WHERE DO WE GO FROM HERE? A SURVEY OF SERIES LLCS IN TEXAS IN LIGHT OF THE PROPOSED FEDERAL TAX CLASSIFICATION FOR THE ORGANIZATION

James Howard*

I. INTRODUCTION

First introduced by Delaware in 1996,[1] the series limited liability company (SLLC) is one of the newest additions to the panoply of available business organizations.[2] The apparent benefits of the structure are appealing: reduced filing fees and administrative costs, organizational flexibility, and compartmentalized liability protection produce a siren song that should attract current owners of complex parent organizations and multiple LLCs to the series form.[3] However, jurisdictions have been slow to adopt the concept,[4] as questions about the treatment and operation of the series entity have crippled the predictability lawyers and business owners desire for their organizational choice.[5] Among those questions is how a series LLC might be treated for federal tax purposes,[6] and that question, of

---

* J.D., Baylor University School of Law, July 2011; B.A., Louisiana State University at Shreveport, May 2008. The author would like to thank Professor Elizabeth Miller for her guidance in writing this article. The author would also like to thank the Baylor Law Review editors who worked to make this article what it is.

[1] Sandra Mertens, Comment, *Series Limited Liability Companies: A Possible Solution to Multiple LLCS*, 84 CHI.-KENT L. REV. 271, 273 (2009) (citing H.B. 528, 138th Gen. Assem., 2d Sess. (Del. 1996), *amended by* DEL. CODE ANN. tit. 6, § 18-215 (West Supp. 2008) (incorporating the concept of a series trust into the code provisions governing LLCs)).

[2] *See* Christopher S. McLoon & Margaret C. Callaghan, *The Dangerous Charm of the Series LLC*, 24 MAINE B.J. 226, 226 (2009) (noting that, to date, only eight states had amended their statutes to provide for series LLCs).

[3] *See id.* at 226–27 ("*At first glance*, the benefits of such an entity seem obvious." (emphasis added)).

[4] *See id.* at 226.

[5] *See id.* at 227 ("Upon further investigation . . . significant uncertainties and risks inherent to the series LLC structure become apparent.").

[6] In fact, almost every commentator to write about the subject has discussed the ambiguity of federal tax classification. *See* Carol R. Goforth, *The Series LLC, and a Series of Difficult Questions*, 60 ARK. L. REV. 385, 401 (2007); McLoon, *supra* note 2 at 230; Thomas E. Rutledge, *Again, For Want of a Theory: The Challenge of the "Series" to Business Organization Law*, 46

course, has been particularly stifling.[7] Though the provisions governing the series form in many jurisdictions have sorted out the question of liability with some specificity,[8] certainty in tax treatment is the pillar upon which modern business planning rests.[9]

However, it seems that some light is shining through the cloud of ambiguity surrounding the series concept.[10] In September of 2010, the IRS opened up a notice and comment period on a proposed rule that would treat each individual series within the LLC "as an entity formed under local law."[11] If the IRS actually promulgates this rule, there may very well be an upswing in series registration, and courts and legislatures will have to finally answer some of the questions that have plagued the series form.

This comment will evaluate the operation of the series LLC in Texas and analyze the current ambiguities of the form in light of the IRS's classification of the series as "an entity formed under local law."[12]

II. BACKGROUND

A. The Business (or Statutory) Trust: Father to the Series LLC

To understand the series LLC, one must understand the context in which it arose. In 1988, Delaware enacted its Business Trust Act in an attempt to recognize the statutory trust "'as an alternative form of business

AM. BUS. L.J. 311, 321–22 (2009); Mertens, *supra* note 1 at 277–80; Charles T. Terry & Derek D. Samz, *An Initial Inquiry into the Federal Tax Classification of Series Limited Liability Companies*, 110 TAX NOTES 1093, 1093 (2006).

[7] *Cf.* NATIONAL CENTER FOR POLICY ANALYSIS, CONGRESSIONAL BRIEF: WHY AREN'T COMPANIES HIRING? 1 (2011) (stating that tax uncertainty is stifling expansion and job creation).

[8] *See, e.g.*, TEX. BUS. ORGS. CODE ANN. § 101.602(1) (West 2010) ("the . . . liabilities . . . with respect to a particular series shall be enforceable against the assets of that series only . . . .").

[9] An interesting exercise in human behavior: Though it is both liability protection and tax treatment that govern effective business planning, business owners do not generally organize in anticipation of future lawsuits. Tax, however, is a certainty. *See* Letter from Benjamin Franklin to Jean-Baptiste Leroy (November 13, 1789), *in* 10 The Works of Benjamin Franklin, 1783–1790, at 410 (Jared Sparks ed.) (1882) ("[I]n this world nothing can be said to be certain, except death and taxes.").

[10] *See* McLoon, *supra* note 2 at 230.

[11] Series LLCs and Cell Companies, 75 Fed. Reg. 55699, 55707 (proposed Sept. 14, 2010) (to be codified at 26 C.F.R. pt. 301) ("For Federal tax purposes, . . . a series . . . is treated as an entity formed under local law.").

[12] *Id.*

organization.'"[13] Though statutory trusts had existed since 1909,[14] the enactment of the 1988 Act in Delaware resulted in a flurry of business trust legislation.[15] At the time, there was demand for trusts grounded in statute,[16] as common-law business trusts were riddled with legal uncertainty.[17]

Under the Delaware Act, a statutory trust is an unincorporated association created by a governing instrument under which business or professional activities for profit are carried on by a trustee for the benefit of persons with a beneficial interest.[18] The trustee of such an organization is generally embodied in a board,[19] and the beneficiaries of the trust are much like stockholders:[20] reaping the profits of whatever business activities the trust is authorized to carry out.[21] The trust form is favored for structured finance transactions in which passive equitable participation rights in securitized asset pools are issued to investors.[22] Though it is not entirely clear why the statutory trust was so eagerly utilized for asset securitization, many commentators have noted that the supremacy of the contractual relationship embodied by the trust allowed promoters to establish their organizations in a way that is "subject only to the pressures and judgments of the markets."[23] Whatever the strengths of the statutory trust, it is important to note that despite Delaware's recognition of the statutory trust as an alternative form of business organization,[24] the statutory trust form

[13] Robert H. Sitkoff, *Trust as "Uncorporation": A Research Agenda*, 2005 U. ILL. L. REV. 31, 36 (2005).

[14] *Id.* at 36.

[15] *Id.* at 36.

[16] *See id.*

[17] *Id.*

[18] The Delaware Code also requires the administrator to file a certificate of trust. DEL. CODE ANN. tit. 12, § 3801(g)(2) (2007).

[19] Rutledge, *supra* note 6 at 313.

[20] Ashworth v. Hagan Estates, 131 S.E. 381, 382 (Va. 1935).

[21] *See* DEL. CODE ANN. tit. 12, § 3801(g)(1) (defining the statutory trust as a relationship in which the trustee carries on business activity for the benefit of beneficiaries).

[22] Sitkoff, *supra* note 13 at 39. "Securitization" occurs when the risk from various contractual obligations (generally arising from mortgages, loans, and other debt obligations) is transferred to an investor (or pool of investors) through a security (such as a bond or collateralized mortgage obligation). *See* SYLVAIN RAYNES & ANN RUTLEDGE, THE ANALYSIS OF STRUCTURED SECURITIES: PRECISE RISK MEASUREMENT AND CAPITAL ALLOCATION, 90 (2003).

[23] Tamar Frankel, *The Delaware Business Trust Act Failure as the New Corporate Law*, 23 CARDOZO L. REV. 325, 325–26 (2001).

[24] In fact, the explicit purpose of the 1988 Act was to recognize as such. *See* 2 R. Franklin

has been almost exclusively utilized by investment companies (asset administrators),[25] not commercial and manufacturing enterprises.[26]

One advantage of the statutory trust, overlooked by many of the more philosophical commentators, is the trustee's ability to segregate assets held by the trust into administrative subunits, or series.[27] This ability to segregate assets should be distinguished from a corporate board's ability to attach rights and restrictions to ownership interests by creating new classes of stock.[28] In the former, beneficial interest owners have rights (defined by their contractual relationship with the trustee[29]) to the assets within the series fund only.[30] In other words, the beneficiary's interest is limited to a specific pool of assets.[31] Even though the trust may administer several different pools,[32] a particular interest holder only has rights to the series defined by his contract, and does not have rights to all assets housed within the trust.[33] Conversely, a share of stock, irrespective of its class or series, will always represent an ownership interest in the corporation that issued

Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations & Business Organizations* § 19.2 (3d ed. & 2011 Supp.).

[25] *See* Frankel, *supra* note 23 at 326–27 ("[A] number of mutual funds have taken advantage of the Act to benefit from its clarifications and the flexibility it offers."). Frankel goes on to identify a number of reasons why commercial and manufacturing enterprises have not adopted the trust form, including the requirement of strict compliance, irregularities in the substantive law, and a lack of significant advantage in converting. *See generally id.*

[26] *Id.* at 327.

[27] *See, e.g.*, GORDON ALTMAN BUTOWSKY WEITZEN SHALOV & WEIN, A PRACTICAL GUIDE TO THE INVESTMENT COMPANY ACT § 2-3 (1996) ("A series company or fund is an investment company composed of separate portfolios of investments organized under the umbrella of a single corporate or trust entity."); *see also* 15 U.S.C. § 80a-18(f)(2) (2006); 17 C.F.R. § 270.18f-2 (2011) ("For purposes of [this section] a series company is a registered open-end investment company which . . . issues two or more classes or series of preferred or special stock each of which is preferred over all other classes or series in respect of assets specifically allocated to that class or series.").

[28] Of course, a corporate board's ability to create new classes or series of stock will vary from jurisdiction to jurisdiction. *See, e.g.*, TEX. BUS. ORGS. CODE ANN. § 21.152 (West 2010) ("A corporation's certificate of formation may divide the corporation's authorized shares into one or more classes . . . .").

[29] *In re Laher*, 496 F.3d 279, 289 (3d Cir. 2007).

[30] *See* Rutledge, *supra* note 6 at 313 (explaining that distinct series are organized with respect to specific classes of assets and that securities are in turn issued with respect to the series).

[31] *See id.*

[32] *See id.*

[33] *See id.* at 313–14.

the share.[34] Though the rights associated with that share might be limited depending on the share's class,[35] the share will never represent anything less than an interest in the corporation as a whole.[36] Ultimately, the source of the limitations on the rights associated with the ownership interest differs between the two organizations.[37] In a corporation, limitations stem from the terms of the class set out in the certificate of formation.[38] In a trust, limitations stem from the segregation of assets into distinct funds.[39]

After the commercial and manufacturing enterprises snubbed Delaware's invitation to utilize the statutory trust organization,[40] Delaware incorporated the series concept into its LLC[41] and limited partnership statutes.[42] Today, the Delaware Code provides that "[a] limited liability company agreement may establish or provide for the establishment of [one] or more designated series of members, managers or limited liability company interests or assets."[43] Though Delaware's superimposition of the series concept onto the LLC did not result in a significant upswing of series registration, several other jurisdictions adopted the series concept,[44] and the

[34] *See, e.g.*, TEX. BUS. ORGS. CODE ANN. § 1.002(80) (West 2010) ("'Share' means a unit into which the ownership interest in a for-profit corporation . . . is divided . . . .").

[35] *See* Rutledge, *supra* note 6 at 314.

[36] *See* TEX. BUS. ORGS. CODE ANN. § 1.002(80) (West 2010).

[37] *E.g.*, TEX. BUS. ORGS. CODE ANN. § 21.152(a) (West 2010); *see* Rutledge, *supra* note 6 at 313.

[38] *E.g.*, TEX. BUS. ORGS. CODE ANN. § 21.152(a) (West 2010) ("A corporation's certificate of formation may divide the corporation's authorized shares into one or more classes . . . .").

[39] *See* Rutledge, *supra* note 6 at 313.

[40] *See* Frankel, *supra* note 23 at 346 ("To [commercial and manufacturing] [e]nterprises, the Delaware Business Trust Act promised more than it delivered.").

[41] 360 Del. Laws 9 (1996) (amending Title 6 of the Delaware code (governing Delaware LLCs to provide that "[a] limited liability company agreement may establish or provide for the establishment of designated *series* of members, managers or limited liability company interests . . . ." (emphasis in original)).

[42] Delaware remains the only jurisdiction to allow limited partnerships to utilize the series concept. 362 Del. Laws 13 (1996) (amending Title 6 of the Delaware code (governing Delaware LPs) to provide that "[a] partnership agreement may establish or provide for the establishment of designated series of limited partners or partnership interests . . . .").

[43] DEL. CODE ANN. tit. 6, § 18-215(a) (Supp. 2008).

[44] McLoon, *supra* note 2 at 226 (noting that—as of 2009—Delaware, Illinois, Iowa, Nevada, Oklahoma, Tennessee, Utah, and Texas had all amended their LLC statutes to allow for the series formation).

series LLC was quickly identified as the newest business organization available to business owners across the country.[45]

Series organization is currently most palatable to three distinct types of enterprises.[46] First, utilizing the series LLC, investment companies organized as statutory trusts could easily convert to the LLC form while continuing the segregation of their asset pools.[47] Series formation for the investment company is particularly useful because the parent organization (the LLC itself) must only file a single registration form under the Investment Company Act of 1940.[48] Second, some commentators have suggested that real estate development and management businesses could effectively segregate ownership rights and liabilities between properties by associating those properties with specific series within the LLC.[49] Again, owners could attain the benefits of segregation while using the parent organization to secure generally applicable licenses or regulatory approval.[50] Finally, series organization might be utilized by businesses with multiple assets under different ownership (such as taxicab companies).[51] If such an industry is highly exposed, a business may want to segregate liabilities to minimize that exposure to passive investors and other owners.[52]

B. 2009: The Series LLC Comes to Texas

In 2009, Texas joined the jurisdictions permitting the formation of series LLCs by amending Chapter 101 of its Business Organizations Code (TBOC).[53] The Texas provisions track the Delaware code fairly closely, providing that LLCs can establish a series of "members, managers, membership interests, or assets . . . ."[54] If specified statutory requirements are met, the liabilities and obligations of a particular series are enforceable

---

[45] *See* Goforth, *supra* note 6 at 386.

[46] McLoon, *supra* note 2 at 228.

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] *Id.*

[52] *See id.* ("[S]egregation of liability [in the context of a single business with multiple assets under different ownership] . . . make[s] the series LLC seem like an ideal business entity.").

[53] Act of May 20, 2009, 81st Leg., R.S., ch. 84, § 45, 2009 Tex. Gen. Laws 140–45.

[54] *Compare* TEX. BUS. ORGS. CODE ANN. § 101.601 (West 2010) with DEL. CODE ANN. tit. 6, § 18-215(a) (Supp. 2008) (providing for the "establishment of [one] or more designated series of members, managers, limited liability company interests or assets.").

only against the assets of that series.[55] Conversely, the liabilities and obligations of the LLC generally, or any other series within that LLC, are unenforceable against the assets of another series.[56]

Importantly, there are three statutory requirements that act as a prerequisite to the liability limitation.[57] First, the LLC's certificate of formation must contain a notice of the limitation of liability with respect to its various series.[58] Second, the company agreement must contain a statement to the effect of the liability limitation.[59] Third, the LLC's records maintained for a series must account for the assets associated with the series separately from the assets of the LLC or any other series.[60] The first two requirements can be satisfied through careful drafting, but the third requires a conscious, consistent effort on the part of the business owner.[61] The records requirement is met if the records are maintained so that the assets of a particular series can be "identified by specific listing, category, type, quantity, or computational or allocational formula or procedure . . . ."[62] Though satisfaction of the records requirement appears to require a minimal effort to tie the asset to the series,[63] a sloppy business owner could easily neglect to properly associate a newly acquired asset. More alarming, there is no indication of how a court might treat an LLC that failed to properly account for its assets.[64]

---

[55] TEX. BUS. ORGS. CODE ANN. § 101.602(a)(1) (West 2010).

[56] *Id.* § 101.602(a)(2).

[57] *Id.* § 101.602(b).

[58] *Id.* § 101.602(b)(3).

[59] *Id.* § 101.602(b)(2).

[60] *Id.* § 101.602(b)(1).

[61] The code requires that the records must be maintained in a way that indicates which series owns which assets. *Id.* Though a lawyer or accountant could set up the records to accurately reflect the state of ownership for the company's initial assets, a business owner or manager would have to accurately update those records as new assets are acquired. *See id.*

[62] TEX. BUS. ORGS. CODE ANN. § 101.603(b) (West 2010).

[63] This is because of the breadth of permissible asset identification. *See id.*

[64] There is neither a code provision nor any case law that indicate how a court would deal with an LLC's failure to comply with Section 101.602(b)(3). Would the court permit a creditor of the parent organization to attach only the misallocated asset? Would the court disregard the series formation all together and allow a creditor access to any asset of the parent and any asset of the series? Is one misallocation enough to subject non-culpable series to liabilities for unrelated debts? The code seems to indicate that the general effect of asset segregation is null and void unless the perquisites are satisfied. *See* TEX. BUS. ORGS. CODE ANN. § 101.602(b) (West 2010) ("Subsection (a) (setting out the effect of segregating assets and liabilities) applies only if . . . .").

Assuming that the LLC complies with the statutory requirements set out in Section 101.602, the members or managers of the entity can effectively wall off members, managers, membership interests, or assets from the liabilities of the LLC and other series.[65] However, it is important to note that the series form means more than just asset segregation.[66] The code explicitly states that a series has the power to: (1) sue and be sued, (2) contract, (3) hold title to assets of the series, and (4) grant liens and security interests in assets of the series.[67] By clearly providing a broad range of powers, this provision is instrumental in demonstrating that the individual series, at base, operates as an entity in its own right.[68]

Finally, it is important to note that members and managers in a SLLC enjoy liability protection from the debts and obligations of both the LLC and any particular series.[69] Questions about the nature of a series's limited liability extend beyond the language of the TBOC. Asset and interest segregation raise a number of questions about the operation and ultimate liability of both the parent and the series within. Therefore, even if a particular member or manager is associated with a series, she remains immune from the liabilities of that series.[70] Of course, a member or manager's liability protection remains subject to that person's duty to the company or series as defined by the company agreement.[71]

---

[65] *See id.* § 101.602 (West 2010) ("the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to a particular series shall be enforceable against the assets of that series only . . . .").

[66] *See, e.g., id.* § 101.605 (enumerating the general powers of the series).

[67] *Id.*

[68] *See* Rutledge, *supra* note 6, at 336 (explaining that the attributes of a series to be considered when determining whether the series is subject to characterization as a corporation include (among other things) whether the series has the ability to hold and transfer property in its own name, whether the series has the right to sue and be sued, and whether the series has the right to contract in its own name).

[69] *See* TEX. BUS. ORGS. CODE ANN. § 101.114 ("[A] member or manager is not liable for a debt, obligation, or liability of a limited liability company . . . . "). Subchapter M (governing series LLCs) specifically provides that a member or manager of a series, regardless of association, is not liable for the debts obligations or liabilities of a series. *Id.* § 101.606(a). Presumably, the members and managers are protected from the liabilities of the LLC by the provision extending that protection to any LLC member or manager, regardless of series formation.

[70] *See id.* § 101.606(a).

[71] *See id.* § 101.606(b) ("The company agreement may expand or restrict any duties . . . and related liabilities that a member, manager, officer, or other person associated with the series has to . . . the series . . . .").

III. OPERATIONAL LIABILITIES OF THE SERIES LLC

A. *The Extent of Limited Liability: Security Interests and Veil Piercing*

As discussed above, the SLLC form—like any LLC—enjoys limited liability.[72] Of course, the series form is distinct from a normal LLC because of its ability to segregate assets, members, managers, and interests.[73] This ability to segregate raises a number of interesting questions about the way certain liabilities would be treated in different contexts. For the purposes of this section, I will analyze two types of liabilities: (1) contractual liability backed by a security interest, and (2) tort liability that may extend to members or series under a veil-piercing theory.[74]

1. Security Interests

At first glance, the operation of security interests within the series form seems relatively straightforward. Recall that the assets of each series within the LLC are effectively walled off from the liabilities of any other series or the parent organization.[75] If the company agreement so provides, only members with the right to manage and control assets within a particular series will be equipped to grant security interests on those assets.[76] Therefore, creditors doing business with the series will only be able to

[72] *Supra* Part II.B.

[73] *Id.*

[74] Of course, a contract claimant may also "pierce the veil" of the series entity. *See, e.g.*, Castleberry v. Branscum, 721 S.W.2d 270, 271 (Tex. 1986). However, it is far more likely that such a creditor will pursue a remedy for default by way of a security interest (as sophisticated entity-creditors likely require the grant of such an interest upon extension of credit). It is the tort claimant that will likely be interested in piercing the veil of a series or parent as his claim is unsecured, and the company's assets will be distributed throughout multiple series. *See* Mertens, *supra* note 1, at 307 ("Assuming each series contains one asset, that asset may not be able to satisfy a judgment against the series.").

[75] *See* TEX. BUS. ORGS. CODE ANN. § 101.60.

[76] *See id.* § 101.607(a)(1) ("The company agreement may . . . establish classes or groups of one or more members or managers associated with a series *each of which has certain express relative rights, powers, and duties, including voting rights* . . . ." (emphasis added)). Presumably, the company agreement would segregate the assets of the LLC as needed and associate one or more members with the series. The associated members would retain the exclusive right to manage and control those assets in compliance with the voting rights enumerated by the company agreement.

obtain security interests on the assets within the series.[77] If the value of the collateral does not satisfy the debt, the creditor simply retains an unsecured claim against the individual series and will be barred from moving against any other series or the parent.[78]

Practically, however, there is no guarantee that the operation of security interests will work this cleanly. Clarity in this area is a function of careful drafting[79] and responsible management.[80] Consider, for example, a situation in which the company agreement provides for the segregation of assets but neglects to associate members or managers with any particular series.[81] Assuming default, a secured creditor is limited to possession of the asset in which it took the security interest.[82] However, because every member arguably has powers with respect to every series (as the company agreement only segregates assets), any member may be able to grant security interests across the board.[83] Even if a member purported to act on behalf of an individual series, sloppy documentation of the security interest in "all the assets" of the "borrower" may result in across-the-board liability if a court interprets the loan documents to apply to the LLC generally.[84] This risk is magnified if a creditor initiates its repossession action in a jurisdiction that does not recognize SLLCs.[85] Consider the following table illustrating the multitude of possible pitfalls relating to security interests in the series context.

[77] *See id.* Because, presumably, the associated member(s) would be barred from granting security interests on assets in series with which they were not associated with.

[78] *Id.* § 101.602.

[79] *See id.* Drafting that clearly delegates the rights and responsibilities of each member or manager. If the company agreement can be construed to allow one or more members the power to grant security interests across the board, the benefits of asset segregation are significantly reduced.

[80] *See id.* As members or managers must both (a) understand the extent of their rights under the company agreement and (b) conduct themselves in a way that complies with that agreement.

[81] This would be possible under the TBOC. *See id.* § 101.601 ("A company agreement may establish or provide for the establishment of one or more designated series of members, managers, membership interests, *or* assets . . . ." (emphasis added)).

[82] TEX. BUS. & COM. CODE ANN. § 9.102(12) (West 2010) ("'Collateral' means the property subject to a security interest . . . .").

[83] This is especially true since a creditor, even a sophisticated one, would not necessarily understand the distinction between an SLLC and simple LLC.

[84] McLoon, *supra* note 2, at 229.

[85] *Id.*; *see also supra* Part II.B.

Specificity of the Company Agreement	**Member/Manager Action**	**Possible Result**
Company agreement validly segregates assets but neglects to associate members or managers to specific series	Member or manager specifies the asset to be encumbered	Because the member/manager is not associated with a series, he likely has the power (as determined by the company agreement) to grant an interest in any asset of the LLC. The creditor only retains an interest in the asset specified.[86]
	Member or manager grants a security interest in "all assets" of the borrower	As noted above, the member/ manager likely has the power to grant the interest. However, even if both parties understood the "borrower" to be the series, the member/manager may have granted a security interest in all the assets of the LLC.[87]
Company agreement validly segregates assets and properly associates one or more members or managers to each series	Member or manager specifies the asset to be encumbered	Assuming the member/manager is acting within his authority, the creditor only retains an interest in the asset specified. Any unsecured claim is enforceable against the series only.[88]
	Member or manager grants a security interest in "all assets" of the borrower	If the member/manager intended to encumber all the assets of the LLC, he has acted outside of his authority (as he would only have the power to encumber assets within his series).[89] However, it is unclear whether a court would interpret the company agreement in a way that would prejudice third parties.

[86] *See* TEX. BUS. ORGS. CODE ANN. § 101.602(a) (West 2010).
[87] *See* McLoon, *supra* note 2, at 229.
[88] *See* TEX. BUS. ORGS. CODE ANN. § 101.602(a).
[89] *See id.* § 101.607(a)(1).

2. Veil Piercing

A member or manager in an SLLC, like a member or manager in any LLC, may be subject to personal liability to third parties under a veil-piercing theory.[90] Unfortunately, there is no indication how a court may go about imposing personal liability in the series context. Assuming a court recognizes the series as a separate entity, there could be multiple veils between a third-party claimant and any given member or manager.[91] Therefore, it stands to reason that if a member or manager associated with a particular series used that series in a way that constituted fraud or injustice, only the members or managers associated with that particular series should be subjected to personal liability.[92]

However, as we saw in the security interest context, the operation of the series form is not always clean.[93] With an SLLC, there are multiple entities that may be subject to piercing.[94] First, consider the scenario in which a member of the LLC uses a series in a way that might justify the veil pierce. As noted above, it seems as though only the members associated with the series would be subject to personal liability.[95] Consider, though, that when courts pierce the veil of an entity, they impose liability on the owners of the

[90] Though the Texas Supreme Court has never officially authorized the use of the veil pierce against an LLC, it has carefully laid out the prerequisites for imposing personal liability in the corporate context. *See* Castleberry v. Branscum, 721 S.W.2d 270, 272–73 (Tex. 1986) ("Because disregarding the corporate fiction is an equitable doctrine, Texas takes a flexible fact-specific approach focusing on equity."). The legislature responded by changing the TBOC to eliminate consideration of corporate formalities and requiring a showing of actual fraud by a contract creditor. TEX. BUS. ORGS. CODE ANN. § 21.223 (West 2010). Many appellate courts in Texas have used the *Castleberry* analysis and the subsequent legislative reaction in determining whether to impose personal liability on the members or managers of an LLC. *See, e.g.*, Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass'n, 77 S.W.3d 487, 500 (Tex. App.—Texarkana 2002, pet. denied).

[91] *See* TEX. BUS. ORGS. CODE ANN. § 101.601. A member or manager may be associated with a series other than the series used to perpetrate the fraud or injustice.

[92] *See* Rutledge *supra* note 6, at 336. The series itself constitutes an entity for the purpose of *lex incorporontis*.

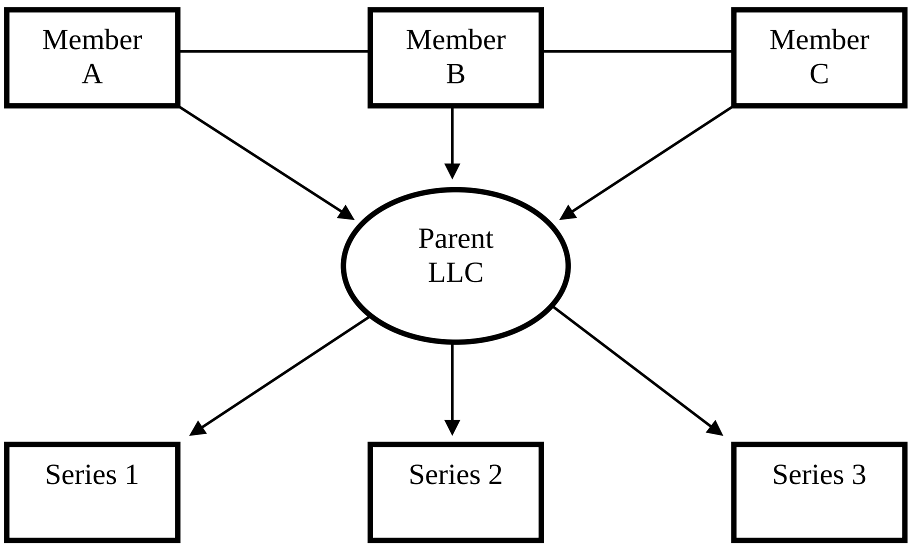
[93] *See supra* Part III.A.1.

[94] *See* TEX. BUS. ORGS. CODE ANN. § 101.601(a) (providing that the company agreement of the parent can establish "one or more" designated series). At a minimum, there are two: (1) the parent organization (the LLC), and (2) the series into which the parent as segregated assets, members, or managers (assuming the parent elects to form only one series).

[95] *See* Rutledge, *supra* note 6, at 336.

organization as they disregard the entity.[96] In the series context however, it is unclear who actually owns the series.[97] Some commentators have suggested that, even if members or managers are associated with a particular series, a series is ultimately "own[ed]" by the parent LLC.[98] This structure is represented in Diagram 1.1.

Diagram 1.1



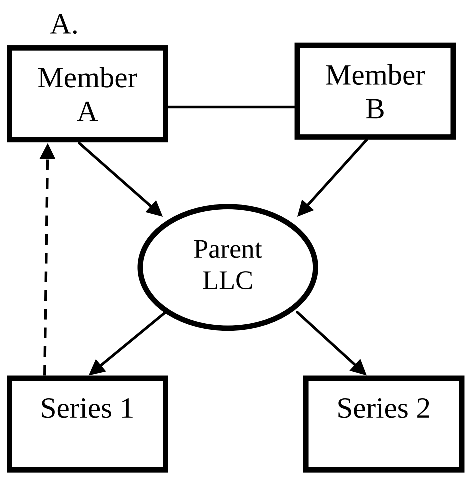
[96] *See* Francis v. Beaudry, 733 S.W.2d 331, 335 (Tex. App.—Dallas 1987, writ ref. n.r.e.) (allowing the estate of a deceased shareholder to reclaim the value of that shareholder's interest from the surviving shareholders); Speed v. Eluma Int'l, Inc., 757 S.W.2d 794, 798 (Tex. App.—Dallas 1989, writ denied) (imposing personal liability on the sole shareholder of a corporation after he used a fraudulent foreclosure to effect a transfer to the detriment of his existing creditors); Seaside Indus., Inc. v. Cooper, 766 S.W.2d 566, 569 (Tex. App.—Dallas 1989, no writ) (imposing personal liability on the sole shareholder of a corporation after he engaged in a series of company-to-company transfers to avoid paying a debt).

[97] Mertens, *supra* note 1, at 275 (noting the existence of two possible structures: The first resembling a parent-child relationship between the company and the series, and the second resembling a brother-sister relationship between the company and the series).

[98] *See id.* ("In its simplest form, the Parent LLC would own a majority share of each series, and the individual owners would have an interest in the Parent LLC.").

Assuming equal ownership interests, Member A would retain a thirty-three percent ownership interest in the parent company regardless of his association with any particular series.[99] In turn, the parent organization owns one hundred percent of each series.[100] In this scenario, if a court were to pierce the veil of a series to impose personal liability on the owner of that series, it would find itself at the parent level, not at the member level.[101] Entities, however, do not act fraudulently in a vacuum.[102] Therefore, courts would likely impose personal liability on the members even though there is no direct link between the members and the series used to perpetrate the wrongdoing.[103] The manner in which a court imposes personal liability on the members in this scenario may, however, make a significant difference. Consider diagram 1.2.

Diagram 1.2



[99] This assumes that the hypothetical LLC chooses not to authorize distributions with respect to any individual series. *See* TEX. BUS. ORGS. CODE ANN. § 101.613(a) (West 2010). Rather, the members have chosen to split the profits and losses of all series equally.

[100] Acting like a holding or operating company. *See* Mertens, *supra* note 1, at 275.

[101] This complies with the traditional application of veil piercing. *See supra* note 83.

[102] *See* Castleberry v. Branscum, 721 S.W.2d 270, 271 (Tex. 1986) (noting that individuals, not entities, abuse corporate privileges).

[103] *See id.* (disregarding the corporate fiction is an equitable doctrine); *see, e.g.*, Hideca Petroleum Corp. v. Tampimex Oil Int'l Ltd., 740 S.W.2d 838, 844 (Tex. App.—Houston [1st Dist.] 1987, no writ) (simply disregarding both corporate entities when the court found that they had been used interchangeably and as an alter ego of the sole shareholder).

Assume that Member A is associated with Series 1 and Member B is associated with Series 2. Member A uses Series 1 to perpetrate a wrongdoing. In 1.2(A), the court disregards the series entity and imposes personal liability on Member A alone. In 1.2(B), the court disregards the series and the parent entity. Because both members have an ownership interest in the LLC, both are potentially subject to personal liability.[104] Considering the purpose and intent of the series provisions, 1.2(A) seems like the most reasonable approach to the piercing dilemma. Association and segregation exist to separate the liabilities incurred by one series from the company and other series.[105] Ultimately, it seems unjust to impose personal liability on a member who lacked even the right to manage and control the business of the series used to perpetrate the wrongdoing.[106] However, in a non-series context, innocent shareholders may very well be subject to liability for the misconduct of one owner (or even director), as all shareholders are considered the equivalent of the corporation for the purpose of liability.[107] Moreover, the shareholders in a corporation, like the members in a series LLC, may have different rights, powers, and duties.[108] Therefore, it is unclear which route a court might pick when piercing the veil of a series.

---

[104] *See supra* note 90.

[105] *See* TEX. BUS. ORGS. CODE ANN. § 101.602(a)(1) (West 2010) ("the debts, liabilities, obligations, and expenses incurred . . . shall be enforceable against the assets of that series only . . . .").

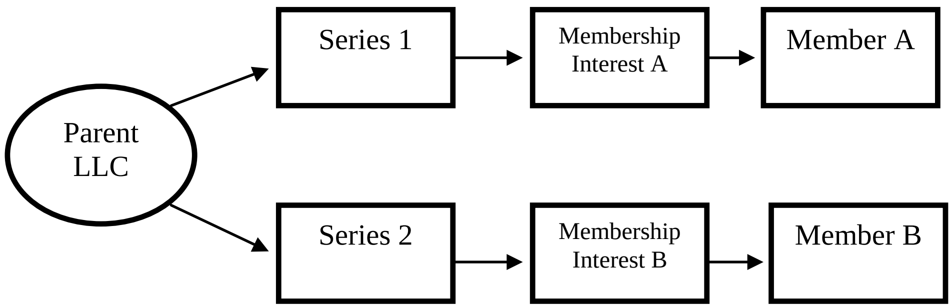
[106] *See id.* § 101.607(a)(1) (providing that the company agreement can provide for the "express relative rights, powers, and duties" with respect to a series).

[107] *See* Menetti v. Chavers, 974 S.W.2d 168, 171 n.5 (Tex. App.—San Antonio 1998, no pet.) ("If the corporate veil is pierced, the shareholders are considered the equivalent of the corporation, not separate parties with individual defenses. The corporation's liability becomes the shareholder's liability absolutely.").

[108] *See* TEX. BUS. ORGS. CODE ANN. § 21.152 (West 2010) (providing for the division of shares into different classes or series).

The other possible structure of the series entity is one in which the LLC exists only as a means to create individually owned series.[109] The TBOC seems to allow this structure, providing that the SLLC can provide for the establishment of one or more designated series of membership interests as opposed to members or managers.[110] Consider Diagram 2.1.

Diagram 2.1



Though this structure seems to effectively separate Member A from Member B, it is unclear exactly how the series entity would operate in practice. Presumably, the members would still be considered members of the parent company for operational reasons.[111] The members' respective membership interests in the company would be segregated from each other, but the TBOC already protects the members of an LLC from the claims of creditors who obtain an ownership interest in the company.[112] It is for this reason that some commentators, specifically, Sandra Mertens, see the map of this structure differently.[113] Consider diagram 2.2.

[109] Mertens, *supra* note 1, at 275 ("Here, the LLC must exist to form the several series, but does not have any further relationship to them."). Presumably, the LLC would also exist to secure generally applicable licenses and other regulatory approval. *See* McLoon, *supra* note 2, at 227.

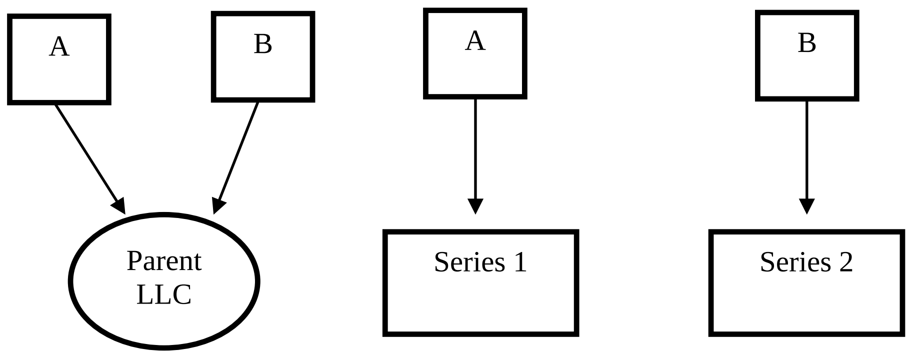
[110] *See* TEX. BUS. ORGS. CODE ANN. § 101.601(a) (West 2010).

[111] *See id.* § 101.101(a). Someone would have to continue operation of the company for the purposes of internal business (the creation of new series, taxes, etc.) and external matters (obtaining blanket regulatory approval, etc.).

[112] *See* TEX. BUS. ORGS. CODE ANN. § 101.108(b)(2) (West 2010) ("An assignment of a membership interest in a limited liability company . . . (2) does not entitle the assignee to: (A) participate in the management and affairs of the company; (B) become a member of the company; or (C) exercise any rights of a member of the company.").

[113] *See* Mertens, *supra* note 1, at 275.

Diagram 2.2



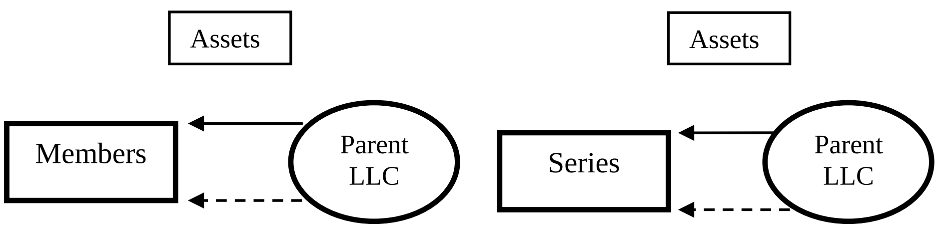
Here, each member retains two distinct membership interests: one in the parent and one in their particular series. Each member's ownership interest is effectively keyed to assets within their particular series, but both remain members of the parent. If Member A uses Series 1 to perpetrate a wrongdoing, it is clear that he (and only he) will be subject to personal liability. However, as one commentator noted, "[w]ith this structure, it is unclear what the LLC is, how it functions, and whether it even exists at all."[114]

[114] *Id.* at 276.

Unfortunately, the picture gets fuzzier if we consider a scenario in which a member or manager uses the LLC in a way that justifies a veil pierce. If the LLC has segregated its assets into various series, it would seem as though the members or managers of the LLC would be subject to personal liability while series assets would remain immune.[115] Of course, an exception would have to lie where a member or manager used asset segregation in an attempt to avoid payment of a creditor or satisfaction of a judgment.[116] In that scenario, the series entity that is used to defraud the claimant would be subject to piercing under the traditional analysis.[117]

Diagram 3.1

A. B.



[115] As a veil pierce only allows the claimant to penetrate the entity used to defraud them. If a particular series was not used in a way that justified the veil pierce, it stands to reason that its liability shield would remain intact. This principal is best illustrated by the narrow entity approach to veil piercing. *See* Gentry v. Credit Plan Corp. of Houston, 528 S.W.2d 571, 573–75 (Tex. 1975) (considering whether to hold the parent liable for the activities of its subsidiary). However, pre-2008 cases dissecting segregated entity structures should be read in light of the Texas Supreme Court's admonition of the single business enterprise theory in *SSP Partners*. *See* SSP Partners v. Gladstrong Invests. (USA) Corp., 275 S.W.3d 444, 454–55 (Tex. 2008) ("We have never held corporations liable for each other's obligations merely because of centralized control, mutual purposes, and shared finances."). In light of the early imprecision in piercing theories seen in pre-*Castleberry* cases and the Supreme Court's disapproval of the single business enterprise theory, this narrow approach is only a slight indication of how modern courts may approach the SLLC.

[116] *See* TEX. BUS. ORGS. CODE ANN. § 101.601(a) (West 2010). This occurs by effectively transferring assets out of the parent LLC into one or more series.

[117] *See Gentry*, 528 S.W.2d at 573.

Conversely, if the LLC has segregated its members or managers into various series,[118] it is unclear whether those members or managers would be subject to personal liability for the fraudulent or unjustified use of the parent. The question seems to turn on whether the associated members or managers are still considered members or managers of the LLC or whether they are solely associated with the series.[119] A clue might lie in the code's distinction between the segregation of members from the segregation of membership interests.[120] If a member is associated with a particular series, he may gain the exclusive right to control and manage the assets of that series while retaining an ownership interest in the parent.[121] However, if a member only retains an ownership interest in a particular series, it stands to reason that she is no longer considered an owner of the parent and would not be personally liable to a third party claimant of the parent.[122]

Though statutes providing for series organization allow for nominal liability protection for each series and the parent,[123] the intersection between the series form and established corporate liability mechanisms remains far from clear. Specificity in the company agreement and contractual relationships between the LLC and third parties may solve some of the ambiguities, but almost every stone remains unturned in the operational liability context. Drafters of series agreements should account for this uncertainty when considering the series form.

[118] *See* TEX. BUS. ORGS. CODE ANN. § 101.601(a) (West 2010).

[119] If an associated member is no longer considered an owner of the parent, there appears to be no reason to allow a claimant access to the associated member's assets. *See* Castleberry v. Branscum, 721 S.W.2d 270, 273 (Tex. 1986) ("Because disregarding the corporate fiction is a equitable doctrine, Texas takes a flexible fact-specific approach focusing on equity.").

[120] *See* TEX. BUS. ORGS. CODE ANN.§ 101.601(a).

[121] *See id.* Because his membership interest has not been segregated as permitted by the code.

[122] *See id.* § 101.602 ("[N]one of the debts, liabilities . . . existing with respect to the [LLC] . . . shall be enforceable against the assets of a particular series.").

[123] *See id.*

IV. TAX LIABILITIES OF THE SLLC

A. Federal Tax Liability: Entity Classification

1. Treatment of the Series Form under Proposed Regulation 301.7701-1(a)(5)

As discussed above, the IRS has recently opened a notice and comment period on a series classification that would purport to treat each series as "an entity formed under local law."[124] The path to this classification is informed by the IRS's initial treatment of the statutory trust.[125] In that ruling, the IRS considered the powers and attributes of the statutory trust form and quickly concluded that the trust was an entity for federal tax purposes.[126] According to the ruling, the presence of certain attributes (for example, recognition of the entity as separate under state law) clearly communicates entity status.[127] The decision was not without precedential value. Prior to Ruling 2004-84, the IRS had treated both unincorporated investment trusts[128] and segregated assets within a limited partnership[129] as separate taxpayers.

[124] Series LLCs and Cell Companies, 75 Fed. Reg. 55699, 55707 (proposed Sept. 14, 2010) (to be codified at 26 C.F.R. Part 301).

[125] *See* Rev. Rul. 2004-86, 2004-2 C.B. 191, 191 (asking "how is a Delaware statutory trust . . . classified for federal tax purposes?").

[126] *See id.* at 194 ("Under Delaware law, DST is an entity that is recognized as separate from its owners. Creditors of the beneficial owners of DST may not assert claims directly against Blackacre. DST may sue or be sued, and the property of DST is subject to attachment and execution as if it were a corporation. The beneficial owners of DST are entitled to the same limitation on personal liability because of actions of DST that is extended to stockholders of Delaware corporations. DST may merge or consolidate with or into one or more statutory entities or other business entities. DST is formed for investment purposes. Thus, DST is an entity for federal tax purposes.").

[127] *See id.* Recognition of the transitive property of these attributes harken back over sixty years. *See* Nat'l Sec. Series–Indus. Stock Series, et. al. v. Comm'r, 13 T.C. 884, 885–86 (1949) (concluding, without analysis, that each unincorporated trust was taxable as a separate regulated investment company).

[128] *See* Rev. Rul. 55-416, 1955-1 C.B. 416, 417 (created under a single trust agreement.).

[129] *See* Rev. Rul. 55-39, 1955-1 C.B. 403, 404 (the assets in question were effectively segregated because the partnership agreement allowed the general partner to select, purchase, and control securities for the benefit of his capital account); *see also* BISHOP & KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 2.11 (Warren, Gorham & Lamont ed. 2010) (1994) (remarking, in regard to Revenue Ruling 55-39, that the segregated funds were considered as a separate taxpayer "even when [the assets were] subject to cross-over liability to

In 2007, the IRS turned to the question of SLLC treatment by issuing a Private Letter Ruling purporting to classify the individual series at issue as separate business entities.[130] Six characteristics required the determination:

> 1. Each series had its own investment objectives, policies and, restrictions;
>
> 2. Each series consisted of a separate pool of assets, liabilities, and stream of earnings;
>
> 3. The owners of a series could share in the income only of that series;
>
> 4. The ownership interest in a series was limited to the assets of that series upon redemption, liquidation, or termination of such series;
>
> 5. The payment of the expense, charges, and liabilities of a series was limited to the assets of that series; and
>
> 6. The creditors of a series were limited to the assets of that series for recovery of expenses, charges, and liabilities.[131]

This 2007 characterization of the series, and the result it mandated,[132] was paralleled by several state tax classifications. Massachusetts,[133] California,[134] and Illinois[135] had all similarly concluded that the subunits of an SLLC should be treated as separate entities for the purposes of state tax classification. Therefore, it was no surprise when the IRS proposed a

partnership creditors.”).

[130] I.R.S. Priv. Ltr. Rul. 2008-03-004 (Oct. 15, 2007).

[131] *Id.*; ABA Section of Taxation, Comments in Response to Notice 2008-19, at 8–9 (2009), *available at* http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2009/090105commentsinresponsetonotice200819.authcheckdam.pdf.

[132] *See* I.R.S. Priv. Ltr. Rul. 2008-03-004 (Oct. 15, 2007). Namely, a series should be treated as a “separate business entity” for federal tax purposes.

[133] Mass. Ltr. Rul. 08-2 (Feb. 15, 2008) (available at the Massachusetts Department of Revenue website). Interestingly, the Massachusetts regulation is keyed to the ultimate federal classification. *See id.*

[134] State of Cal. Franchise Tax Board, Cal. Forms & Instructions 568 Booklet § F 5 (2007).

[135] 805 Ill. COMP. STAT. 180/37-40(b) (West 2010).

regulation that would treat each series as a separate entity under local law.[136]

In drafting the proposed regulation, the IRS notes that whether an organization is an entity separate from its owners does not key to state law classification.[137] Indeed, the IRS has disregarded some state law entities[138] while other non-entity arrangements have been treated as separate taxpayers.[139] For example, when considering whether a partnership exists for the purpose of federal tax classification, courts have traditionally considered whether the parties intend to join together to conduct an enterprise and share in its profits and losses.[140] The status of the relationship between the parties under state law, while potentially relevant, is not determinative.[141]

Under the proposed regulation, a "series" (for the purposes of the separate entity tax classification) is a "segregated group of assets and liabilities that is established pursuant to a series statute . . . by agreement of a series organization."[142] The term includes "a series, cell, segregated account, or segregated portfolio . . . ."[143] Assuming a Texas SLLC falls within the IRS's definition, its subunits would qualify as "entit[ies] formed under local law."[144] Entity classification would confer "eligible entity" status to the series form.[145] This status is important because it would allow the series to elect its tax classification as provided in Section 301.7701-3.[146] A series with two members could elect to be classified as an association or a partnership.[147] A series with one member could elect to be classified as an

[136] Series LLCs and Cell Companies, 75 Fed. Reg. 55699, 55707 (proposed Sept. 14, 2010) (to be codified at 26 C.F.R. pt. 301).

[137] *Id.* at 55699–700.

[138] *See* Aldon Homes, Inc. v. Comm'r, 33 T.C. 582, 597 (1959).

[139] *See* Bergford v. Comm'r, 12 F.3d 166, 169 (9th Cir. 1993).

[140] *See* Madison Gas & Elec. Co. v. Comm'r, 633 F.2d 512, 514–15 (7th Cir. 1980).

[141] Series LLCs and Cell Companies, 75 Fed. Reg. 55699, 55700 (proposed Sept. 14, 2010) (to be codified at 26 C.F.R. pt. 301).

[142] *Id.* at 55708.

[143] *Id.*

[144] *Id.* at 55707.

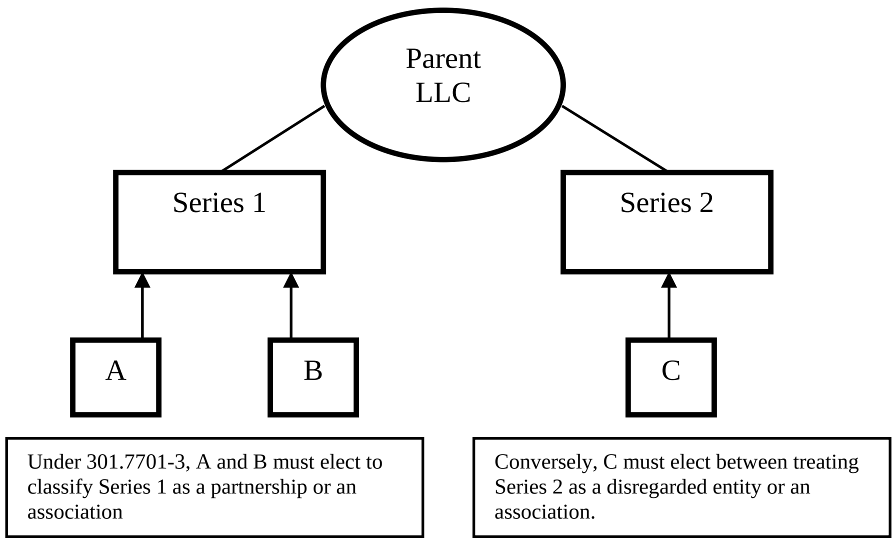
[145] *See* 26 C.F.R. § 301.7701-3(a) (2011) ("A business entity that is not classified as a corporation under [other IRS provisions] (an eligible entity) . . . .).

[146] *Id.*

[147] *Id.*

association or a disregarded entity.[148] Diagram 4 illustrates the operation of the proposed treatment.[149]

Diagram 4



The primary advantage to the separate-entity structure is its flexibility. Because an SLLC can choose how many members to associate with any given series,[150] it can effectively elect how that series will be treated for federal tax purposes.[151]

In the diagram above, imagine members A and B are natural persons where member C is an entity. If the parent and both series were treated as an aggregate entity, the members would be forced to choose to elect either partnership or corporate treatment.[152] If the members elected corporate treatment, they would be unable to opt for S-corporation classification

[148] *Id.*

[149] *See id.*

[150] TEX. BUS. ORGS. CODE ANN. § 101.607(a)(1) (West 2010) ("The company agreement may: (1) establish classes or groups of one or more members . . . .").

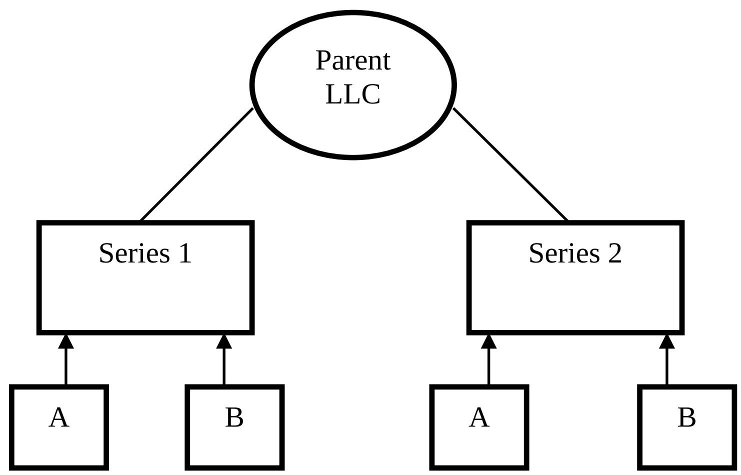
[151] If the SLLC wishes to treat a series as a disregarded entity, it can associate one member with the series and make the election. For partnership treatment, it would associate two or more members with the series. *See* 26 C.F.R. § 301.7701-3(a) (2011). The SLLC can always elect association treatment. *See id.*

[152] *See id.*

because of the entity's ownership interest.[153] However, because the SLLC can associate only the natural-person members with one series, it could elect S-corporation treatment for that series if it so wished.[154]

One potential downside to the separate-entity classification is its apparent susceptibility for inefficiency. Consider Diagram 5.1.

Diagram 5.1



Because each series is treated as a separate business entity, members A and B would have to file Schedule K-1s (assuming they elected partnership treatment) for each entity.[155] If the parent and both series were treated in the aggregate, A and B could simply elect partnership treatment for the parent and file one schedule. However, the ABA Section on Taxation has considered this problem and suggested a solution.[156] Consider Diagram 5.2.

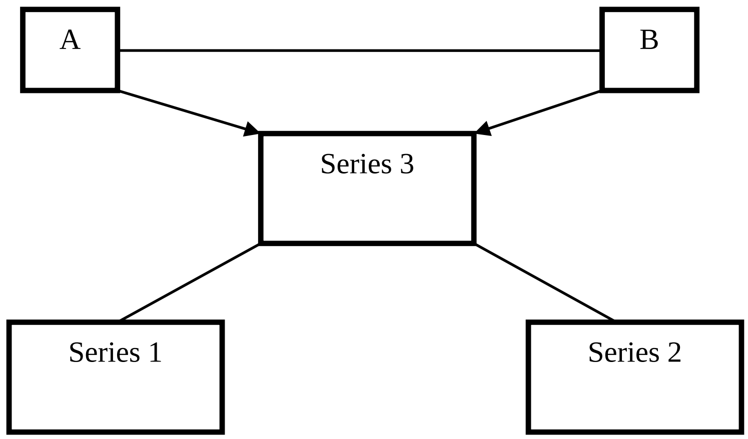
[153] *See* 26 C.F.R. § 1.1361-1(b)(1) (2011) ("[T]he term small business corporation means a domestic corporation that is not an ineligible corporation . . . and that does not have . . . (ii) [a]s a shareholder, a person . . . who is not an individual . . . .").

[154] Because it has excluded the entity-member from consideration in determining the series-classification. *See id.*

[155] *See* ABA Section of Taxation, *supra* note 131, at 22.

[156] *See* ABA Section of Taxation, *supra* note 131, at 22–23.

Diagram 5.2



In its response to the IRS's request for guidance on series classification, the Section of Taxation used the above structure to demonstrate how the series form could be practically aggregated.[157] Aggregation requires the members to form a new series (Series 3) to claim the ownership interest of the worker series below.[158] Here, Series 3 would own one-hundred percent of both Series 1 and Series 2.[159] Assuming that none of the series elect to be treated as an association, Series 3 would be treated as a partnership because it has more than one member.[160] Series 1 and 2 would both be disregarded because they are wholly owned by Series 3.[161] Now, members A and B are only required to file one schedule (on behalf of Series 3) but can craft a company agreement that ensures that they share in profits and losses as if they were directly associated with Series 1 and 2.[162]

157 *See* ABA Section of Taxation, *supra* note 131, at 23.
158 *See* ABA Section of Taxation, *supra* note 131, at 22.
159 *See* ABA Section of Taxation, *supra* note 131, at 22.
160 *See* 26 C.F.R. § 301.7701-3(b)(i) (2011).
161 *See id.* § 301.7701-3(b)(ii).
162 *See* ABA Section of Taxation, *supra* note 131, at 22.

2. Questions Unanswered

Though the proposed regulations governing the classification of the series provide thorough guidance on the IRS's characterization of the form, some questions remain unanswered.

a. What Is the Effect on the Federal Tax Classification of a Series if that Series Loses Its Series Characterization Under State Law?

Recall that the proposed regulations purport to treat the series "as an entity formed under local law."[163] However, almost every jurisdiction that allows the creation of series requires that the segregating organization comply with certain requirements.[164] If a series organization failed to comply with a particular jurisdiction's requirements, it would presumably lose its ability to segregate assets and liabilities.[165] This begs an important question: If the series organization can no longer segregate assets, is it even a series organization at all? The Preamble to the proposed regulations seems to indicate that it is (at least as between the owners and the IRS).[166]

Ultimately, even though the series has lost its liability limitation, the series organization and its respective subunits remain nominally intact.[167] The IRS would likely insist on treating the nominal series as separate under the proposed regulations, as "limitations on liability of owners of an

[163] Series LLCs and Cell Companies, 75 Fed. Reg. 55699, 55707 (proposed Sept. 14, 2010) (to be codified at 26 C.F.R. pt. 301).

[164] *See, e.g.*, TEX. BUS. ORGS. CODE ANN. § 101.602(b) (West 2010) (mandating that the parent company: (1) include notice of limited liability in the certificate of formation, (2) include a statement in reference to limited liability in its company agreement, and (3) account for the assets of a series separately from the assets of the parent).

[165] *See, e.g.*, *id.* at § 101.602. ("[The ability to segregate] applies only if . . . .").

[166] *See* Series LLCs and Cell Companies, 75 Fed. Reg. 55699, 55700 (proposed Sept. 14, 2010) (to be codified at 26 C.F.R. pt. 301) ("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."); Paul D. Carman et. al., *First Steps—Proposed Regulations on Series LLCs Provide Clarity*, 113 J. TAX'N, 325, 329 (2010).

[167] Even if the company has not properly accounted, documentation as to the nature and organization of the various series would exist in the company agreement and possibly elsewhere. *See* TEX. BUS. ORGS. CODE ANN. § 101.602(b)(2).

entity . . . do not alter the characterization of the entity for federal tax purposes."[168]

b. Is Series Ownership (for Tax Purposes) Limited to the Assets It Holds Title to?

The cornerstone of effective tax treatment is the identification of asset ownership. Recall that there are competing theories about the conceptualization of the series form.[169] However, one thing is clear: series emanate from the parent organization (namely, the company agreement)[170] and are structured to wall off assets and liabilities from other series and the parent.[171] It follows that series ownership is not a mechanical process, focusing on legal title, but an investigative one, focusing on the character of assets.[172] Ultimately, a series will be treated as the owner of the assets for federal tax purposes if it bears the economic benefits and burdens of the assets under general federal tax principles.[173] Therefore, even if the parent organization holds legal title to an asset,[174] the series may still be treated as the owner for federal tax purposes.[175]

B. State Tax Liability: What's the Margin?

1. Treatment of the Series Form in Texas – Application of the State "Franchise" Tax

The series form poses a unique challenge in Texas because of our State's franchise tax: a percentage of an entity's "taxable margin."[176] The

[168] Carman, *supra* note 166, at 329.

[169] *See supra* Part III (Veil Piercing).

[170] *See, e.g.*, TEX. BUS. ORGS. CODE ANN. § 101.607(a)(1) (West 2010).

[171] *See, e.g.*, TEX. BUS. ORGS. CODE ANN. § 101.602.

[172] *See* Carman, *supra* note 166, at 325.

[173] *See* Carman, *supra* note 166, at 326–27.

[174] Parent ownership may be required if state law prohibits series ownership. *See* Carman, *supra* note 166, at 325. In Texas, however, series are expressly permitted to hold legal title. TEX. BUS. ORGS. CODE ANN. § 101.605.

[175] *See* Carman, *supra* note 166, at 326–27.

[176] Eric L. Stein, *Texas Revised Franchise Tax*, 2400-2d Tax Mgmt. Multistate Tax Portfolios 2400.02.A.1 (2009), *available at* http://taxandaccounting.bna.com/btac/T8000/split_display.adp?fedfid=11802885&vname=tmsporst&fn=11802885&jd=tms_2400_02_a&split=0 ("The revised franchise tax is calculated based on a taxable entity's 'taxable margin,' instead of the former tax base of taxable capital and taxable earned surplus."); *see* TEX. TAX CODE ANN.

margin tax has recently undergone serious structural changes and now applies to a wide berth of entities, including corporations, LLCs, partnerships, and certain trusts.[177] Under the reformulated provisions, an eligible entity's margin is the "entity's total revenue attributable to Texas operations, less certain statutorily-defined deductions and exemptions."[178] The margin hinges on the definition of "total revenue."[179] Interestingly, the code requires an eligible entity to use numbers reported on the entity's federal-income-tax return to determine its total revenue for franchise tax purposes.[180] An entity will then annualize its revenue to determine eligibility for the "No Tax Due threshold, [d]iscounts, and E-Z computation."[181] Total revenue is annualized by dividing total revenue by the number of days in the period upon which the tax is based and multiplying by the number of days in the year.[182] Thus, if an entity's franchise tax report was based on a period less than the entire year, that entity may be able to annualize its total revenue to a level that exempts it from the franchise tax or qualifies it for additional discounts.[183] Finally,

§ 171.002 (West Supp. 2010).

[177] TEX. TAX CODE ANN. § 171.0002(a) (West 2008); *see* Nikki Laing, Comment, *An Income Tax by Any Other Names Is Still an Income Tax: The Constitutionality of the Texas "Margin" Tax as Applied to Partnerships and Other Unincorporated Associations*, 62 BAYLOR. L. REV. 573, 574 (2010); 19 ROBERT W. HAMILTON ET AL., TEXAS PRACTICE SERIES: BUSINESS ORGANIZATIONS § 4.3 (2d ed. 2004 & Supp. 2009-2010) ("Beginning in 2008, the Texas franchise tax will be calculated under a completely new system and will apply to partnerships and other unincorporated entities not previously subject to the franchise tax."); Cynthia M. Ohlenforst et al., *Taxation*, 60 SMU L. REV., 1311, 1311 (2007) ("In 2006, Texas legislators enacted the most substantial franchise tax reform the state has seen since 1907 . . . .").

[178] Laing, *supra* note 177, at 574; *see* TEX. TAX CODE ANN. § 171.101 (West 2008).

[179] *See* TEX. TAX CODE ANN. § 171.1011(c)(1) (West Supp. 2010).

[180] *Id.* ("[F]or the purpose of computing its taxable margin . . . the total revenue of . . . a taxable entity treated for federal income tax purposes as a corporation [is] an amount computed by [adding]: (i) the amount reportable as income on line 1c, Internal Revenue Service Form 1120; (ii) the amounts reportable as income on lines 4 through 10, Internal Revenue Service Form 1120 . . . ."). Of course, if the entity to be taxed is a partnership, the regulations key to the partnership's Form 1065 and corresponding Schedule K. *Id.* at § 171.1011 (c)(2). Alternatively, if the entity is not treated as either a corporation or a partnership for federal tax purposes, the Code provides that total revenue is to be determined in a "substantially equivalent" manner as a corporation or partnership. *See id.* at § 171.1011 (c)(3).

[181] Tex. Comptroller of Pub. Accounts, Franchise Tax Policy Staff, Overview: Texas Tax Code Chapter 171, at 10 (May 2008), http://window.state.tx.us/taxinfo/franchise/May2008overview.pdf.

[182] *Id.*

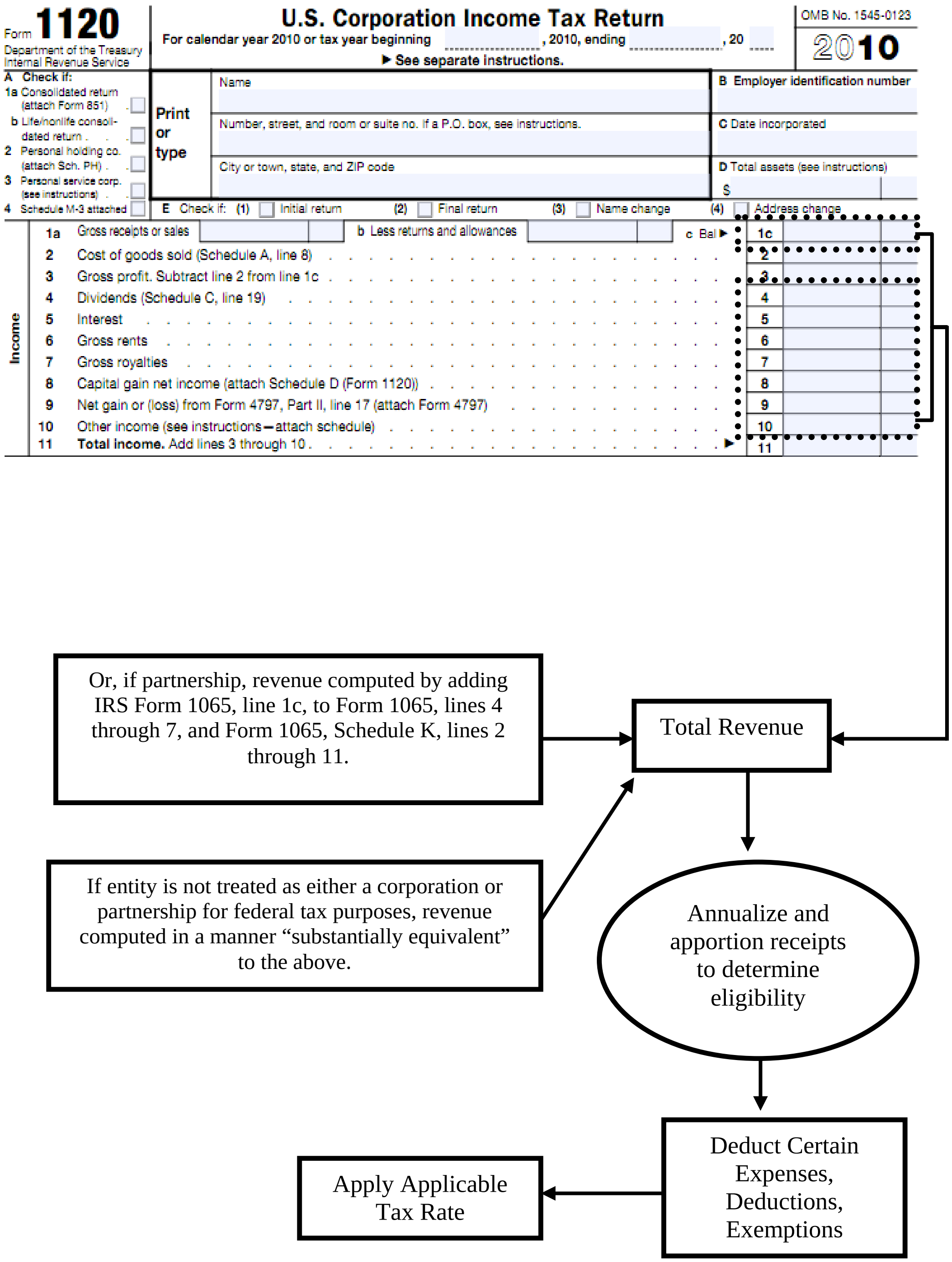
[183] *See id.*

after determining its total revenue and determining its eligibility under the annualized revenue scheme, an entity that remains eligible will subtract certain expenses reported in its federal income tax return and other statutorily defined deductions and exemptions.[184] The resulting number is the entity's "taxable margin" against which the applicable rate is applied.[185] Consider Figure 1 on the following page.

184 TEX. TAX CODE ANN. §§ 171.1012–.1013 (West 2008); Laing, *supra* note 177, at 579.

185 TEX. TAX CODE ANN. § 171.002(a)–(b) (West Supp. 2010) (stating that the margin tax rate is 0.5 percent for retailers and wholesalers and 1 percent for all other industries).

Figure 1


Form 1120
Department of the Treasury Internal Revenue Service
U.S. Corporation Income Tax Return
For calendar year 2010 or tax year beginning , 2010, ending , 20
▶ See separate instructions.
OMB No. 1545-0123
2010
A Check if:
1a Consolidated return (attach Form 851)
b Life/nonlife consolidated return
2 Personal holding co. (attach Sch. PH)
3 Personal service corp. (see instructions)
4 Schedule M-3 attached
Print or type
Name
Number, street, and room or suite no. If a P.O. box, see instructions.
City or town, state, and ZIP code
B Employer identification number
C Date incorporated
D Total assets (see instructions)
$
E Check if: (1) Initial return (2) Final return (3) Name change (4) Address change
Income
1a Gross receipts or sales
b Less returns and allowances
c Bal ▶ 1c
2 Cost of goods sold (Schedule A, line 8) 2
3 Gross profit. Subtract line 2 from line 1c 3
4 Dividends (Schedule C, line 19) 4
5 Interest 5
6 Gross rents 6
7 Gross royalties 7
8 Capital gain net income (attach Schedule D (Form 1120)) 8
9 Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797) 9
10 Other income (see instructions—attach schedule) 10
11 Total income. Add lines 3 through 10 ▶ 11
Or, if partnership, revenue computed by adding IRS Form 1065, line 1c, to Form 1065, lines 4 through 7, and Form 1065, Schedule K, lines 2 through 11.
Total Revenue
If entity is not treated as either a corporation or partnership for federal tax purposes, revenue computed in a manner "substantially equivalent" to the above.
Annualize and apportion receipts to determine eligibility
Deduct Certain Expenses, Deductions, Exemptions
Apply Applicable Tax Rate

The question, of course, is how this scheme would be applied to the series form. Consider, to begin, the margin treatment of a standard LLC in Texas.[186] If the LLC elected to be treated as a corporation for federal tax purposes, it would simply use its Form 1120 to determine its total revenue for the franchise tax.[187] If the LLC had two or more members and checked the box to elect partnership treatment, it would use its Form 1065 and Schedule K to determine its total revenue.[188] Finally, if the LLC had only one member and checked the box to disregard the entity, it would use the methods proscribed by the comptroller (or "substantially equivalent" methods to those set out for entities treated as corporations and partnerships) to determine its total revenue.[189]

If we consider the SLLC in its simplest form, the application of the franchise tax seems fairly straightforward. Assuming an LLC segregates assets into only one series, the result is a parent company with little or no assets and a workhorse series through which most of the company's revenue would flow. Regardless of how the series is treated for federal tax purposes, all of its revenue would attributable to the LLC as a whole for franchise purposes.[190]

Application gets more complex if we consider an SLLC with multiple entities (or an SLLC with a parent that derives substantial revenue apart from its series). Commentators have noted that the reformulated franchise tax contains several "cliffs that produce all-or-nothing results . . . ."[191] Subtle changes, either in the character of the ownership of the entity[192] or the amount of income realized in a taxable period,[193] could effectively

[186] *See* TEX. TAX CODE ANN. § 171.1011(c) (West Supp. 2010).

[187] *Id.* § 171.1011(c)(1).

[188] *Id.* § 171.1011(c)(2).

[189] *See id.* § 171.1011(c)(3). Note that these single-member entities are not "disregarded" for franchise tax purposes as they are for federal tax purposes. *See id.*

[190] The member(s) will either elect to treat the series as a corporation (where total revenue for franchise tax purposes would key to the Form 1120), a partnership (where total revenue would key to the Form 1065), or a disregarded entity (where total revenue is determined in substantially similar measure). *Id.* at § 171.1011(c).

[191] Ohlenforst, *supra* note 177, at 1319.

[192] For example, general partnerships in which all the partners are natural persons are exempt from the tax. TEX. TAX CODE ANN. § 171.0002(b) (West 2008). Ohlenforst has noted that if a partner in such a partnership died, the partnership interest passing to the dead partner's non-natural person estate, the once-exempt partnership could find itself classified as an eligible entity under the franchise tax. Ohlenforst, *supra* note 177, at 1320.

[193] Entities with total revenues of $434,782 and entities that calculate that they owe less than

trigger the tax. The character of ownership of the SLLC is likely irrelevant in calculating the margin tax, as LLCs, unlike partnerships, are always subject to the franchise tax.[194] The nature and amount of an SLLC's income, however, may very well affect its status as a taxable entity under the franchise scheme.[195]

The ability to circumvent the quantitative threshold by employing multiple entities (or, in our case, multiple series) did not escape the drafters of the reformulated provisions.[196] The code includes a provision requiring "combined reporting" for certain associated entities.[197] Combined reporting is mandatory for affiliated groups in which: (a) more than fifty percent of the interest is owned by a common owner, and (b) the members of which are engaged in a unitary business.[198] A "unitary business" is "a single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts."[199] Assuming the Comptroller was to employ the traditional concept of series ownership (in which the parent technically owns the series[200]), more than fifty percent of any series would always be owned by the same entity—the parent. Additionally, it seems that any SLLC would qualify as a "unitary business," as a series is, by definition, a "separate part of a single entity"—the SLLC itself.[201] Consider Diagram 6 on the following page.

$1000 for any reason are exempt from the tax completely. Tex. Comptroller of Pub. Accounts, Franchise Tax Policy Staff, *supra* note 181, at 7. (The Franchise Tax Policy Staff notes that while the Code actually identifies $300,000 as the cap, the working number is actually $434,782).

194 *See* 34 TEX. ADMIN. CODE § 3.581(c)–(d)(2) (West 2011) (Comptroller of Pub. Accounts) (describing taxable entities).

195 *See* Tex. Comptroller of Pub. Accounts, Franchise Tax Policy Staff, *supra* note 181, at 7.

196 If the threshold amount of income to qualify as a taxable entity is $434,782, an owner could theoretically form multiple entities (or multiple series) and ensure that the amount of revenue passing through each entity is less than the statutory threshold. *See* Tex. Comptroller of Pub. Accounts, Franchise Tax Policy Staff, *supra* note 181, at 7.

197 *See* TEX. TAX CODE ANN. § 171.1014 (West 2008); 34 TEX. ADMIN CODE § 3.590(b)–(c) (Comptroller of Pub. Accounts).

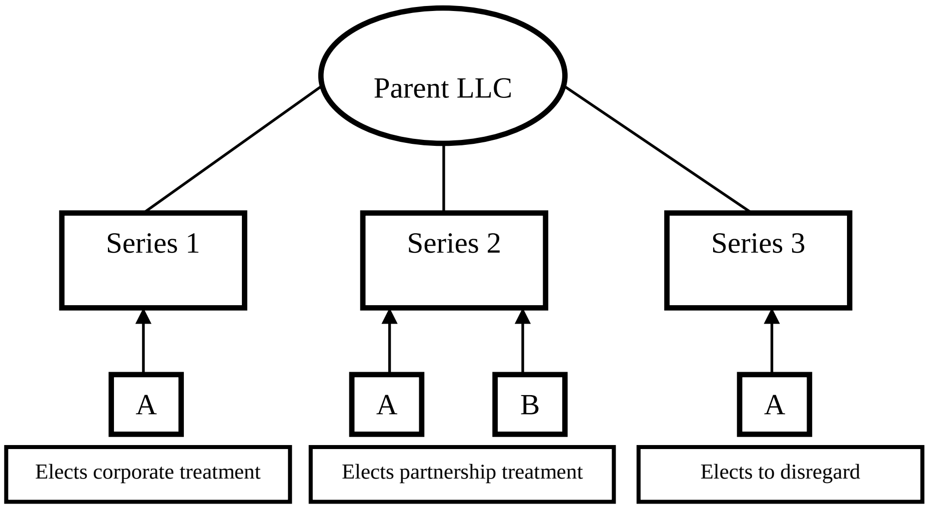
198 Tex. Comptroller of Pub. Accounts, Franchise Tax Policy Staff, *supra* note 181, at 19.

199 Tex. Comptroller of Pub. Accounts, Franchise Tax Policy Staff, *supra* note 181, at 19.

200 *See supra* Part III ("Veil Piercing").

201 *See* Tex. Comptroller of Pub. Accounts, Franchise Tax Policy Staff, *supra* note 181, at 19.

Diagram 6



Assume that each series above grosses $200,000 for the purposes of the margin tax. For Series 1, revenue is pulled from the series's Form 1120.[202] For Series 2, revenue is pulled from the series's Form 1065.[203] For Series 3, revenue is pulled in a method that is substantially equivalent to the method of revenue calculation for the other two series.[204] Now that we have the total revenue for each series, we add the total revenues of each member (series) together to determine the total revenue for the affiliated group (the SLLC).[205] The affiliated group then subtracts certain authorized items from the total number[206] and elects between deducting the cost of goods sold or applicable compensation.[207] Finally, the group would apply applicable deductions and exemptions[208] and apply the applicable tax rate[209] to

[202] *See* TEX. TAX CODE ANN. § 171.1011(c)(1) (West Supp. 2010).

[203] *See id.* § 171.1011(c)(2).

[204] *See id.* § 171.1011(c)(3).

[205] *See* TEX. TAX CODE ANN. § 171.1014(c) (West 2008).

[206] *Id.* (referencing TEX. TAX CODE ANN. § 171.1011, which authorizes the subtraction of certain debt, foreign royalties and dividends, certain distributive income, allowable deductions, some income attributed to a disregarded entity, and other amounts authorized).

[207] *See id.* § 171.1014(d). ("Regardless of the election, the taxable margin of the combined group may not exceed 70 percent of the combined group's total revenue . . . .").

[208] *See* TEX. TAX CODE ANN. § 171.101 (West 2008).

[209] *See* TEX. TAX CODE ANN. § 171.002 (West Supp. 2010).

determine the tax liability for the entire group (for which all members of the group are jointly and severally liable[210]). Therefore, even though every series's total revenue is less than the statutory "trigger," the affiliated group provision ensures that the SLLC is effectively taxed as a single entity.

V. CONCLUSION

The new federal tax classification for the series form will likely legitimize the organization in a way that will result in both an upswing in series formation in Texas and codification of the series concept across the country. As demonstrated, however, the form remains plagued with uncertainties with respect to both operation and taxation. As more businesses opt to organize as SLLCs, some of those questions will be answered. However, organizers on the frontier of the series movement should be wary of how courts will treat conflicts between the creditor (tax or otherwise) and the entity. Though carefully drafted company agreements will resolve some problems before litigation is warranted, conflicts with outsiders are outside the reach of an agreement between members. The series form has its advantages—consolidated filing fees, organizational flexibility, and compartmentalized liability protection—but these advantages are likely outweighed by the multitude of uncertainties, at least for now.

[210] *See id.* § 171.1014(i).