2012

Tax Exemptions for Charitable Single-Member Limited Liability Companies

Terri Lynn Helge
Texas A&M University School of Law, thelge@law.tamu.edu

David M. Rosenberg

Back to Table of Contents

Tax Exemptions for Charitable Single-Member Limited Liability Companies

by Terri Lynn Helge and David M. Rosenberg

I. Introduction. This summer, the IRS issued long-awaited guidance on the deductibility of charitable contributions made to a single-member limited liability company ("SMLLC") that is wholly-owned by a charitable organization exempt from federal income tax as a organization described in Section 501(c)(3).[1] Previously, in a 2001 private letter ruling, the IRS confirmed that a SMLLC wholly-owned by a U.S. charity did not need to submit a separate application for recognition of federal income tax exemption, but declined to rule on whether contributions made to the SMLLC would be deductible under Section 170 as charitable contributions.[2] An article in the IRS Continuing Professional Education Text for the fiscal year 2001 stated that "[g]uidance on this issue will be forthcoming in the near future."[3] Notice 2012-52 provides this guidance.[4] In Notice 2012-52, the IRS ruled that a contribution to a domestic SMLLC that is wholly owned by a U.S. charity would be treated as a deductible charitable contribution, assuming all the requirements of Section 170 are met.[5] This article discusses the requirements for federal income tax exemption of a SMLLC and the deductibility of contributions made to the SMLLC as well as the availability of Texas state tax exemptions for the SMLLC.

II. Federal Tax Exemption.

A. Section 501(c)(3) Exemption. Under the choice of entity regulations, a SMLLC is disregarded as an entity separate from its owner for federal income tax purposes, unless a timely election is made to treat the SMLLC as a corporation for federal income tax purposes.[6] As a disregarded entity, the activities of the SMLLC are treated as a branch or division of its owner.[7] Thus, a U.S. charity that is the sole member of a SMLLC treated as a disregarded entity must report the operations and finances of the SMLLC on the charity's own annual information return (Form 990/990PF).[8] Since the SMLLC is disregarded as a separate entity for federal income tax purposes, the Section 501(c)(3) exempt status of the charity-member extends to the operations and activities of the SMLLC. No separate determination of exemption as a Section 501(c)(3) organization is required for a charitably-owned SMLLC that is treated as a disregarded entity. By using a SMLLC, a charity can avoid the expense and time delay of seeking a separate determination of exemption for activities that the charity would like segregated in a

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.
[2] *See* Priv. Ltr. Rul. 200150027 (Aug. 7, 2001).
[3] Richard A. McCray & Ward L. Thomas, *Limited Liability Companies as Exempt Organizations: Update*, 2001 EO CPE Text, chpt. B, at 28, available at http://www.irs.gov/pub/irs-tege/eotopicb01.pdf.
[4] Practitioners who deal with the IRS on a regular basis will not be surprised to learn that the IRS considers 11 years the "near future."
[5] Notice 2012-52, 2012-35 I.R.B. 317.
[6] *See* Treas. Reg. § 301.7701-2(c)(2)(i).
[7] *See* Treas. Reg. § 301.7701-5(a).
[8] Ann. 99-102, 1999-2 C.B. 545.

separate entity to, for example, minimize exposure to potential liability from these activities for the charity.

Nonetheless, caution should be taken in forming a SMLLC to conduct activities of the charity-member. Because the operations and activities of the SMLLC treated as a disregarded entity are attributable to the charity-member, it is important to consider the potential effect the operations and activities of the SMLLC may have on the tax-exempt status of the charity-member. For example, if the SMLLC conducts an unrelated business activity that would jeopardize the tax-exempt status of the charity-member if conducted by the charity-member directly, the potential risk is not minimized by conducting the unrelated business activity through a SMLLC instead. Collectively, the SMLLC's and the charity-member's operations must primarily further the charitable purpose for which the charity-member was granted tax exemption. Furthermore, all of the activities of the SMLLC are considered activities of the charity-member for purposes of the unrelated business income tax[9] and the excise taxes imposed under Chapter 42 of the Code (e.g., prohibition on self-dealing and excess benefit transactions with disqualified persons).[10] Thus, the charity-member should monitor the SMLLC's activities carefully to ensure that the SMLLC does not conduct activities that would call the charity-member's tax exempt status into question.

In its 2001 Continuing Professional Education Text, the IRS stated that a SMLLC treated as a disregarded entity does not need to independently satisfy the organizational test required of Section 501(c)(3) charitable organizations.[11] However, the articles of organization of the SMLLC cannot prohibit the SMLLC from operating exclusively for tax exempt purposes.[12] Moreover, if the SMLLC's articles of organization do not satisfy the organizational test, the article suggests closer scrutiny by an examining agent of the SMLLC's activities to ensure compliance with the operational test required of Section 501(c)(3) charitable organizations.[13] Accordingly, it may be prudent to structure a SMLLC to satisfy the organizational test under Section 501(c)(3) by including the following provisions in its articles of organization:

- The activities of the SMLLC are limited to one or more exempt purposes and the SMLLC is operated to further its charity-member's exempt purposes;

[9] The unrelated business income tax applies to a trade or business activity that is regularly carried on by a charity and the conduct of which is not related to the accomplishment of the charity's exempt purposes. *See* I.R.C. § 511.
[10] *See* I.R.C. §§ 4940—4967.
[11] McCray & Thomas, *supra* note 3, at 28. Generally, in order to meet the Section 501(c)(3) organizational test, the articles of organization of the entity (i) must limit its purposes to one or more exempt purposes, (ii) may not empower the entity to engage in activities which are not in furtherance of its exempt purposes, other than to an insubstantial degree, (iii) may not empower the entity to engaged in prohibited political campaign intervention or lobbying activity, and upon dissolution of the entity, its assets must be distributed for exempt purposes by operation of law or by provision in the articles of organization. Treas. Reg. § 1.501(c)(3)-1(b).
[12] McCray & Thomas, *supra* note 3, at 28.
[13] *Id*. In general, the operational test requires the entity to engage primarily in activities that accomplish its exempt purposes and to not engage in a substantial amount or lobbying activity or any prohibited political campaign intervention. Treas. Reg. § 1.501(c)(3)-1(c). In addition, no part of the net earnings of the entity may inure to the benefit of private shareholders or individuals. *Id*.

- Transfer of a membership interest in the SMLLC is prohibited except to a charitable organization or governmental unit, and only with the approval of the charity-member;
- Upon dissolution of the SMLLC, its assets will be distributed to the charity-member or for one or more exempt purposes as determined by the charity-member;
- No distributions will be made from the SMLLC to a member who ceases to qualify for exemption as a charitable organization; and
- The SMLLC is prohibited from conducting any activity that is not permitted of a charitable organization exempt from federal income tax as a Section 501(c)(3) organization.

B. Charitable Contribution Deduction. Notice 2012-52 provides that a contribution to a domestic SMLLC that is wholly owned by a U.S. charity is treated as a deductible charitable contribution, assuming all the requirements of Section 170 are met.[14] Section 170(a) allows donors to deduct certain charitable contributions in computing taxable income. A deductible charitable contribution generally is made to or for the use of a U.S. organization which has been determined to be organized and operated for charitable purposes by the IRS.[15] A donor may verify that the charity qualifies as an organization that is eligible to receive tax-deductible charitable contributions by requesting a copy of the charity's IRS determination letter or verifying the status of the organization through the IRS "Exempt Organizations Select Check" on the IRS website.[16] However, a SMLLC treated as a disregarded entity will not have its own IRS determination letter and will not be listed in the Exempt Organization Select Check database, potentially causing confusion for some donors. Therefore, even though Notice 2012-52 allows contributions made to the SMLLC to be deducted, the charity-member may need to provide more information to potential donors to alleviate concerns regarding the deductibility of the contribution.

Notice 2012-52 also provides that even though the contribution is made to the SMLLC, the charity-member is considered the donee organization for purposes of the substantiation and disclosure requirements. For charitable contributions of $250 or more, a donor generally is allowed a deduction only if the contribution is substantiated by a contemporaneous written acknowledgment.[17] That acknowledgment must be from the charity and must generally state: (i) the amount of cash and a description of any noncash property contributed by the donor; (ii) whether the charity provided any goods or services in consideration for the property contributed; and (iii) a description and good faith estimate of the value of any goods or services provided by the charity.[18] A written acknowledgment is contemporaneous if the donor obtains the acknowledgment on or

[14] Notice 2012-52, 2012-35 I.R.B. 317.
[15] *See* I.R.C. § 170(c)(2). Organizations with annual gross receipts of $5,000 or less and churches are not required to apply for recognition of tax-exempt status, though many churches voluntarily apply for recognition of tax-exempt status so that the church has an IRS determination letter of its exempt status to show to potential donors.
[16] Exempt Organizations Select Check is available at http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check.
[17] I.R.C. § 170(f)(8)(A).
[18] I.R.C. § 170(f)(8)(B).

before the earlier of the due date (including extensions) of the return for the taxable year in which the contribution was made, or the date on which the donor actually files such return.[19] Notice 2012-52 recommends that "[t]o avoid unnecessary inquiries by the [IRS], the charity is encouraged to disclose, in the acknowledgment or another statement, that the SMLLC is wholly owned by the U.S. charity and treated by the U.S. charity as a disregarded entity."[20]

Recently, the IRS has won several court cases in which the deduction for a contribution made to a charity was denied by the IRS because the donor did not have adequate contemporaneous written acknowledgement from the charity or other required substantiation of the charitable contribution.[21] In particular, the Tax Court rejected a taxpayer's "substantial compliance" argument in one case stating:

> We recognize that this result is harsh—a complete denial of charitable deductions to a couple that did not overvalue, and may well have undervalued, their contributions—all reported on forms that even to the Court's eyes seemed likely to mislead someone who didn't read the instructions. But the problems of misvalued property are so great that Congress was quite specific about what the charitably inclined have to do to defend their deductions, and we cannot in a single sympathetic case undermine those rules.[22]

Due to the IRS's and the courts' insistence on perfect compliance with the acknowledgment and substantiation requirements, it is curious that the IRS is not more specific on the requirements for properly acknowledging a contribution made to a SMLLC. In particular, the IRS's recommendation, rather than requirement, that the acknowledgment contain a statement about the disregarded entity status of the SMLLC is a bit perplexing. It may be prudent, therefore, for a charity-member to use a separate form of acknowledgment for contributions made to the SMLLC which contains the recommended disclosure about the disregarded entity status of the SMLLC.

Finally, Notice 2012-52 clarifies that the limits on the deductibility of charitable contributions set forth in Section 170(b) are applied as if the contribution were made to the charity-member of the SMLLC. Section 170(b) establishes limits on the maximum amount of the cash or property contributed to a charitable organization that may be deducted in a given year. For individuals, these limits are based on specified percentages of the donor's adjusted gross income depending on the type of charity to which the contribution was made (public charity or private foundation) and the type of property contributed to the charity.[23] In addition, if the donor contributes property to the charity instead of cash, the amount deductible may be limited to the donor's cost basis rather

[19] I.R.C. § 170(f)(8)(C).
[20] Notice 2012-52, 2012-35 I.R.B. 317.
[21] *See, e.g.*, Mohamed v. Comm'r, T.C. Memo 2012-152; Durden v. Comm'r, T.C. Memo 2012-140; Cohan v. Comm'r, T.C. Memo 2012-8; DiDonato v. Comm'r, T.C. Memo 2011-153.
[22] Mohamed v. Comm'r, T.C. Memo 2012-152.
[23] *See* I.R.C. § 170(b).

than the fair market value.[24] Thus, if the SMLLC is wholly-owned by a private foundation, contributions to the SMLLC are governed by the deduction limits applicable to contributions to private foundations. Likewise, if the SMLLC is wholly-owned by a church, school, hospital, publicly supported organization or other public charity, contributions to the SMLLC are governed by the deduction limits applicable to contributions to public charities.

Notice 2012-52 is effective for contributions to SMLLCs made on or after July 31, 2012. However, a taxpayer may rely on Notice 2012-52 retroactively for taxable years in which the statute of limitations has not expired.[25]

III. State Tax Exemptions.

A. Texas Sales and Use Tax. Generally, charitable organizations exempt from federal income tax are also exempt from paying Texas sales tax on goods and services they purchase for use in their charitable activities.[26] This Texas sales and use tax exemption is also available to SMLLCs which are wholly-owned by a charitable organization described in Section 501(c)(3). Note that the Texas sales and use tax exemption does not apply to goods or services sold by the charity or the SMLLC. Thus, the charity or the SMLLC is responsible for collecting the applicable sales tax on goods or services provided by it, unless another exemption applies to the transaction under the Texas Tax Code.

B. Texas Margin Tax. The Texas margin tax (formerly known as the Texas franchise tax) applies to all business entities that are organized or conduct business in the State of Texas, including limited liability companies, partnerships and corporations. An exemption from the Texas margin tax applies to "nonprofit corporations exempt from federal income tax under Section 501(c)(3)."[27] To qualify for this exemption, the charity must provide a copy of its IRS determination letter to the Texas comptroller's office or if one is not available, evidence that the charity has applied for recognition of tax exemption with the IRS.[28] Recall that a SMLLC wholly-owned by a charity is treated as a disregarded entity for federal income tax purposes, and thus does not receive its own IRS determination letter. The Texas Comptroller's office has taken the position that the charity-member's IRS determination letter is not sufficient to grant exemption from Texas margin tax to the SMLLC,[29] even though for federal tax purposes, the SMLLC uses the same exemption granted to the charity-member. Thus, the Texas Comptroller will not grant exemption from the Texas margin tax to a SMLLC unless the SMLLC applies for and receives its own IRS determination letter.

---

[24] *Id*.
[25] Notice 2012-52, 2012-35 I.R.B. 317.
[26] TEX. TAX. CODE § 151.310(a)(1).
[27] TEX. TAX. CODE § 171.063(a)(1). Section 171.088 of the Texas Tax Code clarifies that the nonprofit corporation form is not essential to securing an exemption from the Texas margin tax, providing that an entity that is not a corporation but which conducts activities that would qualify for exemption if it were a corporation, is eligible for such exemption.
[28] *See* TEX. TAX. CODE § 171.063(b)-(d). Where the exemption application is pending with the IRS, the Comptroller's office will issue a provisional exemption.
[29] *See* 34 TEX. ADMIN CODE § 3.583 (2009) (Tex. Comptroller, Margin: Exemptions).

Even though the exemption from Texas margin tax is generally[30] not available to SMLLCs that do not have their own IRS determination letter, the SMLLC may nonetheless be exempt from Texas margin tax if its revenues fall below the prescribed "no-tax-due" threshold.[31] Currently, for franchise tax reports due before January 1, 2014, the no-tax-due threshold is $1,030,000.[32] The no-tax-due threshold for franchise tax reports due on or after January 1, 2014 decreases to $600,000.[33] A SMLLC that has annual revenues in excess of the no-tax-due threshold must pay the Texas margin tax on its "taxable margin," generally at a rate of one percent.[34] The taxable margin is the lowest of the following three amounts: (i) the SMLLC's revenues[35] less its cost of goods sold; (ii) the SMLLCs revenues less its compensation paid to officers and employees; and (iii) 70% of the SMLLC's revenues.[36] Note that a SMLLC which has revenues in excess of the no-tax-due threshold must generally pay the full tax computed on its taxable margin.[37] Accordingly, a charity should carefully consider the potential implications of the Texas margin tax when deciding whether to form a SMLLC to conduct certain of its activities. If the expected revenues of the SMLLC exceed the no-tax-due thresholds, in the long run it may be more beneficial for the charity to form an affiliated, controlled nonprofit corporation and apply for separate federal income tax exemption for this corporation. Even if the SMLLC's revenues fall below the no-tax-due threshold, the SMLLC is required to file a "no tax due" franchise tax report each year to maintain its good standing in the State of Texas. Since a charity exempt from the Texas margin tax is not required to file this report, this administrative nuance for the SMLLC may be overlooked by the charity.

IV. Conclusion. With the issuance of Notice 2012-52, the federal income tax questions regarding the use of a SMLLC wholly-owned by a U.S. charity have, for the most part, been answered. With automatic exemption for the SMLLC's activities and the eligibility of the SMLLC to receive tax-deductible charitable contributions, the popularity of

---

[30] Section 171.062 of the Texas Tax Code provides an exemption from franchise taxes for a "nonprofit corporation organized for purely public charity." *Id.* § 171.062. Section 171.088 of the Texas Tax Code provides an exemption from franchise taxes for an entity that is not a corporation, but because of its activities, would qualify for exemption if it was a corporation. *Id.* § 171.038. Thus, a SMLLC that is organized for purely public charity is entitled to an exemption from Texas franchise taxes. Texas Administrative Code Rule 3.541(c)(4) provides that to be exempt from franchise taxes as organized for purely public charity, an organization must devote substantially all of its activities to the alleviation of poverty, disease, pain and suffering by providing food, clothing, drugs, treatment, shelter, or psychological counseling directly to indigent or similarly deserving members of society, with funds derived primarily from sources other than fees or changes for services. 34 TEX. ADMIN. CODE § 3.541(c)(4).

[31] *See* TEX. TAX. CODE § 171.002(d.

[32] *Id*.

[33] *Id*.

[34] *See* TEX. TAX. CODE § 171.002(a).

[35] For purposes of the Texas margin tax, revenues are generally computed with reference to the entity's federal income tax return reporting of its gross income less certain enumerated deductions, such as bad debt expense and the net distributive share of income reported to the entity from a partnership or S corporation for federal income tax purposes. *See* TEX. TAX. CODE § 171.1011.

[36] TEX. TAX. CODE § 171.101(a)(1).

[37] The Texas Tax Code provides some discounts for "small businesses" that have revenues which exceed the no-tax-due threshold by certain prescribed limits. For example, for franchise tax reports due on and after January 1, 2014, a 40% discount is allowed to an entity that has revenues between $600,000 and $700,000, and a 20% discount is allowed to an entity that has revenues between $700,000 and $900,000. TEX. TAX. CODE § 171.0021(a).

SMLLCs as divisions of existing charities may rise. For Texas charities, however, the application of the Texas margin tax to the SMLLC may hinder the ability to use the SMLLC form for divisions that are expected to produce sizeable revenues.