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## Series LLC: Ruling Clarifies IRS View, But Leaves Uncertainty

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Many in the real estate development and rental real estate business favor conducting their business activity through one or more limited liability companies (“LLCs”). LLCs provide all of the flexibility offered by partnerships; yet, while partnerships typically require one or more partners to bear general liability for the liabilities of the partnership, LLCs protect all of their members from the liabilities of the LLC. For tax purposes, an LLC is generally treated as a partnership (or is disregarded as an entity separate from its owner if it has only a single owner), but can elect to be treated as a corporation if desired.

Delaware, in 1996, was the first state to enact a statute providing for the establishment of a series limited liability company (“Series LLC”). Under the Delaware statute, the operating agreement of a Series LLC may provide for the establishment of one or more designated series of members, managers, limited liability company interests or assets. Each series may establish separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property. For instance, a Series LLC may segregate its assets and

the liabilities encumbering those assets in different series, such that each series is akin to a separate LLC. Each series of the Series LLC may have its own business purpose or investment objective.

One of the main benefits afforded by the use of a Series LLC to those in the real estate business is the ability to segregate assets for asset protection purposes within a single entity as opposed to creating a separate LLC to hold each real estate asset. For example, if a real estate group owns a portfolio of properties, the owners can transfer each specific real property into a separate series with liability limited solely to that property. Using one Series LLC in lieu of many separate LLCs can create administrative efficiencies and minimize both initial formation and filing expenses and annual maintenance, administrative, compliance and tax costs. Only a single manager may be needed for a Series LLC. To the extent relevant, only one registration document need be filed with the Securities and Exchange Commission with respect to a Series LLC rather than one for each LLC.

Despite the benefits offered by using a Series LLC, thus far, the use of Series LLCs in the real estate industry has been scarce. A major factor contributing to the disuse of the Series LLC has been the uncertainty for federal tax purposes as to how the entity will be treated. Specifically, the unsettled question has been whether a Series LLC is

treated as one entity or several for federal tax purposes. Although the question has not yet been firmly settled, the IRS recently published a private letter ruling indicating that the IRS would treat the Series LLC in question as consisting of several LLCs.

How an entity will be treated for federal tax purposes is governed by Internal Revenue Code (the “Code”) section 7701 and the regulations thereunder. Conceptually, the Code and regulations divide entities into either “eligible entities” or “per se corporations.” A per se corporation is an entity that is treated as a corporation under state law. Entities not classified as per se corporations are eligible entities. Eligible entities may elect to be treated as a corporation. An eligible entity that does not elect to be treated as a corporation will be treated as a partnership for federal tax purposes if it has more than one owner and will be treated as an entity disregarded from its owner if it has only one owner.

In Private Letter Ruling (“PLR”) 200803004, the IRS ruled on the entity classification of the various types of series within a Series LLC. Implicit in this ruling is the notion that each series of a Series LLC is treated as an entity. In the facts of the ruling, a business trust which operated as an open-end management investment company (*i.e.*, a mutual fund) had several series of beneficial interests. Each series corresponded

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to a separate portfolio of assets of the trust. Each of these series was treated as a regulated invested company (“RIC”) for federal tax purposes. The business trust was seeking a ruling with respect to its reorganization as a Series LLC. As part of the reorganization, each of the former trust portfolios would transfer its assets and liabilities to a separate series of the Series LLC in exchange for an interest in that series, and would distribute the Series LLC interest to its owners in liquidation of the trust series.

In PLR 200803004, the beneficial interests in the Series LLC’s property were divided into shares in multiple segregated portfolios of assets, each with separate investments and separate streams of earnings. Separate accounts were maintained with respect to each portfolio, and the income, gains and losses from the assets of a separate account were credited to or charged solely against that separate account. The creditors of a particular portfolio of the Series LLC were limited to the assets of that portfolio for the recovery of expenses, charges and liabilities. Votes of the shareholders were conducted on a separate portfolio basis with respect to matters that affected only that particular Series LLC portfolio, except to the extent that securities law required all shares of the Series LLC to be voted as a single class of shares.

Based on these characteristics, the IRS examined three types of portfolios of the Series LLC: “Type C,” “Type D,” and “Type P”. The Type C Portfolios would have one or more members and would elect to be treated as RICs (a type of corporation) for federal tax purposes. The Type D portfolios would each have only a single owner and would not seek to elect to be treated as corporations for federal tax purposes. The Type P portfolios would have more than one owner, but would not seek to elect to be treated as a corporation for federal tax purposes. The IRS ruled that the Type C portfolios would be taxable as RICs, the Type D portfolios as entities disregarded from their sole owner, and the Type P portfolios as partnerships. Inherent within this ruling is the conclusion that each portfolio series of the Series LLC is treated as a separate entity.

Perhaps this new guidance on the tax status of Series LLCs will foster greater use of Series LLC by those previously deterred by the uncertain federal tax treatment. Significant caveats remain, however. First, while PLR 200803004 provides insight into the IRS’s position, the ruling itself may not be relied upon as precedent other than by the taxpayer to whom it was issued. Second, it is possible that not all Series LLCs are properly viewed as consisting of multiple LLC entities for federal tax purposes. The series on which the ruling

focused were strictly segregated and operated very much in the manner of separate entities. It appears that assets and liabilities were strictly segregated by series. It is not clear from the ruling the extent, if any, to which there was overlapping ownership of the series; however, there seems to have been significant overlap. Where assets, liabilities, income, or expenses are not entirely segregated, or where each of the series are beneficially owned by the same persons, the multiple series are more likely to be treated as a single entity.

For instance, consider a Series LLC made up of Series A and Series B. Both Series A and B are owned 50 percent by Y and 50 percent by Z. Series A and B (in addition to owning separate assets) each owns a 50 percent interest in each of Assets 1 and 2 and the Series LLC creditors can enforce their liabilities against either Series A or B. Given the many interrelationships between the series, this case may be distinguishable from the case in the ruling and may lead to a different result. Thus, while this ruling is a step in the right direction toward clarifying the tax treatment of Series LLCs, there remains much uncertainty in this area. We are hopeful that the IRS will continue to publish guidance so that taxpayers will be able to take advantage of the benefits offered by using a Series LLC.

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