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## IRS Issues Proposed Rules Regarding Series LLCs and Cell Companies

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On September 13, 2010, the Internal Revenue Service (“IRS”) and Treasury Department issued proposed regulations regarding the classification for Federal tax purposes of a series of a domestic series limited liability company (“LLC”), partnership, or trust; a cell of a domestic “cell company” (as defined below); or a foreign series or cell that conducts an insurance business.<sup>1</sup>

### OVERVIEW

In general, the proposed regulations make it clear that each “series” established by a particular “series organization” (e.g., a series LLC) can be treated as a separate entity for tax purposes that can have its own tax classification separate from the series organization and the other series. This position confirms what many people already thought should be the tax treatment of a series in a series organization. However, the proposed regulations also leave a number of questions unanswered.

### DEFINITIONS

The proposed regulations provide a group of definitions with respect to series:

*Series:* a segregated group of assets and liabilities that is established pursuant to a “series statute” by agreement of a “series organization.” A series includes series, cells, segregated portfolios, and certain segregated accounts.<sup>2</sup>

*Series statute:* a statute of a state or foreign jurisdiction that explicitly provides for the organization or establishment of series of a juridical person and explicitly permits (1) members or participants of a series organization to have rights, powers, or duties with respect to the series; (2) a series to have separate rights, powers, or duties with respect to specified property or obligations; and (3) the segregation of assets and liabilities such that none of the debts and liabilities of the series organization or of any other series of the series organization are enforceable against the assets of a particular series of the series organization.<sup>3</sup>

*Series Organization:* a juridical entity that establishes and maintains a series, including series LLCs, series partnerships, series trusts, protected cell companies, segregated cell companies, segregated portfolio companies, and segregated account companies.

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<sup>1</sup> The U.S. federal income tax classification of a foreign series or cell that does not conduct an insurance business is not addressed by these proposed regulations.

<sup>2</sup> However, the term “series” does not include a segregated asset account of a life insurance company because life insurance companies and their segregated asset accounts are already subject to special rules under the Internal Revenue Code.

<sup>3</sup> However, the proposed regulations (and their preamble) make clear that an election, agreement, or other arrangement that permits the 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 record keeping requirements for the limitation on liability available under the relevant series statute, will not prevent a series from meeting the definition of “series” in the proposed regulations. Accordingly, a series generally will not cease to be an entity under the proposed regulations simply because it guarantees the debt of another series within the series organization.

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*Domestic:* The proposed regulations treat a series as created or organized under the laws of the same jurisdiction in which the series is established. Thus, a series established by a domestic series organization will be domestic for these purposes.

## SUBSTANTIVE RULES

A domestic series is treated for Federal tax purposes as an entity formed under local law, whether or not it is a juridical person for local law purposes. This rule, which recognizes that a series organization will be a juridical person under local law, but that a series may not be, provides the foundation for applying the normal Federal tax entity classification rules to a series. As noted above, this rule applies to a foreign series only if it conducts an insurance business.

Whether a series that is treated as a local law entity is recognized as a separate entity for Federal tax purposes is determined under the normal rules of the entity classification regulations and general tax principles. This rule accommodates the treatment of a series as a single-owner business entity that can choose either to be recognized as a separate entity or disregarded as an entity separate from its owner.

The Federal income tax classification of a series that is recognized as a separate entity for Federal tax purposes is determined under the general rules governing entity classification for Federal tax purposes (Treasury Regulations Section 301.7701-1(b)), which apply to other types of entities as well. Thus, for a series that is a business entity but is not a per se corporation, the normal rules for elective tax classification of eligible business entities apply. This Federal tax classification of a series is independent of the other series or the series organization itself, and operates without regard to whether the other series (or the series organization) do not make certain elections or make different elections. For instance, under these proposed regulations, each series of a domestic series trust will be treated as a separate entity for Federal income tax purposes. Each series, then, will be analyzed under the general tax rules, just like any other trust created under state law, to determine whether that series is properly treated as a trust or a partnership or a corporation for Federal income tax purposes.

For Federal tax purposes, the ownership of interests in a series and of the assets associated with a series is determined under general tax principles. A series organization is not treated as the owner for Federal tax purposes of a series or of the assets associated with a series merely because the series organization holds legal title to the assets associated with the series.

The proposed regulations also provide that each series of a series organization must file an annual statement containing identifying information with respect to the series or series organization to ensure proper assessment and collection of tax.

Under the proposed regulations it appears that most, if not all, variations in state statutes relating to the degree of legal separateness and independence accorded to a series, will not affect its Federal tax classification, e.g., presence or absence of the following: (1) the power to enter into contracts, sue, be sued, and/or hold property in its own name, (2) the power to convert into another type of entity, merge with another entity, or domesticate in another jurisdiction independent of the series organization, (3) dissolution of a series organization generally terminating all of its series, and (4) the degree of insulation of one series from the debts of another.

For the IRS, the controlling factors supporting the approach taken in the regulations include: (1) 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, and (2) individual series may (but generally are not required to) have separate business purposes

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and investment objectives.

The proposed regulations generally are effective on the date that final regulations are published in the Federal Register.

## UNADDRESSED QUESTIONS

### **Series Organizations.**

The proposed regulations do not address the entity status or reporting requirement for Federal tax purposes of a series organization. Specifically, the proposed regulations do not address whether a series organization is recognized as a separate entity for Federal tax purposes if it has no assets and engages in no activities independent of its series. The preamble to the proposed regulations states that series organizations are generally recognized as entities under local law and that organizations so treated generally are treated as entities for Federal tax purposes. The preamble also states that (based on existing Treasury Regulations Section 301.6031(a)-(1)(a)(3)(i)), a series organization characterized as a partnership for Federal tax purposes that does not have income, deductions, or credits for a taxable year is not required to file a partnership tax return for that year. The preamble also asserts that, 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. No other guidance is provided regarding series organizations. Given these statements in the preamble to the proposed regulations, it is unclear why the proposed regulations chose not to take the view that a series organization having no assets and engaging in no activities independent of its series is disregarded as a separate entity for Federal tax purposes.

### **Employment taxes.**

The proposed regulations do not address how a series should be treated for Federal employment tax purposes. Instead, the preamble to the proposed regulations concedes that treating a series as a separate entity for Federal employment tax purposes “would create the possibility that the series could be an ‘employer’ for Federal employment tax purposes, which would raise both substantive and administrative issues.” As a threshold matter, the first issue is whether the series or the series organization is the employer for Federal employment tax purposes. However, once the employer is identified, additional issues exist such as how to determine the wage base for employees who work for more than one series of a series organization. Another related issue not addressed by the proposed regulations is whether a series can maintain an employee benefit plan.

The proposed regulations are helpful in determining the entity classification for Federal income tax purposes of a series of a domestic series organization and a foreign series that conducts an insurance business. However, as series organizations become more popular, the IRS and Treasury Department will need to face the issues left unresolved by this initial guidance.

Morrison & Foerster’s Federal Tax Department will continue to monitor related developments closely. For questions or comments, you may contact [Stephen L. Feldman](#), [Robert A.N. Cudd](#) or [Arthur Man](#) of the Federal Tax Department.

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