NEW YORK STATE BAR ASSOCIATION
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Report No. 1459
March 8, 2022

The Honorable Lily Batchelder
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Thomas C. West, Jr.
Deputy Assistant Secretary
Department of the Treasury
1500 Pennsylvania Avenue
NW Washington, DC 20220

Mr. Krishna Vallabhaneni
Tax Legislative Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Report No. 1459 – Report on Notice 2021-56

Dear Mme. Batchelder and Messrs. West and Vallabhaneni:

I am pleased to submit Report No. 1459 of the Tax Section of the New York State Bar Association discussing Notice 2021-56.

We appreciate your consideration of our Report. If you have any questions, please feel free to contact us and we would be happy to assist in any way we can.

Respectfully Submitted,

Robert Cassanos
Chair

Enclosure

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Report No. 1459

New York State Bar Association Tax Section

Report on Notice 2021-56

March 8, 2022

I. Introduction

This report* (the "***Report***") provides comments on Notice 2021-56 (the "***Notice***"), issued by the Internal Revenue Service (the "***IRS***") on October 21, 2021, which sets forth the standards a limited liability company (an "***LLC***") must satisfy to obtain a determination letter recognizing the entity as tax-exempt under sections 501(a) and 501(c)(3) of the Internal Revenue Code (the "***Code***").[1] The Notice also raises specific questions on which the IRS and the Department of the Treasury (the "***Treasury***") request public comments to determine whether further guidance is needed. In general, the questions identified in the Notice deal with the applicability of state law issues to the determination of an LLC's tax-exempt status, as well as whether the use of an LLC instead of a corporation as a tax-exempt entity is a likely or desirable tax planning tool. We address these questions in Part V of this Report, in which we provide comments to the IRS and Treasury on the proposed standards.

The Report is organized as follows. Part II summarizes our conclusions and recommendations to the IRS and Treasury on the Notice's proposed standards. Next, Part III summarizes the Notice. Then, to provide context for our comments and recommendations, Part IV briefly outlines the requirements of section 501(c)(3) for an entity to obtain federal tax exemption. Finally, Part V contains a detailed discussion of our responses to the IRS' and Treasury's questions and our recommendations thereto.

II. Summary of Conclusions

We encourage Treasury and the IRS to continue their efforts to address issues arising from the use of LLCs for charitable activities. While we understand the cautious approach evidenced in the Notice, we have a number of comments addressing how Treasury and the IRS can permit the use of LLCs in this area without jeopardizing compliance with the requirements for tax exemption under section 501(c)(3). Our principal comments are as follows:

Generally, we believe that Treasury and the IRS should be agnostic on the form of organization used to pursue charitable activities. The applicable rules should continue their historic focus on whether the applicant can meet the requirements for tax exemption under section 501(c)(3). These rules for qualification as tax-exempt should be the same whether the charitable activity is carried out by a corporation, limited liability company, trust or other unincorporated entity. It is the entity's organizational documents and activities, rather than the identity of its members, that should determine eligibility for tax exemption. The Notice's proposed limitation on membership for an LLC seeking tax-exemption is unduly restrictive. Accordingly we recommend that an LLC be permitted to have members that are taxable

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* The principal drafters of this Report are Stuart Rosow and Dahlia B. Doumar. Substantial contributions were received from Robert Cassanos. Helpful comments were received from Stephen B. Land, Kimberly S. Blanchard and Michael L. Schler. Research assistance was received from Rita N. Halabi and Tony R. Meyer, Jr. This report reflects solely the views of the New York State Bar Association Tax Section and not those of the New York State Bar Association's Executive Committee or its House of Delegates.

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

individuals or entities if they hold only a non-economic interest and it otherwise satisfies the substantive requirements of section 501(c)(3) and the regulations thereunder. We do not believe that limiting membership to only section 501(c)(3) organizations, governmental units, and wholly-owned instrumentalities thereof is the most appropriate means of ensuring compliance with section 501(c)(3).

Similar to the provisions in the Notice, we recommend that Treasury and the IRS provide a list of organizational and operational safeguards that must be satisfied in order to qualify as a tax-exempt entity. We believe the rules should permit these requirements to be satisfied either in the organizational documents, which include the articles of organization and the operating agreement, or by reliance under applicable provisions of state law.

We also recommend that provisions required under section 508(e) in the case of organizations that would be considered private foundations should be required of tax-exempt LLCs in their organizational documents.

Regarding the form of organizational documents, we believe that an LLC seeking to qualify for tax-exemption under section 501(c)(3) should be able to satisfy the Notice's organizational requirements through its governing documents, which include both its articles of organization and its operating agreement. We support the Notice's requirement that LLCs add to their governing documents language that demonstrates an exclusively tax-exempt purpose. However, we do not believe that the provisions in satisfaction of section 501(c)(3) need to be in both the articles of organization and operating agreement, so long as the provisions are enforceable under state law.

Finally, regarding the enforceability of such provisions relevant to tax-exemption, we recommend Treasury and the IRS consider adding a requirement that the organization include documentation as to enforceability. Such documentation may consist of relevant legal authority addressing enforceability of the particular provision, including, if deemed necessary, advisory opinions of the particular state attorney general or a legal opinion procured by the organization seeking tax exemption.

III. Summary of Notice 2021-56

The Notice generally requires an LLC seeking to qualify as tax-exempt under sections 501(a) and 501(c)(3) to include provisions in both its articles of organization[2] and operating agreement that demonstrate that the entity is organized and operated for exclusively exempt purposes, and that its assets are dedicated to such purposes and do not inure to private interests. In this regard, the Notice sets forth proposed standards for an LLC that submits a Form 1023 ("Application for Recognition of Exemption under section 501(c)(3) of the Internal Revenue Code") after October 21, 2021 to obtain a favorable determination from the IRS that recognizes its tax-exempt status.

[2] Articles of organization are also referred to as certificates of organization or certificates of formation, depending on state law. For purposes of this analysis, we use the term "articles of organization" throughout.

A. Provisions required in LLC articles of organization and operating agreement

First, an LLC's articles of organization and operating agreement must contain provisions requiring that each of its members is either (i) an organization described in section 501(c)(3) and exempt from taxation under section 501(a) or (ii) a governmental unit described in section 170(c)(1) (or a wholly-owned instrumentality of such a governmental unit). Second, an LLC's articles of organization and operating agreement must demonstrate that the entity is organized and operated for express charitable purposes, and accordingly, these documents must contain a charitable dissolution provision in compliance with Treas. Reg. Sec. 1.501(c)(3)-1(b)(1) and (4). Third, if an LLC is a private foundation, the Notice requires that the LLC's articles of organization and operating agreement contain express Chapter 42 compliance provisions, as described in section 508(e)(1). Finally, an LLC's articles of organization and operating agreement must set forth an acceptable contingency plan in the event that a member ceases to be a section 501(c)(3) organization or section 170(c) governmental unit (or wholly-owned instrumentality thereof).[3]

Importantly, the Notice provides that if an LLC is formed in a state that prohibits adding provisions to the articles of organization besides those mandated by that state's LLC statute, the condition that both documents contain the foregoing provisions are deemed to be satisfied so long as the operating agreement contains those provisions, and the provisions in the articles of organization and operating agreement are not inconsistent with the charitable purpose provisions otherwise required by the Notice.

B. Representation on enforceability

Moreover, the Notice also requires an LLC seeking to qualify for tax-exemption to represent that all provisions in its articles of organization and operating agreement are consistent with state LLC law and are legally enforceable thereunder. The Notice does not provide any details as to what is required as to the nature of, or support for, the representation.

C. Request for public comments

In addition, to determine whether further guidance is needed, the Notice requests public comments on specific issues the IRS and Treasury have identified with respect to the Notice's proposed standards. Of particular note, the Notice asks whether an LLC seeking to qualify for tax-exemption should be allowed to have members that are not themselves section 501(c)(3) organizations, governmental units, or wholly-owned instrumentalities of such governmental units. In such a situation, the Notice requests identification of safeguards that should be required in order to ensure that the statutory and regulatory standards for tax exemption are satisfied, including the requirement that the assets remain dedicated to exempt purposes and do not inure to private interests.

The Notice inquires about the desirability of forming a charitable LLC, as opposed to a charitable corporation or trust. Specifically, the Notice requests comments on the advantages and disadvantages of using an LLC as compared to charitable trust or not-for-profit corporation as the form of organization for a charitable entity. The Notice requests

[3] As an example of an acceptable contingency plan, the Notice proposes suspension of membership rights until such member regains its qualifying status.

comments on whether state laws regulating charitable assets apply to charitable LLCs to the same degree as charitable corporations or trusts.

Moreover, many of the questions presented by the IRS and Treasury relate to potential conflicts between provisions of state LLC statutes and requirements under section 501(c)(3). The Notice asks whether there are provisions in state LLC statutes that may affect the ability of an LLC to qualify as tax-exempt under section 501(c)(3), such as requirements to distribute assets only to LLC members on dissolution.

Finally, the IRS and Treasury also ask whether the charitable purpose and dissolution language need not be required in both the articles of organization and operating agreement. This question is motivated by the concern that some state LLC statutes may limit the provisions that are eligible to be included in an LLC's articles of organization, as well as by a concern that state laws differ in terms of which organizational document is controlling in the case of conflicting provisions. In that case, the question is whether provisions in the operating agreement should be treated as satisfying the organizational requirement, given that operating agreements are not filed with the state and thus not readily available to the IRS.

This Report addresses these questions and provides recommendations to the IRS and Treasury for further guidance.

IV. Requirements of section 501(c)(3)

Pursuant to section 501(c)(3), for an organization to qualify as tax-exempt, it must be organized and operated exclusively for, *inter alia*, charitable purposes.[4] In addition, no part of the organization's net earnings can inure to the benefit of any private shareholder or individual, and no substantial part of the organization's activities can carry on propaganda, influence legislation, or participate in or intervene in political campaigns.[5] The Treasury Regulations promulgated under section 501(c)(3) set forth two tests an organization must satisfy to qualify as tax-exempt under that section: the organizational and operational tests.

A. The organizational test

First, an organization satisfies the organizational test based on the terms of its articles of organization. For this purpose, "articles of organization" includes a trust instrument, corporate charter, articles of association, or any other written instrument by which an organization is created.[6] To meet the organizational test, the articles of organization or other written instrument by which the organization is created must state that the organization is formed for one or more exempt purposes[7] and must not expressly empower the organization

[4] §501(c)(3).

[5] *Id*.

[6] Treas. Reg. § 1.501(c)(3)-1(b)(2).

[7] Treas. Reg. § 1.501(c)(3)-1(b)(1). The Regulation accepts general statements of purpose. For example, it is sufficient that the entity is formed for "charitable purposes". Treas. Reg. § 1.501(c)(3)-1(b)(1)(ii). Similarly, it is also sufficient if the organization is formed for "literary and scientific purposes within the meaning of section 501(c)(3). *Id*.

to engage in activities (other than an insubstantial part of its activities) that do not further an exempt purpose.[8] Moreover, an organization must demonstrate that its assets are dedicated to exempt purposes.[9]

In addition, in order to satisfy the organizational test, the Regulations require that the organizational documents provide that on dissolution, the organization's assets must be distributed for exempt purposes.[10] This requirement may be met if, upon dissolution, the organization's assets would be distributed for one or more exempt purposes or to the Federal or State government for a public purpose.[11] If, under the articles of organization or state law, the organization's assets may be distributed to its members or shareholders on dissolution, the organization will not satisfy the organizational test.[12]

B. The operational test

Second, an organization satisfies the operational test based on its primary activities. To meet the operational test, the organization must demonstrate that it engages primarily in activities that accomplish one or more exempt purposes specified in section 501(c)(3), and it will not be regarded as such if more than an insubstantial part of its activities does not further an exempt purpose.[13] In addition, if an organization's net earnings inure to private benefit, it will not be regarded as operated exclusively for exempt purposes.[14]

C. Classification of LLCs

For purposes of analyzing limited liability companies as tax-exempt entities, Treas. Reg. §301.7701-3(c)(1)(v)(A) provides that an entity that has been determined to be, or claims to be, exempt from taxation under section 501(a) is treated as having made an election to be classified as an association. It is therefore treated as a per se corporation under Treas. Reg.§301.7701-2(b)(2). In this regard, the classification as a corporation negates any pass through notions such as an allocation of income. Instead, the focus is on the actual use of the entity's income and assets and, in particular, whether any private person actually receives a distribution from the organization. As a result of its classification, an LLC that asserts it

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[8] Treas. Reg. § 1.501(c)(3)-1(b)(1). Under the regulation an organization does not satisfy the organizational test if the articles empower it to conduct activities which are not in furtherance of one or more exempt purposes. Treas. Reg. § 1.501(c)(3)-1(b)(1)(iii). Additionally, the organizational test is not satisfied if the purposes are broader than those permitted under section 501(c)(3), even if its activities are actually so restricted. Treas. Reg. § 1.501(c)(3)-1(b)(1)(iv).

[9] Treas. Reg. § 1.501(c)(3)-1(b)(4).

[10] *Id*.

[11] *Id*. The requirement can also be satisfied if the assets will be distributed by a court in a manner that will accomplish the purposes of the exempt organization.

[12] *Id*.

[13] Treas. Reg. § 1.501(c)(3)-1(c)(1).

[14] Treas. Reg. § 1.501(c)(3)-1(c)(2).

qualifies for tax-exemption is effectively no different for federal income tax purposes than an entity organized under a state corporate law that makes the same claim.

V. Comments and Discussion

A. Limitation on membership to 501(c)(3) organizations, governmental units, or wholly-owned instrumentalities of governmental units

Recommendation: We believe that the Notice's proposed limitation on membership for an LLC seeking tax-exemption is unduly restrictive. Accordingly we recommend that an LLC be permitted to have members that are taxable individuals or entities provided the rights associated with that membership do not include any economic rights: i.e., rights or entitlement to the income or assets of the entity whether on dissolution or otherwise. Additionally, the organization would otherwise be required to satisfy the substantive requirements of Section 501(c)(3) and the regulations thereunder. In this vein, we recommend a number of safeguards to ensure that the requirements of Section 501(c)(3) and the regulations are satisfied.

Discussion: The Notice states that the membership requirements it imposes are intended to ensure that an LLC is organized and operated exclusively for exempt purposes, including that its assets are dedicated to an exempt purpose and do not inure to private interests (the organizational and operational tests). We believe that these tests should be applied in a consistent manner across the field of entities that seek tax exemption: corporations, trusts and LLCs, as well as certain unincorporated associations. Treasury and the IRS should be agnostic regarding the form of entity and accordingly need not single out limited liability companies for special limitations in circumstances in which the organizational and operation tests are satisfied. In large measure, a concern about taxable members of an LLC can be addressed by requiring that the organizational documents contain enforceable provisions that prevent a member from having an economic interest in the entity or its assets. As long as any LLC member that is a taxable individual or entity holds a non-economic membership interest, we believe the Treasury and the IRS should adopt rules that focus on whether the LLC meets these organizational and operational tests under Treas. Reg. § 1.501(c)(3)-1(b) and not the tax status of its members. Thus, the focus of the rules should be on the nature of the LLC's activities—whether those activities meet the definition of "exempt" or "charitable"—and whether the organization's income and assets benefit only tax-exempt uses or tax-exempt organizations, including on dissolution. Those requirements go to the organization and operation of the LLC and the use of its income and assets, and not to any specific tax status of its members.

For purposes of the analysis, LLCs can be viewed as falling into the four categories: those LLCs organized under and in conformity with state not-for-profit LLC statutes; those LLCs which have only tax-exempt members; those LLCs which have both taxable and tax-exempt members, where all of the economic benefits of membership always inure to the tax-exempt members and never to the taxable members whose membership interest does not entitle them to an economic interest; and those LLCs who have only taxable members whose membership interest does not entitle them to an economic interest, where the organizational documents contain provisions preventing any inurement to private interests, including upon dissolution. The Notice approves only those organizations in the second group. We believe that Treasury and the IRS generally should be agnostic as to the

form of entity and therefore at a minimum the rules should approve LLCs that are organized under state not-for-profit LLCs laws that prevent members from holding economic interests in the LLC and contain provisions similar to state not-for-profit incorporation statutes intending to comply with the section 501(c)(3) requirements. More generally, we believe that the rules should also approve LLCs in the other two categories if the necessary safeguards are met.

In all circumstances, we believe that the analysis of entitlement to tax exemption should be based on uniform rules for all entities, recognizing that the inquiry may be more difficult for LLCs with both taxable and tax-exempt members or just taxable members. As a general principle, we believe the issues that should be addressed are the rights associated with membership in the LLC, and not the specific tax status of the members themselves. We believe that as long as those rights can be structured so that individual and for-profit members hold no economic rights in connection with their membership interest in the LLC and the LLC otherwise satisfies the section 501(c)(3) organizational and operational requirements, that, as described below, adequate safeguards can be adopted to ensure that no taxable member may impermissibly benefit financially from the organization's net income or assets.

Viewed in this manner, we believe that the Notice's membership restriction is inconsistent with the approach taken with respect to tax-exempt entities organized either under corporate or trust statutes. For example, such statutes may permit a not-for-profit corporation to issue shares, including to individuals.[15] We would assume that there are no per se limitations on the ability of such an entity to obtain tax-exempt status, so long as there are adequate safeguards to ensure that only charitable purposes are served. In other words, we believe that charitable LLCs should be subject to essentially the same membership rules as those for other charitable entities – the section 501(c)(3) requirements should be neutral as to the form of organization of the charitable entity. Given that there are safeguards besides a limitation on membership to ensure that an LLC complies with the requirements of section 501(c)(3), there is no policy reason to make the membership rules for charitable LLCs more restrictive than those for other charitable entities. Therefore, we recommend that the requirement be modified to permit taxable members to be admitted as members in charitable LLCs, provided they are non-economic members and that that the requirements of section 501(c)(3) are satisfied.

Importantly, no particular form of organization is required to obtain tax-exempt status. Indeed, in special circumstances and subject to stringent limitations, entities organized under "for-profit" corporation statutes can obtain tax-exempt status if they meet the requirements of 501(c)(3). For example, similar issues to those discussed in the Notice are presented by the treatment of the ownership rules for charitable corporations involving the corporate practice of medicine.[16] In that case, state law requires that a physician own the

[15] For example, Pennsylvania law provides that a not-for-profit corporation can be organized on either a nonstock or stock share basis. Shareholders in a not-for-profit corporation are entitled to voting rights on the basis of their stock ownership. 15 PA Cons Stat § 5752 (2014). In general, such shareholders are not entitled to any economic rights as shareholders. See 15 PA Cons. Stat. § 5551(a) (2013).

[16] See generally, Chapter F, Corporate Practice Of Medicine, by Charles F. Kaiser III and Marvin Friedlander, in Internal Revenue Service, Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2000, available at http://www.irs.gov/pub/irs-tege/eotopicf00.pdf, setting forth the rules and

professional service corporation that employs physicians to provide medical services. The professional service corporation may be organized under the "for-profit" corporation statute of the relevant jurisdiction. Nevertheless, the IRS has recognized that such organizations may qualify for tax-exempt status under section 501(c)(3), despite the stock ownership by the physician. In these cases, in order to be tax-exempt, the professional service corporation must be controlled by a tax-exempt organization—typically, a tax-exempt hospital. Despite formal ownership of all of its stock by the physician-shareholder, the corporation will be exempt from taxation so long as the corporation meets the section 501(c)(3) organizational and operational tests. To meet the organizational test, the professional service corporation's articles of organization must contain language that demonstrates that the corporation's assets and activities are dedicated to exempt purposes. Next, to meet the operational test, the professional service corporation must demonstrate that it provides services for or carries on a function for the benefit of its tax-exempt parent.[17] To further satisfy the operational test, the physician-shareholder must be subject to stringent restrictions on his or her activities, such that the corporation's tax-exempt parent exercises effective control in all respects. This can be achieved through a variety of mechanisms: shareholder control agreements, employment agreements, management services agreements, or a combination of these agreements. In addition, the IRS requires the professional service corporation to represent that it will exercise all of its rights in law and equity as an attorney general would to prevent diversion of the corporation's charitable assets. Effectively, the IRS analyzes the "for-profit" professional corporation based upon the substance of its organization and operation and, in appropriate circumstances concludes that it may qualify for tax exemption.[18]

This approach of looking at the substance of the arrangement rather than its legal form or the identify of its members is also consistent with the treatment under existing law of non-exempt multi-member LLCs in other situations involving tax-exempt members, where the nature of an organization's activities and relevant safeguards control over the form of organization. The approach that has been adopted in the analysis of a pass-through, multiple-member LLC, which has both tax-exempt and taxable entities as members is in essence a look through approach. Despite having taxable members with an economic interest who have invested for profit, the income of such an entity may still effectively qualify for tax-exemption in the hands of tax exempt members. Of note, the IRS has provided guidance on this scenario in Revenue Ruling 98-15.[19] In Situation 1, a not-for-profit hospital and a for-

guidelines for corporations that are organized as for-profit entities but are in fact controlled by tax-exempt organizations. Under these circumstances, the article describes various measures and agreements that are used to ensure that the professional service corporations satisfy the section 501(c)(3) requirements.

[17] Treas. Reg. § 1.502-1(b); Rev. Rul. 78-41, 1978-1 CB 148.

[18] There are two principal issues presented by the professional corporation. The first is identifying the entity that economically benefits through its operation. In the usual case, the organizational documents, including the agreements with the hospital, provide that the doctor cannot benefit economically (other than through reasonable compensation for services provided) and that any assets and earnings will effectively benefit only the hospital. Equally important is that the operation of the entity meets the "charitable" standard. There is nothing inherently charitable about providing medical care, including physician services. The activity become charitable only when it is provided in a certain manner that benefits the public at large, including, importantly, through the provision of free or discounted care to indigents. The documentation among the physician, the professional corporation and the hospital also address this issue.

[19] Rev. Rul. 98-15, 1998-1 CB 718.

profit corporation that operates hospitals formed an LLC together. The not-for-profit hospital wanted to obtain additional funding to better serve its community, and the for-profit corporation provided financing in exchange for a reasonable return. Since the not-for-profit hospital maintained control over the LLC, which acted exclusively in furtherance of its exempt purpose and only incidentally for the benefit of its for-profit member, the IRS ruled that the not-for-profit hospital maintained its tax-exempt status.[20]

This general tax treatment of LLCs as pass-throughs already provides considerable flexibility to tax-exempt organizations with respect to both conducting their wholly-owned activities as well as conducting activities jointly with taxable persons. In each of those cases, the determination of whether the activity and the entity participating in the activity meet the section 501(c)(3) requirements is made by reference to the rights of the tax-exempt and taxable participants with respect to the activity. Among those rights are rights to control the activity to ensure that it is conducted in a manner consistent with charitable purposes.

Currently, Minnesota, Kentucky, North Dakota and Tennessee specifically recognize nonprofit LLCs. In addition, Texas allows for the formation of an LLC with a non-profit purpose. Certain of these statutes directly address the rights of for-profit members to ensure that they are non-economic rights only. The applicable statutes in Minnesota and Kentucky, for example, permit for-profit members that are not individuals, but specifically provide that no dividends or distributions may be made to members of the LLC that are for-profit entities.[21] Other states have not enacted not-for-profit LLC statutes, but allow LLCs to pursue either for-profit or not-for-profit activities and allow members to, by agreement, disclaim any rights to distributions or assets upon dissolution. Once those economic rights are removed, the members remaining rights can be compared to the rights of a member of a not-for-profit corporation.[22]

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[20] The Tax Court has routinely held that a tax-exempt entity maintains its exempt status even when it forms a multiple-member LLC with taxable entities. As in Revenue Ruling 98-15, one of the key factors is whether the tax-exempt member retains control over the organization. In *Plumstead Theatre Society, Inc. v. Commissioner*, a tax-exempt theatre company formed a limited partnership with taxable investors, who provided financing for a play, in exchange for a portion of rights in that play. The Tax Court held that the theatre company was indeed organized and operated exclusively for exempt purposes because the theatre company was not obligated to return the capital contributions of taxable partners out of its own funds; the partnership had no interest in the theatre company or any other plays it planned to produce; and the taxable partners did not exercise control over the theatre company. *See Plumstead Theatre Society, Inc. v. Comm'r.*, 74 T.C. 1324 (1980), *aff'd per curiam*, 675 F.2d 244 (9th Cir. 1982). Similarly, in *St. David's Health Care Sys. v. United States*, a not-for-profit organization that owned a hospital formed a partnership with a for-profit company. There, the Court opined that a not-for-profit hospital would not be regarded as organized and operated for a charitable purpose if the for-profit company exercised control over the partnership. *See St. David's Health Care Sys. v. United States*, 349 F.3d 232 (5th Cir. 2003) ("Where the non-profit organization cedes control over the partnership to the for-profit entity, we assume that the partnership's activities via the partnership are not exclusively or primarily in furtherance of its charitable purposes."). Since control is an essential element in the determination of whether a tax-exempt organization that conducts all of its activities through an LLC with tax-exempt and taxable members maintains its exempt status, the IRS could require the LLC to add a provision to its governing documents prohibiting the LLC from ceding control to taxable members.

[21] Minnesota Statutes 322C.1101, Subdivision.2 and Kentucky Statutes 275.520.t

[22] *See e.g.* Del.Code. § 18-101, et seq. (DLLC Act).

We can discern no policy reason to apply a different analytic approach to LLCs that seek tax exemption and limit the exemption to LLCs having only tax-exempt members. This is not to say that an LLC jointly owned by tax-exempt and taxable members could obtain tax-exempt status in its own right if some of its earnings inured to the benefit of the taxable members. It could not. But the fact remains that in appropriate cases, non-tax exempt LLCs have been permitted to have such structures without either becoming taxable entities or endangering the tax-exempt status of their exempt members, so long as proper safeguards are followed. This illustrates the principle that it is the nature of those safeguards that guides the tax analysis, not the form of entity.

By contrast, any entity or arrangement (including an LLC) that seeks tax exemption is classified as a corporation for federal income tax purposes.[23] As reflected in the case of professional medical corporations, especially those not organized under "non-for-profit" statutes, there is a similar analytic framework for determining eligibility for tax exemption. That framework examines the rights of the participants in the enterprise rather than the status—taxable or tax-exempt—of the members.

We believe that this framework is applicable to multiple-member LLCs seeking tax exemption and should be adopted by Treasury and the Service. The logic of the Notice is to ensure that LLCs seeking to qualify as tax-exempt satisfy the organizational and operational requirements of section 501(c)(3); we do not believe that limiting membership to other section 501(c)(3) organizations, governmental units, and wholly-owned instrumentalities thereof is the most appropriate mechanism. Instead, compliance with the organizational and operational requirements of section 501(c)(3) could be safeguarded with other mechanisms that do not restrict taxpayers' choice of entity for planning purposes.

B. *Safeguards*

Recommendation: Similar to the provisions in the Notice, we recommend that Treasury and the IRS provide a list of organizational and operational safeguards that must be satisfied in order to qualify as a tax-exempt entity. These requirements may be satisfied either in the organizational documents, which include the articles of organization and the operating agreement, or by reliance under applicable provisions of state law.

Discussion: There are several issues to be considered in developing safeguards to ensure compliance with the requirements under section 501(c)(3). These include the substantive provisions to be included in the organizational documents; the treatment of an LLC's operating agreement as an organizational document in addition to the articles of organization; and the enforceability of those provisions.

1. Substantive Provisions

Similar to the requirements for corporations, the organizational documents for an LLC need to contain provisions which specify that its purposes and activities are limited to

[23] Although today most if not all states have statutes providing for the incorporation of not-for-profit corporations, such organization is not required to obtain tax-exempt status. However, in whatever manner the charitable undertaking is organized, the act of seeking a tax exemption for it creates per se corporate status for U.S. federal tax purposes.

those that are considered charitable within the meaning of section 501(c)(3). Additionally, the organizational documents need to ensure that the assets and income of the organization can benefit only those charitable activities of the LLC or otherwise be paid, distributed or transferred to tax-exempt entities or for tax-exempt purposes.

In addition, the organizational documents need to specifically negate the possibility of taxable members having any economic or proprietary rights to the entity's net income or assets. The governing documents should be required to state that taxable members will not be entitled to receive distributions or make capital contributions in exchange for proprietary interests in the charitable LLC.[24] These provisions would not need to similarly restrict distributions to, or capital contributions made by, tax-exempt members.[25]

The governing documents would also be required to address the disposition of assets upon dissolution of the organization in a manner that prevented any of those assets inuring to the benefit of any of the organization's taxable members. We believe that the organizational documents should be able to address this in several different ways. First, the organizational documents may provide that distributions of assets upon dissolution may be made solely to the organization's members that are tax-exempt. Second, similar to provisions in many private foundations, the organization's documents may provide, as an alternative or ultimate failsafe, that the assets will be transferred to another organization exempt from taxation under the Code.[26] Thus, on dissolution, a charitable LLC should be able to distribute its assets to its tax-exempt members or to another tax-exempt organization. While the organizational test in Treas. Reg. Sec. 1.501(c)(3)-1(b)(4) provides that "an organization does not meet the organizational test if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders", the Regulation should be interpreted as prohibiting distribution of assets only to taxable members or shareholders.[27] Again, the essence of the organizational test of section 501(c)(3) is to ensure that the exempt organization's activities and assets are dedicated to exclusively exempt purposes. Transferring assets on dissolution of an LLC either to tax-exempt members or tax-exempt non-members should not violate this requirement of section 501(c)(3).

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[24] Such provisions would not be intended to restrict payments to members as compensation for services. Such payments would be subject to the same restrictions and requirements as compensation payable by other tax-exempt organizations. Rules identical to those applicable to tax-exempt organizations and their contracts with insiders and third parties would also be applicable to dealings by LLCs seeking exemption.

[25] This approach is consistent with some state statutes authorizing non profit limited liability companies. See for example Minnesota section 322C1101, subdivision 2.

[26] We would expect that such provision would require that the recipient organization be classified as a public charity exempt under section 501(c)(3) or a governmental unit (or wholly-owned instrumentality thereof) exempt under Section 115 or other applicable sections of the Code.

[27] Treas. Reg. § 1.501(c)(3)-1(b)(4). This is consistent with the Notice, which permits blanket formation of LLCs with exclusively tax exempt members, apparently even in states where liquidating distributions are required to be made to members. Similarly, in the case of the for-profit professional corporations discussed above, the IRS has issued exemption letters where the documents, including the agreements among the physician, corporation and hospital, negate any right of the physician to benefit economically from ownership of the shares and such arrangement is enforceable under state law.

We recognize that there may be difficulties in applying this approach in circumstances in which all of the members of the LLC are taxable entities. This is especially the situation when the LLC is organized in a state that requires assets to be distributed to members or shareholders upon dissolution. One potential solution would be to require that any entity organized in such a state have at least one tax-exempt member and for the organizational documents, including the operating agreement, to require that any distributions on liquidation are made solely to that member. This approach would also address the situation, raised in Notice, with respect to states whose LLC statutes require that on dissolution, an LLC's assets be distributed to its members and shareholders and the question whether that would cause a violation of Treas. Reg. 1.501(c)(3)-1(b)(4).[28] As with other provisions in the organizational documents, certification as to enforceability by the organization would be required.

Additionally, Treasury and the IRS could require explicit statements in the organizational documents stating that the assets must be disposed of in this manner and require additional support showing that such agreement is enforceable. Such additional support could, for example, take the form of binding undertakings by all of the taxable members to cause the organization to dispose of its assets in this manner and a waiver of any rights to distributions. This would be akin to those situations in which tax exemption has been granted to professional service corporations that are required to be organized as for-profit corporations.[29] In those situations, the relevant documentation, including agreements with the physicians, require a waiver of any rights to financial benefit from ownership of the stock. As discussed below concerning the issues of enforceability, Treasury and the IRS in these instances could require opinions of counsel or identification of authority under state law supporting the conclusion.

Finally, that provisions required under section 508(e) in the case of organizations that would be considered private foundations should be required of tax-exempt LLCs. The organizational documents should be required to include provisions on conflicts, as well as private foundation limitations. In addition, managers of the tax-exempt LLC should be considered "disqualified persons" for the private foundation rules, and their salaries would have to be measured in accordance with those rules.

2. Determination of Organizational Documents

We believe that an LLC seeking to qualify for tax-exemption under section 501(c)(3) should be able to satisfy the Notice's organizational requirements through its governing documents, which should contain the same limitation on operations that would be required for a charitable corporation's articles of incorporation. In this respect, we support the Notice's requirement that LLCs add to their governing documents language that demonstrates an exclusively tax-exempt purpose; however, we propose alternative requirements than those provided in the Notice.

[28] For example, Section 79-29-123 of the Mississippi Code prohibits the operating agreement from varying the manner in which Section 79-29-813 mandates the distribution of assets upon dissolution of the LLC, which restricts such distributions to creditors and members of the LLC. Mississippi appears to be the only state that has such a restrictive provision governing distributions on dissolution.

[29] See exemption letters in Chapter F, Corporate Practice of Medicine.

We do not believe that the provisions in satisfaction of section 501(c)(3) need to be in both the articles of organization and operating agreement, so long as the provisions are enforceable under state law. Treas. Reg. §1.501(c)(3)-1(b)(2) defines the organizational documents to include the "trust agreement, the corporate charter, the articles of association or any other written instrument by which an organization is created." This language should be interpreted broadly enough to include the operating agreement. This is particularly the case for limited liability companies where typically the economic rights of the members are specified in the operating agreement and not in its articles of organization. Indeed, the Notice in section 3.04 specifically permits the relevant required organizational provisions to be contained only in the operating agreement where state law prohibits the provisions from addition to the articles of organization.

We recognize that the IRS and Treasury have expressed their concerns in the Notice that, unlike the articles of organization, the operating agreement is not filed with the state. While the concern that an operating agreement may be changed without public notice is legitimate, we do not believe that ability should be fatal for the purpose of qualifying for tax-exemption. A similar issue is presented in the case of a charitable trust, which generally needs not publicly file its declaration of trust. Moreover, we believe these concerns can be addressed in other ways. For example, the operating agreement could prohibit amendment of the provisions bearing on the tax exemption (including the purpose, distribution and dissolution provisions) without express approval from the IRS. Alternatively, LLCs could be required to notify the IRS of changes to the operating agreement on Form 990, as tax-exempt entities must do when there is a material change in their bylaws or a change to their organizational form, and specifically identify provisions directly bearing on the tax exemption.

3. Enforceability under state law

The critical element in this approach is ensuring that the provisions in the operating agreement and articles of organization limiting the activities to charitable purposes are enforceable under applicable state law. The Notice partially addresses this issue by requiring the LLC to represent that the provisions of its organizational documents are consistent with state law and legally enforceable. We agree with this approach and believe that with respect to all relevant matters, an LLC seeking to qualify for tax-exemption under section 501(c)(3) should be required to represent that the provisions in its documents are enforceable under applicable state law in accordance with their terms.

In most cases, such as state LLC laws that follow the Revised Uniform Limited Liability Act or have similar provisions providing that economic rights are governed by the terms of the operating agreement, we would expect that a certification from the organization would be sufficient. However, we also recognize that depending upon the particular state law, there could be issues as to enforceability that would require additional support. In general, we do not believe that the IRS should be burdened with the responsibility of deciphering nuances under state law. Instead, the responsibility should be that of the LLC. If Treasury and the IRS are concerned about enforceability on a particular matter, they could consider adding a requirement that the organization obtain a legal opinion or other documentation as to enforceability. Such documentation could consist of relevant legal

authority, including, for example, advisory opinions of the particular state attorney general addressing enforceability of the particular provision.[30]

We would expect that the need for safeguards would be applied in a manner that does reflect the applicable members and state law. For example, organizations governed by a state not for profit LLC statute with appropriate section 501(c)(3) compliant provisions would be analyzed differently than an organization with similar membership not governed under such provisions. Similarly, we would expect a different analysis for LLCs with only tax exempt members that present less difficult issues involving distributions upon liquidation. As in the case of professional service corporations organized as for profit entities, we would expect more detailed analysis of the safeguards with organizations involving taxable and tax exempt or only taxable members.

C. Other Issues

1. Advantages and disadvantages of using LLCs as tax-exempt entities

The Notice requests comments on the use of LCCs rather than tax-exempt corporations to conduct exempt activities. In general, we anticipate that LLCs will be chosen where ease of management and operation is important. In general, LLCs offer greater flexibility in structuring the management of the enterprise. For example, in general, LLCs may be managed either directly by the members or by managers selected by the members. There is no need for a board of directors. Accordingly, we would expect LLCs to be used in circumstances in which the need for a formal management structure is less important. For example, the uses could include ventures expected to have a limited specific purpose or a short-term duration.

2. Applicability of state laws regulating charitable assets

In general, it is our understanding that state laws regarding charitable assets apply to assets held in LLCs, at least to the extent the entities have received tax exemptions or claim to be tax exempt.[31] For example, the New York State Charities Bureau has jurisdiction over "charitable organizations",[32] which includes organizations exempt from federal income taxation.[33] Even in Delaware, which has much less regulation of charities, the attorney general has the power to act on his or her own initiative or in response to complaints to obtain voluntary compliance and seek or provide remedies.[34] The attorney

[30] A similar approach has been used to address issues arising on the eligibility of professional service corporations to qualify as tax-exempt entities.

[31] Thirty-seven states have laws requiring charitable organizations (or those that solicit on behalf of an organization) to register with the state, generally either with the attorney general's office or another state department charged with overseeing charitable activities. Thirteen states have no registration requirement for fundraising by charitable organizations. In general, those registration laws (and oversight) apply to LLCs as well as corporations.

[32] 13 NYCRR 91.1.

[33] 13 NYCRR 90.2.

[34] 6 Del. C. 2432A.

general can also move the Delaware Court of Chancery to cancel an LLC's articles of organization for abuse or misuse of its LLC powers, privileges, or existence.[35] In any event, we do not believe that the IRS needs to consider how an LLC that is exempt under section 501(c)(3) is regulated by states authorities other than in unusual circumstances. The IRS's focus should be on the provisions of the Code which provide adequate protections.

3. Resolving state law issues

A number of the questions raised by the Notice address potential conflicts of interpretation with state law, and the Notice has requested comments from state attorneys general on these points. These inquiries include questions about (i) the nature of the organizational documents, given that while articles of organization are filed with the state, operating agreements are not; (ii) the application of the rules in states in which an LLC must have a profit-seeking purpose; and (iii) the treatment of state law dissolution requirements that assets be distributed only to the members. Additional questions involve whether there should be a requirement in state law that confines the activities of an LLC to charitable purposes similar to the provisions in state law governing non-profit corporations. Other questions involve the treatment of managers and whether manager-managed LLCs should be treated in the same manner as member-managed LLCs. Finally, the Notice requests comments on whether there are any other provisions of state law that may affect the ability of an LLC to meet the requirements of section 501(c)(3).

We have specifically addressed the more important of the questions, including the nature of the organizational documents, the requirement that upon dissolution the assets be used only for charitable purposes and the requirement that no non-exempt member receive any distribution. With respect to other issues arising under the various state LLC statutes and regulations, we believe that Treasury and the IRS should adopt the following approach: establish uniform federal rules for tax exemption and require organizations requesting exemption to bear the burden of establishing compliance with such rules under their local state law.

In general, we do not believe that the IRS should undertake the burden of interpreting and understanding the nuances of various state laws. Instead, we urge that Treasury and the IRS establish uniform federal rules specifying the requirements for tax exemption for LLCs. Those rules should be substantially the same as the rules for other types of entities seeking tax-exempt status, namely that the entity meet the organizational and operational requirements of 501(c)(3). As we have recommended earlier, those rules should be focused on the activities of the organization and the use of its assets, including that those assets must, in all circumstances, be used to further charitable purposes and not inure to private benefit.

The burden of establishing compliance with the rules should rest with the organization requesting the exemption. The Notice already contemplates this approach by requiring a certification from the organization that the relevant provisions of its organizational documents are enforceable. We suspect that in many cases providing this

[35] 6 Del. C. Sec. 18-112(a).

certification will be straightforward. These would include, for example, LLCs organized under state law charitable LLC statutes or other state laws that specifically permit the provisions of the operating agreement to govern activities and use of assets. In other cases, we believe that the rules should request additional support. As with professional service corporations seeking exemption, such additional support could include interpretations of the state's LLC statutes confirming enforceability of the relevant chartable and distribution provisions, including advisory opinions by state attorneys general.[36] Additionally, we believe that LLCs should be provided the option of providing legal opinions that address potentially problematic issues.

[36] While we believe that the treatment of professional service corporations organized under for-profit laws as tax-exempt entities provides a reasonable precedent for the approach to LLCs, we recognize that the two situations are not entirely analogous. The exemption for professional service corporations is largely derived from their activities being considered essential activities of the tax-exempt entity that ultimately controls the professional service corporation. Nevertheless, the requirements and safeguards employed to ensure compliance with section 501(c)(3) do provide a pathway to employing similar rules for LLCs.