The Texas Series LLC:

Sophisticated Planning Tool or Trap for the Unwary?

By: Cindy L. Grossman and Stephen L. Phillips[1]

In May 2009, Governor Perry signed into law Texas Senate Bill 1442, which amends the Texas Business Organizations Code to include new Subchapter M: Series Limited Liability Company, establishing the "series LLC" as a recognized legal entity under Texas law. While Texas is at the forefront of adopting this complex entity structure, having joined just seven other states in doing so, the series LLC remains a poorly understood planning vehicle. Prior to recommending its use by clients, its perceived advantages should be weighed carefully against potential disadvantages, including uncertainties surrounding the interaction of the series structure with tax, securities, and bankruptcy laws and the laws of non-series jurisdictions.

Features of the Texas Series LLC

The series LLC is a limited liability company ("LLC") that is segregated into separate cells, called "series," for the purpose of holding assets separately in each of the individual series rather than combined in one entity. Each series can also have its own members, managers, and/or membership interests, separate and apart from other series within the same LLC[2]. Each series may have rights, powers, and duties with regard to specific property or obligations of the LLC that are separate from the rights, powers, and duties of other series[3]. Furthermore, each series may have its own allocation and distribution of profits and losses associated with the property it holds[4]. A series may have a business purpose or investment objective that differs from the business purpose or investment objective of other series, and can sue and be sued, contract, hold title to property, and grant liens and security interests in its assets, all on its own behalf[5].

A series is, by statute, insulated from the debts and liabilities of other series and those of the LLC itself. The debts, liabilities, and other obligations of a particular series are enforceable only against the assets of that series[6]. In addition, the debts, liabilities, and obligations of the LLC may not be enforced against the assets of a series[7].

The liability protection afforded to a series requires and is dependent on the observation of certain formalities in the formation and continued maintenance of the series LLC. The series structure will be respected only if (1) the assets of each series are separately recorded and maintained, (2) the company agreement contains language contemplating the series structure and establishing the segregation and distinctness of managers, members, assets, liabilities, and obligations of each series, and (3) the LLC's certificate of formation contains notice of the liability limitations provided by the series structure[8].

The company agreement of the series LLC establishes the liabilities of the members and managers associated with a particular series. If no such language is used, by default, a member or manager associated with a series is not liable for any debt or obligation of the series—similar to the existing Texas LLC statute as it relates to liabilities of members and managers of a regular LLC[9].

As with a traditional LLC, the company agreement may establish various classes of members or managers associated with each series, and may provide for certain voting rights, powers, and duties to be attached to such classes[10].

Governing authority of an individual series is established in the same manner as that of a traditional LLC. The LLC's company agreement may set the parameters for governance of specific series. If it does not, then a series will be managed by managers associated with such series as set forth in the LLC's certificate of formation, or, if the LLC's certificate states that the LLC will not have managers, then the members associated with a specific series in the certificate of formation will govern that series[11].

The LLC may make distributions with respect to a series, but it may not make a distribution if, after such distribution, the liabilities of the series exceed the fair value of the assets of the series[12].

A series may be wound up and terminated in a manner similar to the winding up and termination of an LLC. The process includes the concept of events requiring winding up, the ability to cancel such events, voluntary winding up, and revocation of voluntary winding up that are already contained in the TBOC[13].

Benefits of Series LLCs

The main benefit in using the series LLC is the ability to segregate the LLC's assets—whether for purposes of profit sharing, management, liability protection, etc.—without the complexity or expense of setting up multiple entities to achieve the same function. One circumstance in which this benefit can be exploited is the typical structuring implemented in a real estate holding company with multiple properties. In most cases, best practices dictate the use of separate entities to hold each separate real estate parcel to avoid cross-collateralization of the individual properties. This structure adds cost and complexity to a structure because each entity requires a separate filing fee and separate organizational documents. If the entities are foreign entities, each must register with the secretary of state of the state(s) in which they are doing business. By contrast, the series LLC should provide the same functionality as multiple entities from a liability perspective by allowing each series of an LLC to have its own members, managers, assets, business purpose, governance, and termination procedures, but at less cost.

Uncertainties and Potential Pitfalls

The series LLC is a new breed of entity and has only been on the scene since 1996, when Delaware became the first state to adopt series LLC legislation[14]. Illinois, Iowa, Nevada, Oklahoma, Tennessee, and Utah have subsequently adopted their own series LLC legislation[15]. Although the concept has been blessed by the legislatures of these states, there is some risk involved in using the series LLC. For example, there are many questions regarding the interaction of the series LLC concept with state and federal taxation laws, but a dearth of guidance on these issues, whether case law, statutory law, or administrative regulations. There is also the prospect of potential disregard of the series concept by non-series jurisdictions. In addition to the above, the traditional risk of disregard of corporate formalities continues to persist.

State Taxation

The Texas Comptroller's office has not issued any guidance on the franchise tax treatment of series LLCs in the wake of the new series LLC legislation. It is possible that the series LLC will be treated as a single entity for franchise tax purposes, but if that is the case, questions remain as to how the calculation will be made given that the existence of the separate series makes the LLC more closely resemble a "combined group" than a single taxable entity.

If all of the series of a series LLC are required to file as a combined group for franchise tax purposes, then it is important to be sensitive from a planning perspective to the potential disadvantages created by the series structure. For example, regardless of whether the series otherwise meet the combined group requirements (i.e., a group of affiliated entities engaged in a unitary business), the LLC may be at a disadvantage in circumstances where a particular series, if it were its own LLC, could take advantage of the small business exemption or $1,000 "no tax due" threshold[16]. The same holds true in circumstances in which a series might benefit from a different standard deduction (i.e., compensation or cost of goods sold) than that used by the other series[17]. Further, if a series holds assets that produce passive income in amounts sufficient to meet the passive entity test, establishing those assets inside an entity type that qualifies as a passive entity (i.e., a partnership or trust) will produce better tax results in most circumstances[18]. In each of these circumstances, assuming that the combined reporting rules would not otherwise apply, it may be more tax efficient to form a separate entity for the assets and operations of such series rather than to place them within a series.

One could speculate endlessly as to how the Comptroller will come down on the series LLC issue, particularly since the Comptroller is still in the midst of digesting the relatively new Texas Margin Tax. We will forego such speculation at this time in hopes that guidance will be forthcoming in the near future. At that time, we will issue an update to this paper addressing the questions surrounding state taxation of the series LLC that are to this date unanswered.

Federal Taxation

The federal taxation of series LLCs likewise remains unclear. This paper will not address the topic in depth until such time as additional guidance is issued. To date, however, the only guidance issued by the Internal Revenue Service is contained in a 2008 private letter ruling[19]. In this ruling, the IRS stated that a series LLC could avail itself of the "check the box" rules to elect the tax status of each separate series, indicating that each series is indeed its own separate taxpayer for federal tax purposes[20]. If this is the case, then each series will be responsible for obtaining its own tax identification number, filing its own tax return, and, if applicable, distributing K-1s to each member of the specific series. This may also indicate that a series LLC must be sensitive to transactions among the separate series, even if such transactions are still occurring "within" the main LLC. Such transactions may be interpreted under applicable provisions of the Internal Revenue Code as occurring between two separate taxpayers (i.e., transfers of property from one series to another may cause a liquidation of the transferor series under §708 of the Internal Revenue Code).

Interaction with Non-Series Jurisdictions

Even if the corporate formalities are followed within a series, there exists the issue of whether the series concept will be recognized by non-series jurisdictions (where the jurisdiction has not enacted its own series legislation). This is particularly important when the LLC or one of its series owns property in a non-series jurisdiction. This problem is relevant to the issue of foreign jurisdiction registration fees, as well as to the very important issue of liability protection.

One of the advantages to using a series LLC is the avoidance of multiple filing fees upon formation of the entity. In Texas, an individual wishing to segregate 10 different properties from each others' liabilities could form a series LLC and place each property into a separate series of the LLC. His total filing fees paid to the Texas Secretary of State would equal $300. If the same individual formed ten separate LLCs, he would have paid $3,000 to the Secretary of State. This obviously works well so long as the state requiring registration is a series state. Presumably, if a Delaware Series LLC owned real property in Texas and therefore was required to register with the Texas Secretary of State, such entity would pay the $750 filing fee only once, for the LLC itself, and not for each individual series, no matter how many of them owned property in Texas. However, this convenience does not hold true for all non-series states. California, for example, has determined that each series in a series LLC is a separate LLC, and must therefore pay its own registration fee if it is doing business in California[21]. So in that circumstance, the Texas LLC must now register each of its 10 series with California and must pay the applicable registration fee for each series. It would appear that this individual would have been better off using California entities to hold his properties.

Of greater concern than excess filing fees is that a non-series LLC state may not recognize the internal liability protections afforded under the Texas series LLC statute. States with series legislation typically address the issue in their statutes, and most recognize the internal liability shields of other series states[22]. However, states that do not have series legislation are not guaranteed to recognize the internal liability shield of the series LLC, thereby undermining one of the major benefits of using the series LLC. Under the Full Faith and Credit Clause of the U.S. Constitution, states are generally required to respect the law of another state that governs the transaction[23]. However, this requirement will not apply in circumstances in which public policy reasons may exist for disallowing such recognition[24]. Although it is a weak policy argument at best, it is possible that a non-series state could argue that the series LLC statute of another state is merely a tool for reducing filing fees for entity formation, and is therefore contrary to the public policy of that state[25]. An individual who relies on such recognition when making his choice of entity decision would be unpleasantly surprised when he comes to realize that the structure does not afford liability protection in the state in which a particular piece of property of the series was located, or is otherwise found to be the controlling law in determining liability when a third party is involved. In circumstances involving internal disputes, use of a series LLC should not cause concern since most LLC statutes across the U.S. provide that the state of formation controls internal governance matters, including liability of members in such matters.

Observation of Corporate Formalities and Recording Requirements

One pitfall that often occurs when operating within an entity structure is the failure of the owners or managers of such entity to observe corporate formalities and treat the entity as separate and apart from its owners. Such negligence can result in disregard of the corporate or LLC form for legal purposes, thus undoing the liability protection afforded thereby. This can also happen between two entities, such as a parent and subsidiary, particularly when assets are moved from one to the other, or employees are "borrowed." The record keeping requirements of a series LLC may pose similar opportunities for non-adherence, with the result being that the series status is disregarded, leaving the assets of the different series exposed to the liabilities of the various series. In a series LLC, the separate form of each series must be respected and the corporate formalities and record keeping requirements must be adhered to. The assets of each series must be recorded and accounted for separately from the other assets of the LLC or other series of the LLC[26]. To satisfy this requirement, records of the assets must be maintained in a manner such that they can be reasonably identified by specific listing, category, type, quantity, or computational or allocational formula or procedure, or any other method in which the identity of the assets can be objectively determined[27]. In addition, because each series is treated as its own separate entity, members and managers of the series should be cautiously observe the traditional anti-veil-piercing formalities that must be observed by any limited liability entity in order to preserve its limited liability character. This means the a series should have its own letterhead, bank account, and contracts. In addition, actions taken on its behalf should be taken by its own managers or members. Individuals acting on behalf of the series should have the proper authority to do so. A manager of another series or of the LLC that takes action for a series of which he is not a manager or for which he otherwise does not have authority to act, may put that series at risk of losing its separate character.

Although the effects are not specifically addressed in the series LLC legislation, the unraveling of a series LLC due to failure to follow the corporate record keeping requirements could create a complex from a membership interest perspective. It may be entirely unclear how the interests of the owners of each series will translate into membership interests in an LLC that has failed to qualify as a series LLC. At the very least, it is not likely a situation the company's owners, managers, accountants, or lawyers wants to find himself sorting through.

Conclusion

The appearance of the series LLC is an interesting development in Texas. It is an entity that, although poorly understood from many tax and liability perspectives, offers a potentially attractive option in choice of entity decisions. Currently, however, its risks may prove to outweigh its benefits, particularly given its unsettled federal and state tax status, and the risks involved in being on the "cutting edge"—namely that entities relying on the liability shield features and tax status of the series LLC may find themselves at the mercy of the uncertain interpretation of their form by the IRS and non-series jurisdictions.

We will continue to monitor guidance provided by federal and state taxing authorities, as well as judicial interpretation of the series LLC statutes, as variations of this legislation is adopted by other states across the United States.

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[1]*Cindy Grossman and Steve Phillips are attorneys with the Austin, Texas-based law firm of Giordani, Swanger, Ripp & Phillips, LLP. Their practice focuses on state, federal, and international tax and business planning and transactions.*

[2]*Tex. Bus. Org. Code § 601.101(a).*

[3]*Id. §101.601(a)(1).*

[4]*Id.*

[5]*Id. §101.605; §101.601(a)(2)*

[6]*Id. §101.602(a)(1).*

[7]*Id. §101.601(a)(2).*

[8]*Id. §101.601(b).*

[9]*Id. §101.606.*

[10]*Id. §101.607.*

[11]*Id. §101.608.*

[12]*Id. §101.613*

[13]*Id. §101.614, §101.615, §101.616, §101.617, §101.618, and §101.619.*

[14]*See H.R. 528, §9, 70 De. Law Ch. 360 (1996); 6 Del. Code §18-215.*

[15]*See 805 ILCS 180/37-40; Iowa Code §490A.305; Nev. Rev. St. §86.296.3; 18 Okla. Stat. §18-2054.4B; Tenn. Code Ann. §48-249-309; Utah Code Ann. §48-2c-606.*

[16]*Under Tex. Tax. Code §171.002, as amended by an entity with total revenue under $1,000,000 or an entity that has a tax liability of less than $1,000 does not pay any franchise tax.*

[17]*See Tex. Tax Code §171.1012 and §171.1013. Under the franchise tax rules, an entity may only use one type of deduction for a given reporting period. The election is made annually.*

[18]*See Tex. Tax Code §171.0003.*

[19]*I.R.S. Priv. Ltr. Rul 200803004 (Jan. 18, 2008).*

[20]*Id. Note also the interesting interplay between the federal tax system, which may treat series of an LLC as separate taxpayers, with various state tax systems, which my treat the LLC and all its series as a single taxpayer. This raises the same types of issues dealt with under the "check-the-box" rules when an entity is disregarded for federal tax purposes, but recognized as a separate entity under relevant state corporate and tax law.*

[21]*See Franchise Tax Board, Tax News, Mar.-Apr. 2006, http://www.ftb.ca.gov/professionals/taxnews/tn_06/03_04.shtml; California 2006 Limited Liability Company Tax Booklet, p. 4, Section F.*

[22]*See, Del. Code Ann. §18-215(n).*

[23]*U.S. Const. Art. IV, §1*

[24]*Nick Marisco, Current Status of the Series LLC: Illinois Series LLC Improves Upon Delaware Series LLC but Many Open Issues Remain, 9 J. Passthrough Entities 35, 52 (Nov.-Dec. 2006).*

[25]*As mentioned previously, California has already rejected the notion that a series LLC is a single entity, and requires each series to register separately with the California Secretary of State.*

[26]*Tex. Bus. Org. Code §101.602(b)(1).*

[27]*Id. §101.603(b).*