

Limited Liability Companies as Tax-Exempt Organizations

By: Isaac Lodico

A limited liability company (LLC) is an unincorporated business entity that provides limited liability for its owners, like a corporation, while providing ease of formation and flexibility in its structure and operations. One of the unique characteristics of LLCs is that their founders can determine how they will be taxed by filing a simple 'check the box' form, IRS Form 8832. The default tax classification for LLC's is a partnership, or sole proprietorship for single-member LLCs. An LLC with two or more members is a 'pass-through' entity, and while taxable attributes (income, gain, loss, etc.) are determined at the entity level, all tax attributes flow through to the member. A single member LLC is a 'disregarded' entity, is not taxed at the entity level, and has essentially no tax existence separate from that of their owners. An LLC's founders can file IRS Form 8832 to elect corporate taxation. Corporations are taxed at the entity level and are regarded as separate from their owners for tax purposes.

An LLC is formed by filing with a state official and developing an Operating Agreement. In California the filing is a short form, called the Articles of Organization, available for download on the Secretary of State's web site. The Operating Agreement is the core document that sets out all of the members' agreements about the company, including its operations, governance, distribution of resources and dissolution. An LLC may permit a degree of flexibility in planning an exempt organization that would not be available under state non-profit corporation laws.

An LLC owned by two or more Section 501(c)(3) organizations can be treated as a tax-exempt, disregarded part of its owner(s). The exempt owner of a disregarded LLC treats the operations and finances of the LLC as its own for tax and information reporting purposes. Thus, LLC activities that are unrelated to the owner's exempt purposes may jeopardize the owner's tax-exempt status and/or generate unrelated business taxable income. On the other hand, an LLC that advances the owner's exempt purposes can be useful for limiting its owner's liability on a specific project or engaging in a joint project with another exempt organization.

For some time it was not clear whether an LLC could qualify for Section 501(c)(3) tax-exempt status. The IRS has issued guidance stating that it will recognize an LLC as exempt under Section 501(c)(3) 12 conditions. 2001 EO CPE Text Topic B. These conditions are designed to ensure that the LLC is organized and operated exclusively for exempt purposes, and to preclude inurement of net earnings to private shareholders or individuals. To qualify for exempt status the LLC must elect to be taxed as a corporation, not a partnership. The IRS has long held that a partnership cannot qualify under Section 501(c)(3).

The 12 conditions necessary to qualify an LLC as a separate Section 501(c)(3) tax-exempt entity are:

1. The organizational documents (articles of organization and operating agreement) must include a specific statement limiting the LLC's activities to one or more exempt purposes, such as "The organization is organized exclusively for charitable purposes under Section 501(c)(3) of the Internal Revenue Code, and may not carry on activities not permitted to be carried on by an organization described in Section 501(c)(3)."
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 instrumentalities (hereafter called "permitted members").
4. The organizational language must prohibit any direct or indirect transfer of any membership interest in the LLC to a transferee other than a permitted member.
5. The organizational language must state that the LLC, interests in the LLC, or its assets may only be availed of or transferred to any person, other than a permitted member, in exchange for fair market value. However, grants for exempt purposes to individuals or non-charitable organizations are permitted.
6. The organizational language must guarantee that upon dissolution of the LLC, the assets devoted to its charitable purposes will continue to be devoted to charitable purposes.
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.
9. The organizational language must require that the LLC not distribute any assets to members who cease to be permitted members, unless the distribution is not made due to membership, such as payment on a loan.
10. The organizational language must contain an acceptable contingency plan in the event one or more members ceases at any time to be a permitted member, such as forfeiture of the member's interest, or forced sale to a permitted member within a reasonable time such as 90 days after ceasing to be a permitted member.

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, in a separate written statement, that all its organizing document provisions are consistent with state LLC laws, and are enforceable at law and in equity.

An LLC that carries out activities consistent with Section 501(c)(4) tax-exempt status may qualify as exempt under that Section if it meets the 12 requirements set out above.

In some states the law is unclear on whether an LLC may operate for charitable purposes. In these states, there is some doubt as to whether an LLC would qualify as a § 501(c)(3) charitable organization. However, absent clear authority to the contrary, the IRS will recognize exemption based on the LLC's representation that its charitable status is permitted under state law. In the event that state laws are resolved to the contrary, exempt organizations can expect some difficulty in unwinding the LLC structure, or reorganizing as an exempt corporation.

The California Legislature has added language to the California Corporations Code § 17002(a) that clarifies the position of non-profit LLCs organized in California. The law is explicit that a California LLC may be formed for any legal purpose, whether or not for profit. The California Franchise Tax Board has indicated that it will not recognize single-member LLCs as exempt entities, except for the purpose of holding title to property under Cal. Rev. and Tax. Code §§ 23701h or 23701x. Unpublished FTB Information Sheet. This would indicate that the use of California LLCs for exempt purposes is limited to LLCs with two or more members. However, the instructions for FTB Form 3500 only indicate that the LLC must elect corporate treatment for state and federal tax purposes to qualify.

Limited Liability Companies provide limited liability for all members and a greater degree of flexibility in structuring their operations and control. Corporate codes often constrain organizations from opting out of the default provisions. LLC statutes also provide default provisions, but typically allow organizations to opt out of the default provisions by specifying alternative provisions in their operating agreements. The degree to which an organization can alter the statutory default provisions will vary from state to state, but is generally greater than that for corporate codes.

Limited liability makes tax-exempt LLCs an attractive structure for joint ventures between two or more nonprofits. The flexibility of control has also made LLCs more popular in structuring for-profit joint ventures between nonprofits and for-profit partners, but in such cases, tax-exemption would not be available or appropriate.