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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 301

[REG-119921-09]

RIN 1545-BI69

Series LLCs and Cell Companies

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations regarding the classification for Federal tax purposes of a series of a domestic series limited liability company (LLC), a cell of a domestic cell company, or a foreign series or cell that conducts an insurance business. The proposed regulations provide that, whether or not a series of a domestic series LLC, a cell of a domestic cell company, or a foreign series or cell that conducts an insurance business is a juridical person for local law purposes, for Federal tax purposes it is treated as an entity formed under local law. Classification of a series or cell that is treated as a separate entity for Federal tax purposes generally is determined under the same rules that govern the classification of other types of separate entities. The proposed regulations provide examples illustrating the application of the rule. The proposed regulations will affect domestic series LLCs; domestic cell companies; foreign series, or cells that conduct insurance businesses; and their owners.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-119921-09), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-119921-09), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the Federal eRulemaking portal at www.regulations.gov (IRS REG-119921-09)

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Joy Spies, (202) 622-3050; concerning submissions of comments, Oluwafunmilayo (Funmi) Taylor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

1. Introduction

A number of states have enacted statutes providing for the creation of entities that may establish series, including limited liability companies (series LLCs). In general, series LLC statutes provide that a limited liability company may establish separate series. Although series of a series LLC generally are not treated as separate entities for state law purposes and, thus, cannot have members, each series has "associated" with it specified members, assets, rights, obligations, and investment objectives or business purposes. Members' association with one or more particular series is comparable to direct ownership by the members in such series, in that their rights, duties, and powers with respect to the series are direct and specifically identified. If the conditions enumerated in the relevant statute are satisfied, the debts, liabilities, and obligations of one series generally are enforceable only against the assets of that series and not against assets of other series or of the series LLC.

Certain jurisdictions have enacted statutes providing for entities similar to the series LLC. For example, certain statutes provide for the chartering of a legal entity (or the establishment of cells) under a structure commonly known as a protected cell company, segregated account company or segregated portfolio company (cell company). A cell company may establish multiple accounts, or cells, each of which has its own name and is identified with a specific participant, but generally is not treated under local law as a legal entity distinct from the cell company. The assets of each cell are statutorily protected from the creditors of any other cell and from the creditors of the cell company.

Under current law, there is little specific guidance regarding whether for Federal tax purposes a series (or cell) is treated as an entity separate from other series or the series LLC (or other cells or the cell company, as the case may be), or whether the company and all of its series (or cells) should be treated as a single entity.

Notice 2008-19 (2008-5 IRB 366) requested comments on proposed guidance concerning issues that arise if arrangements entered into by a cell constitute insurance for Federal income tax purposes. The notice also requested comments on the need for guidance concerning similar segregated arrangements that do not involve insurance.

The IRS received a number of comments requesting guidance for similar arrangements not involving insurance, including series LLCs and cell companies. These comments generally recommended that series and cells should be treated as separate entities for Federal tax purposes if they are established under a statute with provisions similar to the series LLC statutes currently in effect in several states. The IRS and Treasury Department generally agree with these comments. See §601.601(d)(2)(ii)(b).

2. Entity Classification for Federal Tax Purposes

A. Regulatory framework

Sections 301.7701-1 through 301.7701-4 of the Procedure and Administration Regulations provide the framework for determining an organization's entity classification for Federal tax purposes. Classification of an organization depends on whether the organization is treated as: (i) a separate entity under §301.7701-1, (ii) a "business entity" within the meaning of §301.7701-2(a) or a trust under §301.7701-4, and (iii) an "eligible entity" under §301.7701-3.

Section 301.7701-1(a)(1) provides that the determination of whether an entity is separate from its owners for Federal tax purposes is a matter of Federal tax law and does not depend on whether the organization is recognized as an entity under local law. Section 301.7701-1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for Federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. However, a joint undertaking merely to share expenses does not create a separate entity for Federal tax purposes, nor does mere co-ownership of property where activities are limited to keeping property maintained, in repair, and rented or leased. Id.

Section 301.7701-1(b) provides that the tax classification of an organization recognized as a separate entity for tax purposes generally is determined under §§301.7701-2, 301.7701-3, and 301.7701-4. Thus, for example, an organization recognized as an entity that does not have associates or an objective to carry on a business may be classified as a trust under §301.7701-4.

Section 301.7701-2(a) provides that a business entity is any entity recognized for Federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under §301.7701-3) that is not properly classified as a trust or otherwise subject to special treatment under the Internal Revenue Code (Code). A business entity with two or more members is classified for Federal tax purposes as a corporation or a partnership. See §301.7701-2(a). A business entity with one owner is classified as a corporation or is disregarded. See §301.7701-2(a). If the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. However, §301.7701-2(c)(2)(iv) and (v) provides for an otherwise disregarded entity to be treated as a corporation for certain Federal employment tax and excise tax purposes.

Section 301.7701-3(a) generally provides that an eligible entity, which is a business entity that is not a corporation under §301.7701-2(b), may elect its classification for Federal tax purposes.

B. Separate entity classification

The threshold question for determining the tax classification of a series of a series LLC or a cell of a cell company is whether an individual series or cell should be considered an entity for Federal tax purposes. The determination of whether an organization is an entity separate from its owners for Federal tax purposes is a matter of Federal tax law and does not depend on whether the organization is recognized as an entity under local law. Section 301.7701-1(a)(1). In Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), the Supreme Court noted that, so long as a corporation was formed for a purpose that is the equivalent of business activity or the corporation actually carries on a business, the corporation remains a taxable entity separate from its shareholders. Although entities that are recognized under local law generally are also recognized for Federal tax purposes, a state law entity may be disregarded if it lacks business purpose or any business activity other than tax avoidance. See Bertoli v. Commissioner, 103 T.C. 501 (1994); Aldon Homes, Inc. v. Commissioner, 33 T.C. 582 (1959).

The Supreme Court in Commissioner v. Culbertson, 337 U.S. 733 (1949), and Commissioner v. Tower, 327 U.S. 280 (1946), set forth the basic standard for determining whether a partnership will be respected for Federal tax purposes. In general, a partnership will be respected if, considering all the facts, the parties in good faith and acting with a business purpose intended to join together to conduct an enterprise and share in its profits and losses. This determination is made considering not only the stated intent of the parties, but also the terms of their agreement and their conduct. Madison Gas & Elec. Co. v. Commissioner, 633 F.2d 512, 514 (7th Cir. 1980); Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964).

Conversely, under certain circumstances, arrangements that are not recognized as entities under state law may be treated as separate entities for Federal tax purposes. Section 301.7701-1(a)(2). For example, courts have found entities for tax purposes in some co-ownership situations where the co-owners agree to restrict their ability to sell, lease or encumber their interests, waive their rights to partition property, or allow certain management decisions to be made other than by unanimous agreement among co-owners. Bergford v. Commissioner, 12 F.3d 166 (9th Cir. 1993); Bussing v. Commissioner, 89 T.C. 1050 (1987); Alhouse v. Commissioner, T.C. Memo. 1991-652. However, the Internal Revenue Service (IRS) has ruled that a co-ownership does not rise to the level of an entity for Federal tax purposes if the owner employs an agent whose activities are limited to collecting rents, paying property taxes, insurance premiums, repair and maintenance expenses, and providing tenants with customary services. Rev. Rul. 75-374 (1975-2 CB 261). See also Rev. Rul. 79-77 (1979-1 CB 448), (see §601.601(d)(2)(ii)(b)).

Rev. Proc. 2002-22 (2002-1 CB 733), (see §601.601(d)(2)(ii)(b)), specifies the conditions under which the IRS will consider a request for a private letter ruling that an undivided fractional interest in rental real property is not an interest in a business entity under §301.7701-2(a). A number of factors must be present to obtain a ruling under the revenue procedure, including a limit on the number of co-owners, a requirement that the co-owners not treat the co-ownership as an entity (that is, that the co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity), and a requirement that certain rights with respect to the property (including the power to make certain management decisions) must be retained by co-owners. The revenue procedure provides that an organization that is an entity for state law purposes may not be characterized as a co-ownership under the guidance in the revenue procedure.

The courts and the IRS have addressed the Federal tax classification of investment trusts with assets divided among a number of series. In National Securities Series-Industrial Stocks Series v. Commissioner, 13 T.C. 884 (1949), acq., 1950-1 CB 4, several series that differed only in the nature of their assets were created within a statutory open-end investment trust. Each series regularly issued certificates representing shares in the property held in trust and regularly redeemed the certificates solely from the assets and earnings of the individual series. The Tax Court stated that each series of the trust was taxable as a separate regulated investment company. See also Rev. Rul. 55-416 (1955-1 CB 416), (see §601.601(d)(2)(ii)(b)). But see Union Trusteed Funds v. Commissioner, 8 T.C. 1133 (1947), (series funds organized by a state law corporation could not be treated as if each fund were a separate corporation).

In 1986, Congress added section 851(g) to the Code. Section 851(g) contains a special rule for series funds and provides that, in the case of a regulated investment company (within the meaning of section 851(a)) with more than one fund, each fund generally is treated as a separate corporation. For these purposes, a fund is a segregated portfolio of assets the beneficial interests in which are owned by holders of interests in the regulated investment company that are preferred over other classes or series with respect to these assets.

C. Insurance company classification

Section 7701(a)(3) and §301.7701-2(b)(4) provide that an arrangement that qualifies as an insurance company is a corporation for Federal income tax purposes. Sections 816(a) and 831(c) define an insurance company as any company more than half the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. See also §1.801-3(a)(1), ("[T]hough its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code."). Thus, an insurance company includes an arrangement that conducts insurance business, whether or not the arrangement is a state law entity.

3. Overview of Series LLC Statutes and Cell Company Statutes

A. Domestic statutes

Although §301.7701-1(a)(1) provides that state classification of an entity is not controlling for Federal tax purposes, the characteristics of series LLCs and cell companies under their governing statutes are an important factor in analyzing whether series and cells generally should be treated as separate entities for Federal tax purposes.

Series LLC statutes have been enacted in Delaware, Illinois, Iowa, Nevada, Oklahoma, Tennessee, Texas, Utah and Puerto Rico. Delaware enacted the first series LLC statute in 1996. Del. Code Ann. Tit. 6, section 18-215 (the Delaware statute). Statutes enacted subsequently by other states are similar, but not identical, to the Delaware statute. All of the statutes provide a significant degree of separateness for individual series within a series LLC, but none provides series with all of the attributes of a typical state law entity, such as an ordinary limited liability company. Individual series generally are not treated as separate entities for state law purposes. However, in certain states (currently Illinois and Iowa), a series is treated as a separate entity to the extent provided in the series LLC's articles of organization.

The Delaware statute provides that a limited liability company may establish, or provide for the establishment of, one or more designated series of members, managers, LLC interests or assets. Under the Delaware statute, any such series may have separate rights, powers, or duties with respect to specified property or obligations of the LLC or profits and losses associated with specified property or obligations, and any such series may have a separate business purpose or investment objective. Additionally, the Delaware statute provides that the debts, liabilities, obligations, and expenses of a particular series are enforceable against the assets of that series only, and not against the assets of the series LLC generally or any other series of the LLC, and, unless the LLC agreement provides otherwise, none of the debts, liabilities, obligations, and expenses of the series LLC generally or of any other series of the series LLC are enforceable against the assets of the series, provided that the following requirements are met: (1) the LLC agreement establishes or provides for the establishment of one or more series; (2) records maintained for any such series account for the assets of the series separately from the other assets of the series LLC, or of any other series of the series LLC; (3) the LLC agreement so provides; and (4) notice of the limitation on liabilities of a series is set forth in the series LLC's certificate of formation.

Unless otherwise provided in the LLC agreement, a series established under Delaware law has the power and capacity to, in its own name, contract, hold title to assets, grant liens and security interests, and sue and be sued. A series may be managed by the members of the series or by a manager. Any event that causes a manager to cease to be a manager with respect to a series will not, in itself, cause the manager to cease to be a manager of the LLC or of any other series of the LLC.

Under the Delaware statute, unless the LLC agreement provides otherwise, any event that causes a member to cease to be associated with a series will not, in itself, cause the member to cease to be associated with any other series or with the LLC, or cause termination of the series, even if there are no remaining members of the series. Additionally, the Delaware statute allows a series to be terminated and its affairs wound up without causing the dissolution of the LLC. However, all series of the LLC terminate when the LLC dissolves. Finally, under the Delaware statute, a series generally may not make a distribution to the extent that the distribution will cause the liabilities of the series to exceed the fair market value of the series' assets.

The series LLC statutes of Illinois, 805 ILCS 180/37-40 (the Illinois statute), and Iowa, I.C.A. §489.1201 (the Iowa statute) provide that a series with limited liability will be treated as a separate entity to the extent set forth in the articles of organization. The Illinois statute provides that the LLC and any of its series may 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 Illinois or any other state.

In addition, under the Illinois statute, a series' existence begins upon filing of a certificate of designation with the Illinois secretary of state. A certificate of designation must be filed for each series that is to have limited liability. The name of a series with limited liability must contain the entire name of the LLC and be distinguishable from the names of the other series of the LLC. If different from the LLC, the certificate of designation for each series must list the names of the members if the series is member-managed or the names of the managers if the series is manager-managed. The Iowa and Illinois statutes both provide that, unless modified by the series LLC provisions, the provisions generally applicable to LLCs and their managers, members, and transferees are applicable to each series.

Some states have enacted series provisions outside of LLC statutes. For example, Delaware has enacted series limited partnership provisions (6 Del. C. §17-218). In addition, Delaware's statutory trust statute permits a statutory trust to establish series (12 Del. C. §3804). Both of these statutes contain provisions that are nearly identical to the corresponding provisions of the Delaware series LLC statute with respect to the ability of the limited partnership or trust to create or establish separate series with the same liability protection enjoyed by series of a Delaware series LLC.

All of the series LLC statutes contain provisions that grant series certain attributes of separate entities. For example, individual series may have separate business purposes, investment objectives, members, and managers. Assets of a particular series are not subject to the claims of creditors of other series of the series LLC or of the series LLC itself, provided that certain record-keeping and notice requirements are observed. Finally, most series LLC statutes provide that an event that causes a member to cease to be associated with a series does not cause the member to cease to be associated with the series LLC or any other series of the series LLC.

However, all of the state statutes limit the powers of series of series LLCs. For example, a series of a series LLC may not convert into another type of entity, merge with another entity, or domesticate in another state independent from the series LLC. Several of the series LLC statutes do not expressly address a series' ability to sue or be sued, hold title to property, or contract in its own name. Ordinary LLCs and series LLCs generally may exercise these rights. Additionally, most of the series LLC statutes provide that the dissolution of a series LLC will cause the termination of each of its series.

B. <u>Statutes with respect to insurance</u>

The insurance codes of a number of states include statutes that provide for the chartering of a legal entity commonly known as a protected cell company, segregated account company, or segregated portfolio company. See, for example, Vt. Stat. Ann. tit. 8, chap.141, §§ 6031-6038 (sponsored captive insurance companies and protected cells of such companies); S.C. Code Ann. tit. 38, chap. 10, §§ 38-10-10 through