HMRC

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Consultation on reform to taxation of UK-resident members of LLCs and other reverse hybrids

Introduction

UK Private Capital (formerly the British Private Equity and Venture Capital Association, or BVCA) represents 600 firms including the wider ecosystem of professional advisers and investors. Private capital consists of private equity and venture capital which makes long-term investments to grow British businesses and build a better economy. Private credit and venture debt also provide active and engaged debt finance to businesses.

The private capital industry backs 13,000 UK businesses, nine in ten of which are small or medium-sized enterprises. Businesses backed by the industry employ 2.5 million people across the UK and contribute 7% to GDP.

In 2024, £29.4bn was invested by private capital into UK businesses in sectors across the UK economy, ranging from consumer products to emerging technology. This increased investment has fuelled the growth of businesses across the UK, with six in ten (58%) of the businesses backed in 2024 located outside the capital. These investments are long term, with an average investment period of six years, in contrast to less than a year in public markets. UK-based private capital specialists have raised £190bn of funds, known as dry powder, expected to be invested over the next three to five years.

We welcome this consultation and are grateful for the opportunity to respond. Changes in law to address the longstanding uncertainty for UK resident members of US LLCs could, if designed carefully, be a very positive development. It would also send an important signal that the UK is an attractive and welcoming destination for entrepreneurs, investors and businesses.

We would, however, highlight that the private capital industry, which is highly mobile, will assess any changes to the UK's tax environment in the round. Changes proposed in other current, or recently closed, consultations that could have a negative impact on the industry risk outweighing any positive effects of the LLC consultation. Consultations in this category include:

- Modernising the distributions framework – the proposals relating to distributions from non-UK companies could result in substantial (and we believe unintended) tax increases for investors in UK-managed funds;

- Timely Payments in Income Tax Self-Assessment – estimating future receipts of carried interest is highly challenging and may be impossible, so making this a requirement will make it very difficult for private capital managers to comply with their tax obligations;

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- Reporting company payments to participators – the new reporting requirements aimed at small family-run businesses could apply to private capital backed companies, because they come within the technical definition of a "close company" (see our response here); and

- Extending the Notification of Uncertain Tax Treatment (UTT) regime – these proposals would introduce further complexity by requiring individuals to carry out alternative tax calculations based on different interpretations of the law (see our response here).

These proposals, particularly when viewed with other recent changes including to the tax rules affecting non-doms, carried interest, entrepreneurs' relief and CGT rates, risk damaging the UK's competitiveness and its attractiveness as a global business hub. Potentially positive measures such as the LLC consultation may have a relatively minor impact on this overall picture.

Turning to the current consultation, the tax treatment of UK-resident members of LLCs raises complex issues, and any changes bring a significant risk of unintended consequences. Therefore, while we support the Government's ambition to resolve the current challenges, the design of any new rules will require considerable care. We strongly recommend further consultation, as happened with, for instance, the recent carried interest reforms, and would be happy to provide more detailed input.

Summary of our response

This is a difficult area, both for the Government and for representative bodies, as US LLCs can be used by a range of taxpayers for many different reasons. There will be considerable challenges in finding a solution which does not create even greater complexity and which is also not open to abuse. It is critical that any changes do not unintentionally make this area even more challenging, as this would risk making the UK less attractive to individuals with interests in US LLCs: an outcome that would be directly contrary to the aims of the consultation. We would therefore urge the Government to hold further discussions with industry stakeholders before any new rules are finalised, so that these can be designed effectively.

Our principal recommendation is that any new treatment should be optional rather than mandatory. An automatic change to the UK tax treatment of LLCs would disrupt existing structures that have been established relying on HMRC's longstanding view that LLCs are opaque for UK tax purposes. Given the wide variety of commercial arrangements involving LLCs, it is impossible to anticipate all the consequences of a compulsory change. We therefore strongly recommend an elective regime that allows taxpayers to choose the treatment most appropriate to their circumstances.

Key additional points include:

- Automatic partnership treatment has the potential to give rise to a range of unintended consequences, including the possibility of "dry" tax charges, implications for tax treatments previously adopted on the basis that the entity was a corporation, and complications arising from the multi-layered nature of many private capital structures.

- Specific practical difficulties may arise in applying partnership treatment, including SP D12, particularly where UK members represent only a small minority of investors. As a possible solution, we recommend that the Government consider using "transparent" treatment as an alternative to partnership treatment.

- If a transparency approach is adopted, legislation should use a clear, familiar and objective definition of transparency, avoiding complex subjective tests that would undermine certainty.

- Any new regime should include appropriate transitional protections, and in particular should not trigger a deemed disposal for capital gains purposes.

- The Government should give serious consideration to a credit relief solution, as this has the potential to achieve the policy objective more simply than changing the underlying characterisation of LLCs. A credit-based approach could avoid many of the technical and compliance challenges associated with deeming LLCs to be partnerships.

Overall, reform should prioritise optionality, certainty, competitiveness and administrative simplicity.

Our responses to the consultation questions that are most relevant to the private capital industry are set out below. As a general point, we sometimes use the term LLCs in this response in contexts which could apply to other entities, because US LLCs are those we most frequently encounter. However, other overseas entities (such as SCIs, S-Corps and Jersey LLCs) would also need to be considered.

Question 1: Have you or your clients faced a high effective tax rate (ETR) on income from reverse hybrids? If so, please provide details about the circumstances, including the ETR, the type of entity and income it related to, and what kind of member you or your clients were.

Reverse hybrids are frequently encountered in the private capital industry. US structures featuring US LLCs that are flow-through for US tax purposes are extremely common; these are often the default entity of choice in US fund structures for asset holding companies, management entities, carried interest vehicles and general partner entities. As such, issues are often encountered where, for example, UK investors or carried interest participants invest in an existing US fund structure, or where there is a desire to grant a UK individual an interest in a US management entity. Issues also arise on "GP stakes" transactions (transactions involving third party investment in, or acquisitions of, asset management businesses) where the use of LLCs is common.

More generally, US businesses may be structured using LLCs, either as holding vehicles for opaque companies or for businesses which are fully transparent for US tax purposes.

Given the range of scenarios in which US LLCs are used, these entities may receive a broad range of returns, including trading income, management fees, carried interest and capital gains. Where a UK tax resident individual is taxed both on US income on a look-through basis and on distributions from the US LLC, the ETR can, as the consultation document notes, be unacceptably high.

Question 2: Have you ever taken steps to mitigate a high ETR related to a reverse hybrid? If so, please provide details. If you were not able to take steps to mitigate a high ETR, please explain what the barriers were.

While not always commercially possible, a high ETR related to a reverse hybrid may be mitigated through bypassing the US LLC, e.g. by the UK tax resident investing in the structure below the US LLC. Alternatively, it may be possible to replace the US LLC with a partnership. In some circumstances, it may also be possible to mitigate the high ETR by checking the US LLC closed (so that both the US and the UK treat it as opaque, and the UK individual is able to claim a tax credit in respect of the US tax paid). However, issues often arise in respect of existing and established structures, where changes (including introducing participants lower down the structure) can be commercially and practically difficult.

In a private capital context, investments may be structured through LLCs which are outside of the control of investors, and so it is not possible to take steps to mitigate any adverse tax consequences (for example investments in US operating businesses structured as LLCs, where the UK resident investor is a limited partner in a US private equity fund).

We would note that this is not exclusively an issue for UK resident US citizens, but also affects UK resident members of LLCs who are not US citizens. US private capital firms invariably use LLCs and offer these to their UK resident managers, without providing an alternative option.

Question 4: Has the UK tax treatment of income from reverse hybrids affected your or your clients' personal decisions about where to live and work? If so, please give details.

As US LLCs, in particular, are frequently encountered in the private capital industry, the existing rules make the UK a less attractive destination for private capital managers and the investments that they make. We are anecdotally aware that issues connected to LLCs are a factor in some private capital managers no longer being based in the UK, or considering potential moves abroad.

Question 5: Has the UK tax treatment of income from reverse hybrids affected your or your clients' commercial decisions such as where to locate offices and staff, do business and make investments? If so, please give details.

Please see our response to Question 4.

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Question 6: Do other jurisdictions offer more favourable treatment for your or your clients' income from reverse hybrids? If so, which jurisdictions are these? What makes the treatment more favourable than the UK?

The jurisdictions which are most commonly used in the private capital industry often offer equivalents to the remittance basis or FIG regime, which allow the cashflows in question to be untaxed in the individuals' jurisdictions of residence. As a result, this issue often does not arise.

Question 7: Do you see any issues with defining the scope in the way stated above? Can you identify any potential boundary issues with any specific entity types?

The proposal set out in the consultation document is that, where an entity is "transparent" for tax purposes in its jurisdiction of establishment but "opaque" from a UK tax perspective, it will be treated as a partnership for tax purposes from the perspective of individual UK resident members.

We think that the proposal raises a number of key challenges, and there may not be a perfect solution in all cases. We would welcome the opportunity to discuss these with you further.

Transparency

One area which will require consideration is the definition of transparency versus opacity under any new regime. If the definition is too complicated it will defeat the purpose of the proposals, which is to provide clarity. We would suggest that the hybrid mismatch definition in s 259BE TIOPA is considered, since it is already in tax legislation and so is familiar. It is also similar to the wording at issue in *Anson*, so that HMRC's view on the point is already clear and, again, familiar to taxpayers. We would be concerned that a complicated and highly subjective definition with multiple criteria would add cost and complexity to the proposals. We anticipate that any definition would be confined to the new legislation, so that the wider *Memec* principles and their application in other circumstances would be undisturbed.

Partnership treatment

The proposals include the suggestion that LLCs be accorded partnership treatment, including the full operation of SP D12. We recognise and support the Government's aim of aligning tax treatment between the UK and elsewhere. However, we are concerned that this may create or exacerbate certain issues.

The question of whether the relationship of partnership has been entered into is, generally, one of fact with those involved being aware of the related tax consequences. Even in the case of UK LLPs, where partnership treatment is "deemed", it is for all taxes on income and gains and the LLP is a UK entity. Deeming a non-UK entity to be a partnership (UK partnership law differs from that in the US and elsewhere) and, even then, only for certain taxpayers, has the potential to raise significant challenges.

SP D12 is not necessarily easy to understand or operate, and imposing all elements of it (e.g. regarding changes in profit sharing ratios, as described in our response to Question 12 below) will increase difficulties for taxpayers and for the LLC itself. In many cases, UK resident LLC members will be a small minority and the potential burdens of managing SP D12 for a minority of members may make the proposals more difficult to manage than is intended.

There are also wider tax implications of deemed partnership treatment. The tests of connected parties sometimes involve partnerships - would UK individual residents be connected with other LLC members for these purposes? Would the mixed member rules need to be considered? From the perspective of the UK individual members or others, would the LLC itself fall within the definition of "company" as being "any body corporate" or would it be excluded as being a "partnership" even though this only applies for some members? From a non-tax perspective, would any elements of partnership law be applicable (we would assume not)? There will doubtless be other considerations, but these examples illustrate the range of issues that would need to be addressed if partnership status were deemed automatically.

A solution might be to use "transparent" treatment as an alternative to "partnership" treatment. This could be supplemented by guidance to the effect that this is likely to mean partnership treatment, but does give greater optionality. We anticipate that any legislation will include a TAAR and we would support this to prevent abuse of the new regime, but we consider there could be benefits in being less prescriptive on the imposition of "partnership" treatment.

"Inside" and "outside" basis and compliance issues

Under US partnership law, there is a concept of "inside" and "outside" basis, where members have an "inside basis" in the LLC assets and an "outside basis" in the LLC itself. If deemed partnership treatment and SP D12 are mandated, then in the event a UK resident individual member disposed of their partnership interest, we are concerned that credit for any US tax on the disposal of the LLC interest would not be available against the UK tax treated as arising on the disposal of the LLC's underlying assets.

Additionally, the UK and US have different rules on allocations of profits to partners.

These issues are not "novel" in that they apply equally to e.g. Delaware limited partnerships. However, in the interests of rendering any new rules attractive to members of LLCs and similar entities, it would be useful if these problems were addressed. The proposal above for the use of "transparency" rather than "partnership" treatment might offer some flexibility here, even if it is not a perfect solution.

Transfers to and from corporate entities

A further issue to address would be the consequence of an individual UK LLC member transferring their interest to a UK company or vice versa. This may result in some oddities if the individual is treated as having a partnership interest and a company as having an interest in the LLC. It might mean that the transferor is disposing of a different asset to that acquired by the transferee. Again, this might be easier if there were some flexibility by use of the term "transparency" rather than imposing partnership treatment.

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Question 9: Do you see any advantages or disadvantages to transparent treatment applying automatically, rather than by irrevocable election?

In our view, it would not be appropriate to introduce a universal, automatically applied treatment to alter the position of existing LLCs. HMRC has been consistent in its view that US LLCs and similar entities are opaque for UK tax purposes, and some structures have been established in reliance on that assumption. The range of situations in which LLCs are used means that it will not be possible to foresee every knock-on effect of an automatic change.

For instance, in the area of employee incentive arrangements, US employees have on occasion been advised that they hold partnership interests and UK employees have been advised that they hold shares. If an LLC used for such arrangements were to be treated as a partnership or even merely described as "transparent", the change would need to be communicated to numerous employees. Apart from the cost of this process, there would also be questions about issues relating to employment related securities (for example, the validity of existing s 431 elections) and other matters.

In other situations, UK resident LLC members may be seeking to rely on relief under e.g. s 135 TCGA on the basis that they held an interest in a "company". If their position automatically changed to an interest in a partnership, this availability would cease. It is highly likely that there would be other examples.

Private capital structures are often complex and it is not uncommon for UK resident individuals to hold interests in multiple layers of entities that would be treated as opaque in the UK and transparent in their home jurisdiction. The proposal could therefore require profits and losses to be computed on a UK income tax basis at multiple levels within a structure, creating substantial compliance and administrative burdens.

There is also a real possibility of "dry" (unfunded) tax charges arising, because tax would be levied on individuals based on the profits and gains of the overseas entity, irrespective of whether those amounts have been distributed. To manage this situation, it is likely that private capital firms would need to pay their managers "tax distributions" to fund this liability. Tax distributions are commercially unattractive (because they must be funded from returns that have not yet been realised, or from investors) and lead to further tax complications, both for the firm and the manager.

Accordingly, we would strongly recommend against an automatic change to the underlying tax treatment of LLCs. Instead, any regime which impacts the treatment of LLCs should provide for a default treatment with an election being made for different treatment.

We would also recommend that the election be made on an individual basis only, so that taxpayers can choose the treatment that is best suited to their own circumstances without disruption to an entire structure, and without the need to balance the considerations of all UK resident members, who may be in different positions. An individual election would be straightforward, which would be consistent with rendering the UK an attractive jurisdiction.

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By contrast, it would be extremely unattractive if some members had to restructure their interest as a result of an election affecting the entire LLC which adversely impacted them individually. It would seem that, in cases such as this, where the UK tax treatment of the LLC itself is unaffected, a joint election is unnecessary. This contrasts with the position in relation to e.g. a s 431 election where there are tax implications for both the employer and employee, so that a joint election is appropriate.

We would, in addition, suggest that it should be possible to change an election, but not frequently. We understand that in the US it is generally possible to change a check-the-box election after 5 years; the Government could consider a similar provision.

Application beyond individuals

Although we would anticipate that corporations are unlikely to want any change in their current position, we would suggest that, if enacted, the proposals are open to corporations and trusts too, on an elective basis. There may be cases where transparent treatment would be helpful, for instance where a small company receives a distribution from an LLC (given the comparatively narrow dividend exemption categories when compared with large companies).

Election for opacity or transparency

On balance, we think it would be more appropriate to have a "default" of transparency for entities which are transparent from a local perspective and opaque from a UK perspective. An election can then be made for opaque treatment by UK residents. This is because it is likely that more taxpayers will seek transparency, so this would create fewer administrative burdens.

Perhaps even better would be a system under which the default for corporations is opacity and for individuals and trusts it is transparency. Those wishing to elect for alternative treatment would be able to do so. This would seem to automatically confer the treatment most likely to be the preference for each type of taxpayer while allowing for an election. Therefore, it would be least burdensome.

Question 10: Do you see any issues with deeming the trade or business of eligible foreign entities to be carried on in partnership (or as a sole trade), and profits/losses being computed in accordance with UK Income Tax rules? If so, what are they?

Please see our response to Question 7.

Question 12: Do you see any issues with applying Statement of Practice D12 to individual members, and capital gains/losses being computed in accordance with UK Capital Gains Tax rules? If so, what are they?

Please see our response to Question 7.

We would also note a specific issue that would arise if, under any new rules, SP D12 became applicable to UK members of LLCs. Often US LLC agreements provide for an annual revaluation of assets and allocation of the revaluation to capital account. For UK members, there would therefore be a risk of triggering dry tax charges under SP D12 on changes in profit sharing percentages. An easement to SP D12, to only tax gains when they are realised and not on a change in profit shares with no cashflow, would assist in removing this issue.

Question 13: Do you see any issues specifically with respect to establishing each member's fractional interest in the assets of the entity? If so, how could these problems be overcome?

An example of the issues that would need to be addressed is how the new treatment would interact with reliefs that are available for investments in shares, such as BADR or EIS, in a situation where a (transparent) LLC itself holds, and disposes of, shares in other companies. Would a UK individual member of an LLC be entitled to these reliefs in respect of their proportionate holding in the underlying shares?

Question 15: Do you see any issues that might arise upon these transitions, in respect of tax rules (or reliefs/exemptions) applicable to a holding that begins or ceases to be treated on a transparent basis? What are the issues that arise? How might these be mitigated?

We would recommend that the Government ensures that appropriate measures are in place to allow for the smooth implementation of any new regime. This could be by way of a transition period or by the option of an retrospective election, even if the retrospective option is only available for an initial period.

If the effect of any new rules is that entities that were previously opaque would become transparent (whether automatically or by election), the legislation should provide that this does not result in a deemed disposal for capital gains purposes. Otherwise individuals could face tax charges based on the market valuation of their interest in the overseas entity, without receiving proceeds from which to fund those liabilities. This would risk undermining the UK's international competitiveness by creating tax liabilities before any realisation event, placing UK-resident individuals at a disadvantage relative to those in other jurisdictions.

Similarly, consideration should be given to the position on exiting the regime, if for instance the local or UK treatment of the entity changes. It is likely that it would be appropriate to have a "grace period" in some instances.

Question 17: Do you see any issues with this approach, including any unintended outcomes for individual or non-individual taxpayers? If so, what are these?

We would strongly recommend that this measure is brought in on an elective basis, so that the issues outlined in our responses to Questions 7 and 9, including the potential unforeseen consequences of automatic partnership treatment, can be avoided and the changes can achieve the stated aim of a fair outcome with long-term certainty.

Question 19: What are your views on the deduction for foreign tax and credit relief options outlined above? Do these approaches have advantages or disadvantages in comparison to UK matching of transparent treatment? Please give details.

We would urge the Government to give serious consideration to a "credit" route so that, rather than changing the overall treatment of LLCs, UK domestic credit would be available for underlying local tax. We understand that a system similar to this is used in France.

This has some very significant advantages, in that it is a much more straightforward route which would avoid complicated concepts of transparency, the potential application of SP D12, different tax treatments of an entity by members of the same entity etc. Accordingly, we regard it as a potentially attractive option which should be pursued further.

The key potential disadvantage is that, assuming LLCs continue to be treated as opaque albeit with credit available, any US tax paid at capital gains tax rates would nonetheless be taxed as a distribution in the UK. This means the available credit would, we assume, be against income taxed at dividend rates, rather than a capital gain. A credit system which can solve this (as the partnership route does) would be welcome.

Accordingly, we would recommend that the Government explores a potential credit option, if it can be constructed in such a way as to address this disadvantage. We would welcome discussion on this topic because, as stated above, a credit option would likely involve far fewer technical issues and would avoid the need to consider most of the issues set out above. Therefore it is intuitively attractive and, overall, would be preferred by many. We have not provided further detail on this option because it is not straightforward and, since the consultation document does not expand on it in the same way as for the "transparency" approach, we are less clear how HMRC might consider a credit to operate. We do have some wider thoughts which we would be happy to discuss, and would appreciate any opportunity to do so.

Question 24: How might any of the proposed changes to the tax treatment of income from reverse hybrids impact your or your clients' view of the UK as a place to live, work, do business and make investments?

As we stated in our introductory comments, addressing the longstanding uncertainty in this area could, if the changes are designed carefully, send an important signal that the UK is an attractive and welcoming destination for entrepreneurs, investors and businesses. It should, however, be viewed in combination with other, less positive, changes or proposals affecting the industry. It is also important for any reform to prioritise certainty, competitiveness and administrative workability. We would welcome the opportunity to discuss these proposals with you further as the Government's policy objectives develop.

Yours sincerely

The UK Private Capital Tax Committee