

# The Series LLC - Raises Serious State Tax Questions but Few Answers Are Yet Available

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The few series LLC laws currently in existence generally allow treatment of each series as a separate entity for state law purposes; whether the series will be treated as a separate entity for federal and state tax purposes remains murky.

The list of "limited liability entities"[LLEs] available under state law continues to expand faster than federal and state taxing authorities can issue guidance on how those entities should be treated for various tax purposes. Since the first limited liability company (LLC) statutes were enacted, we have also witnessed the rapid development of other LLEs such as limited liability partnerships and limited liability limited partnerships. While questions still remain about the taxation of these LLEs, a relatively new entity is starting to gain attention-the "series LLC."

The series LLC has actually been in existence since 1996, when Delaware enacted the first series LLC statute but, since that time, only a handful of other states have enacted similar provisions. The concept behind the series LLC is similar to that of a series trust, which is made up of a series of subtrusts with their own assets and streams of income. The Internal Revenue Service has generally treated each series within a series trust as a separate and distinct entity. For example, in *National Securities Series-Industrial Stock Series v. CLR*,<sup>1</sup> the U.S. Tax Court recognized each of several series of an investment trust that was formed as a separate entity under a single trust instrument. While the treatment of each series as a separate entity was not at issue in the case, the court, in analyzing the issues, classified each series as a separate regulated investment company. The IRS has continued to follow that separate-entity treatment in analyzing series trusts. In several private letter rulings,<sup>2</sup> the Service has treated each series of a series trust as a separate entity for federal income tax purposes where each trust was treated as a separate trust under the trust

instrument (e.g., the interest holders of a particular series can share in the income of only that series) and the creditors of one series may not reach the assets of another series of the trust. Since the structure and formation of the series trusts at issue in these letter rulings closely resembles the requirements of a series LLC, it is likely that the IRS would treat each series of a series LLC as a separate entity. But, as discussed below, that treatment is not guaranteed.

The purpose of the series LLC law is to allow an LLC to, in essence, be subdivided into separate series of "members, managers or limited liability company interests..." with separate rights, powers, or duties with respect to specific property or obligations of the LLC, or with respect to profits and losses associated with specific property or obligations.<sup>3</sup> One of the stated benefits of the series LLC is that the debts and other liabilities of a separate series will be enforceable against only that series. Prior to the advent of the series LLC, achieving that same benefit would have required the formation of separate LLCs to hold separate assets or activities. It has been argued that the formation and maintenance of numerous LLCs can be costly, while the costs of establishing and maintaining a separate series should be minimal.

A series LLC is designed to allow the owner of an LLC that comprises separate businesses or separate lines of business (e.g., manufacturing and transportation) to put each in a separate series and protect the assets of one series from the creditors of another. The series LLC also will likely be a popular entity for real estate ventures and investment activities, and it has already become a common investment vehicle with mutual funds and venture capital funds. The series LLC laws are generally structured to allow the treatment of each series as a separate entity for state law purposes, although, as discussed below, whether the series will be treated

<sup>1</sup> 13 TC 884 (1949).

<sup>2</sup> See, e.g., Ltr. Ruls. 9837005, 9847013, and 9435015.

<sup>3</sup> DEL. CODE ANN. tit. 6, § 18-215(a).

as a separate entity for federal and state tax purposes remains murky.

### Some Sample State Series LLC Statutes.

It is useful, first, to review, compare, and contrast some of the existing state statutes that provide for series LLCs.

**The Delaware statute.** The Delaware series LLC statute, which was the progenitor for several other state series LLC statutes, provides that "any such series [of the LLC] may have a separate business purpose or investment objective."<sup>4</sup> The law further provides that if a "limited liability company agreement establishes or provides for the establishment of 1 or more series [and if certain procedural requirements are met], then the debts, liabilities and obligations and expenses incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of such series only, and not against the assets of the limited liability company generally or any other series thereof..."<sup>5</sup> This provision essentially protects the assets of a particular series from the liabilities of the LLC or of another series of the LLC.

The Delaware law further provides that "the management of a series shall be vested in the members associated with such series in proportion to the then current percentage or other interest of members in the profits of the series owned by all of the members associated with such series, the decision of members owning more than 50 percent of the said percentage or other interest in the profits controlling;" unless the LLC agreement provides for the management of the series by one or more managers. In addition, even if the LLC itself is insolvent and would not be allowed to make a distribution under § 18-607(a) of the Delaware LLC Act, a distribution can be made from a series for which the fair value of its assets exceeds its liabilities.<sup>6</sup>

If for any reason a member ceases to be associated with a series, such event does not, by itself, "cause such member to cease to be associated with any other series or terminate the continued membership of a member in the limited liability company or cause the termination of the series" even if that member was the last remaining member of the series.<sup>7</sup> A separate series can be "terminated and its affairs wound up without causing the dissolution of

the limited liability company."<sup>8</sup> A series is terminated upon the dissolution of the LLC or upon the first to occur of the following:

1. The time specified in the LLC agreement.
2. The happening of events specified in the LLC agreement.
3. On the affirmative vote of the members associated with such series.
4. By decree of the Court of Chancery where requested by a member or manager of a series when "it is not reasonably practicable to carry on the business of the series in conformity with a limited liability company agreement."<sup>9</sup>

**The Illinois statute.** More recently, Illinois enacted a statute allowing for the formation of series LLCs.<sup>10</sup> While the provisions are often similar to the Delaware law, some key differences exist. For example, the Illinois law goes further in establishing the separate existence of the series LLC. Like the Delaware law, the Illinois provision states that a series "may have a separate business purpose or investment objective" but the Illinois statute requires that this be provided for in the LLC's operating agreement.<sup>11</sup>

In addition, in contrast to the Delaware law, Illinois law specifically states that the series "shall be treated as a separate entity to the extent set forth in the articles of organization." Further, "[e]ach series with limited liability may, in its own name, contract, hold title to assets, grant security interests, sue and be sued and otherwise conduct business and exercise the powers of a limited liability company...."<sup>12</sup> The Illinois law also states: "The name of the series with limited liability must contain the entire name of the limited liability company and be distinguishable from the names of the other series set forth in the articles of organization."<sup>13</sup>

**Other state statutes.** In addition to Delaware and Illinois, Iowa, Nevada, Oklahoma, Tennessee,

<sup>4</sup> *Id.*

<sup>5</sup> DEL. CODE ANN. tit. 6, § 18-215(b).

<sup>6</sup> DEL. CODE ANN. tit. 6, §§ 18-215(f), (h).

<sup>7</sup> DEL. CODE ANN. tit. 6, § 18-215(i).

<sup>8</sup> DEL. CODE ANN. tit. 6, § 18-215(i).

<sup>9</sup> *Id.*

<sup>10</sup> 805 ILCS § 180/37-40. For a more detailed discussion of the Illinois series LLC statute, see Terry and Samz, "An Initial Inquiry Into the Federal Tax Classification of Series Limited Liability Companies." 110 Tax Notes 1093 (3/6/06). According to Professor Terry, a co-author of the Illinois Act, the language of the Illinois statute "allows only one logical conclusion to be drawn" individual series "are definitely business entities separate from the parent LLC and should be treated as such for federal purposes."

<sup>11</sup> 805 ILCS § 180/37-40(a).

<sup>12</sup> 805 ILCS § 180/37-40(b).

<sup>13</sup> 805 ILCS § 180/37-40(c).

and Utah have enacted series LLC statutes.<sup>14</sup> The provisions of all five of these statutes are substantially similar to the Delaware statute and do not contain the specific separate-entity provisions found in the Illinois law. Several other states authorize classes and series of membership interests but do not have the "internal shields" that are the essence of a Delaware- or Illinois-type series LLC.

Notably, the drafters of the 2006 Revised Uniform Limited Liability Company Act (Re-ULLCA) recently considered but rejected the idea of including series provisions in the Act.<sup>15</sup> In contrast, but perhaps in light of the number of IRS rulings implicitly approving the use of series within a business trust, the latest draft of the Uniform Statutory Trust Entity Act (USTEA) does contain series provisions.<sup>16</sup>

### Tax Treatment of Series LLCs

While the potential benefits of the series LLC are tremendous, to date they do not appear to be widely used. One reason for the hesitancy of many tax advisers to recommend their use is the uncertainty surrounding how they will be treated for federal and state tax purposes. Even though the statutory provisions authorizing series LLCs allow for the treatment of each series as a separate entity for state law purposes, this does not necessarily mean that this separate existence will be respected for federal or state tax purposes. For example, an LLC with several series could be treated as a single partnership for federal and, perhaps, state tax purposes despite the fact that each series is treated as a separate entity for state law purposes. It is also unclear whether the courts of a state that has not enacted series LLC provisions will respect the

separate status of any series LLCs operating in the state for state law liability purposes."<sup>17</sup>

Surprisingly, the IRS has issued no public guidance on series LLCs to date. Furthermore, very few states have addressed the state tax issues. It is unlikely that any significant state guidance in relation to series LLCs will be issued prior to the IRS's taking action, since most states probably will piggyback the federal tax treatment of the series, at least for income tax purposes. And even the issuance of guidance by the IRS for income tax purposes will likely not have much effect on state sales and use tax treatment of series LLCs. Thus, taxpayers are forced to look to cases and rulings applying the tax laws to similar entities, and to attempt, by analogy, to glean the proper taxation of the series LLC.<sup>18</sup>

**Applying "check-the-box."** As with regular LLCs, determining how a series LLC will be classified for federal, and often state, income tax purposes involves the application of the entity classification provisions of Treas. Reg. §§ 301.7701-1 through -5 (commonly known as the "check-the-box" regulations). Under the check-the-box rules, a domestic entity formed as a corporation under state law must be treated as a corporation for tax purposes. A business entity that is not a state law corporation and that has more than one owner generally can elect to be treated as either a corporation or a partnership. If it has only one owner, it can elect to be treated as a corporation or to be disregarded as an entity separate from its owner (i.e., like a branch or division of the owner).<sup>19</sup>

In applying these entity classification rules to a series LLC) however, several obstacles must be overcome. First, one must determine whether the LLC and all of its series are to be treated as one entity, with the series being treated as disregarded entities owned by the LLC for tax purposes. In other words, would a multi-member LLC with several series be treated as one tax partnership under the regulations? Alternatively, should each series be treated as a separate entity, apart from the LLC, that

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<sup>14</sup> IOWA CODE § 490A.305; NEV. REV. STAT. § 86.011 *et seq.* (series LLC provisions effective 10/1/05); OKLA. STAT. tit. 18, § 2054.4 TENN. CODE ANN., § 48-249-309; and UTAH CODE ANN. § 48-2c-606.

<sup>15</sup> See Prefatory Note to the 2006 Re-ULLCA, available online at the website of the National Conference of Commissioners on Uniform State Laws (NCCUSL), at [www.nccusl.org](http://www.nccusl.org) (click on "Drafting Committees"). The NCCUSL is a nonprofit, unincorporated association created in 1892; it comprises more than 300 "uniform law commissioners", all members of the bar qualified to practice law. The commissioners are practicing lawyers, judges, law professors, and legislators who are appointed by the states (as well as by the District of Columbia, Puerto Rico and the U.S. Virgin Islands) to draft proposals for uniform and model laws on subjects where state uniformity is desirable and practicable, and they work toward enactment of those models by the state legislatures.

<sup>16</sup> Interview with Thomas E. Rutledge, ABA Business Law Section Advisor to USTEA Drafting Committee of the NCCUSL, 10/9/06. Also, see [www.nccusl.org](http://www.nccusl.org) (click on "Drafting Committees"). The USTEA is currently being drafted by the NCCUSL and is scheduled for final reading in 2007

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<sup>17</sup> See, e.g., Rutledge, "To Boldly Go Where You Have Not Been Told You May Go: LLCs, LLPs, and LLLPs in Interstate Transactions," 58 Baylor L. Rev 205 (Winter 2006), which discusses the extent to which states other than the state of organization are required to respect the limited liability afforded an entity by its state of organization.

<sup>18</sup> A more detailed examination of the federal tax issues related to series LLCs can be found in Gerson, "Taxing Series LLCs," 45 Tax Management memorandum 75 (3/8/04).

<sup>19</sup> Treas. Reg. § 301.7701-3(a). See generally Peabody, "Check-the-Box Treasury Regs. Encourage States to Authorize Single-Member LLCs," 7 JMT 79 (May/June 1997); Peabody, "States Generally Endorse Check-the-Box but Key Issues Remain," 7 JMT 206 (Nov/Dec 1997).

is owned directly by the members of the series or of LLC? That is, could each series be treated as a separate tax partnership owned by the members of the LLC or of the series, if the identity of the members were different? Whether the series would be treated as owned (1) by the LLC itself as an umbrella entity, or (2) by the members of the LLC directly, is not completely clear.

Also not clear is what role the state law treatment of the series will play in determining its tax treatment. While an organization's federal tax classification is not dictated strictly by the organization's status under state law,<sup>20</sup> the requirements of a specific state's series LLC statute may play a role in determining the tax classification. For example, the Delaware series LLC statute imbues each series of an LLC with some indicia of a separate entity, such as having its own managers and being able to partition liability with respect to certain assets. It does not, however, give the series the right to transact business in its own name, e.g., it cannot enter into agreements, sue or be sued, or borrow money in its own name. To date, the only guidance of which the authors are aware that Delaware has issued on its series LLC statute is a private letter ruling issued by the Delaware Department of Finance to the law firm of one of the authors, simply confirming that Delaware series LLCs will be classified the same as other LLCs and that the check-the-box regulations will apply.<sup>21</sup> In addition, a New York Advisory Opinion issued by the state's Department of Taxation and Finance, dealing with the use of a Delaware series LLC by individuals, states that, for purposes of the New York personal income tax, all of the series will be treated as "partnerships," which the authors interpret to mean that each series is to be treated as a separate LLC.<sup>22</sup>

The Illinois series LLC statute, however, more clearly indicates that a series should be treated as a separate entity and specifically states that each series may "in its own name, contract, hold title to assets, grant security interests, sue and be sued and otherwise conduct business and exercise the powers of a limited liability company..."<sup>23</sup> Thus, a series formed under this statute is apparently intended to be a separate entity; but this intent nevertheless may not be sufficient to make it a separate entity for tax purposes. It would certainly seem that whether an individual series is actually carrying on a separate business should affect whether it can be treated as a separate entity for tax purposes.

In determining whether each series in a series LLC would be treated as a separate entity under the check-the-box regulations, the first question is whether the particular series would qualify as a "business entity" as defined in those regulations (i.e., any entity, including an entity with a single owner that may be disregarded as an entity separate from that owner, recognized for federal tax purposes that is not classified as a trust or otherwise subject to special treatment under the Internal Revenue Code).<sup>24</sup> While, as discussed above, the series LLC statutes that have been enacted to date provide some indication that the series are to be treated as separate entities, the treatment of the series as entities under state law is only one factor in determining whether each series will be treated as an entity under the check the box rules. Those regulations, however, do not provide an exact definition of what constitutes an "entity." Federal case law indicates that: an organization that changes the legal and economic relationship between the owners and their assets will be considered an entity.<sup>25</sup>

If each series is treated as a separate business entity, the next determination is whether it is an "eligible entity" for purposes of the check-the-box rules. An "eligible entity" is a "business entity" (as described above) that is not classified as a corporation under specified provisions of the entity classification regulations.<sup>26</sup> Since the Code contains no special provisions relating to series LLCs, a series will be an eligible entity if it is neither a trust nor a per se corporation. A trust has generally been interpreted to be an organization that exists only to conserve and protect property and does not conduct a business for profit.<sup>27</sup> Because the series LLC statutes permit, but do not require, a series to have a separate business purpose, a series could be set up to be either a business entity or a trust.

Of course, while some series will house complete businesses and others will simply hold assets, many series likely will fall within a grey area that will be much more difficult to classify. Until these issues are addressed by the IRS, many taxpayers will be hard-pressed to determine on which end of the spectrum a particular series lies. While the Illinois series LLC statute appears to be tailored more toward the treatment of the series as a separate entity, whether a series will be treated as such by the IRS in all circumstances still is not clear. Thus, in analyzing the

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<sup>20</sup> 20 Treas. Reg. § 301.7701-1(a)(1).

<sup>21</sup> Delaware Dept. of Finance, Div. of Revenue, Private Letter Ruling (9/16/02).

<sup>22</sup> TSB-A-98(8)I (9/4/98).

<sup>23</sup> 805 ILCS § 180/37-40(b).

<sup>24</sup> Treas. Reg. § 301.7701-2.

<sup>25</sup> See, e.g., *Dorman v. U.S.*, 296 F.2d 27, 8 AFTR2d 5818 (CA-9, 1961); *Madison Gas & Electric Co. v. C.I.R.*, 633 F.2d 512, 46 AFTR2d 80-5955 (CA-7, 1980).

<sup>26</sup> Treas. Reg. §§ 301.7701-2(a) and -3(a).

<sup>27</sup> See *Morrissey v. C.I.R.*, 296 US 344, 16 AFTR 1274 (1935).

potential federal and state tax treatment of a series LLC, one must contemplate the treatment of each series both as a separate tax partnership and as part of a single pass-through entity.

### State Income Tax Issues Regarding Series LLCs

Since most states will likely follow the federal entity classification rules in determining the treatment of a series of an LLC,<sup>28</sup> and also will likely conform to the federal computation of the tax base for pass-through entities, the remainder of this article focuses on the effect that the federal tax treatment of a series LLC will have on issues that must be determined at the state level, such as nexus, apportionment, and the application of specific state taxes that some states impose on various forms of pass-through entities.

**Entity level taxes.** One of the first questions that arises for state tax purposes is whether state tax law conforms with the check-the-box rules regarding series LLCs and, even if so, whether the series will be subject to any state entity-level income or franchise taxes that may be imposed on pass-through entities, while for federal income tax purposes a pass-through entity such as a partnership or LLC electing partnership treatment is not taxed at the entity level but, instead, the income or loss flows through to the owners of the pass-through entity,<sup>29</sup> certain states impose entity-level income or franchise taxes on LLCs and/or partnerships operating in the state.<sup>30</sup>

Only one state, so far, has addressed, at least publicly, the question of whether its entity-level tax on LLCs would be applied to a series LLC. California recently issued guidance stating that it will treat each series as a separate LLC, each of which will be subject to the California LLC fee if the series LLC is registered or doing business in California,<sup>31</sup> Unfortunately, California has provided little detail as to how it reached the conclusion that each series was a separate entity. Some commentators surmise that because the more LLC entities or series that are doing business in California, the more tax that is generated, the Franchise Tax Board's conclusion

may not have been completely objective.<sup>32</sup> It remains to be seen whether California's conclusion is affected by any guidance that might eventually be issued by the IRS on the tax treatment of series LLCs. Since the California LLC fee is an entity-level fee and not a net income tax, California conceivably could treat a series LLC as a separate entity for purposes of the fee but not for purposes of the state's income tax.

**Composite returns and withholding.** A state's decision, like California's, to treat each series as a separate taxable entity may also have an effect on composite return filings for state income tax purposes. Most states allow or require the filing of composite returns for pass-through entities with nonresident owners.<sup>33</sup> A composite return is generally filed on behalf of all nonresident members of the entity, with the tax being computed at the highest marginal rate. If a state determines that each series of an LLC is a separate entity, presumably a composite return would be filed, and taxes paid, by each series, rather than one return being filed by the LLC as an umbrella entity if the series were treated as disregarded entities. If an LLC were to have numerous series with activities in a state where owners were nonresidents, a tremendous compliance burden would be created, as compared to the filing of one composite return if the various series were disregarded as entities apart from the LLC.

Similarly, whether each series is treated as a separate entity can affect state pass-through entity withholding requirements. In the absence of a composite return, most states require a pass-through entity with nonresident owners to withhold the state's income tax on distributions made to those owners.<sup>34</sup> States also may require withholding by pass-through entities if the nonresident owners fail to sign consents agreeing to be subject to the state's jurisdiction and to pay state income tax on distributions from the

<sup>28</sup> See Ely, Grissom and Houser, "LLC/LLP Update: Noted Trends in the State Taxation of Pass-Through Entities," 16 JMT 30 (May 2006); Keatinge and Conaway on Choice of Business Entity (Thomson/West 2006), §15:51.

<sup>29</sup> See IRC § 702(a).

<sup>30</sup> For a detailed examination of which states impose entity-level taxes on pass-through entities, see Fenwick, McLoughlin, Salmon, Smith, Tiney, and Wood, "State Taxation of Pass-Through Entities and Their Owners" (Warren, Gorham & Lamont 2006, ¶ 7.01.

<sup>31</sup> See 2005 Limited Liability Company Tax Booklet (instructions to California Form 568, Limited Liability company Return of Income).

<sup>32</sup> In addition, in *Northwest Energetic Services, LLC v. California Franchise Tax Board*, Cal. Super Ct. San Francisco County, Docket No. CGC-05-437721, 3/2/06, the California LLC fee was struck down because it was applied to all of the income of the LLC, not just that earned in California. This case was analyzed in Pace, Moll and Ely, "Wrestling With Taxes in the Golden State--California's Unconstitutional LLC Fee," 16 JMT 24 (July 2006). The California legislature recently passed legislation (A.B. 1614) designed to cure the problem, at least on a prospective basis, by limiting the tax base to income apportioned and allocated to the state. On 9/30/06, however, the governor vetoed the bill, noting that further litigation on the matter is pending.

<sup>33</sup> Composite returns are generally allowed only when the nonresident owners are individuals but some states allow composite returns that include corporations. For a detailed explanation of state composite-return filing requirements see Fenwick, McLoughlin, et al., *supra* note 30, ¶ 6.01 *et seq.*

<sup>34</sup> See Fenwick, McLoughlin, et al., *supra* note 30, ¶ 6.01 *et seq.*, for a discussion of state withholding requirements for pass-through entities.

pass-through entity. A state's decision to treat each series as a separate entity would presumably mean that withholding determinations would have to be made with regard to each series and not just the LLC as a whole. This situation also could create a considerable compliance burden for an LLC with numerous series.

**Nexus issues.** Another state tax issue of much interest to owners of pass-through entities in recent years, and one that could be complicated by the use of series LLCs, is whether a nonresident owner of a pass-through entity has a sufficient "nexus" with the taxing state. Generally, before a nonresident individual or non-domiciliary corporation can be subjected to tax by a state, the individual or corporation must have "nexus" with the state, such that the state's exercise of jurisdiction over the nonresident satisfies both the Due Process Clause<sup>35</sup> and Commerce Clause<sup>36</sup> of the U.S. Constitution. The U.S. Supreme Court has not directly addressed what level of activity is necessary in a state before that state can impose an income tax on a nonresident. The Court has held, however, that a state cannot impose a use tax collection obligation on a nonresident unless the nonresident has a physical presence (e.g., property or employees) in the taxing state.<sup>37</sup> State courts have come down on both sides of the fence with regard to whether the same sales and use tax physical presence requirement exists for income tax purposes.<sup>38</sup>

While most states will take the position that a nonresident owner of a partnership, or of an LLC treated as a partnership, will have income tax nexus if the partnership or LLC is doing business in the state, this view is not necessarily correct; the result may depend on the entity vs. aggregate theory adopted by the state's partnership or LLC act. For example, in *Lanzi v. Alabama Department of*

*Revenue*.<sup>39</sup> The Alabama Court of Civil Appeals held that a Georgia resident who was a limited partner in a partnership formed and doing business in Alabama did not have sufficient nexus with Alabama for that state to impose an income tax on his earnings from the partnership without violating the Due Process Clause. The Alabama court based its holding largely on *Shaffer v. Heitner*,<sup>40</sup> in which the U.S. Supreme Court held that a nonresident's ownership of stock in a Delaware corporation, without more contacts with that state, was not sufficient to subject the nonresident shareholder to Delaware's jurisdiction. In *Lanzi*, the court found that a limited partnership interest in a limited partnership "is directly analogous" to the ownership of stock in a corporation and, thus, the due process requirements should apply equally to both.

Similarly, in *Asworth Corp. v. Kentucky Revenue Cabinet*,<sup>41</sup> the Kentucky Board of Tax Appeals determined that a foreign corporate partner in a partnership doing business in Kentucky was not subject to that state's corporate income tax based solely on the corporation's receipt of its distributive share of the profits that the partnership earned in Kentucky. Because the foreign corporate partner itself did not own or lease property or have employees in Kentucky, it was found not to meet the statutory requirements for imposition of the corporate income tax.<sup>42</sup> Subsequent to the tax years at issue in *Asworth* but prior to the decision, the Kentucky legislature amended the tax statutes to provide that foreign corporate partners "[m]aintaining an interest in a general partnership doing business in [Kentucky]" are themselves doing business in the state and, thus, are subject to the Kentucky corporate income tax.<sup>43</sup>

**Example.** Making such nexus determinations regarding a series of an LLC can become even more

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<sup>35</sup> U.S. Const., Amend. XIV, § 1.

<sup>36</sup> U.S. Const., Art. I, § 8, Cl. 3.

<sup>37</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). See generally Eule and Richman, "Out-of-State Mail-Order Vendors Need Not Collect Use Taxes--Yet!," 2 JMT 163 (Sep/Oct 1992). See also Nolan, "Crossing the Bright Line: Evaluating Physical Presence in *Quill's* Shadow," 7 JMT 244 (Jan/Feb 1998).

<sup>38</sup> See, e.g., *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App., 1999), cert. den. U.S. S.Ct. 10/10/00 (holding that *Quill*, supra note 37, applies both to sales and use taxes and to state income taxes); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App., 2004), cert. den. U.S. S.Ct. 10/3/05 (holding that *Quill* was limited to sales and use taxes). *J.C. Penney* was analyzed in Goodman, "Tennessee: Bank's Credit Card Business Did Not Create Tax Nexus," 10 JMT 34 (Mar/Apr 2000); the North Carolina Court of Appeals' holding in *A&F Trademark* affirmed the N.C. Secretary of Revenue's final decision, which was analyzed in Hannah and Hall, "North Carolina Enters the Delaware Intangible Holding Company Fracas," 11 JMT 6 (July 2001).

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<sup>39</sup> Ala. Civ. App., No. 2040298, 6/30/06, 2006 WL 1793221, petition for cert. pending.

<sup>40</sup> 433 U.S. 186 (1977).

<sup>41</sup> Ky. Bd. Of Tax App., Nos. KOO-R-31, KO2-R-30, K02-R-31, and KO2-R-32, Order No. K-19449, 1/27/06 (this case is currently on appeal).

<sup>42</sup> Imposed under KY. REV. STAT. § 141.040.

<sup>43</sup> Kentucky H.B. 272, 3/18/05; L. 2005, Act No. 168 (amending KY. REV. STAT. § 141.010 to add subsection (25)(e), effective for tax years beginning after 2004). Section 141.010(25)(e) has since been amended (H.B. 1, 6/28/06; L. 2006, 1<sup>st</sup> Extra. Sess., Act No. 2; generally effective for tax years beginning after 2006) to substitute "pass-through entity" for "general partnership." For more on these and other recent changes to Kentucky's tax laws, see Zefi, Kane, Collins, and Carr, "Kentucky Tax Modernization Legislation Has Major Effect on Businesses," 16 JMT 14 (July 2006); and Shop Talk, "Kentucky Modifies Recent Tax Act to Give Small Business Tax Relief, Pass-Through Entity Changes," 16 JMT 42 (October 2006).

problematic. Consider the following example: A and B are the owners of LLC, which is treated as a partnership for federal and state income tax purposes. LLC owns and operates a manufacturing facility in State X, the same state in which both A and B reside. Subsequently, LLC acquires another manufacturing facility, which is located in State Y. Based on its ownership of the two facilities, LLC will have reporting requirements in both States X and Y, and A and B, potentially, will have to file income tax returns in both of those states. But what if, instead, LLC forms two separate series, Series 1 to hold the State X operations and Series 2 to hold the State Y operations, and A and B are treated as the owners of the series and each owns 50% of each series? If the series are treated as separate entities for tax purposes, Series 1 should have a reporting requirement in only State X, while Series 2 should have a reporting requirement in only State Y.

Assume further that Series 1 is a highly profitable sales company and State X has a single-factor apportionment formula based on sales or gross receipts, and that Series 2 is a low-margin manufacturing operation and State Y employs a three-factor apportionment formula. Total state taxes would be greatly reduced if the series were treated as separate entities instead of as part of one tax partnership that filed in both states. If treated as separate entities, none of the substantial profit of Series 1 would be subject to State Y's high apportionment percentage based on Series 2's labor- and capital-intensive business being conducted in State Y. In addition, based on the *Lanzi* and *Asworth* holdings and their predecessors, A and B arguably would have a filing obligation only in State X, where they are residents, assuming they have no connection to State Y other than holding an interest in Series 2. If, instead, LLC were treated as an umbrella entity and both Series 1 and 2 were treated as disregarded entities. A and B, as owners of LLC, would pay an apportioned tax in both States X and Y based on the earnings and activities of both Series 1 and 2.

**Net operating loss issues.** If the series are treated as separate entities by the states, another issue that arises is the calculation of any net operating losses (NOLs) of the LLC. For example, under the same setup as in the example above, if Series 1 has net income of \$1,000 for the year and Series 2 has a \$1,500 NOL, and each series is treated as a separate tax partnership. Series 1 will have income in State X for the year despite the loss incurred by Series 2. Thus, A and B could potentially have an income tax liability in State X even though their LLC investment as a whole generated a loss for the year. Essentially, this result would be similar to what would occur if Series 1 and Series 2 were

subsidiary corporations, instead of series of an LLC, and States X and Y each required the filing of separate returns instead of combined reports or consolidated returns.

If, however, the two series were not treated as separate entities apart from LLC, i.e., both states treated them as one tax partnership-LLC would have an NOL of \$500 for the year and would have no net income under either state's income tax laws. This result would be similar to what would occur for corporations in a combined reporting state, assuming the series were unitary under that state's definition of the term, or in a consolidated return state.

**Apportionment issues.** The treatment of the series also can affect the determination of the LLC's proper apportionment formula. If instead of apportioning its income to two or more states, the LLC placed each state's operations into a separate series, and the states treated each series as a separate entity, the series may lose their ability to apportion income among the states in which they are doing business.

For example, if Series 1 and Series 2 are treated as being part of one tax partnership with LLC, the income earned by the LLC would be apportioned to States X and Y based on each state's apportionment formula. If, instead, the series are treated as separate entities, Series 1 and 2 arguably would not be able to apportion any of their incomes out of, respectively, States X and Y, if all of their activities are confined to their respective states. Depending on the apportionment formula of each state (e.g., single-factor, three-factor, etc.) and the states' respective income tax rates, the ability to apportion could make a significant difference in the ultimate income tax liability incurred by owners A and B.

Placing certain operations in a particular state in a separate series treated as a separate entity for state tax purposes also can have an effect on apportionment in states that require "throw-back" of certain sales for purposes of the sales factor. Several states require that when computing the sales factor, any sales delivered to a state where the selling company either does not have nexus or is protected under P.L. 86-272,<sup>44</sup> must be "thrown back" and

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<sup>44</sup> 15 USC §§ 381-384 (the "interstate Commerce Tax Act"), limits a state's ability to assert income tax jurisdiction over a business whose only activity in the state is the solicitation of orders for sales of tangible personal property, provided the orders are sent out of the state for approval and are filled by shipment from outside the state. P.L. 86-272 does not protect other types of activities in a state and does not apply to non-income taxes (e.g., sales or use taxes) or to the sale of intangibles. See *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.* 505 U.S. 214 (1992), which was analyzed in Marcus and Lieberman, "Does *Wrigley* Clarify 'Solicitation' for Purposes of Taxing Interstate Commerce?," 2 JMT 148 (Sep/Oct 1992). See also Lieberman, "MTC Guidelines

included in the numerator of the sales factor of the state of origin for the sale.<sup>45</sup> This approach seeks to avoid "nowhere" sales (i.e., sales the receipts from which are not assigned to any taxing state). In determining the treatment of receipts from out-of-state sales, some states do not require throw-back if an affiliate of the selling taxpayer has nexus with the destination state.<sup>46</sup> But other states look to the activities of only the company that actually makes the sale.<sup>47</sup> The use of a separate LLC series to hold operations in a particular state could therefore affect the throwback determination.

**Example.** LLC is based in State X, which has a throwback rule. LLC also has operations in State Y and it makes sales to customers there. In determining its State X sales factor, LLC should not have to throw back the sales it ships into State Y because it also has a presence there. If, however, LLC placed its State Y operations into a separate series that was treated as a separate entity for state tax purposes, LLC arguably would no longer have any presence in State Y. Thus, if in determining the sales factor, State X looked to the activities of only the selling entity, LLC would be required to throw back to State X any sales it made into State Y. If State X looked also to the activities of a related entity, however, the presence of the series in the destination state presumably would allow LLC to exclude from the State X sales factor numerator the gross receipts from its sales into State Y.

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on P.L. 86-272 Implement the U.S. Supreme Court's Decision in *Wrigley*," 5 JMT 52 (May/June 1995).

<sup>45</sup> Approximately 24 states currently require throw-back. See Congressional Research Service, "State Corporate Income Tax: A Description and Analysis," RL 32297 (7/21/06). The Congressional Research Service, a legislative branch agency within the Library of Congress, is the public policy research arm of the U.S. Congress.

<sup>46</sup> This is generally known as the "Finnigan" rule, based on the California State Board of Equalization's decision in *Appeal of Finnigan Corp.*, Cal. SBE, No. 88-SBE-022-A, 1/24/90 (the SBE required inclusion of California destination sales for all members of a unitary group if any member of the group was subject to California tax, even if the selling entity was not itself taxable in California). Few states follow this rule; it is no longer followed even by California. See note 47, *infra*.

<sup>47</sup> This is known as the "Joyce" rule, after the California State Board of Equalization's decision in *Appeal of Joyce, Inc.*, Cal. SBE, No. 66-SBE-070, 11/23/66 (the SBE required the sourcing of a group member's sales to the destination state only if the selling member was taxable in that state, regardless of whether any other member was taxable there). Joyce was overruled by the SBE in Finnigan, *supra* note 46. Later, however, in *Appeal of Huffy Corp.*, Cal. SBE, No. 99-SBE-005, 4/22/99, amended on denial of reh'g Cal. SBE, No. 99-SBE-005-A, 9/1/99, the SBE overruled Finnigan and reinstated the Joyce rule, which is now also followed by most states that require throwback. See, e.g., 86 Ill. Admin. Code § 100.5270(b)(1)(A). For more on California's actions in this area, see Shop Talk, "California SBE Reverses *Finnigan*, Returns to Joyce Apportionment Rule," 9 JMT 40 (July 1999).

### Apportionment issues for series LL owners.

Whether the series is considered to be a division of the LLC or a separate entity owned directly by the members of the LLC also can have an effect on the entity's owners' apportionment of the income earned by the series. In apportioning a corporate partner's income, most states require the partner's share of the partnership's apportionable income to be added to the partner's other income, with that total income apportioned based on a formula that combines the partner's share of the partnership's apportionment factors with the partner's own apportionment factors if the partner and partnership are engaged in a unitary business. For example, a corporation owning a 50% partnership interest would include 50% of the partnership's income in its own apportionable income, and apply an apportionment formula that combines the corporation's own factors with 50% of the partnership's apportionment factors.<sup>48</sup>

Thus, consider (as in the earlier example, above) that A and B are corporate owners of LLC, which forms two separate series: Series 1 to hold its State X operations and Series 2 to hold its State Y operations. A and B both file income tax returns in State Y, which does not treat Series 2 as an entity separate from LLC and requires apportionment at the owner level. Accordingly, their State Y returns, A and B would include 50% of LLC's State Y income and factors in computing their own State Y incomes, provided A and B were unitary with LLC. If Series 2 were treated as a separate entity, however, and A and B were unitary with Series 2, A and B, in preparing their State Y returns, would include their respective shares of the Series 2 income and factors and not the factors of LLC as a whole. As discussed above, based on the income and factors of the series in State Y vs. the LLC as a whole, the tax results for A and B could differ significantly depending on whether each series is treated as a separate entity for state tax purposes.

In a state where apportionment is calculated at the partnership level only, or if corporate owners A and B were not unitary with LLC, the treatment of each series as a separate entity also could have a material impact on apportionment. For example, if Series 2 were operating only in State Y and its tax were calculated on a separate-entity basis, Series 2 likely would have a 100% apportionment factor in State Y, and A and B would apportion 100% of their respective Series 2 incomes to State Y. If, instead, Series 2 were treated as a division of LLC, the State Y apportionment percentage could be diluted by the inclusion of LLC's factors from its activities in State X. This apportionment factor dilution potentially could

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<sup>48</sup> See, e.g., Ala. Admin. Code Rule 810-27-1-4-09.

result in a lower State Y tax for both A and B, depending on the income earned from activities in State X.

**Sale of a series LLC.** Another question that arises when each series is treated as a separate entity for state tax purposes is whether the sale of the separate operations that are owned by one series would be treated as a sale of (1) tangible assets or (2) a membership interest in that series (i.e., an intangible). While most states require the owner of a tax partnership to flow-up the partnership's apportionment factors, essentially looking through the partnership, most states treat the sale of a partnership interest as a sale of the entity itself and not as a sale of the entity's various assets by the entity's owners,<sup>49</sup>

For example, a sale of the State Y manufacturing facility owned by Series 2 could be treated either as a sale by owners A and B of the underlying manufacturing assets owned by Series 2 or as the sale of an intangible, i.e., the interest in Series 2. If Series 2 is disregarded as a separate entity and the transaction is treated as a sale of a portion of the assets of LLC, with the sale generating allocable income, any gain likely would be sourced to the location of the assets. If, instead, the transaction were treated as the sale of an entity, i.e., an intangible, the proceeds generally would be allocable to the seller's commercial domicile or to the business situs of the intangible, unless the sale were determined to generate apportionable (business) income.

Currently, very little guidance exists with regard to the state tax treatment of UIC sale of a pass-through entity. Generally, the transaction will be treated as the sale of an intangible, and the seller will need to consider the method the taxing state employs for determining apportionable or allocable income (e.g., business vs. nonbusiness income, operational vs. investment function). Until states declare whether they will treat a series as a separate entity (as California apparently does, at least for purposes of its LLC fee), it will be difficult to deduce how they will apply these provisions to the sale of a separate series of an LLC. Presumably, if a state treats the series as a separate entity for tax purposes, the sale of the series will be treated similar to the sale of an ownership interest in a partnership or LLC.

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<sup>49</sup> See Fenwick, McLoughlin, et al., *supra* note 30, ¶ 9.01 *et seq.*, for a discussion of allocation and apportionment issues related to pass-through entities.

## Sales and Use Tax Considerations

Aside from the income tax area, the state treatment of a series LLC also can have an effect on several sales and use tax determinations. With regard to sales and use tax collection issues, for example, it will be necessary to ascertain how the presence of a series of an LLC will affect nexus determinations.

Consider that LLC, with operations and sales in State X, clearly would have an obligation to collect sales/use tax on those sales if they were subject to such a tax imposed by that state. If, however, LLC placed its sales activities into Series 1 and its State X manufacturing facilities into separate Series 2, and Series 1 had no connection to State X other than shipping goods into the state by common carrier, arguably Series 1 would not have sufficient nexus with State X to incur a sales or use tax collection obligation. Nevertheless, many states likely would assert that Series 1 was responsible for collecting the tax, based on the in-state presence of Series 2, regardless of whether the state treated Series 2 as a separate entity. Much litigation, and now legislative efforts, concern whether the presence of a related corporate entity in a state will create sufficient nexus for a remote seller.<sup>50</sup> The same issues likely will arise with regard to the presence of a series of an LLC in a state if that series is treated as a separate entity for state tax purposes.

The determination of whether the series is treated as a separate entity for state tax purposes also will affect the treatment of transfers of goods between the different series. For example, would a sale of goods between the separate series be treated as a taxable sale or as an intercompany transfer similar to the movement of goods between divisions of an entity? Even if the series is treated as a disregarded entity for federal and state *income tax* purposes under the check-the-box rules, it will not necessarily be treated also as a separate entity for *sales and use tax* purposes.<sup>51</sup> Thus, taxpayers need to be aware that a transfer of goods between

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<sup>50</sup> See, e.g., *Louisiana v. Dell International, Inc.*, 922 So.2d 1257 (La. App. 1<sup>st</sup> Cir., 2006) (third-party's in-state repair services created nexus for out-of-state computer vendor that contracted for the services on its products in the state), and *Borders Online, LLC v. State Bd. Of Equalization*, 129 Cal. App. 4<sup>th</sup> 1179, 29 Cal. Rptr. 3d 176 (1<sup>st</sup> Dist., 2005) (in-state presence of related retailer created nexus for remote Internet vendor). Cf. *National Geographic Society v. California Bd. Of Equalization*, 430 U.S. 551 (1977) (in-state presence of a nonretail division created nexus for the out-of-state vendor). In *Borders Online*, the appellate court affirmed the lower tribunal's decision, which was discussed in Hull, "California: Affiliate's product-Return Services Created Nexus," 12 JMT 33 (Mar/Apr 2002).

<sup>51</sup> See Fenwick, McLoughlin, et al, *supra* note 30, ¶ 17.01 *et seq.*

separate series for a consideration could be treated as a taxable transaction by some states,<sup>52</sup> despite the fact that for income tax purposes this transaction would be disregarded.

## Conclusion

Similar to what occurred after the first LLC statutes were enacted,<sup>53</sup> most businesses have been reticent to embrace the series LLC concept because of concerns regarding whether states without series LLC statutes will respect the limited liability of the series, and uncertainty over federal and state tax treatment of the series. Once these issues have been settled, the series LLC likely will become a popular vehicle for certain business activities because it will allow businesses to achieve limited liability for separate activities without going through the burden and expense of establishing and maintaining multiple LLCs.

Practice Note:  
Current State Series LLC Statutes

Seven states currently have statutes that provide for the creation or establishment of series LLCs. The two major versions of series LLC statutes are found in the laws of, respectively, Delaware and Illinois. Iowa (Iowa Code Sec. 490A.305) Nevada (Nev. Rev. State § 86.011 *et seq.*), Oklahoma (Okla. Stat. tit. 18, § 2054.4), Tennessee (Tenn. Code Ann. § 48-249-309), and Utah (Utah Code Ann. §48-2c-606) have enacted provisions that are substantially similar to the Delaware statute and do not contain the specific separate-entity provisions found in the Illinois law. Some key points of the Delaware and Illinois statutes are as follows:

**Delaware.** Del. Code Ann. Tit. 6, § 18-215 (which was the progenitor for several other state series LLC statutes), provides that “any such series [of the LLC] may have a separate business purpose or investment objective.” The law also essentially protects the assets of a particular series from the liabilities of the LLC or of another series of the LLC.

**Illinois.** 805 ILCS § 180/37-40 is, in some respects, similar to the Delaware law, but key differences exist. For example, the series “may have a separate business purpose or investment objective” but the Illinois statute requires that this be provided for in the LLC’s operating agreement. In contrast to Delaware law, the Illinois law specifically states that the series will be “treated as a separate entity to the extent set

forth in the articles of organization,” and “[e]ach series with limited liability may, in its own name, contract, hold title to assets, grant security interests, sue and be sued and otherwise conduct business and exercise the powers of a limited liability company.”

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<sup>52</sup> Assuming no exemption or exclusion applies, e.g., a sale for resale.

<sup>53</sup> The first LLC statute was enacted in Wyoming in the 1970s but LLCs did not come into vogue until the 1990s, after the IRS began issuing guidance that helped make the tax picture more clear. See, e.g., Rev. Rul. 88-76, 1988-2 CB 360.

## WORTH READING

Sandra K. Miller, Penelope Sue Greenberg, and Ralph H. Greenberg, *An Empirical Glimpse into Limited Liability Companies, Assessing the Need to Protect Minority Investors*, 43 AMERICAN BUSINESS LAW JOURNAL 609 (Winter 2006).

Michael W. McLoughlin and Bruce P. Ely, *The Series LLC Raises Serious State Tax Questions But Few Answers are Yet Available*, 16 JOURNAL OF MULTI-STATE TAXATION AND INCENTIVES 6 (January, 2007).

Nick Marsico, *Current Status of the Series LLC: Illinois Series LLC Improves Upon Delaware LLCs But Many Open Issues Remain*, 9 JOURNAL OF PASSTHROUGH ENTITIES 35 (Nov./Dec. 2006).

Deborah A. DeMott, *Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences*, 48 ARIZ. O. REV. 924 (Winter 2006).

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Allan W. Vestal & Thomas E. Rutledge, *Disappointing Diogenes: The LLC Debate That Never Was*, 51 ST. LOUIS UNIVERSITY L. J. 53 (Fall 2006)