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Much Anticipated Guidance Concerning the Federal Tax Classification of Series Issued

On September 13, the Internal Revenue Service and Treasury issued proposed Treasury regulations addressing the federal tax classification of a series of a domestic series limited liability company, a cell of a domestic cell company, or a foreign series or cell that conducts an insurance business (the Proposed Regulations). In brief, the Proposed Regulations provide that, whether or not a series of a domestic series limited liability company, a cell of a domestic cell company, or a foreign series or cell that conducts an insurance business is a juridical person for local law purposes, it will be treated as an entity formed under local law for federal tax purposes. Furthermore, the Proposed Regulations provide that the classification of a series or cell that is treated as a separate entity for federal tax purposes generally must be determined under the same rules that govern the classification of other types of separate entities.

Background

For more than a decade, the “check-the-box” Treasury regulations (the CTB Regulations) have allowed for certainty by choice in classifying business entities for federal tax purposes. The CTB Regulations generally provide a flexible framework, permitting owners and managers in most instances to choose the entity’s federal tax classification. For those who do not affirmatively make that choice by election, the CTB Regulations fill the gap with default classifications both for domestic and foreign business entities.

Fundamental to the application of the CTB Regulations is that, first, there must exist a “business entity” to be classified. Generally, a business entity is any entity recognized for federal tax purposes. Whether an organization or enterprise is recognized as an entity separate from its owner or owners for federal tax purposes (a separate entity) is a matter of federal tax law. Correspondingly, that determination is not dependent upon recognition of the entity as a legal entity under local law. While the CTB Regulations provide that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on, *inter alia*, a business or financial operation and divide the profits therefrom, in many circumstances, the question of whether an enterprise constitutes a separate entity for federal tax purposes is not one that can be answered confidently.

The Proposed Regulations address whether separate entities arise for federal tax purposes in arrangements that dissect business and investment activities into segregated compartments. Domestically, the most prominent of these arrangements are the “series” entities authorized by Delaware’s statutes. Under Delaware law, each series of the “umbrella” legal entity has a distinct portfolio of assets and liabilities that are considered separate from the assets and liabilities of the other series of the same legal entity. Following Delaware’s lead, several other jurisdictions have adopted similar statutes. The issue presented by these “series” arrangements is whether each series should be cast as a separate entity for federal tax purposes even though there is a single juridical entity for state law purposes.

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Framework of the Proposed Regulations

The Proposed Regulations define a “series statute” as 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:

1. Members or participants of a series organization to have rights, powers, or duties with respect to the series;
2. A series to have separate rights, powers, or duties with respect to specified property or obligations; and
3. The segregation of assets and liabilities such that none of the debts and liabilities of the series organization (other than liabilities to the state or foreign jurisdiction related to the organization or operation of the series organization, such as franchise fees or administrative costs) or of any other series of the series organization are enforceable against the assets of a particular series of the series organization.

For purposes of this definition:

- A “participant” of a series organization includes an officer or director of the series organization who has no ownership interest in the series or series organization, but has rights, powers, or duties with respect to the series;
- A “series organization” is defined as a juridical entity that establishes and maintains, or under which is established and maintained, a series. A series organization includes a series limited liability company, series partnership, series trust, protected cell company, segregated cell company, segregated portfolio company, or segregated account company; and
- A “series” is defined as a segregated group of assets and liabilities that is established pursuant to a series statute by agreement of a series organization. A series includes a cell, segregated account, or segregated portfolio, including a cell, segregated account, or segregated portfolio that is formed under the insurance code of a jurisdiction or is engaged in an insurance business. Notably, however, the term “series” does not include a segregated asset account of a life insurance company, which consists of all assets the investment return and market value of which must be allocated in an identical manner to any variable life insurance or annuity contract invested in any of the assets, as such an account is accorded special treatment under Subchapter L of the Internal Revenue Code of 1986, as amended.

As noted above, the Proposed Regulations provide that, for federal tax purposes, a domestic series, whether or not a juridical person for local law purposes, is treated as an entity formed under local law. With one exception, the Proposed Regulations do not apply to series or cells organized or established under the laws of a foreign jurisdiction. The one exception is that the Proposed Regulations apply to a foreign series that engages in an insurance business.

Whether a series that is treated as a local law entity under the Proposed Regulations is recognized as a separate entity for federal tax purposes is determined under Treas. Reg. § 301.7701-1 and general tax principles. The Proposed Regulations further provide that the classification of a series that is recognized as a separate entity for federal tax purposes is determined under Treas. Reg. § 301.7701-1(b), which provides the rules for classifying organizations that are recognized as entities for federal tax purposes.

The Proposed Regulations do not provide guidance with respect to the federal tax classification of the series organization itself, although the preamble to the Proposed Regulations (the Preamble) notes that such organizations generally are juridical persons for local law purposes and, thus, generally would be treated as separate entities for federal tax purposes.

Proposed Effective Date and Exception

When finalized, the Proposed Regulations will apply on the date that they are published as final Treasury regulations in the Federal Register (Final Regulations). Generally, when the Final Regulations become effective, taxpayers that are treating series differently for federal tax purposes than series are treated under the Final Regulations will be required to change their treatment of series. For example, a series organization that previously was treated as one entity with all of its series may be required to begin treating each series as a separate entity for federal tax purposes. General tax principles will apply to determine the consequences of the conversion from one entity to multiple entities for federal tax purposes.

The Proposed Regulations include an exception for series established prior to publication of the Proposed Regulations that treat all series and the series organization as one entity. If the requirements for this exception are satisfied, after issuance of the Final Regulations, the series may continue to be treated together with the series organization as one entity for federal tax purposes. Specifically, these requirements are satisfied if:

1. The series was established prior to September 14, 2010, *i.e.*, the date of the publication of the Proposed Regulations in the Federal Register;
2. The series (independent of the series organization or other series of the series organization) conducted business or investment activity or, in the case of a foreign series, more than half the business of the series was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies, on and prior to September 14, 2010;
3. If the series was established pursuant to a foreign statute, the series' classification was relevant (as defined in Treas. Reg. § 301.7701-3(d)), and more than half the business of the series was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies for all taxable years beginning with the taxable year that includes September 14, 2010;
4. No owner of the series treats the series as an entity separate from any other series of the series organization or from the series organization for purposes of filing any federal income tax returns, information returns, or withholding documents for any taxable year;
5. The series and series organization had a reasonable basis (within the meaning of section 6662) for their claimed classification; and
6. Neither the series nor any owner of the series nor the series organization was notified in writing on or before the date Final Regulations are published in the Federal Register that classification of the series was under examination (in which case the series' classification will be determined in the examination).

This exception will cease to apply on the date any person or persons who were not owners of the series organization (or series) prior to September 14, 2010, own, in the aggregate, a 50 percent or greater

interest in the series organization (or series). For this purpose, the term interest means (i) in the case of a partnership, a capital or profits interest and (ii) in the case of a corporation, an equity interest measured by vote or value. Notably, this transition rule does not apply to any determination other than the entity status of a series.

Additional Comments Sought

As described in the Preamble, the Internal Revenue Service and Treasury are actively seeking comments on a number of important areas that are in need of further development. The areas in which comments are sought include those listed below:

- Whether a series organization that has no assets and that does not engage in independent activities should be recognized as a separate entity for federal tax purposes;
- How a series with no members, but that has not been terminated for local law purposes, should be classified for federal tax purposes;
- The federal tax classification of a foreign series or cell that does not conduct an insurance business;
- The manner in which the federal employment tax issues raised by the Proposed Regulations and similar technical issued should be resolved;
- The manner in which a series and series organizations will be treated for state employment tax purposes and other state employment-related purposes;
- The issues that could arise with respect to the provision of employee benefits by a series organization or series; and
- The requirement for the series organization and each series of the series organization to file an information statement with the Internal Revenue Service and what information should be included on the statement.

Comments on the Proposed Regulations are due by December 13, 2010.



If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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