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Treasury Issues Proposed Regulations on Series LLCs and Cell Companies
Further Solidifying the Place of the Delaware Series LLC in the Captive Market

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The Treasury Department issued Proposed Regulations on September 13, 2010, regarding the Federal tax classification of so-called "series limited liability companies" or "series LLCs," "series statutory trusts," and cell companies created under insurance laws (collectively "Series Organizations").

A Series Organization is an entity which is authorized, by statute, to segregate pools of assets into separate series which are then isolated from the liabilities associated with the other series and possibly the Series organization itself. The State of Delaware was the first state to authorize Series Entities in its statutory trust and LLC laws. Delaware law provides that each series may have its own members, assets, rights, obligations, investment objectives, and business purposes. In addition, a Delaware Series LLC has the power to contract and to hold title to assets in the name of the series, and to grant a security interest. Of the eight other U.S. jurisdictions that have followed Delaware's lead, a majority have denied entity status to the series (including Delaware), although a few, most notably Illinois and Iowa, have afforded separate entity status to the series. The Proposed Regulations treat each series as a separate taxable entity, notwithstanding their characterization under applicable state law as separate legal entities. In reaching its conclusion, the Treasury cited to a history of prior rulings in which entities recognized under state law are disregarded for tax purposes, and others in which contractual arrangements not creating a juridical entity may be considered a separate taxpayer for federal tax purposes.

The Proposed Regulations provide certainty for parties concerned about the effect of a failure to comply with the technicalities ensuring limitation of interseries liabilities, by expressly stating that no such failure will impact the tax classification of a series. In addition, the mere titling of assets in the name of the Series Organization instead of titling them in the name of an individual series will not disqualify a series from being a separate taxpayer. Rather, entity status will hinge on the extent to which the series bears the benefits and burdens of ownership.

Other factors supporting the separate taxation of series include the ability of a series to have members and managers distinct from those of the Series Organization or other series, with specified rights, duties and powers. Also significant is the ability to assign a discrete business purpose or investment objective to an individual series. While these attributes led the IRS to conclude that series should be treated as separate taxpayers, no distinction will be made between the various state statutes permitting the creation of series by Series Organizations, nor will the IRS disqualify from taxpayer treatment series that are structured with less than all of the "separate" attributes permitted by the applicable statute.

The Proposed Regulations further recognize that once a domestic series is classified as an entity for tax purposes, it is entitled to make tax elections separately from the Series Organization or any other series.

The Proposed Regulations specifically avoid characterization for tax purposes of a Series Organization that has no business purpose or assets separate from the individual series.

The Proposed Regulations apply to all domestic Series Organizations; the IRS specifically declined to establish separate rules for a series that conducts insurance business. While the Proposed Regulations do not address foreign series generally, they expressly do grant separate tax treatment to a foreign series that would be classified as an "insurance company" under applicable law; that is, a foreign series for which a majority of its business involves the issuance of insurance, reinsurance or annuity contracts.

Because series that are not legal entities for state law purposes generally do not have annual filing requirements, the Proposed Regulations recommend a required annual federal filing statement for all Series Organizations that would disclose certain information.

The Proposed Regulations will become effective at an unspecified future date following the submission and review of comments to the proposals.

Series Organizations that currently consolidate the activities of the Series Organization and all of its series as one taxable entity may be grandfathered following the effective date of Final Regulations if they meet certain criteria. Those that do not meet the criteria may be required to become compliant with the new rules.

Following the 1997 revisions to the Delaware Captive Insurance Laws, the Delaware Department of Insurance, the Delaware Captive Insurance Association and professionals involved in the captive insurance industry have advocated the use of the Delaware series LLC as a cost-effective vehicle for captive insurance structures. A series LLC can be used as a sponsored captive under Section 6932 of the Delaware Captive Insurance Act. In addition, the Delaware Department of Insurance recently licensed a Delaware series LLC as a special purpose insurance company, relying on the series LLC provisions of the Delaware LLC Act to provide the interseries liability protections while paying only a single entity-level premium tax.

The uses of a series LLC in a captive context are diverse and numerous. For example, a series LLC can be used to develop a captive insurance or reinsurance program for smaller insureds who may not have the capital to fund a standalone captive, similar to a protected cell structure. Unlike a protected cell captive that is a creature of insurance statutes, the series LLC is governed by Delaware's alternative entity laws. As such, the series LLC should provide better creditor protection of series assets because alternative entities have withstood attacks in the past, i.e., there is more of a precedent around such structures. To date, the series LLC has not been challenged in the courts.

In addition, series LLCs can be used as a vehicle for middle market companies to achieve a number of insurance and income tax benefits, as well as significant wealth transfer advantages for the business owner. Through a series LLC, a company may allocate different risks or combinations of risks to different series, and each series may have a different owner. If the premium to each series is less than $1.2 million annually, because of the separate tax treatment of each as provided for in the Proposed Regulations, each series could elect to be treated as an 831(b) small insurance company and enjoy an income tax exemption for its premium income. The business would be able to deduct the amount of premium paid to the captive the year in which they are paid. If each series is owned by a LLC or trust for the benefit of the business owner's descendants gift and generation skipping transfer taxes will not apply. The captive is also outside the estate of the business owner, thus providing an opportunity to transfer wealth to future generations tax free. Before the Proposed Regulations, skeptics of these ideas raised the tax uncertainty as a potential obstacle to such structures.

With the guidance the Proposed Regulations provide, using a Delaware series LLC in the captive context makes more sense now than ever.