Originally published in:
BNA Tax Management Real Estate Journal **November 3, 2010**

Series LLC—Is It Finally Usable?

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BACKGROUND

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, but whereas partnerships typically require one or more partners to bear general liability for the liabilities of the partnership, LLCs can 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.

In 1996, Delaware enacted a statute providing for the establishment of a series limited liability company (series LLC), and seven other states have since enacted similar statutes. Under the Delaware statute, the operating agreement of a series LLC may provide for the establishment of one or more series of the LLC. Although the series are not separate entities for local law purposes, they are similar to separate entities in many respects. For example, each series can have a separate business purpose or investment objective and can separately own property. In addition, assuming that certain criteria are satisfied, a series LLC provides for the segregation of liabilities such that the creditors of one series cannot reach the assets of the LLC generally (the series organization) or of any other series of the series organization, and creditors of the series organization cannot reach the assets of any of its individual series.

The organizational structure of a series LLC formed under the Delaware statute can be similar to the more traditional "master LLC" structure, where one LLC owns interests in other LLCs. In a classic master LLC structure, one LLC owns 100% of the interests in lower-tier LLCs. Both a series LLC and a master LLC structure provide for the segregation of the assets of each series or LLC (as applicable) from the other series or LLCs. However, whereas a series LLC formed under the Delaware statute is not a separate entity for local law purposes, each LLC in a master LLC structure is a separate entity for local law purposes. This distinction can result in significant cost savings in both the initial formation and the annual operation of a series LLC as opposed to a master LLC structure.

Despite the benefits offered by using a series LLC, the use of series LLCs in the real estate industry thus far has been scarce. A major factor has been the uncertainty of how this entity will be treated for tax purposes, in addition to certain non-tax questions about series LLCs. Until recently, the only direct guidance from the IRS on the treatment of a series LLC for federal tax purposes was a January 2008 private letter ruling.[2] However, that ruling did not address whether certain facts (such as a commonality of ownership and business purpose between the series) would affect this result, and regardless, a private letter ruling may be relied upon only by the taxpayer to which it was issued.

On September 14, 2010, the IRS issued Proposed Regulations that address the treatment of a series LLC for federal tax purposes. The general approach of these Proposed Regulations is to treat each series of a series LLC as a separate local law entity, and then to have the classification of the series for federal tax purposes depend on general tax principles. Despite the IRS's attempts to provide certainty with regard to the treatment of series LLCs for federal tax purposes, a few questions remain unanswered. Nevertheless, will the issuance of the Proposed Regulations finally make series LLCs usable?

VARIOUS STATE LEGISLATION

The Delaware statute provides that an LLC agreement may "establish or provide for the establishment of 1 or more designated series of members, managers, limited liability company interests or assets." [3] Each series of a Delaware LLC is not a separate entity for state law purposes. However, each series is treated similar to a state law entity in several significant respects. First, each series may have a separate business purpose or investment objective and may have separate rights, powers, or duties with respect to specified property or obligations.[4] In addition, each series has the power and capacity to, in its own name, contract, hold title to assets, grant liens and security interests, and sue and be sued.[5] The LLC agreement may provide for different classes or groups of members or managers "associated" with each series, having rights, powers, and duties as provided for in the LLC agreement.[6]

Assuming that the LLC agreement of a Delaware series LLC so provides and certain reporting criteria are met, the debts, liabilities, obligations, and expenses of any one series are enforceable against only that series (i.e., not against the series organization or any other series of the series organization); and none of the debts, liabilities, obligations, and expenses of the series organization or any other series is enforceable against that series.[7] The requirements for a series LLC to be afforded this limited liability are as follows:

- The LLC agreement establishes one or more series and provides for the limitation of liabilities with respect to such series.
- Records maintained for such series account for the assets associated with each series separately from the assets associated with the series organization or other series.
- The certificate of formation provides notice of the limitation on liabilities of a series.[8]

Most of the other state series LLC statutes are similar to the Delaware statute in that each series of a series LLC is not a separate entity for state law purposes. However, the Illinois statute provides that "a series with limited liability shall be treated as a separate entity to the extent set forth in the articles of organization." [9] Each of the state statutes is also similar to the Delaware statute in allowing series of a series LLC to have separate business purposes, investment objectives, members, and managers.[10] Each provides that a series may have separate rights, powers, or duties with respect to specified property or obligations. In addition, each of the state statutes provides that if certain requirements are met, assets of one series are isolated from creditors of other series or the series organization, and assets of the series organization are isolated from creditors of its series.[11]

At the same time, each of the state statutes places certain limitations on the powers of the series of a series LLC. For example, they do not allow a series to convert into another type of entity or to merge with another entity — rights that generally are granted to LLCs.[12] Certain of the state statutes do not address whether a series can sue or be sued, hold title to property, or contract in its own name.[13] Also, most of the state statutes provide that the dissolution of the series organization of a series LLC automatically causes the termination of each series of the series organization.[14]

PRACTICAL USES AND ADVANTAGES COMPARED TO A MASTER LLC STRUCTURE

As noted above, a master LLC structure can be used to accomplish the objective of isolating the assets of each entity from the creditors of the other entities in the structure. However, the use of a series LLC offers a significant potential for cost savings. Upon formation, a series LLC does not require the incurrence of LLC formation costs and filing expenses for each individual series that would be required for each LLC in a master LLC structure. On an annual basis, a series LLC can minimize maintenance, administrative, and compliance costs as opposed to those of a master LLC structure. In addition, a series LLC would simplify tax reporting requirements if only one information return were required for the series LLC and all of its series together. Also, if relevant, one registration document could be filed with the Securities and Exchange Commission with respect to the series organization and all of its series together.

Thus, the series LLC structure offers the potential for significant administrative efficiencies and cost savings. However, there have been lingering uncertainties regarding series LLCs, relating to both tax and non-tax issues, which have discouraged real estate professionals from using this structure.

OPEN NON-TAX ISSUES

The open non-tax issues generally relate to the question of the extent to which courts will respect the limited liability that is granted to series LLCs by the Delaware LLC Act and other statutes enabling series LLCs.[15] For example, under what circumstances will courts "pierce the veil" of a series to provide for liability of the series organization, members associated with the series, or other series of the series organization? Will they be more likely to do so than they would with LLCs in a master LLC structure? Will courts in states that do not provide for the creation of series LLCs apply Delaware law or the state's own law when determining whether the creditors of one series of a Delaware series LLC may claim assets of the series organization or of another series of the series organization?[16] Will bankruptcy courts respect the isolation of the assets of one series from the series organization and from other series of the series organization? Can one series make a separate bankruptcy filing? Would a tort judgment against one series be enforceable against the series organization or other series of the series organization? These questions provide uncertainties that cannot be answered by guidance provided by the IRS and the Treasury Department.

OPEN FEDERAL TAX ISSUES

How will the series of a series LLC be treated for federal income tax purposes? Specifically, will each series be treated as separate from the series organization and the other series of the series organization for federal tax purposes? This determination is made as a matter of federal tax law, and does not depend on whether series are treated as separate entities under local law.[17] If a series is recognized as a separate entity for federal tax purposes, is it a "business entity" under Regs. §301.7701-2(a) such that, for federal tax purposes, a series with two or more members would be classified as either a partnership or a corporation, and a series with only one member would be classified as either a disregarded entity or a corporation?[18] Is it an "eligible entity" under Regs. §301.7701-3(a), which may elect whether to be treated as a corporation?[19]

In addition, there are various specific questions that relate to the classification of a series of a series LLC for federal tax purposes. Is each series required to file a separate information return? If so, would this reduce the administrative efficiencies of a series LLC over a master LLC structure? What are the tax consequences of transferring property from one series to the series organization or to another series of the series organization, or from the series organization to one of its series? Are such transfers taxable events? What are the tax consequences of an owner of one series exchanging its interest in the series for an interest in the series organization or in another series of the series organization? Can one accomplish a §1031 exchange by transferring relinquished property from one series and replacing it with property acquired in another series? Can net income from one series be offset by a net loss of the series organization or of another series of the series organization? Is each series separately responsible for employment taxes? What are the tax consequences of terminating one series while other series of the series organization continue to exist?

To address the classification of a series of a series LLC for federal tax purposes, one possible approach is to consider the "association" of members of the series LLC who have the rights with respect to the series as would a member of a regular LLC.[20] Under this approach (the association approach), if at least two members are associated with a series, the series would be a separate entity for federal tax purposes (as would an LLC with two members). If only one member is associated with a series, the series would be disregarded for federal tax purposes unless it elects to be treated as an association taxable as a corporation for federal tax purposes (as would an LLC with only one member).[21]

An alternative approach is to focus on the presence or absence of a commonality of ownership and business purpose between the series in a series LLC (the commonality approach). Under this approach, where there is a high level of commonality of ownership and business purpose, the series LLC would be treated as a single entity for federal tax purposes, even if multiple members were associated with each series. If there is a low level of commonality of ownership and business purpose between the series, then each series with which at least two members are associated would be treated as a separate entity for federal tax purposes. In effect, commonality of ownership and business purpose would be used as a proxy for demonstrating whether the members consider the series LLC to be one entity or multiple entities.

The following examples illustrate distinctions between these two approaches. Each example first describes a series LLC and then describes an analogous master LLC structure that accomplishes the same business objectives as the series LLC. Note that certain of the issues raised with respect to the series LLC also apply to the analogous master LLC structure.

Example 1

Series LLC Structure. Suppose that there are three series of a series LLC (Series X, Y, and Z). Three individuals (Members A, B, and C) are associated with each of the three series. Member A contributes a property to Series X, Member B contributes a property to Series Y, and Member C contributes a property to Series Z. In addition, Member D will provide management services to Series X, Member E will provide management services to Series Y, and Member F will provide management services to Series Z. Profits and losses of the series are allocated in the following manner:

	Series X	Series Y	Series Z
Member A	35%	25%	25%
Member B	25%	35%	25%
Member C	25%	25%	35%
Member D	15%	0%	0%
Member E	0%	15%	0%
Member F	0%	0%	15%

Analogous Master LLC Structure. Members A, B, and C each contribute a property to an LLC (the master LLC) in exchange for an interest in the master LLC. The master LLC then contributes each property to a different wholly owned subsidiary (LLCs X, Y, and Z). Members D, E, and F each perform management services for one of the subsidiaries in exchange for an interest in the master LLC. The master LLC makes special allocations of its income from each of the subsidiary LLCs in the same manner as is described in the above table.

Analysis. More than one member is associated with each series in the series LLC. Therefore, under the association approach, each series would be considered to be a separate entity for federal tax purposes. However, there is a significant amount of overlap in the ownership interests of the series, and the series share a common business purpose. Therefore, under the commonality approach, one might conclude that the entire series LLC should be treated as a single entity for federal tax purposes.

The analogous Master LLC structure may support the conclusion that the series LLC should be treated as a single entity because the master LLC structure accomplishes the same business objectives as does the series LLC and, assuming the allocations are respected as having substantial economic effect, presumably the master LLC structure would be treated as a single entity (since each of the subsidiary LLCs is wholly owned by the master LLC). Given the high degree of commonality of ownership and business purpose, it appears unlikely that the master LLC would be recharacterized as multiple partnerships.

Example 2

Series LLC Structure. The same as the series LLC structure in Example 1, except that Member D provides services for each of the three series and receives 15% of the profits and losses of each series. Members E and F are not associated with any of the series in this series LLC structure.

Analogous Master LLC Structure. The same as the master LLC structure in Example 1, except that Member D is allocated 15% of the income from each of the subsidiary LLCs. Members E and F have no interest in the master LLC structure.

Analysis. The changes in this example from Example 1 have no effect on the analysis under the association approach, and each series would be treated as a separate entity for federal tax purposes. However, the fact that Member D receives 15% of the profits and losses of each series for his services increases the overlap in ownership, and therefore strengthens the case for treating the series LLC as a single entity under the commonality approach.

Example 3

Series LLC Structure. The same as the series LLC structure in Example 2, except that Members A, B, and C each are allocated 28.33% of the profits and losses of each series.

Analogous Master LLC Structure. The same as the master LLC structure in Example 2, except that Members A, B, and C each are allocated 28.33% of the profits and losses of each subsidiary LLC.

Analysis. Under the association approach, each series again would be treated as a separate entity for federal tax purposes because more than one member is associated with each series. However, the ownership composition of each series is now identical, so that it is even clearer that this series LLC should be a single entity under the commonality approach. The analogous master LLC structure in this scenario accomplishes the same objective through a structure that almost certainly would be treated as a single entity (because this master LLC structure does not even involve special allocations), which may support the proposition that the series LLC should be treated as a single entity.

Example 4

Series LLC Structure. The same as the series LLC structure in Example 1, except that profits and losses of the series are allocated in the following manner:

	Series X	Series Y	Series Z
Member A	75%	5%	5%
Member B	5%	75%	5%
Member C	5%	5%	75%
Member D	15%	0%	0%
Member E	0%	15%	0%
Member F	0%	0%	15%

Analogous Master LLC Structure. The same as the analogous master LLC structure in Example 1, except that the allocation of profits and losses of each of the subsidiary LLCs is done in accordance with the above table.

Analysis. As in Example 1, each series of the series LLC would be treated as a separate entity for federal tax purposes under the association approach. Under the commonality approach, there does not appear to be significant commonality of ownership unless Members A, B and C were viewed on a group basis. One might argue for that result, particularly if the series still shares a common business purpose.

Would the analogous master LLC structure be treated as a single entity? Initially it would appear to be a single entity for federal tax purposes, with each subsidiary LLC disregarded as a single-member LLC. Alternatively, one could contend that each entity in the master LLC structure would be a separate entity for federal tax purposes due to the extreme lack of common ownership,[22] or that the special allocations lack substantial economic effect. If the analogous master LLC structure were treated as a single entity for federal tax purposes, one could contend that the series LLC structure should also be a single entity for federal tax purposes.

EXISTING AUTHORITY[23]

Under Regs. §301.7701-1(a)(1), whether an organization is classified as a separate entity for federal tax purposes depends on federal tax law, and not on whether the organization is recognized as an entity under local law. In *Comr. v. Culbertson*, the Supreme Court stated that whether an entity is a considered to be a partnership for tax purposes depends on whether, considering all of the facts and circumstances, "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[24] Relevant facts to consider in this analysis include "the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent." [25]

Although there is little direct authority on the treatment of series of a series LLC for federal tax purposes, there is analogous authority. In *National Securities Series — Industrial Stocks Series v. Comr.*,[26] the Tax Court considered various unincorporated investment trusts that were regulated investment companies (RICs) created under a single trust that held property in trust and invested and reinvested property in securities. They differed only in the composition of their assets (which consisted of different types of securities). The RICs regularly issued certificates representing shares in the property held in trust and regularly redeemed the certificates. When a shareholder of any given RIC would have its shares redeemed, it was entitled to a share of the assets and earnings of only that RIC. The Tax Court determined that each RIC was a separate entity for tax purposes.[27] Later, in Rev. Rul. 55-416,[28] the IRS applied the Tax Court's holding in *National Securities Series*, and referred to the RICs in *National Securities Series* as "taxpayers" in the plural.

In Rev. Rul. 55-39,[29] the taxpayer was a general partner in a limited partnership, where the partnership agreement allowed the taxpayer to direct that the amount of his capital account be invested in securities, which he would select. The partnership agreement provided that these securities would remain property of the partnership, but that (1) the general partner's capital account would be credited with any dividends, interest, or other distributions received by the partnership with respect to those securities; and (2) the general partner could direct that these securities be sold and the proceeds of such a sale would be credited to his capital account. The IRS ruled that, notwithstanding the fact that such property was owned by the partnership as a matter of local law, the property was considered for tax purposes to be owned by the taxpayer. In so ruling, the IRS stated that "[w]here, as here, the agreement provides that certain property is acquired and held for the account of a particular partner, and all of the incidents of ownership, including the right to be credited with all income and profits therefrom and all rights of control, are in him, such property cannot qualify as jointly owned property." [30]

In Rev. Rul. 2004-86,[31] the IRS ruled that a Delaware Statutory Trust that was formed to hold property for investment was a separate entity for tax purposes. The IRS cited the following factors in support of its conclusion:

- The entity was recognized as separate from its owners under local law.[32]
- Creditors of the owners of the trust could not assert claims against the trust's assets.
- The trust could sue or be sued.
- The trust's assets were subject to attachment and execution.
- The trust's owners were entitled to limited personal liability for actions of the trust similar to the limited liability of the shareholders of a corporation.
- The trust could merge or consolidate with or into other entities.
- The trust was formed for investment purposes.

The foregoing authorities may provide support for the proposition that each series of a series LLC should be treated as a separate entity for federal tax purposes. However, (1) they provide support for this conclusion only by analogy to series LLCs, and (2) none of them addresses the impact of commonality of ownership and business purpose. Therefore, they are of limited usefulness in determining whether the commonality approach addressed above should be adopted for series LLCs.[33]

In PLR 200803004, the IRS ruled on the classification of each series of a series LLC. The following are among the representations that the taxpayer made to the IRS:

- Each series would consist of a separate pool of assets, liabilities, and stream of earnings.
- The shareholders of one series would share only in the income of that series.
- The ownership interest of the owners of a series would be limited to the assets of that series upon redemption, liquidation, or termination of the series.
- The payment of the expenses, charges, and liabilities of one series would be limited to that series' assets.
- Creditors of one series would be limited to the assets of that series for recovery of expenses, charges, and liabilities.
- Each series would have its own investment objectives, policies, and restrictions.
- Votes of each series generally could be conducted separately with respect to matters affecting only that series.

The IRS ruled that (1) series with only one owner that would not elect to be treated as a corporation for federal tax purposes (the Type D Portfolios) would be disregarded as separate from the sole owner for federal tax purposes; (2) series with more than one owner that would not seek to be treated as a corporation for federal tax purposes (the Type P Portfolios) would be considered a partnership for federal tax purposes; and (3) series that elected to be treated as an association taxable as a corporation for federal tax purposes (the Type C Portfolios) would be treated as an association taxable as a corporation for federal tax purposes.

A premise of these conclusions must be that each series is for federal tax purposes a separate entity that is treated as a "business entity" and an "eligible entity." However, the ruling also did not consider commonality of ownership and business purpose. In addition, as it is a private letter ruling, it may be relied upon only by the taxpayer to whom it was issued.

IRS NOTICE 2008-19

In Rev. Rul. 2008-8,[34] the IRS considered whether certain arrangements involving a "protected cell company" constituted insurance for federal income tax purposes. The following describes the protected cell company structure which the IRS considered:

- A protected cell company established separate accounts (cells), each of which had its own name and was identified with specific participants, but was not treated as a separate entity for local law purposes.
- Each cell's participant made a capital contribution to the cell in exchange for non-voting preferred stock associated with the cell.
- The income, expense, assets, liabilities, and capital of each cell were accounted for separately from those of other cells.
- Creditors of one cell could not claim assets from another cell, and creditors of the protected cell company could not claim assets from the cells.
- Each cell could make distributions with respect to the stock of that cell.
- When a participant would cease its participation in a cell, the participant could receive the cell's assets less its outstanding liabilities.

Notice 2008-19 [35] proposed that a cell of a protected cell company would be treated as an insurance company separate from any other entity if:

- The assets and liabilities are segregated from the other cells and from the protected cell company, such that creditors of the protected cell company, and of other cells of the protected cell company, cannot collect assets from the cell; and
- Based on all the facts and circumstances, "the arrangements and other activities of the cell," if conducted by a corporation, would result in such corporation being classified as an insurance company.

In this Notice, the IRS also requested comments on the following issues relating to protected cell companies:

- What transition rules are appropriate for protected cell companies and their cells that do not comply with the Notice?
- What reporting would be required by each individual cell?
- Would special rules apply with respect to foreign entities, including controlled foreign corporations?
- Is further guidance needed regarding the proper treatment of protected cell companies and their cells regarding the use of consolidated returns?

In addition, in Notice 2008-19, the IRS requested comments on guidance regarding segregated arrangements that do not involve insurance, including series LLCs.

STATE TAX ISSUES[36]

Similarly, as with federal tax law, there also has been little guidance regarding the treatment of series LLCs for state tax purposes. Is each series of a series LLC a separate entity for state tax purposes? Numerous uncertainties relate to this question. Will each series be subject to any franchise taxes and/or income taxes to which an LLC is subject? Would determinations of whether withholding is required for nonresidents associated with series in a series LLC be made separately for each series? Where a composite return would be allowed or required for nonresidents with an interest in an LLC, would a separate composite return be allowed or required to be filed on behalf the nonresidents who are associated with each series of the LLC? State sales and use tax questions also arise. For example, if a series has a physical presence in a state in which the series organization and the other series of the series organization do not have a presence, do the series organization and the other series have nexus with such a state for purposes of being required to collect sales and use tax for the state?

There has been some limited state guidance relating to the tax treatment of series LLCs. The Illinois Series LLC statute provides that a series organization and any of its series "may elect to consolidate their operations as a single taxpayer to the extent permitted under applicable law."[37] The State of Massachusetts issued a letter ruling to the effect that each series of a Delaware series LLC is classified as a separate entity for purposes relating to Massachusetts income tax and corporate excise tax.[38] California's Franchise Tax Board provides in its instructions for LLC returns that, if a series LLC is formed in a state where the law provides for the creation of series LLCs, each series is considered to be a separate LLC (and therefore must file its own LLC return and pay its own annual LLC tax and fee) if the following conditions are met:

- The holders of the interests in each series are limited to the assets of that series upon redemption, liquidation, or termination; and
- The payment of the expenses, charge, and liabilities of a series is limited to that series under state law.[39]

However, there generally has been little guidance regarding the treatment of series LLCs for state tax purposes, which likely has also contributed to the lack of use of series LLCs.

PROPOSED REGULATIONS

On September 14, 2010, the Treasury Department and the IRS issued Proposed Regulations regarding the treatment of series LLCs and certain other series entities for federal tax purposes. Prop. Regs. §301.6011-6 describes certain annual reporting relating to series entities, and Prop. Regs. §301.7701-1(a)(5) attempts to provide a general framework to govern the federal tax treatment of these series entities.

Overview of the Proposed Regulations

Definitions

The Proposed Regulations [40] define a "series organization" as a "juridical entity that establishes and maintains, or under which is established and maintained, a series," including a series LLC and a series partnership as well as other series entities.[41] A "series" is defined as a "a segregated group of assets and liabilities that is established pursuant to a series statute by agreement of a series organization." [42] A "series statute," in turn, is a statute of a state or foreign jurisdiction that "explicitly provides for the organization or establishment of a series of a juridical person and explicitly permits the following:

- members or participants of a series organization to have rights powers, or duties with respect to the series;
- a series to have separate rights, powers, or duties with respect to specified property or obligations; and
- the segregation of assets and liabilities such that none of the debts and liabilities of the series organization or of any other series of the series organization are enforceable against the assets of a particular series of the series organization." [43]

Treatment of Series LLCs

For federal tax purposes, the Proposed Regulations provide that a series is "treated as an entity formed under local law" regardless of whether or not it is a juridical person for local law purposes.[44] Then, whether a series is recognized as a separate entity for federal tax purposes is determined under Prop. Regs. §301.7701-1 and "general tax principles." [45] If a series is recognized as a separate entity for federal tax purposes, it is classified under Prop. Regs. §301.7701-1(b), thereby subjecting it to the normal rules for classification of an entity for federal tax purposes. Such a series would be a "business entity" under Prop. Regs. §301.7701-2(a) and an "eligible entity" under Prop. Regs. §301.7701-3(a). The ownership of interests in a series and of the assets associated with a series is determined under "general tax principles" [46] (i.e., based on an analysis of benefits and burdens of ownership).

Under the above definitions, a series statute must *permit* the enumerated attributes relating to (1) the rights, powers, and duties of a member with respect to the series; (2) the rights, powers, and duties of a series with respect to specified property or obligations; and (3) the segregation of assets and liabilities.[47] However, a particular series is treated as a separate local law entity for federal tax purposes if it is formed under a qualifying series statute regardless of whether the series itself has these attributes. The Preamble to the Proposed Regulations (the Preamble) explains that these attributes "primarily involve procedural formalities and do not appear to affect the substantive economic rights of series or their creditors with respect to their property and liabilities."[48]

With regard to tax collection, the Proposed Regulations state that, if a debt of one series may be collected from the series organization or another series, a tax liability assessed against the one series may be collected from the series organization or such other series. Similarly, if a creditor can collect a debt attributable to the series origination from a series, the Proposed Regulations state that a tax liability assessed against the series organization may be collected from such series.[49]

Annual Reporting Requirements

The Proposed Regulations require that a series organization and each of its series file a statement for each taxable year containing identifying information to be prescribed by the IRS.[50] The Preamble states that the IRS and the Treasury have not yet decided which information would be required on this statement, but that the following information is "tentatively being considered":

- Name, address, and taxpayer identification number of the series organization and each of its series, and status of each as a series or a series organization.
- The jurisdiction in which the series organization was formed.
- An indication of whether the series holds title to its assets or whether title is held by another series or the series organization.
- If title to the series' assets is held by another series or the series organization, the name, address, and taxpayer identification number of the series organization and/or each series holding title to any of its assets.

This statement would have to be filed on or before March 15 of the year following the period for which the return is made.[51]

The Preamble also states that a series organization that is characterized as a partnership for federal tax purposes but has no income, deductions, or credits for a taxable year would not need to file a partnership return for such taxable year.

Transition Rule

The Proposed Regulations contain a transition rule providing that a taxpayer's treatment of a series in a manner that is inconsistent with the final regulations will continue to be respected after the date on which the final regulations are published if the following criteria are met:

- The series was established before September 14, 2010;
- The series conducted business or investment activity;
- No owner of the series has treated the series as an entity separate from the series organization or any other series of the series organization for purposes of filing any federal income tax returns, information returns, or withholding documents in any taxable year;
- The series and the series organization had a "reasonable basis" (within the meaning of Internal Revenue Code §6662) for their claimed classification; and
- Notice was not given on or before the publication of the final regulations that classification of the series was under examination.[52]

This transition rule will no longer apply on and after any date on which persons who were not owners of the series or series organization before September 14, 2010 own in the aggregate an interest of at least 50% in the series or the series organization.[53]

The Proposed Regulations include (only) the following example to illustrate its series LLC provisions.[54] This example involves a series LLC with a series organization that has three members (1, 2, and 3), which establishes two series (A and B). The example states that, under general tax principles, members 1 and 2 are the owners of Series A, and member 3 is the owner of Series B. The example in the Proposed Regulations concludes that each of series A and B is treated as an entity formed under local law and that the default classification (i.e., assuming that neither series elects to be an association taxable as a corporation for federal tax purposes) under Prop. Regs. §301.7701-3 of series A is a partnership and of series B is a disregarded entity.

Issues on Which the IRS and the Treasury Specifically Request Comments

The Preamble to the Proposed Regulations specifically requests comments on the following issues:

- Whether a series organization should be recognized as a separate entity for federal tax purposes if it has no assets and engages in no activities independent of its series.
- Treatment of a series that does not terminate for local law purposes when it has no members associated with it.
- Treatment of a series for federal and state employment tax purposes.
- Issues relating to the provision of employee benefits by a series organization.
- The requirement that each series and the series organization must file an annual statement, and what information should be required on this statement.

Analysis of the Proposed Regulations

The approach of the Proposed Regulations with regard to the treatment of a series for federal tax purposes is based on the "association" of members and managers with a series and whether such association constitutes ownership "under general tax principles." The Preamble explains that "[t]he IRS and the Treasury Department believe that, overall, the factors supporting separate entity status for series outweigh the factors in favor of disregarding series as entities separate from the series organization and other series of the series organization. Specifically, managers and equity holders are `associated with' a series, and their rights, duties, and powers with respect to the series are direct and specifically identified. Also, individual series may (but generally are not required to) have separate business purposes and investment objectives." The Preamble states that the Proposed Regulations reject an approach based on commonality of ownership and business purpose because "[s]eparate state law entities may have common or overlapping business purposes, investment objective and ownership, but generally they still are treated as separate local law entities for federal tax purposes."

To consider the reasonableness of the approach of the Proposed Regulations, consider the four examples presented above, describing various scenarios where several members are associated with three series of a series organization. Those examples describe scenarios with differing degrees of commonality of ownership and business purpose. Under the Proposed Regulations, all three series in each example would be treated as separate local law entities. Based on general tax principles, the members would be considered the owners of the interests in the series and, because each series would be considered to have more than one owner, each series would be treated as a separate partnership for federal tax purposes. This result certainly makes sense in Example 4, where there is very little commonality of ownership. However, consider Examples 1 and 2, where there is significant commonality of ownership and business purpose. Does it make sense for the three series to be separate entities in this situation? How about in Example 3, where the same members would be considered to own identical interests in each series? The approach of the Proposed Regulations ignores the reasonableness of treating a series with significant commonality of ownership and business purpose as a single partnership.

Series LLC as a Single Entity

Based on conversations with the IRS, the authors read the Delaware LLC statute to provide that an operating agreement of a series LLC can be drafted so that either (1) the members are associated with the series and are directly allocated the profits and losses of the series, or (2) the members are associated with the series organization (SO) and are allocated the profits and losses of the series indirectly through the SO. The Preamble states that "the proposed regulations do not address the entity status for federal tax purposes of a SO. Specifically, the proposed regulations do not address whether a SO is recognized as a separate entity for federal tax purposes if it has no assets and engages in no activities independent of its series." [55] On its face, this clause appears to state that the IRS is considering whether the SO would be a separate entity for federal tax purposes even in a structure where it is associated with the series and more than one member owns the interests in the SO. If such a series organization were disregarded, then each of the series would have more than one owner and likely would be considered a separate partnership for federal tax purposes. However, based on conversations with the IRS, it is our understanding that they intended to question the entity status of a SO only where it has no assets, engages in no activities independent of its series, and is not associated with its series. In fact, this appears to be Treasury's way of permitting the series to be treated as one taxpayer.[56] An example confirming this in the final regulations would be most appreciated.

Assume a special allocation is made at the SO level, so that the members of the SO are allocated certain amounts of profits and losses with respect to certain of the series. Does that mean the members of the SO are "associated with" certain of the series, with the result that there are multiple tax partnerships? If that is the IRS's view, the regulations then would not effectively provide any ability to create one tax partnership in a series LLC context. The final regulations should address this point.

Other Outstanding Issues

The following are various additional issues that the Proposed Regulations appear to leave unanswered:

- The Proposed Regulations provide that a series is "a segregated group of assets and liabilities that is established pursuant to a series statute by agreement of a series organization." [57] What if a series has no liabilities? Such a series would not appear to be a "segregated group of assets *and liabilities*" given the absence of liabilities. While it is almost inconceivable that the drafters of the Proposed Regulations intended to require that a series must have liabilities in order to qualify as a "series" under the Proposed Regulations, it is not clear that the Proposed Regulations get to this result.

- The Proposed Regulations state that the ownership of interests in a series is determined under "general tax principles." Is the analysis to determine who is a federal tax owner of a series any different from what would be done in a master LLC structure?

- Would the analysis of series and series organizations be impacted if state courts and bankruptcy courts do not recognize the limited liability provided by the Delaware statute between a series and the series organization or other series?

- The Proposed Regulations impose a requirement that an annual statement of information to be determined by the IRS must be filed by series organizations and series. The Proposed

Regulations do not make clear whether each series and the series organization may jointly file a single statement, or whether they must file separate statements. It is also not clear whether statements must be filed for each series that will be treated as a disregarded entity. Depending on how onerous this reporting requirement turns out to be, it might reduce the administrative efficiencies that make series LLCs attractive.

- One of the requirements for the applicability of the Proposed Regulations' transition rule is that the taxpayer must have had a "reasonable basis" (within the meaning of §6662) for its claimed classification. If a taxpayer treated a series LLC as a single entity in a manner that would not be allowed by the final regulations, how much commonality of ownership and/or business purpose (if any) would be required in order for the taxpayer to have a reasonable basis for that position?

CONCLUSION

Series LLCs offer an attractive structure for the operation of real estate businesses, but as a result of tax and nontax uncertainties, they have not been widely used. The Proposed Regulations take a giant step toward providing certainty for federal tax purposes. However, the Proposed Regulations leave certain important points unexplained, and their only example involves a very simple scenario. In addition, the Proposed Regulations do not address questions that appear to be common to both series LLCs and master LLC structures, most notably the effect of special allocations of income from different series or LLCs. Numerous state tax questions and nontax uncertainties also remain unresolved. Will series LLCs now be widely used? Only time will tell.

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[1] Howard J. Levine is a member of, and Daniel W. Stahl is associated with, Roberts & Holland LLP.

[2] *See* PLR 200803004.

[3] Del. Code Ann. tit. 6, §18-215(a).

[4] *Id.*

[5] *Id.* §18-215(c).

[6] *Id.* §18-215(e).

[7] *Id.* §18-215(b).

[8] *Id.*

[9] 805 ILCS 180/37–40.

[10] *See, e.g., id.*

[11] *Id.*

[12] 75 Fed. Reg. 55699, 55702.

[13] *Id.*

[14] *Id*

[15] See Bishop and Kleinberger, *Limited Liability Companies: Tax and Business Law* ¶¶[2.11] and [14.03] (Warren, Gorham & Lamont ed. 2006) for a discussion of these open non-tax issues.

[16] *Id.*

[17] Regs. §301.7701-1(a)(1).

[18] A “business entity” is “any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under Regs. §301.7701-3) that is not properly classified as a trust under Regs. §301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code.” Regs. §301.7701-2(a).

[19] An “eligible entity” generally is any business entity other than a per se corporation under Regs. §301.7701-2(b). An eligible entity with at least two members can elect to be classified as either an association taxable as a corporation or as a partnership. An eligible entity with only one member can elect to be classified as an association taxable as a corporation or to be disregarded as an entity separate from its owner. Regs. §301.7701-3(a).

[20] A member associated with a Delaware series LLC in general appears to have the same rights with respect to that series as does a member of a regular LLC. The Delaware LLC Act provides the following relating to both a member who is associated with a series of an LLC and a member of an LLC: The LLC agreement may provide for classes or groups of members “having such relative rights, powers, and duties as the limited liability company agreement may provide.”
The LLC agreement may provide for the taking of an action, including amending the LLC agreement, without the vote of any member, class, or group of the members.
The LLC agreement may provide that any member, class, or group of members has no voting rights.
The LLC agreement may grant to all members, or to certain members, a specified class, or a group of the members the right to vote “separately or with all or any class or group of members or managers” on any matter.
Voting by members may be on a per capita, number, financial, interest, class group, or any other basis.
See Del. Code Ann. tit. 6, §§18-305; 18-302(a–b); 18-215(e–f).

[21] The following analysis initially assumes that each member who is associated with a series in a series LLC has the same rights as those of a member in an LLC, and then considers this point below.

[22] *See, e.g.*, Rev. Rul. 59-39, discussed below.

[23] Also, see the discussion of existing authorities cited in Letter from the American Bar Association Section of Taxation to the Honorable Douglas Shulman, Jan. 5, 2009.

[24] 337 U.S. 733 (1949). *See also Comr. v. Tower*, 327 U.S. 280 (1946).

[25] *Culbertson*, 37 AFTR 1391 at 1395.

[26] 13 T.C. 884 (1949).

[27] The issue that the Tax Court considered was whether the accumulated net earnings distributed by the RICs during the taxable year on the redemption of shares were “preferential dividends” under §27(h) of the Internal Revenue Code of 1939, and whether they could include these amounts as dividends paid in determining their basis surtax credits under §362(b) and §27(b)(1) of such Code.

[28] 1955-1 C.B. 416.

[29] 1955-1 C.B. 403.

[30] *Id.*

[31] 2004-2 C.B. 191.

[32] Note that the Delaware statutory trust was different from a Delaware series LLC in this respect.

[33] *See* Letter by Howard J. Levine, Esq., to the Honorable Douglas Shulman, Jan. 21, 2009.

[34] 2008-5 I.R.B. 340.

[35] 2008-5 I.R.B. 366.

[36] For an in-depth discussion of these state tax issues, see McLoughlin and Ely, “Series LLCs: Many State Tax Questions Are Raised but Few Answers Are Yet Available,” *Business Entities* (Jan./Feb. 2007).

[37] 805 ILCS 180/37–40.

[38] Mass. Ltr. Rul. 08-2: *Separate Entity Status and Federal Classification for Each Series of an LLC* (Feb. 15, 2008). The ruling did not consider the potential impact of commonality of ownership or business purpose between series.

[39] California 2009 Limited Liability Company Tax Booklet, p. 5, §F.

[40] REG-119921-09 (9/14/10).

[41] Prop. Regs. §301.7701-1(a)(5)(viii)(A). These other series entities include a series trust, protected cell company, segregated cell company, segregated portfolio company, and segregated account company. This article discusses the effect of the Proposed Regulations on series limited liability companies only.

[42] Prop. Regs. §301.7701-1(a)(5)(viii)(C).

[43] Prop. Regs. §301.7701-1(a)(5)(viii)(B) (parenthetical removed). An exception is made to the provision relating to the segregation of liabilities for liabilities to the jurisdiction related to the organization or operation of the series organization, such as franchise fees or administrative costs.

[44] Prop. Regs. §301.7701-1(a)(5)(i).

[45] Prop. Regs. §301.7701-1(a)(5)(iii).

[46] Prop. Regs. §301.7701-1(a)(5)(vi).

[47] *See* Prop. Regs. §301.7701-1(a)(5)(viii)(B).

[48] 75 Fed. Reg. 55699, 55703.

[49] Prop. Regs. §301.7701-1(a)(5)(vii).

[50] Prop. Regs. §301.6011-6(a).

[51] Prop. Regs. §301.6071-2(a).

[52] Prop. Regs. §301.7701-1(f)(3)(ii).

[53] For proposes of this provision, an “interest” of a partnership means a capital or profits interest, and an “interest” of a corporation means an equity interest measured by vote or value.

[54] Prop. Regs. §301.7701-1(a)(5)(x), *Ex. 1*.

[55] 75 Fed. Reg. 55699, 55703.

[56] A similar series LLC structure could be organized by creating a “master series,” such that only the master series would be associated with the lower-tier series, with more than one member associated with the “master series.” It appears that such a series LLC should be treated in the same manner as a series LLC where the SO is associated with the series and more than one member is associated with the SO.

[57] Prop. Regs. §301.7701-1(a)(5)(viii)(C).