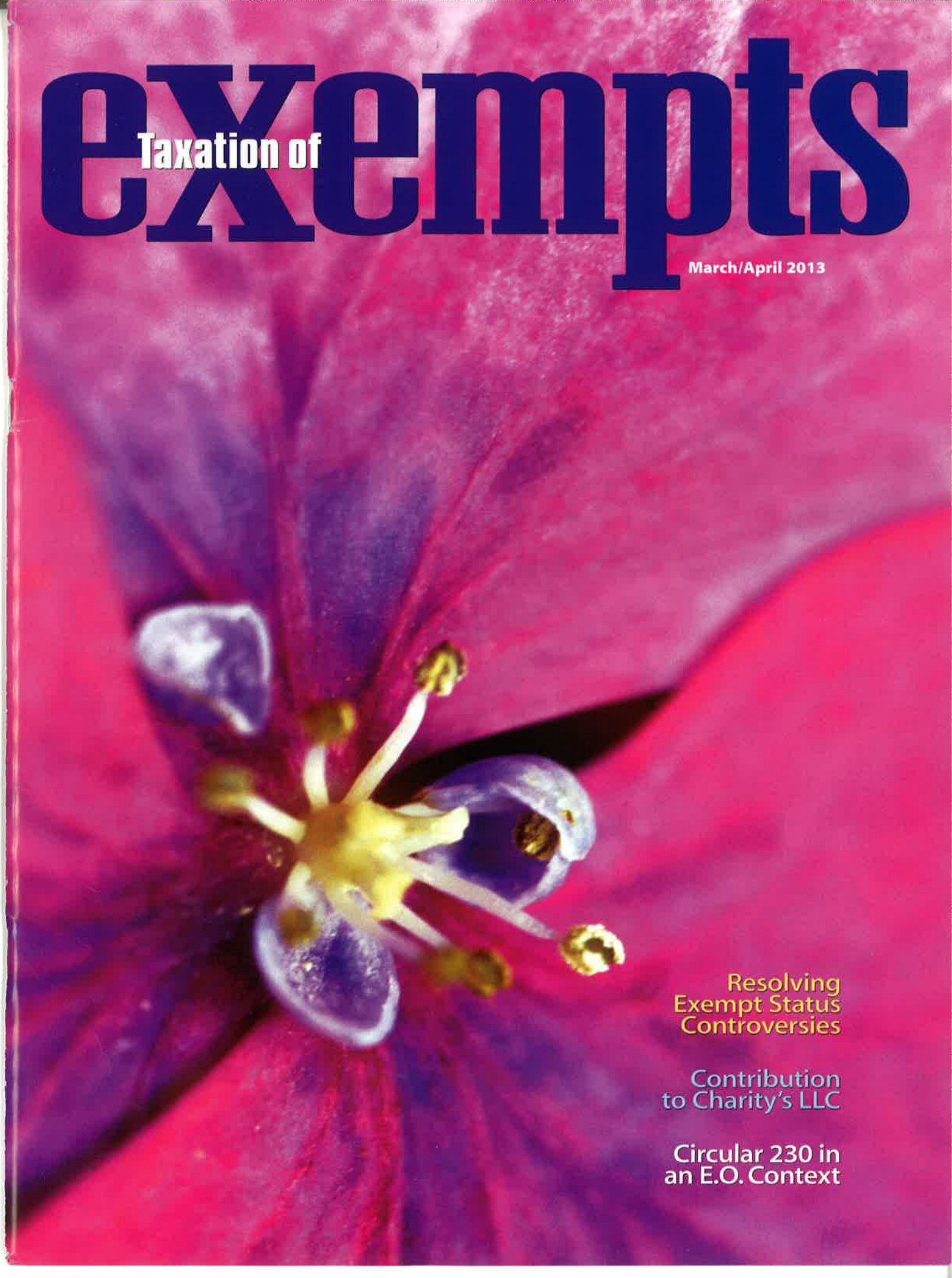

Taxation of exempts

March/April 2013

Resolving Exempt Status Controversies

Contribution to Charity's LLC

Circular 230 in an E.O. Context

CONTRIBUTIONS TO CHARITY'S WHOLLY OWNED LLC DEDUCTIBLE UNDER LONG-AWAITED REGS.

JAMISON K. SHIPMAN

The IRS issued Notice 2012-52, 2012-35 IRB 317, on 7/31/12. It provides that contributions made to a domestic limited liability company (LLC) that is wholly owned by a U.S. charity will be treated as a charitable contribution to the U.S. charity, assuming all other requirements under Section 170 are met. Notice 2012-52 confirms what many long believed was the correct answer (despite doubts about such treatment created by the IRS in previous guidance) and eliminates a potential trap.[1]

Background

Prior guidance, Ann. 99-102, 1999-2 CB 545, specifically provided that an entity that is disregarded for tax purposes under the Section 7701 entity classification regulations is to be treated as part of its tax-exempt sole member for purposes of reporting information pertaining to the finances and operations of the disregarded entity on annual IRS information returns. Ann. 99-102 also expressly states that this conclusion is required by the regulations. The entity classification regulations provide that a single-member LLC (absent an election to be treated as an association) was generally to be "disregarded."[2]

JAMISON K. SHIPMAN is a partner with the law firm Lathrop & Gage LLP in Kansas City, MO.

Logically, it seemed clear under this guidance that if the single-member LLC had a Section 501(c)(3) organization as its sole member, and the taxpayer made a charitable contribution to that LLC, the taxpayer could claim the contribution as a charitable deduction under Section 170. Notwithstanding the regulations, however, the IRS refused to rule in advance that a contribution made to such an entity that is wholly owned by a tax-exempt charitable organization would qualify for a charitable contribution deduction.[3] At the time of its publication in 2000, the Service's 2001 Continuing Professional Education (CPE) Text indicated that the IRS intended "in the near future" to provide "guidance" on the availability of a charitable contribution deduction for contributions made to single-member LLCs. In the end, it took the IRS approximately 12 years to issue this long-awaited guidance and remove the uncertainty.

Impact of the Notice

Notice 2012-52 provides that contributions made to a single-member LLC that (1) is created or organized under the laws of the United States, a U.S. possession, a state, or the District of Columbia and (2) was wholly owned and controlled by a U.S.

The long-awaited guidance in Notice 2012-52 provides potential planning opportunities for charities and eliminates a potential trap.

charity will be treated as a charitable contribution to a branch or division of the charity.[4] The charity is the donee organization for purposes of the substantiation and disclosure requirements under Section 170 with respect to the charitable contributions. Notice 2012-52 encourages the charity to disclose in acknowledgments of donations or other statements to the donor that the LLC is wholly owned by the charity and treated by the charity as a disregarded entity to avoid unnecessary inquiries by the IRS.

A charity can form a wholly owned domestic LLC to receive and hold donations of real estate in order to shield the charity from potential associated liabilities.

Notice 2012-52 is effective for charitable contributions made after 7/31/12. However, taxpayers may rely on Notice 2012-52 prior to its effective date for tax years for which the statute of limitations for claiming a refund or credit has not expired.[5]

Planning opportunities. Notice 2012-52 provides charities with planning opportunities. The most common situation involves a prospective donor who wishes to contribute real estate to a charity. The charity will not want to directly own the real estate, however, to minimize the risk with respect to the real estate's associated liabilities, particularly environmental liabilities. Prior to the issuance of Notice 2012-52, there were two primary options available to the donor that would protect the charity against this liability and to avoid uncertainty regarding the deductibility of the contribution: (1) contributing the real estate to a supporting organization of the charity that has received recognition as an organization described in Section 501(c)(3) or (2) contributing the real estate to a wholly owned LLC of the donor, after which the donor would contribute all of the interests in the LLC to the charity.

There are issues with both options, however. With respect to a supporting organization, if the charity did not already have a supporting organization to accept the contribution, it would have to go through the effort and cost of creating such an organization and applying for tax exemption. There would also be ongoing compliance obligations and costs (such as filing a separate annual information return) that the supporting organization would have to satisfy. With respect to making a donation first to an LLC, then donating all of the interests in the LLC to the charity, the donor would have to engage in multiple steps to complete the donation.

Under Notice 2012-52 a charity can form an LLC, with the charity holding all of the LLC's ownership interests, to receive and hold donations of real estate (or perhaps other assets) in order to shield the charity from potential liabilities associated with the real estate. The charity will not have to apply for separate tax-exemption for the LLC and all of the activities of the LLC will be reported on Schedule R, Part 1 of the charity's Form 990. Thus, the charity's compliance costs will be reduced in comparison to forming and operating a separate supporting organization. Also, the donor will have to engage in only one transaction by making the donation to the charity's LLC (versus the two-step option described above) and not have to worry about any potential issues with the characterization of the donated property.

The efficiencies of a charity's forming an LLC may also extend to state law issues. For instance, Missouri statutes provide that for purposes of state income, sales, and unemployment taxes,

1 See Livingston, "The Tax Consequences of Accepting Charitable Contributions through a Single-Member LLC," 13 Exempts 107 (Nov/Dec 2001); McCarden, "The Deductibility of Contributions to Single-Member LLCs Owned by Tax-Exempt Organizations," 2005 TNT 115-36; and Shipman, "IRS Guidance on Contributions to a Charity's Wholly Owned LLC Still Missing," 23 Exempts 2, page 3 (Sep/Oct 2011).

2 There are specific exceptions with respect to certain employment and excise tax matters described in Regs. 301.7701-2(c)(2)(iv) and (v).

3 See McCray and Thomas, "Limited Liability Companies as Exempt Organizations—Update," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2001* (2000), hereinafter "the CPE Text"; Ltr. Rul. 200150027.

4 Thus, the guidance provided in Notice 2012-52 does not cover contributions made to a U.S. charity's wholly owned foreign LLC.

5 Notice 2012-52 references only the statute of limitations for a taxpayer to seek a refund under Section 6511 and does not reference the statute of limitations for assessing taxes under Section 6501. This begs the question whether a taxpayer that had claimed a deduction for a charitable contribution to a charity's LLC in a prior year for which the statute of limitations for assessment is still open can rely on this guidance. It would seem that such a taxpayer should be able to rely on Notice 2012-52.

6 RSMo. 347.187.2 (2012).

7 The statute notably excludes other Missouri taxes, such as property taxes. Therefore, it appears that a single-member LLC would have to apply for a separate property tax exemption and could not rely on the charity's property tax exemption.

8 Notice 2012-52 confirms the position taken by the IRS in an Information Letter (IRS INFO 2010-0052), which provides that for purposes of Sections 4942 and 4945, distributions by a private foundation to the wholly owned LLC of a public charity will be treated as a distribution directly to the public charity on the basis that the LLC was disregarded for tax purposes under the entity classification regulations.

an LLC and its members will be classified and treated on a basis consistent with the LLC's classification for federal income tax purposes.[6] This means that the activities of a charity's wholly owned LLC will be treated as those of the charity for these specific types of taxes.[7] Therefore, if the charity already has a Missouri sales tax exemption, the LLC will be able to use that exemption for its benefit without having to file a separate sales tax exemption application with the Missouri Department of Revenue.

A single-member LLC's classification for state tax purposes will likely vary from state to state. Therefore, a charity should confirm how its LLC will be classified in each state in which the LLC is conducting activities to ensure that the charity and the LLC are complying with each respective state's laws, including its non-tax laws (e.g., fundraising registration requirements) that could apply to the LLC.

While the LLC will shield the charity from the liability related to real estate or other assets donated to the LLC, the charity's ownership interest in the LLC will be an asset that could be subject to claims made by the charity's creditors. Thus, the assets held by the LLC are indirectly subject to the claims of the charity's creditors. In situations where the charity wants to protect donated assets from its own liabilities, it would make more sense to utilize a separate supporting organization to hold those assets because a supporting organization's assets generally will not be subject to claims of the charity's (i.e., the supported organization's) creditors.

The efficiencies of a charity's forming an LLC may also extend to state law issues.

Notice 2012-52 also makes it easier for a single-member LLC to engage in direct fundraising activities for its own charitable activities. Oftentimes a potential donor to a single-member LLC, especially a donor that is a private foundation, will want confirmation that the LLC is in fact a charity. Now it is clear that the single-member LLC is a charity based on its being an arm or division of its charitable sole member. The LLC can provide a donor with a copy of the charity's IRS determination letter as proof that the LLC is a charity. This will be especially beneficial if the charity is classified as a public charity for tax purposes, because the private foundation will not have to exercise expenditure responsibility on the donation made to the LLC.[8]

Considerations for forming an LLC. If a charity elects to form a wholly owned LLC that will accept donations on behalf of the charity, there are several important issues that the charity should consider before forming the LLC. These include:

1. Satisfying the organizational and operational tests under Section 501(c)(3).
2. Avoiding private inurement and benefit.
3. Avoiding political activities and minimizing lobbying activities.
4. Complying with reporting obligations.

The IRS does not require that the articles of organization for a disregarded entity independently satisfy the organizational test of a charity.

Satisfying the organizational and operational tests. The CPE Text states that the IRS does not require that the articles of organization for a disregarded entity independently satisfy the organizational test of a charity. Rather, "because the entity is treated as an activity of the owner, it is the owner's articles that matter."[9] While it is not mandatory that the articles of organization and operating agreement satisfy the organizational requirements if the LLC does not apply separately for recognition as a tax-exempt organization, the CPE Text provides that if they do not, the IRS should "closely scrutinize the past and planned activities of the LLC to ensure that the entire entity (including the disregarded entity) complies with the 501(c)(3) operational test."[10] Therefore, it will be important for the charity to regularly monitor the activities of the LLC to insure its activities are consistent with the charitable purposes of the charity. This holds especially true in situations where the LLC is operated by individuals who are not officers, directors, or employees of the charity.

Avoiding private inurement and benefit. The charity must also ensure that the LLC does not engage in any activities that result in private inurement to officers, directors, or other "insiders" of either the LLC or the charity. It likewise must ensure that the LLC avoids providing more than an incidental private benefit to any person, other than an incidental benefit. Therefore, the charity should implement procedures to prevent the LLC from conducting any activities that might result in private inurement or private benefit, which could jeopardize the charity's tax exemption.

Avoiding political activities and minimizing lobbying activities. A charity is prohibited from participating in or intervening in any political campaign on behalf of, or in opposition to, any candidate for public office.[11] Like private inurement, this is an absolute prohibition. Therefore, any participation in a political campaign for a candidate likely will result in the imposition of excise taxes under Section 4955 and can result in revocation of a charity's tax exemption (particularly when a charity and its LLC violate this prohibition multiple times). Thus, a charity must ensure that its single-member LLC does not participate in any political campaign for a candidate.

A charity can engage in only a limited amount of lobbying activities. Any lobbying activities of the LLC will be attributed to, and must be accounted for by, the charity. For that reason, the charity must be sure that not more than an insubstantial part of its activities—which include the activities of the LLC—involve lobbying. If the charity has made a Section 501(h) election for purposes of determining whether its lobbying activities are insubstantial in amount, any lobbying expenses of the LLC must be included as part of the calculations the charity is required to make under Section 501(h).

Complying with reporting obligations. Ann. 99-102 provides that for purposes of reporting information pertaining to the finances and operations of the charity's single-member LLC, such information should be reported on the charity's annual information return filed with the IRS. This includes the revenue and expenses of the LLC (including any unrelated business income), compensation paid to certain key employees of the LLC, political campaign activities, lobbying activities, program service accomplishments, donor information for charitable contributions, and transactions with interested persons. The charity must report such information for each single-member LLC or other disregarded entity it owns on Schedule R of its Form 990. Specifically, Schedule R requires the name of the LLC, its primary activity, the location of its legal domicile, its total income, its total assets at the end of the year, and the name of the entity that directly controls the LLC. The charity would also have to file Form 990-T to report the LLC's unrelated business income, if any, even if the charity itself did not have any unrelated business income. Finally, the charity must comply with the substantiation and disclosure requirements under

[9] CPE Text, *supra* note 3 at p. 28.
[10] *Id.*
[11] Section 501(c)(3).
[12] Reg. 301.7701-2(c)(2)(v).

Sections 170(f) and 6115 with respect to donations made to the LLC.

Notice 2012-52 and Ann. 99-102 do not, however, require reporting of the LLC's activities on all of the charity's required returns and reports. For instance, although the LLC's employment expenses will be included with the charity's annual information return, the LLC will still have to file separate federal and state employment tax returns.[12] There may also be separate filing and reporting obligations that the LLC will have to complete for state purposes. For instance, many states require certain organizations and individuals that engage in fundraising activities to register with the state. Unless a statute specifically excludes disregarded entities from making a separate filing, a charity should confirm whether its single-member LLC must comply with the fundraising registrations requirements.

Conclusion

It is unfortunate that it took the IRS 12 years to issue guidance on whether contributions to a charity's wholly owned LLC should be treated as a charitable deduction under Section 170. The guidance provided in Notice 2012-52 reaches a conclusion that most, if not all, tax practitioners would say is readily apparent from the Code and regulations. However, the long-awaited guidance is appreciated because it provides potential planning opportunities for charities and eliminates a potential trap. ■