

IRS Issues Proposed Regulations on “Series LLCs”

Several states (including Delaware, Illinois, Nevada and Texas) have enacted statutes to provide for the creation of entities that may establish separate “series,” including series limited liability companies (“series LLCs”). Although each series of a series LLC generally is not treated as a separate entity for state law purposes, each series has associated with it specified members, as well as specified assets, rights, obligations, investment objectives and business purposes. A member’s association with one or more particular series is comparable to direct ownership by the member in such series, in that the member’s rights, duties and powers with respect to the series are direct and specifically identified. 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.

On September 13, 2010, the Internal Revenue Service issued proposed regulations addressing the U.S. federal income tax classification of series LLCs (and other similar entities). The threshold question for determining the income tax classification of a series LLC (and a series therein) is whether an individual series should be considered a separate entity for U.S. federal income tax purposes.

Existing regulations provide that the state law classification of an entity is not controlling for federal income tax law purposes. Nonetheless, the proposed regulations provide that the characteristics of series LLCs under state law is an important factor in analyzing whether series should be treated as separate entities for federal income tax purposes. All existing series LLC state statutes contain provisions that grant series certain attributes of separate entities. For example, as indicated above, individual series may have separate business purposes, investment objectives, members and managers; and assets of a particular series generally are not subject to the claims of creditors of other series or of the series LLC itself.

In light of the above considerations, the proposed regulations provide that each series of a domestic series LLC, whether or not a juridical entity for local law purposes, is treated for federal income tax purposes as a separate entity formed under local law. With the exception of certain insurance companies, the proposed regulations do not apply to series LLCs organized under foreign law. Also, the proposed regulations do not address how a series LLC should be treated for federal employment tax purposes.

Whether a series that is treated as a distinct entity under the proposed regulation is then recognized as a separate entity (*i.e.*, as opposed to a disregarded entity), and, if so, the classification of such an entity for federal income tax purposes (*i.e.*, as a partnership or corporation), is determined under generally applicable entity classification (“check-the-box”) rules.

The proposed regulations also provide that, for federal income tax purposes, the ownership of interests in a series, and of the assets associated with a series, is determined under general tax principles. For example, the series LLC itself is not treated as the owner of a series or of the assets associated with a series merely because the series LLC holds legal title to such assets. Instead, federal tax principles require an inquiry into who bears the economic benefits and burdens of the assets.

The proposed regulations are expected to be effective when finalized, rather than retroactively. Taxpayers who are treating a series for federal income tax purposes differently from the fashion described in the regulations generally will be required to change their treatment of such series as of such point. However, the proposed regulations do provide an exception for series LLCs established prior to September 13, 2010, that treat all series and the series LLC as one entity. Such an entity generally may continue to be treated as one entity for federal income tax purposes until a change in control occurs with respect to the series (or series LLC).

To date, the use of series LLCs by private equity funds and hedge funds has been limited. Now that the IRS has provided guidance relating to their treatment for U.S. tax purposes, increased use of series LLCs is likely to be seen. For example, series LLCs could be used by investment funds as a substitute for creating multiple parallel fund entities designed to accommodate the needs of different classes of investors.

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