Tax Advisory

September 24, 2010

IRS Issues Proposed Regulations on Tax Treatment of Series LLCs

The U.S. Treasury Department just proposed new regulations (75 Red. Reg. 55699 *et seq.,* September 14, 2010), known as the “Series LLC Regulations” regarding the tax classification of so-called “series” or “cells.” This alert provides fundamental information regarding Series LLC statutes which will assist you in establishing future Series LLCs should you determine that this entity structure suits your needs.

Overview of Series LLC Statutes

In 1996, Delaware adopted a statute that authorized the formation of a limited liability company (LLC) that is empowered to establish separate series or cells under the primary LLC. Since then, at least six other states have followed suit, adopting statutes with basically the same features, ultimately forming what has become known as a “Series LLC.”

A Series LLC is recognized as a juridical person under the various state laws. Individual series or cells within an LLC (or cell company) are not. This means that, unlike the Series LLC (or cell company), an individual series may not have the capability to bring legal action, be sued or hold title to property in its name. It is important to also note that the assets of an individual series are segregated and economically owned by the members or associates. As such, they are not subject to the claims of creditors of the Series LLC or of other series with the Series LLC. Furthermore, a series is not empowered to engage in corporate-type transactions such as merging with another entity, migrating to a different jurisdiction, or converting its state law status.

Federal Tax Classification

Prior to the issuance of proposed tax regulations last week by the IRS, the tax classification of a Series LLC (or cell company) arrangement was uncertain under the existing classification regulations promulgated under Section 7701 of the Code. Although a separate series or cell had characteristics of a separate entity, they were not recognized as a legally separate entity for state law purposes.

Now, under the long-awaited proposed regulations issued by the IRS, it is clear that an individual series of a Series LLC or an individual cell of a cell company formed under applicable state law will generally be considered a separate entity for federal tax purposes and not disregarded, including foreign entities

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if engaged in an insurance business, and thereby classified under the regulations according to its separate characteristics within each series or cell. The Series LLC Regulations further clarify that separate entity status is available to series for federal income tax purposes even if it is not treated as a separate juridical person under local law. Hence, depending upon the number of members, their rights and duties among each other, a separate series may be either a partnership or a corporate entity and may even be disregarded if only one member exists for a series.

For example, if A, B and C form a Series LLC, and A and B enter into a separate series, that series will be viewed as a separate entity and most likely classified as a partnership. If C then enters another series without any other members, it would most likely be disregarded and C would be deemed the tax entity or person.

Effective Date Considerations

The Series LLC Regulations are merely proposed, not final. However, it is apparent that the U.S. Treasury would like new activities to conform to these regulations. Therefore, any new series established after September 14, 2010 should be treated in a manner that is consistent with the Series LLC Regulations so it is honored should the regulations be adopted.

For Series LLCs that are established and conducting business prior to September 14, 2010, a highly favorable transition rule would apply which would permit single entity treatment for the series and the Series LLC if a reasonable basis for claiming a single entity classification is provided. Also, there is a proposed annual filing requirement (regardless of the tax classification of any given series) calling for a statement to be filed providing information “to insure the proper assessment and collection of tax,” including the name, address and taxpayer identification number of each series. Due to the fact that the proposed regulations will generally treat each series as a separate entity, it could mean that a series is a separate employer for employment tax purposes, however, no clear guideline has been provided thus far.

Limitations

Recognition of a series as a separate taxpayer does not extend to all federal tax purposes. More importantly, this recognition does not extend to employment tax matters. Instead, the (umbrella) Series LLC will remain the employer and be subject to employment tax withholding duties. Similarly, questions concerning employee benefit matters may not be resolved by recognition of entity status under the Series LLC Regulations. All of this suggests that Series LLCs may not be well-suited to operations with employees. However, the provision of services by independent contractors, instead of employees, would eliminate this complication.

Concluding Observations

Benefits of using a Series LLC, versus multiple LLCs, will need to be weighed against the drawbacks (*e.g.,* limitations on acquisitions, mergers, conversing, etc.). It is important to note that since only one entity is formed under state law upon the creation of a Series LLC, the use of series is a significant advantage over the creation of separate LLCs to separate risks or to provide differing interests among members of an LLC. With the proposed regulations providing much needed clarification of the tax status of Series LLCs, this form of business entity should be viewed as another option in structuring any business.

With a team of attorneys who are highly experienced in the tax field, MLA can provide insight and assistance in determining which entity structure best meets your needs.

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