Series LLCs: Practical Pointers and Tax Implications

Illinoisan can now enjoy the cost-effective protection afforded by the series limited liability company. However, advisors need to beware the danger in failing to properly separate assets in the series and to note unanswered questions about taxation the series LLC.

By Randall H. Borkus and Kimberly J. Myers

An Illinois series limited liability company ("ISLLC") is a single legal entity that allows its members to partition assets and liabilities among various "series" and permits different economic arrangements for each series within the single entity.

From an asset protection viewpoint, separating "high liability" assets and businesses from other assets, especially from "low or no liability" assets, is always a good idea. For example, an individual who owns an airplane and rental real property should not own both within the same legal entity. Moreover, large amounts of liquid assets such as cash and securities should not be held in the same legal entity as an airplane, rental real property, or trucking business.

Smart business practices require that every individual business or major business asset be segregated into different limited liability entities. In the perfect scenario, someone owning 35 rental properties would have 35 separate limited liability companies, one for each rental property. Not surprisingly, this becomes impractical for many clients because of the administrative, compliance, and government costs that are inherent to such a structure.

So what is a cost-effective way for a businessperson who owns 35 rental properties to protect his or her assets from unrelated liabilities between the different properties? Illinois limited liability company law has an answer.

The Illinois Series Limited Liability Company

Effective August 16, 2005, Illinois amended its Limited Liability Company Act (805 ILCS 180/1-1 et seq) ("Act") to permit the designation of "series" of ownership interests. Section 37-40(a) of the Act states as follows:

> An operating agreement may establish or provide for the establishment of designated series of members, managers or limited liability company interests having separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations, and to the extent provided in the operating agreement, any such series may have a separate business purpose or investment objective.

805 ILCS 180/37-40(a).

The uniqueness of the "series" structure is that the members of an ISLLC

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can hold separate property interests in separate series that are compartmentalized for liability purposes. The profits and losses as well as the assets and liabilities of each series are legally separated from each other.

The significant advantage of this structure is the ability of a business owner to hold all of his, her, or its investment properties or lines of business in one master LLC (with an unlimited number of other members), without the attendant cost of forming and maintaining multiple legal entities. An ISLLC is similar in structure to a parent company with multiple tiers of subsidiaries, insofar as the risks and liabilities associated with each series are insulated from the risks and liabilities of every other series.

However, unlike the "affiliated company" structure, an ISLLC may significantly reduce legal, accounting, and other administrative and compliance expenses (including taxes). Therefore, the ISLLC has the effect of accommodating multiple subsidiaries without the associated organization, maintenance, and compliance expenses.

Formation requirements

The importance of separateness. Section 37-40(b) of the Act allows for limitation on liabilities with respect to each series by providing that all debts, liabilities, and obligations with respect to a particular series shall be enforceable against the assets of such series only and not against the assets of the ISLLC generally or any other series, and none of the debts, liabilities, and obligations with respect to the ISLLC generally or of any other series shall be enforceable against the assets of such separate series.

This limitation on liability is available provided the ISLLC conforms as follows: (1) the operating agreement must create one or more separate series; (2) separate records for any such series must be maintained; (3) the assets associated with each series must be held and accounted for independently from the other assets of the LLC or any other series; (4) the operating agreement must provide for such separate accounting of assets and liabilities; (5) notice of the limitation on liabilities of a separate series shall be set forth in the articles of organization; and (6) the LLC must file a "certificate of designation" with the office of the Illinois Secretary of State for each separate series of the LLC.

In the case where a client fails to follow the separateness requirements described above, hazards loom.

Piercing the veil. When a series is operated in a manner truly independent and separate from other series, there is no greater public policy reason for disregarding the "internal" shields of an ISLLC than there is for disregarding the overall shield of an LLC or a corporation.

However, where assets or operations are commingled, the separateness requirements are ignored, series are undercapitalized (or under insured), the conduct or representations of the ISLLC contradict the constructive notice of segregation given in the articles of organization, or other abusive facts are present, courts can be expected to exercise their equitable powers to "pierce the veil" of the ISLLC.

The piercing-the-veil doctrine is an equitable doctrine, giving courts discretion in applying it to prevent the members of an ISLLC from abusing their limited liability shield. Creditors and tort claimants may argue that the ISLLC failed to provide sufficient notice of the separateness of each series and thus that the court should exercise its equitable powers to disregard the separate status of each series and apply all of the ISLLC's assets to satisfy the creditor's claim.[1]

On its face, a creditor's claim of lack-of-notice should fail. Section 37-40(b) of the Act states "[t]he fact that the articles of organization contain the foregoing notice of the limitation on liabilities of a series and a certificate of designation for a series is on file in the Office of the Secretary of State shall constitute notice of such limitation on liabilities of a series." 805 ILCS 180/37-40(b).

Nonetheless, it is in a client's best interest to take every feasible step to give potential creditors actual notice of the existence of a separate series.

How to avoid the pitfalls

To ensure the asset protection benefits of an ISLLC, the members must observe the formalities and operate each series as a separate business from the other series and the ISLLC itself. Following are steps that an ISLLC can take to increase the likelihood that creditors will receive actual notice of the segregated status of each series.

As required in section 37-40(c),

each series must adopt a distinctive business name that is distinguishable from the names of the other series but includes the full name of the ISLLC. For example, if the Borkus Family held Blackacre, Whiteacre, and Greenacre in different series of an ISLLC, The Borkus Family Series LLC, the ISLLC would file a certificate of designation for each of the series. The series' legal names could be "Blackacre Series of The Borkus Family Series LLC", or "Whiteacre Series of The Borkus Family Series LLC," and "Greenacre Series of The Borkus Family Series LLC." In these examples, a creditor dealing with the Greenacre Series would have a difficult time showing a justifiable belief that it was dealing with the entire Borkus Family Series LLC.

In all cases, each separate series' manager should sign all contracts, deeds, instruments, and other documents on behalf of that series in a way that puts the creditor, recipient, or public at large on notice that the document is being executed solely on behalf of a specific series within an ISLLC. The signature block of the contract might look like this:

Whiteacre Series of The Borkus Family LLC
By: ________________
Manager, Whiteacre Series of The Borkus Family Series LLC

The members should use series-specific checks, business cards, and stationery to give notice to third parties that they are dealing with a separate series of the ISLLC. These formalities are easy to observe and bolster the protection that the Act provides to the ISLLC.

Deeds to real property must be recorded in the name of each individual series to provide constructive notice on creditors. Pocket deeds and improperly recorded deeds provide a formidable argument for a creditor to use against the limitation of liability of an ISLLC and the separate series.

Additionally, when real property is transferred to an ISLLC, take special care to avoid termination of coverage under the members' title insurance policy. In *Gebhardt Family Restaurant, LLC v Nation's Title Ins Co of NY,*[2] the court held that a transfer of land from two family members to an LLC, of which they were the only members, terminated coverage under a policy naming the individual family members as the insured parties.[3] Mortgage companies will also require notice of any transfer.[4]

Assets of separate series must not be commingled. A separate bank account must be established and separate books and records must be maintained for each individual series.

There should also be adequate capitalization and liability insurance depending on the nature and extent of the business. Though not required by statute, the members should have annual meetings and produce statements about the past business year and expectations for the future. The meetings should be documented in a minute book and kept in the ISLLC's office and also in the attorney's office.

Loans between each series must be properly documented as arms-length transactions and approved by the manager or managing members of each series involved.

Transactions between the series should be conducted in an arm's-length manner at fair market values using the appropriate interest rates (AFR).[5] Whenever possible, appraisals, valuations and comparables must be obtained in connection with any sales, leases, and other transfers between series.

How are assets in the series taxed?

The primary tax issue is whether the ISLLC and its separate series should be treated as separate taxable partnerships or as a single partnership. Under federal tax law, it is unclear whether each separate series is owned by the LLC itself as an umbrella entity or the LLC is a transparent legal vehicle with the members owning the series directly. LLCs are most often drafted with the intent of being taxable as a partnership under subchapter K of the Tax Code rather than as a corporation.[6] To date, the Treasury Department has not issued any direct guidance on the tax treatment of series LLCs.

However, Illinois law gives us flexibility. Under section 37-40(b) of the Act, the LLC and its series may elect to consolidate their operations as a single taxpayer to the extent permitted under applicable law. In general, an entity organized under state law will not always be recognized as a separate entity for federal tax purposes[7] (e.g., a separate series of a series LLC). Therefore, it may be reasonable to surmise that the IRS could treat the ISLLC and its separate series as a single tax entity, regardless of the number of series registered, but the reality is that the issue remains ambiguous without the IRS's firm guidance.

While the assets and liabilities of each series within an ISLLC are segregated for state law purposes, federal income tax treatment of the series LLC and each of its series remains potentially erratic.

Further study reveals varying opinions. It has been argued that one must examine the LLC's lines of business and profit/loss sharing arrangements to determine if the series actually constitutes separate businesses for which separate returns will be required.[8]

Others argue that common ownership among the separate series is the key. In the case of certain business trusts that create numerous series, it has been held that each series be treated as a separate tax entity due to a lack of common ownership of the individual series.[9]

Therefore, each member should own a percent of the total interest of each individual series. For example, in an ISLLC consisting of series A, B, and C, and members X, Y, and Z, the ownership interests among each of the series may vary as follows: Series A: one-third each; Series B: 10 percent to X, 10 percent to Y, 80 percent to Z; and Series C: 45 percent to X, 45 percent to Y, and 10 percent to Z.

Additionally, members may want each series to be managed by the same manager(s) when possible. Arguably, if commonality of members and managers among the series is shown, the IRS may have difficulty finding that each series constitutes a separate taxable entity.

Accounting issues

Section 37-40(b) of the Act also provides that where separate series are created, separate records for each series must be maintained, and the assets associated with any such series shall be accounted for separately from the other assets of the ISLLC or any other series. Of course, the members and/or managers of the ISLLC will want to maintain separate accounting records for each series so that the economic performance of each series can be determined.

The ISLLC's managers must also be able to ascertain the activity in each series for purposes of allocating general overhead expenses among the series (such as fees for accounting, legal, and other professional advisors, as well as operating expenses such as rent, filing fees, taxes, etc.).

Finally, the ISLLC will issue its members K-1s so that the members may report their share of the income and losses on their personal tax returns. Assuming the ISLLC is treated as a single partnership for tax purposes, the appropriate method of generating each investor's K-1 would be to aggregate each investor's share of the profits and losses from each of the respective series, net the results from all the series, and issue each member a single K-1. From the member's perspective, the ease of having to deal with only one K-1 is an attractive feature of an ISLLC.

Conclusion

The principal benefit of the ISLLC is that it insulates the liability associated with the assets of any one particular series from the assets of the ISLLC generally, as well as assets held in other series. The ability to place multiple assets in a single LLC, yet insulate the assets and liabilities, eliminates the administrative burden and expense of forming multiple LLCs to hold separate business or investment interests. Before setting up an ISLLC, however, an advisor must understand the tax consequences that result from the overall business structure and ownership interests. ■

If your client fails to follow the separateness requirements of the LLC Act, hazards loom.

Theoretically, the IRS could treat the ISLLC and its separate series as a single tax entity, but the issue remains ambiguous without the IRS's firm guidance.

1. *In re Albright*, 291 BR 538, 50 Collier Bankr C
2d 1 (2003).

2. 132 Md App 457, 465-66, 752 A2d 1222, 122
27 (2000).

3. See John C. Murray, *Title-Insurance Endorsemen for Limited Liability Company Transactions*, The Firs American Corporation (2001), available at http://www firstam.com/content.cfm?id=2912.

4. See John C. Murray, *Assignment of an LL Member's Rights to Profits, Losses, and Distribution A Violation of the Due-on-Sale Clause?*, The Firs American Corporation (2004), available at http://www firstam.com/content.cfm?id=2890.

5. The Internal Revenue Service publishes base interes rates known as the applicable federal rates ("AFRs") See http://www.irs.gov/taxpros/lists/0,,id=98042,00 html.

6. Craig A. Gerson, Tax Management Memorandum, *Taxing Series LLCs*, BNA Tax Management, Vol 45 No 4 Feb 23, 2004, available at http://www.bnatax.com/ tm/jc_memorandum_vol45no05.htm; Craig A. Gerson, *Series LLCs–Difficulty Surrounding US Federal Tax Classification*, BNA Tax Management (2006), available at http://www.bnatax.com/tm/insights_SeriesLLCs.htm.

7. Treas Regs § 301.7701-1(a)(3), (26 CFR §301. 7701-1(a)(3)).

8. See, for example, Thomas M. Stephens & Mark L. Schultz, *Segregating Assets Within a Single Partnership: Delaware Series Partnerships and LLCs*, 78 Taxes 231 (Mar 2000).

9. See National Securities Series -- Industrial Stock Series, 13 TC 884 (1949); Rev Rule 55-416; PLR 9819002 (May 8, 1998); See Craig A. Gerson, *Taxing Series LLCs*, 45 Tax Mgmt Mem 75 (Feb 2004), available at http://www.bnatax.com/tm/jc_memorandum_vol45 no05.htm; Christopher M. Riser, *Delaware Series LLC*, Offshore Today (Sept 2000), available at http://www. riserlaw.com/publications/business/seriesllc.htm; *ASA Investerings Partnership v CIR*, 76 TCM 325 (1998), affd 201 F3d 505 (DC Cir 2000).