



Single Member LLCs

The Flexibility of Limited Liability Companies is One Asset for Nonprofits

by Kathryn M. Vanden Berk

There is virtually no nonprofit enterprise for which an LLC would be inappropriate. They can be used internally to re-organize, promote, and/or isolate specific activities, and they are particularly helpful in reducing the risk of loss where certain activities are inherently prone to liability.

In recent years, the limited liability company (LLC) has emerged as a popular form of business entity. An LLC is a hybrid entity that combines the limited personal liability of a corporation, with the flow-through tax treatment of a partnership (see sidebar).

An LLC is created by filing articles of organization (or a certificate of formation) with the Secretary of State (or your state's business equivalent). Articles of organization identify your founders as "members." A business entity—a nonprofit corporation, for example—can be a member.

Instead of bylaws, LLCs are governed by operating agreements. The operating agreement (like bylaws) controls how the LLC will be managed, how interests may be transferred, what will happen when or if the LLC dissolves, etc. State LLC laws allow for substantial flexibility in the operating agreement, a fact that is often noted as an LLC's most attractive feature. For example, the LLC can be organized like a partnership or it can mimic a corporation, or it can be organized in a way not contemplated by either of these more traditional business structures.

An LLC is eligible under IRS rules to seek

and obtain its own exemption. The new Form 1023 Exemption Application handles LLCs in the same way as corporations. Thus, a new entity may start out as an LLC without any ties to a pre-existing exempt organization, and independently qualify as a tax-exempt LLC.

Use of LLCs in the Exempt Sector

There is virtually no nonprofit enterprise for which an LLC would be inappropriate. They can be used internally to re-organize, promote, and/or isolate specific activities, and they are particularly helpful in reducing the risk of loss where certain activities are inherently prone to liability. They are also useful externally when the exempt organization wishes to enter into joint ventures, whether they are with another exempt organization or a for-profit partner. Yet, despite their potential versatility, it has taken a long time for exempt organizations to see them as an acceptable vehicle for doing business.

LLCs were first used by exempt organizations as a vehicle for joint ventures with for-profit organizations, particularly in the health care field. In 1998, the IRS responded by issuing Revenue Ruling 98-15 as guidance

for such ventures. The ruling describes "good situations" and "bad situations" in somewhat black and white terms, illustrating the point that a joint venture with a for-profit entity must remain under the exempt organization's control in order to remain exempt under the Code.

LLCs are not limited to for-profit/non-profit joint ventures. An LLC's members can all be tax-exempt organizations. For example, two exempt child welfare organizations could joint venture via an LLC to accept a government contract for services. So long as the services are related to each member's

exempt purpose, the LLC's net income would be tax-free to them.

Single-Member LLC (SMLLC)

The IRS ruled in late 1999 that an exempt organization's wholly owned LLC would be disregarded for tax purposes. That means

WHAT IS AN LLC? YOUR QUESTIONS ANSWERED.

Until LLCs came on the scene, the choice of business entity was generally limited to corporations or partnerships.

Corporations. Corporations are formed by filing articles of incorporation and they are governed by bylaws. They provide their directors and officers a shield against the organization's creditors (whether lenders, suppliers, or judgment creditors). In most states, the assets of nonprofit directors and officers cannot be attached unless there is financial malfeasance or intentional wrongdoing involved.

In the for-profit world, a C corporation is subject to tax as if it were a separate person, and its earnings are reduced by taxes it must pay. The corporation can make an election under Subchapter S of the Code to create a "disregarded entity" known as an S corporation. These tax ramifications are not generally an issue for nonprofit corporations. The nonprofit corporation obtains recognition from the Internal Revenue Service in order to be designated a tax-exempt entity, and that entity must be recognized under Section 501(c)(3) of the Code in order to offer tax deductibility to its contributors.

Partnerships. A partnership is an association of two or more individuals or business entities. The owners of a general partnership are personally and fully liable for all business debts. A partnership's taxable income and losses flow directly to the partners and are not subject to tax at the partnership level. A limited partnership retains these tax benefits but it can limit the liability only of its limited partners. The general partner remains open to personal

liability. Partnerships are formed by agreement, and they are legally recognized whether or not the partners sign formal partnership documents. Limited partnerships generally must file notices of limitation in order to ensure protection for their limited partners.

Limited Liability Companies. LLCs offer both limited liability (of the corporation) and the pass-through treatment (of the partnership) discussed above. Under most state statutes, an LLC's members are shielded from the company's debts. The IRS allows an LLC to report as a partnership for tax purposes (although it may elect to be taxed as a corporation).

Tax Exempt LLCs. The IRS has ruled that an LLC formed by a tax exempt organization with only a single member—the exempt organization itself—will automatically be classified as tax exempt. The reason for this is that the single member exempt organization will have total control over the LLC, and it (the member) will be fully accountable to the IRS for any activities carried out by the LLC. Of course, if the LLC is formed for the purpose of carrying on a for-profit activity, the LLC will pay taxes on net profits of that activity just as if the activity remained within the exempt organization.

that its activities are treated as if they occurred within a member division, and the member is accountable to the IRS for all activities that go on within it. Both are considered to be exempt under Section 501(c)(3) of the Internal Revenue Code: (1) the "parent" entity gets its exemption by the IRS determination letter, while (2) the "subsidiary" entity gets its exemption from the fact that it is owned and controlled entirely by the exempt parent-member.

As with all 501(c)(3) entities, an exempt organization's SMLLC is exempt from FUTA. The IRS has ruled that charitable contributions to an exempt organization's single member LLC will be deemed a contribution to the exempt organization itself. Its financial activities and assets are reported by the parent organization on its Form 990 annual informational returns as if the LLC is a department or separate functional activity.

The principle of transparency operates at the state level as well. For example, most states have established that property owned by a single member LLC will have the same property tax exemption as its parent. If you are in such a state, you need not worry that a piece of real property transferred to a wholly owned LLC will risk losing the property tax exemption it held when the property was titled in the name of its exempt parent.

Putting the SMLLC to Work

Creative use of single-member LLCs provides you with a powerful and versatile asset protection and planning tool, a tool that is particularly useful if you own multiple parcels of real property or conduct activities with potential liability concerns. All you need to do is form one or more single-member LLCs as separate legal entities to hold certain properties or engage in certain activities.

For example, let's say you are told that you will be receiving a contribution of real property and you are worried that the property may have undisclosed environmental liabilities or costs. You want to accept the gift if you can, but you don't want it to jeopardize your regular operations if it turns out that there are liabilities attached. You may place the property in a separate, single-member LLC. You will still control the property, but the LLC will shield your other assets from liability.

Similarly, if you decide to accept a government contract to take on an activity that may expose your organization to a higher risk of

liability (for example a contract to take seriously behaviorally disordered children into foster care), it may be advisable to insulate your agency from the more risky operations by placing them in a single member LLC. You will retain control over the operations, but your liability exposure will be limited to the assets of that entity.

What all of this means is that a pre-existing 501(c)(3) organization can become the same as a "parent" organization in a group exemption. You might call it the "poor man's group exemption," since you get the same ultimate result without going through the trouble of getting a separate EIN and applying for exemption as a Group Return.

Caution is Advised

I must alert you to some possible problems. First, if the LLC is going to be engaged solely in exempt activities, be sure that your organizational documents reflect this. That means that the LLC documents should have the same powers and limitations required by the IRS for all 501(c)(3) entities.

Second, if the LLC is engaged in activities that are unrelated to your exempt purposes, you must pay unrelated business income tax (UBIT) just as you would if you carried out such activities in your existing exempt organization.

Third, the limited liability of the member of a single-member LLC is less certain in some jurisdictions than in others. Thus, a wholly-owned corporation might be preferable if you want absolute certainty of limited liability for business debts in all jurisdictions.

Fourth, until SMLLCs have become well accepted as exempt entities, you may find difficulties in getting tax-exempt bond financing. Ironically, in the non-exempt world, lenders might welcome or even require that a property be placed in a SMLLC in order to insulate it from bankruptcy of the parent. But in the tax-exempt arena, bond counsel might be less concerned about this than how the LLC might create ambiguity or unfavorably impact your exempt status.

Finally, assets in wholly-owned LLCs may be vulnerable to attachment in bankruptcy. In other words, while the SMLLC form of entity might protect you from claims that have been made against your wholly owned LLC, it may not protect your LLC from claims made against you.▲

Disclaimer

The above is only a brief summary of a very complex and evolving area of law. Whether an LLC is useful and how it should be organized and operated in any given situation will depend on the specific facts and circumstances of the case. Accordingly, nothing herein is to be interpreted as legal advice, as such advice can only be rendered upon a complete understanding of all relevant facts in any particular situation.

Endnotes

1. See Rev. Rul. 98-15, 1998-1 C.B. 718. A number of cases have illustrated the problem of control. See, for example, Redlands Surgical Services, 113 T.C. 47, 92-93 (1999), aff'd 242 F.3d 904 (9th Cir. 2001) and St. David's Health Care System v. United States, 349 F.3d 232, 236-237 (5th Cir. 2003).
2. To date, it appears that only 501(c)(3) entities have embraced the LLC, but there is no reason other types of exempt organizations can't take advantage of this form.
3. 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.
4. If the SMLLC seeks to have independent exempt status, it will be treated as having elected to be treated as a corporation for federal tax purposes, just as if it had been organized under the not-for-profit corporation statutes of the state in which it was formed. It will be directly accountable to the IRS for its exempt activities.
5. In a private letter ruling, the IRS noted that a charity may set up a single member LLC to receive donated vehicles and the value of cars donated to that charity would be deductible to their owners as if the car was donated directly to the charity. The SMLLC was considered to be a qualified agent of the charity. PLR 200230005
6. For example, Minnesota law establishes that for property tax exemption purposes, property owned and operated by a single-member limited liability company shall be treated as if owned by that member. New York City's Office of Legal Affairs came to the same conclusion.
7. I suggest that you check this out in your state before you organize a property-holding SMLLC; it would be foolish to lose a property tax exemption if that is a possible result!
8. In a 2003 case, *In re: Ashley Albright*, the U.S. Bankruptcy Court in Colorado allowed an SMLLC owner's creditors to take over control of the SMLLC and its assets.



Kathryn Vanden Berk practiced law for nine years before serving as the president of two residential treatment centers for children. Now practicing in Chicago, she focuses on nonprofit start-ups, corporate and tax law, and employment issues. She serves as adjunct faculty at several Chicago universities, and is a member of the Advisory Board of the Axelson Center for Nonprofit Management at North Park University. She authored a handbook on starting nonprofits that is available from the Nonprofit Financial Center, Chicago, and a chapter in the Illinois attorney's handbook Not-for-Profit Corporations, 2004 Ed., published by the Illinois Institute of Continuing Legal Education. In 2004 she authored "Retooling Employment Standards for the Future," a publication of the First Nonprofit Educational Foundation, Chicago. She can be reached at 312-442-9076 or at info@beavandenberk.com.