# B. LIMITED LIABILITY COMPANIES AS EXEMPT ORGANIZATIONS - UPDATE

**by**
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## 1. Introduction

This article updates last year's article at 2000 CPE 111, which discussed the state laws governing limited liability companies ("LLCs"), federal tax treatment generally, and issues regarding their use as exempt organizations (focusing on IRC 501(c)(3)). The Service has developed an approach for dealing with such LLCs. This article discusses recent developments in the area and issues still pending with respect to LLCs, again with the focus on IRC 501(c)(3).

## 2. Disregarded Entities

### A. Ann. 99-102

The question was posed in last year's article whether an LLC can be exempt as a disregarded part of an exempt organization that is the sole owner of the LLC. The Service has determined that it can.

Ann. 99-102, 1999-43 I.R.B. 545, establishes that an LLC wholly owned by a single exempt organization (exempt under IRC 501(a)) may be disregarded as an entity separate from its owner. Under Reg. 301.7701-3(b)(1), an eligible entity (which includes most LLCs) with a single owner is disregarded unless it elects otherwise. There are two ways for the eligible entity to elect separate entity treatment: by filing for separate entity treatment on Form 8832 (Reg. 301.7701-3(c)(1)(i)), or by claiming exemption as an entity separate from its owner, as by filing a separate Form 1023 or Form 990 (Reg. 301.7701-3(c)(1)(v)(A)). In the latter case, the eligible entity is treated as having made the election for the period it claims exemption or is determined to be exempt.

Ann. 99-102 requires the exempt owner of a disregarded LLC to treat the operations and finances of the LLC as its own for tax and information reporting purposes. In addition, the new Form 990 (Part IX) solicits information relating specifically to disregarded entities.

B. IRC 508

The notice requirements under IRC 508 apply to a disregarded entity in the same manner as to a subordinate organization in a group exemption. See Situation 3 of Rev. Rul. 90-100, 1990-2 C.B. 156.

C. Organizational Test

The question was posed in last year's article whether a disregarded entity's articles of organization must satisfy the 501(c)(3) organizational test. The Service currently does not require that the articles independently satisfy the test: because the entity is treated as an activity of the owner, it is the owner's articles that matter. However, nothing in the disregarded entity's articles should prohibit the entity from operating exclusively for exempt purposes. For instance, a provision allowing a disregarded LLC to operate "for all purposes for which LLCs may be operated" would be permissible. A provision that "the remaining assets upon dissolution are to be distributed to the members of the LLC" would be permissible, because the sole member is qualified under IRC 501(c)(3). Where the disregarded LLC's articles do not satisfy the 501(c)(3) organizational test, the examining agent or determination specialist should closely scrutinize the past and planned activities of the LLC to ensure that the entire entity (including the disregarded entity) complies with the 501(c)(3) operational test.

D. Charitable Deduction

Ann. 99-102 clearly allows the disregarded entity to be treated as part of its exempt owner for purposes of subchapter F (IRC 501 et seq.), Chapter 42, and information and UBIT reporting purposes. However, the Service is considering whether the same treatment applies for purposes of IRC 170. If not, then a contribution to a disregarded entity would not be deductible as a charitable contribution unless the disregarded entity either qualified in its own right under IRC 170(c), or it qualified as an agent of the exempt owner under the facts and circumstances. Guidance on this issue will be forthcoming in the near future.

E. Employment Taxes

Another guidance project of the Service involves employment taxes. In Notice 99-6, 1999-3 I.R.B. 12, the Service solicited public comment regarding issues related to employment tax reporting and payment by disregarded entities. Currently, disregarded entities are still allowed to choose between regarded or disregarded status for employment tax purposes.

F. Disregarded as Entity but Not as Activity

Where an applicant for recognition of exemption indicates that it is or intends to be the sole owner of a disregarded LLC, the governing documents and information regarding the LLC's activities and finances should be obtained and reviewed. The LLC may be disregarded as a separate entity, but should not be disregarded as an activity. Special care should be taken to insure that disregarded LLCs are not used as a device to thwart the various rules governing exempt organizations. A disregarded LLC's operations may give rise to exemption problems, UBIT problems, or excise tax problems for the sole exempt owner.

3. Regarded Entities (Associations)

A. Partnership vs. Association Status

One confusing concept is determining when an LLC (or other eligible entity) is treated as a partnership. The longstanding Service position is that a partnership cannot qualify under IRC 501(c)(3). However, an eligible entity (which may include an LLC or a partnership) that claims exemption as a separate entity is treated as an association, rather than as a partnership or disregarded entity, during the period in which it claims exemption or is determined to be exempt (Reg. 301.7701-3(c)(1)(v)(A)).

B. 501(c)(3) Exemption for LLCs--12 Conditions

Last year's article posed the question whether an LLC can qualify for exemption under IRC 501(c)(3) (other than as a disregarded entity with a sole exempt organization owner). The Service has determined that it can, under certain conditions.

The Service will recognize the 501(c)(3) exemption of an LLC that otherwise qualifies for exemption if it satisfies each of the 12 conditions below. The conditions are designed to ensure that the organization is organized and will be operated exclusively for exempt purposes and to preclude inurement of net earnings to private shareholders or individuals.

1. The organizational documents must include a specific statement limiting the LLC’s activities to one or more exempt purposes.

This requirement may be satisfied by standard purposes and activities clauses that satisfy the 501(c)(3) organizational test, such as "The organization is organized exclusively for exempt purposes under section 501(c)(3) of the Internal Revenue Code," and "The organization may not carry on activities not permitted to be carried on by an

organization described in section 501(c)(3)." Taxpayers may not rely upon the cy pres doctrine to meet this requirement for LLCs.

2. The organizational language must specify that the LLC is operated exclusively to further the charitable purposes of its members.

3. The organizational language must require that the LLC's members be section 501(c)(3) organizations or governmental units or wholly owned instrumentalities of a state or political subdivision thereof ("governmental units or instrumentalities").

4. The organizational language must prohibit any direct or indirect transfer of any membership interest in the LLC to a transferee other than a section 501(c)(3) organization or governmental unit or instrumentality.

Because state laws generally provide LLC members with ownership rights in the assets of the LLC, the Service is concerned that allowing non-exempt members would result in potential inurement problems. Thus, the LLC cannot have private shareholders or individuals as members, and its organizing documents must state a purpose to further the members' charitable purposes. It should be noted, however, that the presence of solely charitable members does not ensure that the organization will be operated exclusively for charitable purposes. See, e.g., Rev. Rul. 72-369, 1972-2 C.B. 245 (organization formed to provide managerial and consulting services at cost to unrelated 501(c)(3) organizations not exempt under IRC 501(c)(3)); compare Rev. Rul. 71-529, 1971-2 C.B. 234 (organization controlled by a group of unrelated 501(c)(3) organizations and providing investment management services for a charge substantially below cost solely to that group qualifies under IRC 501(c)(3)).

5. The organizational language must state that the LLC, interests in the LLC (other than a membership interest), or its assets may only be availed of or transferred to (whether directly or indirectly) any nonmember other than a section 501(c)(3) organization or governmental unit or instrumentality in exchange for fair market value.

This provision helps ensure that the LLC and its assets are devoted exclusively to charitable purposes and that any dealings with private interests are at arm's length. Grants for exempt purposes to individuals or noncharitable organizations (as described in Rev. Rul. 68-489, 1968-2 C.B. 210) would also be permitted.

6. The organizational language must guarantee that upon dissolution of the LLC, the assets devoted to the LLC's charitable purposes will continue to be devoted to charitable purposes.

This requirement may be satisfied by a standard dissolution clause that satisfies the 501(c)(3) organizational test, such as "Upon dissolution, all assets remaining after the payment of liabilities shall be distributed exclusively to exempt organizations or for exempt purposes under section 501(c)(3) of the Internal Revenue Code." Taxpayers may not rely upon the cy pres doctrine to meet this requirement for LLCs.

7. The organizational language must require that any amendments to the LLC's articles of organization and operating agreement be consistent with section 501(c)(3).

8. The organizational language must prohibit the LLC from merging with, or converting into, a for-profit entity.

The idea here is that the LLC, like any other charitable organization, should intend to operate as a charity for its entire life and not flip between exempt and nonexempt status.

9. The organizational language must require that the LLC not distribute any assets to members who cease to be organizations described in section 501(c)(3) or governmental units or instrumentalities.

Such distribution would be inurement, unless the distribution is to a member other than in its capacity as a member, as where the member is the creditor on a loan to the LLC.

10. The organizational language must contain an acceptable contingency plan in the event one or more members ceases at any time to be an organization described in section 501(c)(3) or a governmental unit or instrumentality.

Forfeiture of the nonexempt member's interest is acceptable. A forced sale of the nonexempt organization's interest to another section 501(c)(3) organization or governmental unit or instrumentality would also be acceptable. The plan cannot involve a distribution of the LLC's assets to the nonexempt member, and should ensure that the nonexempt member's rights in the LLC are fully terminated within a reasonable time, e.g., 90 days from the date that a member's exemption is revoked.

11. The organizational language must state that the LLC's exempt members will expeditiously and vigorously enforce all of their rights in the LLC and will pursue all legal and equitable remedies to protect their interests in the LLC.

12. The LLC must represent that all its organizing document provisions are consistent with state LLC laws, and are enforceable at law and in equity.

Some states (California, Indiana, Iowa, Maryland, Minnesota, New York, North Dakota, Rhode Island, Texas, Utah, and Virginia) and the District of Columbia appear to require that an LLC be formed for a business purpose. In such states, it is questionable whether an LLC may be formed as a 501(c)(3) charitable organization. For the time being, however, absent state case law to the contrary, the Service is willing to recognize exemption based on the LLC's representation that its charitable status is permitted under state law, and that the provisions set forth above are enforceable.

C. Organizing Documents

The question arises as to which organizing document must meet the conditions set forth above. Unfortunately, state laws lack uniformity in determining whether the articles of organization (referred to in some states as the certificate of organization or certificate of formation--to confuse matters more, some states use the latter terms to refer to a document issued by the state when the state approves the articles of organization upon submission) or the operating agreement (referred to in some states as the regulations) controls in the event of a conflict. In some states, the articles of organization are the controlling document. In other states, it appears that the articles of organization control as to third parties, and the operating agreement controls as to members. For administrative convenience, the Service will require that both the articles of organization and the operating agreement separately comply with the 11 conditions above (the 12th condition is met in a separate written statement from the organization).

Most states expressly allow provisions to be included in the articles of organization that are not inconsistent with law, at least if the provisions are permitted to be included in the operating agreement. A few states (Arkansas, Colorado, Idaho, Oklahoma, and Wisconsin) appear to prohibit the inclusion of any information in the articles of organization other than certain specified items (e.g., name, address, whether the organization is managed by the members)--in these states, the 11 provisions set forth above may be included in the operating agreement only, so long as there are no conflicting provisions in the articles of organization.

D. National Office Involvement

Cincinnati and Area Offices may recognize the 501(c)(3) exemption of LLCs that meet the 12 conditions set forth above and otherwise qualify for exemption. Where the LLC is unwilling or claims it is unable to comply with all conditions, or where it is questionable whether the organization's governing documents, as amended, comply with all conditions (e.g., where terms are ambiguous or appear to conflict with one another), the case should be referred to EO Technical.

E. Other Exempt Organizations

An LLC that meets each of the 12 conditions above would also qualify for 501(c)(4) status if it otherwise met the requirements of that section. A 501(c)(4) case should be coordinated with EO Technical if the 12 conditions are not met.

The Service has yet to establish its position on whether and under what circumstances LLCs may qualify for exemption under other Code sections. Such issues should continue to be coordinated with EO Technical.

4. Summary

The Service now recognizes the exempt status of disregarded entity LLCs owned by a sole exempt owner. It also recognizes the separate 501(c)(3) exemption of LLCs that represent that such status is permitted of LLCs under state law, and whose articles of organization and operating agreement comply with 11 other conditions.