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LLCs in the World of Nonprofit and Mission-Minded Organizations

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I. INTRODUCTION

It is no secret that the limited liability company (“LLC”) continues to be an incredibly popular entity choice. Offering the pass-through taxation and ability to participate in management of a partnership and the liability protection of a corporation, the LLC provides significant advantages. However, the opportunities to use the LLC form for nonprofit and mission-minded purposes is rarely considered by practitioners not working in the tax-exempt organization space. This paper will seek to address that gap by providing an overview of the charitable organization, a quick primer on unrelated business taxable income, and a look at various ways the LLC may be used in the nonprofit and mission-minded area including use of a single member LLC for liability protection and ancillary joint venture participation, use of the LLC for social enterprise businesses, and use of the LLC by entrepreneurs engaged in philanthropy such as Mark Zuckerberg and his wife, Dr. Priscilla Chan. This article will not provide an exhaustive treatise on these areas but rather serve as a travelers’ guide into this unique area of the law.¹

II. AN OVERVIEW OF SECTION 501(C)(3)

The nonprofit sector is vast. In 2016 over 1.5 million nonprofit (tax-exempt) organizations were registered with the Internal Revenue Service (“Service”).² Section 501(c)(3) and Section 501(c)(4) organizations comprised approximately seventy-five percent of that number.³ It is estimated that Section 501(c)(3) organizations employ approximately 10% of the workforce in United States, the third largest workforce in the country, behind only retail and manufacturing.⁴ Twenty-five percent of the American adult population volunteers in the third sector providing over \$184 billion in contributed time.⁵

As expected from such a large industry sector, the nonprofit sector includes organizations of many shapes and sizes. The common link among all such organizations being what has been termed the “non-distribution constraint,” that is, nonprofit organizations may not distribute profits to private individuals in the form of dividends or otherwise. This prohibition on distributing profits sets the nonprofit sector apart as unique and applies regardless of the type of nonprofit, basis for exemption, or any other distinction.

A. NONPROFIT, TAX-EXEMPT, OR CHARITABLE

While all organizations exempt from federal income tax come within the “nonprofit tent,” not all nonprofit organizations are eligible for exemption. Rather, eligibility for exemption depends upon the organization meeting specific requirements for exemption. The Internal Revenue Code (the “Code”) contains over twenty-five (25) categories of federal income tax exemption classifications. As addressed above, the overwhelming majority of organizations exempt from federal income tax are exempt as organizations described under Section 501(c)(3) of the Code. However, the organizers and their counsel should consider whether the organization properly qualifies as an organization exempt from federal income tax under Section 501(c)(3)—specifically, as an organization organized and operated exclusively for religious, charitable,

¹ Portions of this article are excerpted from Darren B. Moore, “*Commercial Activities and Subsidiaries – Issues and Choices in Planning*,” 28 Exempts 4, 12 (Jan/Feb 2017); MOORE, DARREN B., GOVERNANCE OF THE SOCIAL ENTERPRISE: STRUCTURAL AND OPERATIONAL CONSIDERATIONS, State Bar of Texas, 14th Annual Governance of Nonprofit Organizations Course, August 2016; SANDERS, MEGAN C., GIFTS FROM COUSIN EDDIE: ACCEPTANCE, OWNERSHIP & MANAGEMENT OF BIZARRE ASSETS, University of Texas School of Law, 32nd Annual Nonprofit Organizations Institute, January 2015; MOORE, DARREN B., A BASIC FRAMEWORK OF THE NONPROFIT SECTOR, University of Texas School of Law 30th Annual Nonprofit Organizations Institute, January 2013).

² See Independent Sector, *Scope of the Nonprofit Sector*, <http://www.independentsector.org/about/the-charitable-sector/> (last visited June 10, 2017).

³ See *id.*

⁴ See *id.*

⁵ See *id.*

scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals as opposed to some other section covering a different type of exemption.⁶ For example, where an organization organized exclusively for the promotion of a particular industry or profession, that organization will qualify under Section 501(c)(6).

B. GENERAL REQUIREMENTS FOR EXEMPT STATUS UNDER SECTION 501(C)(3)

1. *Organizational Test*

To be eligible for recognition of exemption from federal income tax as an organization described in Section 501(c)(3), an organization must have a proper organizational structure (charitable trust, nonprofit corporation, unincorporated association, or limited liability company), and must be organized and operated exclusively for charitable purposes.⁷ Under Section 1.501(c)(3)-1(b)(1)(i) of the Regulations, an organization is organized for exempt purposes if its organizational documents limit its purposes to one or more exempt purposes and do not otherwise empower the organization to engage in a more than insubstantial manner in activities not in furtherance of one or more exempt purposes. To demonstrate compliance with this “organizational” test, an organization must show that its assets are dedicated to an exempt purpose.⁸ Such dedication is accomplished by way of a dissolution provision requiring that upon dissolution, the assets of the organization will be distributed for exempt purposes or to the Federal government, or to a State or local government, for a public purpose.

2. *Operational Test*

As referenced above, to qualify for tax-exemption under Section 501(c)(3), a nonprofit corporation must satisfy an operational test. For purposes of the operational test, an organization must show it is (or shall be) operated exclusively (read: primarily) for exempt purposes.⁹ Said differently, an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such exempt purposes specified in the relevant section of the Code.¹⁰ An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.¹¹ The purpose(s) of the organization must be closely evaluated to determine if they are exempt or if they are nonexempt, and if nonexempt, whether the nonexempt purpose is substantial. A single nonexempt purpose, if substantial, destroys eligibility for exemption.¹² In determining whether an organization is operated to further a substantial nonexempt purpose, the decision-maker looks to the purposes furthered by an organization’s activities rather than the nature of those activities.¹³ As one court noted, “[u]nder the operational test, the purposes towards which an organization’s activities are directed, and not the nature of the activities themselves, is ultimately dispositive of the organization’s right to be classified as a section 501(c)(3) organization exempt from tax under section 501(a)...[I]t is possible for ... an activity to be carried on for more than one purpose ... [T]he critical inquiry is whether ... [an organization’s] primary purpose for engaging in its ... activity is an exempt purpose”¹⁴ That an organization engages in a trade

⁶ See § 501(c)(3).

⁷ See Reg. 1.501(c)(3)-1(a).

⁸ See Reg. 1.501(c)(3)-1(b)(4).

⁹ See Treas. Reg. § 1.501(c)(3)-1(c)(1).

¹⁰ See *id.*

¹¹ See *id.*

¹² See *id.*; *Better Business Bureau*, 326 U.S. 279, 283 (1945).

¹³ *B.S.W. Group, Inc. v. Comm’r*, 70 T.C. 352, 356-357 (1978).

¹⁴ *Id.*

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