



## **The Texas Series LLC: Federal Tax Developments - Is it Prime Time Yet?**

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### **For Clients and Friends of GSRP, LLP**

In May 2009, the Texas legislature amended the Texas Business Organizations Code to include new “Subchapter M: Series Limited Liability Company,” establishing the “series limited liability company” (“series LLC”) as a recognized legal entity form under Texas law. We previously wrote on this new legislation, pointing out its advantages, but also pointing out the many uncertainties surrounding the use of the series LLC. See [The Texas Series LLC: Sophisticated Planning Tool or Trap for the Unwary](http://gsrp.com/resources/Tax/The_Texas_Series_LLC.pdf) ([http://gsrp.com/resources/Tax/The\\_Texas\\_Series\\_LLC.pdf](http://gsrp.com/resources/Tax/The_Texas_Series_LLC.pdf)) (“Trap for the Unwary”).

One of the key uncertainties involves the classification and treatment of series LLCs under U.S. federal tax law. The Internal Revenue Service recently attempted to address this particular area of uncertainty by the issuance of proposed Treasury regulations (“Proposed Regulations”) which address some, but certainly not all, of these tax issues.<sup>2</sup> In their simplest form, the Proposed Regulations provide that each series of a series LLC will be evaluated under the so-called “check-the-box” entity classification regulations as a separate legal entity. As a result, depending on the ownership of each series, each series and perhaps the series LLC itself may be disregarded, treated as a partnership, or electively treated as a corporation.

Even in light of this proposed guidance, the putative series LLC user must still proceed cautiously and, except in the simplest and clearest of circumstances, would do well to await further guidance from the Internal Revenue Service, such as that which might come in revised and finalized regulations. While series LLCs may someday see the limelight in the world of entity selection, that prime time has not arrived yet in most situations.

Federal tax law provides but one area of uncertainty regarding series LLCs. As we wrote in *Trap for the Unwary*, statutory and judicial case law regarding “series organizations,” such as series LLCs, is still in its infancy in key areas important to the selection and use of entities generally...These areas include state tax law, securities laws, bankruptcy laws, and the laws of non-series jurisdictions. At this time there, there are still more questions than answers, particularly in Texas. We will examine the Proposed Regulations to see what they tell the taxpayer and their advisors, and more importantly, what they leave for another day. We will also update the reader on current developments in Texas regarding the series LLC.

### **Background - Overview of the Texas Series LLC**

*Trap for the Unwary* provides a more detailed overview of the statutory underpinnings for Texas series LLCs, but, as background, we will revisit some of the key elements of the enabling statute.

The Texas series LLC is a special type of limited liability company that can be segregated into separate “series” for the purpose of holding assets separately in each of the individual series rather than

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<sup>2</sup> 75 Fed. Reg. 5569 et seq. (Sept. 14, 2010) (adding Treas. Reg. Sec. 301.6011-6, adding Treas. Reg. Sec. 301.6071-2, adding Treas. Reg. Sec. 301.7701-1(a)(5), amending Treas. Reg. Sec. 301.7701-1(e) and (f)).



combined in one entity. (Under the “series organization” laws of other jurisdictions, the series organization is referred to as a “cell company” and the series referred to as “cells.”) Each series can have its own members, managers, and/or membership interests, separate and apart from other series within the same series LLC. Each series may have rights, powers, and duties with regard to specific property or obligations that are separate from the rights, powers, and duties of other series. Furthermore, each series may have its own allocation and distribution of profits and losses associated with the property it holds. A series may have a business purpose or investment objective that differs from the business purpose or investment objective of other series, and can sue and be sued, contract, hold title to property, and grant liens and security interests in its assets, all on its own behalf.

A series is, by statute, insulated from the debts and liabilities of other series and those of the series LLC itself. The debts, liabilities, and other obligations of a particular series are enforceable only against the assets of that series. In addition, the debts, liabilities, and obligations of the series LLC itself may not be enforced against the assets of a series.<sup>3</sup>

The liability protection afforded to a series requires and is dependent on the observation of certain formalities in the formation and continued maintenance of the series LLC. The series LLC company agreement may establish various classes of members or managers associated with each series, and may provide for certain voting rights, powers, and duties to be attached to such classes.

The series LLC is a relatively new entity-type and has only been available in the U.S. since 1996 when Delaware adopted series LLC legislation, followed by Illinois, Iowa, Nevada, Oklahoma, Tennessee, Utah, and Texas. While Wisconsin, Minnesota, and North Dakota LLC statutes contain language referencing “series” entities, these statutes do not provide the same level of detail as the other state statutes. Puerto Rico has also recently adopted a series LLC statute. The Texas series LLC statute differs in some important respects from the law of these other jurisdictions so any description of Texas series LLC law here cannot be assumed to accurately reflect the law of any other jurisdiction. In that same vein, the choice-of-jurisdiction decision tree that often leads to formation of a business entity under one state's statute over another must also be engaged in deciding which series jurisdiction statute best fits the needs of the members. The Illinois and Delaware series LLC statutes are considered the existing “gold standard” due to their clear language regarding liabilities and obligations of the series cells amongst each other.

The relative “newness” of series LLCs has left many areas of the law in catch-up mode. For example, there is the prospect of potential disregard of the series concept by non-series jurisdictions if the series LLC engages in multi-jurisdictional activities. Aside from potential disregard, there are questions as to how a particular state will require a “foreign” series LLC to register. There are also many questions regarding the interaction of the series LLC concept with federal bankruptcy and state and federal securities laws. Finally, under state and federal taxation laws, many questions have not yet received significant attention, particularly in Texas. This set of circumstances weighing against use of the series LLC has changed somewhat for the better with the issuance of the Proposed Regulations, but as we will discuss, many areas of uncertainty remain even in the federal tax arena. And, after all, the Proposed Regulations are just that – proposed.

### **Federal Taxation – Proposed Regulations**

As background, prior to the issuance of the Proposed Regulations, the only guidance issued by the Internal Revenue Service regarding series LLC's was contained in a 2008 private letter ruling (although the notion of series in the context of certain types of investment trusts had been dealt with in

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<sup>3</sup> *Id.* §101.601(a)(2).



prior private letter rulings).<sup>4</sup> In this ruling, the Internal Revenue Service stated that a series of series LLC with multiple owners could avail itself of the so called “check the box” regulations (“CTB Rules”) to elect the tax status of each separate series, thus indicating that each series is in effect its own separate taxpayer for federal tax purposes.<sup>5</sup>

The Proposed Regulations follow the rationale of that private letter ruling and very simply and elegantly provide that “series” of a “series organization” formed under the authority of a “series statute” will be treated as an entity under local law for federal tax purposes. For these purposes, a series organization is a “juridical” entity that establishes and maintains, or under which is established and maintained as, a “series.” In this memorandum, we use the terms series LLC and series organization interchangeably.

The notion of a “juridical” entity is a new concept in tax law parlance, but is interpreted to mean the series organization itself that is created under the series statute when appropriate series organization documents are filed with the appropriate government authority (for example, the Texas Secretary of State). A “series” in turn is a segregated group of assets and liabilities established pursuant to the authority and principles of a “series statute” and it does not matter that the series is not a “juridical” person under local law. A “series statute” is a law of a state or foreign jurisdiction that explicitly provides for the organization or establishment of a “juridical” person (that is, series organization), and explicitly permits (1) members 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 (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.

The implications of providing that a series or series organization is a local law entity invites the classification of the entity for federal tax purposes under the general CTB Rules.<sup>6</sup> A detailed examination of the CTB Rules is beyond the scope of this article. As a general overview, however, a U.S. domestic entity that is not a corporation (as defined under the CTB Rules), is defined as an “eligible entity” and is classified as follows: If an eligible entity has one owner, it is disregarded, unless an election is made to treat it as a corporation. If the eligible entity has two or more owners, it is treated as a partnership, unless an election is made to treat it as a corporation. General partnerships, limited liability partnerships, limited partnerships, and limited liability companies formed under U.S. or state law have thus been susceptible to classification under the CTB Rules since 1997 – the Proposed Regulations would simply bring series (and perhaps, but not as clearly, series organizations) into the ambit of these rules.

As applied to a series organization or a series, this means that each is analyzed to determine whether it has the requisite single or multiple owners. This analysis is conducted under the same legal principles that apply to determining ownership in other legal entities, such as an examination of whether a purported owner bears the economic benefits and burdens of ownership. The CTB Rules are then applied to treat each series as a disregarded entity or partnership entity for federal tax law purposes, subject to each of the series to “check-the-box” and elect to be treated as an association taxable as a corporation. In practical result, the various series formed under the umbrellas of a single series organization could be made up of entities of varying classifications depending on the ownership structure of each. Further, a series that elects to be treated as a corporation could presumably further

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<sup>4</sup> I.R.S. Priv. Ltr. Rul 200803004 (Jan. 18, 2008).

<sup>5</sup> The CTB Rules are found generally in Treas. Reg. Sec. 301.7701-2, -4, -5, and -6.

<sup>6</sup> See discussion below, however, as to whether the series organization itself is subject to such classification.



elect to be treated as an electing small business corporation (“S” corporation), so long as it otherwise met the requirements to make the election.<sup>7</sup>

Interestingly, the Proposed Regulations are not clear in their application to the series organization itself. It is possible, however, that by designating the series organization as a juridical person, it is thus a separate local law entity and there is no more to be said – the series organization should be considered a separate local entity and subject to classification. This uncertainty, however, has led many planners to use a holding company, such as a separate ordinary limited liability company, to hold the series organization in an attempt to avoid this uncertainty.

Further, the Proposed Regulations do not apply to series or series organizations formed under foreign law except for insurance companies. The Internal Revenue Service is taking great pains to avoid the perceived missteps, and perceived opportunities for abuse that occurred when it provided that the CTB Rules applied generally to foreign entities in 1997. So the subject of the use of series organizations and series in the foreign context, outside of the insurance arena, will be the dealt with in future regulations.)

The Proposed Regulations are lenient in their application in one sense: The failure of the organizers of the series organization and related series to adhere to all of the operational requirements under local law will not obviate application of the Proposed Regulations. For example, if the organizers fail to properly adhere to statutorily required recordkeeping requirements necessary to support the segregation of liabilities among series, the Proposed Regulations will still apply. The only requirement is that the enabling series statute permit such segregation of assets and liabilities, not that the user actually follow the required rules.

The Proposed Regulations require that general tax principles are used to identify the owners of a series and to determine whether a series owns assets, for tax purposes. For example, even though a series may not be legally qualified to hold bare legal title to assets, that will not prevent the series from being the “tax” owner of those assets, provided other agreements and arrangements are in place so establishing its ownership (that is, agreements attributing the benefits and burdens of ownership of the assets to the series). This principle is important in jurisdictions where the enabling series statute does not allow individual series to hold legal title to assets (Texas is not one of those jurisdictions).

The Proposed Regulations provide for a transition rule for certain series and series organizations that existed prior to the date of publication of the Proposed Regulations (September 14, 2010) but are treated inconsistently with the new rules. To qualify for the transition relief, one requirement is that the series and series organization must have been treated as one entity for federal tax purposes. Such a series organization can generally maintain its inconsistent status so long as certain requirements are met. For example, a change in control of the relevant series organization or a series thereof will cause loss of the grandfathered status.

As already demonstrated, the Proposed Regulations are not holistic in their approach to the series organization issue, leaving important issues unaddressed. One such issue deals with employment taxes and how they would apply to a series organization and its series. In the preamble to the Proposed Regulations, the Internal Revenue Service expresses great concern with the many issues that could arise if a series or series organization is allowed to be treated as a separate employer for employment tax purposes. This uncertainty regarding the employment tax consequences of series organizations is a significant obstacle to using a series organization where employees are involved.’

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<sup>7</sup> See Internal Revenue Code of 1986, as amended, Sec. 1361 et seq.



The Internal Revenue Service has informally pointed out in various forums that the Proposed Regulations have not changed other principles of tax law. For instance, if a particular series is treated as a separate partnership entity, then it would be required to file its own federal tax return. Even though other series of the same series organization might have the same or very similar ownership, for instance, that does not mean that the two series would be entitled to file a single consolidated tax return. There are no “consolidated” return principles applicable to federal tax partnerships. On the other hand, if the series organization itself could be or is treated as the sole owner of the individual series, then perhaps the series organization itself would file a tax return, with the series being treated as disregarded entities. Clarification from the Internal Revenue Service is needed on this point.

The Proposed Regulations also contemplate annual reporting by series organizations to the Internal Revenue Service. The preamble to the Proposed Regulations indicate that the contents and filing date of such annual statement are still being considered. The rationale for requiring such reporting is somewhat logical given that series formed under a particular series organization will not have any separate existence apart from the agreements and other documents establishing the series.

### **State Taxation**

Although this update is primarily directed towards the Proposed Regulations and federal taxes, it seems appropriate to address Texas tax law and its effect on series LLCs. The Texas Comptroller (Texas’ general taxing authority) has been slow to issue official rules or regulations regarding series LLCs. As the authors wrote in the Trap for the Unwary, the way in which the Texas franchise tax (generally applicable to entities in Texas) applies to series LLCs is less than clear.

Although the Texas Comptroller has not issued formal guidance, the authors are aware that it has unofficially stated that each series will be taxed as a separate entity for Texas franchise tax purposes. Seeking clarity, the State and Local Tax Committee of the State Bar of Texas Section of Taxation (the “Committee”), in March 30, 2011 comments to the Texas House Ways and Means Committee (the “Comments”), urged the Texas Legislature to amend the Texas Tax Code to clarify how a series LLC will be treated for Texas franchise tax purposes. The Committee noted in these comments that, while treatment of a series LLC as a single entity would further the Texas series statute’s goal of easing the administrative burden of creating multiple entities to achieve the same result as the series statute intends, this benefit is at least partially outweighed by the fact that each series must already separately calculate its taxes for federal income tax purposes.

The Comments authors further argue against treating the entire series as one entity since significant inconsistencies would exist in application (or lack of application) of the combined/unitary reporting rules to a series when compared to application of the same rules to a traditional LLC holding company/subsidiary structure. For example, a group of otherwise affiliated entities in a traditional LLC holding company/subsidiary structure that are not engaged in unitary business would not be combined for Texas franchise tax purposes. However, if the franchise tax were applied to treat an entire series LLC as a single taxpayer, the non-unitary series cells would not be excluded from reporting for the entire group. This may harm the taxpayer (or perhaps the Texas fisc) where issues of deduction elections are important (i.e., cost of goods sold deduction versus compensation deduction).

The Comments authors also encourage the Legislature to consider treatment of each series of a series LLC as individual taxpayers in order to promote consistency with the federal income tax treatment of these entities. In addition, they note that treatment of the series of a series LLC as multiple taxable entities would allow continued application of the favorable “Joyce rule,” which allows a combined group of taxable entities to determine its apportionment factor by including in Texas gross receipts only those entities having nexus with Texas. Separation of receipts of series without Texas nexus would not be possible if the entire series LLC was treated as a single taxable entity.



Although not addressed in the Comments, the treatment of series LLCs is also unclear under Texas sales tax law. Texas tax law provides for a broad-based sales tax applicable to the sale of goods and also applicable to many types of services. As a general matter, transactions between commonly held or closely held entities are subject to Texas sales taxes, with an exception for the sale of goods between corporations generally considered as consolidated for federal tax purposes. It is uncertain whether individual series of a series organization, treated as separate entities for federal tax purposes, would be disregarded for Texas sales tax purposes such that goods and services transactions between and among a series LLC and its series could be disregarded. If such were the case, this presents obvious tax-saving opportunities for restructuring certain closely held business groups. In light of the Comptroller's unofficial position to treat series as separate taxpayers for Texas franchise tax purposes, it is difficult to see how this would square with disregarding those entities for sales tax purposes.

### **Conclusion**

The Proposed Regulations have somewhat clarified the direction that the Internal Revenue Service will take with series LLCs. They have also unleashed a torrent of writing by tax specialists and professional tax organizations across the U.S. To be sure, though, there are important and lingering federal tax issues that will have to wait for another day for clarification. This, coupled with the uncertain application of laws in other areas, including Texas state tax law, means that the use of the series LLC should only be undertaken after a careful evaluation of whether that uncertainty is outweighed by the perceived advantage of using the series LLC format. In practice, it is the authors' perception that series LLCs are used most frequently only with non-operating passive investments not involving multiple jurisdictions.

We will continue to monitor guidance provided by federal and state taxing authorities, as well as judicial interpretation of the series LLC statutes, as variations of this legislation are adopted by other states across the United States. Series LLCs are undoubtedly in their infancy and remind the authors (the oldest one of them at least) of the myriad issues surrounding the use of limited liability companies when they were first introduced in the U.S. many years ago. From those humble beginnings, limited liability companies have come to represent the preferred entity for closely held (and not so closely held) business and investment purposes in the U.S. Prime time for the use of series LLC, however, has not yet arrived in the authors' view.

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