

IRS' Lukewarm Endorsement of LLCs as Section 501(c)(3) Organizations

Alert

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In late October 2021, the Internal Revenue Service (IRS) issued Notice 2021-56 setting forth requirements for limited liability companies (LLCs) to receive a determination letter from the IRS for recognition as §501(c)(3) organizations under the Internal Revenue Code (IRC). The notice requests public comments on the standards set forth in the notice, indicating further refinements may be made in the future.

Background

The IRS has recognized LLCs as business entities and the regulations provide for certain wholly owned LLCs to be ignored for tax purposes, except for employment taxes and certain excise taxes. The IRS and the IRC also set forth standards for tax exempt organizations to meet, such as requirements for §501(c)(3) organizations to be organized only for exempt purposes and upon dissolution, to distribute assets to other organizations that are also §501(c)(3)s or to governmental agencies for a public purpose. These requirements predate the existence of LLCs, which first started in Wyoming in 1977, with other states soon enacting their own LLC statutes. Many state laws differ in what they require of LLCs in regards to their purposes or permitted activities and in rights granted to LLC members. State LLC statutes generally are less detailed than state not-for-profit corporation statutes with regard to language required in organizational documents and state filings. Many LLC owners appreciate the ease of formation and operation of LLCs.

Requirements for LLCs to be Tax Exempt Organizations Under Notice 2021-56

While continuing to study the issues and inviting public comments on LLCs being tax exempt organizations, the IRS has decided to issue determination letters to LLCs seeking §501(c)(3) status; provided that an LLC's articles of organization and its operating agreement include the following:

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1. Provisions that each member of an LLC either be: (a) an organization described in IRC §501(c)(3) and exempt from federal income tax under IRC §501(a); or (b) a state, a U.S. possession or any political subdivision of the U.S., a state, the District of Columbia or a U.S. possession or a wholly owned instrumentality of the above (a "governmental entity").
2. Charitable purposes and charitable dissolution provisions that are currently included in the treasury regulations that govern the conduct of an organization described in IRC §501(c)(3).
3. If the LLC is to be treated as a private foundation, provisions that comply with IRC §508(e), stating that the LLC/private foundation will comply with the self-dealing rules, will avoid the excise taxes due upon a failure to distribute its income, will prohibit the retention of excess business holdings, and will prohibit the LLC from making investments that jeopardize its charitable purpose and from making taxable expenditures, all as detailed in IRC §§4941-4945.
4. Should one of the LLCs members cease to meet the first requirement above (i.e., if a member ceases to be an IRC § 501(c)(3) organization or a governmental entity) an acceptable contingency plan that will be acceptable to the IRS.

In those states that restrict the addition of certain language in an LLC's Articles of Organization, the above requirements can be met by inclusion of the provisions required in 1-4 above in the LLC's Operating Agreement only and no inconsistent provisions must be present in the LLCs Articles of Organization or the Operating Agreement.

Significance of Notice 2021-56

This notice illustrates the IRS's willingness to be accommodative to the significant popularity of using an LLC to operate a new business or activity. The requirements noted in 1-4 above are needed to cause newly formed LLCs to fit within the requirements imposed under federal law for IRC §501(c)(3) organizations which contain strict rules to insure that the tax exempt purposes continue for the life of the entity and the assets remain dedicated to the tax exempt purposes after the entity is dissolved. The requirement that the members all be IRC §501(c)(3)s or governmental entities is a stricter requirement than exists for IRC §501(c)(3) organizations formed as not-for-profit corporations or as trusts. However, this requirement avoids the need to monitor the ownership of the LLC that purports to be an IRC §501(c)(3) entity throughout its existence. The requirements in (2) and (3) above are already in place for IRC §501(c)(3) organizations formed as not-for-profit corporations or as trusts.

Expect to see comments proposing alternatives to (1) and (4) above to permit an LLC and its members to be treated in a manner similar to not-for-profit corporations or trusts seeking IRC §501(c)(3) status. In the meantime, consider using a not-for-profit corporation or a trust as the entity for IRC §501(c)(3) status as the required language in such entity's organizational documents will be far reduced, in part because the

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state statutes under which such entities are formed already contain the language that the IRS requires. Using an LLC as an alternative to form an IRC §501(c)(3) organization can be a trap for the unwary, as the required language will necessitate specific drafting. Finally, while LLCs are generally appreciated in the for-profit sector due to the flexibility they provide for governance and economics, those benefits are less relevant for a tax exempt organization.

IRS Seeks Input

The IRS requests comments to the above requirements from those seeking to expand the ability of LLCs to obtain IRC §501(c)(3) status, including safeguards to ensure that such LLCs would meet the applicable federal requirements that the assets of the entity remain dedicated to an exempt purpose and the requirement that the earnings of an exempt organization not inure to the benefit of a private person or entity. Those comments should be submitted by February 6, 2022. This notice does not affect LLCs already recognized by the IRS as §501(c)(3) organizations. Note that the IRS is also requesting comments on whether there should be special requirements or considerations for recognizing LLCs as tax exempt organizations in other categories, not just IRC §501(c)(3)s.

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