

CM SKYE

CM Notes

ISLE OF MAN LIMITED LIABILITY COMPANIES (LLCs)

Note. In this brochure, the word 'Company', when standing alone, is given the meaning found in English Company law, and equates to the American word 'Corporation'.

The concept of the *Limited Liability Company* as found in the USA, is described here as an LLC.

Summary - Basic Characteristics of an LLC

- a. It has legal personality.
- b. All members have limited liability.
- c. Only the Articles of Organisation, which are simple and basic, are public. All other documents including the Operating Agreement are private.
- d. There are no directors. Management is carried on by the members. Any Manager is appointed with specifically delegated powers only.
- e. There is no requirement for filing of accounts.
- f. There is no requirement for an Annual General Meeting.
- g. It has infinite flexibility.

Origins and US Tax Status of the LLC

There are a great many different jurisdictions across the world, each with its own unique contribution to make to the world of corporate and trust structuring and tax planning. The good professional adviser will be familiar with most of the jurisdictions which are commonly used for international work, although there are always hidden gems to be found, and, of course, new forms being evolved

One of these newer forms of Company is the Limited Liability Company, as originally conceived in Wyoming, USA, and which has now spread throughout the USA and beyond.

At the outset, we need to define some terms. The English language as used in the USA differs somewhat from that used in the rest of the English-speaking world. A *Limited Liability Company*, as it would be understood in England, is, in US terminology, a *Corporation*, whereas the word '*Corporation*' in England normally means an agency of government operating under a Charter, such as the *British Broadcasting Corporation*.

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 British English as an *Association with Limited Liability* - not far removed from a Limited Partnership. In order to keep matters clear, the abbreviation 'LLC' will be

used from here on to describe this new and unique form of business organisation, as that is the term which is universally used.

The Internal Revenue Code of the USA has to contend with the fact that it is one tax code, being applied in 50 different jurisdictions, each with its own laws, forms of organisation, and internal tax systems. What is called a 'Corporation' in Delaware may have markedly different characteristics to a Corporation incorporated in California. Some states, with legal systems rooted in French or Spanish law, barely have trust law as we understand it. The only way open for the Internal Revenue Code is to define its own terms, which can then be applied, irrespective of the terms of individual States' legislation.

The distinctive characteristic of the original Wyoming LLC is that it has corporate form and personality while, under the former regulations of the Internal Revenue Code of the USA, being characterised as a Partnership.

The former criteria applied by the Internal Revenue Code against which an organisation was defined were:

- a. the existence of associates, i.e. a number of persons joined together to the enterprise;
- b. an objective to carry on business, and divide the gains and profits thereon;
- c. the continuity of the life of the entity;
- d. the degree of centralisation of management;
- e. whether there is limited liability for the debts of the entity;
- f. free transferability of rights.

However, under the *Check-the-Box* Regulations which came into effect on 1st January 1997, this characterisation ceased. The current rules are as follows:

- a. *Per Se*. The rules list certain entities which are, *per se* Corporations for Tax Purposes. An LLC is not on the list;
- b. if the entity is for the purpose of preserving and conserving assets, and has no commercial purpose, it will be characterised as a Trust for tax purposes. Most pure holding companies will fall under this heading, as will any entity designed purely for Asset Protection purposes;
- c. if the entity fails both the above two tests, it will be an Association for tax purposes;
- d. if the Association has Limited Liability, it will be a default Corporation, but it can elect to be treated as a Partnership;
- e. if the Association does *not* have Limited Liability, it will be a default Partnership, but it can elect to be treated as a Corporation.

It needs to be borne in mind, however, that each State of the USA has its own tax system, and characterisation for State Tax purposes does vary from State to State.

The Isle of Man in its legislation adopted the Wyoming legislation as its model and legislated the Limited Liability Companies Act 1996 specifically, with the intent of ensuring that an Isle of Man LLC would always meet the criteria in the former regulations of the Internal Revenue Code of the USA to be classified as a Partnership. However, with the introduction of the *Check-the-Box* Regulations in 1997, the Isle of Man LLC could for US tax purposes, be a constructive Trust,

depending on the drafting of the Articles of Organisation. If it is not a Trust, it will be a default Corporation, but could elect to be treated as a Partnership.

For Isle of Man Income Tax purposes, an Isle of Man LLC will always be taxed as a Partnership, and, if owned by Non-Resident Members and having no Isle of Man source income, can be exempt from all Isle of Man direct taxation.

Constitutional Characteristics of an Isle of Man LLC

An Isle of Man LLC is formed by the registration with the Registry of LLCs of the Articles of Organisation, and subsequent issuing by the Registrar of a Certificate of Registration.

The constitutional documentation of an Isle of Man LLC is:

- a. the documents which govern the LLC are the *Articles of Organisation* and the *Operating Agreement*;
- b. the Articles deal with a few major points, such as the name of the LLC, the identity of the Members, the capital introduced by each Member, the principles governing the admission of new Members, and the ability of surviving Members to continue the business in the event of a Member dropping out as a result of death, resignation, or otherwise;
- c. the Articles of Organisation is a public document;
- d. the Operating Agreement is a private document entered into by the Members, and deals with the internal governance of the LLC. Although a few matters must be dealt with as required by the Limited Liability Companies Act 1996, the Operating Agreement is largely drafted to suit the Members;
- e. there are no Directors of an LLC. As in a partnership, the Members manage the LLC directly;
- f. the Members may appoint one or more Managers, but such a Manager has only those powers specifically delegated to him by the Members, and has no assumed powers or duties as is the case with the Director of a Company. His powers are only those that are specifically given to him. If he is appointed but specific powers are not formally defined, in theory he merely has the title, but no powers to go with it. It is essential, therefore, that an appointment defines in writing the powers granted to him;
- g. the LLC will be wound up automatically if a Member ceases to be such, whether by dint of death, resignation or disqualification. If the number of Members falls below two the winding up is obligatory. However, if two or more Members remain, they may resolve to carry on, in which case the outgoing Member will be paid out, and the LLC will continue. This means that technically, there cannot be a **transfer** of an interest, without the LLC going into liquidation. The procedure is for a member to resign and assign his interest to a new applicant for membership. The LLC is thus placed into liquidation by the resignation, and then the continuing members resolve to continue, with the retiring member being paid out by the replacement member taking an assignment of the retiring member's interest;

- h. the LLC does not have a Share Capital. The Members declare in the Articles of Organisation their capital contributions, and their voting and profit sharing rights are deemed to be proportionate in the absence of provisions to the contrary in the Operating Agreement. Thus it is possible to issue a Certificate stating that a particular Member has a percentage 'share' in the business, but there are no definitive 'shares' as there would be for a US-style Corporation, or a Company Limited by Shares;
- i. the Members have their liability limited to the amount of their capital contribution as declared in the Articles of Organisation;
- j. membership is not transferable or assignable. As noted above, the equitable interest of a Member can be transferred on the basis of a Member resigning and a new Member joining in replacement, and the interest of an existing Member can be, of course, subject to a charging order, but a third party holding such a charged interest has no power to participate in the management of the LLC, and no power to require a distribution of capital or profit, or to require the LLC to be wound up;
- k. there is no provision for an annual meeting or, indeed, any formal meeting of Members. There is no provision for the auditing or filing of accounts, although the Act does require the Members to keep proper accounts;
- l. charges on the assets of the LLC must be registered, as is the case with a Company;
- m. an annual return is submitted each year, setting out the details of the Members and any Manager;
- n. under Isle of Man tax law, the LLC is taxed as a Partnership, and thus is a wholly transparent entity. Where the LLC derives its income from a non-Manx source, and its Members are non-resident in the Isle of Man, it may register as an 'International LLC', in which case, for a fee of £475 per annum, it is entirely exempted from Isle of Man direct taxation. If, however, it is carrying on a trading activity in the Isle of Man, it may have to register for Value Added Tax. This, however, creates yet another set of opportunities, in the context of trading in Europe.

Formation of an Isle of Man LLC

The LLC is formed by two or more persons who register, with the Registrar of LLCs, the Articles of Organisation of the LLC, and, simultaneously, enter into a private Operating Agreement. The Articles of Organisation need not be long. They are obliged to deal with following matters:

- i. the Name of the LLC (which must receive prior approval from the Registrar, and must end with 'Limited Liability Company', 'L.L.C.' or 'LLC');
- ii. the period of duration of the LLC. (There is no longer any statutory limitation);
- iii. the names and addresses of the Members;
- iv. the name and address of the Isle of Man Registered Agent, who must be a professionally qualified Manx resident individual;

- v. the total amount of cash, and description and agreed value of property other than cash, contributed by the Members of the LLC;
- vi. the total additional contributions, if any, agreed to be made by the Members and when they are to be made;
- vii. the right of the Members, if any, to admit additional Members;
- viii. the right of the remaining Members to continue the business on the cessation of Membership of a Member. Such cessation would otherwise terminate the LLC;
- ix. the right of a Member to receive out of the property of the LLC repayment of all or a part of his capital contribution;
- x. if the Members are permitted to appoint a Manager.

At the same time as the Articles are signed, the parties enter into the Operating Agreement. These provide for the internal governance of the LLC and the rights of the Members amongst themselves.

After the Articles have been registered, the Registrar will issue a Certificate of Registration, and the LLC is in business.

What would one use an Isle of Man LLC for?

We need to understand that the LLC is an entity that owes its existence and its significance to the US federal taxation system. That does not mean, however, that it is of significance only to US persons. Far from it. The simplest way to analyse the uses of an LLC, therefore, is to divide the matter in two, being:

- a. the use of the offshore LLC by a US persons;
- b. other uses of offshore LLCs.

5. The use of the offshore LLC by a US person

As noted, the LLC may have any characterisation available under the Internal Revenue Code. This means that it could be a Trust, a Corporation or a Partnership. If the LLC is a Trust or a Partnership, it cannot, by definition, be a corporation, and cannot therefore be a Controlled Foreign Corporation (CFC), a Foreign Personal Holding Corporation (FPHC), or a Passive Foreign Investment Corporation (PFIC).

This is significant because, where a US person participates in a foreign corporation, there are some severe tax drawbacks. Such a company may well be a CFC, a FPHC or a PFIC. In all these cases, the reporting requirements are considerable and onerous. Furthermore, for a CFC, on the death of the US shareholder, certain punitive rules apply in relation to basis step-up. (Sec 1246(e) and 1291(e)). (For the layman, '*basis*' is the base value of the asset for Capital Gains Tax purposes. '*Step-up*' is the increase of the basis which occurs when the assets are sold or transferred to another party, and which triggers off the Capital Gains Tax liability (or '*causes the liability to be recognised*').) On the

death of a US person, his estate is subject to Inheritance Tax, and Capital Gains Tax is forgiven, thereby providing a tax free 'basis step-up'. In respect of holdings in a CFC, there is no such forgiveness, and this could easily result in the tax payable being greater than the value of the assets.

The LLC, however, can provide an offshore holding vehicle with complete avoidance of these onerous provisions, including considerably reduced reporting requirements, and complete avoidance of the penal basis step-up provisions. We show below some examples of usage:-

a. As Asset Protection vehicles.

For the last few years persons in the USA have been responding to the highly litigious environment in which they live, where the doctrine of remoteness in tort has been under assault, and the amount of damages awarded by juries has apparently lost touch with the real world. The establishment of overseas asset protection trusts to hold family assets safe from US court judgements and creditors has grown enormously.

Unfortunately, the trust, as a concept, has always had a number of limitations in this context. In the first place, a trust is a creature of Equity, that branch of traditional English law which is concerned with remedies in personal disputes. In this context, the transfer of assets so as to deny a creditor, both present, and future, the ability to access the assets has been considered fraudulent since the sixteenth century (the so-called Statute of Elizabeth), and the principle is embodied in nearly all modern 'Common Law' jurisdictions, either directly in legislation (Uniform Fraudulent Transfer Act in the USA) or in precedent. Although this issue is one of Bankruptcy Law, the implicit fraud is sufficient for a Court of Equity to decline to enforce the provisions of a trust set up 'without clean hands'. The Isle of Man is the only traditional 'Common Law' jurisdiction which never adopted the precepts of the Statute of Elizabeth, which makes it one of the most secure jurisdictions for asset protection work. (see our brochures: '*Asset Protection Trusts in the Isle of Man*' and '*Asset Protection: Fraudulent Transfer; and Re the Petition of Christopher Jollian Heginbotham 1999*'.)

In order to remedy this, a few jurisdictions have legislated to define the circumstances in which a transfer will be considered fraudulent and otherwise. Some of this legislation is satisfactory in that it merely clarifies an existing principle. However, one or two jurisdictions have introduced legislation which many lawyers, and increasingly the courts, consider has swung unacceptably the balance the other way, thereby creating major difficulties at the equitable heart of trust law.

Another problem has been that the concept of the trust has, at its heart, some fundamentals which clients may not care for. For example, there is an absolutely fundamental requirement that the Trustee takes full legal ownership and control of the assets, which he cannot divest. Many a client seeking an Asset Protection vehicle is horrified to find that he loses control of his hard earned assets to some foreigner in a remote jurisdiction who could, theoretically, take decisions entirely independently of him.

This again has prompted one or two jurisdictions to change the rules. What they have failed, apparently, to understand, is that a trust where the Settlor (or Grantor) retains control is not a trust as the law of equity understands it. It is an agency, or perhaps a bailment, and entirely different legal rules apply. The solution to this problem is to use an incorporated 'Foundation' as the vehicle. A Foundation in the Isle of Man will have exactly the same protection from fraudulent

transfer as a trust, but avoids the problems associated with trusts. At the same time, however, it can be structured so as to be a trust for US tax purposes, and could therefore be a Grantor Trust.

The massive increase in the use of offshore trusts over the last thirty years, often in jurisdictions with either no, or entirely inadequate trust law, has led to a corresponding explosion in litigation. In the last two or three years there has been a succession of decisions which have raised large question marks over the future use of offshore trusts as assumptions that have been made for years have been overturned (e.g. the fiduciary nature of a Protector).

The US legislation in 1966 (*Small Business Jobs Protection Act 1966*) in the area of offshore trusts, (which abolished the grantor rules relating to trusts other than a trust with a US person as Grantor, and imposing obligations on offshore trustees), came as a direct result of the explosion of overseas Asset Protection Trusts and the view of the Internal Revenue Services that there had been massive under-reporting of their establishment.

The offshore partnership has been used as a Family Property Protection vehicle for some time, but it too has drawbacks. For a start it has unlimited liability and no legal personality. Even a Limited Partnership is unable to provide legal personality.

The LLC seems to be the best current vehicle for Family Property Protection planning. Having legal personality, and corporate form, it cannot be simply dissolved or voided as can a trust. Membership rights are not transferable, and the best that a creditor can obtain is a charging order over the interests of a Member. But, unless the other Members agree, the creditor has no rights to participate in management, nor to vote at any meeting. Thus, the creditor can only hope that, one day, the LLC might make a distribution. Since this hope could be over twenty years away before it is fulfilled, the pressures on a creditor to settle the matter are substantial, especially as an attorney working on a contingency fee will certainly not be prepared to wait twenty years!

See brochure: '*Asset Protection Trusts in the Isle of Man*'

See brochure: '*A simple introduction to Isle of Man private Foundations (Excluding Registered Charities)*'

b. Joint Ventures with Non-Resident Aliens

It is by no means uncommon for US persons to enter into foreign joint ventures with non-resident aliens of the USA. However, because of the IRS rules, a US person entering into such a joint venture will wish to have the joint venture vehicle in the USA. If he participates in a foreign holding company, the company will almost certainly be a Controlled Foreign Corporation with all that that implies.

Of course, the non-resident alien is unlikely to be thrilled about participating through a US entity, as that then exposes him to US taxation.

The solution is to use an offshore LLC, where the LLC elects to be treated as a partnership for US federal tax purposes. The taxable profits attributable to the US partner will be taxed in his hands, and he suffers no penalties. The taxable profits attributable to the non US partner will not be liable to US taxation.

Thus, by far the best arrangement is to use a foreign LLC classification as a partnership. An Isle of Man LLC can achieve this.

Other uses of offshore LLCs.

The most significant large scale potential of an offshore LLC is for use instead of an IBC or other corporate form for simple situations.

Over the years both company law and company taxation has become more and more complex. In nearly every country, there has been growing an awareness that company law does not differentiate adequately between the Multi-national corporate entity which employs thousands, and the simple company used, for example, to hold a property, and which employs nobody. As a result, there has been increasing pressure to 'deregulate' small private companies.

In Europe, this pressure has resulted in substantial relaxation of disclosure requirements for small companies.

The pressure led, in the Caribbean, to the introduction of the phenomenally successful 'International Business Company' or *IBC*. It has effectively created a brand new type of company, with minimal administrative and reporting requirements, but equally, with considerable restrictions on both its design capability and its uses. It is not possible, for example, to structure such a company as a Foundation or other form of Quasi Trust. A creditor of a Shareholder can, following a judgement, take possession of the shares, and thus control of the company.

The modern offshore LLC is frequently, as we have already noted, merely a variant of the IBC. However, in the Isle of Man, it is not. It is an entirely separate form of business organisation, able to provide exactly what most clients need in an offshore structure:

- a. corporate personality;
- b. Limited Liability;
- c. minimal administrative requirements, with no Directors. A Manager has only such powers as the Members choose to give him;
- d. tax exemption and/or transparency;
- e. Asset Protection;
- f. safety in that there are no shares, bearer or otherwise, to be lost or alienated. There is no loss of control;
- g. minimal disclosure.

a. Double Tax Treaty - Double Dips

Since an LLC can elect to be treated as a partnership in the USA, and is treated as a partnership in a number of countries, while other countries, such as the UK, treat the LLC as a corporation for tax purposes, the LLC lends itself to the creation of 'Double-Dip' structures for interest or leasing deductions.

b. Charitable deductions

If a US person wishes to make a donation to a foreign charity, but also wishes to take a tax deduction for the gift, we can arrange for a US charitable remainder trust to be set up, with a

subsidiary overseas LLC. The LLC elects to be treated as a partnership. In the overseas county where the LLC is established, a parallel charity is established, with an underlying company. The LLC can enter into a contract with the offshore company, so that the actual assets of the LLC are transferred to the offshore company.

As a result, the gift, for US tax purposes, is treated as having been made to the US charity, whereas control of the actual assets is outside the scope of the Internal Revenue Code.

c. Reproducing a US-type split interest charitable trust in a non US environment

The charitable split interest 'Charitable Remainder Trust' or 'Charitable Lead Trust' is a fundamentally important vehicle in the USA, acting as incentives to charitable giving. There is no equivalent anywhere else in the world. However, by using an offshore LLC, we can get close to it.

To replicate a Charitable Remainder Trust, the LLC is set up so that there are two members with different rights as defined in the Operating Agreement. The first member has no rights to any distributions during the lifetime of the LLC but has the right to receive everything upon the dissolution of the LLC. The second member has the right to receive all and any income distributions from the LLC, but no right to receive any distribution on the dissolution of the LLC. Further refinements to these rights are set out in the Operating Agreement.

The first Member then donates his interest to a Charitable trust. Depending on his circumstances he may or may not obtain a charitable tax deduction. For example, if the LLC elects (Form 8832) to be characterised as a partnership for US purposes, and the charitable trust to which the interest is donated is s. 501(c)(3) charity for US purposes, a charitable deduction would be attainable.

If the LLC is set up by non-US persons in a no-tax jurisdiction, like the Isle of Man, the tax effect for non-US persons can be similar to that of a Charitable Remainder Trust in the USA.

Costs

The cost of establishing and maintaining an offshore LLC can be considerably cheaper than maintaining a regular company. As a cost effective Asset Protection vehicle, the offshore LLC is the most inexpensive solution available.

Please keep in mind:

The contents of this material are not intended to provide anything other than general information as to the issues addressed. This material is confidential and may contain proprietary information, and its contents may not be disclosed, copied or otherwise made available to any person without prior consent.

This material is distributed with the understanding that it is not rendering accounting, legal or tax advice.

Additional information is available upon request from CM Skye at 2 Water Street, Ramsey, Isle of Man IM8 1JP.

Email: office@cm-worldwide.com