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## Classification of Series and Cell Companies

*Prop. Reg. 301.7701-1(a)(5); 75 Fed. Reg. 55699 (Sept. 14, 2010).*

In recent years, foreign and domestic jurisdictions have allowed a single limited liability company to organize various series or cells. The local laws may not classify the series or cell as entities on par with the umbrella LLC, but generally do accord to the series or cell most if not all of the usual rights and duties of property and income ownership and liability. Such arrangements occur mostly for reasons of administrative efficiency and not tax planning. The principal tax advantages desired by sponsors and advisors of these arrangements are certainty of tax treatment and flexibility of choice. Recently proposed regulations aim to provide that certainty.

Local law may call the series organization a “domestic series LLC,” a “domestic cell company” or a foreign protected cell insurance company allowed to organize series or cells. Although the local laws providing for these series organizations are the fundamental starting point for the proposed regulations, their purpose is not to define the series organization, which normally will be a known type of person, but to characterize the cells or series formed by the series organizations. Their entity status might not be so obvious, particularly where the local jurisdiction does not label them entities on par with the series organization, but rather treats them as contractual arrangements created by the series organization.

The proposed Reg. section 301.7701-1(a)(5) would treat domestic cells of cell companies or domestic series of domestic series organizations as “an entity formed under local law,” with the goal of making them subject to the general entity characterization regulations by which they can be recognized as entities separate from their owners for federal income tax purposes, and recognized as a type of person according to the code’s pigeonholes (partnership, corporation or trust, if not disregarded).

The series or cell of a series organization is not like a subsidiary of the series organization; rather, it is to be beneficially owned by persons who might otherwise appear to be the owners of the series organization, through what is akin to tracking stock. However, ownership of a cell differs dramatically from owning tracking stock because the cell owners usually want to own the cells and series directly (whereas owners of tracking stock hope they own stock of the issuing parent corporation whose value merely tracks identified assets).<sup>1</sup> The proposed regulations accommodate those desires.

The proposal does not address foreign organizations, except for foreign insurance companies. Perhaps one of the reasons for avoiding foreign organizations is that Treasury was burned by applying the check-the-box rules, Reg. section 301.7701-1, -2 and -3, to foreign as well as domestic entities, and would like to approach this similarly tricky issue more incrementally.

The proposed regulation provides:

- **The operative rule:** A series that meets the regulation’s definition is treated as an entity formed under local law for federal tax purposes, whether or not it is a “juridical person for local law purposes.”

<sup>1</sup> For discussion and comparison of tracking stock and cell companies, see Stephen B. Land, “Entity Identity: The Taxation of Quasi Separate Enterprises,” 63 *Tax Law.* 99 (2009).

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- **The consequences of the operative rule:** The series/local law entity is eligible—indeed, almost certain—to be treated as an entity separate from its owners for federal tax purposes, determined under Reg. section 301.7701-1 and general tax principles (unless it is an eligible entity that chooses to be disregarded).
- **Definition of series:** A series is a segregated group of assets and liabilities that is established pursuant to a “series statute” by agreement of a “series organization,” which itself was organized under or authorized to create series by the series statute.
- **Definition of a series organization:** A series organization is a juridical entity that establishes and maintains a series.
- **Definition of series statute:** A series statute is a state or country statute that specifically provides for the organization of a series of a juridical person (the series organization), and explicitly permits (1) the series organization to have members with rights and powers with respect to a series, (2) the series to have rights and obligations with respect to specified property and (3) the segregation of a series’ assets and liabilities from those of other series or of the series organization.

Thus, the classification process is and should be as follows [with the steps that current and proposed regulations do not identify bracketed]:

- **Organization:** The Treasury regulations start with the undefined term *organization*, which refers to whatever it is that causes the classification analysis to begin;<sup>2</sup>
- **[Single Owner:** Determine whether an organization is the *single owner* of income and property by analysis of local law ownership *rights and duties*];<sup>3</sup>
- **Local Law Entity:** Identify that single owner for federal income tax classification as a *local law entity* [in other words, this and the preceding step are identical if local law entity status is tied to the single ownership of property];<sup>4</sup>
- **Entity Separate From Owner for Federal Tax Purposes:** Classify the local law entity as an *entity separate from its owners* for federal tax purposes in almost all cases, under Reg. section 301.7701-1;
- **Business Entity:** Classify the entity separate from its owners as a *business entity* or trust under Reg. section 301.7701-2 or -4;
- **Eligible Entity:** Classify a business entity that is not a corporation as an *eligible entity* under Reg. section 301.7701-3(a);
- **Person:** Depending on elections made under Reg. section 301.7701-3, classify the eligible entity as a *person* (corporation or partnership) under section 7701(a)(1), or not; and
- **Taxpayer:** Classify a person subject to tax as a *taxpayer*.<sup>5</sup>

## Conclusion

This appears to be a very complicated process just to identify a legal unit for tax purposes. If adopted, the proposed regulation will clarify one small corner of the process.

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<sup>2</sup> Reg. § 301.7701-1(a)(1). “Organization” is used throughout the Code in reference to political, charitable, non-profit and other sorts of organizations, but is not used in the definition of person or corporation.

<sup>3</sup> Admittedly, income may derive from services as well as from property. However, non-natural persons can perform services usually only through the use of natural persons. Therefore, non-natural persons derive services income from property—i.e., from the contract rights entitling the employer to be paid for the services performed by its human employees.

<sup>4</sup> Reg. § 301.7701-1(a)(1).

<sup>5</sup> I.R.C. §§ 7701(a)(1) and (14).

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