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Series LLCs: Getting Comfortable with Uncertainty

Austin Jones *

I. INTRODUCTION

Our American system of federalism incentivizes individual states to race to the proverbial “bottom” to increase their revenue. When states attempt to increase revenue by attracting business, the resulting legislation can be beneficial for both the business and the consumer.¹ As a result, states often look to implement innovative entity forms that will bring more business to their state. Until recently, organizations were limited to operating as corporations or as some form of a partnership.² In 1977, Wyoming became the first state to implement a Limited Liability Company (“LLC”) statute.³ Indeed, Wyoming did this to attract capital from companies looking to take advantage of broader liability protection, and more specifically as a result of lobbying from Texas Oil Companies.⁴ These incentives, including the fact that business formation law is regulated by the states,⁵ drives states to act as the catalyst for new entity classifications that push the limitations of current state and federal regulations. In 1996, as many of the questions surrounding LLCs were finally being answered by states and the Federal Government,⁶ Delaware

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1. In order to attract business, legislation often lowers taxes and regulatory hurdles, which can result in cheaper costs for the business being passed on to the consumer in an oversimplified trickle down model.

2. Options included: C-Corporations, S-Corporations, Limited Partnerships, General Partnerships, and Limited Liability Partnerships among others.

3. *Limited Liability Company — History*, J.D. RANK, <http://law.jrank.org/pages/8277/Limited-Liability-Company-History.html> (last visited Feb. 23, 2016).

4. *Id.*

5. *Choosing a Business Structure*, IRS, <https://www.irs.gov/uac/Choosing-a-Business-Structure>. By allowing states to create their own laws and regulations regarding entity formation, it appears natural that states will use this power to incentivize businesses by creating business friendly entity forms.

6. Check-the-box regulations were finalized and implemented on Jan. 1, 1997. I.R.M. 4.61.5.1 (05-01-2006).

introduced legislation creating the Series LLC.⁷ It has now been nineteen years since Delaware introduced this legislation, and practitioners are still uncertain about how Series LLCs or Cell LLCs (referred to collectively as “Series LLCs”) will be treated in a number of areas — primarily bankruptcy⁸ and tax.⁹ A Series LLC is a master LLC whose organizing document provides for separate sub-units (series), which operate as independent LLCs.¹⁰

On September 14, 2010, the Treasury Department and the Internal Revenue Service (“IRS”) issued proposed regulations that would classify series as separate entities for federal tax purposes based on established rules the IRS uses to determine other types of business forms.¹¹ Although these regulations have yet to be codified, they provide states and practitioners vital guidance. According to the proposed regulations, each series would be classified as a separate entity for federal tax purposes, requiring each series to file a partnership informational return, turn in a form 1065, and conform with other IRS requirements.¹² These proposed regulations have yet to be finalized, and it appears that unless a critical mass of businesses choose the Series LLC form, the Treasury Department may never use its precious resources to finalize the regulations.

This Note will analyze the current IRS regulations and apply that guidance to the newest business entity — the Series LLC. First, this note will explore the background of LLC and Series LLC statutes. After exploring the statutory framework, this Note will analyze case law relating to entity classification in order to determine how prior entity regulations have been interpreted and to what extent the courts have classified business organizations as separate entities. By examining the differences between the two major types of Series LLC statutes, this Note will analyze how current law should apply to series. Then, this Note will look to the proposed regulations and past IRS rulings and discuss how these Treasury regulations would change the landscape for Series LLCs.

7. DEL. CODE ANN. tit. 6, § 18-215 (2015). Delaware amended its Limited Liability Company Act to permit the designation of series of ownership interests. MICHAEL G. SCHINNER & MICHAEL S. POWLEN, SERIES LLCs, IN FORMING AND OPERATING CALIFORNIA LIMITED LIABILITY COMPANIES, CONTINUING EDUCATION OF THE BAR, CALIFORNIA 688 (2d ed. 2007).

8. Shannon L. Dawson, Comment, *Series LLC and Bankruptcy: When the Series Finds Itself in Trouble, Will It Need Its Parent to Bail It Out?*, 35 DEL. J. CORP. L. 515 (2010) (discussing bankruptcy debate in relation to Series LLCs).

9. The tax issues revolve around whether each series will be treated as a separate entity or if there is only one entity in the parent LLC.

10. Series Limited Liability Companies (Series LLC), STATE OF CALIFORNIA FRANCHISE TAX BOARD, https://www.ftb.ca.gov/businesses/bus_structures/SLLcompany.shtml (last visited Jan. 23, 2016).

11. Series LLCs and Cell Companies, 75 Fed. Reg. 55699 (proposed Sept. 14, 2010) (to be codified at 26 C.F.R. pt. 301).

12. *Id.*

Classifying each series as a separate entity for federal tax purposes¹³ appears to eliminate one of the major advantages of Series LLCs¹⁴ — reduced administrative and regulatory costs — but it provides clarity in a way that is in harmony with prior IRS regulations. Finally, this Note concludes that the current regulatory landscape answers a significant amount of the uncertainty regarding the tax status of Series LLCs, and as a result, practitioners should feel confident that each series will be treated as a separate entity for federal and most state tax purposes.

II. BACKGROUND

A. LLC AND SERIES LLC ENTITIES

1. LLC Background

Although LLCs are now one of the most popular entity forms for new businesses in America,¹⁵ as with anything new and unsettled, practitioners were very skeptical in the beginning due a number of uncertainties including the tax status, liability protection, court responses, and market responses.¹⁶ It took years for all 50 states to implement LLC statutes,¹⁷ but the business and legal communities were already taking full advantage of LLCs by the time anyone knew with certainty what the legal landscape looked like across the nation.¹⁸ Regulatory regimes¹⁹ constantly lag in providing guidance and regulation for innovative entities.²⁰ This delay in clarification and guidance typically leads risk adverse practitioners to advise clients to avoid these new business entities until there is a sense of certainty and clarity.

13. Which will invariably have a major influence on how states decide Series LLCs. A final regulation will also likely open the floodgates for states to begin implementing their own Series LLC statutes.

14. Streamlining administrative costs and procedural requirements of having to file information and tax returns for each series.

15. Daniel M. Hausermann, *State-Level Data on Limited Liability Companies (LLC)*, *United States, 2004-2009*, ICPSR31561-v1 (June 27, 2011), <http://doi.org/10.3886/ICPSR31561.v1>.

16. See generally Thomas Earl Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer (Part One)*, 37 S.D. L. REV. 44, 44–96 (1992) (discussing a history of LLCs).

17. Wyoming was the first in 1977. *Limited Liability Company — History*, *supra* note 3. California lagged far behind and implemented its first LLC statute in 1996, 8 years after IRS provided guidance that Wyoming LLCs would be taxed as partnerships. Franklin A. Gevurtz, *California's New Limited Liability Company Act: A Look at the Good, the Bad, and the Ambiguous*, 27 PAC. L.J. 261, 261–62 (1996).

18. *Limited Liability Company — History*, *supra* note 3.

19. By “regulatory regimes,” I mean those regimes established by the United States Department of Treasury, the Internal Revenue Service, and different state authorities.

20. Whether regulations are promulgated through the notice and comment process or whether clarity is brought about by court decisions, it takes years for any of these processes to be complete.

LLCs provide a significant advantage for business owners who wish to escape the double taxation of corporations, but do not wish to be exposed to the personal liability associated with sole proprietorships or general partnerships.²¹ The IRS defines an LLC as a business structure allowed by state statute, which may be regulated differently by each state.²² Federal definitions in this arena provide minimal information since entity law is state created law. Owners of LLCs are called members, and may generally be individuals, corporations, other LLCs, or foreign entities.²³ Most states also permit single-member LLCs which, for federal tax purposes, are disregarded as business entities and treated as a Schedule C business.²⁴ This means that for liability purposes the sole member is shielded like any other member of an LLC, but for tax purposes, the IRS ignores the existence of any entity, thus reducing regulatory and reporting requirements. Unlike most forms of partnerships, an LLC does not require any member to be held personally liable for the LLC's liabilities. While members are shielded from liability much like owners of a corporation, they avoid the double taxation seen in the corporate tax scheme at both the corporate and individual levels.²⁵

When an LLC is formed, the IRS will treat the LLC either as a corporation, a partnership, or a disregarded entity depending on the election made by the LLC's owners.²⁶ When an LLC has only one member and it does not make an election to be treated otherwise, it is treated as a disregarded entity, taxed as a sole proprietorship, and the LLC's activities are reported on the taxpayer's Schedule C. The federal regulations regarding these "check-the-box regulations" will be discussed in the next section, but it is important to note that while LLC legislation and regulations are promulgated at the state level, it is the IRS that ultimately determines the federal classification rules for tax purposes. This is important because as discussed below in more detail, many states borrow their tax rules directly from the Federal Government and the IRS.

LLCs were innovative in the way they provided greater liability protection while avoiding double taxation. Within a relatively short amount of time,²⁷ LLCs became the most popular entity choice²⁸ for small business, the self-employed, and even many larger companies that found

21. LLCs have also become a widely used tool in estate planning.

22. I.R.S., SMALL BUSINESS AND SELF-EMPLOYED, U.S. DEP'T TREASURY (2015), <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Limited-Liability-Company-LLC>.

23. *Id.*

24. *Id.*

25. 26 U.S.C. § 11 (2016).

26. I.R.S., *supra* note 22; Dep't. of Treas. Form 8832.

27. Compared to how established corporate and partnership law was at the time.

28. Hausermann, *supra* note 15.

the LLC structure suitable for their purposes. The LLC filled a void for those wanting to protect themselves from liabilities while still reaping the tax benefits of partnerships.

2. Series LLC

Just as the IRS was finalizing rules surrounding LLCs and both practitioners and business owners were becoming comfortable with them, Delaware pushed the envelope and legislated for the existence of Series LLCs.²⁹ By 1996, Delaware had recognized the desire of LLC members to protect their assets from the liabilities of their other assets. While many businesses were setting up multiple LLCs to hold different assets, Delaware understood that it would be more efficient to allow one parent LLC to hold all of the assets separately in series. Series LLC statutes allow LLCs to establish separate series of management and economic rights for specific assets or obligations.

Since there is a clear gap in the guidance surrounding Series LLCs, it may be helpful to look to Series Trusts to help us better understand series in general and why they are a valuable option for businesses.³⁰ Series Trusts are used as a means to separate assets for investment vehicles such as mutual funds. A firm would share a board of trustees, a chief compliance officer, and a single infrastructure supporting compliance, reporting, shareholder services, transactions, and back-office functions, but be able to separate assets into multiple trusts.³¹ This allows one core group to diversify assets without the compliance problems of establishing totally separate trusts. With this same overarching efficiency theme in mind, it is easy to imagine the many ways Series LLCs could potentially be used;³² all of which consist of separating assets and liabilities in order to protect a business. Some commentators imagine even greater uses for Series LLCs amongst businesses established as corporations.³³ Among other potential planning opportunities, Series LLCs could separate large corporate

29. DEL. CODE. ANN. tit. 6, § 18-215 (2015).

30. Michael W. McLoughlin & Bruce P. Ely, *The Series LLC — Raises Serious State Tax Questions but Few Answers Are Yet Available*, J. OF MULTI-ST. TAX'N & INCENTIVES (2007), <http://apps.americanbar.org/buslaw/newsletter/0059/materials/pp7.pdf>.

31. *Series Trust Gain Popularity with Funds: Assets Climbed to \$15.9 Billion in 2007*, INVESTMENTNEWS, <http://www.investmentnews.com/article/20080324/REG/438853815/series-trusts-gain-popularity-with-funds> (last visited Feb. 12, 2016).

32. For example: A landlord with multiple properties can hold each property in a separate series; a manufacturing company may wish to hold the manufacturing part of the business in one series while holding the management portion in a different series.

33. Melissa A. Ferley, *Expert Insight: The State Tax Treatment of Series LLCs*, SALT TALK BLOG, BLOOMBERG BNA TAX'N (Jan. 8, 2013), <http://www.bna.com/expert-insight-series-b17179871756/>.

enterprises without triggering the consolidated return regulations, could potentially reduce state and local transfer taxes, could avoid triggering the disguised sale rules, and could possibly defer recognition of gain on sales of assets or entire businesses.³⁴ This same outcome could also be obtained by creating a different LLC for each venture or each part of a business. However, creating and maintaining multiple LLCs can be costly and time consuming. Series LLCs provide the same level of asset protection in a streamlined manner.

The Series LLC operates much like a corporation with subsidiaries. Although it may sound like an alternative to traditional LLCs with minimal downside, Series LLCs are plagued with confusion, especially with regard to the tax treatment of the series. The IRS was nearly silent on the issue until it proposed regulations fourteen years after the first Series LLC statute was promulgated.³⁵ Do the proposed regulations conform to current entity classification policy without frustrating the states' intent in creating Series LLCs in the first place?

a. Series LLC Statutes and Cell Company Statutes

State statutes that establish Series LLCs generally fall under two categories. Most of the 13 states³⁶ that have Series LLC statutes have enacted statutes similar to the industry leader, Delaware. Other states tend to follow a statute that is structured like that of Illinois.

1. Delaware

Delaware law provides that an LLC may establish one or more designated series of members, managers, limited liability company interests, or assets.³⁷ The statute provides that any series may have "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 or obligations, and any such series may have a

34. Melissa A. Ferley, *Expert Insight: The State Tax Treatment of Series LLCs*, SALT TALK BLOG, BLOOMBERG BNA TAXATION (Jan. 8, 2013), <http://www.bna.com/expert-insight-series-b17179871756/>.

35. Series LLCs and Cell Companies, 75 Fed. Reg. 55699 (proposed Sept. 14, 2010) (to be codified at 26 C.F.R. pt. 301).

36. DEL. CODE ANN. tit. 6, § 18-215 (2015); D.C. CODE § 29-802.06 (2013); ILL. COMP. STAT. § 180/37-40 (2014); IOWA CODE § 489.1201(2009); KAN. SUB. H.B. 2207 (2012); MO. REV. STAT. § 347.186 (2013); MONT. H.B. 362 (2013); NEV. REV. STAT. § 86.296 (2015); NEV. REV. STAT. § 86.296 (2015); OKLA. STAT. tit. 18, §2005 (2015); P.R. LAWS 14, § 3967 (2015); TENN. CODE § 48-249-309 (2015); TEX. BUS. ORGS. CODE §101.601 (2015).

37. DEL. CODE ANN. tit. 6, § 18-215 (2015).

separate business purpose or investment objective.”³⁸ As long as separate records are kept for each LLCs’ assets and the partnership agreement articulates such separation, liabilities, obligations, and expenses incurred with respect to a particular series shall be enforceable only against that series.³⁹ This tax structure and requirements seem typical of Delaware, as it is constantly an industry leader in corporate and business law.

2. Illinois

The Illinois statute is very similar to the Delaware statute but is more explicit in expressing the separate business purpose of the series.⁴⁰ In the Delaware statute, “any such series may have a separate business purpose,” but the Illinois statute requires that the separate business purpose be provided for in the operating agreement.⁴¹ Illinois law also specifically states that the series “shall be treated as a separate entity to the extent set forth in the articles of organization.”⁴² Additionally, Illinois law specifically states that each series “may, in its own name, contract, hold title to assets, grant security interests, sue and be sued and otherwise conduct business and exercise the powers of a limited liability company.”⁴³

B. ENTITY CLASSIFICATION UNDER STATE AND FEDERAL FRAMEWORKS

1. Federal Regulatory Framework: “Check-the-Box”

The first step of entity classification is determining whether there is an entity for federal tax purposes.⁴⁴ As stated earlier, this is a matter of federal law, and the determination does not depend on local law.⁴⁵ An entity will exist separately from its owner if there is a joint venture or other arrangement where participants carry on a trade, business, financial operation, or venture and divide the profits.⁴⁶ The second step is to determine if the entity is a business entity. Any entity is a business entity if it is not properly classified as a trust or is subject to other special federal

38. DEL. CODE ANN. tit. 6, § 18-215 (2015).

39. *Id.*

40. ILL. COMP. STAT. § 180/37-40 (2014).

41. Compare DEL. CODE ANN. tit. 6, § 18-215 (2015), with ILL. COMP. STAT. § 180/37-40 (2014).

42. ILL. COMP. STAT. § 180/37-40(b) (2014).

43. *Id.*

44. I.R.M. 4.61.5.3.1.

45. *Id.*

46. Treas. Reg. § 301.7701-1(a)(2) (2011).

tax treatment.⁴⁷ The regulations specifically classify some entities as corporations by definition.⁴⁸ If the entity is not automatically classified as a corporation, the entity has the ability to elect how it will be classified.⁴⁹ If the entity has two or more members, it may elect either partnership status or corporate status.⁵⁰ If the entity has only one member, it may elect to be treated as a corporation, a partnership, or a disregarded entity.⁵¹ If an entity wishes to be treated differently than the default rules provide or if the entity wishes to change its classification, an election is required.⁵² In order to make an election, an eligible entity must file a Form 8832.⁵³ Once an election is made, the regulations place limitations on the number of elections that may be made in a certain time period.⁵⁴ Once an entity is classified as a partnership, the partnership has the responsibility to file an informational partnership return form 1065, to issue informational returns to members through K-9s, and to keep accurate partnership records.⁵⁵ Similarly, if the entity is classified as a corporation (either by default or through an election), the entity must comply with the Internal Revenue Code's rules for corporations.⁵⁶

Without further guidance from the federal taxing authorities, the current check-the-box and entity classification regulations would be what practitioners and LLC members would look to in order to determine if their series are treated as separate entities. If each series carries on a separate business activity or has a separate business purpose, then each series would be treated as a separate entity. This result does not seem unreasonable based on the current regulations and the policy reasoning behind them.

An issue arises, however, when the purposes and policy considerations of the Series LLC statutes are taken into account when attempting to determine the status of Series LLCs. The purpose of the Series LLC is to provide a solution to the complexity of forming and operating multiple separate LLCs in order to obtain asset protection. Regardless of federal tax regulations, Series LLCs allow the operators to file only one Article of Organization in their state of formation, maintain

47. I.R.M. 4.61.5.3.1.

48. Treas. Reg. § 301.7701-2(b) (2014). § 301.7701-2(b)(8) also contains a list of foreign entities that are corporations by definition ("per se" entities).

49. I.R.M. 4.61.5.3.1.

50. *Id.*

51. *Id.* A disregarded entity is treated as a sole proprietor for tax purposes.

52. *Id.*

53. I.R.M. 4.61.5.3.1.

54. *Id.* Generally, the taxpayer that makes the entity classification cannot change the classification by a subsequent election for the sixty months following the election. There is an exception to this rule if more than fifty percent of the ownership has changed during this time.

55. I.R.S., Pub. 3402, TAXATION OF LIMITED LIABILITY COMPANIES (Nov. 2014).

56. I.R.C. Subt. A, Ch. 1, Subch. C.

one core management system, and consolidate other compliance functions. While each state has different rules, it is generally accepted that each series has the ability to contract and operate apart from the parent LLC. This is where the paradox presents itself: The states wish to streamline the current process of establishing separate LLCs, but by allowing each series nearly as much power as an individual, separate LLC, the statutes seem to create separate entities in each series under federal tax law.⁵⁷

2. State Regulatory Framework

The classification of series has important implications at the federal level, but even more so at the state level because states stand to gain additional revenue if series are classified as separate entities.⁵⁸ Many states impose annual taxes or fees on the existence of an entity and then again on the profits of the entity.⁵⁹ The tax system of many states mirrors the federal system in an attempt to obtain unity and lessen the burden on state agencies.

California, for example, has made it clear that each series will be classified as a separate entity regardless of any decision made by the federal government.⁶⁰ California uses the same entity classification as the federal government for tax purposes.⁶¹ Although California does not allow Series LLCs to be formed under California state law, series formed in other states may register to transact business in California, much like a corporation that may have incorporated in Delaware may register to transact in many states.⁶² All LLCs in California, regardless of whether they are disregarded entities for actual tax reporting, must pay an \$800 annual tax.⁶³ In addition, LLCs are subject to a fee based on total income “derived or attributable” to California.⁶⁴ If series are not treated as separate

57. As long as the series meets the initial requirements of being a separate entity under Treas. Reg. § 301.7701-1(a)(2) (2011).

58. Although a few hundred-dollar entity fee may not seem like much, if Series LLCs become popular and tens of thousands of series are being formed each year in states like California, there is the potential for significant revenue.

59. CAL. FRANCHISE TAX BD., LIMITED LIABILITY COMPANY (LLC), https://www.ftb.ca.gov/businesses/bus_structures/LLcompany.shtml (last visited Nov. 15, 2015).

60. CAL. FRANCHISE TAX BD., SERIES LIMITED LIABILITY COMPANY (SERIES LLC), https://www.ftb.ca.gov/businesses/bus_structures/SLLcompany.shtml (last visited Nov. 15, 2015).

61. CAL. FRANCHISE TAX BD., GENERAL LLC INFORMATION, <https://www.ftb.ca.gov/forms/misc/3556.pdf> (last visited Nov. 15, 2015).

62. *Id.*

63. *Id.*

64. LLCs determine total income from California sources by using the rules for sales assignment under CAL REV. & TAX. CODE §§ 25135 and 25136 and the related regulations, as modified by regulations under § 25137, other than those provisions that exclude receipts from the sales factor (§ 17942(b)(1)).

entities, then only the master LLC would be subject to the eight-hundred dollar tax.⁶⁵

Imagine a couple that owns and operates ten commercial and residential buildings in California. Without using a Series LLC form, in order to separate the liability between each property, ten separate LLCs will need to be established. This results in an \$8,000 fee upon formation and each year while the LLCs, exist just for the entity level tax. If the Series LLC is considered only one entity and therefore only pays \$800 upon formation and each subsequent year, there is a potential for large tax savings. Since there are no concrete federal guidelines, the Franchise Tax Board has taken the position that if each unit has features consistent with a Series LLC under the laws of the state where the Series LLC was formed, then each unit will be treated as a separate entity for filing and tax purposes.⁶⁶ When this is the case, each series must fulfill the filing and tax requirements of a regular LLC, thereby eliminating one of the major advantages of Series LLCs — their efficiency.⁶⁷ This also creates a mismatch in treatment between states where different reporting requirements could hypothetically create fifty different rules. If liability protection is the main concern, such protection can be obtained by forming separate LLCs, but Series LLCs aim to reduce the transaction cost of doing that and that advantage is all but extinguished in states such as California.

Although the IRS has been late to the game, states are responding to the growing popularity of Series LLCs. As a general rule nearly all states⁶⁸ use the federal rules of classification to tax LLCs.⁶⁹ Among the twenty-five states that impose a “net-worth” or “debt-based” Corporate Franchise tax,⁷⁰ only seven of them also impose a Franchise tax on partnerships and LLCs.⁷¹ Alabama, California, Delaware, District of Columbia, Florida, Illinois, Iowa, Kansas, Kentucky, Massachusetts, Missouri, Montana, Nevada, New York, Oklahoma, Tennessee, Texas, and Utah all either have Series LLC provision or have provided guidance regarding Series LLC tax

65. LLC, *supra* note 59.

66. SERIES LLC, *supra* note 60.

67. *Id.*

68. Excluding those that do not have state income tax — Nevada, Florida, South Dakota, Washington, and Wyoming.

69. BRADLEY ARANT BOULT CUMMINGS, LLP, *Tax Treatment of LLCs/LLPs/LPs (LLEs) by States Imposing Net-Worth-or Debt-Based Corporate Franchise Taxes* (Jan. 1, 2014), <http://www.Babc.com/files/Publication/99c4df9d-81b6-4dac-902806d12bccb212/Preview/PublicationAttachment/a7f432b3-9d7b-4ac5-81c010ad2286207d/ElyThistleRhyne-May2014JMT-LLC-LLP-Exh2-ForAuWebsite.pdf>.

70. Most states do not impose taxes on the profits of LLCs but instead use metrics such as net-worth — the value of the assets minus the liabilities.

71. BRADLEY ARANT BOULT CUMMINGS, LLP, *supra* note 69.

status.⁷² The fact that seventeen states and the District of Columbia have all either enacted Series LLCs provisions or at least provided guidance is significant. All of these states defer to the federal classification scheme to determine their own classification rules, but even in the absence of federal clarity these states have gone ahead and acknowledged the potential of Series LLC. States realize the demand for this streamlined type of entity and do not want to be left behind when more and more Series LLCs decide to register in Delaware or other preferable states. The fast moving pace of the states should encourage the IRS to realize the future business landscape will include Series LLCs.

3. Case Law Application to Statutory Framework

The Supreme Court has held that as long as a corporation was formed for a business purpose, regardless of what that entails, the corporation is an entity separate from its owners.⁷³ While it is recognized that partnerships and corporations are inherently different in many ways, there seems to be no basis for courts to treat partnerships any different than corporations for entity classification purposes. A separate entity either exists or it does not — regardless of the legal form it takes. In fact the federal regulations do not differentiate between corporations and partnership forms when they make a determination of whether a separate entity exists.⁷⁴ The courts have also concluded that even if an organization is classified as a separate entity for state or local purposes, it may still be disregarded if it lacks a legitimate business purpose for federal tax purposes.⁷⁵

Before exploring how certain cases have interpreted and formulated entity classification rules, it is necessary to understand a few foundational court decisions regarding the treatment of partnerships. In *Commissioner v. Culbertson*,⁷⁶ the Respondent entered into an oral agreement to join in the operation of a cattle ranch as a partnership.⁷⁷ The court held that a partnership is created “when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses.”⁷⁸ These same rules were subsequently codified in IRS regulations as discussed above.

72. BRADLEY ARANT BOULT CUMMINGS, LLP, *supra* note 69.

73. *Moline Properties, Inc. v. Comm’r*, 319 U.S. 436 (1943).

74. *See Bertoli v. Comm’r*, 103 T.C. 501 (1994); *Aldon Homes, Inc. v. Comm’r*, 33 T.C. 582 (1959).

75. *Id.*

76. *Comm’r v. Culbertson*, 337 U.S. 733 (1949).

77. *Id.*

78. *Id.* at 740.

Although the courts have yet to rule explicitly on Series LLCs, they have ruled on similar entities and have delivered decisions that appear applicable to the case at hand. The U.S. Tax Court has previously ruled that each series within a Series Trust is a separate and distinct entity.⁷⁹ As discussed above, Series LLCs are both theoretically and practically very similar to Series Trusts in their organization, purpose, and functionality. Thus, it would be natural to assume that for federal tax purposes, the U.S. Tax Court would classify each series within an LLC as its own separate entity just as the court did for Series Trusts.⁸⁰ Although the U.S. Tax Court does not promulgate regulations and their decisions are not fully indicative of the views of the IRS and the Treasury Department, they do interpret current regulations and are experts in the field. Despite all of this, the answer has not proven to be as straightforward as it may seem, and the federal government has yet to finalize the proposed regulations that clearly state each series should be treated as separate entities.⁸¹

The following cases exhibit how courts have dealt with entity classification questions in the past and then this note applies the analysis to Series LLCs.

*a. Moline Properties, Inc. v. Commissioner*⁸²

In *Moline Properties, Inc.*, the Petitioner wished to have its corporate existence ignored so the gain on the sale of real property would be income taxable to its sole shareholder, instead of to the corporation.⁸³ The Supreme Court held that the doctrine of a business entity fulfills a useful “purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.”⁸⁴ As long as the purpose for forming the entity is the equivalent of a business activity, the corporation maintains its separate taxable entity status.⁸⁵

79. *National Security Series – Industrial Stock Series v. Commissioner*, 13 T.C. 884 (1949). Although the treatment of each series as a separate entity was not a direct issue in the case, in analyzing the issues, the court classified each series as a separately regulated investment company. The IRS has continued to follow that separate-entity treatment in analyzing series trusts.

80. *McLoughlin & Ely*, *supra* note 30.

81. *Id.*

82. 319 U.S. at 436.

83. *Id.*

84. *Id.* at 438–39.

85. *Id.* at 439.

We have seen an analysis almost identical to this in the regulations.⁸⁶ This approach to entity classification has been in use since 1943, and it hinges on whether the organization has a separate business activity or business purpose aside from a mere tax purpose. Under this framework, entity classification would be fact specific and there would be no blanket rule applicable to all Series LLCs. As long as a series has a legitimate business purpose or a business activity, it will be classified as a separate entity under this regime. In order for a series to not be a separate entity it would have to lack a business purpose or business activity, but then it would run into problems establishing a Series LLC in the first place. It appears that asset protection or simplification is a legitimate business purpose and that there would rarely be a scenario where a series is not classified as a separate entity under a rule that looks to the existence of a separate business purpose. The only roadblock at this point is that *Moline* addresses corporations and not partnership forms.

b. *Bertoli v. Commissioner*

The court in *Bertoli v. Commissioner*⁸⁷ upheld *Campbell County State Bank, Inc. v. Commissioner*⁸⁸ by holding that the principles announced in *Moline Properties*⁸⁹ also applied to entity recognition of partnerships not just corporations for federal tax purposes.⁹⁰ In relying on the *Moline Properties* ruling regarding corporations, courts have subsequently used a two-prong test when determining whether or not a partnership will be recognized for tax purposes.⁹¹ The test asks whether (1) the entity was created for a business purpose, or (2) if the entity carries on a business activity.⁹²

This finding is in perfect harmony with the analysis of the Court in the *Moline Properties* decision. With judicial authority to use the same classification rules for corporations on partnerships, there is no reason to deny using this analysis for Series LLCs. As discussed above, however,

86. Treas. Reg. §301.7701-1(a)(2) (2011).

87. *Bertoli*, 103 T.C. at 511.

88. 37 T.C. 430, 441 (1961).

89. *Moline Properties*, 319 U.S. at 439.

90. *Bertoli*, 103 T.C. at 511.

91. See *Hagist Ranch, Inc. v. Comm'r*, 295 F.2d 351 (7th Cir. 1961), aff'g. T.C. Memo. 1960-206; *O'Neill v. Comm'r*, 271 F.2d 44, 49 (9th Cir. 1959), aff'g. T.C. Memo. 1957-193; *Jackson v. Comm'r*, 233 F.2d 289 (2d Cir. 1956), aff'g. 24 T.C. 1 (1955); *Paymer v. Comm'r*, 150 F.2d 334 (2d Cir. 1945), aff'g. in part and rev'g. in part; *Lomas Santa Fe, Inc. v. Comm'r*, 74 T.C. 662, 674 (1980), aff'd. 693 F.2d 71 (9th Cir. 1982); *Cooper v. Comm'r*, 61 T.C. 599, 602 (1974); *Shaw Constr. Co. v. Comm'r*, 35 T.C. 1102, 1114 (1961), aff'd. 323 F.2d 316 (9th Cir. 1963); *Aldon Homes, Inc. v. Comm'r*, 33 T.C. 582, 597 (1959).

92. *Bertoli*, 103 T.C. at 512.

this analysis may go against the spirit of Series LLCs in that it would classify each series as a separate entity and eliminate the efficiency incentive to use a Series LLC form. The *Moline Properties* case was decided before the invention of LLCs, which act as a blend of incorporated and flow-through entities. It appears that until the current discussion surrounding Series LLCs, partnerships were nearly always argue to be classified as an entity, but we are now seeing a developing area of the law in which organizations do not wish to be classified as a separate entities for federal tax purposes.

c. Aldon Homes, Inc. v. Commissioner

In *Aldon Homes, Inc. v. Commissioner*, the Petitioner operated sixteen alphabet corporations in order to carry out a construction and development business.⁹³ The court was tasked with determining whether each corporation should be treated as a separate entity. In order to do this, the court followed the same guidelines set forth in *Moline Properties*.⁹⁴ To be a separate business entity, the entity must either have been formed for a substantial business purpose or actually engage in substantial business activity.⁹⁵ In this case, petitioner argued that all sixteen corporations were formed for legitimate business reasons (not just for tax purposes), all engaged in substantial business activities, and that the corporations, not the owner, earned the income in dispute.⁹⁶ After deliberation, the court disagreed and found the corporations to be shams on the basis that they were not carrying on business activities that resulted in the profits at issue and that they were formed for no reason other than for tax purposes.⁹⁷

This case seems to have particular importance in regards to Series LLCs. Setting aside the fact that, in the end, the sixteen corporations were found to be sham corporations, the court originally found that each corporation was formed for a legitimate business purpose and that it carried out a business activity, giving rise to classification as a separate entity.⁹⁸ This analysis seems to permeate the underlying rationale behind the proposed regulations that the IRS has released. Intuitively, it seems natural to base entity classification off of the organization's business purpose or business activity. Otherwise there is little need for any entity classification

93. *Aldon Homes*, 33 T.C. at 582.

94. *Moline Properties*, 318 U.S. 435; *Jackson v. Comm'r*, (C.A. 2, 1956) 233 F.2d 289 (Escaping taxation is not a substantive business activity.).

95. *Aldon Homes*, 33 T.C. at 597.

96. *Id.*

97. *Id.*

98. *Id.*

at all. *Aldon Homes*⁹⁹ holds that unless series were being formed for nothing more than tax purposes,¹⁰⁰ each series would be treated as a separate entity.

d. *Bergford v. Commissioner*

The court further decided in *Bergford v. Commissioner* that when determining whether a partnership has been formed, it is more important to look at the terms of the parties' agreement and their conduct, rather than their mere stated intents.¹⁰¹ The court also held that the definition of a partnership for federal tax purposes is broader than the common law meaning of a partnership, and that the IRS is not restrained by state classifications of partnerships.¹⁰² Each determination of an organization's entity status is very fact specific and requires an investigation into the intent of the parties, the activity of the organization, and the business purpose of forming the partnership.¹⁰³

This case has particular importance to the tension existing between state Series LLC statutes and federal classification of separate entities. As discussed, the Series LLC was implemented to make business more efficient for owners who wish to separate assets with multiple LLCs. Regardless of how the states classify each series within a Series LLC, the federal classification regime will have the final say for all federal tax purposes, and *Bergford* suggests a fact intensive investigation that allows the federal government to create standards contrary to state goals.

e. PLR 200803004

With the case law and current federal regulations as a backdrop, the IRS issued a private letter ruling describing its position on the Series LLC entity classification issue. Although private letter rulings are not binding authority on the IRS and cannot be used as citable authority,¹⁰⁴ they do provide a glimpse into the mind of the IRS.

This October 15, 2007, private letter ruling was the first published statement on the federal taxation of a Series LLC.¹⁰⁵ The IRS issued the private letter ruling to a group of insurance companies that were

99. *Aldon Homes*, 33 T.C. at 597.

100. The IRS does not typically recognize transactions done solely for tax purposes and would therefore disregard entities as sham series.

101. *Bergford v. Comm'r*, 12 F.3d 166, 168–69 (9th Cir. 1993).

102. *Id.* at 169.

103. *Id.*

104. 26 U.S.C. § 6110 (2016).

105. I.R.S. P.L.R. 200803004 (Oct. 15, 2007).

reorganizing their mutual fund operations as a Delaware Series LLC.¹⁰⁶ The IRS implicitly ruled that each series of the Series LLC was a separate entity for federal income tax purposes and that each series is therefore entitled to choose its own entity classification independent of the classification of other series.¹⁰⁷ Although the facts of the letter ruling involved a particular type of taxpayer,¹⁰⁸ the analysis and holdings should be broadly applicable to Series LLCs conducting other types of activities.¹⁰⁹

This private letter ruling mirrors what the IRS later released as proposed regulations.¹¹⁰ This private letter ruling is yet another piece of evidence that supports the IRS's position that each series in a Series LLC should be treated as a separate entity.

III. IRS PROPOSED REGULATIONS

A. AN IN DEPTH LOOK AT THE PROPOSED REGULATIONS

The proposed federal regulations were released on September 14, 2010.¹¹¹ The comment period ended on December 13, 2010, and the federal register website originally said that the regulations were set for final action in June 2014.¹¹² That time has come and gone, and as of the publication of this note, the federal register website now provides an outdated message that final action will be taken in December 2014.¹¹³ It has been over five years since the proposed regulations were first introduced, and the time for finalizing the proposed regulations may have passed. However, with the growing popularity of Series LLCs, it would be imprudent of the IRS to never update and subsequently finalize these relevant regulations.

The proposed regulations walk through an analysis very similar to the one above from part II.B.3. regarding entity classification.¹¹⁴ From this analysis, the regulations find that the federal government may find the existence of a separate entity even when, for state purposes, no separate entity exists. The regulations discuss cases when the courts found entities

106. I.R.S. P.L.R. 200803004 (Oct. 15, 2007).

107. *Id.*

108. Mutual funds used to fund variable annuity and life insurance contracts.

109. Ferley, *supra* note 33.

110. I.R.S. P.L.R. 200803004 (Oct. 15, 2007).

111. Series LLCs and Cell Companies, 75 Fed. Reg. 55699 (proposed Nov. 8, 2010) (to be codified at 26 CFR 301).

112. *Id.*

113. As of the date of writing, it has now been three months past this date and there has yet to be any final action taken on behalf of these proposed regulations.

114. Series LLCs and Cell Companies, *supra* note 111.

for tax purposes in some co-ownership situations where the co-owners agreed to restrict their ability to sell, lease or encumber their interests, to waive their rights to partition property, or to allow certain management decisions to be made other than by unanimous agreement among co-owners, all to hopefully escape entity classification.¹¹⁵

After going through some case law analysis, the proposed regulations provide that for federal tax purposes, regardless of local law, series in domestic Series LLCs are separate entities.¹¹⁶ In order to ensure that the proposed regulations do not leave any new or innovative series companies out of the picture, the proposed regulations state that Series LLCs, series partnerships, series trusts, protected cell companies, segregated cell companies, segregated portfolio companies, and segregated account companies are subject to these regulations and rules.¹¹⁷ In classic federal tax definition form, the proposed regulations define a series as a segregated group of assets and liabilities that is established pursuant to a series statute by agreement of a series organization.¹¹⁸ A series includes a cell, segregated account, or segregated portfolio that is formed under the insurance code of a jurisdiction or is engaged in an insurance business.¹¹⁹ However, the term “series” does not include a segregated asset account of a life insurance company, (which consists of assets, the investment returns, and market values of which must be allocated in an identical manner to any variable life insurance or annuity contract invested in any of the assets).¹²⁰ While briefly mentioned, the impact on insurance companies is beyond the scope of this note.

In some state statutes, series must maintain separate and adequate records in order to be able to separate liability between them. The IRS and the Treasury decided that asset protection and liability issues would not play a role in the determination of entity classification.¹²¹ The proposed regulations do provide, however, that the IRS and Treasury considered the option of not treating series as separate entities under the theory that series generally are not considered entities for local law purposes.¹²² In addition, while series have the power to contract, they do not possess every power and all the independence that entities recognized under local law usually

115. See Series LLCs and Cell Companies, *supra* note 106 (discussing *Bergford*, 12 F.3d 166, *Bussing v. Comm’r*, 89 T.C. 1050 (1987), and *Alhouse v. Comm’r*, T.C. Memo. 1991-652).

116. Series LLCs and Cell Companies, *supra* note 111.

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. “Except, for example, potentially under the statutes of Illinois and Iowa, where a series may be treated as a separate entity to the extent set forth in the articles of organization.” Series LLCs and Cell Companies, *supra* note 106.

possess.¹²³ In the end, the proposed regulations classify series as separate entities after balancing the factors in favor of both classification decisions.

When final regulations are released, they may look significantly different from the proposed rules discussed here. The proposed regulations left many questions unanswered and the five-year period has likely been used to further examine the landscape of Series LLCs. The notice and comment period provided the IRS with a general understanding of practitioners' views of the subject, along with a greater understanding of what uncertainty still permeates the issue. The IRS does not wish to publish hastily formulated regulations. They will take their time to ensure that when they do publish final regulations, they clarify the uncertainty.

IV. POSSIBLE SOLUTIONS FOR PRACTITIONERS AND BUSINESS OWNERS

A. UTILIZING SINGLE-MEMBER SERIES IN A SERIES LLC

For state purposes, a single-member LLC is a business separate from its owner, who is thus protected from the business liabilities.¹²⁴ However, for federal tax purposes, the LLC is not considered separate from its owner and the owner is liable for the tax liabilities.¹²⁵ When a single-member LLC exists, it is treated as a sole proprietorship for federal tax purposes.¹²⁶ If the disregarded entity is owned by another entity, it is treated as a branch or division of its owner.¹²⁷

With the above in mind, how can using single-member series help alleviate the uncertainty surrounding entity classification and provide the cleanest way to create efficient and streamlined asset protection? Regardless of federal regulations, a single-member LLC will be a disregarded entity unless it chooses to be taxed differently.¹²⁸ Disregarded entities are not recognized by the IRS and are not required to file any federal tax filings, but maintain their liability protection under local law. Below is an illustration of a potential typical Series LLC structure¹²⁹:

123. Series LLCs and Cell Companies, *supra* note 111.

124. I.R.M. 5.1.21, 5.1.21.3.1.

125. *Id.* at 5.1.21.3.1.

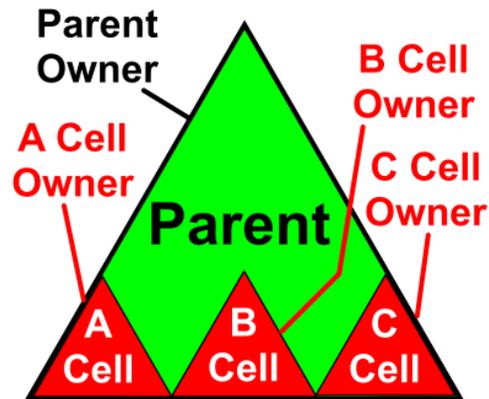
126. *Id.*

127. *Id.*

128. *Id.*

129. Jay Adkisson, *Series LLC and the Abyss of the Unknown*, FORBES (Dec. 23, 2013, 11:56 PM), <http://www.forbes.com/sites/jayadkisson/2013/12/26/series-llc-and-the-abyss-of-the-unknowns/>.

Typical Series LLC Structure



All three cells (A, B, and C) are owned by one person or entity. This results in each cell being classified as a single-member LLC. Assuming that the parent LLC is owned by three members (A, B, and C), this structure allows the LLC to separate its assets and liabilities without creating three new entities for federal tax purposes. Realistically, there are few situations in which the solution would be this simple, but this is the general principle behind using single-member LLCs.

V. CONCLUSION

If the option to hold assets and liabilities in different entities already exists, but it is costly and time consuming for owners, why not allow them a streamlined process to effectuate the same result? Enter the Series LLC. With innovative states like Delaware at the forefront, Series LLCs are a promising new entity form that provides another level of asset protection that is currently only attainable by forming multiple separate entities, which is a time consuming and labor-intensive process. While uncertainty permeates these new business forms in many ways, the IRS has issued proposed regulations that would classify each series within a Series LLC as a separate entity.

While finalizing the regulations will certainly provide clarity for the tax issue, there remains major uncertainty in the bankruptcy arena. Despite this uncertainty, Series LLCs have continued to grow, and states are increasingly implementing statutes relating to them. Although many academics may argue that the uncertainty still exists, it seems that at least from a tax perspective, the uncertainty has nearly been stamped out. While

the regulations have yet to be finalized, based on current regulations and decades of case law, there appears to be no reason why the IRS would change its proposed stance that each series will be a separate entity for federal tax purposes. The lack of federal regulations could be the result of a lack of resources in which case it seems safe to assume that Series LLCs are separate entities. If the answer is as simple as the current regulations may make it seem, there is no need for finalized regulations. In reality, it is a likely a mixture of these considerations and the Treasury is waiting until Series LLCs have enough traction to make the landscape of this new entity clearer because the federal government does not wish to overly frustrate the goals of states in their creation of Series LLC regulations. Whether the regulations are finalized soon or not, we can expect to see Series LLC popularity to continue to rise.