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**Pass-Through Entities**

In this “Expert Insight,” well-known tax attorney and BNA Multistate Tax Advisory Board member Bruce Ely answers our questions about the emergence of Series LLCs and their state tax treatment. As a member of a task force working on a comprehensive report to the U.S. Treasury Department and the ABA Tax Section, Ely is uniquely situated to offer insight on this topic, but he cautions that his responses below are purely his own personal views.

## **Expert Insight: State Tax Treatment of Series LLCs, The Next Generation of Pass-Through Entities?**

BRUCE ELY, INTERVIEWED BY STEVEN ROLL AND  
MELISSA FERNLEY

**BLOOMBERG BNA:** Tell us about the next generation of pass-through entities. What new entity is in the forefront?

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**ELY:** The next generation of pass-through entity is called a “Series LLC.” In a series LLC, members, managers, and membership interests are treated as separate and distinct “series,” almost as if each were a separate LLC, so that the debts, liabilities, and obligations incurred or contracted with respect to a particular series are enforceable against the assets of that series only, and not against the assets of the “mother ship” LLC or the other series.

Since 1996, Delaware law has permitted LLCs to form and register separate series within a single LLC (collectively, a series LLC). Eight other states and Washington D.C. also now officially authorize their formation, while at least two others recognize series LLCs formed in other states. In our experience, most multistate series LLCs are formed under either Delaware law or Illinois law.

These statutes allow LLCs to establish separate series of management and economic rights for specific assets or obligations. Among other potential planning opportunities, series LLCs could separate large corporate enterprises without triggering the consolidated return regulations, potentially reduce state and local transfer taxes, avoid triggering the disguised sale rules, and possibly defer recognition of gain on sales of assets or entire businesses.

**BLOOMBERG BNA:** How are series LLCs currently treated for federal tax purposes?

**ELY:** Until recently, Congress, the courts, and the IRS had all failed to provide any guidance on the federal tax classification of a series LLC. The threshold question is whether each series is treated as a separate entity. Prior to 2008, it appeared that series LLCs could be classified in different ways, including treating each series of a series LLC as (1) a separate entity or (2) as a parent company that is the sole owner of each series that is taxed as a disregarded entity, in which case the series LLC and all of its series could be treated in the aggregate as a single entity. Assuming that each series could be taxed separately, there was further uncertainty as to whether all of the series must have the same tax classification.

PLR 200803004 was the first published statement on the federal taxation of a series LLC. The IRS issued the private letter ruling to a group of insurance companies that were reorganizing their mutual fund operations as a Delaware series LLC. The IRS implicitly ruled that each series of the series LLC is a *separate entity* for federal income tax purposes and each series is therefore entitled to choose its own entity classification independent of the classification of other series. Although the facts of the letter ruling involved a particular type of taxpayer (*i.e.*, mutual funds used to fund variable annuity and life insurance contracts), the analysis and holdings should be broadly applicable to series LLCs conducting other types of activities. The Massachusetts Department of Revenue issued a ruling that appeared to be a parallel state tax ruling.

Until a little over two years ago, the IRS had only implicitly indicated its intention to treat each series in a series LLC as a separate entity. Finally, in September 2010, the Treasury Department issued its long-awaited guidance in the form of proposed regulations explaining how a series would be treated for federal income tax purposes.

**BLOOMBERG BNA:** How do the proposed federal regulations treat series LLCs?

**ELY:** Not surprisingly, and consistent with previous rulings, the proposed regulations generally treat each series of an LLC as a separate entity and apply the check-the-box entity classification provisions to each.

Oddly, however, the proposed regulations do not address the entity status of the series organization itself; they only address the status of each series underneath the series organization.

The proposed regulations treat a series as created or organized under the laws of the same jurisdiction in which the series organization, or master LLC, is established. Because a series may not be a separate juridical entity for state law purposes, this rule provides the means for establishing the applicable state law jurisdiction of the series for federal tax purposes.

By clarifying the circumstances under which a series will be treated as a separate entity and the interrelationship with the check-the-box regulations, the well-reasoned proposed regulations generally benefit taxpayers. But we anxiously await their finalization.

**BLOOMBERG BNA:** How are series LLCs currently treated by the states?

**ELY:** Only a handful of states have issued rulings or other forms of guidance on series LLCs. I belong to a joint task force of the ABA Tax Section's Partnerships and State & Local Tax Committees which is working on a comprehensive report both to the Treasury Depart-

ment and to the ABA Tax Section. We plan to have the report in approved form by the first week of May. Our task force report will summarize the responses from 30 or so states on issues ranging from income and franchise tax conformity to the proposed series regulations to how they treat series for unemployment compensation purposes. Much of the credit for the report goes to my trusty associate Jimmy Long, and to our friend Leigh Griffith of the Waller Lansden firm in Nashville. Leigh was involved in drafting the Tennessee series LLC act.

Here is a very brief overview of some of the states that have already issued relevant guidance:

- **California:** While California law does not allow series LLCs to be formed in the state, at least the California FTB recognizes them. (California Franchise Tax Board, Tax News (Oct. 1, 2011))

- **Florida:** The Florida Department of Revenue has indicated that it will follow the federal income tax treatment of the series in a series LLC, unless that treatment conflicts with Florida law—whatever that means. (Florida Technical Assistance Advisement, No. 02(M)-009 (Nov. 27, 2002))

- **Massachusetts:** The Massachusetts Department of Revenue has concluded that the Massachusetts rules for classifying an LLC extend to a series established and governed pursuant to the Delaware LLC statutes. (Massachusetts Dept. of Rev. Letter Ruling 08-2, Feb. 15, 2008) (discussed above)

- **New York:** The New York Department of Taxation and Finance has ruled that series LLCs will be treated like partnerships because under New York law, LLCs treated as partnerships for federal income tax purposes are also treated as partnerships for state personal income tax purposes. (New York Advisory Opinion No. TSB-A-98(8)I, New York Dept. of Taxation and Finance (Sep. 4, 1998))

- **Tennessee:** The Tennessee Department of Revenue held that a Tennessee series LLC was required to file separate franchise and excise tax returns for each individual series rather than filing on a single Tennessee return because the clear intent of the law was for each series to be treated as a separate entity for purposes of the Tennessee franchise and excise tax. The proposed Treasury Regulations were referenced. (Tennessee Dept. of Rev. Letter Ruling 11-42 (Sep. 6, 2011))

- **Texas:** For Texas margin tax purposes, a series LLC is considered a single taxpayer and thus the series as a whole must file a single margin tax report (in contrast to all the other state rulings so far). (Texas Policy Letter Ruling 201005184L (May 5, 2010))

**BLOOMBERG BNA:** What are the risks of doing business as a series LLC in a state that does not recognize them?

**ELY:** There are several. There is real debate about the extent to which a foreign series LLC is entitled to protection under the Full Faith and Credit Clause of the U.S. Constitution. That is especially true in the large majority of the states that don't have any sort of statutory recognition of these entities—neither foreign nor domestic. I normally advise against using these entities in states that don't have a statute that speaks to their status under that particular state's laws. Based on our survey, and not surprisingly, the state legislatures seem to be waiting on the Treasury to finalize their proposed regulations.

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**BLOOMBERG BNA:** Can taxpayers expect further guidance from the states on this issue?

**ELY:** Many states have promised this as soon as the Treasury issues final regulations, although we can expect to see a handful of states, especially those with se-

ries LLC acts in place already, issue at least limited guidance this year.