

State Law & State Taxation Corner

By *John A. Biek**

IRS and Massachusetts Rule on the Income Tax Classification of a Delaware Series Limited Liability Company—But Questions Still Abound

Introduction

For more than ten years, the Delaware limited liability company laws have provided for a “series LLC” form of business organization that is essentially a subset of LLCs within the overall LLC, with each series consisting of a separate pool of assets, liabilities and stream of earnings. Three years ago, Illinois adopted its own series LLC statute that more clearly states that each series of the Illinois series LLC will be treated as a separate business entity for corporate, commercial and possibly tax purposes. Series LLCs have been hailed as a convenient device to create the effect of separate sister LLCs with less organizational documentation and filing fees, but the novelty of the series LLC has discouraged many corporate and tax lawyers from recommending this form of business organization to their clients.

Until this year, there were no federal or state rulings on the income tax classification treatment of series LLCs. In January 2008, the IRS issued Private Letter Ruling 200803004,¹ which concluded that the federal “check-the-box” rules separately applied to each series in what is believed to be a Delaware series LLC. A month later, the Massachusetts Department of Revenue applied a more detailed analysis to reach the same conclusion in its Letter Ruling No. 08-2,² which appears to address the same Delaware series LLC.

This federal private letter ruling does not necessarily mean that the IRS has decided to give separate entity treatment to the series in every series LLC. Indeed, treating the series in the series LLC as separate entities can give rise to adverse tax consequences, and it is



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possible that if the IRS is presented with a different set of facts, *e.g.*, a series LLC in which members intend to utilize the assets of the various series in a common business operation, the IRS would classify that series LLC as a single tax partnership.

Nevertheless, these two rulings do provide support to series LLCs that want to be classified as a group of separate partnerships, disregarded entities and/or corporations for state income tax purposes. However, a host of other state tax questions remain unanswered regarding series LLCs. These questions will need to be carefully thought through before a multiform business is organized as a series LLC instead of as a group of separate and distinct LLCs.

The Delaware Series LLC Laws

The Delaware legislature created the Delaware series LLC in 1996 through the addition of Section 18-215 (the “Delaware Series LLC Law”) to the Delaware Limited Liability Act.³ Section 18-215(a) of the Delaware LLC Act provides that:

A limited liability company agreement may establish or provide for the establishment of one or more designated series of members, managers, limited liability company interests or assets. Any such series may have separate rights, powers or duties with respect to specified properties or obligations of the limited liability company or profits and losses associated with specified property or obligations, and any such series may have a separate business purpose or investment objective.⁴

Each series in a Delaware series LLC may carry on any lawful for-profit or nonprofit business, purpose or activity other than a banking business.⁵ As a result of the 2007 amendments to the Delaware Series LLC law, unless otherwise provided in the series LLC agreement, each series shall have the power and capacity, in its own name, to contract, hold title to assets (including real, personal and intangible property), grant liens and security interests, and sue and be sued.⁶

The key provision in the Delaware Series LLC Law is Section 18-215(b), which provides:

This federal private letter ruling does not necessarily mean that the IRS has decided to give separate entity treatment to the series in every series LLC.

Notwithstanding anything to the contrary set forth in this chapter or under other applicable law, in the event that a limited liability company agreement establishes or provides for the establishment of 1 or more series, and *if the records maintained for any such series account for the assets associated with such series separately from the other*

assets of the limited liability company, or any other series thereof, and if the limited liability company agreement so provides, and if notice of the limitation on liabilities of a series as referenced in this subsection is set forth

*in the certificate of formation of the limited liability company, or any other series thereof, then the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of such series only, and not against the assets of the limited liability company generally or any other series thereof, and, unless otherwise provided in the limited liability company agreement, none of the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to the limited liability company generally or any other series thereof shall be enforceable against the assets of such series.*⁷

The two linchpins to achieving this separate limited liability for each series of the Delaware series LLC are that (1) the series LLC must clearly attribute each of its assets to a specific series of the LLC and (2) the series LLC must put creditors and investors on notice of this limitation of liability of each series in the certificate of formation that the series LLC files with the Delaware Secretary of State’s office. Presumably, any other state that recognizes the limited liability of each series would require that the series LLC provide similar notice in the instrument that the LLC files to qualify to do business in that state.

The Delaware Series LLC Law provides considerable flexibility as to how the LLC designates the assets of each series. Section 18-215(b) explains that:

Records maintained for a series that reasonably identify its assets, including by specific listing,

category, type, quantity, computational or allocation formula or procedures (including a percentage or share of any asset or assets) or by any other method where the identity of such assets is objectively determinable, will be deemed to account for the assets associated with such series separately from the other assets of the limited liability company, or any other series thereof.⁸

The notice of the limited liability of each series of the Delaware series LLC does not have to be extensive either. According to Section 18-215(b), “[n]otice in a certificate of formation of the limitation on liabilities of a series as

referenced in this subsection shall be sufficient for all purposes of this subsection whether or not the limited liability company has established any series when such notice is included in the certificate of formation, and there shall be no requirement that any specific series of the limited liability company be referenced in such notice. The fact that a certificate of formation that contains the foregoing notice of the limitation on liabilities of a series is on file in the office of the Secretary of State shall constitute notice of such limitation on liabilities of a series.”⁹ A member or manager of a Delaware series LLC may agree to be personally obligated to pay any or all of the debts, obligations and liabilities of one or more series of the LLC.¹⁰

The Delaware Series LLC Law allows the LLC Agreement to provide for classes or groups of members or managers associated with a series having such relative voting rights and other duties and powers as the LLC Agreement may provide.¹¹ The LLC Agreement may grant to all or certain identified members or managers, or a specific class or group of the members or managers associated with a series, the right to vote separately, or with all or any class or group of the members or managers associated with the series on any matter. Voting by members or managers associated with a series may be on a per capita, number, financial interest, class group or any other basis.¹²

As for the management of a particular series in the Delaware series LLC, the default rule is that:

Unless otherwise provided in a limited liability company agreement, the management of a series

shall be vested in the members associated with such series in proportion to the then current percentage or other interest of members in the profits of the series owned by all of the members associated with such series, the decision of members owning more than 50 percent of the said percentage or other interest in the profits

controlling; provided, however, that if a limited liability company agreement provides for the management of the series, in whole or in part, by a manger, the management of the series, to the extent so provided, shall be vested in the manager who shall be chosen

in the manner provided in the limited liability company agreement.¹³

Except as otherwise provided in the LLC Agreement, any event under the Delaware LLC Act or in the LLC Agreement that causes a manager to cease to be a manager with respect to a particular series shall not, by itself, cause the manager to cease to be a manager of the series LLC or of another series of the LLC.¹⁴

A series LLC may make distributions to the members of a particular series out of the profits or assets of that series, as long as the distribution does not cause the liabilities of the series to exceed the fair market value of its assets.¹⁵

Unless otherwise provided in the LLC Agreement, a member shall cease to be associated with a series, and shall cease to have the power to exercise any rights or powers of a member with respect to that series, upon the assignment of all the member’s LLC interest with respect to that series.¹⁶ Except as otherwise provided in the LLC Agreement, any event that causes a member to cease to be associated with a series shall not, by itself, cause the member to cease to be associated with any other series in the LLC, or terminate the continued membership of the member in the LLC or cause the termination of the series, regardless of whether the member was the last remaining member associated with the series.¹⁷

In addition, the Delaware Series LLC Law provides that “a series may be terminated and its affairs wound up without causing the dissolution of the limited liability company” and the termination of

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the series does not affect the limitation of liabilities of such series.¹⁸ A series is considered to be terminated and its affairs wound up either upon the dissolution of the LLC or upon the first to occur of the following events:

- (1) At the time provided in the LLC Agreement;
- (2) Upon the happening of termination events specified in the LLC Agreement;
- (3) Upon the affirmative vote of the members of the series; or
- (4) By decree of the Delaware Chancery Court, where requested by a member or manager of a series when “it is not reasonably practicable to carry on the business of the series in conformity with a limited liability company agreement.”¹⁹

While the Delaware Series LLC Law lays out in considerable detail the concepts that each series of the LLC is deemed to have separate assets, profits and liabilities, with its own members and managers; that a series can contract, hold title to assets, grant security interests and sue and be sued in its own name; and that a series can be terminated without impacting the other series or causing the dissolution of the LLC, there is no specific statement in the Delaware Series LLC Law that each series is a separate legal entity distinct from the other series and the LLC itself.

It is also necessary in order for the federal check-the-box election regime to apply that each series of a series LLC be considered to be a “business entity.”

The Illinois Series LLC Law

Illinois enacted its series LLC law as of July 1, 2005, again by adding a new Section 37-40 (the “Illinois Series LLC Law”) to the Illinois Limited Liability Company Act.²⁰ The Illinois Series LLC Law bears many similarities to the Delaware Series LLC Law previously discussed. According to Section 37-40(a):

An operating agreement may establish or provide for the establishment of designated series of members, managers or limited liability company 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, and to the extent provided in the operating agreement, any such series may have a separate business purpose or objective.²¹

The creation of a series in an Illinois series LLC is accomplished by the filing of a Certificate of Designation with the Illinois Secretary of State’s office *for each series*.²²

As in the Delaware Series LLC Law, Section 37-40(b) requires that the Illinois series LLC maintain separate and distinct records for each series, and the assets associated with the series, and that notice of the limitation on liabilities of a series be set forth in the articles of organization of the LLC and the Certificate of Designation for the series filed with the Illinois Secretary of State’s office.²³ If these requirements are satisfied, Section 37-40(b) then provides that:

The debts, liabilities and obligations incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of such series only, and not against the assets of the

limited liability company generally or any other series thereof, and unless otherwise provided in the operating agreement, none of the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to the limited liability company generally or any other series thereof shall be enforceable against the assets of such series.²⁴

Illinois improved on the Delaware Series LLC Law, however, by expressly stating in Section 35-40(b) that a “series with limited liability shall be treated as a separate entity to the extent set forth in the articles of organization.”²⁵ Section 35-40(b) also authorizes the LLC and any of its series to “elect to consolidate their operations as a single taxpayer to the extent permitted 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. Such elections shall not affect the limitation of liability set forth in this Section except to the extent that the series have specifically accepted joint liability by contract.”²⁶ In addition, until last year, Section 35-40(b) went beyond the Delaware Series LLC Law by specifically stating that each series in the Illinois series LLC may, in its own name, contract, hold title to assets, grant security interests, sue and be sued, and otherwise

conduct business and exercise the powers of an LLC under the Illinois LLC Act.²⁷

These provisions in the Illinois Series LLC Law make it clearer that each series in an Illinois series LLC will be treated as a separate legal entity for state law purposes than is the case with the Delaware Series LLC Law.

To date, Iowa, Nevada, Oklahoma, Tennessee, Utah and Wisconsin also have enacted series LLC laws.²⁸ While California has not yet enacted a series LLC statute, the California Franchise Tax Board has announced in its instructions to the California LLC tax return form that “each series in a series LLC is considered a separate LLC and must file its own [Form] 568, Limited Liability Company Return of Income and pay its own separate LLC annual tax and fee if it is registered or doing business in California.”²⁹

Federal Income Tax Classification of Series LLCs

Although the clear objective of the state series LLC statutes is to allow an LLC to conduct business as a group of separate and distinct sub-LLCs, it has been unclear whether the Internal Revenue Service would consider each series of the LLC to be a separate entity for federal income tax purposes.³⁰ This has been a particularly serious concern for Delaware series LLCs because, as noted earlier, the Delaware Series LLC Law does not expressly state that each series is a separate legal entity. The default rule under the Illinois Series LLC Law does provide that each “series with limited liability shall be treated as a separate entity to the extent set forth in the articles of organization,”³¹ so it has been easier for tax advisors to conclude that the IRS should treat each series in an Illinois series LLC as a separate entity for tax purposes, with the federal “check-the-box” rules then being separately applied to each series.

As readers are aware, the federal “check-the-box” entity classification regulations permit an unincorporated “eligible entity” to elect its own federal tax classification.³² An eligible entity that has two or more owners may elect to be classified as a partnership or as a corporation, while an eligible entity with only one owner may elect to be classified

as a disregarded entity or as a corporation.³³ The default classifications for domestic LLCs under the check-the-box regulations are the partnership and disregarded entity classifications.

To be an “eligible entity,” the taxpayer must be treated as an “entity” for federal income tax purposes, it must be a “business entity,” and it cannot be a “per se” corporation.³⁴ A series LLC clearly is not a “per

se” corporation under any of the state enabling statutes or any other legal authority, but it has been less clear whether the IRS might consider each series in a series LLC to be a separate “entity” for federal income tax purposes.

This was particularly the case with the series in a Delaware series LLC,

which appears to be a hybrid with characteristics of both divisions within a corporation and corporate subsidiaries. For example, as pointed out earlier, until 2007, the Delaware Series LLC Law did not provide, as the Illinois Series LLC Law always has, that each series has the power to enter into agreements, hold title to assets, sue or be sued, and otherwise transact business in its own name. On the other hand, the Delaware Series LLC Law does provide for separate management of each series, attribution of the assets of an LLC to specific series, and that each series has limited liability and the authority to make distributions out of its own assets and profits, subject only to the requirement that the series itself not be rendered insolvent by the distributions made to its members.

The federal check-the-box regulations further muddle this issue by providing that “whether an organization is an entity separate from its owners for U.S. federal income tax purposes is a matter of U.S. federal tax law and does not depend on whether the entity is recognized as an entity under local law.”³⁵ This statement in the check-the-box regulations suggests that even the provision in the Illinois Series LLC Law stating that each “series with limited liability shall be treated as a separate entity to the extent set forth in its articles of organization” might not be dispositive of the question of whether each series constitutes a separate business entity for federal income tax purposes.

The federal case law and rulings on entity classification questions generally have found a partnership

If states decide to classify each series in a series LLC as a separate entity for income tax classification purposes, it would make sense for the state also to apply its . . . nexus and apportionment rules on a series by series basis.

to be a separate entity if its creation changed the legal and economic relationship among the owners of the organization and the assets that they contributed to the partnership, signifying an intention of the members to jointly conduct business for profit.³⁶ Indeed, if the property owners gave up rights to sell, partition, encumber and manage the property by contributing legal title to the property to the partnership, the federal check-the-box regulations treat the partnership as a separate business entity.³⁷ On the other hand, if the property owners formed the partnership merely to facilitate the sharing of their expenses associated with the property, the courts and the IRS have concluded that such a partnership will *not* be treated as a business entity separate from the property owners because the owners did not change their legal and economic rights with respect to the property that they had contributed to the partnership.³⁸

There is legal precedent for treating the individual series in series trusts as separate legal entities for federal income tax purposes. In *National Securities Series-Industrial Stock Series v. Commissioner*,³⁹ the Tax Court made an assumption in reaching its holding in the case that each series of a single investment trust was a separate taxable entity. In Rev. Rul. 55-416, the IRS acquiesced in the holding of the *National Securities Series* case and followed the Tax Court's implied treatment of each series of a series trust as a separate taxable entity.⁴⁰

In LTR 9819002,⁴¹ the IRS again determined that each series of a series trust was a separate entity owned by the trust beneficiaries rather than by the trust itself for federal income tax purposes. Under the applicable state trust statute, if the trust and series declarations so provided, the interests in each series of the trust were to be treated as separate and distinct from the interests of the other series. The state statute also provided that the expenses, fees, charges, taxes and other liabilities of a particular series were to be paid out of the assets of that series. Finally, matters affecting a particular series were to be voted on only by the beneficiaries of that series. Citing these facts, the IRS concluded in LTR 9819002 that each series of the trust constituted a separate business entity for federal income tax purposes.

The principles of the *National Securities Series* case and the foregoing IRS rulings would appear to apply rather easily to the series of a Delaware or Illinois series LLC. Like the series trusts addressed by the Tax Court and the IRS, the series LLC consists of

separate pools of assets, income and liabilities corresponding to each series. Moreover, each series is separately managed, has limited liability, and can be terminated without causing the liquidation of other series or the LLC as a whole. Drawing on this analogy between a series trust and a series LLC, it was possible to conclude that each series in a Delaware or Illinois series LLC should be treated as an "entity" under the federal check-the-box regulations.

It is also necessary in order for the federal check-the-box election regime to apply that each series of a series LLC be considered to be a "business entity."⁴² Under the regulations and case law, a "business entity" is an entity that provides a vehicle for conducting business transactions and sharing its gain, as distinguished from a trust that merely holds and conserves property.⁴³ Under these rules, a series of a series LLC should be treated as a business entity if it carries on a profit-making business and is not organized and operated merely to protect and conserve property for the owners of the series.

On January 18, 2008 the IRS finally issued a private letter ruling addressing the entity classification of a series LLC.⁴⁴ The entity referred to in LTR 200803004 as "Trust" was a state business trust that divided its shares into several portfolios or series of portfolios that were separate from each other under the provisions of the Trust's Declaration of Trust. Each Trust Portfolio was currently being taxed federally as a separate regulated investment company (a "RIC") under Code Sec. 851. The Trust Portfolios had filed federal check-the-box elections to be taxed as corporations.

The Trust planned to reorganize its mutual fund business as a series LLC under state law. Under the reorganization plan, each Trust Portfolio would transfer its assets and liabilities to a series of the LLC (which was referred to in the ruling as an "LLC Portfolio") in exchange for the membership interests in that series. The Trust Portfolio would then distribute the LLC Portfolio membership interests to the Trust Portfolio shareholders in complete liquidation. Alternatively, the Trust might be reorganized through a statutory conversion as a series LLC.

The taxpayer in LTR 200803004 represented that each LLC Portfolio consisted of a separate pool of assets, liabilities and stream of earnings and that the shareholders of an LLC Portfolio would be entitled to share in the income of that Portfolio. The ownership interests of the shareholders in an LLC Portfolio would be limited to the assets of that LLC

Portfolio in the event of the redemption, liquidation or termination of the LLC Portfolio. The expenses of a particular LLC Portfolio would be paid out of the LLC Portfolio's own assets, and the creditors of an LLC Portfolio would be limited, under the applicable state law, to asserting a claim against the assets of the LLC Portfolio. Each LLC Portfolio would have its own investment objectives, policies and restrictions.

The taxpayer in LTR 200803004 also represented that the various Trust Portfolios wished to have different federal tax classifications. Each Type D LLC Portfolio currently had only one shareholder and proposed to be treated as a disregarded entity under the default rule of the federal check-the-box regulations, while each Type P LLC Portfolio currently had two or more owners and proposed to be classified as a tax partnership under the check-the-box regulations. The Type C LLC Portfolios planned to file check-the-box elections to continue to be classified as associations taxable as a RIC for federal tax purposes.

Without offering much legal analysis, the IRS granted the federal tax classifications that the taxpayer had requested in LTR 200803004. As a result of applying the check-the-box regulations to each series in the series LLC, the IRS determined that the series would have the following tax classifications:

- If each Type D LLC Portfolio had a single owner and did not file a check-the-box election to be treated otherwise, the Type D LLC Portfolio would be treated as a disregarded entity separate from its owners.
- Each Type P LLC Portfolio and Type D LLC Portfolio that had two or more owners would be treated as a tax partnership, as long as it did not file a check-the-box election to be classified as a corporation.
- If a Type C LLC Portfolio filed a check-the-box election to be classified as an association taxable as a corporation for federal income tax purposes, that would be its federal tax classification until it made a new election to be treated otherwise.

State Income Tax Classification of Series LLCs

On February 15, 2008, the Massachusetts Department of Revenue concluded in Ruling No. 08-2 that each series of a yet to be formed Delaware series LLC would be treated as a separate entity for

Massachusetts income tax purposes, with the Massachusetts classification of each series following its tax classification under the federal check-the-box regulations.⁴⁵ According to the facts presented in Ruling No. 08-2, a Massachusetts business trust (the "Trust") was operating as a mutual fund under the Investment Company Act of 1940. The beneficial interests in the Trust were divided into transferable shares of several Trust Portfolios, and each Trust Portfolio was taxed federally as a separate RIC under Code Sec. 851.

The Trust proposed to reorganize its business operations as a Delaware series LLC. For several reasons, it appears that this was the same Trust that the IRS had addressed one month earlier in LTR 200803004. First, the descriptions of the LLC Series that would result from the reorganization, the reorganization steps, and the labeling of the resulting LLC Series as "Type D Series," "Type P Series," and "Type C Series" match the facts presented in LTR 200803004. Second, the Department noted in Ruling No. 08-2 that "in a private letter ruling issued to the taxpayers, the IRS ruled that each series of LLC will be treated as a separate entity for federal income tax purposes," with each Type D Series being treated as a disregarded entity, each Type P Series and each Type D Series with more than one owner being treated as a partnership, and each Type C Series that filed a check-the-box election to be classified as an association taxable as a corporation receiving that tax classification. The only IRS private letter ruling available online that fits this description is LTR 200803004.

The Department provided a detailed legal analysis in Ruling No. 08-2 of the Series LLC classification issue, touching on most of the cases and IRS rulings previously discussed in this article. The Department noted that although it had not previously considered how a series LLC would be classified for Massachusetts income tax purposes, the Department had determined in its Letter Ruling 87-19 that each series of investment portfolios to which a RIC had allotted its assets constituted a separate entity (a corporation trust) under the Massachusetts tax laws. Applying a similar analysis, the Department concluded in Ruling No. 08-2 that:

The LLC and the LLC Series will be set up similarly to the trust and the separate series in Letter Ruling 87-19. The LLC will have no assets, liabilities or income because everything will be

allocated among the series and the function of the LLC is to make it easier to file amendments and other documents with the SEC. Each series will be separate with respect to the rights of shareholders and creditors. Under Section 5.11(c) of the Operating Agreement, each LLC Series will consist of a separate pool of assets, liabilities and stream of earnings; the shareholders of an LLC Series may share in the income only of that LLC Series; the ownership interest of the shareholders in an LLC Series will be limited to the assets of that LLC Series upon redemption, liquidation, or termination of such LLC Series; the payment of the expenses, charges, and liabilities of an LLC Series is limited to that LLC Series' assets; and votes of shareholders may be conducted by each LLC Series separately with respect to matters that affect only that particular LLC Series, except to the extent the 1940 Act requires shares to be voted as a single class of shares. Under Section 4.1 of the Operating Agreement, the creditors of each LLC Series are limited to the assets of that LLC Series for recovery of expenses, charges, and liabilities. Under Section 5.11(b) of the Operating Agreement, each LLC Series will have its own investment objectives, policies and restrictions.

Therefore, based on Letter Ruling 87-19, the federal guidance of *National Securities*, Rev. Rul. 55-416 and the IRS private letter ruling issued to the Taxpayers, *each LLC Series should be classified as a separate entity for Massachusetts income tax purposes.*

The Department then turned to the question of how each LLC series would be classified for Massachusetts income tax purposes. In TIR 97-8, the Department had announced that it would follow the federal check-the-box rules when determining the Massachusetts income tax classification of an LLC. The Department concluded in Ruling 08-2 that it would "interpret the rules for classifying an LLC for Massachusetts income and corporate excise tax purposes to extend to an LLC Series that is established within an LLC and is organized and governed pursuant to a limited liability company statute. Given that the LLC Series are established within LLC and are authorized, organized, and governed pursuant to the Delaware LLC Act, the Commissioner will adopt the federal classification of each series."⁴⁶

Analysis of the IRS and Massachusetts Series LLC Rulings

The IRS's issuance of LTR 200803004 does not necessarily mean that the IRS has decided to treat every series LLC as a group of separate entities. After all, private letter rulings represent the IRS's analysis of a particular taxpayer's tax issue based on the facts presented by the taxpayer in its ruling request. Giving separate entity treatment to each series in a series LLC will make it more difficult to transfer assets among the series without triggering tax liability for the members, and it could create a number of other federal tax issues that could be avoided if the series LLC were classified as a single tax partnership. If the members of a series LLC utilize the assets of the various series in an overarching business, signifying the intention of the members to jointly conduct a business for profit, the IRS might well classify that series LLC as a single tax partnership. Thus, the IRS is likely to address the tax classification of series LLCs on a facts and circumstances basis.

LTR 200803004 and Massachusetts Letter Ruling 08-2 are significant developments, however, in that they provide a road map to taxpayers that want the series in their series LLCs to be classified as separate entities. The Massachusetts ruling did a particularly nice job of analyzing the tax classification issue. Because most states with income taxes have adopted the federal check-the-box rules, it would not be surprising to see additional states issue rulings that the series in a series LLC are separate entities.

State Tax Issues Remain For Series LLCs

These recent rulings provide a clue as to how Delaware series LLCs (and presumably other state series LLCs) might be classified for federal and state income tax purposes, but a number of important state tax questions remain unanswered.⁴⁷ Until states tax agencies or legislatures address these issues, businesses managers and tax advisors are still operating in the dark when they consider whether to structure a business as a series LLC instead of as a group of separate LLCs.

The paramount question may be whether state tax authorities will treat each series in a series LLC as a separate entity for nexus purposes. If the business is organized as a group of separate and distinct sister LLCs, the business activities of one LLC in a state should

not create income tax or sales and use tax nexus for the other commonly owned LLCs in the group. The constitutional sales/use tax nexus standard is physical presence under the Supreme Court's decision in *Quill Corp. v. North Dakota*,⁴⁸ and the physical presence of an LLC in a state will not be attributable to its sister LLCs unless it is conducting activities in the taxing state on their behalf. Similarly, the state tax agencies would have to utilize such attributional nexus principles to ascribe the income tax nexus of one LLC to its sister LLCs.

The nexus consequences of a series LLC have yet to be addressed by the states. If a state tax agency treats each series in a series LLC as a separate entity for income/franchise tax classification purposes, it would be logical for the state tax agency to take a consistent approach in determining whether a particular series has established income/franchise tax nexus to the state. This means that if the series is classified as a corporation for entity classification purposes, its business activities in the taxing state would *not* be attributable to the other series in the series LLC. If the series is classified as a partnership, its in-state business activities might (or might not) flow through to the owners of the series, depending on whether the state has adopted the entity or aggregate theory of partnerships.⁴⁹ Finally, if the series is classified as a disregarded entity for federal and state income tax purposes, activities of the series presumably would create income tax nexus for its single owner.

If a state has not yet announced how it will classify series LLCs, however, which is the case for nearly all of the states, the income tax nexus consequences for the series in the series LLC is very much up in the air. The danger, of course, is that state tax agencies will determine nexus for the LLC as a whole, in which case the contacts of *any* series with the state would contaminate every other series in the LLC. This could be a state tax planning disaster.

The sales/use tax nexus analysis for series LLCs also is unresolved. As mentioned earlier, states are required under the *Quill* case to show that a vendor making a retail sale of tangible personal property or taxable services to a consumer located in the taxing state has physical presence in the state before the vendor can constitutionally be obligated to collect the state's sales/use tax from the consumer. Because the Illinois Series LLC Act expressly provides that each series in an Illinois series LLC will be treated as a separate entity unless the series LLC elects otherwise, it appears that the Illinois Department of Revenue should not assert sales/use tax nexus over a particular series unless that series has

established physical presence in Illinois. However, the Delaware Series LLC Act is ambiguous about whether the respective series in a Delaware Series LLC will be treated as separate entities. The classification of a series as a disregarded entity under the federal check-the-box regulations should not, at least as a theoretical matter, determine the sales/use tax nexus consequences for the series because the disregarded entity treatment of the series is a fiction of the income tax laws. Again, attributional nexus principles must be thought through when analyzing whether a series is deemed to have physical presence in a state and thereby acquire sales/use tax nexus in the state.

The other big state income/franchise tax question for series LLCs is whether the state allocation and apportionment rules will be applied separately to each series or to the LLC as a whole. This raises several questions. First, states that have adopted the Uniform Division of Income for Tax Purposes Act ("UDITPA") generally require that the taxpayer be taxable in at least one other state in order for the taxpayer to be entitled to utilize specific allocation and formulary apportionment to compute its state income tax liability.⁵⁰ Similarly, a number of states have adopted the "throwback rule" to require that the numerator of the taxpayer's sales factor in that state include the receipts from the taxpayer's shipments of goods from a facility in the state to customers located in other states in which the taxpayer does *not* have income tax nexus.⁵¹

Therefore, it will matter greatly for state allocation apportionment purposes whether the state tax agency treats each series in a series LLC as a separate entity. If the state tax agency affords separate entity treatment to each series for entity classification purposes, then it would be logical for the state to apply its specific allocation, formulary apportionment and throwback rules separately to each series. Following that line of thought, the net income of the series would be apportioned with its own apportionment factors unless the series is engaged in a unitary business with its owner, or unless the series is treated as a disregarded entity, in which case states probably would require that the net income and apportionment factors of the series be "rolled up" to its owner or owners and that the apportionment be determined on the owner's state income/franchise tax return.

Of course, the apportionment consequences would be different if a state treats a series LLC as a single tax partnership. Under those circumstances, the net income of the various series probably would be aggregated and apportioned with the group's apportionment

factors. Hopefully, nonunitary states will refrain from applying this combined group apportionment approach to series LLCs because it would be at odds with the concept that each series in a series LLC represents a separate pool of assets, liabilities and income.

Conclusion

Notwithstanding the issuance of LTR 200803004 and Massachusetts Letter Ruling No. 08-2, critical state

income/franchise tax and sales/use tax questions remain unresolved for series LLCs. If states decide to classify each series in a series LLC as a separate entity for income tax classification purposes, it would make sense for the state also to apply its income tax and sales/use tax nexus and apportionment rules on a series by series basis. However, until these issues are resolved, the state tax uncertainty surrounding series LLCs will counsel caution in their use as a form of business organization.

ENDNOTES

* The author would like to thank his partner Andrea M. Desportes for her insightful comments on this column.

¹ LTR 200803004 (Oct. 15, 2007).

² Letter Ruling 08-2, Massachusetts Department of Revenue, February 15, 2008, CCH ¶401-146.

³ Del. Code tit. 6, §18-101 *et seq.* (the "Delaware LLC Act"). For thoughtful discussions of the Delaware Series LLC Law and some of the tax issues that it raises, see Charles T. Terry and Derek D. Samz, *An Initial Inquiry Into the Federal Tax Classification of Series Limited Liability Companies*, 110 Tax Notes 1093 (Mar. 6, 2006), 2006 TNT 44-40 (Mar. 7, 2006); Carol R. Goforth, *The Series LLC, and a Series of Difficult Questions*, 60 Ark. L. Rev. 385 (2007); G. Gerson, *Taxing Series LLCs*, 45 Tax Management Memo 75 (Mar. 8, 2004) (hereinafter, referred to as "Gerson"); T. Cuff, *Series LLCs and the Abolition of the Tax System*, Business Entities, 2000 WL 330996 (Jan.-Feb. 2000); K. Harris & A. Desportes, *Limiting Liability within the LLC: Another Reason to Choose Delaware?*, 5 J. Limited Liability Companies 132 (Winter 1998). Delaware series limited partnerships raise similar entity classification questions, which are analyzed in Thomas M. Stephens and Marc L. Schultz, *Segregating Assets Within a Single Partnership: Delaware Series Partnerships and LLCs*, TAXES--THE TAX MAGAZINE, Mar. 2000, at 231.

⁴ Del. Code, tit. 6, §18-215(a).

⁵ Del. Code, tit. 6, §18-215(c).

⁶ *Id.* These amendments to the Delaware Series LLC Law were made by Del. S.B. 96, 76 Laws 2007, ch. 105, §§22-28 (eff. Aug. 1, 2007).

⁷ Del. Code, tit. 6, §18-215(b) (emphasis added).

⁸ *Id.*

⁹ *Id.*

¹⁰ Del. Code, tit. 6, §18-215(d).

¹¹ Del. Code, tit. 6, §18-215(e).

¹² Del. Code, tit. 6, §18-215(f).

¹³ Del. Code, tit. 6, §18-215(g).

¹⁴ *Id.*

¹⁵ Del. Code, tit. 6, §18-215(i).

¹⁶ Del. Code, tit. 6, §18-215(j).

¹⁷ *Id.*

¹⁸ Del. Code, tit. 6, §18-215(k).

¹⁹ *Id.*

²⁰ 805 ILCS 180/1-1 *et seq.* (the "Illinois LLC Act").

²¹ 805 ILCS 180/37-40(a).

²² 805 ILCS 180/37-40(b) and (d).

²³ 805 ILCS 180/37-40(b).

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ Iowa Code §490A.305; Nev. Rev. Stat. §§86.161(1)(e) and 86.1255; Okla. Stat. tit. 18, §2054.4; Tenn. Code §48-249-309; Utah Code §48-2c-606; Wis. Stat. §183.0504.

²⁹ See Instructions to 2007 California Form 568, Limited Liability Company Return of Income, at p. 5.

³⁰ For an extensive discussion of this federal entity classification issue, see Gerson, *supra*, footnote 3.

³¹ 805 ILCS 180/35-40(b).

³² Reg. §301.7701-3(a).

³³ *Id.*

³⁴ Reg. §301.7701-2(b).

³⁵ Reg. §301.7701-1(a)(1).

³⁶ See, e.g., *P.E. Dorman*, CA-9, 61-2 USTC ¶9773, 296 F2d 27; *Madison Gas and Electric Co.*, CA-7, 80-2 USTC ¶9754, 633 F2d 512.

³⁷ Reg. §301.7701-1(a)(2).

³⁸ See Gerson, *supra*, footnote 3.

³⁹ *National Securities Series-Industrial Stock Series*, 13 TC 884, Dec. 17, 299 (1949), acq. 1950-1 CB 4.

⁴⁰ Rev. Rul. 55-416, 1955-1 CB 416.

⁴¹ LTR 9819002 (Jan. 27, 1998).

⁴² Reg. §301.7701-2(a).

⁴³ See *T.A. Morrissey, Trustee*, S Ct, 36-1 USTC ¶9020, 296 US 344, 352, 56 S Ct 289 (1935).

⁴⁴ In LTR 200733003 (May. 18, 2007), the IRS granted an extension of time to a series in a Delaware series LLC to elect out of the installment method of accounting. By addressing its ruling to the series itself, the IRS implied in LTR 200733003 that the series was a separate entity for federal income tax purposes.

⁴⁵ Letter Ruling 08-2, Massachusetts Department of Revenue, February 15, 2008, CCH ¶401-146.

⁴⁶ Letter Ruling 08-2, Massachusetts Department of Revenue, February 15, 2008, CCH ¶401-146.

⁴⁷ See M. McGloughlin & B. Ely, *The Series LLC Raises Serious State Tax Questions But Few Answers Are Yet Available*, Journal of Multistate Taxation & Incentives (Jan. 2007) (hereafter referred to as "McGloughlin & Ely").

⁴⁸ *Quill Corp. v. North Dakota*, 504 US 298, 112 S Ct 1904 (1992).

⁴⁹ As the McGloughlin and Ely article notes, the courts in Alabama and Kentucky have concluded based on the entity theory of partnerships that an out-of-state limited partner in a limited partnership doing business in the state did *not* acquire income tax nexus as a result of the limited partnership's activities in the state. See *Lanzi v. Alabama Department of Revenue*, No. 2040298, 2006 Ala. Civ. App. LEXIS 406 (June 30, 2006); *Asworth Corp. v. Revenue Cabinet*, Kentucky Bd. Tax Appeals, File Nos. K00-R-31, K02-R-30, K-2-R-31, K02-R-32 (Order No. K19449) (Jan. 27, 2006).

⁵⁰ UDITPA §2.

⁵¹ UDITPA §16(b).

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