



13 May 2020

Office of the Chief Tax Counsel
Inland Revenue
Wellington

By email: public.consultation@ird.govt.nz

Re: Tax public consultation – PUB00338: Investment in US limited liability companies

1. The New Zealand Law Society | Te Kāhui Ture o Aotearoa (**Law Society**) welcomes the opportunity to comment on the draft item: *PUB00338: Investment in US limited liability companies*, which is comprised of five rulings (**the Rulings**) and commentary (**the Commentary**) setting out the income tax treatment and availability of foreign tax credits for NZ investments in a US limited liability company (LLC) that is taxed on a fiscally transparent basis as a partnership in the US, but as a company in NZ. Comments from the Law Society's Tax Law Committee are set out below.

US taxation of LLCs

LLCs can elect to be taxed as corporations

2. The Commentary suggests that a US LLC with at least two members is always taxed as a partnership for US federal income tax purposes (for example, at paragraphs 1 and 16). This is incorrect.
3. Although a US LLC with at least two members will be classified as a partnership by default, the LLC can elect to be treated as a corporation for US federal tax purposes.¹ If this election is made, the LLC will itself be taxed (as an opaque entity) rather than the members of the LLC being subject to tax on a flow-through basis.
4. The Tax Law Committee understands that the Rulings and the Commentary are only intended to apply to US LLCs which are treated as partnerships for US federal income tax purposes. The Commentary should be amended to make this distinction clear.
5. Because the Rulings define a US LLC to mean a limited liability company formed under state law in the US that is classified as a partnership for US federal income tax purposes, we do not believe any changes to the Rulings are technically required. However, for clarity we suggest that wording should be added to "The Arrangement" to make it clear that each Ruling only applies where the US LLC has not elected to be taxed as a corporation for US federal income tax purposes.

¹ The LLC can elect to be taxed as a corporation by filing Form 8832, Entity Classification Election. See: <https://www.irs.gov/businesses/small-businesses-self-employed/limited-liability-company-llc>

Single-member LLCs

6. Most US states permit an LLC to have only one owner (a “single-member” LLC).
7. By default, a single-member LLC will be a flow-through/disregarded entity for US federal income tax purposes, with the single member responsible for paying US federal income tax on the LLC’s income.² As with multiple member LLCs, a single-member LLC may alternatively elect to be treated as a corporation for US federal tax purposes.³
8. It is possible that an NZ investor may be the owner of a single-member US LLC.⁴ Under the default settings, the NZ investor would pay US federal income tax on all of the US LLC’s income. In this case, the application of NZ’s taxation rules to the NZ investor should be identical to those set out in the Rulings and the Commentary.⁵
9. The Tax Law Committee suggests that the Rulings should be expanded to include circumstances where an NZ investor is the owner of a single-member US LLC that has not elected to be taxed as a corporation for US federal income tax purposes. This should only require modest updates, given the outcomes are effectively the same as in the draft Rulings. The Commentary should likewise be updated to accommodate single-member LLC scenarios.

Clarification of terminology relating to US LLC “distributive shares” and capital account allocations

10. The Commentary and examples are not clear as to the differences for US tax purposes between US LLC “distribute shares”, capital account allocations and members’ shares of taxable income and distributions. For example, Example 1 in the Commentary provides that the NZ investor’s shares of the US LLC’s accounting profit is \$1,200 which is credited to their capital account (and can be withdrawn at will, in this example), but that their share of the LLC’s income for US tax purposes is \$1,000.
11. The Tax Law Committee’s understanding of US LLC taxation is that:
 - a. Each member of an LLC (that is taxed as a partnership) must take into account their “*distributive share*” of all items of the LLC’s income, gains, losses, deductions and credits for US federal tax purposes.⁶

² Where the member is a natural person, the LLC’s income is treated as self-employment income on the individual’s personal income tax return.

³ As with multiple member LLCs, this can be done by filing Form 8832, Entity Classification Election.

⁴ This is not a hypothetical scenario. Members of the Law Society’s Tax Law Committee are aware of individual NZ investors who are the owners of single-member US LLCs.

⁵ Effectively treating the NZ investor as having a 100% “partnership” interest.

⁶ We note that a “distributive share” is a defined term in the US tax code in relation to partnership taxation (see 26 U.S. Code § 704). The Commentary at paragraph 12 states that most LLC operating agreements include an explanation of “how profits and losses for financial accounting and tax are to be allocated to each member (***commonly referred to as a member’s distributive share***)” [emphasis added]. Given a “distributive share” is a defined concept for US federal tax purposes, we suggest that saying it is “commonly referred to” as such is not a helpful description. Moreover, the concept of a “distributive share” is only mentioned once more in the Commentary, at Example 5 (paragraph 172). It is unclear to us why this terminology is not used throughout the Commentary for consistency and technical accuracy.

- b. Distributive shares are generally determined by the LLC’s operating agreement and are not necessarily the same as a member’s percentage ownership interest in the LLC (it is possible to make special allocations to members, subject to certain restrictions).
 - c. A member’s capital account is essentially a measure of a member’s equity in an LLC. It is generally added to by a member’s contributions to the LLC, added to or subtracted from to reflect a member’s share of net income or loss annually (based on a member’s distributive share), and subtracted from by any distributions taken by the member.
 - d. Because a member’s distributive share is not necessarily the same as their percentage ownership in the LLC, the LLC’s accounting profits on an ownership percentage basis will not necessarily align with the profit on which a member pays tax.
12. Based on our understanding set out above, we believe that on the facts set out in Example 1, the member’s “distributive share” of the profits (on which they would pay US federal income tax) should be the \$1,200 amount credited to their capital account and available for distribution. It is unclear why the \$1,000 figure is stated to be the share on which the NZ investor will pay US federal income tax.
 13. We note that Examples 2 through 6 abandon the distinction between distributive shares under the operating agreement and simply refer to shares of income on which US federal income tax is paid (although Example 5 specifically refers to this as a “distributive share”).
 14. We recommend that the Commentary be reviewed for consistency with these principles and terminology be updated accordingly, in particular the description of US LLC taxation at paragraphs 15 and 16.

Figures in the Commentary Examples should reflect economic reality

15. The Tax Law Committee appreciates Inland Revenue’s efforts to illustrate the principles in the Rulings through the use of Examples in the Commentary. In general, examples are useful to illustrate the application of often complex rules to real-world scenarios. However, it appears to us that the numbers used in some of the Examples are unrealistic and, although the analysis is technically correct, have the potential to provide distorted views as to the effect of the rules in practice.
16. To illustrate this point, we note the following:
 - a. In **Example 3**, we are to assume the NZ investor has \$2,000 of FIF income (NZ tax at 33% is \$660) and a “partnership” share of US LLC income for US purposes of \$1,000 (US tax at 30% is \$300). As illustrated, there is no further tax on a distribution from the US LLC to the NZ investor, and no foreign tax credits or relief under section CD 18 is available. The end result is the NZ investor suffers total tax of \$960 on income of \$1,000. This represents a 96% effective tax rate. In our view this is an unrealistic example as no rational investor would make this investment, or if the investment was made, the investor would elect a different FIF income calculation method (e.g. CV instead of FDR) better to reflect their actual return on investment.⁷

⁷ As an additional observation, we note this example implies a \$40,000 investment in the US LLC (assuming the FDR method applies), while also assuming the cost of the investor’s FIF interests is greater

- b. In **Examples 4 and 5**, it is suggested that the NZ investor has attributed FIF income or CFC income (respectively) of \$2,000 in year 1 for NZ tax purposes, while at the same time having US taxable income of \$1,000 (being the investor's "partnership" share of the LLC's income). We submit that it is not realistic for attributed income to be double the actual income derived by the investor in relation to their "partnership" share for US purposes, and these assumptions result in an unrealistic outcome. Specifically:
- i. The effect is that the NZ investor ends up with a large BETA tax credit which can fully satisfy the prima facie NZ tax owing on the net dividend received from the US LLC.
 - ii. The large BETA tax credit arises because the US tax paid on "partnership" income (\$300) is far less than the notional NZ tax payable on attributed income (\$660 before claiming \$300 foreign tax credit), meaning there is a net NZ tax liability on attributed income of \$360 (which becomes a BETA credit to fully offset NZ tax payable on the distribution from the US LLC).
 - iii. In a more realistic scenario, if we assume attributed FIF/CFC income equals the US taxable income of \$1,000, then the BETA credit would only be \$30 (\$330 prima facie NZ tax less \$300 foreign tax credit). The NZ tax liability on the \$700 net dividend from the US LLC of \$231 would only be partially satisfied by the \$30 BETA tax credit, with further tax to pay in NZ on the distribution.

US tax paid by LLCs on behalf of NZ investors

17. Examples 1 to 6 each refer to the NZ investor's US federal tax liability being paid by the US LLC on behalf of the investor. The mechanism by which this occurs is not otherwise referred to in the Commentary, which (correctly) states that where an LLC is taxed as a partnership, the individual partners (including an NZ investor) are responsible for paying tax in the US on their share of the LLC's income. In our view this may lead to confusion given the Examples refer to the US LLC paying the NZ investor's tax with no further explanation.
18. Where an LLC is taxed as a partnership, the LLC is subject to a partnership withholding tax regime in relation to non-US resident members' shares of the LLC's income (although the withholding tax only applies in relation to US-sourced income of the LLC).⁸
19. We recommend that the Examples be updated to clarify that the US LLC's payment of an NZ investor's US tax liability is via this withholding mechanism. We also recommend noting that NZ investors remain obliged to file US income tax returns in these circumstances, even if no further US taxes are due.

than \$50,000. While the investor may have other FIF interests in addition to their interest in the US LLC, to aid clarity we suggest amending the numbers in the example so that the US LLC interest alone puts the investor over the \$50,000 threshold.

⁸ See: <https://www.irs.gov/individuals/international-taxpayers/partnership-withholding>.

Further assistance

20. We trust Inland Revenue will find these comments helpful and if further discussion would assist please contact the Tax Law Committee convenor Neil Russ, through the Law Society's Law Reform Adviser, Emily Sutton (Emily.Sutton@lawsociety.org.nz).

Yours faithfully

A handwritten signature in black ink, appearing to read 'Herman Visagie', with a large, sweeping flourish at the end.

Herman Visagie
Vice President