

**TAX MANAGEMENT MEMORANDUM**  
***Classification of Series Entities***  
**by**  
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**I. Introduction**

The check-the-box regulations have, for the past decade, allowed for certainty by choice in the classification of various organizations for federal tax purposes.<sup>1</sup> The regulations provide a flexible framework, permitting owners and managers to, in most instances, choose the tax classification of the business entity. For those who do not affirmatively make that choice by election, the regulations fill the gap with default classifications both for domestic and foreign business entities.

Fundamental to the application of these regulations is the concept that, first, there must exist a "business entity" to be classified.<sup>2</sup> Whether an organization or enterprise is treated as a business entity separate from its owner or owners for tax purposes is a matter of federal tax law. That determination, correspondingly, is not dependent upon recognition of the entity as a legal entity under local law. While prescribing that a joint venture or other contractual arrangement may create a "separate entity" for federal tax purposes if the participants carry on a business or financial operation and divide the profits, there remains a lack of certainty in determining whether certain arrangements engender separate business entities for federal tax purposes.<sup>3</sup>

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<sup>1</sup>Treas. Reg. §§301.7701-1, *et seq.*

<sup>2</sup>Generally, a business entity is any entity recognized for federal tax purposes. Treas. Reg. §301.7701-2(a).

<sup>3</sup>A common setting in which the "separate entity" issue presents itself is in connection with an arrangement that may be viewed as a mere contractual alliance, but there are sufficient indicia to deem a partnership to exist for tax purposes. *See, e.g., Commissioner v. Culbertson*, 337 U.S. 733 (1949); *Madison Gas & Elec. v. Commissioner*, 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980).

This paper addresses that question—whether there is a separate business entity for federal tax purposes—with respect to arrangements that dissect business or investment activities into separate, segregated compartments. On the domestic front, the most prominent of these arrangements are the “series” entities under Delaware’s limited liability company and limited partnership statutes.<sup>4</sup> Under Delaware law, each series of the “umbrella” legal entity has a distinct portfolio of assets and liabilities that, under Delaware law, are considered separable from the assets and liabilities of other series of the same legal entity. Following Delaware’s lead, several other jurisdictions have adopted similar authorizations.<sup>5</sup> The issue presented in connection with these series arrangements is whether each series should be cast as a separate business entity for federal tax purposes. Indeed, a recent submission of the New York State Bar Association addressed this topic in connection with individual “cells” of a protected cell company in the context of proposing a safe harbor analytic structure for determining that a “cell” would be treated as an insurance company separate from any other entity.<sup>6</sup>

The classification of series entities is not, however, confined to determinations of domestic arrangements. Many foreign jurisdictions have enacted legislation authorizing the formation of series entities.<sup>7</sup> In similar fashion, the European Union adopted regulations for “undertakings for collective investments in transferable securities” (or “UCITS”) which incorporate the concept of an “umbrella fund” divided into a number of sub-funds. The UCITS regulations are designed to facilitate collective investment portfolios that operate freely throughout the European Union on the basis of a single authorization from one Member State.

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<sup>4</sup> See Del. Code Ann. tit. 6, §18-215 (2007); Del. Code Ann. tit. 6, §17-218 (2007).

<sup>5</sup> See, e.g., 805 Ill. Comp. Stat. 180/37-40 (2005); Iowa Code Ann. section 490A.305 (2006); Nev. Rev. Stat. Ann. section 86.296 (2005); Okla. Stat. Ann. tit. 18, section 2054.4 (2007); Tenn. Code Ann. 48-249-309 (2006); Utah Code Ann. section 48-2c-606 (2006); Puerto Rico Laws Ann. tit. 14, section 3426(p) (as amended through 2004).

<sup>6</sup> See Comment on Protected Cell Company Guidance, NYSBA (May 2, 2008). See also Notice 2008-19, announcing that the Internal Revenue Service (“Service”) will be proposing guidance as to the federal income taxation of protected cell companies.

<sup>7</sup> See, e.g., Bermuda Segregated Accounts Companies Act 2000, as amended by the Segregated Accounts Companies Amendment Act 2004; British Virgin Islands, Statutory Instrument 2005 No. 96, Segregated Portfolio Company Regulations; Cayman Island Companies Law, Part XIV-Segregated Portfolio Companies, sections 232-248 (2004); Guernsey, Protected Cell Companies Ordinance, 1997, amended by the Protected Cell Companies (Amendment) Ordinance, 2006; Luxembourg Securitisation Act (2004); Mauritius Protected Cell Company Act (1999).

These series arrangements typically are premised upon a recognized effort to realize cost-efficiencies by establishing an “umbrella” legal entity. And, although the authorizing statutes in the various jurisdictions use different terminology, one common theme is present: There is an intended commercial benefit to isolating the assets and the liabilities of the respective series. No matter whether the series entity is domestic or foreign, nor whether the business conducted by the separate series is an active operating business or investment activity, the framework for analysis for federal tax proposes—whether each series is a separate business entity—should be consistent and predictable. While the check-the-box regulations control once the existence of a business entity is established, the satisfaction of that premise requires guidance. The Service seemingly appreciates the need for guidance, as it has issued numerous informal letter rulings on the subject. Yet, there remains no formal guidance.<sup>8</sup>

## **II. Delaware Law and the UCITS Regulations**

### **A. The Delaware Series Entities**

In 1996, Delaware amended its limited liability company and limited partnership statutes to permit the designation of “series” of ownership interests. These innovations provided managers and owners the flexibility of creating membership interests having “separate rights, power or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligation ....”<sup>9</sup> In the event that one or more “series” is established, and if (i) proper records are maintained for each series that account for the assets belonging to such series separately from the assets of the limited liability company or any other series; and (ii) notice of the limitation on liabilities of a series is set forth in the certificate of formation (and is set forth in the limited liability company agreement), then the debts, liabilities, obligations, and expenses of a particular series will be enforceable only against the assets of that series, and not against the assets of the limited liability company generally or of any other series.<sup>10</sup> The statute effectively causes the assets and the liabilities of each series to be segregated from the assets and the liabilities of each other series, as well as from the assets and the liabilities (if any) of the umbrella entity.<sup>11</sup>

### **B. The Umbrella Trust Under UCITS Regulations**

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<sup>8</sup>It is the author’s understanding that the topic had been considered for inclusion in the 2007-2008 guidance priority plan issued by the Service and Treasury.

<sup>9</sup>Del. Code Ann. tit. 6, §18-215. Similar provisions apply to series limited partnerships.

<sup>10</sup>In an article by James M. Peaslee and Jorge G. Tenreiro, “Tax Classification of Segregated Portfolio Companies,” *Tax Notes*, October 1, 2007, the authors noted that, “[i]n drafting the Delaware statute, a conscious choice was made not to describe portfolios as separate legal entities,” as the drafters of the statute sought to avoid concerns “that each series would be analyzed as a separate entity for nontax purposes unrelated to creditor rights (for example, in applying the Investment Company Act of 1940).” *Id.* at 46.

<sup>11</sup>Not only is there a separation of assets and liabilities. Different series routinely have different investment managers, different contribution and distribution policies, and different borrowing policies, to name a few.

An umbrella unit trust established under the laws of a Member State of the European Union and authorized as an undertaking for collective investment in transferable securities pursuant to the UCITS regulations bears the same features as a Delaware series entity. Such a vehicle is comprised of, and offers, units of investment interests in separate sub-funds, with the units of any particular sub-fund being distinguishable from units of each other sub-fund and providing holders rights and benefits attributable solely to the relevant sub-fund. As with membership interests in a Delaware series entity, the units of a particular sub-fund constitute beneficial ownership interests in the property of that sub-fund, each unit representing one undivided share in the sub-fund's property, and each unit having an issue price based on the net asset value per unit of said sub-fund.

Both the Delaware series entities and umbrella entities under the UCITS regulations contemplate that each "series" constitutes a separate pool of assets having distinct investment objectives that differ from those of each other series. These arrangements, as is true with other undertakings such as segregated portfolio companies addressed in the Peaslee and Tenreiro article and the protected cell companies addressed in the New York State Bar Association comment letter, have one recurring commercial feature: The assets and liabilities (and income and expenditures) attributable to a particular series belong to, and only to, that series.<sup>12</sup> While there may be "common" expenses incurred by the umbrella entity that are not associated with any particular series, or (less likely) common assets or income not attributable to a particular series, the operative documents typically allow that, for any such asset, income, liability, or expense, a trustee or other manager has the discretion to determine the basis upon which such item is to be allocated among the series.

In any event, the assets of each series "belong" exclusively to that series, are segregated from the assets of other series, and cannot be used to discharge directly or indirectly the liabilities of or claims against any other series. Further, distributions with respect to ownership interests of a particular series are to be paid out of the assets of that series. Quite often, the manager of a series may call for the surrender and cancellation of units of a particular series without any effect on any other series, or may cause funds to be borrowed for the account of a particular series without any effect on any other series. In some instances, the manager may appoint separate auditors and accountants for each series. And generally without exception, a manager may terminate a series without terminating the umbrella entity and other series.

### **III. Analysis of Treatment of Series Entities**

#### **A. Historic Case Law**

The prevailing view among practitioners (primarily with respect to sub-trusts of multi-fund arrangements) has been that, where a series possesses its own economic attributes, has distinct owners, and achieves commercial separateness, it should be recognized as a separate entity for federal tax purposes. That view, however, should not be confined to a particular vehicle (such as a unit trust) or activity (such as an investment activity). Rather, that view should be extended to any series entities having the commercial feature of asset and liability separation. Accepting that view—that each series should be regarded as a separate "business entity" for federal tax purposes and, correspondingly, concluding that the umbrella entity does not constitute a "single" business entity—each series, in turn, would then be classified as a trust, a corporation (or an association taxable as a corporation), or a partnership under the check-the-box regulations.

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<sup>12</sup>Further, where any asset is derived from any other asset (whether cash or otherwise) of a particular series, such derivative asset would be applied in the records and accounts of the same series as the asset from which it was derived.

The issue—whether each series of an umbrella entity should be considered a separate entity for federal tax purposes—has a long history. In the first case on this issue, *Union Trusteed Funds, Inc. v. Commissioner*, 8 T.C. 1133 (1947), the Tax Court considered whether a domestic multi-fund investment company (incorporated under state law) that made an election to be treated as a regulated investment company (“RIC”) should be treated as a single corporate RIC, or whether each fund of the investment company should be treated as a separate RIC. The Service argued that each fund should be treated as though it were a separate corporation—a theory the court considered (at the time) to be novel and unsupported by law. The court thus concluded that the multi-fund investment company should be treated as a single taxable entity. The Service later reached the same conclusion in Revenue Ruling 56-246, 1956-1 C.B. 316 (ruling that a multi-fund RIC constitutes “one taxpayer”).

However, after *Union Trusteed Funds* (but before the issuance of Rev. Rul. 56-246), the Tax Court implicitly reached a contrary conclusion in *National Securities Series—Indus. Stocks Series, et al. v. Commissioner*, 13 T.C. 884 (1949), *acq.* 1950-1 C.B. 4. The principal issue in this case was whether certain distributions in redemption of shares by different series of an investment trust (the investment trust was an unincorporated entity, formed as a trust) that elected to be taxed as a RIC were preferential dividends.<sup>13</sup> Each redemption distribution by a trust series reflected the earnings of that series with respect to which the shareholder was redeeming shares. Although it concluded that the distributions of particular series’ earnings in redemption of shares were not preferential dividends, the court did not directly address whether each series of the investment trust was a separate and distinct entity for tax purposes. But recognition of each series as a separate RIC was implicit in (and a necessary premise for) the court’s conclusion.<sup>14</sup> For the next 30 years, there remained a seeming inconsistency in treatment of series entities, based on *Union Trusteed Funds* and *National Securities Series* results.

## **B. The Service Reconciles the Case Law**

Then, in the mid-1980s, the Service issued several private letter rulings addressing whether a series of an unincorporated business trust should be treated as a separate entity for federal tax purposes. *See, e.g.*, PLR 8419017 (February 2, 1984).<sup>15</sup> In this 1984 letter ruling, a business trust, registered as an investment company under the 1940 Act, was comprised of separate investment funds, each represented by a separate series of shares of beneficial interests. The economic interest of a shareholder in a particular fund was limited to the net assets of that fund, and the liabilities of each fund also were so restricted. Procedural and administrative matters were handled on a fund-by-fund basis (except for matters required to be handled otherwise by the 1940 Act). Each fund had a different investment objective, a different composition of assets, a different management fee arrangement, and different shareholders. The Service, citing *National Securities Series*, ruled that each series of the trust was a separate and distinct economic entity consisting of a separate pool of assets and stream of earnings and, accordingly, should be classified as a separate entity for federal tax purposes.

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<sup>13</sup>In calculating its tax liability, a RIC generally is entitled to a deduction for dividends paid to its shareholders. *See* IRC §§562 and 852. However, in determining the amount of the deduction for dividends paid, a RIC is not allowed a deduction for “preferential dividends.” *See* IRC §562(c).

<sup>14</sup>The Service cited *National Securities Series* with approval in Rev. Rul. 55-416, 1955-1 C.B. 416, although this ruling concerned only the effect of distributions in redemption of shares of a RIC and did not involve a multi-fund investment company.

<sup>15</sup>*See also* PLR 8451029 (Sept. 14, 1984); PLR 8453058 (Oct. 1, 1984), PLR 8507013 (Nov. 16, 1984), and PLR 8510013 (Dec. 5, 1984).

In its analysis, the Service distinguished its position from the holding in *Union Trusteed Funds* and from prior Rev. Rul. 56-246. See GCM 39211 (January 13, 1984). The Service suggested that there was an inherent difference between an incorporated business entity and an unincorporated business entity,<sup>16</sup> ruling that:

Incorporated entities are characterized for tax purposes as corporations without regard to the rules for classifying unincorporated entities. Cf \* \* \* G.C.M. 34376, I-3933 (Nov. 13, 1970), concluding that the entity in that case is a corporation 'per se.' Therefore, we do not believe that the classification of an incorporated entity [as in *Union Trusteed Funds*] controls the classification of unincorporated entities [as in *National Securities Series*].

Thus, under the Service's analysis at the time, a series of a business entity organized as a corporation could not be treated as a separate entity for federal tax purposes, but a series of an unincorporated business entity, such as a business trust, could be so treated.<sup>17</sup>

### **C. Congress Takes a Limited Step**

Congress entered the fray in 1986, partially modifying the treatment of separate series of an investment company.<sup>18</sup> Section 851(g) provides that, in the case of a regulated investment company having more than one fund, each fund will be considered a separate corporation for tax purposes.<sup>19</sup> This provision applies *both* to incorporated and to unincorporated entities electing to be taxed as RICs. Because the Service had already concluded that each fund of a multi-fund RIC organized as a business trust could be treated as a separate entity, the principal effect of the new statutory provision was to allow each fund of a multi-fund RIC organized as a corporation to be similarly treated.<sup>20</sup> Although section 851(g) by its terms applies only to a fund that elects to be taxed as a RIC, Congress clearly recognized that separate funds (or series) of a multi-fund investment entity may be treated as distinct entities for federal tax purposes.

### **D. After Check-the-Box**

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<sup>16</sup>This observation in 1984 (and preceding the check-the-box regulations) seemingly foresaw the distinction to be drawn between "per se" corporate entities and "eligible entities" under the check-the-box regulations.

<sup>17</sup>Interestingly, the Service' analysis focused upon whether the subject entity was incorporated, not on whether the entity was taxable as a corporation. In fact, in these rulings of the mid-1980s, the separate series of unincorporated investment trusts were in fact treated as separate corporations for tax purposes because each series had more corporate than non-corporate characteristics under the prior corporate resemblance regulations.

<sup>18</sup>See IRC §851(g) (originally designated as section 851(h)).

<sup>19</sup>As a collateral consequence of this statutory change, Revenue Ruling 56-246 (described above) was declared obsolete. See Rev. Rul. 88-14, 1988-1 C.B. 405.

<sup>20</sup>Because section 851(g) applies only to a fund (whether incorporated or unincorporated) that elects to be taxed as a RIC, an incorporated entity with multiple series that is ineligible to make an election or otherwise does not elect to be taxed as a RIC would not be covered by section 851(g).

The historical discussion above suggests the following: (i) if a series entity were incorporated, separate entity treatment for each series was reliant upon section 851(g); (ii) if a series entity were unincorporated, section 851(g) would apply if the entity were a RIC or the Service's letter rulings position may apply if it were not a RIC. Following issuance of the check-the-box regulations, the Service continued to focus upon whether (or not) each fund of a multi-fund investment entity (that is not a "per se" corporation) is a distinct economic entity. For example, again relying upon *National Securities Series*, the Service ruled repeatedly that each series of an unincorporated business trust would be respected as a separate entity for federal tax purposes. See, e.g., PLR 9702024 (Oct. 11, 1996) (series of a business trust registered as an open-end management company under the 1940 Act is a separate entity, in this case classified as a partnership); PLR 9702016 (same); PLR 9644014 (July 15, 1996) (same). In each of these letter rulings, involving tax years preceding the effective date of the check-the-box regulations, the Service, first, found each series to be a "separate taxable entity" and, second, because of the non-corporate characteristics, the Service classified each series as a partnership.

Following issuance of the check-the-box rules, the Service' analysis remained on course. See, e.g., PLR 9847013 (Aug. 20, 1998).<sup>21</sup> Here, for an open-end investment company organized as a trust, the Service observed that (i) the jurisdiction in which the trust was formed recognizes sub-trusts; (ii) each series had distinct investment objectives; (iii) each series invested in a portfolio of securities independent of any other series' investments; and (iv) a holder of a particular series could look only to assets of that series. Consequently, each series was found to constitute a "separate entity" under the check-the-box rules and each separate entity was then classified thereunder.<sup>22</sup>

Most recently, in Private Letter Ruling 200803004 (Oct. 15, 2007), the Service found each series of a limited liability company to constitute a separate entity for federal tax purposes where:

- (i) the ownership interest of a member of each series was limited to the assets of that series;
- (ii) the members of each series shared only in the profits of that series;
- (iii) allocations of profits and losses of each series were made separately (and in accordance with sections 704(b) and (c)); and
- (iv) the claims of creditors of each series were limited to the assets of that series.

This consistent stream of informal guidance from the Service rests upon its views expressed in 1984 in GCM 32911, where the Service explained:

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<sup>21</sup> See also PLR 98937005 (June 9, 1998).

<sup>22</sup> See also PLR 200303017 (Sept. 30, 2002) (each sub-trust, which invests so as to comply with Subchapter M as applied at the sub-trust level, regarded as a separate business entity classified as a partnership); PLR 2003171527 (June 1, 2005) (each portfolio of series business trust classified as a separate partnership).

[E]ach fund is a *separate and distinct economic entity* consisting of separate pools of assets and streams of earnings. The ownership of beneficial interests in each fund is different, and the beneficial owners of each fund may look only to its assets in redemption, liquidation, or termination. The shareholders and creditors of each fund are limited to the assets of that fund for recovery of expenses, charges, and liabilities. Each fund has different arrangements with the management advisors. Votes of shareholders are conducted by each series individually, except to the extent the 1940 Investment Company Act requires shares to be voted in the aggregate without regard to series. Joint activities of the funds are extremely limited. Under these circumstances, we believe that the funds should be classified as separate taxable entities.

Those fundamental criteria should frame the analysis for series entities today. The most important criteria for determining that each series should be regarded as a separate business entity for federal tax purposes seemingly are (i) the economics associated with an owner's interests in a particular series (in terms of valuation, distribution rights and liquidation rights) are determined by reference to the capital investment in the relevant series (without regard to capital investment in any other series); (ii) the recovery rights of an owner are limited to the net assets of the relevant series; and (iii) the limitation of liability is secured under local law, providing that the satisfaction of liabilities of a series is limited to that series' assets.

This analysis is logical, reliant upon the substantive economic features of the arrangement, and provides certainty and predictability. In issuing formal guidance, the Service may also consider helpful safe harbor elements prescribed by the New York State Bar Association in its comment letter on protected cell companies, which (if paraphrased) include:

- The series is formed under the statute (or regulations) of a state or foreign sovereign jurisdiction;
- The relevant statute (or regulations) provide for unambiguous separateness of assets and liabilities, and permit ownership on a series-by-series basis; and
- The umbrella entity is not a per se corporation.

Adoption of these principles also would be consistent with the analytic approach in a different, but related, federal determination. For example, there are occasions under the Code that identification of an "issuer" is relevant.<sup>23</sup> While section 851 (applicable to RICs) refers to the term "issuer" that term is not defined. Section 851(c)(6), however, provides that undefined terms used in section 851 have the same meaning as provided in the 1940 Act. The 1940 Act defines issuer as "every person who issues or proposes to issue any security or has outstanding any security which it has issued." 1940 Act, Sec. 2(a)(22). As this definition suffers from imprecision, the Service also has looked to releases from the staff of the Securities and Exchange Commission ("SEC") for added guidance.

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<sup>23</sup> See, e.g., IRC §851(b)(3) (RIC qualification requires a degree of diversification, looking to the percentage of asset value invested in an issuer). See also IRC §817(h) and the regulations thereunder (diversification requirements for variable life and annuity contracts).

The SEC has taken the position under section 5(b)(1) of the 1940 Act (regarding the definition of a "diversified company" for 1940 Act purposes), that the "issuer" of a security is "the person to whom the holder of the security looks for payment." See *Hyperion Capital Management, Inc.*, SEC No-Action Letter (Aug. 1, 1994), citing *The Dreyfus New York Tax Exempt Bond Fund*, SEC No-Action Letter (May 16, 1977) (under section 5(b)(1), the issuer is the person against whom the holder of a security has a legal claim); and *Pennsylvania Tax-Free Income Trust*, SEC No-Action Letter (Mar. 4, 1977) (under section 5(b)(1), the entity responsible for payment of a bond obligation is the issuer). In *Hyperion*, the SEC agreed that an asset pool backing a specific security could be viewed as a separate issuer under section 5(b)(1), notwithstanding that a large number of such pools had a common sponsor. In so agreeing, the SEC observed that holders of a specific asset-backed security would look to a single pool for return of principal and interest, and that in the event of a sponsor's bankruptcy, the sponsor's creditors would have no recourse against the pool.

Further, the SEC more recently agreed that each portfolio of a domestic master trust should be treated as a separate issuer for purposes of section 3(a)(1) of the 1940 Act. See *Washington Capital Joint Master Trust*, SEC No-Action Letter (Sept. 25, 2006). Similarly, the SEC agreed that each sub-fund of an umbrella fund authorized by the UCITS Regulations should be regarded as a separate issuer for purposes of Section 3(c)(1) of the 1940 Act. *Coutts Global Fund*, SEC No-Action Letter (Dec. 7, 1994) (umbrella trust is analogous to a domestic "series company," with authority to issue shares of multiple series, and with each series of shares representing interests in a discrete sub-fund). This treatment of identifiable series, or sub-funds, as separate issuers supports a tax analysis that is based upon the substantive economic arrangement.

#### **IV. Conclusion**

The check-the-box regulations, helpful as they are, do not provide significant guidance in determining whether a business arrangement constitutes a separate business entity for federal tax purposes. This deficiency results in uncertain treatment of series entities, whether domestic or foreign, whether active or passive. A safe harbor analysis, along the lines prescribed above and based primarily upon substantive economic rights and the commercial separation of assets and liabilities, would provide a degree of certainty and predictability in determining the proper classification of series entities.