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PROTECTED CELL (SERIES LLC) ARRANGEMENTS SHOULD CONSIDER SEGREGATION OF CORPORATE EARNINGS AND LIQUIDATION RIGHTS

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In Notice 2008-19[1] and Rev. Rul. 2008-8[2] the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") provided guidance and requested comments on the circumstances under which a protected cell of a protected cell company (or a "Series" of a "Series LLC") would be treated as a separate insurance company for federal income tax purposes, and some of the consequences of such treatment as well as the treatment of a Series in a non-insurance context.[3] Recently, the American Bar Association Section of Taxation responded to the request for comments in Notice 2008-19 by submitting a letter detailing its members' recommendation (the "ABA Recommendation").[4] Interestingly, while both the Notice and the ABA Recommendation proposed separate entity treatment of each Series, neither required segregation of the traditional equity ownership rights, (*e.g.*, earnings and liquidation rights, in one Series from another). Without such segregation, if a Series is treated as a corporation for federal income tax purposes, it may be difficult to determine who is the owner of the equity interest, *i.e.*, stock, of each Series and whether such interest is common or preferred stock.[5] The following discussion summarizes the government guidance for protected cells in the insurance context and the ABA Recommendation, and comments on the Notice and ABA Recommendation in light of traditional notions of equity ownership for federal corporate income tax purposes.

REV. RUL. 2008-8

In Rev. Rul. 2008-8, the IRS described two arrangements, one between a protected cell and its participant ("Participant") ("cell-participant arrangement"), and another between a cell and multiple subsidiaries of its Participant ("cell brother-sister arrangement"). It analogized those arrangements to an arrangement between parent-subsidiary corporations and brother-sister corporations, respectively, in determining whether such arrangements constituted insurance for federal income tax purposes. The analysis is based on the IRS's position that "risk shifting" and "risk distribution" are both necessary elements to establish "insurance" for federal income tax purposes.[6] The IRS's established position is that risk shifting and risk distribution are not adequate in a parent-subsidiary arrangement if no unrelated risks are insured.[7] However, in brother-sister arrangements, the IRS has taken the position that the arrangement may qualify as "insurance," even if there are no unrelated risks, if the requisite risk shifting and risk distribution are present.[8]

Consistent with its established positions in connection with insurance arrangements between corporations, the IRS concluded that the cell-participant arrangement is not an insurance contract, but that the cell brother-sister arrangement is an insurance contract and the subsidiaries, which are brother-sister to the cell providing the insurance, may deduct amounts paid pursuant to the arrangement as "insurance premiums" under section 162. Although, the IRS did not explicitly conclude that the cells were separate entities for federal income tax purposes, the analysis used in Rev. Rul. 2008-8 presumes the cells are separate entities.

In the structure considered by the IRS in the Ruling, the protected cell company was a legal entity under the laws of the applicable jurisdiction, the common stock of which was owned by a sponsor. Multiple cells were within the protected cell company, none of which were treated as a legal entity distinct from the protected cell company under the laws of the applicable jurisdiction. At the same time, the income, expense, assets, liabilities and capital of each cell were accounted for separately from the protected cell company and the other cells, and the assets of each cell were statutorily protected from the creditors of any other cell and from the creditors of the protected cell company.

Each cell was identified with a specific Participant that funded their cell with capital contributions, and in turn, received nonvoting preferred stock of that cell. Participants also contributed "premiums" to their cell with respect to contracts issued by the cell, and the cell was required to pay out claims with respect to such contracts. The cell was entitled to make distributions with respect to the class of stock that corresponds to that cell, regardless of whether distributions were made with respect to any other class of stock. Significantly, in the event a Participant ceased its participation in the protected cell company, the Participant was entitled to a return of the assets

of the cell in which it participated, subject to any outstanding obligations of that cell. In its analysis, the IRS stated that all the income, expense, assets, liabilities and capital of the cell were separately accounted for and, upon liquidation, became the property of the Participant, who was the sole shareholder with respect to the cell. However, the Ruling cautioned that the terms "common stock" and "preferred stock" as used in the protected cell company and cell instruments do not necessarily reflect the federal income tax status of those instruments.

NOTICE 2008-19

In Notice 2008-19, issued in connection with the issuance of the Ruling, the Treasury and the IRS proposed a rule under which a cell of a protected cell company would be treated as an insurance company separate from any other entity if:

1. The assets and liabilities of the cell are segregated from the assets and liabilities of any other cell and from the assets and liabilities of the protected cell company such that no creditor of any other cell or of the protected cell company may look to the assets of the cell for the satisfaction of any liabilities, including insurance claims (except to the extent that any other cell or the protected cell company has a direct creditor claim against such cell); and

2. Based on all the facts and circumstances, the arrangements and other activities of the cell, if conducted by a corporation, would result in its being classified as an insurance company within the meaning of sections 816(a) or 831(c).

However, there was no explicit requirement that limited the equity ownership rights in each protected cell to the earnings or liquidation value of that protected cell.

ABA RECOMMENDATION

In Notice 2008-19, the Treasury and the IRS also requested comments on the proposed guidance, including comments relating to what guidance, if any, would be appropriate concerning similar segregated arrangements that do not involve insurance. In response to that request, the ABA Tax Section recommended that guidance should be issued confirming that each Series of an LLC (or the LLC itself) is a separate "business entity" for purposes of Treas. Reg. § 301.7701-2(a), assuming that certain minimum requirements are met. Under the ABA Recommendation, in order to be treated as a separate business entity, the Series must (i) be formed under a statute having characteristics such as those contained in the Delaware Limited Liability Company Act, Del. Code Ann. tit. 6, section 18-215 (2007) ("Delaware Series LLC Provision"), and (ii) satisfy applicable record keeping and notice requirements so that the liabilities of a particular Series may only be enforceable against that Series' assets.

The Delaware Series LLC Provision provides that an LLC agreement may establish one or more designated Series of members, managers, limited liability company interests or assets. Generally, under the Delaware Series LLC Provision:

1. A Series may have separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations.

2. A Series may have a separate business purpose or investment objective.

3. Provided that certain notice and recordkeeping requirements are satisfied, 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 such Series only, and not against the assets of the LLC generally or any other Series thereof, and, none of those with respect to the LLC generally or any other Series thereof shall be enforceable against the assets of such Series.

4. Each Series shall have the power and capacity to, in its own name, contract, hold title to assets, grant liens and security interests, and sue and be sued.

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Because the Delaware Series LLC Provision provides that each Series may have separate rights, powers or duties with respect to specified property, obligations or profits and losses associated with specified property or obligations, there appears to be no explicit requirement in Delaware law that would limit the equity ownership rights in each Series to the earnings or liquidation value of that Series.

If the Treasury and the IRS accept the ABA Recommendation, and each Series is treated as an "eligible entity" under the check-the-box regime (Treas. Reg. § 301.7701-1 through Treas. Reg. § 301.7701-3), a Series could elect to be an association taxable as a corporation.

COMMENTS

If, as proposed in Notice 2008-19 and the ABA Recommendation, a protected cell is treated as a separate entity and corporate tax treatment is contemplated, taxpayers should consider segregating the traditional equity ownership rights, *e.g.*, earnings and liquidation rights, in one Series from another. Therefore, if the applicable LLC statute does not necessarily provide for this result, taxpayers should consider such a provision in the Series LLC agreement when tax treatment of a Series as a corporation for federal income tax purposes is contemplated.

In general, an equity interest in an organization treated as a corporation for federal income tax purposes implicates three basic rights: (1) the right to vote and thereby to exercise control; (2) the right to participate in current earnings and accumulated surplus; and (3) the right to share in net assets on liquidation.[9] Based on this general principle, the IRS has taken the position that certain Series stock may be neither common stock nor preferred stock, but some type of "special stock." In Rev. Rul. 54-65, 1954-1 C.B. 101, the IRS held that where each Series of a registered investment company was wholly dependent for its earnings and liquidating value upon entirely different underlying assets from any other Series, an exchange of one Series for another did not qualify as an exchange of common shares for common shares or preferred shares for preferred shares under the predecessor to section 1036, as set forth in the Internal Revenue Code of 1939.

Accordingly, without a requirement that limits the corporate equity ownership rights in each Series to the earnings and liquidation value of that Series, identification of the stockholders could become difficult to discern because individuals having an equity interest in one Series may also have varying degrees of equity interests in another Series, creating cross-ownership patterns among the Series. Moreover, the classification of the equity interest as common stock or preferred stock would be in question.

The IRS appears to have recognized these potential issues in Rev. Rul. 2008-8 and a private letter ruling.[10] In Rev. Rul. 2008-8, the IRS's conclusions were dependent upon the ownership analogies between the cell arrangements and the parent-subsidiary and brother-sister subsidiaries arrangements. Not surprisingly, in its analysis, the IRS relied on the fact that all the income, expense, assets, liabilities and capital of each of the cells was separately accounted for and, upon liquidation, become the property of the Participant, who was the sole shareholder with respect to each cell. At the same time, in connection with the preferred stock owned by the Participant, the ruling cautioned that terms "common stock" and "preferred stock" as used in the protected cell company and cell instruments do not necessarily reflect the federal income tax status of those instruments.

In PLR 200803004, the IRS ruled generally that each Series of an LLC, which was an open-end management investment company formed by an insurance company to hold assets in connection with variable insurance products, should be classified as a separate business entity for federal tax purposes. The ruling included several classification rulings which were dependent upon the numbers of shareholders of each Series for federal income tax purposes. For example, in connection with one of the Series, the IRS ruled that the Series would be classified as an entity disregarded as an entity separate from its owner unless it makes an election to be treated otherwise. Under the entity classification regulations, such a ruling is dependent upon the existence of a single shareholder, hence, identification of the owners of the equity interests. The IRS did not rule on this issue, however. The private ruling was

predicated upon the representations that (i) the shareholders of a Series may share in the income only of that Series; (ii) the ownership interest of the shareholders of a Series will be limited to the assets of that Series upon redemption, liquidation or termination of such Series; and (iii) each of the insurance companies that purchased shares of a Series will be treated as the owner of those shares for federal income tax purposes.

It will be interesting to see whether the Treasury and the IRS will continue to rely on representations, or will provide Series LLC guidance that requires segregation of the traditional equity ownership rights, *e.g.*, earnings and liquidation rights, in one Series from another, in both the insurance and non-insurance context. Regardless, however, it would be prudent for Series LLC arrangements in the insurance context to consider segregation of the earnings and liquidation rights of each Series, if the relevant statute does not otherwise so provide, when tax treatment of a Series as a corporation for federal income tax purposes is contemplated.

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END NOTES

1. 2008-5 I.R.B. 366.
2. 2008-5 I.R.B. 340.
3. For other discussions relating to Notice 2008-19 and Rev. Rul. 2008-8, *see* "Protected Cells As Insurance Companies," Mark H. Kovey, *TAXING TIMES*, May 2008, and "Tax Factors Influence the Viability of NAIC Securitization Initiatives," Emanuel Burnstein, *TAXING TIMES*, September 2008.
4. *See* Letter from American Bar Association, Tax Section (January 5, 2009), regarding *Notice 2008-19 and Segregated Arrangements That Do Not Involve Insurance*, 2009 TNT 2-56.
5. This suggestion is equally applicable to a Series LLC treated as an entity separate from each of its Series.
6. Rev. Rul. 2008-8; Rev. Rul. 2002-90, 2002-2 C.B. 985. The term "insurance" is not defined in the Internal Revenue Code. In *Helvering v. LeGierse*, 312 U.S. 531, 539 (1941), the Supreme Court addressed the issue of the scope of insurance for tax purposes, noting that "[h]istorically and commonly insurance involves risk-shifting and risk distributing."
7. Rev. Rul. 2008-8, *supra*, Note 2.
8. *Id.*
9. *Paulsen v. Commissioner*, 469 U.S. 131, 138 (1985); *Himmel v. Commissioner*, 338 F.2d 815, 817 (2nd Cir. 1964).
10. PLR 200803004 (Oct. 15, 2007).

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