AN INITIAL INQUIRY INTO THE FEDERAL TAX CLASSIFICATION OF SERIES LIMITED LIABILITY COMPANIES

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Introduction

Limited liability companies have had a brief but eventful history in the United States. The first LLC act in the United States was enacted by Wyoming on March 4, 1977.1 Less than 30 years later, LLCs are now authorized by statute in every state in the country.2

Almost 10 years ago, Delaware enacted the first series LLC statute in the country.3 A series LLC, generally speaking, is one that may "establish separate series of members, managers, or interests, with separate rights, powers, or duties, including rights to profits and losses, with respect to specific property or obligations."4 In some states, under statutory provision5 or legislative history,6 each of the series functions as a separate state law entity.

On July 16, 2005, Illinois Gov. Rod Blagojevich (D) signed the Illinois Series Limited Liability Company Act (ISLLCA),7 making Illinois, along with Delaware and Iowa, one of only three states to enact a fully developed series LLC statute.8 The purpose of this article is to make an introduction to the federal tax classification of series LLCs in general, to analyze both the Delaware and

2By the close of 1996, the last three states, Hawaii, Vermont and Massachusetts, enacted LLC legislation, establishing the LLC as a choice for doing business in all fifty states." Id. at 297.
5A series with limited liability shall be treated as a separate entity to the extent set forth in the articles of organization." 805 Ill. Comp. Stat. 180/37-40(b).
6See Gerson, supra note 4, at 10 n.2.
8See Bishop and Kleinberger, Limited Liability Companies (Warren, Gorham & Lamont (2006), S2-79, n.378 (10 states allow "classes or series"), and n.379 (only three states have true series LLCs). In drafting the ISLLCA, the Secretary of State Business Law Advisory Committee chose to use the Iowa "partnership" model as a starting point, rather than the original Delaware "corporation" model. In addition, it decided to allow individual series to be treated as separate entities for tax purposes as much as possible. This article explains the tax classification of series LLCs in all three jurisdictions in general, but analyzes the provisions of the Delaware and Illinois series LLC acts in particular.
Illinois series LLC statutes in particular, and ultimately to suggest the correct tax classification of Illinois series LLCs.

Part II of this article discusses the general federal tax classification treatment of business entities operating as LLCs. Part III will examine the possible application of the federal tax classification regulations to the Delaware series LLC. Part IV will examine the application of those regulations in a recently issued technical advice memorandum. Part V conducts a thorough analysis of the relevant provisions of the ISLLCA, and Part VI analyzes the federal tax classification of Illinois series LLCs. The analysis leads the authors to conclude in Part VII that individual series within an Illinois series LLC should be treated as a separate business entity apart from the parent LLC for federal tax purposes. The result is that both the LLC and each series should be characterized as partnerships for federal income tax purposes.

Tax Classification of LLCs in General

The rapid birth, development, and evolution of LLCs has caused the Treasury Department to tentatively classify those entities for federal income tax purposes on the fly for almost 10 years. Only recently did the Treasury issue new final entity classification regulations that finally replaced the last set of final regulations, which were published in 1996.

Under those relatively new regulations, an ostensible business association must undertake the following steps to determine its classification for federal income tax purposes:

- Is the organization a separate “entity” for federal tax purposes?
- Does a special provision of the code stipulate how the entity must be treated? If so, that provision will govern the classification of the entity.
- Is the entity a trust? If so, the entity must be taxed under subchapter J of the code. If not, the entity qualifies as a “business entity” and is subject to the check-the-box regulations.
- Is the business entity an “eligible entity” that is permitted to elect its tax classification? Corporations (as defined in reg. section 301.7701-2(b)) are not eligible entities and must be treated as corporations.
- How many owners does the entity have? An eligible entity having at least two members may elect to be classified as either an association or a partnership. An eligible entity with a single member may elect to be classified as an association (that is, a corporation) or to be disregarded as an entity separate from its owner (that is, be treated as a division or branch).
- How will the entity be classified under the default rules? In the absence of an election? An election may not be necessary to achieve the desired classification.
- Did the entity exist before December 31, 1996 (that is, is it an “existing entity”)? If so, if specific conditions are satisfied, it will retain the tax classification it claimed under prior law unless it elects to change its classification.

Modern LLCs should have little trouble applying those regulations to elect corporation or partnership tax classification (or to receive partnership classification by default). Although “identity” status under state law is not conclusive for federal income tax purposes, it speaks volumes that LLCs have been implicitly acknowledged as entities for federal tax classification purposes for many years. Applying the preceding checklist, because LLCs are not statutorily classified and are not trusts, they are classified as “business entities” under the regulations. And finally, because they are not corporations, LLCs are classified as “eligible business entities,” which allows them to elect to be classified as either corporations or as partnerships.

Tax Classification of Delaware Series LLCs

There are three possible approaches to classifying Delaware series LLCs for federal tax purposes:

- Treat all of the series in the aggregate as a single tax entity, regardless of how many series the parent LLC has registered;
- Treat the LLC itself as an umbrella entity, and each series as a disregarded entity owned by the LLC; or
- Treat each series as a separate entity independent of the LLC for U.S. federal tax purposes.

The threshold question for federal tax classification purposes is whether each series should be treated as a separate entity. In other words, is each series a separate organization apart from the LLC and therefore an independent federal tax entity? Generally, the federal tax classification depends on federal tax law and does not depend on whether the entity is recognized as an entity under local state law. However, according to one commentator, “few would disagree that once an organization achieves ‘entity’ status under state law, it is more difficult for federal tax law to ignore that status than it is for federal law to grant separate entity status on relationships that do not constitute a separate entity under state law.”

There are several potential tax classification problems surrounding the Delaware series LLC statute. The first critical question is whether a series is a separate entity...
under the regulations at all. In analyzing that question, the first potential problem is that the Delaware LLC statute states that a series LLC is a separate legal entity, but the series LLC provision of the statute does not state that each series is a separate legal entity.  

Also, various entity status rights accrue only to the LLC, and not to any particular series. For example, the Delaware LLC may sue in its own name, but a Delaware series may not. Second, under the Delaware LLC statute, the parent LLC is legally able to merge or consolidate with another taxable entity, but guidance on whether a series may separately merge with another taxable entity has not yet been issued. Third, other Delaware business entities may convert to an LLC, but it has yet to be seen whether those same entities will be allowed to elect to become a series of an LLC. Fourth, it has yet to be seen whether those same entities will be able to elect to become a series of an LLC. It offers no similar guidance regarding the limitations of the series LLC. The result is that one must make an extensive effort to find common law precedent to justify treating the series of a Delaware series LLC as a separate entity.

The second critical question is whether an LLC series is an independent "business entity." For federal tax purposes, a business entity is defined as any recognized entity that is not properly classified as a trust or subject to special tax treatment for federal tax purposes. There are two notable court cases that shed light on the application of the entity classification regulations: and . Based on the precedents established in those cases, an LLC series will be considered a business entity if it carries on a profit-making business and does not merely protect or conserve property akin to the function of a trust.

Applying those tests to series LLCs can be problematic. For instance, the Delaware series LLC statute allows, but does not require, a series to have a separate business purpose. That represents another difference between state and federal law, requiring careful planning before being able to successfully create a separate business entity. One proposal to rectify that potential problem is to analyze each potential series under the test and see where it lands. If it meets both factors, it should be respected for federal tax purposes as a stand-alone business entity, regardless of the absence of explicit statutory confirmation. While seemingly clear-cut, that approach may ultimately prove difficult to apply effectively. Using the test carries the pitfall of leaving outcomes dependent on matters of interpretation. Indeed, interpretation differences between the taxpayer and the IRS could ultimately result in a series being rendered useless to the taxpayer, at least temporarily.

Given the uncertain scope of the business purpose requirement, it is clearly risky for LLCs to create a series with no explicit business purpose. However, in our view, the regulations should allow the business purpose requirement to be met if the purpose or the assets of a series are directly related to the trade or business of the parent LLC, or of another series.

Finally, under the federal tax classification regulations, if a potential entity is not a trust or business entity, due to the lack of a connection to the business purpose of the parent LLC, the joint venture, co-ownership, or contractual arrangement is not an entity for federal tax purposes.

However, there is a possible solution. Instead of not being recognized as an entity, the association could be classified, at least initially, as a disregarded entity for federal tax purposes. That approach is illustrated below.

TAM 200540010

In support of the proposed alternative approach, some inferences can be drawn from a recent IRS technical advice memorandum regarding the creation of a separate taxable entity under federal tax law. The situation discussed in the TAM in February 2005 involved transactions between a foreign subsidiary corporation owned by a state corporation and various other entities. The IRS

Footnote continued on next page.
concluded that “a ‘contractual arrangement’ (CA) between the foreign subsidiary of a U.S. corporation and another company created an entity separate from the subsidiary, and that the new entity would be initially treated as a disregarded entity and then as a partnership.”

The CA at issue in the TAM involved the transfer of two classes of certificates from the subsidiary (Company B) to another corporation (titled the Counterparty). Also, Company B and the Counterparty entered into “termination agreements” whereby the Counterparty would purchase the certificates from Company B if a purchase event occurred. The IRS determined that for federal tax purposes the CA did not affect a full and complete transfer of the underlying money market mutual shares. Furthermore, the IRS concluded that because the CA did not result in joint ownership interests in the underlying shares for Company B and the Counterparty, the parties’ arrangement formed a separate entity under reg. section 301.7701-1(a)(2). The IRS also examined whether the CA created multiple classes of ownership interests, and determined that the arrangement should be classified as a business entity under reg. section 301.7701-2. Finally, relying on the default classification rules in reg. section 301.7701-3(b)(1), the TAM stated that the CA was classified as a disregarded entity when it was formed by Company B, and as a partnership when the certificates were later transferred to the Counterparty.

The TAM is significant because it sanctions characterizing contractual arrangements as disregarded entities initially, and subsequently as partnerships under the regulations under some circumstances. It is not difficult to imagine circumstances in which an LLC series, which functions primarily as a liability shield for a component of a business, for example, can be treated in the same fashion as the “contractual entity” in the TAM, and both recognized and characterized for federal income tax purposes as a business entity.

...corporation, which owned 100 percent of Company B, a Country X corporation. Taxpayer is wholly owned by Company C, a Country X corporation. Company C is a wholly owned subsidiary of Company D, a Country Y corporation. Company E, a State A corporation, is wholly owned by Company F, a Country Y corporation. Company F is a wholly owned subsidiary of Company D. Company G is a subsidiary of Company E.

The parties agreed a purchase event would occur if: a) an issuer of an underlying money market mutual fund liquidated the fund, b) an underlying money market mutual fund failed to maintain its status . . . , or c) an issuer of an underlying money market mutual fund redeemed more than one owner. See id.

The section clearly sets forth the statute’s purpose to allow each series to operate and be treated as a complete business entity with both the particular and the general powers of the LLC, but separate from and independent of the parent LLC. There is no apparent need to apply the Morrissey-Culbertson test, as in the case of the Delaware statute, to satisfy the business purpose requirement.

The ISLLCA sets forth the manner and procedure by which a series is created. The act itself provides guidance on all aspects of the operation of the series LLC in Illinois, including the general applicability of the Illinois LLC Act to the functions of the series, the manner in which a member ceases association with the series, and the events that will cause the winding up or dissolution of the series.

The ISLLCA provides the manner in which it interacts with the other provisions contained in the Illinois LLC Act rather simply. It provides that “[e]xcept to the extent modified in this Section, the provisions of this Act which are generally applicable to limited liability companies, their managers, members and transferees shall be applicable to each particular series with respect to the operation of such series.” The ISLLCA also deals with the effect on the series of a member ceasing his association. The members can still freely continue their association with any other series of the parent LLC, and furthermore the series can freely continue to exist and operate regardless of whether there are any members remaining associated with the series. Even more importantly, the series can be dissolved and its affairs wound up without triggering dissolution of the parent LLC; however, a caveat to this is that on the dissolution of the LLC itself, all series shall be terminated.

The ISLLCA

Now we outline sections of the ISLLCA that relate to a proposed series’ separate entity status and function. Those sections of the ISLLCA grant the series organizations separate status under Illinois state law, and thereby lend substantial support to granting the same treatment for federal tax purposes. Also, several sections of the ISLLCA discuss the business purpose requirement.

Most significantly, the statute provides:

- a series with limited liability shall be treated as a separate entity to the extent set forth in the articles of organization. Each series with limited liability may, in its own name, contract, hold title to assets, grant security interests, sue and be sued and other wise conduct business and exercise the powers of a limited liability company under this Act.

The section clearly sets forth the statute’s purpose to allow each series to operate and be treated as a complete business entity with both the particular and the general powers of the LLC, but separate from and independent of the parent LLC. There is no apparent need to apply the Morrissey-Culbertson test, as in the case of the Delaware statute, to satisfy the business purpose requirement.

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45Id. at 37-40(b).
46Id. at 37-40(d).
47ld. at 37-40(a).
48ld. at 37-40(l).
49ld. at 37-40(d).
50ld. at 37-40(j).
51ld. at 37-40(l).
Tax Classification of Illinois Series LLCs

The language in the ISLLCA allows only one logical conclusion to be drawn. Individual series created under the ISLLCA are definitely business entities separate from the parent LLC and should be treated as such for federal tax purposes. Each section of 805 Ill. Comp. Stat. 180/37-40 enumerates traits inherent in newly created Illinois series LLCs that are characteristics associated with all independent taxable business entities.55 The intent of the legislature in drafting the act is no clearer than when the act sets forth the separate nature and characteristics of a created series.56

Other ISLLCA provisions list additional powers granted to an LLC series that are associated with other independent taxable entities, lending further support to the conclusion that LLC series should be treated as independent taxable entities by the IRS. A critical fact is that the series creates its own existence by filing a separate certificate of designation instead of altering the certificate associated with the parent LLC.57 On the certificate of designation, the series can register to do business under its own newly created name in Illinois or in any other state.58 The only requirement showing any connection to the parent company is that “the name of the series with limited liability must contain the entire name of the [LLC] and be distinguishable from the names of the other series set forth in the articles of organization.”59 Otherwise, the name chosen by the series can be as varied and imaginative as its members can create. While initially troubling, ultimately that is a clear indicator that the series operates as its own entity, rather than merely as an extension or branch of the parent organization.

Moreover, the business and operational capabilities of the series are as comprehensive as they are significant. Subsection (b) of 805 Ill. Comp. Stat. 180/37-40 clearly lists the ability of the series to individually and separately contract, hold title to assets, grant security interests, sue and be sued, and otherwise conduct business, and most importantly exercise the powers of a LLC under the Illinois LLC Act.60 Finally, the dissociation of any member of the series in no way triggers the dissolution or winding up of that series; its existence can continue “regardless of whether such member was the last remaining member associated with such series.”61 All the powers granted to series in the ISLLCA lend strong support to the stand-alone quality of the series of an Illinois series LLC.

A point needing discussion is the language in the statute regarding the taxpayer status of the series.62 The statute provides that “[t]he [LLC] and any of its series may elect to consolidate their operations as a single taxpayer to the extent provided under applicable law, elect to work cooperatively, elect to contract jointly or elect to be treated as a single business for purposes of qualification to do business in this or any other state.”63 Noticeably, elect is the crucial word at work in the preceding sentence. That shows the practitioner that the default treatment of the series and parent LLC under the Illinois statute is that they are separate entities and will remain so until the series and parent LLCs choose to be treated as one taxing entity. Therefore, the IRS should follow the guidance the Illinois legislature has provided and treat both the series and parent LLC as separate entities for federal income tax purposes.

Even if the powers enumerated within the act itself are not fully convincing, the individual series under the ISLLCA definitely meets the business and or investment purpose tests explored above. For example, the statutory language itself allows the series’ operating agreement to provide a separate business purpose or investment objective.64 Even absent such a provision, per section 301.7701-4(b), a business trust is excluded from classification as a trust because joint enterprise and other arrangements for the conduct of business are to be treated as associations or partnerships, even if technically cast in a trust form.65 Also:

an investment trust that has multiple classes of ownership interest is classified as a trust for tax purposes only if a) there is no power under the trust agreement to vary the investment of the certificate holders, and b) the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.66
The IRS concluded in the TAM discussed above that "the existence of multiple classes is not incidental to any purpose of the arrangement to facilitate direct investment in the assets, and therefore, the contractual entity is classified as a business entity under [the regulations]." 67

The IRS conclusion in the TAM can be applied to the situation presented by the ISLLCA. The series created under the act with multiple classes of ownership operate in such a way that they do not represent direct investment by the parent LLC in the series. Therefore, the existence of the series should not be construed as incidental to a purpose to facilitate direct investment by the parent LLC in the assets of the series. As a result, each series should be properly classified as a separate business entity.

Although the ISLLCA was enacted before the new entity classification regulations were promulgated, it anticipated some of the principles on which the regulations would eventually be based. First, many provisions of the act clearly establish that each series is an entity separate from both the LLC and the other series. For example, the act itself states that each series shall be treated as a separate entity to the extent set forth in the articles of organization. Furthermore, as discussed above, many other provisions of the act substantiate that statement in defining the structural and operational parameters of each series’ legal rights and obligations.

Second, regarding the business purpose requirement, the act provides that, to the extent provided in the operating agreement, any such series may have a separate business or investment objective. The language prevents the possibility of the series being characterized as a trust, while making a wide range of business or investment objectives available to each series. To provide greater utility, the act also provides that any series or the LLC itself may elect to consolidate their operations as a single taxpayer, or elect to work cooperatively.

Conclusion

Under the new Treasury regulations, the tax classification of each series within an Illinois series LLC is independent of that of the LLC itself. Furthermore, both the LLC and each series are classified as partnerships by default if they have more than one member, which they are required to have under the statute. Overall, the Illinois series LLC is both a clearly defined and yet flexible business entity that allows each series to conduct its own business or possibly function as a component of a larger business, while still providing its members with limited liability and flow-through tax treatment. In conclusion, at present, the ISLLCA offers tax classification certainty under the most recent Treasury regulations superior to that offered by the Delaware statute.

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67 TAM 200540010, supra note 40.