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Memorandum

Almost a "Fall Classic": Proposed Treasury Regulations Leave a "Series" of Issues Unresolved

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INTRODUCTION[1]

On September 14, 2010, the IRS and the Department of the Treasury published long-awaited proposed Treasury regulations addressing the federal tax classification of ''series'' entities or, more precisely, of the ''eligible series'' of a ''series organization.'' In brief, these proposed Treasury regulations (the ''Proposed Regulations'')[2] provide that an eligible series [3] will be treated as an entity formed under local law for federal tax purposes whether or not it actually is recognized as a separate legal entity for local law purposes. The Proposed Regulations further provide that the classification of an eligible series that is treated as a separate entity for federal tax purposes must be determined under the same rules that govern the classification of other types of separate entities.

Although the IRS and Treasury have taken a significant step forward by providing an initial framework for the federal tax classification of eligible series, the Proposed Regulations leave a number of important issues unresolved. This article reviews the Proposed Regulations and offers recommendations for addressing several of their most pressing unresolved issues.

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.[4] In general, the CTB Regulations provide a flexible framework, permitting owners and managers in most instances to choose the entity's federal tax classification. In situations where that choice is not made affirmatively by election, the CTB Regulations fill the gap with default classifications that apply for both 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.[5] 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

[1] Unless otherwise specified, all ''section'' references are to the Internal Revenue Code of 1986, as amended (the ''Code''), and all ''Regs. §'' references are to the Treasury regulations promulgated thereunder.

[2] Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699 (9/14/10).

[3] The term ''eligible series'' is used to refer to a series of a domestic series organization or a series of a foreign series organization where such series conducts an insurance business.

[4] *See generally* Regs. §§301.7701-1–4.

[5] *See* Regs. §301.7701-2(a).

law.[6] Correspondingly, that determination is not dependent upon recognition of the entity under local law.[7] 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,[8] the question of whether an enterprise constitutes a separate entity for federal tax purposes is not one that can be answered with certainty in many circumstances.[9]

The Proposed Regulations address whether one or more separate entities may 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.[10] Delaware amended its limited liability company and limited partnership statutes in 1996 to permit the designation of series of ownership interests within such entities.[11] These innovations provided owners and managers of the ''umbrella'' legal entity the flexibility of creating membership interests having ''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 . . . .'' [12]

The Delaware statute provides that, in the event that one or more series is established within an umbrella legal entity, and if (i) proper records are maintained for each series that account for the assets belonging to such series separately from the assets of the umbrella legal entity or any other series, and (ii) notice of the limitation on liabilities of a series is set forth in the certificate of formation, then the debts, liabilities, obligations, and expenses of a particular series will be enforceable only against the assets of that series, and not against the assets of the umbrella legal entity generally or of any other series.[13] In other words, the Delaware statute effectively creates separate economic compartments, with the assets and the liabilities of each compartment segregated from the assets and the liabilities of each other compartment, as well as from the assets and the liabilities (if any) of the umbrella legal entity.[14] Following Delaware's lead, a number of other jurisdictions have adopted similar statutes.[15]

Series arrangements typically are premised upon the ability to realize cost efficiencies by establishing an umbrella legal entity. The threshold issue presented by these arrangements is whether each series of the umbrella legal entity should be cast as a separate entity for federal tax purposes even though only a single legal entity may be recognized for local law purposes. Although the statutes authorizing series entities in the various jurisdictions use different terminology, one common theme is present: There is an intended commercial benefit to isolating the assets and liabilities (and revenues and expenses) of the respective series of the umbrella legal entity. In light of this common theme and those sought-after cost efficiencies, any analytic framework for determining whether each series of a series entity is a separate entity for federal tax purposes should be consistently and predictably applied.

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[6] *See* Regs. §301.7701-1(a)(1). In *Moline Properties, Inc. v. Comr.*, 319 U.S. 436 (1943), the Supreme Court noted that, so long as a corporation was formed for a purpose that is the equivalent of business activity or the corporation actually carries on a business, the corporation remains a taxable entity separate from its shareholders. *See id.* at 438–439.

[7] Although entities that are recognized under local law generally also are recognized for federal tax purposes, a state law entity may be disregarded if it lacks business purpose or any business activity other than federal tax avoidance. *See Bertoli v. Comr.*, 103 T.C. 501, 511–512 (1994); *Aldon Homes, Inc. v. Comr.*, 33 T.C. 582, 597 (1959).

[8] *See* Regs. §301.7701-1(a)(2).

[9] A common setting in which the ''separate entity'' issue presents itself is in connection with an arrangement that may be viewed as a mere contractual alliance between parties, but sufficient ''partnership'' indicia are evident to deem a partnership to exist for federal tax purposes. *See, e.g., Comr. v. Culbertson*, 337 U.S. 733 (1949); *Comr. v. Tower*, 327 U.S. 280 (1946); *Madison Gas & Elec. Co. v. Comr.*, 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980); *Luna v. Comr.*, 42 T.C. 1067 (1964).

[10] *See* DEL. CODE ANN. tit. 6, §§17-218 (limited partnerships), 18-215 (limited liability companies) (2007).

[11] The Delaware series began its life as a signature feature in the former Delaware Business Trust Act (now the Delaware Statutory Trust Act, DEL. CODE ANN. tit. 12, §§3801–3826 (2006)) where transactions generally involved mutual funds or highly financed asset securitizations. The Delaware Business Trust Act originally was enacted in 1988; however, the series language was not brought into that act until July 5, 1990. *See* 67 Del. Laws ch. 296 (1990).

[12] DEL. CODE ANN. tit. 6, §18-215 (2007). Similar provisions apply to series limited partnerships.

[13] In drafting the Delaware statute, a conscious choice likely was made not to describe the series as separate legal entities in order to avoid concerns that each series would be analyzed as a separate legal entity for non-tax purposes unrelated to creditor rights (e.g., in applying the Investment Company Act of 1940). *See* Peaslee & Tenreiro, ''Tax Classification of Segregated Portfolio Companies,'' 117 *Tax Notes* 43, 46 (2007).

[14] Not only is there a separation of assets and liabilities, but different series routinely have different owners, different investment managers, different contribution and distribution policies, and different borrowing policies. Incidentally, there is no restriction under the Delaware statute on the types of business or investment activities undertaken by series entities.

[15] *See, e.g.,* 805 ILL. COMP. STAT. 180/37–40 (2008); IOWA CODE §490A.305 (2008); NEV. REV. STAT. ANN. §86.296 (West 2005); OKLA. STAT. ANN. tit. 18, §2054.4 (West 2007); TENN. CODE ANN. §48-249-309 (2006); TEX. BUSINESS ORGANIZATIONS CODE ANN. §101.601 (Vernon 2009); UTAH CODE ANN. §48-2c-606 (2007); P.R. LAWS ANN. tit. 14, §3426(p) (2004).

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THE FRAMEWORK OF THE PROPOSED REGULATIONS

As an initial matter, it is important to understand the key definitions that underlie the Proposed Regulations. First and foremost, the Proposed Regulations define the term ''series statute'' as a statute of a state or foreign jurisdiction that explicitly provides for the organization or establishment of a series of a legal entity [16] and explicitly permits —

- Members or participants of a series organization to have rights, powers, or duties with respect to the series;
- A series to have separate rights, powers, or duties with respect to specified property or obligations; and
- 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.[17]

The Proposed Regulations (and the preamble thereto) further define the term —

- ''Series'' as a segregated group of assets and liabilities that is established pursuant to a series statute by agreement of a series organization;[18]
- ''Series organization'' as a legal entity that establishes and maintains, or under which is established and maintained, a series; and[19]
- ''Participant'' as including 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.[20]

Under the Proposed Regulations, a *domestic* series, whether or not recognized as a separate legal entity for local law purposes, will be treated as an entity formed under local law for federal tax purposes.[21] The Proposed Regulations also address *foreign* series, but only foreign series that conduct an insurance business.[22] Specifically, a series established under the laws of a foreign jurisdiction will be treated as an entity formed under local law for federal tax purposes only if the arrangements and other activities of the series, if conducted by a domestic entity, would result in the classification of the series as an insurance company within the meaning of §816(a) or §831(c).[23] The Proposed Regulations otherwise do not address the

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[16] We note here that the definition of the term ''series statute'' refers to a ''juridical person'' rather than a legal entity, and the definition of the term ''series organization'' refers to a ''juridical entity'' rather than a legal entity. We have chosen to reconcile the different terms by following the lead of the IRS and Treasury, as set forth in the preamble to the Proposed Regulations, by using the term ''legal entity.'' *See, e.g.,* Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55699 (9/14/10) (''For example, certain statutes provide for the chartering of a *legal entity* (or the establishment of cells) under a structure commonly known as a protected cell company, segregated account company or segregated portfolio company (cell company). A cell company may establish multiple accounts, or cells, each of which has its own name and is identified with a specific participant, but generally is not treated under local law as a *legal entity* distinct from the cell company.'' [Emphasis added.]); *see also* BLACK'S LAW DICTIONARY 350 (Pocket ed. 1996) (providing that one of the definitions of the term ''juridical'' is ''of or relating to law; legal''). For a critique of the use of the term ''juridical person'' in the definition of the term ''series statute,'' see Cummings, Jr., ''Ownership, Series, and Cells,'' 129 *Tax Notes* 1129, 1136–1137 (2010).

[17] Prop. Regs. §301.7701-1(a)(5)(viii)(B).

[18] Prop. Regs. §301.7701-1(a)(5)(viii)(C). 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 that is engaged in an insurance business. *Id.* However, the term does not include a segregated asset account of a life insurance company, as such an account is accorded special treatment under Subchapter L of the Code. *See id. See generally* §817(d) (defining the term ''variable contract''); Regs. §1.817-5(e) (describing the assets comprising a ''segregated asset account'').

[19] Prop. Regs. §301.7701-1(a)(5)(viii)(A). 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. *Id.* In general, a protected cell company, a segregated cell company, a segregated portfolio company, or a segregated account company (a ''cell company'') is a legal entity that holds assets in one or more segregated cells. The insurance codes of a number of states include statutes that provide for the chartering of such legal entities. *See, e.g.,* S.C. CODE ANN. §§38-10-10 through 38-10-80 (2009) (protected cell insurance companies); VT. STAT. ANN. tit. 8, §§6031–6038 (2010) (sponsored captive insurance companies and protected cells of such companies). Under those statutes, the assets of each cell of the cell company are segregated from the assets of any other cell of the cell company. *See generally* Rev. Rul. 2008-8, 2008-5 I.R.B. 340 (providing a general description of what constitutes a cell company). A cell of a cell company may issue insurance or annuity contracts, reinsure such contracts, or facilitate the securitization of obligations of a sponsoring insurance company.

[20] Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55702 (9/14/10).

[21] Prop. Regs. §301.7701-1(a)(5)(i).

[22] *See* Prop. Regs. §301.7701-1(a)(5)(ii).

[23] *Id.* For purposes of §816(a), the term ''insurance company'' means any company more than half of the business of which during the taxable year is (i) the issuing of insurance contracts or annuity contracts or (ii) the reinsuring of risks underwritten by in-

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treatment of series established under the laws of a foreign jurisdiction.[24] Rather, until further guidance is issued, the entity status of such foreign series will have to be determined under ''applicable law.'' [25]

In brief, the Proposed Regulations also provide that —

- A series will be treated as created or organized under the laws of the same jurisdiction in which the series is established.[26]
- An election, agreement, or other arrangement that permits debts and liabilities of other series or the series organization to be enforceable against the assets of a particular series, or a failure to comply with the recordkeeping requirements for the limitation on liability available under the relevant series statute, will be disregarded for purposes of determining whether an arrangement satisfies the definition of the term ''series.'' [27] Thus, a series generally will not cease to be treated as an entity formed under local law because it guarantees the debt of another series within the series organization.[28]
- Ownership of interests in a series and of the assets associated with a series is determined under general tax principles.[29] Thus, in accordance with the Proposed Regulations, a series organization should not be treated as the owner of a series or of the assets associated with a series merely be-

surance companies. §816(a) (flush language). Accordingly, it is the character of the business actually done by the company in the taxable year that determines whether it is taxable as an insurance company for federal tax purposes. *See Bowers v. Lawyers' Mortgage Co.*, 285 U.S. 182, 188 (1932); *see also* Regs. §1.801-3(a)(1) (''Thus, . . . it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.''); Notice 2008-19, 2008-5 I.R.B. 366 (''Although its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.''); S. PRT. NO. 98-169 (Vol. 1), DEFICIT REDUCTION ACT OF 1984 — EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 526 (4/2/84) (''It is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Code[.]''); *cf. Cardinal Life Ins. Co. v. U.S.*, 300 F. Supp. 387, 391 (N.D. Tex. 1969) (''Thus, to qualify as a life insurance company under the federal tax laws, a corporation must use its capital and efforts primarily in earning income from the issuance of contracts of insurance.''), *rev'd on other grounds*, 425 F.2d 1328 (5th Cir. 1970). The same definition applies for purposes of §831(c), which provides that, for purposes of §831, ''the term 'insurance company' has the meaning given to such term by §816(a).''

[24] Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55702 (9/14/10).

[25] *See id.* at 55703 (''Until further guidance is issued, the entity status of a foreign series that does not conduct an insurance business will be determined under applicable law. Foreign series raise novel Federal income tax issues that continue to be considered and addressed by the IRS and the Treasury Department.'').

[26] Prop. Regs. §301.7701-1(a)(5)(v). Because a series may not be recognized as a separate legal entity for local law purposes, this rule provides the means for establishing the jurisdiction of the series for federal tax purposes.

[27] Prop. Regs. §301.7701-1(a)(5)(viii)(C).

[28] *See* Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55702 (9/14/10).

[29] Prop. Regs. §301.7701-1(a)(5)(vi).

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cause the series organization holds legal title to the assets associated with the series.[30] Similarly, the obligor of a liability of a series is determined under general tax principles.[31]

- When a creditor is permitted to collect a liability *attributable to a series organization* from one or more series of the series organization, a tax liability assessed against the series organization may be collected directly from those series.[32]
- To the extent that federal or local law permits a creditor to collect a liability *attributable to a series* from the series organization (or other series), the series organization (and other series) also may be considered the taxpayer from whom the tax assessed against the series may be collected.[33]

Because the Proposed Regulations treat an eligible series as an entity formed under local law, the classification of an eligible series for federal tax purposes is then made under Regs. §301.7701-1 and general tax principles.[34] In this regard, the Proposed Regulations provide that the classification of an eligible series is determined under Regs. §301.7701-1(b).[35] Accordingly, an eligible series that is described in Regs. §301.7701-2(b)(1) through (8) (e.g., a *per se* corporation) would be classified as a corporation regardless of the classification of the series organization.[36] Furthermore, an eligible series that is recognized as a separate entity for federal tax purposes may make any federal tax elections that it otherwise is eligible to make independently of other series (or the series organization itself), and regardless of whether other series (or the series organization) make corresponding elections, different elections, or no elections.[37]

When finalized, the Proposed Regulations will apply on the date that they are published as final Treasury regulations in the Federal Register (''Final Regulations'').[38] Generally, when the Final Regulations become effective, taxpayers that are treating an eligible series differently for federal tax purposes than is provided under the Final Regulations will be required to change their treatment of such eligible series.[39] For example, a series organization that, along with all of its eligible series, has been treated as a single entity for federal tax purposes may be required to begin treating each eligible series as a separate entity for such purposes.[40] General tax principles will apply to determine the consequences of the conversion of the series organization into multiple entities for federal tax purposes.[41] Notably, the Proposed Regulations also include an exception (to the required change in treatment referenced above) for certain arrangements that have been treating a series organization and its eligible series as a single entity for federal tax purposes.[42]

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[30] *See* Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55703 (9/14/10). The necessity of describing the manner in which ''ownership'' of assets ''associated with'' a series should be determined likely follows from the use of the ''segregation'' concept in the definitions of the terms ''series statute'' and ''series.'' *See* Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55703 (9/14/10) (''For example, if a series organization holds legal title to assets associated with a series because the statute under which the series organization was organized does not expressly permit a series to hold [legal title to] assets in its own name, the series will be treated as the owner of the assets for federal tax purposes if it bears the economic benefits and burdens of the assets under general tax principles.'').

[31] Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55703 (9/14/10).

[32] Prop. Regs. §301.7701-1(a)(5)(vii).

[33] *See id.*

[34] *See* Prop. Regs. §301.7701-1(a)(5)(iii).

[35] Prop. Regs. §301.7701-1(a)(5)(iv); *see also* Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55704 (9/14/10) (''If a domestic series or a foreign series engaged in an insurance business is treated as a separate entity for federal tax purposes, then §301.7701-1(b) applies to determine the proper tax classification of the series.'').

[36] Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55703 (9/14/10).

[37] *Id.* at 55704. To the extent that an eligible series is a taxpayer against which tax may be assessed under Chapter 63 of the Code (i.e., §§6201–6255), any tax assessed against the eligible series may be collected by the IRS from the eligible series in the same manner that the assessment could be collected by the IRS from any other taxpayer. *See* Prop. Regs. §301.7701-1(a)(5)(vii).

[38] Prop. Regs. §301.7701-1(f)(3)(i).

[39] *See* Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55706 (9/14/10); *cf.* Prop. Regs. §301.7701-1(f)(3)(ii)(A) (providing a transition rule for certain series established prior to Sept. 14, 2010).

[40] *See* Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55706 (9/14/10).

[41] *Id.* (noting, *inter alia*, ''[t]he division of a series organization into multiple corporations may be tax-free to the corporation and to its shareholders; however, if the corporate division does not satisfy one or more of the requirements in §355, the division may result in taxable events to the corporation, its shareholders, or both'').

[42] *See* Prop. Regs. §301.7701-1(f)(3)(ii)(A). The exception would apply if: (i) the series was established prior to Sept. 14, 2010; (ii) 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; (iii) the series' classification was relevant (as defined in Regs. §301.7701-3(d)) in the case of a foreign series; (iv) 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 tax purposes; (v) the series and the series organization had

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ISSUES LEFT UNRESOLVED BY THE PROPOSED REGULATIONS

The IRS and Treasury explicitly recognized in the preamble to the Proposed Regulations that a number of important areas of guidance need to be further developed. As an initial matter, the IRS and Treasury invited comments on the areas listed immediately below.[43]

1. 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;[44]
2. The manner in which an eligible series that has no members, but that has not been terminated for local law purposes, should be classified for federal tax purposes;[45]
3. The entity status of a foreign series that does not conduct an insurance business and the other federal tax consequences of establishing, operating, and terminating such a foreign series;[46]
4. The manner in which the federal employment tax issues raised by the Proposed Regulations and similar technical issues should be resolved;[47]
5. The manner in which 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;[48]
6. The issues that could arise with respect to the provision of employee benefits by a series organization or an eligible series;[49] and
7. The requirement that a series organization and each series of the series organization file an annual information statement with the IRS and what information should be included on the statement.[50]

In addition to the areas listed above, the IRS and Treasury describe in the preamble to the Proposed Regulations the uncertainties surrounding many of the decisions that were made during the course of drafting the Proposed Regulations. Specifically, in the preamble to the Proposed Regulations, the IRS and Treasury identified the following areas as deserving special attention: (i) ascertaining the factors that should dictate the characterization of a series for federal tax purposes;[51] (ii) deciding whether the treatment of domestic series as separate legal entities formed under local law for federal tax purposes would be consistent with taxpayers' current ability to create similar structures using multiple local law entities that can elect their federal tax classification pursuant to Regs. §301.7701-3;[52] (iii) determining the entity status of a series organization (i.e., the umbrella legal entity) for federal tax purposes;[53] (iv) resolving the ''novel'' federal tax issues raised by foreign series other than foreign series that conduct insurance businesses;[54] and (v) developing insurance-specific guidance to address

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a ''reasonable basis'' (within the meaning of §6662) for their claimed classification; and (vi) neither the series nor any owner of the series nor the series organization was notified in writing on or before the date of the Final Regulations that classification of the series was under examination (in which case the series' classification will be determined in the examination). *Id.* This exception will cease to apply on the date that any person or persons that were not owners of the series organization (or series) prior to Sept. 14, 2010, own, in the aggregate, a 50% or greater interest in the series organization (or series). *See* Prop. Regs. §301.7701-1(f)(3)(ii)(B).

[43] Comments on the Proposed Regulations were due by Dec. 13, 2010. *See* Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55699 (9/14/10).

[44] *See id.* at 55707.

[45] *See id.*

[46] *See id.*

[47] *Id. See generally id.* at 55704–55705 (section entitled ''Employment Tax and Employee Benefits Issues'').

[48] *Id.* at 55707. *See generally id.* at 55705 (section entitled ''Employment Tax and Employee Benefits Issues'').

[49] *Id.*

[50] *Id.*; *see also* Prop. Regs. §301.6011-6(a). *See generally* Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55705–55706 (9/14/10) (section entitled ''Statement Containing Identifying Information About Series'').

[51] The factors considered by the IRS and Treasury included (i) the manner in which the series is characterized for local law purposes; (ii) the failure of the series to elect or qualify for the liability limitations under a series statute; (iii) the inability of the series to enter into contracts, sue, be sued, and/or hold property in its own name; (iv) the inability of the series to convert into another type of entity, merge with another entity, or domesticate in another jurisdiction independent of the series organization; (v) the termination of the series upon the dissolution of the series organization; (vi) the relationship that the equity holders and managers of the series organization generally have with the series, and the nature of their rights, duties, and powers with respect to the series generally; and (vii) the series having members, a business purpose, and/or an investment objective that overlap with another series or the series organization. *See* Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55702–55703 (9/14/10).

[52] *See id.* at 55703.

[53] *See id.*

[54] *See id.*

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the issues identified in Notice 2008-19[55] and other insurance-specific transition issues that may arise for cell companies that previously reported in a manner inconsistent with the Final Regulations.[56]

GENERAL OBSERVATIONS AND RECOMMENDATIONS FOR THE FINAL REGULATIONS

A Welcome Approach to the Threshold Question

The Proposed Regulations take a cautious approach to the threshold question of whether an eligible series should be recognized as a separate entity for federal tax purposes. Specifically, the Proposed Regulations merely provide that an eligible series should be treated as an entity formed under local law for federal tax purposes; however, in the preamble to the Proposed Regulations, the IRS and Treasury explained that ''[a]n organization that is an entity for local law purposes generally is treated as an entity for federal tax purposes.'' [57] Thus, the conclusion to be drawn is that an eligible series should be recognized as a separate entity for federal tax purposes.[58]

The factors identified by the IRS and Treasury as guiding the characterization of an eligible series for federal tax purposes also provide a broader framework for evaluating the threshold question than was provided in previous guidance issued by the Service concerning series (and similar arrangements).[59] For example, in PLR 200803004 (10/15/07),[60] the IRS concluded that each series of a limited liability company constituted a separate entity for federal tax purposes where the following facts were present:

- Each series of the limited liability company consisted of a separate pool of assets and liabilities;
- The shareholders of a series of the limited liability company shared only in the income of that series;
- The shareholders of a series of the limited liability company were limited to the assets of that series upon redemption, liquidation, or termination of such series;
- The payment of the expenses, charges, and liabilities of a series of the limited liability company were limited to the assets of that series;
- The claims of creditors of a series of the limited liability company were limited to the assets of that series; and
- Each series of the limited liability company had its own investment objectives, policies, and restrictions.

Despite the list of ''necessary'' factors that can be derived from authorities such as PLR 200803004, the IRS and Treasury stated in the preamble to the Proposed Regulations that the characterization of an eligible series for federal tax purposes is driven by two primary factors:

- The relationship that the equity holders and managers of the series organization have with the eligible series, and the nature of their rights, duties, and powers with respect to the eligible series; and
- The business purpose for, and/or the investment objective of, the eligible series (notwithstanding the possible overlap of that business purpose and/or investment objective with that of another series or the series organization).[61]

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[55] 2008-5 I.R.B. 366.

[56] *See* Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55704 (9/14/10).

[57] Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55704 (9/14/10); *see also id.* at 55700 (''entities that are recognized under local law generally are also recognized for Federal tax purposes'').

[58] *See, e.g.,* Elliott, ''Proposed Series LLC Regs Put Series on Par with LLCs, Former Treasury Official Says,'' 2010 *TNT* 180-2 (9/17/10) (''The regs, which the IRS released on September 13, say an individual series of a series LLC or an individual cell of a cell company formed under local law is treated as an entity under local law for testing its tax status. Such an entity would then most likely also be a separate taxable entity for federal tax purposes.''); *see also* Ricaurte, ''Proposed Series LLC Regulations Address 'Threshold Question,' Speakers Say,'' 210 *BNA Daily Tax Rpt.* G-1 (11/2/10) (describing statements made by Dianna Miosi of the IRS's Office of Associate Chief Counsel (Passthroughs and Special Industries)); Young, ''Series LLCs May Have Joint and Several Tax Liability, Official Says,'' 2010 *TNT* 189-3 (9/30/10) (''The proposed regs for series LLCs were released on September 13. They treat an individual series of a series LLC or an individual cell of a cell company as an entity under local law for testing its tax status. Series and cells are also likely to be separate taxable entities for federal tax purposes.'').

[59] *See, e.g.,* PLR 200803004 (10/15/07) (discussed above); *see also* PLR 200303017 (9/30/02); PLR 9847013 (8/20/98); PLR 9837005 (6/9/98).

[60] For a thorough analysis of this private letter ruling, *see* Grob & Hannawa, ''Federal Tax Status of a Series Limited Liability Company,'' 10 *Bus. Entities* 24 (Mar./Apr. 2008).

[61] *See* Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55703 (9/14/10) (''[T]he IRS and the Treasury Department believe that, overall, the factors supporting separate entity status for series outweigh the factors in favor of disregarding series as entities separate from the series organization and other series of the series or-

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In so concluding, the IRS and Treasury rejected the notion that the following factors (among others) should impact the determination of the characterization of an eligible series for federal tax purposes: (i) the manner in which the eligible series is characterized for local law purposes;[62] (ii) the failure of the eligible series to elect or qualify for the liability limitations under a series statute;[63] (iii) the existence of an election, agreement or other arrangement that permits debts and liabilities of other series or the series organization to be enforceable against the assets of the eligible series;[64] (iv) the possibility that federal or local law may permit a creditor to collect a liability attributable to the eligible series from the series organization or other series of the series organization;[65] (v) the inability of the eligible series to enter into contracts, sue, be sued, and/or hold property in its own name;[66] (vi) the inability of the eligible series to convert into another type of entity, merge with another entity, or domesticate in another jurisdiction independent of the series organization;[67] (vii) the dissolution of the series organization causing the eligible series to terminate;[68] and (viii) the possibility of the eligible series having members, a business purpose, and/or an investment objective that overlap with another series or the series organization.[69]

In sum, under the approach developed by the IRS and Treasury in the Proposed Regulations with respect to the threshold question, an eligible series usually will be characterized as a separate entity for federal tax purposes.[70] This approach is a welcome one, given the various jurisdictions in which series statutes have come to exist and the differences in those statutes. Furthermore, it reveals the IRS and Treasury's predisposition to forego a facts-and-circumstances analysis and to avoid being viewed as preferring one jurisdiction's series statute over that of another.

Furthermore, the approach adopted by the IRS and Treasury in the Proposed Regulations should not disrupt the federal tax treatment of existing ''stacked'' or ''tiered'' limited liability company structures.[71] In this regard, a common technique in real estate and investment partnerships is to establish a ''master'' or ''parent'' limited liability company that wholly owns one or more ''subsidiary'' single-member limited liability companies, each of which in turn may wholly own one or more single-member limited liability companies. A primary benefit generally sought from the use of such a structure is the ability to file a single part-

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ganization. Specifically, managers and equity holders are 'associated with' a series, and their rights, duties, and powers with respect to the series are direct and specifically identified. Also, individual series may (but generally are not required to) have separate business purposes and investment objectives. The IRS and the Treasury Department believe these factors are sufficient to treat domestic series as entities formed under local law.'').

[62] *See id.* (''Because Federal tax law, and not local law, governs the question of whether an organization is an entity for Federal tax purposes, it is not dispositive that domestic series generally are not considered entities for local law purposes.'').

[63] *See id.* at 55702 (''[L]imitations on liability of owners of an entity for debts and obligations of the entity and the rights of creditors to hold owners liable for debts and obligations of the entity generally do not alter the characterization of the entity for Federal tax purposes.''); *see also* Prop. Regs. §301.7701-1(a)(5)(viii)(C).

[64] *See* Prop. Regs. §301.7701-1(a)(5)(viii)(C). However, the price exacted by the IRS and Treasury for this concession is found in Prop. Regs. §301.7701-1(a)(5)(vii), which provides that, when a creditor is permitted to collect a liability attributable to a series organization from a series of the series organization, a tax liability assessed against the series organization may be collected directly from that series of the series organization by administrative or judicial means.

[65] *See* Prop. Regs. §301.7701-1(a)(5)(vii). In similar fashion to the preceding point, the *quid pro quo* for this concession also is found in Prop. Regs. §301.7701-1(a)(5)(vii), which provides that the series organization and other series of the series organization may be considered the taxpayer from which the tax assessed against the eligible series may be collected pursuant to administrative or judicial means.

[66] *See* Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55703 (9/14/10) (''These attributes primarily involve procedural formalities and do not appear to affect the substantive economic rights of series or their creditors with respect to their property and liabilities. Even in jurisdictions where series may not possess these attributes, the statutory liability shields would still apply to the assets of a particular series, provided the statutory requirements are satisfied.'').

[67] *See id.* (''The IRS and the Treasury Department believe that, notwithstanding that series differ in some respects from more traditional local law entities, domestic series generally should be treated for Federal tax purposes as entities formed under local law.'').

[68] *See id.*

[69] *See id.* (''Separate State law entities may have common or overlapping business purposes, investment objectives and ownership, but generally are still treated as separate local law entities for Federal tax purposes.'').

[70] *See id.* (''[T]he rule provided in the proposed regulations would provide greater certainty to both taxpayers and the IRS regarding the tax status of domestic series and foreign series that conduct insurance businesses. In effect, taxpayers that establish domestic series are placed in the same position as persons that file a certificate of organization for a State law entity. The IRS and the Treasury Department believe that the approach of the proposed regulations is straightforward and administrable, and is preferable to engaging in a case-by-case determination of the status of each series that would require a detailed examination of the terms of the relevant statute.'').

[71] *See id.* (''[T]he IRS and the Treasury Department believe that a rule generally treating domestic series as local law entities would be consistent with taxpayers' current ability to create similar structures using multiple local law entities that can elect their Federal tax classification pursuant to [Regs.] §301.7701-3.''); *see also* Elliott, ''Proposed Series LLC Regs Put Series on Par with LLCs, Former Treasury Official Says,'' 2010 *TNT* 180-2 (9/17/10).

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nership tax return.[72] That benefit should not be jeopardized under the Proposed Regulations.[73]

Determining the Status of a Series Organization

Missing from the Proposed Regulations is guidance for characterizing a series organization for federal tax purposes. We suggest that the characterization of a series organization be determined under the same approach as that applied for determining whether the eligible series of the series organization should be recognized as separate entities for federal tax purposes. Specifically, because a series organization is a separate legal entity for local law purposes, it follows that the series organization generally would be treated as a separate entity for federal tax purposes. Of course, this analysis leaves open the possibility that the series organization could be disregarded for federal tax purposes, notwithstanding its status as a separate legal entity for local law purposes.[74]

Although arguments have been made to the effect that, unless a series organization has ''its own'' assets and liabilities (that are not associated with one or more of its series), the series organization should be treated (by default) as transparent or as a nominee, it may be difficult to reconcile that approach with the framework in the Proposed Regulations for characterizing eligible series. Rather, it seems that the same approach should be applied to determine the characterization of the series organization as is applicable to its eligible series. In this regard, we note the following explanation included in the preamble to the Proposed Regulations:

> A series organization generally is an entity for local law purposes. An organization that is an entity for local law purposes generally is treated as an entity for Federal tax purposes. However, an organization characterized as an entity for Federal income tax purposes may not have an income or information tax filing obligation. For example, [Regs.] §301.6031(a)-[1](a)(3)(i) provides that a partnership with no income, deductions, or credits for Federal income tax purposes for a taxable year is not required to file a partnership return for that year. Generally, filing fees of a series organization paid by series of the series organization would be treated as expenses of the series and not as expenses of the series organization. Thus, a series organization characterized as a partnership for Federal tax purposes that does not have income, deductions, or credits for a taxable year need not file a partnership return for the year.[75]

Issues Raised by ''Non-Insurance'' Foreign Series

As noted in the preamble to the Proposed Regulations, many foreign jurisdictions have enacted legislation authorizing the formation of series entities.[76] In similar fashion, the European Union has adopted directives providing for ''undertakings for collective in-

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[72] *See, e.g.,* Sider, ''Check-the-Box Proposed Regulations Make LLCs Even More Appealing,'' *J. Limited Liability Companies* (Fall 1996) (''With a single-member LLC, these taxpayers may create a single entity and then establish a wholly owned subsidiary LLC for each new venture. Thus, rather than having ten separate brother-sister LLCs, each of which must file its own tax return, structuring a chain of parent-subsidiary LLCs would result in only one tax return being required for the entire group.''); Elliott, ''Series LLCs Regs Do Not Address Return Filing Requirements, IRS Official Says,'' 2010 *TNT* 211-2 (11/2/10) (''[T]he primary benefit of such a structure is the potential administrative savings of filing one set of return documents, rather than separate operating agreements and separate Forms 1065 'U.S. Return of Partnership Income' for each lower-tier entity.'').

[73] *Cf.* Elliott, ''Series LLCs Regs Do Not Address Return Filing Requirements, IRS Official Says,'' 2010 *TNT* 211-2 (11/2/10) (describing statements made by Dianna Miosi of the IRS's Office of Associate Chief Counsel (Passthroughs and Special Industries)).

[74] *See* above note 7. For example, if the sole activity of the series organization is to arrange for the disbursement of expenses to be shared by the series, the series organization could be viewed as a mere undertaking to share expenses and, thus, may not constitute a separate entity for federal tax purposes. *Cf.* Regs. §301.7701-1(a)(2).

[75] Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55704 (9/14/10).

[76] The following list should not be considered exhaustive, but it should demonstrate the popularity of series organizations in foreign jurisdictions.

- Anguilla — Protected Cell Companies Act (2004), *available at* http://www.fsc.org.ai/PDF/Protected%20Cell%20Companies%20Act.pdf.
- Barbados — Companies Act, Part III (Other Registered Companies), Division G (Segregated Cell Companies) (as amended), *available at* http://www.investbarbados.org/docs/Companies%20Act%20-%20CAP%20308.pdf.
- Belize — Protected Cell Companies Act (2000), *available at* http://www.ifsc.gov.bz/downloads/protected-cell-cap271.pdf.
- Bermuda — Segregated Accounts Companies Act 2000 (as amended in 2002 and 2004), *available at* http://www.bma.bm/uploaded/37-Segregated_Accounts_Companies_Act_2000_(consolidated).pdf.
- British Virgin Islands — Segregated Portfolio Companies Regulations, 2005, *available at* http://www.bvifsc.vg/DesktopModules/Bring2mind/DMX/Download.aspx?EntryId=66&PortalId=2&DownloadMethod=attachment.

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vestments in transferable securities'' (or ''UCITS'').[77] In accordance with these directives, UCITS are intended to facilitate collective investment portfolios that operate freely throughout the European Union on the basis of a single authorization from one member state. As relevant to the question posed in the preamble to the Proposed Regulations, the implementing regulations for the UCITS directives generally incorporate the concept of an ''umbrella fund'' that can be divided into a number of sub-funds, with the units of any particular sub-fund (i) being distinguishable from units of each other sub-fund of the umbrella fund and (ii) providing holders with rights and benefits attributable solely to the relevant sub-fund.[78] It should be apparent from the proliferation of foreign statutes authorizing the formation of series entities that resolving the federal tax issues raised by a foreign series other than a foreign series that conducts an insurance business (a ''non-insurance foreign series'') is of paramount importance.

Issues Involving Foreign Tax Credit Splitter Structures

At the fall 2010 meeting of the American Bar Association's Section of Taxation, an attorney-adviser in Treasury's Office of Tax Legislative Council noted that the primary concern with non-insurance foreign series is that such series could be used to separate foreign income from the foreign taxes related to that income (and the corresponding foreign tax credits).[79] It may be that the IRS is concerned with a structure where a U.S. corporation wholly owns a series organization formed under the laws of a foreign jurisdiction which, in turn, is comprised of one or more non-insurance foreign series. Because the foreign series organization generally is treated as a separate legal entity for local law purposes (and the separate series are not), the incidence of the relevant foreign jurisdic-

- Cayman Islands — Companies Law (2004 Revision), Part XIV (Segregated Portfolio Companies), *available at* http://www.knighthedge.com/CaymanCompaniesLaw2004Revision.pdf.
- Gibraltar — Protected Cell Companies Act 2001, *available at* http://www.gibraltarlaws.gov.gi/articles/2001-22o.pdf.
- Guernsey — The Companies (Guernsey) Law (2008), Part XXVII (Protected Cell Companies) and Part XXVIII (Incorporated Cell Companies), *available at* http://www.guernseyregistry.com/ccm/cms-service/stream/asset/?asset_id=9578104&.
- Isle of Man — Companies Act (2006), Part VII (Protected Cell Companies), *available at* http://www.gov.im/lib/docs/infocentre/acts/companies.pdf.
- Jersey — Companies (Amendment No. 8) (Jersey) Law (2005) (concerning protected cell companies and incorporated cell companies), *available at* http://www.jerseylaw.je/Law/lawsinforce/htm/LawFiles/2005/L-37-2005.pdf.
- Luxembourg — Securitisation Act (2004) (concerning securitisation undertakings), *available at* http://www.securitisation.lu/securitization_securitisation/lois/.
- Mauritius — Protected Cell Companies Act (1999), *available at* http://www.gov.mu/portal/sites/ncb/fsc/download/pccact.doc.
- Republic of the Marshall Islands — Limited Liability Company Act 1996, §79 (Series of members, managers of limited liability company interest) (as amended), *available at* http://www.paclii.org/mh/legis/consol_act/llca1996256/.
- Seychelles — Protected Cell Companies Act, 2003 (as amended in 2004), *available at* http://www.sterlingoffshore.com/downloads/Protected-Cell-Company-Act-2003.pdf.
- U.S. Virgin Islands — The Alternative Market and International Reinsurance Act, V.I. CODE ANN. tit. 22, §1346 (2008) (authorizing, *inter alia*, protected cell companies).

[77] Council Directive 2009/65/EC, 2009 O.J. (L 302) 32, i.e., the most recent directive concerning the coordination of the laws, regulations, and administrative provisions relating to UCITS, can be found on the European Union's official website at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:EN:PDF.

[78] *See, e.g.,* European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2003 (as amended) (bringing into force in Ireland the measures necessary to implement the UCITS directive) [hereinafter *Irish UCITS Regulations*]. For reference purposes, the Irish UCITS Regulations are available at http://www.finance.gov.ie/documents/publications/legi/finregucits.rtf.

Similar to membership interests in a Delaware series limited liability company, the units of a particular sub-fund of an umbrella fund constitute beneficial ownership interests in the property of that sub-fund alone, with each unit representing an undivided share in the sub-fund's property and having an issue price based on the net asset value per unit of that sub-fund. *See Irish UCITS Regulations*, §§3(2) (''For the purposes of these Regulations . . ., UCITS are undertakings the units of which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings' assets.''), 23(1) (''The assets of a UCITS established as either a unit trust or common contractual fund shall belong exclusively to the UCITS. The assets shall be segregated from the assets of either the trustee or its agents or both and shall not be used to discharge directly or indirectly liabilities or claims against any other undertaking or entity and shall not be available for any such purpose.''), 23(2) (''Where a UCITS established as . . . a unit trust . . . is constituted as an umbrella fund the assets shall belong exclusively to the relevant sub-fund and shall not be used to discharge directly or indirectly the liabilities of or claims against any other sub-fund and shall not be available for any such purpose.''), 60(1) (''Units shall be issued or sold at a price arrived at by dividing the net asset value of the UCITS by the number of units outstanding'').

[79] *See* Hench, ''Official Welcomes Comments on Annuity Contracts, Proposed Series LLC Regs,'' 2010 *TNT* 188-6 (9/29/10).

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tion's tax usually will fall on the foreign series organization. However, if the principles of the Proposed Regulations were to apply to the non-insurance foreign series, that series may be treated (from a federal tax perspective) as earning the income that otherwise is subject to the foreign jurisdiction's tax imposed upon the foreign series organization. This structure, in theory, may allow the income generated by the business activities of the non-insurance foreign series to be split from the foreign taxes on that income (and the corresponding foreign tax credits).[80]

In order to address similar types of arrangements, the IRS and Treasury published proposed Treasury regulations in August 2006 that would amend the technical taxpayer rules of Regs. §1.901-2(f).[81] These proposed Treasury regulations in large part are designed to shut down transactions in which U.S. taxpayers have sought to ''hype'' their foreign tax credits by splitting the foreign taxes from the underlying income through the use of the CTB Regulations and/or a perceived ambiguity in the legal liability rule of Regs. §1.901-2(f).[82] More recently, §909 was added to the Code generally effective for taxable years beginning after December 31, 2010.[83] In brief, the new anti-splitting (or matching) rule of §909 attempts to give the foreign tax credit (in the case of a ''foreign tax credit splitting event'') to the person that takes the related income into account for federal tax purposes, not foreign tax purposes.[84]

Given the apparent difficulty that the IRS and Treasury have had with proposed Treasury regulations addressing the technical taxpayer rules, and the unclear timeframe for their issuing any further guidance with respect to those rules or with respect to the possible interaction of those rules with new §909, it seems that the guidance concerning the characterization of non-insurance foreign series for federal tax purposes may not be arriving any time soon. However, these circumstances may present the IRS and Treasury an excellent opportunity to integrate forthcoming guidance concerning the characterization of non-insurance foreign series for federal tax purposes with further guidance regarding the technical taxpayer rules and new §909.

Issues Involving Investment Diversification

A further consequence of leaving unresolved in the Proposed Regulations the federal tax issues raised by non-insurance foreign series is the continuing impact that this lack of guidance has on the application of investment diversification rules for insurance company segregated asset accounts and regulated investment companies.[85] For example, §817(h)(1) provides that a variable contract that is otherwise described in §817

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[80] *See generally* Regs. §1.901-2(f)(1) (''The person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax.''), (f)(3) (''If foreign income tax is imposed on the combined income of two or more related persons (for example, . . . a corporation and one or more of its subsidiaries) and they are jointly and severally liable for the income tax under foreign law, foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of the tax, regardless of which person actually pays the tax.'').

[81] Notice of Proposed Rulemaking, Definition of Taxpayer for Purposes of Section 901 and Related Matters, REG-124152-06, 71 Fed. Reg. 44240 (8/4/06).

[82] Examples of such arrangements usually involve a U.S. person (U.S. Parent) that owns a foreign holding company, which, in turn, owns a foreign operating company. The foreign holding company is a hybrid entity (i.e., fiscally transparent for federal tax purposes, but a corporation for foreign tax purposes), and the foreign operating company is a ''reverse'' hybrid entity (i.e., a corporation for federal tax purposes, but fiscally transparent for foreign tax purposes). Under the relevant foreign tax law, the foreign operating company's tax would be considered a liability of its owners (i.e., the foreign holding company). However, because the foreign holding company is fiscally transparent for federal tax purposes, the foreign tax that it paid on its allocable share of the foreign operating company's income would flow into the federal income tax return of U.S. Parent. Moreover, because the foreign operating company would be treated as a corporation for federal tax purposes, the underlying income would not be subject to current federal income tax.

[83] *See* P.L. 111-226, §211, 124 Stat. 2389 (2010).

[84] Although §909 may not make the proposed Treasury regulations addressing the technical taxpayer rules unnecessary, it is not entirely clear at this point in time how the two provisions will interact. *See* Notice 2010-92, 2010-52 I.R.B. 916, §2.03 (''Section 909 was enacted to address concerns about the inappropriate separation of foreign income taxes and related income. These concerns were also the basis for the issuance in 2006 of proposed regulations under section 901 (the ''2006 proposed regulations'') concerning the determination of the person who paid a foreign income tax for foreign tax credit purposes. 71 F.R. 44240 (Aug. 4, 2006). The Treasury Department and IRS are evaluating the 2006 proposed regulations following the enactment of section 909. In this regard, the Treasury Department and IRS do not intend to finalize the portion of the 2006 proposed regulations relating to the determination of the person who paid a foreign income tax with respect to the income of a reverse hybrid. See Prop. Reg[s]. §1.901-2(f)(2)(iii). Comments are solicited on whether other portions of the 2006 proposed regulations should be finalized or modified in light of the enactment of section 909.''). *See generally* American Bar Association, Section of Taxation, Comments on the Effective Date of Section 909 (2010); Rosenberg, ''New Foreign Tax Credit Anti-Splitting Rule,'' 129 *Tax Notes* 701 (2010).

[85] *See* §§817(h) (diversification provisions for annuity, endowment, and life insurance contracts), 851(b) (diversification rules for regulated investment companies). By way of background, §817 sets forth a series of rules intended to govern the treatment of contracts in which payments or benefits thereunder are tied in some way to the market value of, or investment return from, certain assets. In this regard, §817(d) defines the term ''variable contract'' for purposes of §§801–818. For a life insurance contract or an annuity contract to qualify as a variable contract, it must provide for the allocation of all or a part of the amounts received under the contract to an account that, pursuant to state law or regu-

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and that is based on a segregated asset account will not be treated as an annuity, endowment, or life insurance contract for any period for which the investments made by such account are not adequately diversified.[86] For diversification purposes, all securities of the same ''issuer'' are treated as a single investment.[87]

Thus, a further benefit of providing guidance with respect to the characterization of non-insurance foreign series would be the certainty that the guidance could provide to insurance companies and regulated investment companies faced with the difficult question of whether their investments in more than one series of a single foreign series entity (e.g., an Irish UCITS) constitute investments in a single issuer or in multiple issuers for purposes of applying the diversification rules. Accordingly, we encourage the forthcoming guidance concerning the characterization of non-insurance foreign series to take this consideration into account.

Insurance-Specific Guidance To Address the Issues Identified in Notice 2008-19

In Notice 2008-19,[88] the IRS made a request for comments on further guidance to address issues that may arise in situations where the arrangements described in Rev. Rul. 2008-8 [89] constitute insurance for federal tax purposes. Pursuant to §3.02 of Notice 2008-19, the IRS identified the federal tax effects of treating a cell of a cell company (an ''insurance cell'') as an insurance company for federal tax purposes as an area in need of further development.[90]

In the domestic context, the consolidated return aspects of characterizing an insurance cell as an insurance company for federal tax purposes is especially interesting where the insurance cell also qualifies as a ''life insurance company'' within the meaning of §816(a).[91] By way of background, §1504(c)(2) generally provides that a life insurance company cannot be an ''includible corporation'' in a life/non-life consolidated group until it has been a member of the relevant affiliated group for the five taxable years immediately preceding the applicable consolidated return year.[92] Regs. §1.1502-47 implements the restrictions of

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lation, is segregated from the general asset accounts of the issuing insurance company, i.e., a segregated asset account.

[86] The investments of a segregated asset account are considered to be adequately diversified for purposes of §817(h) if no more than 55% of the value of the total assets of the account is represented by any one investment; no more than 70% by any two investments; no more than 80% by any three investments; and no more than 90% by any four investments. *See* Regs. §1.817-5(b)(1)(i).

[87] *See* Regs. §1.817-5(b)(1)(ii)(A). Through a cross-reference to the definitions set forth in §851, the term ''issuer'' for purposes of Regs. §1.817-5 has the meaning set forth in the Investment Company Act of 1940 (the ''1940 Act''). *See* Regs. §1.817-5(h)(10); *see also* §851(c)(6). The 1940 Act defines the term ''issuer'' as ''every person who issues or proposes to issue any security or has outstanding any security which it has issued.'' 1940 Act, §2(a)(22).

[88] 2008-5 I.R.B. 366.

[89] In Rev. Rul. 2008-8, 2008-5 I.R.B. 340, the IRS provided guidance on the standards for determining whether an arrangement between a participant and a cell of a cell company constitutes insurance for federal tax purposes, and whether amounts paid to the cell are deductible as ''insurance premiums'' under §162.

[90] Specifically, §3.02 of Notice 2008-19 provides as follows:

> .02 Effect of insurance company treatment at the cell level. Consistent with the proposed rule:
>
> (a) Any tax elections that are available by reason of a cell's status as an insurance company would be made by the cell (or, in certain circumstances, by the parent of a consolidated group) and not by the Protected Cell Company of which it is a part;
>
> (b) The cell would be required to apply for and receive an employer identification number (EIN) if it is subject to U.S. tax jurisdiction;
>
> (c) The activities of the cell would be disregarded for purposes of determining the status of the Protected Cell Company as an insurance company for federal income tax purposes;
>
> (d) The cell (or, in certain circumstances, the parent of a consolidated group) would be required to file all applicable federal income tax returns and pay all required taxes with respect to its income; and
>
> (e) A Protected Cell Company would not take into account any items of income, deduction, reserve or credit with respect to any cell that is treated as an insurance company under §3.01.

We generally agree that the federal tax effects outlined in §3.02 of Notice 2008-19 should follow from an insurance cell's characterization as an insurance company for federal tax purposes.

[91] Section 816(a) provides that a life insurance company is an insurance company that is engaged in the business of issuing either (i) life insurance contracts and annuity contracts (either separately or combined with accident and health insurance) or (ii) noncancellable contracts of accident and health insurance, so long as more than 50% of the company's total reserves are comprised of life insurance reserves and unearned premiums and unpaid losses (whether or not ascertained) on noncancellable life, health, or accident policies that are not included in life insurance reserves. *See* above note 23 for the definition of the term ''insurance company'' for purposes of §816(a).

[92] Stock and mutual property/liability insurance companies generally may consolidate with corporations in other types of businesses without restriction. *See generally* §§1501, 1504(a), 1504(b). Additionally, life insurance companies generally may consolidate solely with other life insurance companies without re-

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§1504(c)(2). Under the rules of that Treasury regulation, a corporation may be an ''eligible corporation'' with respect to a life/non-life consolidated group only if, for every day of the ''base period'' (i.e., the five taxable years preceding the taxable year for which eligibility is being determined),[93] such corporation, *inter alia*, (i) was in existence and a member of the group (determined without regard to the restrictions in §1504(b)(2)) (the ''member requirement'') and (ii) was engaged in the active conduct of a trade or business (the ''ATOB requirement'').[94]

For purposes of determining whether a life insurance company satisfies the member requirement and the ATOB requirement, a special ''tacking'' rule is provided by Regs. §1.1502-47(d)(12)(v). Under that rule, the period during which an old corporation is in existence and a member of the group engaged in the active conduct of a trade or business is included in (or tacks onto) the period for the new corporation[95] if certain conditions are satisfied.[96]

Assuming that an insurance cell is characterized as a separate entity that qualifies as a life insurance company for federal tax purposes, the insurance cell apparently would constitute a ''new corporation'' for purposes of applying the tacking rule of Regs. §1.1502-47(d)(12)(v). However, it is not entirely apparent at this time which company would constitute the ''old corporation'' for purposes of applying the tacking rule. The Proposed Regulations suggest that the ''old corporation'' label should be limited to (i) the corporate sponsor of the cell company, so long as the corporate sponsor contributes capital to the insurance cell, and (ii) any other corporate participant in the insurance cell that also contributes capital to the insurance cell.[97] However, the Proposed Regulations do not appear to preclude the cell company itself from constituting the old corporation for purposes of applying the tacking rule in a situation where the corporate sponsor of the cell company or a corporate participant in the insurance cell makes its initial capital contribution to the insurance cell by way of the cell company.[98]

In light of the difficulties associated with this fundamental aspect of life/non-life consolidation, we believe that the IRS and Treasury should issue guidance that integrates treating an insurance cell as an insurance company for federal tax purposes with the possible treatment of the insurance cell (and, for that matter, the cell company) as a member of a life/non-life consolidated group.

CONCLUSION

The Chinese philosopher Confucius has been credited with saying that ''A journey of a thousand miles begins with a single step.'' The IRS and Treasury should be commended for publishing the Proposed Regulations and taking the first (and significant) step toward providing a degree of certainty with respect to the federal tax treatment of series entities. While the journey is far from complete, we encourage timely guidance with respect to the remaining unanswered questions.

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striction. *See generally* §§1501, 1504(a), 1504(b), 1504(c)(1).

[93] *See* Regs. §1.1502-47(d)(12)(ii).

[94] *See* Regs. §1.1502-47(d)(12)(i)(A), (B).

[95] For purposes of Regs. §1.1502-47(d)(12)(v), a ''new corporation'' is a corporation (whether or not newly organized) during the period its eligibility depends upon the tacking rule.

[96] The four conditions are as follows:

1. At any time, 80% or more of the assets of the new corporation acquired by the new corporation other than in the ordinary course of its trade or business were acquired from the old corporation in one or more transactions described in §351(a) or §381(a).

2. At the end of the taxable year during which the first condition is first met, the old corporation and the new corporation must have the same tax character. For this purpose, a corporation's tax character is determined by the section of the Code under which it would be taxed (i.e., §§11, 801, or 831) if it filed a separate federal income tax return.

3. At the end of the taxable year during which the first condition is first met, the new corporation is not determined to have undergone a ''disproportionate asset acquisition'' under Regs. §1.1502-47(d)(12)(viii).

4. If there is more than one old corporation, the first two conditions apply to each of the old corporations. Thus, the second condition (tax character) must be satisfied by each of the old corporations that transfers assets that are taken into account by the new corporation for purposes of meeting the first condition.

[97] *Cf.* Prop. Regs. §301.7701-1(a)(5)(vi) (''For Federal tax purposes, the ownership of interests in a series . . . is determined under general tax principles. A series organization is not treated as the owner for Federal tax purposes of a series . . . merely because the series organization holds legal title to the assets associated with the series.'').

Notably, it is not uncommon for a corporate sponsor of a cell company to own all of the common stock of the cell company and, as such, possess 100% of the voting power with respect to the cell company. *Cf.* Rev. Rul. 2008-8, 2008-5 I.R.B. 340 (providing a general description of what constitutes a cell company); Notice of Proposed Rulemaking, Series LLCs and Cell Companies, REG-119921-09, 75 Fed. Reg. 55699, 55706 (9/14/10) (''Based on information available at this time, the IRS and the Treasury Department believe that many series and series organizations are large insurance companies or investment firms and, thus, are not small entities.'').

[98] Of course, this conclusion assumes that the cell company is recognized as a separate entity (and, more specifically, a corporation) for federal tax purposes.

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