AN UNWRITTEN STORY

Texas and the Series LLC

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In 2009, the series LLC made its appearance in Texas when Gov. Perry signed S.B. 1442 into law.

Although relatively new to Texas, the series LLC first made its debut in 1996 when Delaware enacted a statute providing for the establishment of a series limited liability company, or what has come to be known as a series LLC. Since then, seven other states, including Texas, have enacted similar statutes.

Under Texas law, a series LLC is a limited liability company that provides in its governing documents for the establishment of a series of members, membership interests or assets that have separate rights, obligations, liabilities and business purposes from the general LLC.

Each series is not a separate entity for state formation purposes, but can nonetheless have a separate business purpose or investment objective and can separately own property.

It differs from a traditional LLC in several significant respects.

Most notably, the law provides generally that the debts, liabilities, obligations and expenses with respect to a particular series can be made only enforceable against the assets of that series. They would not be enforceable against the assets of the limited liability company generally or any other series.

Each individual series also has the ability to sue and be sued, enter into contracts, hold title to assets and grant liens or security interests in its assets. Essentially, a series acts as a private segregation of assets and liabilities within a single LLC. Each series comes into existence as a result of the company agreement.

It is largely this internal limited liability feature that has caused the series LLC to generate significant buzz in the business and legal communities.

On paper, the series LLC serves as an attractive vehicle for businesses that have assets with respective attendant liability exposure. This is evident in other states where the series LLC has gained popularity in the real estate development industry – an industry that largely relies on the creation of separate entities (e.g. LLCs or partnerships) for each real estate acquisition.

In theory, the series LLC operates in a similar fashion in that the liabilities of a particular series will not affect the assets of another despite there being only one entity for state formation purposes.

In other words, the segregation of liabilities among assets previously achieved only through the creation of different entities, can now - theoretically - be achieved through the formation of a series LLC such that the creditors of one series cannot reach the assets of the LLC or another series within the LLC.

HERE'S THE CAVEAT: UNCERTAINTY

Despite the attractive features of a series LLC, it has been slow to gain use in Texas due largely to the great deal of uncertainty surrounding it from both tax and nontax perspectives.

For example, there are a number of unanswered questions related to the federal and state tax treatment of a series LLC.

The principal question at the federal level is whether a series is a separate business entity for purposes of Treas. Reg. Section 301.7701-1. If it is, this allows a series to file its own tax return and elect tax classification under the check-the-box regulations. If it is not, the LLC remains the business entity, and it will file one return including all of the activities of the collective series and members.

In September, the IRS issued proposed regulations providing generally that the IRS will treat each series of a series LLC as a separate local law entity with the classification of the series for federal tax purposes dependant on general tax principles.

This is one of many federal tax issues implicated by the creation of a series LLC.

At the state level, there are questions regarding the applicability of the Texas Franchise Tax, a privilege tax imposed on each taxable entity chartered, organized or doing business in Texas. The Texas Business Organizations Code does not give entity status to a particular series in a series LLC, leaving many to wonder whether the series LLC will be treated as a single entity for purposes of determining whether the threshold at which businesses become subject to the Texas Franchise Tax has been met.

The Texas comptroller has not issued published guidance regarding this issue. However, some legal commentators anticipate the comptroller's position will be that the LLC, rather than each series, is the reporting entity for franchise tax.

This invariably raises a number of issues – most significantly, whether the series LLC structure is advantageous for those contemplating varied activities, some of which might not otherwise meet the franchise tax threshold when standing alone.

From a liability perspective, the uncertainty relates to the question of the extent to which courts will respect the limited liability of each series. For example, will bankruptcy courts respect the isolation of the assets of one series from the LLC generally and from other series of the LLC? Will nonseries jurisdictions recognize the individual series liability features afforded in Texas? Recent court opinions have added to this uncertainty.

WHERE DO WE GO FROM HERE?

The story of the series LLC is still being written. There remain significant tax questions and concerns regarding the internal liability protections afforded by the series LLC, particularly in nonseries jurisdictions.

Nevertheless, in the years to come, particularly as the IRS and state and federal courts continue to provide guidance, the series LLC will likely gain more traction, making it the one to watch.

This article is not intended as an exhaustive discussion of the points raised herein, nor is it intended as a substitute for legal advice, which can only be rendered when related to specific fact situations.

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