LLCs and Nonprofit Organizations—For-Profits, Nonprofits, and Hybrids

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"There is no reason why good cannot triumph as often as evil. The triumph of anything is a matter of organization. If there are such things as angels, I hope that they are organized along the lines of the Mafia."

Kurt Vonnegut, THE SIRENS OF TITAN (1959).

INTRODUCTION

The acceptance of the limited liability company (LLC) in 1998 afforded business owners and their advisors with a more straight-forward and flexible way of doing business than was available at that time. Two decades ago, there were two organizational forms under which business owners could obtain pass-

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through taxation without vicarious liability for the obligations of the organization—the S corporation and the limited partnership with a corporate general partner.[2] The LLC eliminated some of the limitations attendant to each of these forms. Unlike the S corporation, the LLC has no limitation on the number and types of owners, the inability to have special allocations and other sorts of economic relationships, and the necessity to comply with state-law corporate strictures. Unlike a limited partnership with a corporate general partner, the LLC does not require the maintenance of two organizations, and unlike limited partners, members of an LLC are not subject to potential vicarious liability for participation in management or control of the organization.[3] In some respects it is remarkable that the simplicity and efficiency of the LLC would only come into existence after decades of increasing complexity in both corporate and unincorporated worlds. As Lord Buckley has put it, "it was so simple it evaded me."[4]

Had the LLC merely provided these benefits, it would have been a useful addition to the arsenal of legal entities available to the business community. But the LLC's flexibility and efficiency has been the occasion for rethinking many other aspects of organizational structures. Two of the most significant are the single-member LLC, discussed by Carter Bishop elsewhere in this journal,[5] and the elimination of the requirement that an unincorporated business organization be organized for profit. One result of this reconsideration of business entities is a reconsideration of the form and structure of organizations that are explicitly not organized to realize an economic profit (nonprofits) and the advent of new forms and structures designed to combine economic returns with non-economic objectives (hybrids). This article considers this aspect of the development of LLCs.

This article deals with the LLC in the context of nonprofit organizations,[6]

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2. *See* Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1469-70 (1998) (providing thorough history of the remarkable development of limited liability companies in the United States); *see also* Susan Pace Hamill, *The Story of Limited Liability Company: Combining the Best Features of a Flawed Business Tax Structure*, *in* BUSINESS TAX STORIES 295 (Steven A. Blank & Kirk J. Starks eds., 2005), *available at* http://www.law.ua.edu/susanhamill/Chapter%2010-Business%20Tax%20Stories%20(Foundation).pdf.

3. Under limited partnership acts in effect before the Uniform Limited Partnership Act of 2001 (ULPA), a limited partner ran the risk of becoming liable by participating in control of the business of the limited partnership. *See* REVISED UNIF. LTD. P'SHIP ACT (RULPA) § 303 (1985). Under ULPA § 303, a limited partner is not liable for the obligations of the limited partnership even if the limited partner participates in the control or management of the business of the limited partnership. UNIF. LTD. P'SHIP ACT § 303 (2001).

4. LORD BUCKLEY, *God's Own Drunk*, *on* JET RIDE (BGM Recordings 2007).

5. *See* Carter Bishop, *Through the Looking Glass: Status Liability and the Single Member and Series LLC Perspective*, 42 SUFFOLK U. L. REV. 459 (2009).

6. Unless otherwise noted, the discussion of "nonprofits" or "nonprofit organizations" is intended to refer to organizations that are exempt from federal taxation under I.R.C. § 501(c)(3), sometimes referred to as charitable organizations. Obviously, many nonprofit organizations are not charitable in nature but may merely be organized for nonprofit purposes. Some of these are also exempt from taxation while not being charitable organizations. Among these are mutual organizations as diverse as social clubs, recreational soccer teams, and

both as a legal entity in which a nonprofit organization may be a member and as an organization that may, itself, be organized as a nonprofit organization, or a hybrid organization—one that may be organized for a purpose that is neither exclusively for-profit nor exclusively nonprofit. Most legal organizations are created pursuant to a state law, referred to in this article as an "organic statute."[7] Unlike partnerships[8] and business corporations under the Model Business Corporation Act,[9] LLCs (and, more recently, limited partnerships) do not need to be organized for profit.[10]

The rules applicable to most business organizations under the organic statutes under which they are created may be supplemented through documents (referred to herein as "organic documents") created by those organizing the organization, the organization's owners, or the managers of the organization. The organic documents have different designations in different organizations.[11] The organic statutes applicable to most LLCs afford great freedom to organize LLCs in the manner best suited to the objectives of those organizing the LLCs.

ditch companies.

7. A principal exception is the common-law trust, which may be considered a separate entity. It should also be mentioned that the statutes addressing general partnerships do not expressly authorize the creation of "an association of two or more persons to carry on a business for profit," but rather describe the characteristics of such an association and legally classify it as a separate entity. Unlike a corporation, a limited partnership, or an LLC, would exist—and, before the Uniform Partnership Act of 1914, did exist—even in the absence of a statute describing it.

8. *See* UNIF. P'SHIP ACT (UPA) § 101(6) (1997) ("'Partnership' means an association of two or more persons to carry on as co-owners a business for profit formed under Section 202, predecessor law, or comparable law of another jurisdiction"); § 201(a) ("Except as otherwise provided in subsection (b), the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership."); UNIF. P'SHIP ACT § 6 (1914) (defining "partnership" as "an association of two or more persons to carry on as co-owners a business for profit").

9. MODEL BUS. CORP. ACT § 1.40(4) (1979) (explaining that "[c]orporation . . . means a corporation for profit"). Under the Delaware General Corporation Law ("DGCL"), a corporation need not be organized for profit. DGCL § 101(b) ("A corporation may be incorporated or organized under this chapter to conduct or promote any lawful business or purposes, except as may otherwise be provided by the Constitution or other law of this State.").

10. UNIF. LTD. P'SHIP ACT § 104(b) (2001) ("A limited partnership may be organized under this [Act] for any lawful purpose."). Before the adoption of the ULPA in 2001, under both the original Uniform Limited Partnership Act of 1916 and RULPA, a limited partnership was defined as a "partnership," meaning that the requirements that a partnership have two or more members and be organized for profit applied to limited partnerships. Under the ULPA, only the requirement that a limited partnership have two members continues for limited partnerships under ULPA (with the possible exception of limited partnerships created as the result of a merger or conversion. UNIF. LTD. P'SHIP ACT § 102(11) (2001) (Limited partnership "means an entity, having one or more general partners and one or more limited partners, which is formed under this [Act] by two or more persons or becomes subject to this [Act] under [Article] 11 or Section 1206(a) or (b).").

11. In a corporation (including a nonprofit corporation) the organic documents generally consist of articles of incorporation and bylaws, although in some corporations they may also include shareholders agreements. In unincorporated organizations such as partnerships and LLCs the organic documents will generally consist of the partnership agreement or operating agreement (which in turn is designated by different names under different statutes). It is worth noting that the organic "document" in unincorporated organizations may not be a document at all, as the organic statutes applicable to most unincorporated organizations do not require that the agreement be in writing.

Part I of the article discusses the basic rules for the operation of organizations exempt from taxes under I.R.C. § 501(c)(3) (exempt organizations) and other nonprofit organizations, including the tax concepts as unrelated business taxable income. Part II discusses the effect that membership in an LLC has on the exemption status of an exempt organization. Part III considers an LLC organized as a nonprofit, particularly as an exempt organization. Part IV explores hybrid organizations, including B corporations and low-profit limited liability companies. Part V discusses drafting considerations when establishing a nonprofit or hybrid LLC.

I. NONPROFIT ORGANIZATIONS

A. General Concepts

There are three common types of organizations that are not organized for profit: (1) organizations that are organized for public benefit under I.R.C. § 501(c)(3) (commonly referred to as "charities" or "public benefit organizations");[12] (2) organizations that are organized for the mutual benefit of their owners, although not for the financial profit of the organization (such as business leagues, homeowners associations, and the like, sometimes referred to as "mutual benefit organizations"); and (3) religious organizations. Each of these organizations may be "exempt," meaning that except for unrelated business taxable income (UBTI), which is discussed below, the income (often including contributions by members) is not taxed to the organization as a result of the exemption under I.R.C. § 501(a). The mere fact that an organization is "exempt" does not mean that contributions to the organization will be deductible. Only contributions to certain charitable organizations and religious organizations are deductible.[13] The Internal Revenue Service (Service) may treat a disregarded LLC owned by a charitable organization as a disregarded entity that can be included on the exempt organization's return,[14] but it is

12. I.R.C. § 501(c)(3) (2000). Like I.R.C. § 170(c)(2), discussed below, section 501(c)(3) includes religious purposes with other public benefit purposes. *Id.* Nonetheless, for reasons beyond the scope of this article many of which are based upon the constitutional protection of religious organizations, organizations created for religious purposes are generally subject to slightly different treatment under state and federal tax rules. For purposes of this article, references to charitable organizations will generally refer to organizations organized for public benefit other than religious organizations. *See generally* Bradley T. Borden, *Limited Liability Companies as Exempt Organizations*, 33 EST., GIFTS & TR. J. 150 (2008), *available at* http://ssrn.com/abstract=1142924.

13. I.R.C. § 170(c)(2) (2000).

14. *See* AM. LAW INST., PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS, at 19-20 (Council Draft No. 5, Sept. 17, 2007) [hereinafter ALI, NONPROFIT LAW, Council Draft No. 5] (citing I.R.S. Ann. 99-102, 1999043 I.R.B. 545; I.R.S. Priv. Ltr. Rul. 200551023 (Sept. 28, 2005); Krista M. McCarden, *The Deductibility of Contributions to Single-Member LLCs Owned by Exempt Organizations*, 49 EXEMPT ORG. TAX REV. 233 (2005)); *see also* I.R.S. Priv. Ltr. Rul. 200150027 (Aug. 7, 2001) (single-member LLC owned by a community foundation disregarded as an entity separate from its owner). *But see* Rev. Proc. 2002-1, 2002-1 C.B. 1

unclear whether a contribution to a disregarded entity will be tax deductible.[15]

Some states will not treat an exempt LLC as a charitable organization for purposes of property tax exemption.[16] Contributions to other exempt organizations are not deductible as charitable contributions.[17] In addition to its federal tax treatment, an organization's status as a charitable organization is important to other rules applicable to it or to others dealing with it. For example, some charitable organizations are granted state property tax exemptions by virtue of that status. A charitable organization's status also makes it a permissible recipient of contributions from other charitable corporations or governmental agencies.

In order to qualify as a charitable organization, an organization must be organized and operated exclusively for one or more exempt purposes.[18] Historically, most charitable organizations have been organized as trusts, foundations, or corporations. The choice of legal form will have some consequences, but there are also overriding policies that apply to charitable organizations of all types (or, in some cases such as health care, charitable organizations of particular types).[19] Under the laws of most states, corporate

(declining to rule on whether a contribution of property to a disregarded entity owned by LLC tax deductible).

15. I.R.S. Priv. Ltr. Rul. 200150027 (Dec. 14, 2001) (finding single-member LLC owned by a community foundation disregarded as an entity separate from its owner). Relying on Rev. Proc. 2002-1, which declined to rule on whether a contribution of property to a disregarded entity owned by a charitable organization would be deductible to the contributor, the IRS stated that there is inadequate authority for allowing a deduction under I.R.C. § 170 for the contribution to the disregarded entity. *Id.*

16. *See* CFM Buckley/North L.L.C. v. Bd. of Assessors of Town of Greenfield, 2007 STT 59-10 (Mass. App. Tax Bd. Mar. 20, 2007).

17. Many "mutual benefit" nonprofit organizations, such as homeowners associations or social clubs, may be exempt from federal income tax. *See* I.R.C. §§ 501(c)(7), 528. Contributions to such organizations, however, are not deductible as charitable contributions. I.R.C. § 170(c). For purposes of this article, the term "exempt" will refer to those organizations that are exempt from taxation and contributions to which are deductible. I.R.C. §§ 501(c)(3), 170(c).

18. I.R.C. § 501(c)(3) describes qualifying organizations as

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

19. *See* ALI, NONPROFIT LAW, Council Draft No. 5, *supra* note 14, at 4-5. As stated by the ALI,

> Subsection (a) follows the position expressed by the Delaware Supreme Court that the founder's choice of the legal form for a charity, like other aspects of donor intent, should be entitled to deference. . . . The choice of form might be influenced by the legal effects of that choice. While, in theory, the donor also chooses the concomitant legal regime, these Principles do not adopt a monolithic approach as to all issues. Rather, these Principles specify, issue by issue, when they

charitable organizations are organized under a separate nonprofit corporation statute, although charitable corporations in Delaware are organized as non-stock corporations under the Delaware General Corporation Law.[20] Neither the Revised Model Nonprofit Corporation Act (RMNCA)[21] nor the recently completed Model Nonprofit Corporation Act, Third Edition (MNCA)[22] limits the operation of a nonprofit corporation to nonprofit purposes,[23] although both proscribe interim distributions.[24] Under the nonprofit corporation statutes of many states, the attorney general is expressly given authority to regulate the affairs of nonprofit corporations.[25] The MNCA limits the attorney general's role in organizational governance.[26] This approach has drawn criticism from the reporter on the ALI Principles of Nonprofit Organizations.[27]

> apply equally to all charities regardless of their organizational form, or, by contrast, when different results obtain for charitable trusts and for nonprofit corporate charities. Among the most important potential differences between charitable trusts and nonprofit charitable corporations are fiduciary standards and consequences for breach; settlor and donor control versus decisional autonomy for the governing board; and supervisory regimes. In these three important areas, however, trust and corporate law have been conforming, with the general result that corporate fiduciary standards of conduct are being applied to both trustees of charitable trusts and members of a nonprofit corporate board (see Chapter 3); trust doctrine applies to modifying restrictions on gifts (see Chapter 4, but compare corporate change of purpose in 5 240); and regulators generally have the same enforcement powers regardless of a charity's organizational form (see also Chapter 6).

Id.

20. DEL. CODE ANN. tit. 8, § 101 (2008).

21. REVISED MODEL NONPROFIT CORP. ACT (RMNCA) § 3.01 (1987).

22. MODEL NONPROFIT CORP. ACT (MNCA) (2008).

23. *Id.* § 3.01(a) ("Every nonprofit corporation has the purpose of engaging in any lawful activity unless a more limited purpose is set forth in the articles of incorporation.").

24. REVISED MODEL NONPROFIT CORP. ACT § 13.02 (1988). The RMNCA divides nonprofit corporations into three categories: public benefit (typically 502(c)(3) organizations), mutual benefit (typically non-501(c)(3) organizations such as social clubs and associations), and religious organizations. *Prefatory Note* to 42 U.S.C. § 1983, at xxiv-xxx (2006); *see also* MNCA § 6.40(a) ("Except as permitted under Section 6.22 [which provides that a nonprofit corporation other than a charitable corporation may provide for repurchase of memberships from members] or 6.41 [dealing with compensation and other permitted payments], a nonprofit corporation shall not pay dividends or make distributions of any part of its assets, income, or profits to its members, directors, members of a designated body, or officers.").

25. *See* CAL. CORP. CODE §§ 5914-5930 (2003) (giving the attorney general a role in improving dispositions of health care facilities). Some statutes simply refer to common-law powers of the attorney general. *See* MASS. GEN. LAWS ch. 68A, § 7 (2008) ("Nothing in this chapter shall impair the rights and powers of the courts or the attorney general of the commonwealth with respect to any trust or corporation.").

26. *See* MNCA §§ 1.53, 1.70 (providing alternative provisions for adopting states to consider with respect to notification of the attorney general on the commencement of an action against a charitable corporation). The comment to MNCA section 1.70 notes, "This section does not detract from the jurisdiction the attorney general may otherwise have in states adopting this act." Similarly, MNCA section 1.51 provides an alternative provision permitting the attorney general to call a meeting in the case of a charitable corporation. The MNCA also provides alternative provisions requiring the attorney general to approve certain transactions concerning the diversion of property of a charitable corporation from the charitable purpose for which the corporation is organized. *See* MNCA §§ 9.03(b), 10.09, 11.01, 12.02, 14.05.

27. Evelyn Brody & Marion R. Fremont-Smith, *Draft Model Nonprofit Corp. Act Needs Coordination with Tax Code*, TAX NOTES, May 12, 2008, at 617.

It will satisfy this test only if it engages primarily in activities that accomplish one or more of the purposes specified in I.R.C. § 501(c)(3).[28] If more than an insubstantial part of the organization's activities is not in furtherance of an exempt purpose, the organization will not qualify as exempt.[29] In addition, such an organization must both (1) be organized and operated so that no part of its net earnings inures to the benefit of any private shareholder or individual (the proscription against private inurement),[30] and (2) not confer more than an incidental private benefit on any individual (the proscription against more than incidental private benefit).[31] The critical distinction between the private inurement and private benefit rules is that the proscription against private inurement is absolute. An incidental amount of private benefit will not jeopardize exempt status, but even the smallest amount of private inurement will. Possibly, as a result of the draconian effects of loss of a charitable organization's exempt status as a result of any private inurement, Congress adopted rules,[32] which are sometimes referred to as "intermediate sanctions," under which a tax is imposed on a "disqualified person" (the beneficiary of the wrongful transaction, referred to as an "excess benefit," rather than the organization) equal to 25 percent or 200 percent of the value of that excess benefit.

In addition, there is a tax of 10 percent of the excess benefit transaction imposed on any "organization manager" who participates in an excess benefit transaction knowing that it is such a transaction, unless the participation is not willful and is due to reasonable cause. In a partnership or LLC, most general partners, managers, and members of a member-managed LLC will have the right to participate in the management of the organization. Because the manager of the LLC is not an officer, director, or trustee of the charitable hospital, the determination of whether the manager is an "organization manager" under the intermediation sanctions rules would have to be made by determining whether the manager of the LLC, through its control of the LLC's business, would have "powers and responsibilities similar to those of officers, directors, or trustees" of the charitable member. Whether a partner, manager, or member would be a "disqualified person" will probably turn on the actual degree of control or influence held by such person in the operation of the organization.

28. Treas. Reg. § 1.501(c)(3)-1(c)(1) (2008).

29. *See* I.R.S. Priv. Ltr. Rul. 9637050; *see also* Better Bus. Bureau of Wash., D.C. v. United States, 326 U.S. 279, 283 (1945) (holding that the presence of a single nonexempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes).

30. Treas. Reg. § 1.501(c)(3)-1(c)(2) (2008).

31. I.R.C. § 501(c)(3) (2008).

32. I.R.C. § 4958(a)(1) (2008) (imposing taxes on excess benefit transactions).

B. UBTI

As noted above, an exempt organization will not ordinarily be taxed on its receipts. Nonetheless, income constituting unrelated business taxable income (UBTI) is subject to tax. UBTI is the gross income derived by any exempt organization from any unrelated trade or business it regularly carries on less the deductions allowed reduced by the deductions directly connected with the carrying on of such trade or business.[33]

Income is UBTI if (1) it is income from a trade or business, (2) such trade or business is regularly carried on by the organization, and (3) the conduct of such trade or business is not substantially related to the organization's performance of its exempt function.[34] Certain forms of income are generally excluded from UBTI, including dividends, interest, royalties, rents from real property, rents from personal property leased with real property if the rents attributable to such personal property are an incidental amount of the total rents received under the lease, and gains from the sale of property other than inventory or property held primarily for sale to customers in the ordinary course of the trade or business.[35]

Notwithstanding the exclusions from UBTI listed above, income from property is included in UBTI to the extent that the property is "debt-financed."[36] The term "debt-financed property" means any property held to produce income with respect to which there is an acquisition indebtedness. The term does not include, however, any property substantially all of the use of which is substantially related (aside from the need for funds) to the performance of an exempt purpose.[37] "Substantially" is defined as 85 percent or more.[38] "Acquisition indebtedness" is an indebtedness incurred in acquiring or improving property or an indebtedness incurred before or after the acquisition or improvement of property, if such indebtedness would not have been incurred but for such acquisition or improvement.[39] An unrelated trade or business is one that is not substantially related (other than the need for funds) to the exempt purposes of the organization.[40] Excessive UBTI within an exempt organization can lead to loss of exempt status.

The characterization of income from another organization received by an exempt organization as UBTI will turn on the tax characterization of the organization from which the exempt organization receives the income. As

33. I.R.C. § 512(a)(1) (2000).

34. Treas. Reg. § 1.513-1(a) (1980).

35. I.R.C. § 512(b) (2000).

36. Treas. Reg. § 1.501(c)(3)-1(c)(1) (1980).

37. I.R.C. § 514(b)(1) (2000).

38. Treas. Reg. § 1.514(b)-1(b)(1)(ii) (1980).

39. I.R.C. § 514(c)(1) (2000); *see also* I.R.S. Priv. Ltr. Rul. 200538027 (Sept. 23, 2005) (the operations of a wholly owned LLC is merely an instrumentality of exempt parent so a building owned by the LLC is treated as owned by the parent for purposes of the debt financed real estate rules under IRC § 514).

40. I.R.C. § 513(a) (2000).

noted above, an LLC with two or more members may be treated as a tax partnership, a tax corporation, or a tax exempt organization in its own right, and an LLC with one member may be treated as a tax corporation or a tax exempt organization, or it may be disregarded as a separate taxable entity. Thus, the characterization of income received by a tax-exempt organization owing an interest in an LLC as UBTI will turn on the tax treatment of the LLC.

If a trade or business regularly carried on by a tax partnership[41] of which an exempt organization is a partner is an unrelated trade or business with respect to the exempt organization, the exempt organization must include its share of the gross income and related deductions from such unrelated trade or business in its calculation of UBTI.[42] Thus, if the LLC is treated as a tax partnership and is engaged in an unrelated trade or business, the exempt organization will be treated as having UBTI. To the extent the LLC is not engaged in a trade or business or the trade or business of the LLC is related to the exempt organization's trade or business, the income will not be treated as UBTI. No distinction is made between general and limited partners for purposes of this rule.[43] Indebtedness incurred to acquire real property will be excluded from "acquisition indebtedness" if all of the partners are exempt or the allocations of deductions meet certain requirements.[44] Generally, the requirements mandate that the allocations of profits and losses be made in accordance with the treasury regulations applicable to allocations having substantial economic effect.[45]

Effective in 1998, an exempt organization may be a shareholder in an S corporation.[46] The income and deductions and the gain or loss from the disposition of stock in the S corporation will be treated as UBTI if the business engaged in by the S corporation is not substantially related to the exempt organization's charitable purposes.[47] Rules with regard to the determination of the amount of acquisition indebtedness will apply to S corporations.[48] The exempt organization's interest in the S corporation is treated as an interest in an unrelated trade or business; and all items of income, loss, or deduction taken into account under I.R.C. § 1366(a) and any gain or loss on the disposition of the stock in the S corporation shall be taken into account in computing the

41. *See infra* Part II (discussing treatment of an exempt organization as a partner in a partnership).

42. I.R.C. § 512(c) (2000).

43. Rev. Rul 79-222, 1979-2 C.B. 236. It is worth noting that if the exempt organization is a general partner, the discharge of its responsibilities and the incurring of liabilities in that capacity may constitute activities by the exempt organization that are inconsistent with its exemption. *See infra* Part II.B.

44. I.R.C. § 514(c)(9)(b)(vi) (2000).

45. Treas. Reg. § 1.704-1(b) (2008).

46. I.R.C. § 1361(c)(6) (2007).

47. I.R.C. § 512(e) (2008).

48. I.R.C. § 514(c)(9)(D), although it is likely that in the case of real estate the one class of stock rules applicable to S corporations should cause the allocations to fit within the requirements of I.R.C. §§ 514(c)(9)(B)(vi), 514(9)(E).

exempt organization's UBTI.[49] The requirement is intended to ensure a "tax indifferent" organization. Tax indifferent organizations are those generally not subject to United States tax, such as exempt organizations and non-resident aliens.[50] The obvious concern with respect to tax indifferent organizations is that to the extent income of a pass-through organization is allocated to such an organization, the income will completely escape United States income tax.

Inasmuch as "dividends" from a C corporation are expressly excluded from UBTI, the earnings of an LLC treated as a C corporation should not be subject to UBTI, but the C corporation will not be exempt.[51] Corporate dividends are generally excluded from UBTI for two reasons. First, the exempt organization *qua* shareholder is generally not engaged in a trade or business, thus the "business" component of UBTI is missing. This is further buttressed by the second reason, which is that while the exempt organization is exempt, the corporation will ultimately be subject to tax. If the corporation is a C corporation, it will be taxed on its income.[52]

The Internal Revenue Code allows tax-exempt organizations to be shareholders in an S corporation. If the corporation is an S corporation, the income of the corporation passed through to the exempt organization and any gain on the exempt organization's sale of its interest will be treated as UBTI.[53] If the LLC in which the exempt organization is a member is disregarded as an entity separate from its owner, the member will be subject to UBTI to the same extent as if it conducted the business itself.[54]

In the event an LLC elects to be treated as an exempt organization in its own right, its exempt member should not recognize UBTI. For example, an exempt organization that is a member in an LLC treated as an association taxable as a corporation may be eligible to be treated as an exempt organization[55] or a homeowner's association[56] will not have UBTI.

49. I.R.C. § 512(e)(1) (2007).

50. While the term "tax indifferent" organization has been common, it has only recently been expressly made part of the Code. *See* I.R.C. § 457A (2007).

51. I.R.C. § 502 (2008).

52. I.R.C. § 311 (2006).

53. *See infra* Part III (discussing rules applicable to S corporations with exempt shareholders).

54. *See supra* note 15 and accompanying text (discussing treatment of the disregarded entity as an exempt organization).

55. *See* I.R.S. Exemption Rul., Island Club Inv. Group, L.L.C., 2002 WL 487199 (Mar. 28, 2002) (holding LLC to be an exempt title holding company under IRC § 501(c)(25)).

56. I.R.S. Gen. Couns. Mem. 37658 (Aug. 31, 1978) (an unincorporated group of condominium owners who joined together in order to manage and maintain their commonly owned property is classified under I.R.C. § 7701 as an association taxable as a corporation and qualifies as and may elect to be taxed as a "homeowners association" under I.R.C. § 528).

II. THE EFFECT OF MEMBERSHIP IN AN LLC ON THE EXEMPTION OF THE EXEMPT ORGANIZATION

In addition to the issue of UBTI, an organization may meet the requirements for exemption under I.R.C. § 501(c)(3) even though it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business.[57] If the nonexempt activities of an organization are more than incidental or insubstantial, the organization is not entitled to exemption, regardless of the number or importance of its exempt purposes.[58]

A. General Background

The position of the Service on the effect of a charitable organization's participation in an organization taxed as a partnership has evolved over time. Initially, the government took the position that the organization was absolutely prohibited from being a general partner based on an inherent conflict of interest between the exempt purposes of the organization and the duties of a general partner to the partnership and the other partners.[59] As a general partner, the organization has a fiduciary duty to the other partners to manage the partnership for profit,[60] a duty inconsistent with the organization's obligation to operate exclusively for exempt purposes. In 1979, the Service modified its position, holding that a charitable organization could be a partner with a for-profit organization sharing the expenses and the output of a blood fractionation laboratory without jeopardizing its exempt status.[61]

In *Plumstead Theatre Society, Inc. v. Commissioner*,[62] the court concluded that a theatrical production company that was a charitable organization could serve as a general partner in a limited partnership in order to raise revenue to operate its theater without losing its exemption.[63] Based on *Plumstead*, the Service released General Counsel Memorandum 39005[64] in which it established a two-part test for when an exempt organization may participate as a general partner in a joint venture that included for-profit partners. Under the GCM, a charitable organization's exemption will not be jeopardized because it acts as a general partner if (1) doing so furthers the exempt purposes of the

57. Treas. Reg. § 1.501(c)(3)-1(e)(1) (2008).

58. *See generally* Better Bus. Bureau of Wash., D.C. v. United States, 326 U.S. 279 (1945); Copyright Clearance Ctr., Inc. v. Comm'r, 79 T.C. 793 (1982).

59. I.R.S. Gen. Couns. Mem. 36293 (May 30, 1975).

60. *See supra* note 8.

61. I.R.S. Gen. Couns. Mem. 37852 (Feb. 15, 1979).

62. 675 F.2d 244 (9th Cir. 1982).

63. *Id.* at 244.

64. I.R.S. Gen. Couns. Mem. 39005 (June 28, 1983).

charitable organization and (2) as the general partner, the charitable organization is not prevented from acting exclusively in furtherance of its exempt purposes and does not confer a substantial private benefit on the for-profit partner.[65]

The critical issue in both *Plumstead* and GCM 39005 was the degree of control that the exempt organization had over the partnership. While GCM 39005 dealt with a situation in which the exempt organization was one of two general partners, subsequent GCMs have dealt with the exempt organization as the sole general partner, using the same two-prong test.[66]

Whether or not a charitable organization may participate in a partnership as a general partner pursuant to the two-part test of GCM 39005, it may still participate as a limited partner without jeopardizing its exemption. Just as an exempt organization may be a shareholder in a corporation, it may own an interest in a limited partnership, although where the partnership is not being operated in furtherance of the charitable organization's exempt purposes, the charitable organization's share of the limited partnership may constitute UBTI.[67]

Subject to certain requirements with respect to excess investments and the possibility that the income will be treated as UBTI, an exempt organization may invest its funds in passive investments without threatening its exempt status. For this reason, an exempt organization may generally receive dividends or income as a limited partner without jeopardizing its status. If, however, the organization's participation in the investment is more active, such as that of a general partner, that participation may cause a loss of tax exemption unless the participation meets more subtle tests and safeguards designed to ensure that the participation does not adversely affect the organization's fulfillment of the purposes giving rise to its exemption. The treatment of an exempt organization as an equity owner will vary depending on the nature of the organization.

In *Redlands Surgical Services v. Commissioner*,[68] relating to a period before the release of Revenue Procedure 98-15, the Tax Court suggested that the presence of a single nonexempt purpose, if substantial in nature, precludes exempt status, regardless of the number or importance of truly exempt purposes.[69] In *St. David's Health Care System v. United States*,[70] the court interpreted the test in *Redlands* as determining whether the joint venture is

65. *Id.*

66. *See* I.R.S. Gen. Couns. Mem. 39444 (Nov. 13, 1985); *see also* I.R.S. Priv. Ltr. Rul. 9709014 (Feb. 28, 1997); I.R.S. Priv. Ltr. Rul. 9518014 (May 5, 1995).

67. *See* I.R.S. Priv. Ltr. Rul. 9642051 (Oct. 18, 1996).

68. 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001).

69. *Id.* at 72; *see also* Quality Auditing Co., Inc. v. Comm'r, 114 T.C. 498 (2000).

70. 349 F.3d 232 (5th Cir. 2003).

largely unfettered by charitable objectives.[71] In *St. David's*, the trial court noted that the hospital had a community board whose purpose was to ensure that the community's interests are given precedence over any private interests.[72] The partnership contract required that all hospitals owned by the partnership operate in accord with the community benefit standard.[73] Should the hospitals fail to meet that standard, St. David's had the unilateral right to dissolve the partnership.[74]

On appeal, the Fifth Circuit held that the determination of whether a nonprofit organization that enters into a partnership operates exclusively for exempt purposes is not limited to "whether the partnership provides some (or even an extensive amount of) charitable services."[75] The court further indicated that the nonprofit partner also must have the "capacity to ensure that the partnership's operations further charitable purposes," and that "the nonprofit should lose its exempt status if it cedes control to the for-profit entity."[76] Thus, the case was remanded to the trial court for a determination of whether the exempt hospital ceded control of the partnership to the for-profit partner.[77]

B. Revenue Rulings 98-15 and 2004-51

While *Plumstead* involved a limited partnership, there has been concern about whether partnership law could allow the purposes of the partnership to allow the exempt purposes of the charitable partner to control the conduct of the business of the partnership. An increasing number of limited liability company statutes permit an LLC to be organized for a nonprofit purpose.[78] This statutory flexibility facilitates establishing an LLC as a nonprofit organization in which the purpose of the exempt organization will be respected in the operation of the LLC.[79]

The IRS has issued several private letter rulings regarding the participation of exempt organizations in LLCs.[80] The rulings suggest that considerations similar to those outlined in GCM 39005 should apply. In March 1998, the IRS

71. *Id.* at 239.

72. St. David's Health Care Sys. v. United States, No. Civ.A-01-CA-046-N, 2002 WL 1335230, at *5 (W.D. Tex. June 7, 2002), *vacated*, 349 F.3d 232 (5th Cir. 2003).

73. *Id.* at *7.

74. *Id.*

75. *St. David's Health Care Sys.*, 349 F.3d at 236-37.

76. *Id.* at 235, 243.

77. *Id.* at 244.

78. *See* DEL. CODE ANN. tit. 6, § 18-106(a) ("A limited liability company may carry on any lawful business, purpose or activity, whether or not for profit, with the exception of the business of banking as defined in § 126 of Title 8").

79. *See infra* Part III.

80. I.R.S. Priv. Ltr. Rul. 9637050 (June 18, 1996); I.R.S. Priv. Ltr. Rul. 9517029 (Jan. 27, 1995).

provided significant guidance in Revenue Ruling 98-15,[81] on the participation of an exempt organization in a joint venture as a member of a limited liability company. In the ruling, a hospital qualified as exempt under I.R.C. § 501(c)(3) contributes its hospital and other operating assets to an LLC that will operate the hospital. The only other member of the LLC is a for-profit corporation. The ruling sets forth two alternative situations.

In Situation 1, the LLC's governing documents provide that the LLC will be managed by a board of five people, three of whom are appointed by the exempt organization. The exempt organization intends to appoint community leaders who have experience with hospital matters but who are not on the hospital staff and do not otherwise engage in business transactions with the hospital as members of the board.

The governing documents specifically provide that the LLC will operate the hospital in furtherance of charitable purposes by promoting health for a broad cross section of the community and that the board must allow this duty to override any duty the board might have to operate the LLC for the financial benefit of its owners. In this respect, the operating agreement places the charitable purposes of the exempt member ahead of the board's fiduciary duties to operate the LLC for the benefit of its members. The governing documents could be changed only by the consent of both members, and all returns of capital and distributions of earnings made to owners of the LLC shall be proportional to their ownership interests in the LLC. The exempt member intends to use its share of the proceeds in furtherance of its exempt purpose.

The LLC enters into a management agreement with an independent management company to provide day-to-day management services. The management agreement is for a five-year period, renewable for additional five-year periods by mutual consent. The management company will be paid a management fee for its services based on the LLC's gross revenue. The terms and conditions of the management agreement, including the fee structure and the contract term, are reasonable and comparable to what other management firms receive for similar services at similarly situated hospitals. The LLC may terminate the agreement for cause.

Situation 2 is the same as Situation 1, except for the following: (1) there is no provision in the operating agreement requiring that the hospital be operated for community benefit or that this purpose supersedes any profitable motivation; (2) the governing board is evenly divided, with each member entitled to appoint three members; (3) the management company that handles the day-to-day management is a wholly owned subsidiary of the for-profit organization; (4) the management contract is renewable solely at the management company's discretion; and (5) the exempt organization agrees to approve the selection of two of the for-profit's former employees as chief

81. Rev. Rul. 98-15, 1998-1 C.B. 718 (Mar. 4, 1998).

executive officer and chief financial officer of the LLC.

On these facts, the IRS ruled that the exempt hospital in Situation 1 will not lose its exempt status as a result of entering into the joint venture. For several reasons, however, the exempt hospital in Situation 2 fails to meet the requirements to be an organization described in I.R.C. § 501(c)(3) when it forms the LLC and contributes all of its operating assets to the LLC because the exempt hospital "has failed to establish that it will be operated exclusively for exempt purposes."[82]

In denying qualification to the exempt hospital in Situation 2, the IRS, citing *Plumstead* and *Housing Pioneers, Inc. v. Commissioner*,[83] stated that an organization that is exempt under I.R.C. § 501(c)(3) may form and participate in a partnership or LLC—but only if (1) the exempt organization's participation in the organization furthers a charitable purpose, and (2) the governing documents permit the exempt organization to act exclusively in furtherance of its exempt purpose (and only incidentally for the benefit of the for-profit partners).[84]

Similarly, the ruling holds that an exempt organization will not lose its exemption solely as a result of entering into a management contract with a private party, giving that party authority to conduct activities on behalf of the organization and direct the use of the organization's assets, provided that (1) the organization retains ultimate authority over the assets and activities being managed and (2) the terms and conditions of the contract are reasonable. If, however, an operational manager of the partnership or LLC who conducts the day-to-day business is allowed to control or use the nonprofit organization's activities or assets for its own benefit and this benefit is not incidental to the accomplishment of exempt purposes, the organization will fail to be organized and operated exclusively for exempt purposes.[85]

In Situation 2, the exempt organization violates these rules by failing to have a governing document in place that requires that the LLC be operated for charitable purposes, failing to maintain more than 50 percent control over the LLC, failing to contract with day-to-day operational managers that are independent of the for-profit member, and failing to retain sufficient control over the managers (particularly with respect to the right to terminate the arrangement). Although the exempt organization receives fair value for its contribution and will apply the proceeds of that value to charitable purposes, it violates the requirements for exempt status by allowing the LLC to be operated more than incidentally for a for-profit purpose.

82. *Id.* From the context, it is not clear whether it is the LLC or the exempt organization that will not be operated exclusively for exempt purposes, although the better reading is that the reference is to the exempt organization. *Id.*

83. 58 F.3d 401 (9th Cir. 1995).

84. Rev. Rul. 98-15, 1998-1 C.B. 718 (Mar. 4, 1998).

85. *Id.*

It remains unclear what would happen if the facts were to fall between the two situations—for example, if there were equal control over the LLC operating management, but the agreement provided that the management will put the charitable purpose before the for-profit purpose. However, the Ruling provides some clear guidance with respect to the sort of arrangements that will be respected.[86]

One question that will arise in structuring these transactions is whether a provision in the operating agreement will be respected where it requires an LLC to conduct its business in furtherance of the charitable objectives of the organization, in preference to the fiduciary duty to make the assets of the LLC profitable and productive for the LLC's members. It seems likely that under many limited liability company acts, such a provision, particularly if written clearly into the operating agreement, would be respected. This will be true where the act under which an LLC is organized does not require that the LLC be organized for profit, particularly where the act also is clear that members may modify the duties owed by the members to each other in the operating agreement. In light of the public policy favoring charitable undertakings, it seems unlikely that a court would set aside a well-drafted operating agreement that put the purposes of the exempt organization ahead of for-profit motives.

In Technical Advice Memorandum 200218037,[87] an exempt corporation formed a limited partnership to operating a magnetic resonance imaging (MRI) facility.[88] The Service challenged the corporation's exemption as a result of its involvement in the partnership. On a request for technical advice, the national office issued the following ruling: (1) Because the corporation was organized for a charitable purpose and retained control over the limited partnership, it would continue to qualify as an exempt organization under I.R.C. § 501(c)(3), and the limited partnership operates an MRI facility in accordance with the community benefit standards, outlined in Revenue Ruling 69-545, and furthers charitable purposes under I.R.C. § 501(c)(3); (2) The corporation does not qualify as a supporting organization under I.R.C. § 509(a)(3) because some of the organizations being supported by the limited partnerships are other supporting organizations, but does qualify as other than a private foundation under I.R.C. § 509(a) as being described in I.R.C. § 509(a)(1) and § 170(b)(1)(A)(iii) or I.R.C. § 509(a)(2); (3) Certain administrative and management fees received from the limited partnership constitute unrelated business taxable income to the corporation; and (4) The corporation's receipt of distributions from the limited partnership does not result in unrelated business taxable income because the limited partnership's activities are substantially

86. *Id.*
87. I.R.S. Tech. Adv. Mem. 200218037 (Mar. 27, 2002).
88. *Id.*

related to the furtherance of the exempt purposes of the corporation.[89]

The Service found that the corporation's control over the limited partnership was sufficient to cause its activities through the limited partnership to be in furtherance of the corporation's exempt purposes, but found the presence of some non-exempt partners in the partnership sufficient to prevent the administrative fees paid by the partnership to constitute unrelated taxable income and to prevent the corporation from qualifying as a supporting organization.[90]

Revenue Ruling 2004-51[91] describes a joint venture between an exempt university teaching program and a for-profit company that conducts interactive video training. The governing documents of the venture grant the exempt member the exclusive right to approve the curriculum, training materials, and instructors, as well as to determine the standards for successful completion of the seminars and to grant the for-profit member the exclusive right both to select the locations where participants can receive a video link to the seminars, and to approve other personnel (such as camera operators) necessary to conduct the video teacher training seminars. All other actions require the mutual consent of the members. They also require that all contracts be at arm's-length for fair market value and preclude the venture from conducting any activities that would jeopardize the exempt partner's exempt status, and the venture is, in fact, operated in accordance with those provisions. Profits from the venture are shared in proportion to capital contributions. The ruling considers both *Redlands* and *St. David's* and holds that the venture will not cause the exempt member to cease to qualify for its exemption and that the income received from the venture will not constitute UBTI.[92]

Generally, ownership of stock in a C corporation should not disqualify an organization as exempt, although certain payments from controlled corporations may give rise to UBTI.[93] Recent legislation has allowed exempt organizations to be shareholders in S corporations. It is unclear, however, whether rules similar to those described below, being developed for LLCs, will be applied to exempt S corporation shareholders.

If an exempt organization is a member or a partner of an LLC or partnership that regularly carries on a trade or business that would be an unrelated trade or business with respect to the exempt organization, the exempt organization shall include the gross income and deductions of such partnership in computing its UBTI.[94] A tax determined under I.R.C. § 511 is imposed on the UBTI of a

89. *Id.*
90. *Id.*
91. Rev. Rul. 2004-51, 2004-1 C.B. 974 (May 7, 2004).
92. *Id.*
93. I.R.C. § 512(b)(13) (2008).
94. *Id.* § 512(c)(1).

charitable organization that would otherwise be taxable as a corporation.[95] UBTI will be taxed at trust rates for a charitable organization that would otherwise be taxable as a trust.[96]

In Private Letter Ruling 200123033, the Service ruled that distributions from an LLC that served as a joint venture among cooperatives and was established in such a manner as to further the cooperative purposes of its members would be treated as patronage sourced income.[97]

The Service recently announced that it will no longer issue private letter rulings on whether a joint venture with a for-profit organization will result in unrelated business income or adversely affect an organization's exempt status, other than as part of an application for recognition of exempt status.[98]

III. LLCS AS EXEMPT ORGANIZATIONS

Although it may not have been considered twenty years ago, there is now no question that an LLC may be treated as a nonprofit organization, including as a charitable organization. Unlike general partnerships, LLCs under most LLC statutes are not limited to being "for-profit" organizations. This has been reflected in many of the LLC statutes.

State LLC laws vary on the purposes for which an LLC may be organized. An LLC's operating agreement allows hybrid ventures to be formed between for-profit and not-for-profit entities to exist in many states, however, they are statutorily limited through their required-purpose clauses. There are eighteen unique purposes among the states and uniform acts; however, most states use the default, "any lawful purpose or purposes," or some derivative of this language.[99] States limit this breadth by merely excepting the areas of business

95. *Id.* § 511(a)(1).

96. *Id.* § 511(b)(1).

97. I.R.S. Priv. Ltr. Rul. 200123033 (June 8, 2001).

98. Rev. Proc. 2006-4, 2006-1 C.B. 132, § 6.12 (Jan. 3, 2006). According to the American Law Institute,

> The position of the IRS and the courts on exempt organization joint venture activities with taxable participants should be viewed as still developing. See John G. Simon, Harvey Dale & Laura B. Chisolm, The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies, in The Nonprofit Sector: A Research Handbook 267 (2d ed., Walter W. Powell & Richard Steinberg, ed. 2006): "In the interest of protecting the third sector from distortion of purpose or from public distrust, should legislative and administrative policy-makers build less permeable fences between the nonprofit and the for-profit territories? Or will such barriers have perverse effects on both of these sectors? And, in any event . . . are either of these questions properly addressed by the tax system?'"

ALI, NONPROFIT LAW, Council Draft No. 5, *supra* note 14, at 70.

99. The following statutes provide for any lawful business regardless of whether for profit: Alabama (ALA. CODE § 10-12-3 (2008)); Alaska (ALASKA STAT. § 10.50.010 (2008)); Arkansas (ARK. CODE ANN. § 4-32-106 (2008)); Colorado (COLO. REV. STAT. § 7-80-103 (2008)); Florida (FLA. STAT. § 608.403 (2008)); Georgia (GA. CODE ANN. § 14-11-201 (2008)); Hawaii (HAW. REV. STAT. 3819 § 428-111 (2008)); Idaho (IDAHO CODE ANN. § 53-605(1) (2008)); Indiana (IND. CODE § 53-605(1) (2008)); Iowa (IOWA CODE § 490A.201 (2008)); Kentucky (KY. REV. STAT. ANN. § 275.005 (2008)); Maine (ME. REV. STAT. ANN. tit. 13, §

for which an LLC may not be formed directly in their purpose clauses.[100] The states using the most common or default language do not impede an LLC being formed for either profit or nonprofit purposes.

Following the default language and exceptions, some statutes define the allowable purposes using "any business" or similar language.[101] As with the default language, states then add exceptions to the "any business" language.[102] The final groups of statutes define an LLC using terms such as "business purpose" and "activity."[103] Many of these statutes pose a problem to hybrid

611 (2008)); Massachusetts (MASS. GEN. LAWS ch. 156(c), § 6(a) (2008)); Mississippi (MISS. CODE. ANN. § 79-29-108 (2008)); Missouri (MO. REV. STAT. § 347.035 (2008)); New Jersey (N.J. REV. STAT. § 42:2B-8(a) (2008)); Nevada (NEV. REV. STAT. § 86.141 (2008)); New Mexico (N.M. STAT. ANN. § 53-19-6 (2008)); South Carolina (S.C. CODE ANN. 4830 § 33-44-1112(a) (2008)); South Dakota (S.D. CODIFIED LAWS § 47-34A-112 (2008)); Vermont (VT. STAT. ANN. tit. 11, § 3012 (2008)); Virginia (VA. CODE ANN. § 13.1-1008 (2008)); West Virginia (W. VA. CODE ANN. § 31B-1-112(a) (2008)); Wisconsin (WIS. STAT. § 183.0106(1) (2007)). REVISED PROTOTYPE LTD. LIAB. CO. ACT (RPLLCA) § 104(b) (2008); REVISED UNIF. LTD. LIAB. CO. ACT (RULLCA) § 104 (2006); UNIF. LTD. LIAB. CO. ACT (ULLCA) § 112(a) (1996); PROTOTYPE LTD. LIAB. CO. ACT (PLLCA) § 106 (1992).

100. The following statutes provide for any lawful purpose except insurance: Maryland (MD. CODE ANN., CORPS. & ASSN'S § 4A-201(2008)); Nebraska (NEB. REV. STAT. ANN. § 21-2602 (LexisNexis 2008)); Oklahoma (OKLA. STAT. tit. 18, § 2002 (2008)). The following statutes provide for any lawful purpose, except banking or insurance: Arizona (ARIZ. REV. STAT. ANN. § 29-609 (2008)); Kansas (KAN. STAT. ANN. § 17-7668 (2008)); Louisiana (LA. REV. STAT. ANN. § 12:1302 (2008)); Pennsylvania (15 PA. CONS. STAT. §§ 8914, 8921 (2008)); Texas (TEX. REV. CIV. STAT. ANN. §§ 2.001-2.003 (Vernon 2008)); Wyoming (WYO. STAT. ANN. § 17-15-103 (2008)). The following statutes provide for any lawful purpose for which a domestic corporation or domestic partnership could be formed: Illinois (805 ILL. COMP. STAT. 180/1-25 (2008) (Any lawful purpose or business except insurance, the practice of dentistry, and the practice of medicine)); New Hampshire (N.H. REV. STAT. ANN. § 304-C:7 (2008) (Any lawful purpose except carrying on the business of banking, the construction and maintenance of railroads, the business of making contracts for the payment of money at a fixed date or upon the happening of some contingency, or the business of a trust, surety, indemnity, or safe deposit company)); Michigan (MICH. COMP LAWS § 450.4201 (2008)); Ohio (OHIO REV. CODE ANN. § 1705.02 (2008) (Any purpose or purposes for which individuals lawfully may associate themselves, including for any profit or nonprofit purpose, except that, if the revised code contains special provisions for the formation of any designated type of corporation other than a professional association, a limited liability company shall not be formed for the purpose or purposes for which that type of corporation may be formed)); Oregon (OR. REV. STAT. § 63.074 (2008)).

101. The Utah statute provides that an LLC may be organized for "any business." UTAH CODE ANN. § 48-2c-105 (2008). The following statutes provide that an LLC may be organized for any business: New York (N.Y P'SHIP LAW § 201 (McKinney 2008)); Rhode Island (R.I. GEN. LAWS § 7-16-3 (2008)); Tennessee (TENN. CODE ANN. § 48-203-101 (2008)). The following statutes provide that an LLC may be organized for any lawful business, except as otherwise provided by the laws of the district unless a more limited purpose is set forth in the articles of organization: District of Columbia (D.C. CODE § 29-1001.01 (2008)); Montana (MONT. CODE ANN. § 35-8-106 (2008)); North Carolina (N.C. GEN. STAT. 57C-2-01(a) (2008)).

102. *See* CONN. GEN. STAT. § 34-119 (2008) (Any business or the promotion of any purpose which may be lawfully carried on by a LLC except that of a state bank and trust company. savings bank, industrial bank, or building and loan association).

103. The following states have general business activity provisions: California (CAL. CORP. CODE § 17002 (West 2008)) (Any lawful business activity, whether or not for profit except the banking business, the business of issuing policies of insurance and assuming insurance risks, or the trust company business); Delaware (DEL. CODE ANN., tit. 6, § 18-106(a) (2008)) (Any lawful business purpose, or activity, whether or not for profit, with the exception of the business of banking); Minnesota (MINN. STAT. § 322B.10 (2008)) (Any business purpose); North Dakota (N.D. CENT. CODE § 10-32-04 (2008)) (Any business purpose); Washington (WASH. REV. CODE § 25.15.030(1) (2008)) (Any lawful business or activity).

joint ventures due to varying definitions of the word "business." Several states' definitions clearly allow for nonprofit LLCs,[104] others expressly omit any mention of nonprofit entities,[105] and a third group leaves the term undefined.[106] The multitude of purposes creates a morass that a drafter must venture through to determine whether the joint venture can be formed in that jurisdiction.

The Internal Revenue Code defines a charitable organization as "Corporations, and any community chest, fund, or foundation."[107] Any questions about whether an LLC could fit within the definition of a charitable organization—because it is not a corporation, community chest, fund or foundation—were resolved by the entity classification regulations (sometimes referred to as the "check-the-box" rules), which provide that an unincorporated entity may be treated as a corporation for tax purposes.[108] In fact, the regulations go on to expressly state that any organization that seeks to be treated as an exempt organization will be treated as if it had made such an election.[109] Further, in informal materials, the Service has expressly discussed the manner in which an LLC may become an exempt organization.[110] The

104. The following states define "business" as including nonprofit entities: Montana (MONT. CODE ANN. § 35-8-102 (2008)) ("Business" includes every trade, occupation, profession, or other lawful purpose, whether or not carried on for profit.); North Carolina (N.C. GEN. STAT. § 57C-1-03 (2008)) ("Business" includes any lawful trade, investment, or other purpose or activity, whether or not such trade, investment, purpose, or activity is carried on for profit); Tennessee (TENN. CODE ANN. § 48-202-101 (2008)) ("Business" includes every trade, occupation, profession, investment activity and other lawful purpose for gain or the preservation of assets whether or not carried on for profit.); Utah (UTAH CODE ANN. § 48-2c-102(2) (2008)) ("Business" includes a lawful trade, occupation, profession, business, investment, or other purpose or activity, whether or not that trade, occupation, profession, business, investment, purpose, or activity is carried on for profit.).

105. The following states define "business" as excluding nonprofit entities: New York (N.Y P'SHIP LAW § 102 (McKinney 2008)) ("Business" means every trade, occupation, profession or commercial activity.); Rhode Island (R.I. GEN. LAWS § 7-16-2 (2008)) ("Business" means any trade, occupation or other commercial activity engaged in for gain, profit or livelihood for which a corporation can be organized under chapter 1.2 of this title.).

106. The following states leave "business" undefined: Connecticut (CONN. GEN. STAT. § 34-119 (2008)); District of Columbia (D.C. CODE § 29-1001.01 (2008)); Minnesota (MINN. STAT. § 322B.10 (2008)); North Dakota (N.D. CENT. CODE § 10-32-04 (2008)); Washington (WASH. REV. CODE § 25.15.030(1) (2008)).

107. *See supra* note 18 (setting forth I.R.C. § 501(c)(3)).

108. Treas. Reg. § 301.7701-3(a) (2006).

109. *Id.* § 301.7701-3(c)(1)(v)(A). This regulation provides:

> Exempt organizations. An eligible 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 under this section to be classified as an association. Such election will be effective as of the first day for which exemption is claimed or determined to apply, regardless of when the claim or determination is made, and will remain in effect unless an election is made under paragraph (c)(1)(i) of this section after the date the claim for exempt status is withdrawn or rejected or the date the determination of exempt status is revoked.

110. *See, e.g.*, Internal Revenue Manual, *Limited Liability Company Reference Guide Sheet*, Exhibit 7.20.4-12 (Dec. 5, 2006) [hereinafter *LLC Guide Sheet*], *available at* http://www.irs.gov/charities/article/0,,id=174949,00.html; Richard A. McCray & Ward L. Thomas, *Limited Liability Companies As Exempt Organizations – Update*, 2001 IRS Exempt Organizations Continuing Professional Education Technical

ability of an LLC to become an exempt organization has also been acknowledged as part of the American Law Institute's Principles of the Law of Nonprofit Organizations project (ALI Nonprofit Governance Project).[111] The ALI Nonprofit Governance Project goes on to discuss the qualification of a nonprofit LLC as an exempt organization.[112]

Instruction Program 27 [hereinafter McCray & Thomas, *LLCS As Exempt Organizations* (2001)], *available at* http://www.irs.gov/pub/irs-tege/eotopicb01.pdf; Richard A. McCray & Ward L. Thomas, *Limited Liability Companies as Exempt Organizations*, 2000 IRS Exempt Organizations Continuing Professional Education Technical Instruction Program 111 [hereinafter McCray & Thomas, *LLCs As Exempt Organizations* (2000)], *available at* http://www.irs.gov/pub/irs-tege/eotopich00.pdf.

111. *See* ALI, NONPROFIT LAW, Council Draft No. 5, *supra* note 14, § 200(a) ("The organizers of a charity may choose its legal form, as a charitable trust, a nonprofit corporation, an unincorporated association, or any other form permitted by state law."). The ALI further provides,

> A significant percentage of charities, predominantly those that are small and informal, choose to form as unincorporated associations. Reform projects here, too, seek to protect members from liability and otherwise afford them statutory protections. The newest legal form for charity is the limited liability company (in states that permit an LLC to be formed for a nonprofit purpose). For purposes of obtaining federal tax exemption for the LLC under Internal Revenue Code § 501 (c)(3), one or more other charities must be the only members of the LLC.

Id. § 200 cmt. c.

112. *Id.* § 200 Rptr.'s Note 9. The Official Reporter for the ALI project, Evelyn Brody, explains,

> Forming a charity as a limited liability company ("LLC") is relatively new. For ease of administration and more-desirable governance structure, a charity might prefer to create a single-member LLC ("SMLLC") to a separate charity of which it is the sole member. See Reporter's Note 6 under § 220; see generally Chapter 5 (Members). Tennessee has adopted a Nonprofit LLC statute. See James M. McCarten & Kevin N. Perkey, Tennessee Nonprofit LLCs - A New Option for Exempt Organizations, 3 Transactions 15 (2001) (noting that if "a exempt organization (the 'parent nonprofit') has previously formed a nonprofit subsidiary corporation (the 'subsidiary nonprofit') as a member organization because nonprofit LLCs were not available at the time that the subsidiary nonprofit was formed, the subsidiary nonprofit may be converted into a nonprofit LLC if certain requirements are met.").
>
> Tax rules must also be taken into account. Under the Treasury Department Regulations, the default classification regime for an unincorporated entity (partnership or LLC) is a partnership if there are one or more owners, or a "disregarded entity" if there is only one owner. Treas. Reg. § 301.7701-3. A partnership or LLC is not eligible for separate recognition of federal tax exemption under § 501(c)(3), although if the only partners or members are themselves charities and the enterprise is engaged in charitable activities, the partners' or members' exemptions are not in jeopardy. If a sole member is itself an exempt organization, the single-member LLC (SMLLC) is viewed for exemption purposes as a division or branch of that member. (The Service has not yet ruled, though, on whether donations to a 501(c)(3)'s SMLLC are deductible under Code § 270. See Krista M. McCarden, The Deductibility of Contributions to Single-Member LLCs Owned by Exempt Organizations, 49 Exempt Org. Tax Rev. 233 (2005)). An unincorporated entity may instead elect to be treated as an association taxable as a corporation. Treas. Reg. 3 301.7701-3. Accordingly, a partnership or LLC of charities—or a SMLLC whose sole member is a charity—may make such an election and apply for separate exemption.
>
> As described in a 1999 announcement by the Internal Revenue Service: "Some state limited liability statutes - notably those of California, New York, and Texas - appear to require that an LLC be formed for a business purpose. However, no case law has decided this issue. . . . The IRS requires the satisfaction of 12 conditions, one of which is the LLC represent that state law permits its charitable status." IRS Ann. 99-102, 1999-43 I.R.B. 545. See also Richard A. McCray & Ward L.

The Service has established a Guide Sheet to respond to requests for information on the federal tax treatment of LLCs associated with exempt organizations and applications for treatment as a charitable organization.[113] Under the Guide Sheet, a reviewer may not approve the exempt status of an LLC unless it can respond affirmatively to all of the following statements:

- Do the organizational documents (e.g., Articles of Organization, Operating Agreement (or their equivalents)) include a specific statement limiting the LLC to one or more exempt purposes?
- Do the organizational documents specify that the LLC is operated exclusively to further the exempt purpose(s) of its members?
- Does the organizational language require that the LLC's members be limited to section 501(c)(3) organizations, governmental units, or wholly owned instrumentalities of a state or political subdivision thereof?
- Does the organizational language prohibit any direct or indirect transfer of any membership interest in the LLC to a transferee other than a section 501(c)(3) organization or governmental unit or instrumentality?
- Does the organizational language state that the LLC's assets may only be transferred (whether directly or indirectly) to any nonmember, other than a section 501(c)(3) organization or governmental unit or instrumentality, in exchange for fair market value?
- Does the organizational language provide that upon dissolution of the LLC, the LLC's assets will continue to be devoted to exempt purposes?
- Does the organizational language require that any amendments to

Thomas, Limited Liability Companies as Exempt Organizations - Update, IRS Exempt Organizations Continuing Professional Education Text for FY 2001, at www.irs.gov/eo.

In Private Letter Ruling 200551023 (Sept. 28, 2005), the Service blessed a (c)(3)'s proposal "to form multiple single member LLCs throughout the state to serve the unique needs of each region. Each of these LLCs will enter into a shared governance structure with a local educational or civic organization which has charitable purposes similar to yours and which has a strong, established presence in the region to be served. You believe this new structure will encourage and foster local community involvement while maintaining and institutionalizing your traditional standards of excellence." State tax laws should also be consulted. See, e.g., CFM Buckley/North LLC v. Bd. of Assessors of Town of Greenfield (Mass. App. Tax Bd., March 20, 2006), at 2007 STT 59-10 (Mar. 27, 2007) (ruling that property-tax exemption is not available to a single member LLC whose single member is a charity, because the statute requires the exempt owner to be a charitable corporation or trust).

Id.

113. *LLC Guide Sheet*, *supra* note 110.

the LLC's articles of organization and operating agreement be consistent with section 501(c)(3)?

- Does the organizational language prohibit the LLC from merging with, or converting into, an entity that is not exempt under section 501(c)(3)?
- Does the organizational language prohibit the LLC from distributing any assets, other than in exchange for fair market value, to members who have ceased to be either organizations described in section 501(c)(3) or governmental units or instrumentalities?
- Does the organizational language include an acceptable contingency plan in the event one or more members of the LLC ceases at any time to be an organization described in section 501(c)(3) or a governmental unit or instrumentality?
- Does the organizational language state that the LLC's exempt members will expeditiously and vigorously enforce all of their rights in the LLC and pursue all legal and equitable remedies to protect their interests in the LLC?
- Does the LLC represent, in a separate written statement, that all of its organizing document provisions are consistent with state LLC laws and are enforceable at law and in equity?[114]

The Guide Sheet demonstrates the issues that LLCs present that are not necessarily present in nonprofit corporations, to-wit, the importation of restrictions on the activities of a charitable organization that may not be expressly reflected in the federal tax rules.[115] In particular, the checklist wants

114. *Id.*

115. *See* McCray & Thomas, *LLCs as Exemption Organizations* (2001), *supra* note 110, at 29-32. The authors explained:

> Last year's article posed the question whether an LLC can qualify for exemption under IRC 501(c)(3) (other than as a disregarded entity with a sole exempt organization owner). The Service has determined that it can, under certain conditions.
>
> The Service will recognize the 501(c)(3) exemption of an LLC that otherwise qualifies for exemption if it satisfies each of the 12 conditions below. The conditions are designed to ensure that the organization is organized and will be operated exclusively for exempt purposes and to preclude inurement of net earnings to private shareholders or individuals.
>
> 1. The organizational documents must include a specific statement limiting the LLC's activities to one or more exempt purposes.
>
> This requirement may be satisfied by standard purposes and activities clauses that satisfy the 501(c)(3) organizational test, such as "The organization is organized exclusively for exempt purposes under section 501(c)(3) of the Internal Revenue Code," and "The organization may not carry on activities not permitted to be carried on by an organization described in section 501(c)(3)." Taxpayers may not rely upon the cy pres doctrine to meet this requirement for LLCs.
>
> 2. The organizational language must specify that the LLC is operated exclusively to further the charitable purposes of its members.

3. The organizational language must require that the LLC's members be section 501(c)(3) organizations or governmental units or wholly owned instrumentalities of a state or political subdivision thereof ("governmental units or instrumentalities").

4. The organizational language must prohibit any direct or indirect transfer of any membership interest in the LLC to a transferee other than a section 501(c)(3) organization or governmental unit or instrumentality.

Because state laws generally provide LLC members with ownership rights in the assets of the LLC, the Service is concerned that allowing non-exempt members would result in potential inurement problems. Thus, the LLC cannot have private shareholders or individuals as members, and its organizing documents must state a purpose to further the members' charitable purposes. It should be noted, however, that the presence of solely charitable members does not ensure that the organization will be operated exclusively for charitable purposes. See, e.g., Rev. Rul. 72-369, 1972-2 C.B. 245 (organization formed to provide managerial and consulting services at cost to unrelated 501(c)(3) organizations not exempt under IRC 501(c)(3)); compare Rev. Rul. 71-529, 1971-2 C.B. 234 (organization controlled by a group of unrelated 501(c)(3) organizations and providing investment management services for a charge substantially below cost solely to that group qualifies under IRC 501(c)(3)).

5. The organizational language must state that the LLC, interests in the LLC (other than a membership interest), or its assets may only be availed of or transferred to (whether directly or indirectly) any nonmember other than a section 501(c)(3) organization or governmental unit or instrumentality in exchange for fair market value.

This provision helps ensure that the LLC and its assets are devoted exclusively to charitable purposes and that any dealings with private interests are at arm's length. Grants for exempt purposes to individuals or noncharitable organizations (as described in Rev. Rul. 68-489, 1968-2 C.B. 210) would also be permitted.

6. The organizational language must guarantee that upon dissolution of the LLC, the assets devoted to the LLC's charitable purposes will continue to be devoted to charitable purposes.

This requirement may be satisfied by a standard dissolution clause that satisfies the 501(c)(3) organizational test, such as "Upon dissolution, all assets remaining after the payment of liabilities shall be distributed exclusively to exempt organizations or for exempt purposes under section 501(c)(3) of the Internal Revenue Code." Taxpayers may not rely upon the cy pres doctrine to meet this requirement for LLCs.

7. The organizational language must require that any amendments to the LLC's articles of organization and operating agreement be consistent with section 501(c)(3).

8. The organizational language must prohibit the LLC from merging with, or converting into, a for-profit entity.

The idea here is that the LLC, like any other charitable organization, should intend to operate as a charity for its entire life and not flip between exempt and nonexempt status.

9. The organizational language must require that the LLC not distribute any assets to members who cease to be organizations described in section 501(c)(3) or governmental units or instrumentalities.

Such distribution would be inurement, unless the distribution is to a member other than in its capacity as a member, as where the member is the creditor on a loan to the LLC.

10. The organizational language must contain an acceptable contingency plan in the event one or more members ceases at any time to be an organization described in section 501(c)(3) or a governmental unit or instrumentality.

Forfeiture of the nonexempt member's interest is acceptable. A forced sale of the nonexempt organization's interest to another section 501(c)(3) organization or governmental unit or instrumentality would also be acceptable. The plan cannot involve a distribution of the LLC's assets to the nonexempt member, and should ensure that the nonexempt member's rights in the LLC are fully terminated within a reasonable time, e.g., 90 days from the date that a member's exemption is revoked.

11. The organizational language must state that the LLC's exempt members will expeditiously and vigorously enforce all of their rights in the LLC and will pursue all legal and equitable remedies

the assurance that the charitable purposes of the charitable LLC are specifically set forth and that there is a mechanism to ensure their enforcement (other than the mere threat of losing exempt status). One of the requirements—that members of the LLC be exempt organizations—differs from that applicable to charitable corporations, which may have non-exempt members so long as those members are not entitled to distributions of the assets of the charitable corporation (think, for example, of a member of a public radio station). Not surprisingly, the Guide Sheet requires that the LLC be organized for appropriate charitable purposes, as must a charitable corporation. The Guide Sheet also inquires into the mechanism to ensure enforcement of the restrictions on purposes for which the charitable LLC is organized.

Thus, although federal tax law imposes some standards on the operation of charitable and other exempt organizations, there is still much variation and opportunity for structural planning afforded by the alternative forms and jurisdictions available to those who create the organizations.[116] The financial

> to protect their interests in the LLC.
>
> 12. The LLC must represent that all its organizing document provisions are consistent with state LLC laws, and are enforceable at law and in equity.
>
> Some states (California, Indiana, Iowa, Maryland, Minnesota, New York, North Dakota, Rhode Island, Texas, Utah, and Virginia) and the District of Columbia appear to require that an LLC be formed for a business purpose. In such states, it is questionable whether an LLC may be formed as a 501(c)(3) charitable organization. For the time being, however, absent state case law to the contrary, the Service is willing to recognize exemption based on the LLC's representation that its charitable status is permitted under state law, and that the provisions set forth above are enforceable.

Id.

116. *See* American Law Institute, Principles of the Law of Nonprofit Organizations pt. II, ch. 3, intro. (Tentative Draft No. 1, Mar. 19, 2007). As stated in the Introduction to this Draft,

> As the law has evolved, the fiduciary standards for trustees of charitable trusts and for directors of corporate charities have grown more similar than is commonly believed. Both trust and corporate founders may modify fiduciary standards and protect fiduciaries from personal monetary liability for breach of duties. At the same time, both trust and corporate law impose minimum—nonwaivable—duties of loyalty and care. Nothing unique to either the trust or the corporate form impedes conforming the standards of fiduciary duty for all forms of charity, and these Principles apply to charity fiduciaries of all types. Of course, how those duties are carried out might vary with the charity's organizational form, as well as with its size, structure, and type.
>
> As long as differences remain between organizational forms and among states, though, some charity organizers will exploit the ability to choose a less-regulated regime. If reforms focus on nonprofit corporation law, charities might prefer to form as trusts. If states vary on their substantive or structural requirements, forum-shopping will result. Notably, organizers might choose a particular state in which to form based on the ease of formation and ongoing regulation; the absence of a requirement that a majority of directors be financially disinterested; or the availability of the limited-liability-company form for charity. See § 200 (Preliminary Draft No. 4, forthcoming 2007). Already an issue of growing importance is the role of state authorities when the charity incorporates in one state but operates in another state. Typically, the state of operation requires the foreign charity to register if it "does business" or owns assets in the state. The degree of state oversight over the "internal affairs" of foreign charities, however, remains largely untested in the courts.

Id.

constraints on charities—the obligations to use the funds exclusively for charitable purposes and not to allow private inurement—are thoroughly dictated by federal tax law, but such matters as purposes and internal governance are points of variation that may turn on state law. The Service, by limiting ownership of a membership interest in a charitable LLC to another charitable organization, appears to be insisting on some state-law charitable principles. This concept is reflected in the view of the IRS.[117]

A second concern that the Service and the reporter for the ALI Project appear to have is the possibility that the purpose of the charitable organization may be changed or that the property otherwise dedicated to the exempt purpose may be redirected. This concern relates to the possibility that those conducting the activities of the organization will not adhere to the limitations set forth in the organic rules (generally the operating agreement or limited liability company agreement by which the LLC and its members are governed) of the organization. In this respect, an LLC is subject to the same considerations as might apply to a charitable trust or state-law nonprofit corporation.

It is also possible that the organic rules may be changed. As a result of the inherent flexibility of an LLC, such modifications are easy to accomplish through an amendment by the members. Even in the absence of such an amendment, the LLC may undergo a fundamental change such as merger. Both the Service and the ALI Project[118] consider this issue an important concern that

117. *See* McCray & Thomas, *LLCs as Exempt Organizations* (2001), *supra* note 110, at 30-32.

118. *See* ALI, NONPROFIT LAW, Council Draft No. 5, *supra* note 14, § 230. This section provides in part,

> (a) A charity may undertake a fundamental transaction or other restructuring as permitted by law and its organizational documents.
>
> (b) The law applicable to a new organizational form or to a new state of organization applies from and after the effective date of the change.
>
> c. Structural transactions not involving trusts comments
>
> (I). Transactions defined.
>
> Organizations are not static: They grow, they evolve, they contract, and they dissolve. Governance structure might be altered as required. This Section addresses the more formal transformations that raise legal issues.
>
> As used in modern nonprofit corporation law, the term "fundamental transaction" includes a merger, conversion, domestication, sale of all or substantially all assets, and change in state of organization. A charity, too, might liquidate or file for bankruptcy. (A nonprofit organization is not subject to involuntary bankruptcy, but could be subject to receivership or judicial dissolution. As to these remedies in the context of breach of fiduciary duty, see § 360.) A charity can engage in other structuring devices: Nonprofit organizations have long pooled resources with other nonprofit or proprietary participants in various types of incorporated or unincorporated pass-through entities (joint ventures, general or limited partnerships, or limited liability companies). See also the tax discussion in Comment e, below.
>
> One legal issue unique to nonprofit organizations results from their having to use membership in lieu of share ownership to create parent-subsidiary structures for affiliated nonprofit corporations (which typically cannot issue stock). In light of the rise of the limited liability company form, a charity might prefer to create a "single-member LLC" (SMLLC). See Reporter's Notes under § 200. The sole-member structure raises issues about the fiduciary duties of the board of the "subsidiary" - and

should be addressed where an LLC is a tax-exempt organization.

IV. HYBRID ORGANIZATIONS

As discussed in Part II, there are circumstances in which a business organization wishes to do good while doing well, *viz*, to operate in the area between the purely pecuniary and the entirely eleemosynary. As discussed above, many forms of organizations are either organized for profit or as both for profit and not for profit.[119] To the extent the managers of such an organization wish to conduct a business in a way as to promote a non-economic objective, they may find themselves confronted with demands from the owners that profit be maximized.[120] On the other hand, many nonprofit organizational statutes preclude any possible financial gain for owners, regardless of the amount of social good accomplished by the organization.[121]

While the strict dichotomy of for-profit/nonprofit organizations has to some extent been ameliorated through the use of representatives of "alternative constituencies," there is still pressure on all managers of a for-profit organization to realize a profit.[122]

A. B Corporations

B Corporations are business organizations that elect to obtain certification from B Lab[123] as being purpose driven and creating benefit for all stakeholders, not just shareholders.[124] In order to obtain certification, the business

the difficulty of moving resources from the "subsidiary" to the "parent" in states that prohibit distributions to members.

Any of these transactions might or might not result in a change in charitable purpose. If it does, § 240 applies. See the commentary under § 250 for discussion of the effect on a charity's assets from a change in purpose.

119. *See supra* notes 8-9.

120. An example of such a problem was the one that confronted Ben & Jerry's Homemade, Inc., which had realized losses and was subject to a takeover offer from Unilever. When the founders attempted to maintain control in order to continue some of the corporation's charitable undertakings, they were subject to shareholder suits and ultimately had to allow the corporation to be acquired by Unilever. *See generally* Rob Walker, *The Scoop on Ben & Jerry's Sellout*, SLATE, Apr. 12, 2000, http://www.slate.com/id/1005081; Hannah Clark, *A New Kind of Company*, INC. MAGAZINE, July 2007, *available at* http://www.inc.com/magazine/20070701/priority-a-new-kind-of-company.html.

121. *See supra* text accompanying notes 21-24.

122. *See generally* E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 BUS. LAW. 761 (2008) (discussing alternative constituencies).

123. B Lab, http://www.bcorporation.net (last visited Apr. 7, 2009).

124. *See* Jonathan Birchall, *Green Seal of Approval for Small Outfits*, FIN. TIMES, June 2, 2008, *available at* http://www.ft.com/cms/s/0/bd5eab2e-303c-11dd-86cc-000077b07658.html?nclick_check=1 (last visited Apr. 7, 2009); Stephanie Strom, *Make Money, Save the World*, N.Y. TIMES, May 6, 2007, *available at* 2007 WLNR 8575652 (last visited Apr. 7, 2009).

organizations must take certain measures.[125] As a result of doing the things necessary to obtain certification—which generally involve meeting comprehensive and transparent social and environmental performance standards, institutionalizing stakeholder interests, and building a collective voice through the power of a unifying brand—the organization obtains the right to use the certification as a B Corp.

The certification entitles the organization to participate in the network of like-minded organizations and to use the B Corp designation in marketing. The organizations listed on the B Corp website are as varied as registered investment advisers, law firms, retailers, and environmental consultants. In May of 2007, B Lab formed a partnership with The Research Initiative on Social Entrepreneurship (RISE),[126] a research project at Columbia Business School that monitors what it refers to as "double-bottom line" (DBL) investors, funds identifying themselves as interested in investing to achieve social or environmental impact as well as financial return. Like B Lab, RISE speaks of B Corps as "corporations,"[127] perhaps indicating that it does not believe that the form of organization is important.

The B Corp program provides certain guidance with respect to the appropriate management, customer, and other structural issues, but does not appear to provide counsel with respect to the form of organization. The choice of organization for a B Corp may not be significant if all of the owners have bought into the limitations on the profit motivation inherent in the B Corp. Nonetheless, even if the original investors are in agreement with the limitation, it is unclear whether under corporate law any successor investor would be bound by the limitations on management's obligation to maximize profit.

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125. Not all B Corporations are corporations. Looking at the examples listed on the B Lab website, "B Corporations" appear to be corporations, limited liability companies, and even limited liability partnerships. B Lab—B Community, http://www.bcorporation.net/community (last visited Apr. 7, 2009). The B Lab website does not discuss the choice of business organizational form.

126. RISE, Research Institute on Social Entrepreneurship, Welcome to RISE, http://www.riseproject.org (last visited Apr. 7, 2009).

127. As stated on its website:

> RISE is pleased to announce a new partnership with B Lab, (www.bcorporation.net), a nonprofit organization which envisions a new sector of the economy which harnesses the power of private enterprise to create public benefit. This sector, sitting between the for-profit and non-profit sectors, is comprised of a new type of corporation – the B corporation. B corporations are unlike traditional responsible businesses because they 1) meet comprehensive and transparent social and environmental performance standards; 2) institutionalize stakeholder interests. The core idea behind B Lab is that by creating a standard rating system for companies to be certified as socially beneficial, those companies that earn enough points can then share a common brand and logo, becoming known as "B Corporations," creating an instant signal to customers, investors and policymakers that they create social benefit through their products, practices and use of profits.

RISE: Research Institute on Social Entrepreneurship, Welcome to RISE, http://www.riseproject.org/index.html (last visited Apr. 7, 2009).

B. L3Cs

If a private foundation makes investments in a manner as to jeopardize the carrying out of any of its exempt purposes, the foundation and its management may be subjected to a tax equal to 10 percent of the amount invested.[128] The tax, however, will not apply to a "program-related investment."[129] A program related investment is one in which the primary purpose is to accomplish one or more of the private foundation's charitable purposes, "and no significant purpose of which is the production of income or the appreciation of property."[130]

To facilitate the creation of program-related loans, a few states have adopted statutes authorizing "low-profit limited liability companies" (often referred to as "L3Cs"). An L3C is an LLC which is established to advance a charitable or educational goal.[131] Unlike a B Corp, an L3C status is limited to one form of

128. I.R.C. § 4944(a) (2006).

129. *Id.* § 4944(c).

130. *See* Treas. Reg. § 53.4944-3 (providing a program-related investment must meet three requirements: (i) The primary purpose of the investment is to accomplish one or more of the purposes described in I.R.C. § 170(c)(2)(B); (ii) No significant purpose of the investment is the production of income or the appreciation of property; and (iii) No purpose of the investment is to accomplish one or more of the purposes described in I.R.C. § 170(c)(2)(D)).

131. *See* 11 V.S.A. §§ 3001(27), 3005(a). The Vermont Limited Liability Company Act defines L3Cs as follows:

> (27) "L3C" or "low-profit limited liability company" means a person organized under this chapter that is organized for a business purpose that satisfies and is at all times operated to satisfy each of the following requirements:
>
> (A) The company:
>
> (i) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(B); and
>
> (ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.
>
> (B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.
>
> (C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(D).
>
> (D) If a company that met the definition of this subdivision (23) at its formation at any time ceases to satisfy any one of the requirements, it shall immediately cease to be a low-profit limited liability company, but by continuing to meet all the other requirements of this chapter, will continue to exist as a limited liability company.

Id. § 3001(27). The statute further provides,

> (a)(1) Except for low-profit limited liability companies, the name of a limited liability company as set forth in its articles of organization shall contain the words "limited liability company" or "limited

legal entity—an LLC—although in order to use the name L3C, the statute requires that (1) the primary purpose of the LLC is to accomplish one or more charitable purposes, (2) the LLC would not have been formed but for its relationship to the accomplishment of charitable or educational purposes, and (3) no significant purpose of the LLC is the production of income or the appreciation of property. It is unclear whether the fact that an organization is an L3C is intended to impose any state-law obligations on the organization. For example, it is not clear whether, other than ceasing to be able to describe itself as an L3C, there is any nontax penalty imposed on the organization for failing to continue to adhere to the statutory definition. It appears that the L3C is principally a definitional addition to LLC statutes, which will hopefully create a norm that the government may be able to recognize as being an appropriate vehicle for a program-related investment.[132]

It should be noted that the flexibility that makes the L3C statute a useful vehicle for program-related investments exists in most LLC statutes. It is the statutory intention to allow LLCs to be organized in such a way as to permit the agreement of the members to modify default rules very broadly. As noted above, the statutes are considered broad enough to allow an LLC to qualify as a

> company" or the abbreviation "L.L.C.," "LLC," "L.C.," or "LC." The word "limited" may be abbreviated as "Ltd." and "company" may be abbreviated as "Co." in a limited liability company name.
>
> (2) The name of a low-profit limited liability company as defined in subdivision 3001(23) of this chapter shall contain the abbreviation L3C or l3c.

Id. § 3005(a)(2).

132. *See* Robert Lang, *The L3C: The New Way to Organize Socially Responsible and Mission Driven Organizations*, (CD-ROM from 22nd Annual Advanced ALI-ABA and ABA Section of Taxation Course Study held Nov. 29-30, 2007) (on file with author). According to Robert M. Lang, Jr. of The Mary Elizabeth and Gordon B. Mannweiler Foundation, who has been a significant proponent of L3Cs, the origin of the L3C occurred in order to facilitate making of program-related investments. *Id.* Lang explains,

> We looked at this and convened a panel of distinguished lawyers, financiers, etc. and asked what would happen if an LLC was chartered from the beginning to be a low profit entity. We wanted to codify the concept that maximization of member (shareholder) profits was not the prime goal. We started there, trying to draw up a law for a special form of LLC called the L3C; low-profit, limited liability company, with the hope that after the law passed and had received a few favorable private letter rulings, that the ruling would become automatic or maybe even unnecessary.
>
> Marcus Owens, who spent 10 years as head of the Exempt Organization Division at the IRS, was on our panel and was the attorney given the task of writing the law. Rather than write a brand new law which runs many pages and opens the door to years of legal interpretation, Owens advocated describing a new class of LLC known as the L3C and state that it must exactly dovetail with the IRS regulation on PRI's. Two other advantages of this approach are that once an L3C law is passed in any state it will be legal in all 50 states, US Territories and many foreign countries and it will not create a whole new class of business structure. In addition, it eliminates the need for private letter rulings. It is our intention following passage in at least one state to ask the Treasury Department and Congress to officially recognize the L3C as a PRI vehicle.

Id.

exempt organization, so they are certainly broad enough to allow the formation of a vehicle having the characteristics of an L3C as described in the Vermont statute.

As a limited liability company, an L3C having legally sufficient provisions in its operating agreement should be able to adhere to the limitations that its socially beneficial purposes mandate. It is not clear from the statute whether the actions of the organizer in describing the organization as an L3C is sufficient to constitute an agreement among the members sufficient to make the description a part of the operating agreement. Because the effect of the investment on the private foundation is based upon the private foundation's "purpose" for making the investment, it is probably prudent practice for the private foundation to ensure that the uses to which the investment is to be put are mandated in the operating agreement of the L3C and that such provision cannot be modified without the consent of the private foundations.

C. Other LLCs as Hybrid Organizations

The flexibility of the LLC form allows LLCs to operate as a hybrid entity. In particular, most of the organic statutes under which LLCs are organized free the LLC from intractable for-profit and multiple-owner requirements and allow the rights of the owners and the organization itself to be broadly modified in the LLC's organic document. That flexibility permits an LLC to act in the manner contemplated by both the L3C and B Corp movements. For example, a properly organized LLC based on a well-drafted operating agreement could constitute an acceptable program-related investment as envisioned for L3Cs. Similarly, the sort of social considerations and rights of alternative constituencies to which B Corps aspire are more certainly permissible and enforceable in a contractual organization like an LLC. By the same token, an LLC could be organized to accomplish the objectives of a mutual benefit organization, such as a cooperative, in which the objectives of the organization, while devoted to the benefit of its owners, were nonetheless directed to non-pecuniary benefits.

As noted below, the efficacy of the attempt to accomplish this goal will turn on the manner in which the organic documents are drafted and the manner in which the LLC is operated. As with any LLC, the starting point is a clear understanding of the ultimate objective of the creation of an LLC. Unlike a pure nonprofit LLC, the objective of a hybrid organization will entail some consideration of a profit inuring to an owner, requiring that the members and managers have a clear understanding clearly documented, one hopes, with respect to how the interests of those participating for profit in the venture will be balanced with the higher purpose of the LLC.

V. DRAFTING CONSIDERATIONS IN ESTABLISHING A NONPROFIT OR HYBRID LLC

Of course, creating an organization having the characteristics of an L3C, B Corp, or other hybrid organization requires thoughtful drafting of the operating agreement.[133] This will often be done in the provision describing the "purposes" of the organization. The enunciated purpose of the organization is important on many levels: it defines the ordinary course of business of the organization, thereby granting or restricting the power of managers to bind the LLC without consent of the highest decisional authority; it may provide guidance on the duties of managers and others involved in the organization with respect to such matters as what are organizational opportunities that must be offered to the LLC and when will a manager be in competition with the organization; and it will provide guidance on the interpretation of the balance of the agreement. Because it is impossible to contemplate all matters that might arise, it is important that the organic agreement clearly establish the objective of the organization. In this manner, the inevitable ambiguities of the agreement will be resolved consistently with underlying objectives of the organizers. Further, because the architecture of the organic statute governing the LLC is devoted to the operation for profit and the division of those profits, it is important to authorize those managing the LLC to limit (or in some cases, totally eschew) the making of profit in favor of other objectives.

Additionally, in appropriate cases, the agreement should expressly authorize the consideration of constituencies other than members. These provisions will require careful consideration of elements beyond the aspirational provisions set forth in the "purposes" language of the agreement. To the extent the document will give rights to nonsignatories, it is important to clearly state who has authority to enforce or compromise those rights and how. In the organic statutes governing many nonprofit corporations, the attorney general or another state official has the right to intercede in the operation of the nonprofit corporation. To the extent the organizers think this is a preferable way to govern these matters, it may be appropriate to simulate the language of the nonprofit corporation statutes dealing with the attorney general's powers. Whether such a provision would be effective, and, if effective, whether the attorney general would choose to enforce rights given in the agreement, are factors that should be considered. The manner and forum of resolving disputes that may arise under these provisions should also be weighed. In this regard there are two distinct but often confused concepts: the requirement of the organization to act in a certain manner, and the liability of the managers if the organization does not. Taking the latter first, the organic statutes governing

133. *See generally* Ann E. Conaway, *Lessons To Be Learned: How the Policy Of Freedom To Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law*, 33 DEL. J. CORP. L. 789 (2008) (discussing issues surrounding impact of B Corps and L3C on LLC legislation).

nonprofit corporations sometimes provide express exculpation for actions of the directors of the corporation except in the case of self-dealing.[134] Because the organic statutes governing LLCs generally do not have this sort of language, it will be necessary to add appropriate language. It may be appropriate to set standards, and perhaps a review function, compliance with which would insulate decision-makers and agents from personal liability. Second, and distinct from the liability of those managing the LLC, lies the issues of when the actions of the LLC itself may be challenged and possibly invalidated. While many statutes suggest that the organic document cannot modify the rights of third parties (such as nonmember constituencies), it is unclear how effective a provision in an operating agreement would be in establishing rights for, and imposing limitations on, such persons.[135] In any case, it is probably prudent to include a provision setting forth the procedure for, and limitations on, resolving disputes with regard to the propriety of the LLC's actions.

In many respects, the most important provision in the organic document is the provision for amendment. Regardless of the other provisions, if the amendment provision grants a member (fewer than all of the members) the ability to modify those provisions through an amendment, those provisions may be meaningless. The agreement should be clear as to the consent necessary to amend the agreement, and where less than unanimous consent for amendments may occur, the drafter of the agreement should consider provisions that may require a different or higher consent. In addition, in some transactions in which a nonmember government or another organization is relying on provisions ensuring tax or other compliance, it may be appropriate to condition granting the amendment on the approval of that nonmember. Finally, it is important to remember that it is generally possible to effect an amendment of the organic document through a merger, conversion, or other reorganization. All of the considerations applicable to the consent to the amendment of the organic

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134. *See* COLO. REV. STAT. § 7-128-402(1) (2008). This statute provides,

> If so provided in the articles of incorporation, the nonprofit corporation shall eliminate or limit the personal liability of a director to the nonprofit corporation or to its members for monetary damages for breach of fiduciary duty as a director; except that any such provision shall not eliminate or limit the liability of a director to the nonprofit corporation or to its members for monetary damages for any breach of the director's duty of loyalty to the nonprofit corporation or to its members, acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, acts specified in section 7-128-403 or 7-128-501 (2), or any transaction from which the director directly or indirectly derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director to the nonprofit corporation or to its members for monetary damages for any act or omission occurring before the date when such provision becomes effective.

Id.

135. *See generally* Robert R. Keatinge, *The Partnership Agreement and Third Parties: ReRULPA § 110(B)(13) v. RUPA § 103(B)(10)*, 37 SUFFOLK U. L. REV. 873 (2004).

documents should apply equally to the consent to mergers, conversions, and other fundamental changes that could be used to effect an amendment.

CONCLUSION

It has been suggested that the greatest contribution of the LLC is its inherent combination of flexibility in structure and limitation of vicarious liability. In many respects the entry of the LLC into the world of nonprofit organizations has been a further, if initially unanticipated, step in that direction. While it may be helpful to establish default vehicles like the L3C to facilitate certain types of LLCs, as a general matter, the efficacy of an LLC as a nonprofit organization, like its effectiveness in any circumstances, will ultimately rely on thoughtful organization from the selection of the jurisdiction of organization to the drafting of the operating agreement and finally to the assurance that those who will operate the LLC understand the particular constraints on the way in which the organization conducts its activities. In other words, what we have learned about LLCs over the past two decades is that their greatest virtue—flexibility of structure—also creates the greatest responsibility and, at times, risk for the lawyer working with them.

The flexibility of LLCs is both a blessing and curse. Like a very sharp knife, properly used, an LLC is an effective tool to accomplish exactly what the craftsperson using it wishes. On the other hand, used carelessly, it can cause severe and unanticipated damage. In the case of nonprofits, the limitations on purposes and financial arrangements provided by the organic statutes under which nonprofit corporations were organized—supplemented in the case of exempt organizations by tax rules that were often made applicable to the corporation through the organic documents—made the organizations reasonably easy to establish and qualify. Problems, if any, in nonprofit corporations would arise when constituents of the corporation would act contrary to the organic statutes and tax rules. In an LLC where the organic statutes generally do not impose the same sort of restrictions, it is critical that the organic document be carefully considered.

It is uncertain whether the freedom to tailor the structure of an LLC to accomplish the precise goal of the organizers is a beneficial or harmful thing for nonprofits. Indeed, it is probably both, depending on the circumstances. Used properly, the flexibility will allow the creation of a more efficient vehicle for accomplishing the nonprofit purpose of the LLC, thereby benefiting the nonprofit and, in the case of a hybrid, the for-profit participants. On the other hand, careless organization or inappropriate actions by the LLC or its constituents can defeat the nonprofit purposes of the LLC, result in adverse tax consequences, and possibly lead to acrimonious litigation or regulatory action. Thus, as with any gift or benefit, the flexibility should be used carefully and thoughtfully.