being the characteristics of relevance in establishing whether an organisation or association is to be classified as a corporation for US federal tax purposes. It will be appreciated from the foregoing that items (iv), (v) and (vii) do not comply with (3), (4) and (6) of those characteristics. Thus the way is open for the limited liability company to be disqualified from having corporation status, which disqualification results, having regard to the fact that the limited liability company complies with the first two of the six *Morrissey* criteria under paragraphs (ii) and (iii) above, in the limited liability company being classified as a partnership for US federal tax purposes. Thus, a position comes into existence whereby a limited liability company having separate juristic personality and having limited liability but without having corporate status - as would an ordinary limited liability corporation - is nevertheless capable of being classed as a partnership for US federal tax purposes.

Although in terms of federal tax law this appeared to be the position, it was not until 1988 that the Internal Revenue Services of the United States formally ruled that the Wyoming Limited Liability Company was to be regarded as a partnership for federal income tax purposes.

The consequence of this was that for tax purposes what was in substance an association having limited liability but lacking incorporated status, and having most of the features of an incorporated body, would nevertheless have partnership status for US federal tax purposes.

Between 1977 and the present day, most of the other States within the US adopted legislation to enable LLCs to be incorporated within those individual States. The States adopting the LLC concept are understood to number forty-nine altogether, the only one not having adopted the LLC concept being Hawaii, which will adopt LLC legislation effective on 1st April 1997. There is a helpful summary (in which the number of States adopting the LLC concept is stated to be forty-six) to be found in a recent article in *Offshore Red Alert*, a magazine published by Campden Publishing in London, and written by James Barrett, an attorney practising in the Miami offices of Baker & McKenzie (and who provided to the writer the information that the adopting number of States in fact amounted to forty-nine and

would become fifty in April 1997). This article by James Barrett is written almost entirely from a US standpoint but is helpful in providing brief details of the organisation and operation of a US founded LLC, as well as containing some details of the US tax classification of LLCs both in relation to LLCs formed within the United States and formed in other jurisdictions, as well as outlining some benefits for US tax purposes which may be available as a result of using the LLC concept by reference to a jurisdiction outside the United States.

LLCs Outside the United States

A number of other overseas, non-US jurisdictions espoused the idea of the LLC as a means of attracting business away from the United States and into those other jurisdictions. Examples of such jurisdictions are the Cayman Islands (in whose legislation the LLC is described as a limited duration company), the Turks and Caicos Islands (part of the Bahamas and in which the LLC is described as a limited life company) and Nevis (part of the territory of St. Kitts and Nevis in the Eastern Caribbean). A number of other jurisdictions are outlined in the article written by James Barrett, published in *Offshore Red Alert* and referred to above. Jurisdictions referred to include the Isle of Man, the jurisdiction with which this paper is henceforth primarily concerned. In the 1990s the attractions of the LLC commended it to a small group of practitioners in the Isle of Man and, under the auspices of the Isle of Man Government, a small working group (bearing the title "the Wyoming Company Working Group") was formed to consider the possible introduction of what was then described as "a new corporate form" into Manx law. The group consisted of the Isle of Man Assessor of Income Tax, a practising chartered accountant (who was Chairman), a practising lawyer, a practising private company and trust promoter and banker and two Isle of Man Treasury officials. At an early stage the group formulated a paper to, as its introduction described it, "put the case for the creation of a new form of corporate entity in Manx law" which "would be called a Limited Life Company (or 'LLC'). The entity" would "be entirely independent of the existing Companies Acts" and would "provide a much simplified and streamlined form of company suitable only as a holding entity or for very small business enterprises". The characteristics proposed were: that it would have corporate personality; its members would be involved in management, there being no separate board of directors; between one and twenty-five members all of whom would have limited liability to the extent of the capital introduced, with members' rights not automatically transferable; to go into liquidation not later than eighty years after its establishment; and to be deemed to be a partnership for all tax purposes, with income, gains, expenses and credits attributed to members on a pro rata basis and with non-resident members liable to tax on Manx source income only. It was reckoned that its effect would be to provide "a simple form of corporate entity with limited liability for domestic use

by small traders and as a simple holding entity" as well as "a first class corporate entity for sale in the international marketplace to rival the Caribbean International Business Company" as well as "an entity of immense appeal to US persons". It was also hoped that "by also legislating reforms into Manx trust law at the same time the Isle of Man could become the market leader in the provision of trust and corporate services for US persons".

The paper included an attempt to evaluate the limited liability company in the USA. Although there was a certain amount of confused language, it is apparent that the paper's editor realised that the US limited liability company was not in fact incorporated. To quote from the paper:

> "The English language as used in the USA differs somewhat from that used in Europe. A limited liability company, as it would be understood in England, is, in US terminology, a Corporation whereas the term "Corporation" in England normally means an agency of Government operating under a charter, such as the Broadcasting Corporation."

As has been explained above, the term "corporation" in England has a somewhat wider significance than just as a reference to an agency of Government operating under charter. But to continue:

> "The term "Company" in the USA does not imply incorporation or even limited liability and can be translated into English as an "Association". Thus the term "Limited Liability Company" as used in the USA can be translated into English as an association with limited liability - not far removed from a limited partnership.... Ever since Wyoming introduced the concept of the limited liability company into US law more and more new uses have been found for it. Today, not merely do more than half the States in the USA either have, or plan to have such legislation, but the idea has been catching on overseas too with the Cayman Islands...and the Turks and Caicos Islands."

After extolling the tax characteristics of the USA limited liability company, the writer of the paper proposed that:

> "By legislating to introduce the concept" of the LLC into Manx law"... we can introduce a new and simple form of corporate entity for domestic use as a simple holding company and for small businesses... Secondly such a domestic entity would provide a simplification for tax purposes. Such companies need not be taxable as such but could be treated for Manx tax purposes as partnerships... The income, gains, expenses and credits would be attributed pro rata to the partners. A non-resident partner would be

> taxable on his Manx source income but not on non-Manx source income... Thirdly a Manx LLC would provide a new entity for the international marketplace to rival" the International Business Company of the Caribbean "and with special appeal to US persons."

After further encouraging remarks, the paper concluded that:

> "It is recommended that without delay legislation should be introduced, modelled on the legislation of Wyoming, USA to provide for the incorporation of LLCs under Manx law both for domestic use and for international use. Such LLCs must be devised so that they would be characterised as partnerships under the Internal Revenue Code of the USA."

The thrust of the paper was thus a proposal to adopt the limited liability concept into Manx law but to endow such companies with corporate status instead of leaving the organisation unincorporated. To emphasise the point being made, the feature of the proposal was to create a fully incorporated limited liability company which would be classified for US tax purposes as a partnership.

The detailed paper which propounded these objectives was apparently prepared at the instigation of the Isle of Man Government, though it had the support of the working group; but it had the disadvantage that; although there was enthusiasm for the acceptance of the ideas put forward in the paper, the group lacked representations from experienced international tax and company law practitioners. This no doubt is the primary reason for the failure to implement the stated primary aim and objective of the paper - namely to create a fully incorporated limited liability company.

The group must have reported favourably to Government because during 1995 legislation was formulated by the Isle of Man Government Treasury. The draft legislation was circulated to a selection of prospectively interested persons in 1995. The draft Bill was accompanied by an explanatory Memorandum which, after stating that the Bill was promoted by the Treasury, stated:

> "2. The object of the Bill is to enable the establishment of a different form of body corporate in Manx law. The new body will be called a limited liability company and will have the following principal characteristics -
>
> - it will be a body corporate which is a separate legal entity to its members."

After listing the other principal features of the USA version of the limited liability company - limited liability, management by members, taxation as a partnership and maximum thirty years' duration - the Memorandum continued:

> "The laws of many States of the United States of America permit the incorporation of such companies and this Bill follows closely the concepts contained in the Wyoming Limited Liability Company Act (Laws 1977, ch 158§1)".

Details of the clauses then followed.

Following the introduction of draft legislation into Tynwald (the Isle of Man Parliament) there was enacted on 9th July 1996 the Limited Liability Companies Act 1996. For ease of brevity and reference, and also to avoid confusion, this Act is henceforth referred to as "the 1996 Act". The legislation contemplates that the 1996 Act is brought into force, not on 9th July 1996 but on a later date which is defined by an Appointed Day Order which provides that the 1996 Act generally came into force on 17th October 1996, although two other sections in the 1996 Act not concerned with limited liability companies (which are henceforth referred to for ease of brevity and reference, and also to enable them to be distinguished in an Isle of Man context from their USA/Wyoming predecessors, as "LLCs") were brought into force on an earlier date, namely 1st August 1996. The legislation also contemplates that it will be supplemented and "fleshed" by Treasury, regulations, some of which have been published and came into force on 17th October 1996 following their promulgation and confirmation by Tynwald. Further details of these regulations follow later in this article.

The tragedy of the 1996 Act, which is explained in more detail below, is that it failed to implement the primary aim and objective of both the early discussion paper and the Bill as explained in the explanatory Memorandum quoted above - namely the intention that the LLC be created by an incorporation process which enabled it to take effect for private law purposes as a body corporate and therefore a company (as that term is understood in English law) but treated as a partnership for USA federal and Isle of Man tax purposes. As is explained below, the LLC is indeed taxed as a partnership: but for the reasons explained below the draftsmen of the Isle of Man legislation failed to appreciate that the Wyoming limited liability company did not have incorporated status, which status was confined under Wyoming law to the Wyoming corporation, of which the Wyoming limited liability company was not a species. Despite the fact that it is plain from perusing the Wyoming Limited Liability Company Act that the Wyoming limited liability company and the Wyoming corporation are different creatures/organisations, the draftsmen appear to have equated the two as being similar and as both having incorporated status. The result is that the Isle of Man LLC is not a body corporate

nor is it a corporation or a company as understood in United Kingdom or Isle of Man law. LLC is not a body corporate nor is it a corporation nor a company as understood in United Kingdom or Isle of Man law. According to section 1(1) of the 1996 Act it is described as (but is nowhere in the Act enacted to be) "a body of persons". This expression has no statutory definition attributed to it either in the Isle of Man Interpretation Act 1976 or in any other Isle of Man legislation. The 1996 Act provides that for tax purposes it is to be treated as a partnership and its members are to be treated for tax purposes as partners. It will in due course no doubt (it is assumed) be accorded similar treatment in the USA. But although the 1996 Act enacts that the LLC is to be treated for tax purposes as a partnership and that its members will be treated for tax purposes as partners, this does not mean that the LLC will be a partnership or that its members will be accorded partner status for other purposes. Its possible nature will be considered in a later part of this article.