H. LIMITED LIABILITY COMPANIES AS EXEMPT ORGANIZATIONS

by
Richard A. McCray and Ward L. Thomas

1. Introduction

Although similar forms of business organization have existed in Europe and South America since the 19th Century, the limited liability company ("LLC") is a relatively new form in the United States. Beginning with Wyoming in 1977, all fifty states and the District of Columbia now have statutes that legally recognize and govern LLCs. While LLCs may not have been introduced in the United States specifically with nonprofit purposes in mind, the nonprofit community is becoming increasingly interested in the uses of LLCs.

This article discusses the general laws governing LLCs, how LLCs are generally treated for tax purposes, and issues arising where LLCs seek exempt status, with a focus on IRC 501(c)(3). Issues raised by the participation by IRC 501(c)(3) organizations in LLCs that have for-profit members, as in Rev. Rul. 98-15, are beyond the scope of this article.

2. General Laws Governing LLCs

LLCs are a hybrid of partnerships and corporations. The major advantage of LLCs over partnerships under state law is that, like corporations, LLCs limit their owners' liability. Limited partnerships provide limited liability to their limited partners but not their general partners. LLCs also differ from limited partnerships in that, unlike limited partners, LLC members may fully participate in governing and managing the entity. The major advantage over corporations for federal tax purposes, as discussed more fully below, is that LLCs need not be subject to an entity-level tax but may elect pass-through treatment like partnerships. LLCs are also not subject to the restrictions of S corporations in obtaining pass-through treatment.

The laws governing LLCs vary from state to state. Although a Uniform LLC Act was approved by the ABA in 1996, it has yet to be adopted in many states. Despite the differences, the laws generally give LLCs great latitude in conducting their affairs. Many state laws only apply by default, absent a contrary rule in the LLC's articles of organization or operating agreement.

Like corporations, LLCs are created under the laws of a particular state, by filing articles of organization with the appropriate state authority. Usually only a minimal amount of information is required to be in the articles, such as the LLC's name, address, and registered agent.

Many states allow an LLC to be formed for any lawful purpose. Some states expressly require that it be formed for a "business purpose" or to conduct a "business." Several commentators have expressed serious doubts that the LLC model is appropriate for nonprofit charitable enterprises, as they are modeled essentially on a for-profit partnership basis. See, Bishop and Kleinburger, Limited Liability Companies: Tax and Business Law, paragraph 5.03(1) fn. 59 (Warren, Gorham & Lamont 1998); Ribstein and Keatinge, Limited Liability Companies, section 4.10 (West Group 1999). However, the members can usually limit the LLC's powers or restrict how the powers are exercised so long as the limitation or restriction is contained in the articles or operating agreement. Absent such limitation or restriction, the LLC may exercise powers necessary and convenient to carry out its business purposes.

The majority of states allow an LLC to have a single member, though many states require an LLC to have two or more members, like partnerships, but unlike corporations. The members, like general partners, own and govern the LLC, subject to any agreement among themselves. Thus, membership interests (i.e., the member's financial and governance rights in the LLC) need not be equal. Each member of an LLC has the same limited liability afforded to shareholders of a corporation for corporate debts--no personal liability beyond the member's investment in the enterprise. Like a corporation, an LLC may acquire and hold property in its name rather than in the names of the members.

States generally allow an LLC to designate a manager to manage or operate its affairs. A few states require a manager (who need not be a member) or an elected board of governors, although the members still retain some governance rights.

An LLC typically has an operating agreement (some states refer to it as "regulations"), which is roughly equivalent to a corporation's bylaws and shareholder agreement, or a partnership agreement. The operating agreement governs the relationship between the members and the LLC and the relationship among the members. The operating agreement orders the LLC's affairs and the manner in which business will be conducted.

Many states limit the life of LLCs. Like partnerships, default rules typically provide that LLCs face dissolution upon the death or resignation of a member, or the sale of his entire interest, unless most or all of the members consent to the LLC's continued existence (although, with the advent of the "check the box" regulations discussed below, the trend is toward continuity of life). Upon withdrawal, a member may be entitled to its share of the net assets or to a return of its capital contribution. Default rules do not allow for members

to receive distributions before withdrawal. A member may be required to obtain the consent of most or all of the other members to sell its interest, or at least its governance rights. Upon dissolution, most states require that net assets be allocated to members in accordance with their capital accounts, profits interests, or similar criteria, though some states provide that the operating agreement controls distributions on dissolution.

LLCs are referred to in some states as "limited liability corporations." They are sometimes abbreviated as "LC" rather than "LLC." Professional firms sometimes use the abbreviation of "PLLC" or "PLC."

LLCs are distinct from limited liability partnerships ("LLPs", sometimes known as registered limited liability partnerships or "RLLPs"), which are not to be confused with limited partnerships. LLPs are general partnerships that elect special liability treatment for the partners. A partner retains unlimited liability for the torts he or she commits, but not those committed by the other partners. In some states, the contractual liability of the individual partners also is limited to those partners that actually guarantee a partnership contract. LLPs were created largely for the benefit of professional services firms, where the professionals cannot legally limit liability for their own malpractice but do not wish to be liable for the malpractice of their partners. Some states preclude professional firms from operating as LLCs, which gave impetus to the rise of LLPs. Unlike LLCs, LLPs are treated as general partnerships for most state law purposes, except for the special rules pertaining to LLPs. There are also limited liability limited partnerships ("LLLPs"), which similarly limit the liability of the general partners in limited partnerships.

LLPs and LLLPs are a more recent phenomenon than LLCs, beginning with Texas in 1991. Now, nearly all states allow for LLPs, and many states permit LLLPs.

3. Entity Status of LLC for Federal Tax Purposes Generally

The "check the box" regulations at Reg. 301.7701 (T.D. 8697, 1997-1 C.B. 215, 61 F.R. 66584), effective January 1, 1997, allow certain organizations to choose treatment as a partnership, corporation, or disregarded entity for federal tax purposes. Under the old regulations, business entities were never disregarded (except in the case of shams), and the Service determined whether the organization more closely resembled a corporation or partnership based on consideration of certain corporate characteristics. The following is an overview of the new regulations.

The regulations retain the distinction between trusts and other organizations (business entities). Reg. 301.7701-2(a). Certain business entities are deemed to be corporations: entities described as corporations under federal or state law; joint-stock companies; insurance companies; certain banks; government-owned business entities that are not integral parts of the state; organizations treated as corporations under special Code

provisions; and certain business entities formed in certain foreign countries and U.S. possessions. Reg. 301.7701-2(b).

Other unincorporated business entities are "eligible entities." An eligible entity with two or more members may elect treatment either as an association (which is treated as a corporation) or as a partnership. An eligible entity with a single owner may elect to be treated as an association or to be disregarded as an entity separate from its owner. Elections are made by filing Form 8832. Reg. 301.7701-3(a). Default rules apply if an election is not made. In general, by default, a domestic eligible entity with two or more members is a partnership, and a domestic eligible entity with a single owner is disregarded as a separate entity. Reg. 301.7701-3(b)(1). If an eligible entity makes an election, it generally cannot make another election for a 5-year period. Reg. 301.7701-3(c)(1)(iv). Rev. Ruls. 99-5 and 99-6, 1999-6 I.R.B. 8, 6, discuss tax consequences where a single-member LLC disregarded as an entity becomes an entity with more than one member, and where an LLC with more than one member classified as a partnership for tax purposes becomes a single-member entity by one person's purchase of all the ownership interests.

An eligible entity that has been determined to be, or claims to be, exempt from taxation under IRC 501(a) is treated as having elected to be classified as an association. The election is effective the first day exemption is claimed or determined to apply, regardless when the claim or determination is made, and will remain in effect unless an affirmative election is made after the claim for exemption is withdrawn or rejected, or exemption is revoked. Reg. 301.7701-3(c)(1)(v)(A).

Notice 99-6, 1999-3 I.R.B. 12, provides for temporary employment tax procedures and requests comments regarding the employment tax ramifications of disregarded entities. With respect to employees of a disregarded entity, the Service will accept reporting and payment of employment taxes in one of two ways. 1) Calculation, reporting, and payment of all employment tax obligations with respect to employees of a disregarded entity by its owner (as though the employees of the disregarded entity are employed directly by the owner) and under the owner's name and taxpayer identification number or; 2) Separate calculation, reporting, and payment of all employment tax obligations by each state law entity with respect to its employees under its own name and taxpayer identification number. Nevertheless, the single owner retains ultimate employment tax liability.

4. Exempt Organizations Issues

IRC 501(c)(3) refers to "Corporations, and any community chest, fund, or foundation." Historically, the Service interpreted these to include associations, but not partnerships. See, Emerson Institute v. United States, 356 F. 2d 824 (D.C. Cir. 1966), cert. denied, 385 U.S. 822 (1966). However, the new regulations conveniently avoid this problem by treating LLCs as associations.

The Service is considering whether state attorneys general have the power to regulate LLCs claiming 501(c)(3) status as traditional charitable corporations and trusts. If not, there may be no way to enforce the organizational requirements of IRC 501(c)(3). For example, if provisions in the articles or operating agreement that prevent a 501(c)(3) LLC from merging into a for-profit entity, or from distributing its net assets upon dissolution to members who are not 501(c)(3) organizations or governmental units or instrumentalities cannot be enforced, it is doubtful that LLCs are "charitable" in the generally accepted legal sense, as Reg. 1.501(c)(3)-1(d)(2) requires.

In this regard, it may be noted that courts in at least two cases have held corporations organized under for-profit statutes exempt under IRC 501(c)(3). The school in Unity School of Christianity v. Commissioner, 4 B.T.A. 61 (1926), was so organized owing to the legal advice received by the founders that their desire to print literature made for-profit incorporation necessary. However, the founders subsequently placed the stock in two trusts for the sole benefit of the school. More recently, University of Maryland Physicians, P.A. v. Commissioner, T.C.M. 1981-23, involved a professional service corporation established by four clinical departments of a teaching hospital for administrative efficiencies in collecting professional fees. Each shareholder was both a physician on the hospital staff and a faculty member of the affiliated school. The court accepted the professional service corporation status because that was the only kind of corporation permitted to practice medicine in the state, and noted that the articles of incorporation contained provisions limiting the purposes and activities to those permitted under IRC 501(c)(3). It may be questioned whether formation under a non-charitable statute is permissible under less compelling circumstances than those present in the Maryland case. Given the particular facts of the Maryland case, it should not be considered precedent for allowing entities forming under any law other than non profit laws to qualify for exemption under IRC 501(c)(3).

Of course, an LLC could not have any members other than 501(c)(3) organizations or governmental units or wholly-owned government instrumentalities, as distributions would be inurement to private shareholders or individuals. The articles of organization should contain provisions that would preclude this possibility.

An LLC, like any other organization, would have to meet the organizational test to be exempt under IRC 501(c)(3). Thus, its articles of organization must contain the purposes, dissolution, and any other provisions required under Reg. 1.501(c)(3)-1(b). Provisions in the operating agreement would not suffice for this purpose where the articles are the supreme governing document. In some states, however, the operating agreement appears to control, or it is not clear which document has priority--in such states, both the articles and the operating agreement should contain the required provisions. In some states, there may be a question whether such provisions are consistent with the requirements of the State's LLC statute, which may preclude LLCs of that State from qualifying under IRC 501(c)(3).

The Service has also received ruling requests and exemption applications where an exempt organization (or an organization claiming exemption) is the single member of an LLC and claims that the LLC may be ignored as an entity and treated as part of the member for federal tax purposes. This raises the issue whether, under the check-the-box regulations, the election to disregard the single-member entity as separate from its owner under Reg. 301.7701-3(a) conflicts with the deemed election as an association under Reg. 301.7701-3(c)(1)(v)(A), and if so, which election takes priority. In other words, is a claim of exemption as a part of an exempt owner a "claim of exemption" under the regulations.

Whatever the resolution of this issue, it would not appear to affect situations where the Code or regulations already disregard legally separate entities, such as component parts of community trusts under Reg. 1.170A-9(e)(11) and qualified subsidiaries under IRC 501(c)(25)(E).

Even if the Service concludes that an LLC can be a disregarded entity, the organizational test, issues discussed above, would remain. In other words, it may still be necessary for the LLC to satisfy the organizational test as if it were treated as a separate entity, as inurement of the LLC's net earnings would be attributed to the 501(c)(3) owner, jeopardizing exempt status or causing imposition of 4958 sanctions against its managers as well as the LLC's managers, along with any disqualified persons benefiting from the transaction.

There are also unresolved issues regarding the application of the notice requirement under IRC 508(a) in the context of an LLC that is disregarded as a separate entity--specifically, whether an election to disregard the entity "stops the clock" on the 508 notice requirement, and whether the exempt status of the single owner matters.

5. Conclusion

Unfortunately for all concerned, the Service at this time has more questions than answers regarding LLCs as 501(c)(3) organizations. It is currently considering the various issues, which implicate a number of policy considerations. Due to the uncertainty resulting from the new regulations, under Rev. Proc. 99-4 the Service currently will not issue letter rulings involving a disregarded LLC whose sole member is an exempt organization, and all exemption applications in which the applicant is an LLC are forwarded to the National Office for processing.