NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON

PROPOSED REGULATIONS CONCERNING SERIES ORGANIZATIONS

AUGUST 5, 2011

Table of Contents

Page

Introduction 1

I. Principal Recommendations 2

II. Background 5

III. Detailed Discussion 11

A. Formed Under Local Law 11

B. Potential Application to Incorporated Entities 15

C. Protective and Deemed Elections 16

D. Treatment of Series Organizations 19

E. Grandfather Rule 20

F. Other Foreign Series Organizations 23

G. Information Statements 24

H. Employment Tax and Employee Benefits Issues 28

Appendix 33

Report No. 1245

NEW YORK STATE BAR ASSOCIATION TAX SECTION

PROPOSED REGULATIONS CONCERNING SERIES ORGANIZATIONS

Introduction

This report[1] of the New York State Bar Association Tax Section provides comments on regulations proposed on September 14, 2010, concerning the tax classification of certain series organizations (the "Proposed Regulations").[2] The Proposed Regulations address the federal tax classification of domestic series limited liability companies ("LLCs"), cells of domestic cell companies, and foreign series or cells that conduct an insurance business. Under the Proposed Regulations, for federal tax purposes, a series of a domestic series LLC, a cell of a domestic cell company, and a foreign series or cell that conducts an insurance business would be treated as a separate entity formed under local law.

Part I is a summary of the principal recommendations of this report. Part II contains background regarding the classification of series organizations and their series. Part III includes a detailed discussion of certain tax issues raised by the potential application of the Proposed Regulations to series organizations and their series.

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1 The principal author of this report is Matthew Lay. Significant contributions were made by Eric Sloan, Elizabeth Drigotas, and Emily Buchbinder. Helpful comments were received from Laura Barzilai, Bradley Borden, James Brown, Peter Canellos, Peter Connors, Stephen Foley, Edward Gonzales, Stephen Land, Alison Lee, Andrew Needham, Andrew Oringer, Michael Schler, David Schnabel, and W. Kirk Wallace. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

2 REG-119921-09, 75 Fed. Reg. 55699 (Sept. 14, 2010). Except as noted, this report does not address insurance tax issues raised by series organizations.

I. Principal Recommendations

The principal recommendations of this report are as follows:

1. The final regulations should amend Treas. Reg. § 301.7701-1(a)(3) to provide that an entity recognized under local law ordinarily is treated as a separate entity for federal tax purposes, subject to the application of general tax principles, such as the substance over form doctrine.[3]

2. The final regulations should clarify whether the treatment of series of stock in a corporation is within the scope of the regulations, and, if so, how the regulations interact with other provisions, such as section 851(g).

3. With respect to tax elections for a series organization and each of its series,

   a. Form 8832 (*Entity Classification Election*) should be modified to permit taxpayers to file protective elections that cover both a series organization and all of its series in order to remove any doubt regarding the classification of the combined entity in the event that the separate series are later found not to be separate entities.

   b. Taxpayers should be permitted to file other protective elections, such as elections under sections 174, 475, 754, 864(f), 953(c)(3), 953(d), and 1295(b), that cover both a series organization and all of its series in order to remove any doubt regarding the taxation of the combined entity in the event that the series later are found not to be separate entities.

4. Examples should be added to the final regulations to illustrate the operation of the regulations to situations in which the series organization (i) is the owner of one or more series or (ii) owns no assets and conducts no activities independent of its series.

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[3] Unless indicated otherwise, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code, both as in effect on the date of this report.

5. The grandfather rule should be modified so that --

    a. The grandfather rule applies to series that are formed on or before the date on which final regulations are published; and

    b. The requirement in Prop. Treas. Reg. § 301.7701-1(f)(3)(ii)(A)(*4*) applies only to the grandfathered entities within a series organization.

6. The final regulations should indicate that, for periods before the final regulations are published, the Internal Revenue Service (the "IRS") will not challenge the treatment of two or more series in a series organization as a single entity, provided that there was a reasonable basis for that treatment, regardless of whether a particular series remains in existence on the effective date of the final regulations.

7. In the future, regulations should provide that similar principles apply to foreign series organizations, regardless of whether those organizations conduct insurance businesses.

8. With respect to the information statements required under the Proposed Regulations,

    a. The final regulations generally should require that those statements be provided when other returns with respect to the series are filed (and, if a return is required with respect to the series organization, when that return is filed).

    b. In the case of a domestic series organization, the contents of the information statements required under the Proposed Regulations generally should not duplicate information already required to be filed by the series organization and its owners.

    c. In the case of a foreign series organization that is not required to file a U.S. return, the information statements required under the Proposed Regulations should be attached to returns for the U.S. owners of the series and/or the series organization and generally should not duplicate information already required to be filed by those owners.

9. Existing tax principles generally should be applied to resolve employment tax and employee benefits issues involving series organizations.

10. The Treasury Department ("Treasury") and the IRS should consider issuing guidance in the future specifying circumstances under which

related corporate and passthrough entities are permitted to establish arrangements under which a single entity processes employment tax reporting and withholding for those entities with respect to concurrent employees, similar to arrangements currently allowed under section 3121(s) for arrangements among related corporations.

II. Background

On January 15, 2008, the IRS issued Revenue Ruling 2008-8,[4] which provided guidance for determining when a transaction between a risk protection buyer and an individual "cell" of a "protected cell company" would constitute insurance for federal income tax purposes. At the same time, the IRS issued Notice 2008-19,[5] which requested comments on a number of issues, including what guidance would be appropriate for similar segregated arrangements that do not involve insurance.[6]

In general, the principal advantage of forming series organizations is administrative convenience. Series organizations generally enable taxpayers to form a single entity under local law to make multiple investments or engage in multiple activities. Although domestic and foreign series organizations have been in existence for some time, there was little guidance before 2008 (other than authorities regarding multiple series of business trusts)[7]

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4 2008-1 C.B. 340. *See also* Notice 2005-49, 2005-2 C.B. 14 (requesting comments on arrangements that qualify as insurance for tax purposes).

5 2008-1 C.B. 366.

6 On May 2, 2008, the New York State Bar Association Tax Section submitted a letter in response to that request. *NYSBA Members Comment on Protected Cell Company Guidance*, 2008 TNT 88-17 (May 6, 2008) (New York State Bar Association, Tax Section Letter No. 1154, Notice 2008-19 and Protected Cell Companies Outside of the Insurance Arena). In that letter, we recommended that the rules addressing protected cell companies in the insurance context be identical to those for similar arrangements not involving insurance. We also suggested that the IRS and Treasury issue guidance establishing a safe harbor under which a cell of a protected cell company could qualify as a separate entity for federal income tax purposes. The letter provided several examples illustrating ways in which those safe harbor provisions could operate. *See also American Bar Association Members Request Guidance on Series LLCs*, 2009 TNT 2-56 (Jan. 6, 2009) (American Bar Association Section of Taxation, Comments in Response to Notice 2008-19) (generally recommending guidance confirming that each series of a series LLC is a separate entity, assuming that certain minimum requirements are satisfied).

7 *See, e.g., National Securities Series-Industrial Stock Series v. Commissioner*, 13 T.C. 884 (1949), *acq.*, 1950-1 C.B. 4 (treating a series in a business trust as a separate entity for tax purposes); PLR 200303017 (Sept. 30, 2002) (treating series formed under a trust as multiple taxpayers); PLR 9847013 (Aug. 20, 1998) (concluding that each series trust established under a single trust instrument is properly treated as a separate entity for federal income tax purposes where the creditors of one series may not reach the assets of any other series); and PLR 9837005 (June 9, 1998) (concluding that two series of a master trust are separate entities for federal income tax purposes).

regarding whether those entities should be treated as one entity, or as more than one entity, for U.S. federal income tax purposes.[8]

On September 14, 2010, Treasury and the IRS issued the Proposed Regulations. Under the Proposed Regulations, a series organization is defined as a juridical entity that establishes and maintains, or under which is established and maintained, a series.[9] The Proposed Regulations provide that a series organization includes a series limited liability company, a series partnership, series trust, protected cell company, segregated cell company, segregated portfolio company, or segregated account company.[10]

A series is defined as a segregated group of assets and liabilities that is established pursuant to a series statute by agreement of a series organization.[11] A series includes a cell, segregated account, or segregated portfolio, including a cell, segregated account, or segregated portfolio, that is formed under the insurance code of a jurisdiction or is engaged in an insurance business.[12] The Proposed Regulations apply to a series organized under the laws of a foreign

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8 In PLR 200803004 (Oct. 15, 2007), the IRS concluded that each series of a domestic LLC constituted a separate entity for federal tax purposes where each series of the LLC consisted of a separate pool of assets and liabilities; the shareholders of a series of the LLC shared only in the income of that series; the shareholders of a series of the LLC were limited to the assets of that series upon redemption, liquidation, or termination of that series; the payment of the expenses, charges, and liabilities of a series of the LLC were limited to the assets of that series; the claims of creditors of a series of the LLC were limited to the assets of that series; and each series of the LLC had its own investment objectives, policies, and restrictions. *See also* PLR 200024024 (Mar. 15, 2000) (ruling that a *fonds commun de placement* with three sub-funds was a business entity eligible to elect its classification under Treas. Reg. § 301.7701-3; the ruling arguably implies, at least in the situation presented, that the umbrella fund and its three sub-funds should be treated as a single entity); PLR 200733003 (May 18, 2007) (a partnership, which apparently was a series in a series LLC, was granted an extension of time to elect out of the installment method under section 453).

9 Prop. Treas. Reg. § 301.7701-1(a)(5)(viii)(A).

10 *Id.*

11 Prop. Treas. Reg. § 301.7701-1(a)(5)(viii)(C). The preamble provides that "[t]he term 'series' does not include a segregated asset account of a life insurance company, which consists of all assets the investment return and market value of which must be allocated in an identical manner to any variable life insurance or annuity contract invested in any of the assets. Such an account is accorded special treatment under subchapter L." 75 Fed. Reg. 55699, 55702 (Sept. 14, 2010).

12 Prop. Treas. Reg. § 301.7701-1(a)(5)(viii)(C).

country only if the entity would be classified as an insurance company under section 816(a) or 831(c) had it been formed as a domestic company.[13]

A series statute exists in a state or foreign jurisdiction if the statute "explicitly provides for the organization or establishment of a series of a juridical person and explicitly permits (1) members or participants 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."[14] An election, agreement, or other arrangement that permits debts and liabilities of other series or the series organization to be enforceable against the assets of a particular series, or a failure to comply with the recordkeeping requirements for the limitation on liability available under the relevant series statute, will be disregarded.[15]

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[13] Prop. Treas. Reg. § 301.7701-1(a)(5)(ii). *Cf.* Treas. Reg. § 301.7701-2(b)(4) (providing that an "insurance company" is a *per se* corporation without expressly defining the term "insurance company").

[14] Prop. Treas. Reg. § 301.7701-1(a)(5)(viii)(B)(*1*) through (*3*).

[15] Prop. Treas. Reg. § 301.7701-1(a)(5)(viii)(C). It could be argued that the Proposed Regulations go too far in disregarding a failure to comply with certain requirements, such as recordkeeping under the Delaware statute, in determining whether a series is treated as a separate local law entity. The Proposed Regulations, for example, could have disregarded such failures only if those failures would not result in the entity's assets becoming subject to the claims of creditors of the other series. If this were the case, however, taxpayers, the IRS, and courts would need to determine the precise effect of such failures under local (nontax) law, even if no creditors of other series actually have made claims against a particular series. We believe that disregarding such failures in all cases, as the Proposed Regulations would, is a more administrable rule. Thus, we agree with the statement in the preamble that the approach of the Proposed Regulations "is preferable to engaging in a case-by-case determination of the status of each series that would require a detailed examination of the terms of the relevant statute." 75 Fed. Reg. 55699, 55703 (Sept. 14, 2010).

The Proposed Regulations provide that, for federal tax purposes, the ownership of interests in a series, as well as the ownership of the assets associated with a series, is to be determined under general tax principles.[16]

The Proposed Regulations would require each series and series organization to file a statement every year.[17] According to the preamble, the statement may include information on the series or series organization, such as its name, address, taxpayer identification number, the jurisdiction in which the series organization was formed, and information regarding ownership and title to assets.[18] Under the Proposed Regulations, this statement would be due in all cases by March 15 of each year.[19] The Proposed Regulations contain no provision for extending that date.

The regulations generally would apply on the date the final regulations are published in the Federal Register.[20] In situations in which a taxpayer is treating a series differently from the treatment required by the final regulations, the taxpayer will be required to change the treatment of that series to conform to the regulations.[21] For example, a series organization that previously was treated as a single entity with all of its series may be required to begin treating each series as a separate entity for federal tax purposes. General tax principles will determine the consequences of the conversion from a single entity to multiple entities. Thus, for example, in a situation in which a series organization had been treated by its owners as a partnership for federal tax purposes, but is required under the final regulations to be treated as

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16 Prop. Treas. Reg. § 301.7701-1(a)(5)(vi).

17 Prop. Treas. Reg. § 301.6011-6(a).

18 75 Fed. Reg. 55699, 55705 (Sept. 14, 2010).

19 Prop. Treas. Reg. § 301.6071-2(a).

20 Prop. Treas. Reg. § 301.7701-1(f)(3)(i).

21 75 Fed. Reg. 55699, 55706 (Sept. 14, 2010).

multiple partnerships for federal tax purposes, the division of the partnership may be tax-free under sections 721(a) and 731, although the division may result in gain recognition under section 704(c)(1)(B) or section 737.[22] Likewise, where a series organization had been treated by its owners as a corporation for federal tax purposes, the final regulations may require it to be treated as multiple entities for federal tax purposes. This division may be tax-free to the corporation and its shareholders under section 355; if, however, the corporate division does not satisfy one or more of the requirements of section 355, the division may be taxable to the corporation, its shareholders, or both.[23]

The regulations provide one exception to the effective date rule for series established before the Proposed Regulations were issued. If the requirements for the exception are satisfied, the series organization and the series may continue to be treated together as one entity for federal tax purposes after issuance of the final regulations. The requirements for the exception are satisfied if:

> (1) The series was established before September 14, 2010;
>
> (2) The series (independent of the series organization or other series of the series organization) conducted business or investment activity or, in the case of a series established pursuant to a foreign statute, more than half the business of the series was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies, on and prior to September 14, 2010;
>
> (3) If the series was established pursuant to a foreign statute, the classification of the series was relevant (as defined in [Treas. Reg.] § 301.7701-3(d)), and more than half the business of the series was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies for all taxable years beginning with the taxable year that includes September 14, 2010;

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22 *Id.*

23 *Id.*

(4) No owner of the series treats the series as an entity separate from any other series of the series organization or from the series organization for purposes of filing any federal income tax returns, information returns, or withholding documents for any taxable year;

(5) The series and series organization had a reasonable basis (within the meaning of section 6662) for their claimed classification; and

(6) Neither the series nor any owner of the series nor the series organization was notified in writing on or before the date final regulations are published in the Federal Register that the classification of the series was under examination (in which case the classification of the series will be determined in the examination).[24]

This exception will cease to apply on the date any person or persons who were not owners of the series organization (or series) before September 14, 2010 own, in the aggregate, a 50 percent or greater interest in the series organization (or series).[25] For this purpose, the term "interest" means (i) in the case of a partnership, a capital or profits interest and (ii) in the case of a corporation, an equity interest measured by vote or value.[26] According to the preamble, this exception does not apply to any determination other than the entity status of a series.[27] Thus, for example, this exception does not apply to the determination of the tax ownership of a series or series organization or the qualification of a series or series organization conducting an insurance business as a controlled foreign corporation.[28]

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24 Prop. Treas. Reg. § 301.7701-1(f)(3)(ii)(A)(*1*) through (*6*).

25 Prop. Treas. Reg. § 301.7701-1(f)(3)(ii)(B).

26 Prop. Treas. Reg. § 301.7701-1(f)(3)(ii)(B)(*1*) and (*2*).

27 75 Fed. Reg. 55699, 55706 (Sept. 14, 2010).

28 *Id.*

The Proposed Regulations do not address how series organizations will be treated for federal employment tax purposes.[29] Comments were requested on this issue, as well as on how the regulations will affect how a series should be treated for state employment tax purposes and other state employment-related purposes.

III. Detailed Discussion

We generally agree with the approach of the Proposed Regulations, which would provide needed clarity to transactions and structures that have become increasingly common, as well as rules that generally are in accordance with the conclusions that most practitioners have reached regarding these organizations.[30] This Part III includes a detailed discussion of certain tax issues raised by the potential application of the Proposed Regulations to series organizations and their series.

A. Formed Under Local Law

As discussed below, we recommend that the final regulations should amend Treas. Reg. § 301.7701-1(a)(3) to provide that an entity recognized under local law ordinarily is treated a separate entity *for federal tax purposes*, subject to the application of general tax principles, such as the substance over form doctrine.

The preamble to the Proposed Regulations cites *Moline Properties, Inc. v. Commissioner*[31] for the proposition that, "so long as a corporation was formed for a purpose that

[29] Prop. Treas. Reg. § 301.7701-1(a)(5)(ix) (reserving on the treatment of series and series organizations under Subtitle C – Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24 and 25 of the Internal Revenue Code)).

[30] We note that whether an arrangement should be characterized as one entity, more than one entity, or something other than an entity for federal tax purposes is a fundamental question that must be answered in many different contexts. As the preamble to the Proposed Regulations notes, the series of a series organization possess some, but not all, of the attributes of a regular entity formed under local law. We believe that the Proposed Regulations appropriately provide simple and administrable rules that are narrowly tailored to address the specific issues raised by series organizations, which may not be appropriate to apply in other situations.

[31] 319 U.S. 436 (1943).

is the equivalent of business activity or the corporation actually carries on a business, the corporation remains a taxable entity separate from its shareholders."[32] The preamble also notes that the Supreme Court, in *Commissioner v. Culbertson*[33] and *Commissioner v. Tower*,[34] "set forth the basic standard for determining whether a partnership will be respected for federal tax purposes."[35] As noted in the preamble, however, Treas. Reg. § 301.7701-1(a)(1) provides that 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. Thus, the preamble properly concludes that "[a]lthough 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."[36] Similarly, the preamble states that, "[i]n 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."[37]

Conversely, consistent with Treas. Reg. § 301.7701-1(a)(1), the preamble goes on to acknowledge that "arrangements that are not recognized as entities under state law may be

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32 75 Fed. Reg. 55699, 55700 (Sept. 14, 2010).

33 337 U.S. 733 (1949).

34 327 U.S. 280 (1946).

35 75 Fed. Reg. 55699, 55700 (Sept. 14, 2010).

36 *Id.* (citing *Bertoli v. Commissioner*, 103 T.C. 501 (1994) and *Aldon Homes, Inc. v. Commissioner*, 33 T.C. 582 (1959)).

37 *Id.* (citing *Madison Gas & Elec. Co. v. Commissioner*, 633 F.2d 512, 514 (7th Cir. 1980); *Luna v. Commissioner*, 42 T.C. 1067, 1077-78 (1964)).

treated as separate entities for federal tax purposes."[38] Indeed, as the preamble notes, "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."[39]

The preamble observes that all of the series LLC statutes contain provisions that grant series certain attributes of separate entities, but that all of the state statutes limit the powers of series of series LLCs.[40] After discussing series statutes regarding insurance, the preamble describes the basic rule of the Proposed Regulations as providing that "for federal tax purposes, a domestic series, whether or not a juridical person for local law purposes, is treated as an entity formed under local law."[41] After clarifying the applicability of this rule to foreign series organizations that are engaged in an insurance business, the preamble describes the intended effect of the basic rule as follows:

> Whether a series that is treated as a local law entity under the proposed regulations is recognized as a separate entity for federal tax purposes is determined under [Treas. Reg.] § 301.7701-1 and general tax principles. The proposed regulations further provide that the classification of a series that is recognized as a separate entity for federal tax purposes is determined under [Treas. Reg.] § 301.7701-1(b), which provides the rules for classifying organizations that are recognized as entities for federal tax purposes.[42]

We agree with the general discussion of *Moline*, *Culbertson*, and *Tower* in the preamble. We also agree with the description of Treas. Reg. § 301.7701-1(a), which provides

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38 *Id.* (citing Treas. Reg. § 301.7701-1(a)(2)).

39 *Id.* (citing *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)).

40 75 Fed. Reg. 55699, 557001-02 (Sept. 14, 2010).

41 75 Fed. Reg. 55699, 55702 (Sept. 14, 2010).

42 *Id.*

that (i) the determination of whether an organization is an entity separate from its owners for federal tax purposes does not depend on whether the organization is recognized as an entity under local law, and (ii) arrangements that are not recognized as entities under state law may be treated as separate entities for federal tax purposes.[43]

We believe, however, that the basic rule stated in the Proposed Regulations – that a domestic series "is treated as an entity formed under local law" – does not provide the guidance intended by the Proposed Regulations.[44] Specifically, while it is true, as the preamble states, that "entities that are recognized under local law generally are also recognized for federal tax purposes,"[45] there is no similar statement in the current regulations under section 7701 or in the Proposed Regulations, and the language in the preamble is not a part of the actual regulations.[46] Consequently, a taxpayer that applies the basic rule stated in the Proposed Regulations, causing each series to be treated as an entity under local law, could have trouble determining its tax classification, because the regulations under section 7701 specifically provide that "the

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43 While, under Treas. Reg. § 301.7701-1(a)(3), an entity formed under local law is not always recognized as a separate entity for federal tax purposes, we believe that determining whether an entity is recognized as a separate entity for federal income tax purposes generally requires analyzing whether the party or parties have taken steps under local law to separate certain activities from the activities of the party or parties. This separation can be accomplished by entering into an arrangement provided for under local law, such as a domestic corporation or limited liability company (the "Entity-by-Attribute Approach"). In Rev. Rul. 2004-86, 2004-2 C.B. 191, the IRS applied an analysis similar to the Entity-by-Attribute Approach in concluding that a state law trust was an entity separate from its owners for U.S. federal tax purposes. In addition, based on the preamble to the Proposed Regulations, it appears that Treasury and the IRS applied a similar analysis in determining that series of series organizations generally should be treated as entities for federal tax purposes. If an arrangement does not satisfy the Entity-by-Attribute Approach, a determination of whether the arrangement should be treated as an entity for U.S. federal tax purposes may also be made by assessing whether the activities of the parties (including contractual arrangements – binding under local law – that govern those activities) give rise to an entity under the principles of Treas. Reg. § 301.7701-1(a)(2) and related judicial and administrative guidance, such as *Culbertson*, *Tower*, and *Luna* (the "Entity-by-Activity Approach").

44 *See* Jasper Cummings, *Ownership, Series, and Cells*, 2010 TNT 234-9 (Dec. 7, 2010) ("The peculiar aspect of the proposed regulations is that their sole function is to say when cells can be treated as entities formed under local law without ever defining the meaning of an entity formed under local law and while contending that whether the organization is a local law entity is irrelevant for identifying federal tax entities.").

45 75 Fed. Reg. 55699, 55700 (Sept. 14, 2010).

46 Others have noted this shortcoming in the current regulations. *See* Cummings, *supra* note 44 ("The current regulations imply but do not state that the normal rule is that a local law entity will be treated as a federal tax entity with limited exceptions ...").

determination of whether an organization is an entity separate from its owners for federal tax purposes *does not depend* on whether the organization is recognized as an entity under local law."[47] As a result, the basic rule as drafted may not have its intended effect, which seems to be for each series in a series organization generally to be treated as a separate entity *for federal tax purposes*.[48]

Therefore, we recommend that, when the Proposed Regulations are finalized, they amend Treas. Reg. § 301.7701-1(a)(3) to provide that an entity recognized under local law ordinarily is treated as a separate entity *for federal tax purposes*, subject to the application of general tax principles, such as the substance over form doctrine.[49] Such an amendment would conform the text of the regulations to the manner in which most practitioners apply them in light of *Moline* and *Culbertson.*

B. Potential Application to Incorporated Entities

In *Union Trusteed Funds, Inc. v. Commissioner*,[50] the Tax Court effectively treated a series fund organized as a domestic corporation as a single entity for federal income tax purposes, notwithstanding the complete segregation of its assets among various fund portfolios. The taxpayer was a Delaware corporation operating as a regulated investment company under

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47 Treas. Reg. § 301.7701-1(a)(1) (emphasis added).

48 Because the basic rule in the Proposed Regulations and Treas. Reg. § 301.7701-1(a)(3) are in tension with each other, it is unclear how, or whether, courts would apply case law involving the tax classification of entities actually formed under local law to series that are *deemed* to be entities formed under local law for tax purposes.

49 *Cf.* Treas. Reg. § 1.704-1(b)(1)(iii) (an allocation that is respected under section 704(b) may be reallocated under other provisions). We also recommend that Treasury and the IRS consider specifying in future guidance the criteria for determining when arrangements generally are treated as entities formed under local law (outside of the series organization context). For example, future guidance could provide that an entity should be treated as formed under local law if (i) the applicable statute provides that the arrangement is a separate entity, (ii) one or more members has limited liability for the obligations of the arrangement, (iii) the entity survives in perpetuity, (iv) the entity can sue or be sued, (v) the entity can hold property in its own name, or (vi) the entity either can or must file with the state to come into existence. *See supra* note 43. We do not believe, however, that it is necessary to identify these criteria before finalizing the Proposed Regulations.

50 8 T.C. 1133 (1947), *acq.*, 1947-2 C.B. 4.

the predecessor to section 851. In 1986, section 851(g) was added to the Code to overrule this result.[51] Section 851(g) applies to corporations that are registered investment companies and treats series funds as separate corporations.[52]

The definition of a series statute in the Proposed Regulations is broad enough to include incorporated entities in which multiple classes of shares are issued, provided that the statute under which those entities are formed explicitly permits the segregation of assets and liabilities held or incurred by each series.[53] Although section 851(g) is mentioned in the preamble to the Proposed Regulations, we assume that the Proposed Regulations were not intended to apply to incorporated entities. We recommend that the final regulations clarify whether the treatment of series of stock in a corporation is within the scope of the regulations, and, if so, how the regulations interact with other provisions, such as section 851(g).

C. Protective and Deemed Elections

As noted above, under the Proposed Regulations, whether a series that is treated as a local law entity is recognized as a separate entity for federal tax purposes is determined

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51 Tax Reform Act of 1986, Pub. L. No. 99-514, § 654(a), 100 Stat. 2085 (1986).

52 For this purpose, the term "fund" means "a segregated portfolio of assets, the beneficial interests in which are owned by the holders of a class or series of stock of the regulated investment company that is preferred over all other classes or series in respect of such portfolio of assets." Section 851(g)(2). For a more detailed discussion of *Union Trusteed Funds* and section 851(g), *see* Stephen Land, *Entity Identity: The Taxation of Quasi-Separate Enterprises*, 63 Tax Law. 99 (Fall 2009).

53 For an example of a state statute that explicitly provides for segregation of assets and liabilities within a corporation that issues multiple classes or series of stock, see Md. Code Ann., [Corps. & Ass'ns] § 2-208.2 (2011), which provides as follows:

> § 2-208.2. Enforcement of debts, liabilities and obligations of a particular class or series of stock
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> If the charter of a corporation registered as an investment company under the Investment Company Act of 1940 creates one or more classes or series of stock, and if separate and distinct records are maintained for the class or series and the assets associated with the class or series are held and accounted for separately from the other assets of the corporation, or assets associated with any other class or series:
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> (1) The debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to a particular class or series are enforceable against the assets associated with that class or series only, and not against the assets of the corporation generally or any other class or series of stock; and
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> (2) The debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to the corporation generally or associated with any other class or series are not enforceable against the assets associated with that class or series.

under Treas. Reg. § 301.7701-1 and general tax principles. A series that is treated as a separate entity for tax purposes may make any federal tax elections it is otherwise eligible to make independently of other series or the series organization itself, regardless of whether other series (or the series organization) make that election or make different elections.[54]

Because general tax principles cannot provide a bright line test for determining whether multiple series are combined with other series or with the series organization, there may be some business arrangements that make it difficult for taxpayers to determine with a high degree of certainty the proper treatment of the series of a series organization for federal tax purposes. This uncertainty is most difficult for foreign series that are not within the scope of the Proposed Regulations because the series are not engaged in an insurance business. In these situations, we recommend that taxpayers be permitted to file a protective election.

For example, a taxpayer may believe that each series in a series organization is a separate entity under current law, but recognizes that there is risk that the various series could be treated as a single entity for tax purposes. Assume that a foreign series organization that is not engaged in an insurance business has two series, A and B, and that the parties believe that each series is a separate entity for federal tax purposes.[55] Assuming that all of the owners of A and B have limited liability, the default classification of A and B would be as corporations if they are separate entities. The taxpayer files separate entity classification elections for each series, electing for them to be classified as partnerships effective on the dates on which the respective series are formed.

[54] 75 Fed. Reg. 55699, 55704 (Sept. 14, 2010).

[55] As noted below, many foreign jurisdictions have enacted legislation authorizing the formation of series organizations that do not conduct insurance business.

In this case, if A and B were properly treated as a single entity for federal tax purposes, the default classification of the combined entity would be as a corporation, because all of the owners of A and B have limited liability. For the combined entity to be classified as a passthrough entity, it arguably may have been necessary to have filed an entity classification election for the combined entity.[56] We recommend that, in these situations, taxpayers be permitted to file a protective election for the combined entity.

Note that if each series is a separate entity, each series is responsible for its own tax elections, such as section 168 depreciation elections, elections to amortize research and development expenses under section 174, mark-to-market elections under section 475, basis adjustment elections under section 754, interest allocation elections under section 864(f), elections to treat income as effectively connected under section 953(c)(3)(C), elections to be treated as a domestic insurance company under 953(d), or qualified electing fund elections under section 1295(b). In these situations as well, we recommend that taxpayers be permitted to file protective elections for the combined entity.[57]

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[56] If all of the series in a series organization elect to be classified (i) as passthrough entities (*i.e.*, partnerships or disregarded entities ("DREs")), or (ii) as corporations, and the series are later determined to be a single entity for federal tax purposes, Treasury and the IRS should consider issuing future guidance addressing the circumstances, if any, under which the combined entity would be deemed to have made a similar election. We do not believe, however, that this guidance would need to be issued when the Proposed Regulations are finalized. Consider, for example, a foreign series organization with three series. Each series has two or more owners, all of which have limited liability, and defaults to corporate status. The taxpayer believes that each series is classified as a separate entity and timely files an entity classification election for each series to be classified as a partnership effective on the date of the formation of each series. It should be noted that, if the series are later found to comprise a single entity, future guidance could indicate whether that entity would be deemed to have elected to be classified as a partnership on the first date on which any of the entities had made such an election, whether under the substantial compliance doctrine, the doctrine of elections, or otherwise. Future guidance also could indicate whether the result would be different if only two of the series elected to be partnerships, or if a partnership election for one of the series was not effective on the date of the formation of that series. It should be noted that, if the combined entity is not deemed to have elected to be classified as a partnership, the taxpayer may qualify for late election relief under Treas. Reg. §§ 301.9100-1 through -3.

[57] If some or all of the series in a series organization make federal tax elections, and the series are later determined to be a single entity for federal tax purposes, Treasury and the IRS may wish to consider issuing future guidance addressing the circumstances, if any, under which the combined entity would be deemed to have made a similar election. We do not believe, however, that this guidance would need to be issued when the Proposed Regulations are finalized. Consider, for example, a series organization that has three series, each of which has two

D. **Treatment of Series Organizations**

The examples in the Proposed Regulations are helpful. We would suggest including additional examples to provide further guidance.

For example, we recommend that the examples in the final regulations include a fact pattern in which the domestic series organization is the owner of a series.[58] In this situation, we believe that the series would be classified as a DRE, and the series organization would be classified under the normal entity classification rules.[59] We understand that this was the intention of the drafters of the Proposed Regulations. (A draft example is included in the Appendix.)

In addition, the preamble to the Proposed Regulations requested comments regarding whether a series organization should be recognized as a separate entity for federal tax

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or more owners. The taxpayer believes that each series is classified as a separate entity classified as a partnership, and each series makes an election under section 754 effective for its first taxable year. If the series are later found to comprise a single entity, future guidance could indicate whether that entity would be deemed to have made a section 754 election and, if so, the effective date of that election. Future guidance also could indicate whether the result would be different if only two of the series made that election. Once again, it should be noted that, if the combined entity is not deemed to have made a particular tax election, the combined entity may qualify for late election relief under Treas. Reg. §§ 301.9100-1 through -3.

[58] As noted above, the Proposed Regulations provide that, for federal tax purposes, the ownership of interests in a series and of the assets associated with a series is determined under general tax principles. It would be helpful if the final regulations included guidance on the factors that are relevant to this analysis. For example, Treas. Reg. § 1.704-1(e)(2)(vi) provides that, in determining whether the donee of a capital interest in a partnership is the owner of the interest, consideration must be given to whether the donee actually is treated as a partner in the operation of the business. In this regard, whether the donee has been held out publicly as a partner in the conduct of the business, in relations with customers, or with creditors or other sources of financing, is of primary significance. Other factors of significance include: (a) compliance with local partnership, fictitious names, and business registration statutes; (b) control of business bank accounts; (c) recognition of the donee's rights in distributions of partnership property and profits; (d) recognition of the donee's interest in insurance policies, leases, and other business contracts and in litigation affecting the business; (e) the existence of written agreements, records, or memoranda, contemporaneous with the taxable year or years concerned, establishing the nature of the partnership agreement and the rights and liabilities of the partners; and (f) filing of partnership tax returns as required by law. Note that the IRS generally will not issue rulings regarding who is the true owner of property or the true borrower of money in cases in which the formal ownership of the property, or the liability for the indebtedness, is in another party. Rev. Proc. 2011-3, 2011-1 I.R.B. 111, § 4.01(3).

[59] *See* Carter G. Bishop, *Tax Classification Appears in Rear View*, 2011 TNT 12-6 (Jan. 19, 2011) (concluding that where a domestic series organization with multiple owners is the sole owner of each of its series, the series organization should be classified as a partnership, provided the series organization does not elect to be classified as a corporation, and each series should be classified as a DRE).

purposes if it has no assets and engages in no activities independent of its series. We recommend that the final regulations provide that, in these cases, the series organization should not be regarded as a separate entity.[60] In contrast, if a series organization has assets or engages in activities independent of its series, the final regulations should clarify that the series organization is permitted to elect its tax classification. (A draft example is included in the Appendix.)

E. Grandfather Rule

The Proposed Regulations include an exception (in the nature of a grandfather rule) for series established before publication of the Proposed Regulations that treats all series and the series organization as one entity.[61] If the requirements for this exception are satisfied, the series may continue to be treated together with the series organization as one entity for federal tax purposes after issuance of the final regulations. One of these requirements is that the series must have been established before September 14, 2010, the date on which the Proposed Regulations were published (the "Pre-September 14 Limitation").

Series organizations have been used for many years. Until the Proposed Regulations were published, however, there was little guidance concerning their classification. Because the grandfather rule does not apply to series formed on or after September 14, 2010, any series formed between September 14, 2010 and the date on which final regulations are published will be treated as separating from the remaining series when the Proposed Regulations are finalized. As the preamble notes, this separation could have adverse tax consequences.

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60 *See generally ABA Tax Section Recommends Revisions to Proposed Regulations on Series LLCs and Cell Companies*, 2011 TNT 84-72 (May 2, 2011) (reprinting comments from the American Bar Association Tax Section (the "2011 ABA Comments") recommending that the final regulations provide that a series organization that has (i) no more than a de minimis amount of assets for administrative costs pending reimbursement or activities other than those undertaken on behalf of its series and (ii) not elected to be classified as a corporation may, depending upon the particular facts and circumstances, be treated as a mere title holding or nominee arrangement and not recognized as a separate entity for federal tax purposes).

61 Prop. Treas. Reg. § 301.7701-1(f)(3)(ii)(A).

Many returns have been filed, and will be filed, for taxable years ending in 2010 regarding series that potentially could be affected by the deemed separation that could result from the Pre-September 14 Limitation. We do not believe it is equitable to require taxpayers to file those returns based on their expectations of what the final regulations may provide as opposed to what they believe the law to be today. In addition, the Pre-September 14 Limitation could place taxpayers in very difficult situations, as illustrated by the following example.

> **Example 1**. A series LLC is formed in Delaware in 2001. In each of the years 2001 through 2010, LLC forms two new series, so that, as of January 1, 2010, LLC has 18 series (series A through R). For 2001 through 2009, LLC and series A through R were treated as a single partnership for U.S. federal income tax purposes. In 2010, new series (series S) is formed on September 13, 2010, and another new series (series T) is formed on September 14, 2010. Series T has two owners, and no entity classification elections are filed for any of the series. Thus, on the last day of 2010, LLC has 20 series, 19 of which (A through S) were established before September 14, 2010 and qualify for the exception under the grandfather rule. Series T, however, would not qualify for the grandfather rule contained in the Proposed Regulations. LLC nevertheless reasonably believes that, consistent with LLC's historic treatment of series formed before September 14, series T should be treated as part of the single partnership of which LLC and series A through S are parts, but LLC believes that if the Proposed Regulations are finalized as drafted, series T likely will be treated as a separate entity for federal tax purposes.

This example highlights a number of issues. First, the grandfather rule creates dilemmas for existing series organizations. In Example 1, there may be adverse tax consequences in the future for LLC and its members if LLC treats all 20 series, including series T, as a single partnership, because, if the Proposed Regulations were finalized as proposed, series T could become treated as an entity separate from the other series. LLC may need to expend significant resources to determine whether such a division would result in taxable income under subchapter K. Moreover, LLC has no way of knowing when the Proposed Regulations will be finalized, what the final regulations will provide, or what the fair market value or adjusted basis of LLC's assets will be at that time.

Accordingly, LLC may decide to treat series T as a separate partnership for 2010, even though it reasonably believes that, consistent with LLC's historic treatment of series formed before September 14, series T should be treated as part of the single partnership of which LLC and series A through S are parts, and there may be no material differences between series T and the first 19 series, other than the dates on which they were formed. Treating series T as a separate entity, however, may make it impossible for *any* of LLC's series to qualify for the grandfather rule, because one of the requirements of the grandfather rule is that "[n]o owner of the series treats the series as an entity separate *from any other series* of the series organization or from the series organization for purposes of filing any federal income tax returns, information returns, or withholding documents for any taxable year" (the "Consistent Treatment Rule")[62] Thus, for example, series S might not qualify for the grandfather rule if any owner of series S treats series S as separate from series T on that owner's 2010 return.

Second, although the grandfather rule as proposed would allow the treatment of 19 series as a single partnership for periods *after* the date on which the Proposed Regulations are finalized, the Proposed Regulations do not specifically address the treatment of periods *before* that date. It would not seem to be appropriate for the IRS to challenge the treatment of series in a series organization in periods *before* the date on which final regulations are published in situations in which the grandfather rule would allow single entity treatment for periods *after* the date on which final regulations are published. We assume that the drafters of the proposed grandfather rule did not intend to allow or encourage such IRS challenges.

Accordingly, we recommend that the grandfather rule be modified so that it applies to series that are formed on or before the date on which *final* regulations are published.

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[62] Prop. Treas. Reg. § 301.7701-1(f)(3)(ii)(A)(*4*).

We also recommend that the Consistent Treatment Rule be modified so that it applies only to the grandfathered entities within a series organization. Thus, in Example 1, above, if series A through S were formed before the date on which the regulations are finalized, and series T were formed after that date, the owners of series A through S should be required to treat series A through S as a single partnership because they are grandfathered series, but should not be required to treat series T as a part of that partnership, because series T is not a grandfathered series.[63]

We also recommend that the final regulations indicate that, for periods before the final regulations are published, the IRS will not challenge the treatment of two or more series in a series organization as a single entity, provided that there was a reasonable basis for that treatment, regardless of whether a particular series remains in existence on the effective date of the regulations.[64]

F. Other Foreign Series Organizations

The preamble to the Proposed Regulations requests comments on the entity status for federal tax purposes of foreign series that do not conduct an insurance business, as well as

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63 If our recommendations are adopted, series organizations generally would not be treated as dividing on the effective date of the final regulations, but may later be treated as dividing if there is a sufficient change in ownership. As the preamble notes, dividing a single entity into more than one entity can result in the recognition of income. In particular, the requirements for a tax-free distribution under section 355 are very specific, and it is possible that many divisions would not satisfy those requirements unless those requirements are modified in connection with the issuance of final regulations. *See generally* the 2011 ABA Comments, *supra* note 60 (requesting that the government consider ways to make more certain the application of section 355 when a pre-existing series organization wants to operate under the new rules).

64 *Cf.* Treas. Reg. § 301.7701-2(d)(1) (providing that a foreign business entity that was in existence on May 8, 1996 generally will not be classified as a corporation under Treas. Reg. § 301.7701-2(b)(8)(i) provided that a reasonable basis existed for treating the entity as other than a corporation and certain other requirements are satisfied); Treas. Reg. § 301.7701-2(d)(3) (describing situations that terminate such an entity's grandfathered status). The grandfather rule of Treas. Reg. § 301.7701-2(d)(1) focuses on May 8, 1996, because the proposed entity classification regulations were issued on May 9, 1996. *See Proposed 'Check-the-Box' Regs Issued; Special Rules Provided for Foreign Entities, Single-Member Entities*, 96 TNT 93-1 (May 9, 1996). Although there are situations in which a regulation can be applied retroactively, or certain transactions may need to be halted by publishing guidance that is effective immediately, we do not believe that this approach is appropriate in the case of series organizations.

other tax consequences of establishing, operating, and terminating foreign cells. Many foreign jurisdictions have enacted legislation authorizing the formation of series organizations that do not conduct an insurance business.[65] We are not aware of any reason why the principles for determining whether series in such entities should be treated as separate entities would be different from the principles for domestic entities. Accordingly, we recommend that future regulations provide that similar principles apply to foreign series organizations, regardless of whether those organizations are engaged in an insurance business. We do not, however, recommend that the finalization of the Proposed Regulations be delayed while these future regulations are pending.[66]

G. Information Statements

The Proposed Regulations require that series and series organizations file statements ("Series Statements") to provide the IRS with certain identifying information to ensure the proper assessment and collection of tax.[67] The preamble indicates that this information may include (1) the name, address, and taxpayer identification number of the series organization and each of its series and status of each as a series of a series organization or as the series organization; (2) the jurisdiction in which the series organization was formed; and (3) an indication of whether the series holds title to its assets or whether title is held by another series or

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[65] *See generally* H. Karl Zeswitz, Jr. & William R. Pauls, *Almost a "Fall Classic": Proposed Treasury Regulations Leave a "Series" of Issues Unresolved*, TM Memorandum (BNA) Vol. 52 No. 05 (Feb. 28, 2011) (discussing undertakings for collective investments in transferable securities formed in the European Union); James M. Peaslee & Jorge G. Tenreiro, *Tax Classification of Segregated Portfolio Companies*, 117 Tax Notes 43 (Oct. 1, 2007) (containing a detailed example of a typical securities repackaging transaction involving a foreign segregated portfolio company and recommending that each series in a segregated portfolio company be classified as a separate entity).

[66] Future guidance on non-insurance foreign series organizations may need to be coordinated with further guidance regarding the technical taxpayer rules and new section 909. *See* Stephanie Hench, *Official Welcomes Comments on Annuity Contracts, Proposed Series LLC Regs*, 2010 TNT 188-6 (Sept. 29, 2010) (indicating that the IRS may be concerned about the "potential use by foreign companies of a series arrangement to separate foreign income from the related foreign tax credit").

[67] 75 Fed. Reg. 55699, 55705 (Sept. 14, 2010).

the series organization and, if held by another series or the series organization, the name, address, and taxpayer identification number of the series organization and each series holding title to any of its assets. We agree that it is reasonable for the IRS to require this information.

The preamble states that the IRS and Treasury also are considering the best time to require taxpayers to file the Series Statements. For example, the preamble states that the IRS and Treasury are considering whether the Series Statements should be filed when returns, such as income tax returns and excise tax returns, are required to be filed or whether the Series Statements should be stand-alone statements filed separately by a set date each year, as with information returns such as Form 1099.[68] In this regard, the Proposed Regulations under section 6071 provide that the Series Statement will be a stand-alone statement due March 15 of each year.[69] In addition, the preamble states that the IRS and Treasury are considering revising Form SS-4 (*Application for Employer Identification Number*) to include questions regarding series organizations.[70]

If the final regulations retain the requirement to file Series Statements, we recommend that Series Statements be filed when other returns are filed with respect to each series, as illustrated below. If a taxpayer requests an extension to file a particular return, the due date for the Series Statement should be extended as well. This would reduce the burden on taxpayers and likely would make it easier for the IRS to associate the information requested with the tax returns of the relevant taxpayers.

In the case of a domestic series organization, we recommend that the Series Statement generally should be filed (i) in the case of partnerships and corporations, with the

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68 75 Fed. Reg. 55699, 55705 (Sept. 14, 2010).

69 Prop. Treas. Reg. § 301.6071-2(a).

70 75 Fed. Reg. 55699, 55706 (Sept. 14, 2010).

returns that are prepared with respect to each series, and (ii) in the case of a DRE, with the return that is filed by its sole owner.[71]

> **Example 2.** A domestic series LLC has no assets or activities independent from its series. The LLC has three series (A, B, and C). A, which has five owners, elects to be classified as a corporation. B, which also has five owners, is classified as a partnership. C, which has only one owner (X, a U.S. taxpayer), is classified as a DRE owned by X. A is required to file Form 1120 (*U.S. Corporation Income Tax Return*), which would include A's name, address, and employer identification number. B is required to file Form 1065 (*U.S. Return of Partnership Income*), which would include B's name, address, and employer identification number. C is not required to file a U.S. return, but X is required to report on X's return the activities of C as though they were conducted directly by X. The series organization generally should not be treated as an entity and should not be required to file a return, because it has no assets or activities independent of its series.[72]

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[71] *See generally* Reducing Regulatory Burden; Retrospective Review Under E.O. 13563, 76 Fed. Reg. 17572 (Mar. 30, 2011) (requesting suggestions as to which Treasury regulations should be modified, expanded, streamlined, or repealed in order to make the regulations more effective, less burdensome, or both). The extent to which U.S. persons must report ownership interests in lower-tier entities varies widely depending on the type of return filed by that person. For example, Form 1065 (*U.S. Return of Partnership Income*) asks whether, at the end of the tax year, the partnership (a) owned directly 20 percent or more, or owned, directly or indirectly, 50 percent or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation, or (b) owned directly an interest of 20 percent or more, or owned, directly or indirectly, an interest of 50 percent or more in the profit, loss, or capital in any foreign or domestic partnership. If the partnership is required to file Form 8858 (*Information Return of U.S. Persons with Respect to Foreign Disregarded Entities*), the filer must state how many of these forms are attached to the return. Form 1120 (*U.S. Corporation Income Tax Return*) asks whether, at the end of the tax year, the corporation (a) owned directly 20 percent or more, or owned, directly or indirectly, 50 percent or more, of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on Form 851 (*Affiliations Schedule*), or (b) owned directly an interest of 20 percent or more, or owned, directly or indirectly, an interest of 50 percent or more, in any foreign or domestic partnership (including an entity treated as a partnership). Form 1040 (*U.S. Individual Income Tax Return*) asks the taxpayer to include items of income or loss from a business and attach further information regarding that income or loss on Schedule C. Form 1040 also instructs the taxpayer to list income from rental real estate, royalties, partnerships, S corporations, trusts, etc. and to attach further information regarding the nature of that income on Schedule E. On Form 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*), the filer is required to state whether the foreign corporation owned any foreign entities that were disregarded as entities separate from their owners under Treas. Reg. §§ 301.7701-2 and 301.7701-3. The form also asks whether, during the tax year, the foreign corporation owned at least a 10 percent interest, directly or indirectly, in any foreign partnership. On Form 8865 (*Return of U.S. Persons with Respect to Certain Foreign Partnerships*), filers are directed to list all partnerships (foreign or domestic) in which the foreign partnership directly or indirectly owns a 10 percent interest. The taxpayer also is asked to enter the number of Forms 8858 that are attached to the return.

[72] If the series organization were considered to be an entity, it generally would be classified as a partnership or a DRE unless an election were filed to classify the entity as a corporation. In that event, it may be required to file a return. *Compare* Treas. Reg. § 301.6031(a)-1(a)(3)(i) (a partnership with no income, deductions, or credits for federal income tax purposes for a taxable year is not required to file a partnership return for that year) *with* Treas. Reg. § 1.6012-2(a)(1) (a domestic corporation generally must file a U.S. tax return regardless of whether it has taxable income or the amount of its gross income).

On these facts, we recommend that the IRS and Treasury require the Series Statements to be filed only with the returns of A, B, and X.

Foreign series organizations are subject to different reporting requirements under current law.

> **Example 3**. A foreign cell company has no assets or activities independent from its cells. The cell company has three cells (A, B, and C). A, which has five owners (all of which are U.S. taxpayers), is classified as a corporation. B, which also has five owners (all of which are U.S. taxpayers), is classified as a partnership. C, which has only one owner (X, a U.S. taxpayer), is classified as a DRE owned by X. None of the cells has U.S. source income.
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> The foreign cell company (*i.e.*, the series organization) generally should not be treated as an entity and should not be required to file a U.S. return, because it has no assets or activities independent of its cells (or series).[73] Moreover, because the cells do not have U.S. source income, they generally would not be required to file U.S. returns. The U.S. owners of the cells, however, may be required to file returns with respect to A, B, and C on Form 5471 (*Information Return of U.S. Persons With Respect to Certain Foreign Corporations*), Form 8865 (*Return of U.S. Persons With Respect to Certain Foreign Partnerships*), and Form 8858 (*Information Return of U.S. Persons With Respect to Foreign Disregarded Entities*), respectively.

If A, B, and C are not otherwise required to file U.S. returns, we do not believe that the cell company or its cells should be required to file Series Statements. Rather, we recommend that the Series Statement should be attached to returns otherwise required to be filed by the cell company's U.S. owners. If one or more the U.S. owners would not be required to file Form 5471, Form 8865, or Form 8858 (because, for example, their ownership interests are very small), we do not believe that additional reporting should be required by those owners merely because the investment structure involves a series organization.

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73 If it were classified as an entity, it may be required to file a return. *Compare* Treas. Reg. § 301.6031(a)-1(a)(3)(i) (a partnership with no income, deductions, or credits for federal income tax purposes for a taxable year is not required to file a partnership return for that year); *with* Treas. Reg. § 1.6012-2(g) (a foreign corporation must file a U.S. tax return if it is engaged in a U.S. trade or business or has U.S. source income subject to withholding tax that was not withheld).

H. Employment Tax and Employee Benefits Issues

As noted in the preamble to the Proposed Regulations, there are a number of issues that can arise when trying to identify the entity that is the employer for certain tax purposes. Among the issues identified in the preamble are the following: What entity is an employer? Is it the same entity with control over payment? If there is more than one possible employer, can one be considered the employer for these purposes, or is it necessary to have double reporting and withholding obligations, as well as double Federal Insurance Contributions Act ("FICA") or Federal Unemployment Tax Act ("FUTA") wage base calculations? What if one entity is treated as the employer for federal purposes and a different entity is treated as the employer for state purposes?[74]

These issues can arise in any situation in which a business is operated through related entities that hold different business lines or assets. Some examples of groups that commonly exist are (1) individuals charged with management of the entire enterprise, some of whom may also have additional entity-specific obligations; (2) individuals who provide services to an entire group, such as finance, human resources, marketing, or other centralized services; (3) individuals who work on specific business lines or projects, which in turn may involve operations or assets across more than one entity; and (4) individuals who work on specific projects, whose duties may shift over time. While a series may facilitate establishment of a business with related operations, it is not the only context in which these fact patterns arise. To the contrary, arguably there are few, if any, issues related to employment tax or employee benefits that arise solely in the context of a series.

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[74] 75 Fed. Reg. 55699, 55705 (Sept. 14, 2010).

In each instance, there is existing law that identifies who is an "employer" for specific purposes, such as the ability to maintain a qualified retirement plan, provide other tax-favored employee benefits, and employment tax obligations. The specific law applicable in each instance is not important. Rather, what is important is that there is existing law applicable in these areas and that it applies in the context of a corporation, partnership, trust, or DRE. Thus, if each series is a separate entity for federal tax purposes, then, regardless of the entity classification of the series (*i.e.*, as a corporation, partnership, trust, or DRE), existing principles will apply accordingly.

> **Example 4**. A domestic series LLC has no assets or activities independent from its series. The LLC has three cells (A, B, and C). A, which has five owners (A1 through A5, all of whom are U.S. individuals), is classified as a corporation. B, which also has five owners (B1 through B5, all of whom are U.S. individuals), is classified as a partnership. C, which has only one owner (X, a U.S. individual), is classified as a DRE owned by X. Each series has employees and pays wages as defined in sections 3121(a), 3306(b), and 3401(a).
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> The employment tax results should be the same as if A1 through A5 were the shareholders of a domestic corporation, B1 through B5 were the partners of a separate domestic partnership, and X owned a separate DRE. Thus, for employment tax purposes, A should be classified as a corporation, B should be classified as a partnership, and C should be classified as a DRE. Thus, A1 through A5 will not be subject to self-employment taxes under section 1401. B1 through B5 will be subject to the tax on self-employment income to the extent of their shares, if any, of "net earnings from self-employment" (as defined in section 1402) with respect to series B. X will be subject to the tax on self-employment income to the extent of X's net earnings from self-employment with respect to series C.
>
> Under the principles of Treas. Reg. § 301.7701-2(c)(2)(iv), series C should be treated as a separate entity for purposes of employment taxes imposed under subtitle C and related reporting requirements. Therefore, each of series A, B, and C is subject to the provisions of subtitle C and related provisions under 26 CFR subchapter C, Employment Taxes and Collection of Income Tax at Source, parts 31 through 39. Accordingly, each series is

required to perform such acts as are required of an employer under those provisions of the Code and applicable regulations.[75]

Under Prop. Treas. Reg. § 301.7701-1(a)(5)(vii), to the extent that one of the series is a taxpayer against which tax may be assessed under chapter 63 of title 26, any tax assessed against the series may be collected by the IRS from the series, the series organization, or the other series to the extent permitted under federal or local law.

It would be helpful, however, for the Treasury and the IRS to provide clarifying guidance related to concurrent employment relationships among related passthrough entities. These issues are not limited to the series context, but, as noted in the request for comments in the preamble to the Proposed Regulations, these issues are relevant in this context. In Example 4, above, there is no overlap in the ownership of Series A, Series B, and Series C, so (assuming that the owners of each series controlled that series) the entities would not be related in a conventional sense. If, however, the facts were changed, Series A and Series B could be owned equally by the same two owners, X and Y, and Series 3 could be owned entirely by Y. If this were the case, we would recommend that, to the extent employees are providing services for more than one of the series, one of the series should be permitted to process employment tax reporting and withholding for the other series, or, to the extent employees are providing services to all three series, that the series organization should be permitted to process employment tax reporting and withholding for all three series.

In the corporate context, section 3121(s) addresses the ability of related corporations with concurrent employees to achieve this result through use of a common

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[75] Thus, for example, each series is liable for income tax withholding, FICA taxes, and FUTA taxes. *See* sections 3402 and 3403 (relating to income tax withholding); 3102(b) and 3111 (relating to FICA taxes), and 3301 (relating to FUTA taxes). In addition, each series must file under its name and employer identification number the applicable Forms in the 94X series (for example, Form 941 (*Employer's Quarterly Employment Tax Return*) and Form 940, (*Employer's Annual Federal Unemployment Tax Return*)); file with the Social Security Administration and furnish to each series' employees statements on Forms W-2 (*Wage and Tax Statement*); and make timely employment tax deposits. *See* Treas. Reg. §§ 31.6011(a)-1, 31.6011(a)-3, 31.6051-1, 31.6051-2, and 31.6302-1.

paymaster, an arrangement under which a single corporation processes employment tax reporting and withholding for a group of related corporations with respect to concurrent employees. Under this type of arrangement, each corporation remains an employer with respect to its employees, responsible for its share of costs and is allowed the related deductions, but with the common paymaster assuming the obligation to coordinate payroll reporting and withholding.

There does not seem to be any controlling principle that would preclude a group of related, non-corporate entities from establishing a similar arrangement with respect to concurrent employees, without regard to the fact that section 3121(s) is not applicable.[76] For example, if an employee worked concurrently for two or more related noncorporate entities, one entity would assume all employment tax related obligations, but that entity would be reimbursed by the other related entities for the costs associated with services provided for the benefit of those entities. Because each entity would continue to be responsible for costs associated with its own employees, such an arrangement does not permit one entity to assume the costs of, or claim deductions for costs, associated with services received by another entity. Otherwise applicable rules, such as what entities can be considered a single employer for qualified retirement plan purposes, would continue to apply, just as they do in the context of a common paymaster agreement.[77] These principles, if adopted by future guidance, would apply equally to entities

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[76] Stated differently, the determination of who is the employer is generally a matter of facts and circumstances. For related entities to agree that one entity will assume the responsibilities associated with administration related to concurrent employees is a rational and efficient way to organize a business, and, based on the facts and circumstances, that entity may properly comply with employment tax obligations for all related entities employing the same individual. Viewed in this light, it seems that section 3121(s) is best considered a codification of a specific set of facts and circumstances, rather than a limitation on the use of such an arrangement in other contexts.

[77] Such an arrangement would be one under which one entity is established as the single entity among concurrent entities that is responsible for employment tax obligations, rather than appointment of an agent for payroll processing purposes. Agency is simply a payment processing arrangement and therefore different from a common paymaster-type arrangement.

that are formed as separate entities under local law and to series of a series organization that are treated as separate entities for tax purposes.

It would be helpful to have published guidance describing the conditions under which a single entity could satisfy the employment tax obligations for all related entities with respect to concurrent employees and providing that an agreement among related entities that satisfies these conditions would be respected. As noted above, while the preamble to the Proposed Regulations raises these issues in the context of series and series organizations, we do not think the guidance should be limited to these entities, as the same principles would apply more generally.

Appendix

Example 3. Series Organization Owns A Series. (i) *Facts.* Series LLC is a series organization (within the meaning of paragraph (a)(5)(viii)(A) of this section). Series LLC has three members (1, 2, and 3). Series LLC establishes two series (A and B) pursuant to the LLC statute of state Y, a series statute within the meaning of paragraph (a)(5)(viii)(B) of this section. Under general tax principles, Members 1 and 2 are the owners of Series A, the series organization is the owner of Series B, and Members 3 and 4 are the owners of the series organization. Series A and B and the series organization are not described in § 301.7701-2(b) or paragraph (a)(3) of this section and are not trusts within the meaning of § 301.7701-4.

(ii) *Analysis.* Under paragraph (a)(5)(i) of this section, Series A and Series B are each treated as an entity formed under local law. Under § 301.7701-1(a), an entity formed under local law ordinarily is treated as an entity for federal tax purposes, subject to general tax principles. Provided that Series A and Series B are treated as separate entities for federal tax purposes, the classification of Series A, Series B, and the series organization is determined under paragraph (b) of this section. The default classification under § 301.7701-3 of Series A is a partnership and of Series B is a disregarded entity. Because, under § 301.7701-2(a), Series B is treated as a branch of its owner, the series organization is classified as a business entity rather than being treated as a mere title holding or nominee arrangement. The default classification of the series organization is a partnership.

Example 4. Series Organization with No Assets or Activity. (i) *Facts.* The facts are the same as in Example 3, except that, under general tax principles, Members 3 and 4 are the owners of Series B. The series organization has no assets and engages in no activities that are independent of its series. The series organization holds legal title to the assets of Series A and B for the benefit of those series.

(ii) *Analysis.* Because the series organization has no assets or activities that are independent of its series, the series organization is properly characterized as a mere title holding or nominee arrangement, rather than as a business entity. The default classification under § 301.7701-3 of Series B is a partnership.