SERIES LLCS: MERE “HIGH-SOUNDING NOTHINGS” – DISREGARDED ENTITIES THAT HAVE MUCH LESS IMPACT THAN AT FIRST MEETS THE EYE

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Comment

Series LLCs: Mere “high-sounding nothings” – disregarded entities that have much less impact than at first meets the eye

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Introduction

When the series LLC first appeared on the business entity landscape, there were high hopes that the “new kid on the block” would be some sort of wonder tax-planning tool — a pass-through entity to rival the LLC. There were so many practitioners who came out singing praises of these new entity forms. The consensus, at the time, seemed to be that the series LLC form was ready to take-off as soon as the IRS gives guidance on taxation matters. Chief among practitioners’ concern at the time, was whether each series or cell was going to be regarded as a separate tax entity.

The long-awaited guidance from the IRS and Treasury has been out since September 2010. While the proposed regulations are incomplete and temporary, the Treasury regulations have answered the threshold question of whether an eligible series of an LLC should be treated as a separate entity for federal income tax purposes. However, the proposed regulations leave several issues unresolved. The Treasury asks for input from the public on some of the issues, while other issues were not acknowledged at all. Both tax and non-tax issues affecting series LLCs remain unanswered. Among the tax issues that are unresolved are: (1) how a series LLC would

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1 Texas Wesleyan Law School, J.D. (2011); SMU Dedman School of Law, candidate for LLM (Taxation) (2012).
2 See e.g. McLaughlin and Ely, The Series LLC - Raises Serious State Tax Questions but Few Answers are Yet Available, 24 J. Multistate Tax 2 (2007) (“The series LLC also will likely be a popular entity for real estate ventures and investment activities, and it has already become a common investment vehicle for mutual funds and venture capital funds.”).
3 See e.g. Craig A. Gerson, 45 Tax Mgmt. Memorandum 75 (concluding that “lack of a clear standard federal tax treatment for series LLCs with multiple members has hindered the adoption of this useful business form.”)
be treated employment tax purposes, and (2) how to handle tax issues surrounding provision of employee benefits by an eligible series. It is the author’s opinion that entity issues regarding liability are more important than tax issues in the adoption of series LLC. Short of the adoption of a Uniform Series LLC Act by the states, entity liability issues are going to persist and hamper movement of Series LLCs away from the niche confines of hedge funds and insurance companies into the mainstream.

**Background**

*History*

The concept of a series of entities under an umbrella entity with each series accorded separate recognition comes from the mutual fund and insurance industries. Precursors to the series LLC concept are the Protected Cell Company and the series fund. The insurance industry has used the concept for some time, especially in offshore banking destinations like Guernsey, Virgin Islands, Bermuda, and the Cayman Islands. The Protected Cell Company concept is typically used in a setting where, by contract or by statute, cells of a company agree to “ring-fence” assets against the creditors of other cells within the company.

In the US, the idea of going beyond special uses in the mutual fund industry and organizing entities in cells or series started in 1996 when Delaware passed Senate Bill 96 that went into effect in August 2007. Whereas before this bill the series

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5 See generally, N. Freetham and G. Jones, Protected Cell Companies - A guide to their implementation and use, Spiramus (2010).
6 Protected Cell Companies have been used in the captive insurance industry since the 1980s. The series of a fund concept has been around since the Investment Act of 1940.
7 Id. Note 1.
8 Id.
9 Id. at 49.
entities allowed were merely for separate bookkeeping purposes, the bill expanded the scope of series entities by providing series LLCs with expanded powers.\textsuperscript{10}

As with most trends in corporate law, the series LLC idea soon spread to seven other states: Illinois, Iowa, Nevada, Oklahoma, Tennessee, Texas, and Utah.\textsuperscript{11} All the states that followed Delaware fashioned their legislation to a large extent based on Delaware’s statute. Iowa and Illinois legislatures made some enhancements to the Series LLC provisions, thereby providing more definiteness than is available under Delaware.

\textit{Attributes}

The most important attribute of series LLCs is that when the enabling statute is followed, a series or cell may be formed within an LLC to separately hold assets and accrue liabilities as if it is a stand-alone LLC. The series is essentially a “mini-LLC” within the LLC itself, which may have separate members, managers, assets, liabilities, and business goals.\textsuperscript{12}

Some attributes of the series LLC are conditioned on meeting statutory requirements. For example, under the Delaware Limited Liability Company Act, protection from enforcement action against the assets of the LLC is only granted if the following apply\textsuperscript{13}:

\begin{enumerate}
\item The LLC agreement allows the establishment of one or more series
\item Separate and distinct records of the assets and liabilities of a series are maintained, and
\item The certificate of formation indicates that liability is limited to a series
\end{enumerate}

\textsuperscript{10} Jacob Stein, Tilting at Windmills: Examining FTB’s Treatment of Series LLCs, 9 No. 3 BUSENT 16 at 18, 2008 WL 2640296.
\textsuperscript{13} Del. Code. Ann. Tit. 6, § 18-215(b).
A member of a series is allowed to voluntarily agree to be personally liable for any or all of the liabilities of one or more series.\textsuperscript{14}

All series LLC statutes provide that a series may have separate members, different business goals, separate managers and management structures, and separate voting rules.\textsuperscript{15} While Delaware treats series as a person in most respects of corporate law, it does not specifically make a series a separate legal entity. In Delaware, the series is a person that “shall have the power and capacity to, in its own name, contract, hold title to assets (including real, personal and intangible property), grant liens and security interests, and sue and be sued.”\textsuperscript{16} The series is not completely separate in that it is not separately registered; it can neither merge (consolidate) with another entity nor can it move from one jurisdiction to another.

The statutes in Illinois and Iowa are clearer on their treatment of series LLCs. The Illinois statute allows for clearly designating series of an LLC and filing a certificate of designation with the Secretary of State.\textsuperscript{17} In both Illinois and Iowa, if the statute is followed the series “shall be treated as a separate entity to the extent set forth in the articles of organization.”\textsuperscript{18} The series is allowed to merge with another series and to obtain a certificate of good standing that is separate from its umbrella LLC. Further, the statute allows the series to register to do business under its own name in Illinois or in a foreign jurisdiction.\textsuperscript{19} Among the extra registration requirements in Illinois are the requirements (1) to designate a name that refers to the LLC but is not confusing; (2) to disclose whether a series is member managed or manager managed; and (3) to pay a filing fee and register each designated series.\textsuperscript{20}

\textsuperscript{14} Id.
\textsuperscript{16} Id. at 18-215(c).
\textsuperscript{17} Ill. Comp. Stat. Ann 180/37-40(b).
\textsuperscript{19} Supra note 17
\textsuperscript{20} Id.
In summary, on the scale of entity separateness, Illinois and Iowa are far ahead; providing for complete legal separation of a registered series. Delaware is in the middle; providing that a series can hold assets in its own name and can be sued separately from its parent LLC. The rest of the states are at the bottom; merely allowing for separate ownership of assets and segregation of liabilities.

**Potential benefits of the series LLC**

Series LLCs have the potential to be potent asset protection tools, especially in jurisdictions that give these entities separate legal status. The assets and liabilities of one series can be segregated into related but separate legal entities that can make entities judgment-proof. Assets can be segregated to achieve different investment goals, for example separating high-risk assets from low risk-assets to better align investment goals with investor expectations.\(^\text{21}\)

Another potential benefit of using a series LLC would be the cost savings involved in eliminating several LLC and replacing them with several series under one LLC. This is what practitioners refer to as the *Bramblett* Structure.\(^\text{22}\) The structure is named after the case *Bramblett v. Comm’er*. The structure requires the owners of property to create a separate LLC to hold the investment property. A separate legal entity would perform services like development, property management, and leasing for the investment entity. If the investment entity a tax partnership, the developer entity will have to be a corporation or other non-partnership entity so as to preserve the capital gains that may arise from the inter-entity transfers of property.\(^\text{23}\) The filing, registration, and other compliance fees that are charged per registered entity would be reduced dramatically. Benefits of the series LLC tiered structure depends on whether a


\(^{22}\) *Bramblett v. Comm’er*, 960 F.2d 526 (5th Cir. 1992).

\(^{23}\) I.R.C. § 707(b (2).
A Bramblett-like structure would be respected using series LLCs instead of multiple LLCs. The savings would not be as dramatic in Illinois where each designated series needs to be registered separately.

Any business that has a principal purpose of holding income-producing property may be attracted to the series LLC entity form. For example a company that operates a fleet of taxis that are owner-operated may want to register one master LLC and have each owner/driver and his taxi under a separate series. A similar use can be in the trucking business where the setup of an umbrella company acting as dispatcher and organizer of several owner/drivers is prevalent. Another possible application is in the real estate investment arena. A REIT with 300 properties across the country would be happy to hold each property under one LLC with each investment property held under one of several series LLCs. Currently the best practice is to hold have a holding company as the sole member of multiple LLCs. Each LLC would then hold a single property. The potential applications become endless once one considers businesses that are multi-location but with a certain level of standardization, for example franchised restaurants or hotels. Since most of these businesses typically operate across different states, a measure of uniformity among the several state series LLC statutes is imperative. If single-entity filings at the state level are adopted, a group of unrelated investors could theoretically sign up with an aggregator middleman who registered a series LLC and proceeds to register a series for each investor who pays him a fee. The investors will each operate a series LLC that is subject to a separate management agreement, has separate investment goals, and a separate management team. The aggregator will incur the recurring filing fees and compliance costs for one entity, while he splits the LLC into multiple entities for re-sale to investors. This may lead to a whole new industry of paper-shufflers.
Federal tax classification of series LLCs

On September 14, 2010, the IRS and the Department of the Treasury published proposed Treasury regulations concerning the federal tax classification of series entities. Practitioners had been waiting since 2006 for this guidance. Most practitioners prior to the proposed regulations were of the opinion that IRS guidance in applicability of Check-the-box rules to series entities would clear the way for widespread adoption of the series LLC business entity.24

The proposed regulations’ treatment of series entities was predictable. It was predictable that the service would choose to treat series entities as separate disregarded entities apart from the parent LLC. This is because the check the box rules are predicated on having an “entity”, and on several occasions prior to 2010, the IRS ruled that a series of an entity is a separate taxpayer.25

In National Sec. Series-Indus. Stock Series v. Comr., the Tax Court concluded that the separate series of a single investment trust were distinct tax entities.26 The classification of the series was not at issue in the case, but to reach its conclusion, the court treated each series as a separate taxable entity. The service repeated the tacit holding of the Tax Court’s characterization of the series funds as separate taxpayers in PLR 9819002.27 The service ruled that a trust consisting of separate series can be classified as multiple taxpayers.28

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24 Gerson, supra note 3.
25 See e.g. PLR 200803004 (2008) (ruling that the series portfolio trusts of an insurance company were separate tax entities).
26 13 T.C. 884 (1949).
28 Id.
The “check-the-box” provisions of the Treasury Regulations state that a business entity that is not classified as a corporation (an eligible entity) under Treas. Reg. § 7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of the code can elect its classification for federal tax purposes. An eligible entity with two or more members can choose to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership. On the other hand, a single-member eligible entity will be disregarded as an entity separate from its owner unless it makes an election to be treated as a corporation. Section 301.7701-3(b) provides generally that if an entity does not make an election, the default rules shall apply: a domestic eligible entity will be treated as (i) a partnership if it has two or more members; or (ii) a disregarded entity if it has a single member.

The proposed regulations address the tax classification of “eligible series of a series organization.” The proposed regulations provide that for Federal tax purposes, a domestic series shall be treated as an entity formed under local law. This treatment does not depend on actual treatment under state law, i.e. whether the domestic entity is a legal entity under state law or not, the regulations will treat the series as an entity. Since classification as an entity is the gateway to check-the-box elections, the domestic series will qualify to make elections under Treas. Reg. §301.7701-3.

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29 Treas. Reg. § 301.7701-3(a), 26 CFR 301.7701-3.
30 § 301.7701-3(b).
31 Id.
32 Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699 (9/14/10).
33 In the Preamble, the proposed regulations broadly define “series organization” to include series LLC, series partnership, series trust, protected cell company, and segregated portfolio companies.
34 Prop. Regs. §301.7701-1(a)(5).
35 Id.
Some state series LLC statutes provide that series limited liability will be lost if there is no distinct separate series accounting and record-keeping. The IRS and the Treasury Department refused to extend these limitations to entity classification of series organizations. So, a series may lose limited liability due to poor record-keeping and still maintain federal income tax entity status as a “series organization.” Similarly, an agreement for the liabilities of one series to be satisfied by, or guaranteed by, another series does not affect tax entity status under the proposed regulations. However, when creditors of one series, say “series A,” are allowed to collect the liabilities of that series from another, say “series B”, then taxes assessed on “series A” can similarly be collected from “series B”.

The proposed regulations left a number of issues for later resolution. The Treasury and the IRS acknowledged the incomplete nature of the proposed rules and invited comments in a number of areas:

1. 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;
2. The appropriate treatment of a series that does not terminate for local law purposes when it has no members associated with it;
3. The entity status for Federal tax purposes of foreign cells that do not conduct insurance businesses and other tax consequences of establishing, operating, and terminating all foreign cells;
4. How the Federal employment tax issues discussed and similar technical issues should be resolved;
5. How series and series organizations will be treated for State employment tax purposes and other state employment-related purposes and how that treatment should affect the Federal employment tax treatment of series and series organizations (comments from the states would be particularly helpful);
6. What issues could arise with respect to the provision of employee benefits by a series organization or series; and
7. The requirement for the series organization and each series of the series organization to file a statement and what information should be included on the statement.

See e.g. Del. Code Ann. Tit. 6, § 18-215(b).
38 Prop. Regs. §301.7701-1(a)(5)(vii).
No doubt by the time the proposed regulations become final, some of the above issues would have been resolved. However, the Treasury may resolve the above issues in a way that makes series LLCs unattractive for use. For example, the proposed information return may involve onerous compilations leading to an erosion of the perceived benefits of the series LLC compare to other entity forms.

Emerging Hurdles

Entity liability issues

The unresolved tax issues have a minimal impact on choice of entity decisions compared to the unresolved issues relating to limitation of liability. The initial responses to the emergence of the series LLC were wildly optimistic. Some responses billed the series LLC an ultimate asset-protection dream machine. With time, it has become clear that entity liability issues are the real hurdle to the adoption of the series LLC entity form. Chief among the unresolved liability issues is whether a series can file for bankruptcy on its own. This would be necessary if a series within an LLC are to approximate the level of protection that a structure with multiple single-member LLCs and a holding LLC offers.

Under the Bankruptcy Code, only “persons”, as defined in the code, can file for bankruptcy. Only a “debtor” may file for bankruptcy; and a “debtor” must be a “person.” The definition in the Code gives examples of “persons” for purposes of defining “debtor.” The list of examples is non-exhaustive. No bankruptcy court has been confronted with the issue of whether a series can file for bankruptcy independent

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41 11 U.S.C. §§ 101(13), 301(a), 303(a) (2010).
43 11 U.S.C. § 102(3) (2006) (“In this title –‘includes’ and ‘including’ are not limiting.”).
of its parent LLC. It is only through case law that the contours of a series’ internal liability shield in bankruptcy can be ascertained. There is no clarity in this area because no guinea pigs have come forward to test the bankruptcy courts. The LLC entity form took a similarly tough path to recognition in bankruptcy courts. Initially courts rejected bankruptcy filings by LLCs. Over the years bankruptcy courts have decided that LLC are similar to corporations and partnerships such that they should not be excluded from the definition of “debtor” in bankruptcy. With the exception of series LLCs formed in Illinois and Iowa, one cannot clearly say that a series of an LLC is “so similar to a corporation or partnership” under bankruptcy law. The bankruptcy courts may choose to treat series within an LLC as divisions within a corporation—“non-persons” that have no limited liability and that cannot file for bankruptcy independently. This is an issue that will hamper adoption of the series LLC as an asset protection vehicle.

The liability protection for a series will be created under state law. Currently there is no indication one way or another whether the bankruptcy courts will respect the series liability limits. It is fairly settled that Federal bankruptcy law preempts state law if there are inconsistencies. An important objective underlying bankruptcy proceedings is to preserve the legitimate expectations of creditors. There is a natural collision of objectives if series LLCs are considered in a bankruptcy setting. Creditors’ expectations may be that the debtor in bankruptcy is an ordinary LLC (the parent company), and not a part of an LLC analogous to an unincorporated division.

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44 See e.g. In re Midpoint Dev., LLC, 313 B.R. 486, 488-89 (Bankr. W.D. Okla. 2004) (comparing LLCs to corporations and partnerships and concluding that there was no reason to disqualify LLC from the definition of “debtor” under the Bankruptcy Code).
45 See Unincorporated Operating Division, 9 Fletcher Cyclopedia Corporations § 4233.50 (2008) (unincorporated divisions are not legal “persons”).
Entity liability issues may arise in cases where dealings between related series within an LLC are such that an outside party seeks to “pierce the veil” between the series entities. Most state series LLC statutes provide that without proper recordkeeping indicating separate operations, the internal shield between series in an LLC collapses. If permitted enterprise liability will allow creditors of one series to disregard the series boundaries and recover damages from other series within the LLC.48 Enterprise liability would be based on answering the following question: are the several series engaged in one enterprise? If the operations of the series are such that they may be regarded as operations of one enterprise, then the internal liability shield may be pierced. If it ultimately proves easier to use enterprise liability to pierce the veil in a series LLC environment, the benefits of using the series LLC entity form will disappear.

State Tax Issues

The emerging issues concerning state taxes spring from the fact that no uniform framework exists for states to recognize series LLC formed in other states. While the series LLC state statutes may expressly provide for reciprocal treatment of similar entities from other states, the question that remains unanswered is whether non-series LLC states will respect foreign series LLCs. Even though full faith and credit looms over state decisions on foreign entities, states may refuse recognition on perceived compelling public policy reasons. Again, most states have not been confronted with the issue of whether to recognize out-of-state series entities or not.

Most states mimic Federal tax classifications for state tax determination. As such, if an entity is disregarded at the Federal level, it is usually treated the same for

48 Id.
state tax purposes. Some states like California\textsuperscript{50}, Connecticut\textsuperscript{51}, and Vermont\textsuperscript{52} impose local taxes on LLCs even if they are disregarded federal tax entities.\textsuperscript{53} The California Franchise Tax Board has said that for purposes of franchise tax in California, each series must file a separate return.\textsuperscript{54} California now requires all series within an LLC to file franchise tax returns separately even though the same entities are disregarded for Federal tax purposes.\textsuperscript{55} Texas has also clarified the treatment of series entities by going the California route. The Texas Comptroller of Public Accounts has indicated that each series will be taxed separately. Texas has gone further to say that if a series in a series organization has a nexus with Texas (for purposes of local taxes that require a nexus with the state), the entire LLC has a nexus with Texas.\textsuperscript{56}

In states that have sales tax, an issue arises as to the treatment of transactions between series within a series LLC. Transactions between divisions in a corporation or between entities that are subject to a consolidated return are usually disregarded for sales tax purposes. No guidance is currently available from most state revenue authorities regarding sales tax on intra-series LLC transactions.

**Conclusions and Recommendations**

Without clarity about how the courts are going to treat series LLC on the above issues, it is hard to recommend the series LLC as a planning tool. The tool may be

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49 See *e.g.* Cal. Rev. and Tax. Code §§ 23038(b)(2)(B)(ii)


53 Other states tax LLCs under catchall categories of "other entities" (e.g. Ohio and Texas).

54 The Franchise Tax Board in California has indicated in the instructions to Franchise Tax Form 568, and in Publication 356 (Tax Information for Limited Liability Companies) that each series within a series LLC must pay a separate franchise tax for each series.

55 California Franchise Tax Board, California 2010 Limited Liability Company Tax Booklet, p7, section F (providing that a series LLC, such as a Delaware Series LLC, must file a separate return).

defective, and the tool may be dangerous. Only time, developing jurisprudence, and uniformity among the states will achieve mainstream adoption of this tool.

**Uniformity among states**

It is hard to imagine the widespread adoption of the Series LLC business form before achieving a level of uniformity among the states that are pioneering the concept of series LLCs. The full faith and credit clause of the U.S. Constitution generally requires states to recognize entities recognized in other states, including series LLCs. Notwithstanding full faith and credit expectations, a state may refuse to recognize a foreign entity if the state has overriding public policy objections to something that is recognized in another state.\(^57\) It will be easier for planning if practitioners knew that any new series LLC statutes will be by-and-large similar to an existing known entity form. A sure way of achieving the necessary uniformity is proposing a Uniform Series Limited Liability Company Act that states may adopt. The drafting committee of the Revised Uniform Limited Liability Companies Act had an opportunity to include Series LLC provisions in the revised Act before it was approved for adoption by the states in 2006.\(^58\) The drafting committee ultimately rejected the concept of a series LLC.\(^59\) The drafting committee categorized series LLC as suitable for “sophisticated Delaware lawyers and their ‘funds’ clients” and therefore not suitable for inclusion in the LLC law of other states.\(^60\) Thus, the adoption of the series LLC will most likely remain slow and fractured as long as uniform provisions are not included in the Uniform LLC laws adopted by states.


\(^{59}\) *Id.*

Entity limited liability must mimic that of regular LLCs

The widespread adoption of the series LLC form depends to a large extent on the attributes of a series LLC approximating those of a multiple-LLC tiered structure (master LLC with “stacked” single-member subsidiary LLCs). The series LLC’s potential is only realizable if the use of multiple LLCs can be eliminated with a resulting structure that has the same liability protection and tax consequences. If states do not recognize series of an LLC as separate entities, series of an LLC will not be the equivalent of using multiple LLCs.

A potential benefit of using series LLCs is to achieve administrative cost savings while maintaining liability shields. Some state tax laws treat each series in an LLC as a taxable unit (including disregarded entities) subject to independent filing requirements. Such standalone treatment means administrative costs may end up being the same as using multiple LLCs. To achieve cost savings, state-level taxes should flow through entities that are disregarded for federal tax purposes. This will allow only the parent LLC to file returns incorporating all the activity from the series within it.

Judgment-proofing series LLC assets

If bankruptcy courts determine that series of an LLC are not “persons” eligible to file for bankruptcy independently, liability shield in series LLCs will fall far short of that in a multiple LLC setup. These and other entity liability issues cast doubt on the series LLC’s ability to surpass the regular LLC as the asset protection tool of choice. This suggests that clearly stating in the statutes that a series LLC is a separate legal entity is a better approach to help reduce uncertainty of liability boundaries. The series LLC registered per the statute in Illinois is more likely to be admissible in
bankruptcy court as a debtor. States that are considering series LLC statutes should consider following the Illinois statute, as opposed to Delaware.

Generally, state statutes provide that a judgment creditor of a member of an LLC is restricted to a court order to charge the LLC interest of the member and not the assets of the LLC.61 The laws in the various jurisdictions adopting series LLC entity forms need to be harmonized in such a way as to include series LLC interests in the definition of member interest that are subject to charging orders. An omission in definition of key terms like “LLC Interest” may lead to a diminished internal liability shield as a judgment creditor may be able to reach the series LLC assets.

61 See e.g. Del. Code Ann. Tit. 6, § 18-703(a) (West 2010).