PRESENTED AT

26th Annual LLCs, LPs and Partnerships

July 12, 13-14, 2017
Austin, Texas

LLCs in the World of Nonprofit and Mission-Minded Organizations

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I. INTRODUCTION

It is no secret that the limited liability company ("LLC") continues to be an incredibly popular entity choice. Offering the pass-through taxation and ability to participate in management of a partnership and the liability protection of a corporation, the LLC provides significant advantages. However, the opportunities to use the LLC form for nonprofit and mission-minded purposes is rarely considered by practitioners not working in the tax-exempt organization space. This paper will seek to address that gap by providing an overview of the charitable organization, a quick primer on unrelated business taxable income, and a look at various ways the LLC may be used in the nonprofit and mission-minded area including use of a single member LLC for liability protection and ancillary joint venture participation, use of the LLC for social enterprise businesses, and use of the LLC by entrepreneurs engaged in philanthropy such as Mark Zuckerberg and his wife, Dr. Priscilla Chan. This article will not provide an exhaustive treatise on these areas but rather serve as a travelers' guide into this unique area of the law.[1]

II. AN OVERVIEW OF SECTION 501(C)(3)

The nonprofit sector is vast. In 2016 over 1.5 million nonprofit (tax-exempt) organizations were registered with the Internal Revenue Service ("Service").[2] Section 501(c)(3) and Section 501(c)(4) organizations comprised approximately seventy-five percent of that number.[3] It is estimated that Section 501(c)(3) organizations employ approximately 10% of the workforce in United States, the third largest workforce in the country, behind only retail and manufacturing.[4] Twenty-five percent of the American adult population volunteers in the third sector providing over $184 billion in contributed time.[5]

As expected from such a large industry sector, the nonprofit sector includes organizations of many shapes and sizes. The common link among all such organizations being what has been termed the "non-distribution constraint," that is, nonprofit organizations may not distribute profits to private individuals in the form of dividends or otherwise. This prohibition on distributing profits sets the nonprofit sector apart as unique and applies regardless of the type of nonprofit, basis for exemption, or any other distinction.

A. NONPROFIT, TAX-EXEMPT, OR CHARITABLE

While all organizations exempt from federal income tax come within the "nonprofit tent," not all nonprofit organizations are eligible for exemption. Rather, eligibility for exemption depends upon the organization meeting specific requirements for exemption. The Internal Revenue Code (the "Code") contains over twenty-five (25) categories of federal income tax exemption classifications. As addressed above, the overwhelming majority of organizations exempt from federal income tax are exempt as organizations described under Section 501(c)(3) of the Code. However, the organizers and their counsel should consider whether the organization properly qualifies as an organization exempt from federal income tax under Section 501(c)(3)—specifically, as an organization 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, or for the prevention of cruelty to children or animals

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[1] Portions of this article are excerpted from Darren B. Moore, *"Commercial Activities and Subsidiaries – Issues and Choices in Planning,"* 28 Exempts 4, 12 (Jan/Feb 2017); MOORE, DARREN B., GOVERNANCE OF THE SOCIAL ENTERPRISE: STRUCTURAL AND OPERATIONAL CONSIDERATIONS, State Bar of Texas, 14th Annual Governance of Nonprofit Organizations Course, August 2016; SANDERS, MEGAN C., GIFTS FROM COUSIN EDDIE: ACCEPTANCE, OWNERSHIP & MANAGEMENT OF BIZARRE ASSETS, University of Texas School of Law, 32nd Annual Nonprofit Organizations Institute, January 2015; MOORE, DARREN B., A BASIC FRAMEWORK OF THE NONPROFIT SECTOR, University of Texas School of Law 30th Annual Nonprofit Organizations Institute, January 2013).

[2] *See* Independent Sector, *Scope of the Nonprofit Sector*, http://www.independentsector.org/about/the-charitable-sector/ (last visited June 10, 2017).

[3] *See id.*

[4] *See id.*

[5] *See id.*

as opposed to some other section covering a different type of exemption.[6] For example, where an organization organized exclusively for the promotion of a particular industry or profession, that organization will qualify under Section 501(c)(6).

B. General Requirements For Exempt Status Under Section 501(c)(3)

1. *Organizational Test*

To be eligible for recognition of exemption from federal income tax as an organization described in Section 501(c)(3), an organization must have a proper organizational structure (charitable trust, nonprofit corporation, unincorporated association, or limited liability company), and must be organized and operated exclusively for charitable purposes.[7] Under Section 1.501(c)(3)-1(b)(1)(i) of the Regulations, an organization is organized for exempt purposes if its organizational documents limit its purposes to one or more exempt purposes and do not otherwise empower the organization to engage in a more than insubstantial manner in activities not in furtherance of one or more exempt purposes. To demonstrate compliance with this "organizational" test, an organization must show that its assets are dedicated to an exempt purpose.[8] Such dedication is accomplished by way of a dissolution provision requiring that upon dissolution, the assets of the organization will be distributed for exempt purposes or to the Federal government, or to a State or local government, for a public purpose.

2. *Operational Test*

As referenced above, to qualify for tax-exemption under Section 501(c)(3), a nonprofit corporation must satisfy an operational test. For purposes of the operational test, an organization must show it is (or shall be) operated exclusively (read: primarily) for exempt purposes.[9] Said differently, an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such exempt purposes specified in the relevant section of the Code.[10] An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.[11] The purpose(s) of the organization must be closely evaluated to determine if they are exempt or if they are nonexempt, and if nonexempt, whether the nonexempt purpose is substantial. A single nonexempt purpose, if substantial, destroys eligibility for exemption.[12] In determining whether an organization is operated to further a substantial nonexempt purpose, the decision-maker looks to the purposes furthered by an organization's activities rather than the nature of those activities.[13] As one court noted, "[u]nder the operational test, the purposes towards which an organization's activities are directed, and not the nature of the activities themselves, is ultimately dispositive of the organization's right to be classified as a section 501(c)(3) organization exempt from tax under section 501(a)…[I]t is possible for … an activity to be carried on for more than one purpose … [T]he critical inquiry is whether … [an organization's] primary purpose for engaging in its … activity is an exempt purpose ... ."[14] That an organization engages in a trade or business does not result in denial of tax-exempt status if the trade or business is in furtherance of such organization's exempt purposes.[15] The question is

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[6] *See* § 501(c)(3).
[7] *See* Reg. 1.501(c)(3)-1(a).
[8] *See* Reg. 1.501(c)(3)-1(b)(4).
[9] *See* Treas. Reg. § 1.501(c)(3)-1(c)(1).
[10] *See id.*
[11] *See id.*
[12] *See id.*; *Better Business Bureau*, 326 U.S. 279, 283 (1945).
[13] *B.S.W. Group, Inc. v. Comm'r*, 70 T.C. 352, 356-357 (1978).
[14] *Id.*
[15] *See* Treas. Reg. § 1.501(c)(3)-1(e)(1).

whether the trade or business is pursued to further the organization's purposes. If the trade or business is unrelated to the organization's purposes (i.e. not pursued to further those purposes) and is a substantial activity, the organization would not be entitled to exemption.[16] This primary purpose test as it relates to the conduct of a trade or business is further influenced by the commerciality doctrine below.

a. Private Benefit

The Treasury Regulations ("Regulations") further provide that to be operated for one or more exempt purposes the organization must serve a public rather than a private interest.[17] An organization will be found to primarily serve a private interest as opposed to a public interest unless the private interest served is merely incidental to the public interest.[18] Whether the private interest is incidental to the public interest is determined on a case-by-case basis depending upon the activities undertaken and the manner by which the public interest is derived.[19] Any private interest must be incidental to the public interest both quantitatively and qualitatively.[20] To be qualitatively incidental, "the private benefit must be a necessary concomitant of the activity which benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefiting certain private individuals."[21] To be quantitatively incidental, the activity must not provide a substantial benefit to a private person in the context of the overall benefit conferred by the activity to the public.[22] For example, regarding educational organizations, the dissemination of information and/or training of individuals serve a public interest by increasing the capabilities of those receiving instruction which serves to better the public welfare. Although all educational activities result in private benefit (i.e. students at any school at any level are necessarily benefited), such private benefit is incidental; the ultimate benefit is to the public absent the educational focus being to train students for a single employer.

b. Private Inurement

Within this broad concept of a prohibition on private benefit is the doctrine of private inurement. The private inurement doctrine is meant to ensure that a tax-exempt organization's "insiders" (i.e. persons in a position to influence the organization's affairs) do not use such position to siphon off any of a charity's income or assets for personal use. Common cases of private inurement revolve around payment of excessive compensation, certain rental arrangements, certain lending arrangements, and the sale of assets for more than fair market value to the organization.

There is an absolute prohibition on allowing assets to inure to the benefit of the organization's insiders.[23] "Insiders" include the organization's founders, directors, officers, key employees, and members of the families of these individuals, and certain entities controlled by these individuals.[24] If such action occurs, the Service may revoke the organization's tax-exempt status.[25] However, as an alternative measure in the context of public charities and social welfare organizations, the Service can impose intermediate sanctions, which results in excise taxes assessed directly against the insiders and other decision-makers

[16] *See* Treas. Reg. § 1.501(c)(3)-1(c)(1).
[17] *See* Treas. Reg. § 1.501(c)(3)-1(d)1(ii).
[18] *See* GCM 37789, (12/18/78).
[19] *See* GCM 38459, (7/31/80).
[20] *See* GCM 37789, (12/18/78).
[21] *See id.* (referencing Rev. Rul. 70–186, 1970-1 C.B. 128); *see also* Ltr. Rul. 9615030 (1996).
[22] *See* Rev. Rul. 72–559; Rev. Rul. 73–313.
[23] *See* Treas. Reg. § 1.501(c)(3)-1(c)(2).
[24] The concept of "insider" for inurement purposes includes disqualified persons identified under § 4958(f)(1) for purposes of the intermediate sanction rules but an "insider" for inurement purposes more broadly includes others who because of a unique position have the ability to influence or control the organization. *See American Campaign Academy v. Comm'r*, 92 T.C. 1053 (1989).
[25] *See* Treas. Reg. § 53.4958-8(a).

who approved this transaction.[26] For example, if an insider were paid an excessive salary, rather than revoke the organization's tax-exempt status (which would be within the purview of the Service), an excise tax sanction could be assessed against the insider in the amount of twenty-five percent (25%) of the excess benefit (which, if not corrected in a timely manner, will cause a second tier tax of two hundred percent (200%) of the excess benefit) and excise tax of ten percent (10%) of the excess benefit (not to exceed $20,000.00) imposed against decision-makers of the charity who knowingly participated in the transaction.[27]

c. Commerciality Concerns

While it is well-recognized that unrelated business activities can generate unrelated business taxable income and potentially risk exempt status, even related business activities can prove problematic. Where the related business is undertaken in a way the Service deems to have a "distinctively commercial hue," the organization may risk its exempt status.[28] The terminology of an organization having a "distinctively commercial hue" is most often referenced in the context of the commerciality doctrine – a non-Code doctrine examining whether an organization operating a business is truly doing so to further an exempt purpose.[29] Clearly, the concept of a charitable organization operating with a commercial hue is troubling for charities engaging in social enterprise activities which are, by their nature, revenue driven.

The commerciality doctrine uses a counterpart analysis looking at factors such as whether the organization sells goods and services to the public for a fee, whether the organization is "in direct competition" with for-profit organizations, whether the organization set prices based on pricing formulas common in the industry, whether the organization utilizes promotional materials normally utilized by for-profit organizations, whether the organization advertises its services in a commercial manner, whether the organization has activities and hours basically the same as for-profit enterprises, how the organization calculates payment for its management, and whether the organization receives charitable contributions.[30]

For example, in *Easter House v. United States*, the Court of Claims considered qualification for exemption of an adoption agency.[31] After reciting the operational test, the court noted that "the key to determining whether an organization, which at first blush might appear to be engaged in commercial activities that would disqualify it from exemption under section 501(c)(3), is qualified for exemption is whether the business purpose of the activities is incidental to the charitable purpose or vice versa."[32] In agreeing with the Service and finding that the business purpose was primary, the court noted the agency's competition with commercial adoption agencies, the accumulation of substantial profits, a fee schedule intended to derive a profit, and a lack of any support from solicitations.[33]

Likewise, in a case frequently cited in the commerciality area, the Seventh Circuit Court of Appeals affirmed the determination of the Service and the holding of the Tax Court in holding that an organization operating restaurants and health food stores ostensibly to further the religious work of the Seventh-Day Adventist Church did not qualify for exemption.[34] There, the court explained that in considering the effect of substantial commercial purposes on qualification for exemption, a court looks to "various objective

[26] *See* IRC § 4958.
[27] *See* IRC § 4958(a)(1); (d)(2).
[28] *See, e.g., Airlie Foundation v. IRS*, 283 F. Supp. 2d 58 (D.D.C. 2003).
[29] For an in-depth look at the commerciality doctrine, *see generally* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS, § 4.11 (John Wiley & Sons, Inc., 11th ed. 2011).
[30] *See, e.g., Living Faith, Inc. v. Commissioner*, 950 F. 2d 365 (7th Cir. 1991).
[31] 12 Cl. Ct. 476 (1987).
[32] *See id.* at 484.
[33] *See id.* at 485-486.
[34] *See Living Faith, Inc.*, 950 F. 2d at 376-77.

indicia" including the "manner in which an organization's activities are conducted, the commercial hue of those activities, competition with commercial firms, and the existence and amount of annual or accumulated profits … ."[35] The Seventh Circuit noted that the entity was in direct competition with other restaurants, had a price structure set competitively with other businesses and a lack of any below-cost pricing, used promotional materials to enhance sales, and lacked any plans to solicit contributions.[36] Noting that the corporation did not accumulate net profits, the court considered that but one factor outweighed by the other "indicia" of commerciality.[37]

In *Airlie Foundation v. I.R.S.*, the District Court for the District of Columbia agreed with the Service that the organization failed to qualify for exemption as its activities evidenced a primary commercial purpose.[38] The organization was organized for educational purposes and carried out its mission through organizing, hosting, conducting, and sponsoring educational conferences.[39] The organization additionally provided certain administrative support for environmental studies conducted at its facility.[40] In clearly setting out the commerciality doctrine, the court stated that "[i]n cases where an organization's activities could be carried out for either exempt or nonexempt purposes, courts must examine the *manner* in which those activities are carried out in order to determine their true purpose."[41] The court analogized the facts in *Airlie* to the organization in *BSW Group* noting that the organization did not directly benefit the public (rather, it benefited other organizations that benefited the public) and did not limit its activities to tax-exempt organizations.[42] The court balanced the entity's fee structure and willingness to subsidize certain attendees (both indicative of a non-commercial purpose) against the nature of the entity's clients (both taxable and tax-exempt), competition with commercial organizations, advertising expenditures, and significant revenues derived from weddings and special events, ultimately determining that the entity was organized for a substantial commercial purpose.[43]

What is, perhaps, most concerning about these commerciality doctrine cases is their inconsistency in recognizing the nexus between the commercial activity and the exempt purpose. The Tax Court has clarified that in determining whether an organization is operated to further a substantial non-exempt purpose, the decision-maker (Service or court) is to look to the purposes furthered by an organization's activities rather than the nature of those activities.[44] The commerciality doctrine, in looking at the manner in which an organization carries out its activities to determine purpose, sets up a logical fallacy where purpose is the lens through which activities are viewed, yet those same activities somehow serve as an indication of purpose.[45] This circular argument is exemplified by the decision in *Living Faith* where the court initially noted that it must "focus on 'the purposes toward which an organization's activities are directed,' and not the nature of the activities" but subsequently stated that "[a]n organization's activities … determine entitlement to tax exemption," and that "[w]hile 'the inquiry must remain that of determining the purpose to which the … business activity is directed,' the activities provide a useful indicia of the organization's purpose or purposes."[46]

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[35] *See id.* at 372.
[36] *See id.* at 373-374.
[37] *See id.* at 374.
[38] 283 F. Supp. 2d 58 (D.D.C. 2003).
[39] *See id*. at 60.
[40] *See id.*
[41] *See id.* at 63 (emphasis in original).
[42] *See id.* at 65.
[43] *See id.*
[44] *See B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352 (1978).
[45] *See* Edward T. Chaney, "*Commerciality, Charter School Management Organizations, and Social Enterprise,*" 27 Exempts 5, page 3 (Mar/Apr 2016).
[46] *Living Faith, Inc.*, 950 F. 2d at 370, 372.

This ambiguity creates uncertainty and can lead to disparate results. No clear guidance exists to allow an organization comfort that its operations will show that its charitable or other exempt purpose trumps profit-making. In the hospital context (another situation in which taxable and tax-exempt organizations exist in the same space), Congress enacted Section 501(r) setting forth specific areas for hospitals to provide demonstrable evidence that charitability trumps profit.[47] Outside of the hospital context, however, exempt organizations are left with the commerciality doctrine, discussions of a "commercial hue," and trying to ascertain indicia of commerciality. Rather than exist in this state of unknown, organizations at risk of violating the commerciality doctrine may spin such activities off into a taxable subsidiary or related organization to avoid such risk and entrepreneurs may eschew the nonprofit form for a for-profit or dual purpose option.

While the commerciality doctrine is not new, the continuing increase in charitable organizations seeking sustainability through commercial activities or seeking to operate as social enterprises has given the commerciality doctrine increased exposure. While greater license may be given to tax-exempt organizations operating social enterprise subsidiaries, it would be unwise to ignore the application of the commerciality doctrine altogether in this context.[48] A clear tension exists between a doctrine that seeks to define charity as acting in a non-commercial manner and social enterprise where charitable purposes are achieved directly through commercial activities. Because the commerciality doctrine is court-created rather than legislatively crafted, no bright line or safe harbor exists to guide the charitable entrepreneur.

3. *Other Prohibitions*

Section 1.501(c)(3)-1(c)(3) provides that an action organization—that is, an organization attempting to influence legislation by propaganda or otherwise or an organization that or intervenes in political campaigns—is ineligible for exemption as it is not operated exclusively for exempt purposes.[49] Finally, case law has appended the foregoing elements with the requirement that an organization must not be violative of public policy to qualify for exempt status.[50]

C. UNRELATED BUSINESS TAXABLE INCOME[51]

Tax-exempt organizations, including private foundations and public charities alike, are subject to tax on unrelated business taxable income ("UBTI") at the regular corporate (or trust, if applicable) income tax rates, subject to a $1,000.00 exemption; excessive UBTI can even jeopardize the organization's tax-exempt status.[52] Further, some practitioners consider the realization of reportable UBTI as increasing the audit exposure on other activities of the organization.[53]

Unrelated business income tax ("UBIT") is triggered when the organization has income from a trade or business regularly carried on that is not substantially related to the exempt purposes of the

[47] *See* IRC § 501(r).

[48] *See, e.g., Council for Bibliographic and Information Technologies v. Commissioner*, T.C. Memo 1992-364 (ignoring the Service's arguments concerning the commercial hue of certain activities noting that the organization at issue was formed by and controlled by a tax-exempt organization). In addition to the fact that the organization was formed by a tax-exempt organization, it should not be overlooked that the organization was providing services that the court viewed as necessary and indispensable exclusively to tax-exempt organizations.

[49] *See* Treas. Reg. § 1.501(c)(3)-1(c)(3).

[50] *See Bob Jones Univ. v. United States*, 461 U.S. 574 (1983).

[51] This portion of the article on UBTI excerpted with permission from SANDERS, MEGAN C., GIFTS FROM COUSIN EDDIE: ACCEPTANCE, OWNERSHIP & MANAGEMENT OF BIZARRE ASSETS, University of Texas School of Law, 32nd Annual Nonprofit Organizations Institute, January 2015.

[52] IRC §§ 511, 512.

[53] CAUDILL, WILLIAM H. "UNRELATED BUSINESS ACTIVITIES: STRATEGIES FOR COPING", University of Texas School of Law Nonprofits Organizations Institute, January 2014.

organization.[54] Most passive income is not subject to UBIT, though it may be if it is derived from a controlled entity or from debt-financed property.[55] The policy behind the concept of taxing unrelated business income is to eliminate unfair competition: the unrelated business activities of the nonprofit sector are to be placed on the same tax basis as the for-profit marketplace with which they compete.[56]

A trade or business is an activity carried on for the production of income from the sale of goods or performance of services; this element will consider the existence of a profit motive in the activity.[57] In determining whether the activity is "regularly carried on", the Service will analyze how frequently the nonexempt activity occurs, comparing the manner of conduct and continuity of the activities to those of their for-profit counterparts. For example, business activities engaged in only periodically would not be considered "regularly carried on" (such as an annual 10k or bake sale), but if the commercial activity is typically seasonal, such as selling beach chairs during the summer, the activity may be considered regular. The time spent preparing for the activity is also considered in the computation of the organization's time involved in the business activity.[58] The Service will determine whether a business is substantially related to the exempt purpose of the organization based on the nature, scope and motivation for conducting the activity. A business is substantially related only if the activity contributes importantly to the accomplishment of the exempt purposes, which depends on the facts and circumstances in each case.[59]

The Service allows for certain activities to be exempt from UBTI, as well as some modifications to UBTI that exclude certain income from this calculation. The volunteer exception allows an activity in which substantially all of the work in carrying on such business is performed for the organization without compensation.[60] The convenience exemption allows an activity carried on primarily for the convenience of the organization's members, students, patients, officers or employees to be exempt.[61] An activity which consists of selling merchandise donated to the organization is an exception to UBTI under the thrift shop exception.[62] Qualified sponsorship payments are also an exception from UBTI, so long as there is no arrangement or expectation that a person/donor will receive a "substantial return benefit" other than the use or acknowledgement of that person's trade or business name or logo. It is irrelevant whether the sponsored activity is related or unrelated to the charity's exempt purposes.[63]

Once the gross income from the unrelated trade or business is calculated and reduced by the appropriate deductions, the remaining amount of UBTI may be further reduced by certain modifications in Code 512(b). For example, passive income is not seen as a source of unfair competition with for-profit entities and is not subject to UBIT. This includes dividends, interest, annuities, royalties, rents from real property, and rents from personal property leased with the real property (so long as the rents from personal property are an incidental amount, 10% or less, of the total rents received or accrued under the lease).

III. LIMITED LIABILITY COMPANY BASICS

[54] Treas. Reg. §1.513(b); U.S. v. Am. Bar Endowment, 477 U.S. 105 (1986).
[55] *See id.; see also* FUENTES TOUBIA, NICOLA, "UBIT: ADVANCED ISSUES AND PRACTICAL APPLICATIONS", presented to the University of Texas School of Law Nonprofit Organizations Institute, January 2014.
[56] *See id.; see also* FUENTES TOUBIA, NICOLA, "UBIT: ADVANCED ISSUES AND PRACTICAL APPLICATIONS", presented to the University of Texas School of Law Nonprofit Organizations Institute, January 2014.
[57] IRC § 513(a); Treas. Reg. § 1.513-(a).
[58] PLR 201251019.
[59] Rev. Rul. 55-676, 1955-2 C.B. 266.
[60] *See* IRC § 513(a)(1).
[61] *See* IRC § 513(a)(2).
[62] *See* IRC §513(a)(3).
[63] Treas. Reg. § 1.513-4(c).

Although newer to the scene, all 50 states have legislation governing the formation of a limited liability company ("LLC"). The LLC was originally enacted as a hybrid entity combining features of corporations and partnerships.[64] It is a single entity in which the owners (called members) have liability protection from the operations of the LLC.[65] However, for federal tax purposes, it is treated as a partnership unless an affirmative election is made to be taxed as a corporation or unless it has a single member, in which event it is disregarded absent an election to be treated as a corporation.[66] Therefore, it combines the benefits of limited liability of a corporation for all the owners of the LLC while retaining tax advantages of a partnership. This has caused it to be a popular entity choice. LLCs are governed by the Texas Business Organizations Code ("BOC") and specifically Chapter 101.[67] LLCs are created through filing a certificate of formation to obtain the benefit of limited liability company status.[68] Instead of bylaws, the LLC normally has an operational document called a company agreement (sometimes called an operating agreement or regulations) which is a hybrid of bylaws (for the corporation) and a partnership agreement (in a partnership). As with for-profit corporations, LLCs in Texas can generally be formed for any lawful purpose or purposes, notably, not simply "business purposes."[69]

The operational aspects of LLCs are flexible under Texas law. Unlike corporations which have a somewhat rigid operational structure (e.g., annual shareholder meetings, annual board of director meetings, election of officers, evidence of authorization of corporate acts, minute books, etc.), LLCs require much less regarding "maintenance" of the entity. LLCs can be member-managed or manager-managed.[70] In the exempt organization context, this means the member (the exempt organization) can manage the LLC by acting though its own board of directors or can appoint others to manage the LLC with those "others" acting essentially as a board of directors of the subsidiary LLC. Whereas in a corporate situation the board of directors must elect officers to bind the corporation to any act or obligation, an LLC may act directly through its members or managers (depending on what type of governance structure it has) to bind the company. Whereas a corporation must show appropriate resolution, meeting minutes or consents in lieu of meetings, an LLC generally can rely on any "reasonable method" in order to evidence a particular person's authority to act on behalf of the LLC. Presumably, this can include meetings, resolutions, or consents in lieu of meetings, but may also include simple representations. Furthermore, LLC members and managers do not have to have annual meetings. These attributes cause the LLC to be an attractive form of business, especially for those that desire a lower-maintenance option to the rigidities of corporate law. Nevertheless, for protection of the separate status necessary to avoid having activities of the subsidiary attributed to the parent tax-exempt organization, some level of documented formality should be followed.

As noted above, Chapter 101 of the BOC provides that members and managers are shielded from debts, obligations, and liabilities of the LLC. This liability protection, with the simple control (such as management overlap), is a beneficial feature of the LLC being used as a subsidiary-type organization, particularly in holding and operating assets that have the potential to be high-risk assets or activities.

IV. LLC AS A SUBSIDIARY OF AN EXEMPT ORGANIZATION

A. FEDERAL TAX TREATMENT

[64] *See* 725 T.M., *Limited Liability Companies* (Bloomberg BNA Tax Management Portfolio 725-3).
[65] *See* Tex. Bus. Orgs. Code § 101.114.
[66] *See* Treas. Reg. § 301.7701-2(c)(2).
[67] *See* Tex. Bus. Orgs. Code § 101.001 *et seq*.
[68] *See id*. § 3.001.
[69] *See id*. §§ 2.001; 2.007.
[70] *See id*. at § 101.251.

As referenced above, the LLC is unique in that it can be classified as a disregarded entity, a partnership, or an association (taxed as a corporation) for federal income tax purposes. Where the LLC is a single member LLC with the single member being an exempt organization, federal tax law provides that the LLC will be disregarded, meaning that the LLC does not need to separately apply for tax-exempt status (discussed below) but rather will effectively take on the tax attributes of its parent member absent an affirmative election to be taxed as a corporation under the "check the box" regulations.

If the LLC is treated as a disregarded entity, it has no independent tax filing or information filing requirement, but rather its income and loss and activities are considered part of the exempt parent and are reported on the exempt parent's Form 990. If the activities undertaken in the disregarded single-member LLC are unrelated to the activities of the parent, they not only create unrelated business taxable income, but they risk the parent's exempt status to the extent they become large enough to be a substantial purpose. Accordingly, while a single-member LLC may be useful in carrying out related activities, it is not an appropriate choice for substantial unrelated business activities.

B. SINGLE MEMBER LLC AS RISK MITIGATION TOOL

One of the most common reasons tax-exempt organizations utilize the single member LLC is risk mitigation. Where the entity is carrying on higher risk activities, it may want to shield its endowment from those activities.[71] This is particularly true for organizations conducting activities such as construction, working with children or seniors, or other similar activities. It is often true for organizations seeking to isolate liability from real property ownership from its other funds. However, caution is advised to determine whether using the single member LLC will create more tax liability – particularly under the margin tax and property tax – than foregoing the separate entity and purchasing additional insurance or utilizing an entity that itself seeks and gains Service recognition of exemption. These considerations will be discussed at IV.D. below.

An LLC, like a corporation, whether nonprofit or for-profit (and whether taxable or tax-exempt) provides a liability shield (sometimes called a corporate veil) to its owners (or members, as the case may be).[72] Because of this corporate veil, the owners/members of the corporation do not generally have liability for corporate obligations or conduct.[73] However, the owners/members will continue to have liability for their own conduct, such as guaranteeing corporate obligations or their own negligent or otherwise tortious actions.[74] The exception to this general rule is when the court "pierces" the corporate veil, effectively finding that the corporate entity should be disregarded because the subsidiary corporation is the alter ego of the parent or because the corporation has been used as a sham to perpetrate a fraud.[75] Under either scenario, under Texas statutory law, a shareholder will not be held liable for contractual obligations of the subsidiary corporation unless there is a finding that the corporation was used by the shareholder to perpetrate an actual fraud for the direct personal benefit of the shareholder.[76] Courts have rejected attempts to pierce the corporate veil on any basis that would run counter to Section 21.223 of the Business Organizations Code.[77] For purposes of Section 21.223 and piercing the corporate veil, actual

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[71] *See* David S. Walker, *A Considerayion of an LLC for a 501(c)(3) Nonprofit Organization*, 38 WM MITCHELL L. REV. 627, 642 637.
[72] *See* Tex. Bus. Orgs. Code § 22.151, § 21.223.
[73] *See, e.g., Willis v. Donnelly*, 199 S.W.3d 262, 271 (Tex. 2006).
[74] *See, e.g., Sanchez v. Mulvaney*, 274 S.W.3d 700, 712 (Tex. App.—San Antonio 2008, no pet.).
[75] *See Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex. 1986); Tex. Bus. Orgs. Code § 21.223.
[76] *See* Tex. Bus. Orgs. Code § 21.223(a)(2) and (b).
[77] *See SSP Partners v. Gladstrong Investments (USA) Corporation*, 275 S.W.3d 444 (Tex. 2008) (rejecting the single business enterprise theory as running counter to the standards of Section 21.223); *see also Willis*, 199 S.W.3d at 271-273.

fraud means dishonesty of purpose and intent to deceive as opposed to requiring that the party seeking to pierce the corporate veil prove the elements of common law fraud. [78]

Because of the standard set by Section 21.223, piercing the corporate veil in Texas poses a significant hurdle. While case law indicates that the relationship between the shareholder and the corporation must be reviewed in its totality to determine whether there is an alter ego relationship, failure to follow corporate formalities is not a basis to hold a shareholder liable for an obligation of the corporation under Section 21.223(a)(3) of the Business Organizations Code. The majority of courts have excluded corporate formalities as even a factor in determining veil piercing, though at least one court has interpreted the provision to mean it cannot be the only basis on which an alter ego is predicated.[79]

Under Section 101.002 of the Business Organizations Code, Sections 21.223-21.226 of the Business Organizations Code (those sections addressed above providing the strict standard for piercing the corporate veil in the corporate context) apply equally to limited liability companies.[80] Thus, members may participate in management and retain the liability shield, unlike the limited partnership context. As with corporations, members and managers of LLCs will continue to be liable if they guarantee obligations of the LLC and for their own tortious conduct.[81] As within the corporate context, owning all of the interests of a limited liability company or failing to follow corporate formalities are not justifications for finding alter ego. Accordingly, in Texas the corporate shield for the LLC is equally strong as the corporate shield for a corporation.

A final note: while piercing the corporate veil is a difficult task in Texas and corporate formalities are not a factor (majority view) or not the only factor (minority view), that rule is based on a specific Texas statute and applies to contractual obligations or matters relating to or arising out of contractual obligations. Where tax-exempt organizations are utilizing subsidiaries formed as corporations in other states, care should be taken to determine what law will apply.[82] Thus, tax-exempt organizations creating LLC subsidiaries in states other than Texas should understand what law applies, as many states do not have statutes that addressing veil piercing in the context of LLCs and may apply more lenient veil-piercing theories under common law. Likewise, Section 21.223 and the high standards contained therein do not technically apply to non-contractual obligations that do not arise out of contractual obligations. Said differently, the statutory standard is not directly applicable to tort causes of action. The proposed instructions for piercing the corporate veil and tort cases provided by the Texas Pattern Jury Charges omit reference to showing actual fraud.[83] Nevertheless, it is still required that the plaintiff seeking to pierce the corporate veil show that the corporate veil has been used to promote injustice or inequity (i.e. injustice or inequity will result if the separate corporate existence is recognized).[84]

Because a tax-exempt organization may create a subsidiary in another state (or having another state's laws apply to the conduct of a subsidiary) and because tort claims are treated slightly differently

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[78] *See, e.g., Latham v. Burgher*, 320 S.W.3d 602, 606-07 (Tex. App.—Dallas 2010, no pet.).

[79] *See* Elizabeth S. Miller, *Governing Persons and Owners in Action: Liability Protection and Piercing the Veil of Texas Business Entities*, State Bar of Texas, Essentials of Business Law Course: The Lifecycle of a Business, March 2014, at page 4 (citing *Burchinal v. P.J. Trailers-Seminole Mgmt. Co., LLC*, 372 S.W.3d 200, 217 (Tex. App.—Texarkana 2012, no pet.) and a string of cases for the majority rule and comparing *Schlueter v. Carey*, 112 S.W.3d 164, 170 (Tex. App.—Fort Worth 2003, pet. denied) as the minority view).

[80] *See* Tex. Bus. Orgs. Code § 101.002.

[81] *See, e.g., Sanchez v. Mulvaney*, 274 S.W.3d at 712.

[82] *See e.g.* Michael W. Peregrine, *The Return of Alter Ego*, Health Lawyers Weekly, American Health Lawyers Association 2007 (discussing *Network for Good v. United Way of the Bay Area*).

[83] *See, e.g.*, PJC 108.2.

[84] *See id.; see also SSP Partners*, 275 S.W.3d 444 (Tex. 2008) (rejecting the single business enterprise theory and requiring the showing of inequity or injustice).

than contractual claims under Texas law, the parent organization should be mindful of maintaining sufficient separateness to avoid a piercing result. Some factors that should be observed are avoiding complete overlap of directors, officers, and employees ensuring that the subsidiary is appropriately capitalized to meet its needs; dealing in arms-length transactions between the subsidiary and the parent, allowing the subsidiary to carry out its own decision making, maintaining separate meetings, separate minutes, separate bank accounts, etc. Even with such showings, however, the plaintiff in Texas seeking to impose liability through a corporate veil for a tort claim must nevertheless demonstrate that the "corporate entity was used to achieve an inequitable result."

C. SINGLE MEMBER LLC AS PARTICIPANT IN JOINT VENTURE

If there are two or more owners of an LLC, the LLC is treated as a partnership for federal income tax purposes unless the owners elect to be treated as an association (taxed as a corporation). Being treated as a partnership for federal income tax purposes can be advantageous to an LLC because it allows it to take advantage of the flexibility in the partnership tax area discussed below while still retaining limited liability for all of its owners in a single entity. While this is a common benefit to LLCs, tax-exempt organizations participating in a multi-member LLC with one or more for profit entities should be cautious about being taxed as a partnership to ensure the activities of the LLC do not negatively affect the exempt status of the single member LLC's tax-exempt parent. Specifically, the unrelated business income is passed through to the partners and the tax-exempt organization would get its allocation. Further, the aggregate approach is used to consider the activities of the partnership with the activities of the exempt organization in considering satisfaction of the operational test for ongoing exempt status.[85]

A tax-exempt organization engaged in a partnership (whether general or limited) must consider whether it has lost control of its charitable assets. This is particularly troublesome with respect to a tax-exempt partner serving as the general partner of a limited partnership where the general partner has fiduciary obligations to operate the partnership to the economic benefit of the limited partners. Because tax-exempt organizations must operate primarily for their exempt purpose, participation in a joint venture requires scrutiny to determine whether participation in such venture causes the tax-exempt organization to operate more than insubstantially in an other-than-exempt purpose. The Service has developed a two-pronged test to make such determination. First, the exempt organization's participation must be substantially related to the exempt purpose of the exempt organization. Second, the structure of the partnership arrangement must avoid conflicts between the exempt organization's purpose and the exempt organization's duty (if any) to further the private interests of non-exempt partners in the venture. With respect to the first prong, the examination requires a review of the purpose of the joint venture, with an eye toward whether an exempt purpose is being served. If the exempt purpose bears only a tenuous relationship to the purpose of the joint venture, there is a risk of the organization losing its exemption. Assuming the purpose of the joint venture is substantially related to the exempt organization's exempt purpose, the second prong looks to whether the exempt organization retains sufficient control of the joint venture to ensure that such exempt purposes are actually met. As a part of this second prong, a determination that any benefits conferred upon private interests are incidental, both quantitatively and qualitatively, must be made. This requires looking to the benefit conferred on private partners and comparing that benefit to the benefit received by the exempt organization regarding the furthering of the exempt organization's purposes.

The Service has outlined certain factors it considers favorable regarding the structure of a joint venture arrangement and certain factors it considers unfavorable. The favorable factors are:

[85] *See, e.g.*, Rev. Rul. 98-15, 1998-1 C.B. 718.

1. Limited contractual liability of the exempt partner;

2. Limited rate of return on invested capital of the non-exempt parties;

3. Exempt organization's right of first refusal on sale of partnership assets;

4. Presence of additional general partners/managers obligated to protect the interests of the non-exempt organization partners;

5. Lack of control by the non-exempt organization partners except during the initial start-up;

6. Absence of any obligation to return the non-exempt organization's capital from exempt organization funds;

7. Absence of profit as a primary motivation;

8. Arm's length transactions with partners;

9. The management contract, if any, is terminable for cause by the joint venture (controlled by the exempt organization partner), has a limited term, any renewal must be approved of the joint venture, and provides for management by a party with independent activities;

10. The exempt organization has effective control over major decisions of the venture, as well day to day operations; and

11. There is a written commitment in the governing documentation of the joint venture to fulfilling the exempt purposes.

The unfavorable factors are:

1. Disproportionate allocation of profits and/or losses in favor of non-exempt organizations;

2. Commercially unreasonable loans by the exempt organization to the partnership;

3. Inadequate compensation received by the exempt organization for services it provides or excessive compensation paid by the exempt organization for services it receives;

4. Control of the exempt organization by the non-exempt organizations or a lack of sufficient control by the exempt organization to ensure it can carry out its exempt purposes;

5. An abnormal or insufficient capital contribution by non-exempt organizations;

6. A profit motivation by the exempt organization; and

7. A guarantee of non-exempt organization protected tax credits or return on investment to the detriment of the exempt organization.

These factors are not exhaustive. Not all of the favorable factors must be met and not all of the unfavorable factors must be avoided. Rather, the test is one of facts and circumstances based on a totality of the facts and circumstances.

In addition to the concern over the impact of unrelated business income being allocated to the tax-exempt organization that is a member of an LLC taxed as a partnership, and the activities of the partnership being aggregated with the activities of the tax-exempt organization, where the LLC has multiple members, some of which are exempt and some of which are taxable, and where the activities of the LLC are unrelated to the exempt purposes of the tax-exempt organization, the tax-exempt organization must be sensitive to concerns of private benefit and private inurement when serving as a managing partner in the same way as were it serving as a general partner of a limited partnership. The assets of the exempt organization may not be used to provide substantial benefits to for-profit partners. Critical to this consideration is the ongoing control of the tax-exempt organization over its charitable assets. Losing control of charitable assets risks the exempt status of the tax-exempt organization member of the LLC even if the activities are related to the tax-exempt organization's charitable purposes.

D. THE DOWNSIDE OF THE SUBSIDIARY LLC

Corporations, if exempt under Section 501(c)(3), are eligible for exemption from the Texas Margin Tax.[86] Likewise, passive entities (as defined under Texas Tax Code § 171.0003) are not subject to the Texas Margin Tax. However, taxable corporations, limited liability companies that are operating businesses (regardless of whether they are disregarded for federal income tax purposes), general partnerships owned by other filing entities, and limited partnerships are subject to the Texas Margin Tax. Although requests have been made that the Texas Comptroller treat the disregarded entity of a charitable organization as exempt from margin tax and sales and use tax, the Comptroller has declined to do so noting that a disregarded entity is nevertheless regarded for Texas tax purposes and the single member LLC must therefore file its annual franchise report and pay tax as due and is further not entitled to exemption from the sales and use tax.[87] Thus while a charitable organization may operate certain activities within the charitable entity and have those activities be free of Texas taxes, as soon as those activities are moved into a disregarded entity, they become taxable.

In addition to the Texas taxes addressed above, use of a single member LLC to hold real property otherwise exempt while held by the charity directly is problematic. Section 11.18 of the Property Tax Code provides exemption for certain real property, buildings, and tangible property owned by the charitable organization and used by one or more charitable organizations for certain types of charitable purposes (note, not every use by a charitable organization allows for exemption).[88] Because a single member LLC is regarded for state law purposes, and because it would not itself be a recognized charitable entity, should it hold the real property (which would be common for rick mitigation purposes), the property would not be eligible for exemption absent a successful argument for equitable ownership.[89]

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[86] *See* Tex. Tax Code § 171.063(a)(1).
[87] *See* Comptr. Ltr. Rul. 200106900L (June 21, 2001).
[88] *See* Tex. Tax Code § 11.18.
[89] Jay M. Chadha, in a paper delivered for the 14th Annual State Bar of Texas Governance of Nonprofit Organizations Course (August 25-26, 2016) queried whether a claim for equitable ownership could be made by the charitable parent of a single member LLC noting the "Texas Attorney General has opined that it is likely a court would determine that the principles of equitable ownership are applicable to an entity seeking a charitable tax exemption under Tex. Tax Code § 11.18. Tex. Att'y Gen. Op. No. GA-1092 (Dec. 8, 2014); *see also* Galveston Cent. Appraisal Dist. V. TRQ Captain's Landing, *423 S.W.3d 374 (Tex. 2014); AHF-Arbors at Huntsville I, LLC v. Walker Cnty. Appraisal Dist.*, 410 S.W.3d 831 (Tex. 2012).

Besides state tax issues, use of a single member LLC poses an additional hurdle when seeking the benefits of the Charitable Immunity and Liability Act of 1987.[90] The Charitable Immunity and Liability Act of 1987 provides limited immunity to charitable organizations and their volunteers. Notably, it defines "charitable organization" primarily in relation to an organization's being listed as an exempt organization under various sections of Chapter 501 of the Code. As a result of being disregarded from an exempt parent as opposed to the single member LLC itself being listed as an exempt organization, a single member LLC must meet the more fact-intensive requirements of Sec. 84.003(1)(B) to qualify for organizational immunity and to provide immunity for its volunteers and employees. As a result, placing higher risk activities in a single member LLC (one of the primary justifications for creating a single member LLC) creates the risk that the charitable immunity provisions of Texas law will no longer apply to cover those activities.

V. THE EXEMPT LLC

Should a single member LLC wish to apply for exemption from federal income tax (as opposed to being a disregarded entity) or should the LLC have multiple members and wish to be recognized as exempt, separate conditions apply. The Service has indicated that it will recognize the 501(c)(3) exemption of an LLC if the LLC otherwise meets the qualification for exemption (discussed above) and meets 12 additional conditions as follows[91]:

1. The original documents must include a specific statement limiting the LLC's activities to one or more exempt purposes.

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 until or instrumentality.

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.

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.

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

[90] *See* TEX. CIV. PRAC. & REM. CODE § 84.001, et seq.
[91] These twelve conditions can be found in the IRS 2001 EO CPE under *Limited Liability Companies as Exempt Organizations—Update*.

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

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.

10. The organizational language must contain an acceptable contingency plan if one or more members cease to be an organization described in Section 501(c)(3) or a governmental unit or instrumentality.

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 to protect their interests in the LLC.

12. The LLC must represent that all its organizations document provisions are consistent with state LLC laws and are enforceable at law and in equity.

VI. LLC FOR SOCIAL ENTERPRISE

A. DEFINING SOCIAL ENTERPRISE

Unlike offering a definition of "charitable organization" under federal tax law or "nonprofit corporation" under state business entity law, there is no agreed upon definition of "social enterprise" under federal law, state law, or even among practitioners and commentators. For example, and not by limitation, these definitions are useful:

- "A social enterprise is any entity that uses earned revenue to pursue a double or a triple bottom line either alone (in a private sector or nonprofit business) or as a significant part of a nonprofit's mixed revenue stream that also includes philanthropic and government subsidies."[92]

- "Social enterprises are businesses whose primary purpose is the common good. They use the methods and disciplines of business and the power of the marketplace to advance their social, environmental, and human justice agendas. A social enterprise addresses an intractable social need and serves the common good, either through its products and services or through the number of disadvantaged people it employs. Its commercial activity is a strong revenue driver, whether a significant earned income stream within a nonprofit's mixture of new portfolio or a for-profit enterprise. The common good is its primary purpose, literally 'baked into' the organization's DNA and trumping all others."[93]

- Social enterprises are "business ventures that prioritize their social purpose(s), operate ethically, and promote democratic ownership and governance by primary stakeholders."[94]

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[92] *See* The Institute for Social Entrepreneurs, "*Social Enterprise Terminology*," available at www.socialent.org/Social_Enterprise_Terminology.htm (last visited July 15, 2016).

[93] *See* Social Enterprise Allowance, "*What's a Social Enterprise?*", available at https://socialenterprise.us/about/social-enterprise/ (last visited July 15, 2016).

[94] *See* Social Enterprise Europe, "*What is Social Enterprise*," available at www.socialenterpriseeurope.co.uk/what-is-social-enterprise (last visited July 15, 2016).

- "A social enterprise can be viewed as one not motivated by profit, in that any profit motive takes a backseat to a mission centered on curing an acute social malady."[95]

- "Social enterprise [refers] to any business model that, to a significant degree, has a mission-driven motive."[96]

These disparate definitions bring to mind the story of the six blind men trying to describe an elephant by touching a different part of the elephant.[97] Because none could see the full picture, they could not agree on a definition. Rather than engage in a theoretical debate, for this article, the best explanation of "social enterprise" may be that used by Justice Potter Stewart in seeking to avoid a fixed definition of pornography and simply offering "I know it when I see it."[98] Accordingly, some examples of social enterprise are useful.

B. I'LL KNOW IT WHEN I SEE IT: EXAMPLES OF SOCIAL ENTERPRISE

- Living Machine Systems: A leading provider of innovative and sustainable ecological wastewater treatment and reuse technology with multiple patents and clients as diverse as the United States Marine Corps and the National Audubon Society with products installed around the world.[99]

- New Belgium Brewing Co., Inc.: A Colorado brewery and the third largest craft brewer in the country (maker of Fat Tire beers) seeking to improve and measure its environmental sustainability using clean water, diverting its waste, and reducing its carbon footprint.[100]

- Puzzles Bakery and Café: A bakery in Schenectady, New York with a mission of improving the livelihood of individuals, families, and communities affected by autism spectrum disorders. The Bakery employs individuals with developmental disabilities to provide work in integrated settings with non-disabled colleagues, pays the same wages, and seeks to nurture compassion and understanding by exposing its community to individuals with disabilities.[101]

- Helping the Aging, Needy and Disabled, Inc. (H.A.N.D.): A social service provider in Austin, Texas seeking to provide exceptional, innovative care and support for those who need assistance with daily living while inspiring others to do the same. H.A.N.D. is a Section 501(c)(3) organization, allowing it to accept donations while also providing Medicaid services and private pay and sliding scale services for low income clients.[102]

- Aunt Bertha: A Delaware public benefit corporation based in Austin, Texas with a mission of making human services information accessible to people in programs. Aunt Bertha began with the idea that every person and family should have a place online where they can find help in a time of need. Aunt Bertha seeks to provide the country's most comprehensive online directory of social service organizations providing information to those needing social services and

[95] MARK J. LANE, SOCIAL ENTERPRISE: EMPOWERING MISSION DRIVEN ENTREPRENEURS, ABA Publishing (2011), at p.4.
[96] *Id*. at p. 7.
[97] *See Blind men and an elephant*, https://en.wikipedia.org/w/index.php?title=Blind_men_and_an_elephant&oldid=728921891 (last visited July 15, 2016).
[98] *See Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964).
[99] *See* www.livingmachines.com/home.aspx (last visited July 14, 2016).
[100] *See* www.newbelgium.com/sustainabiltiy (last visited July 13, 2016).
[101] *See* www.puzzlesbakerycafe.com/about-us (last visited July 15, 2016).
[102] *See* www.handcentraltx.org (last visited July 13, 2016).

providing the social service organizations with tools and insights to provide the necessary services in the right places. Aunt Bertha is a certified B corp (a designation discussed below).[103]

- Participant Media, LLC: An entertainment company producing feature films, television shows, and digital programs. It was founded by Jeffrey Skoll, one of the founders of eBay, to create entertainment to inspire and compel social change. Participant Media's filmography includes *Spotlight*; *Contagion*; *Lincoln*; *The Help*; *He Named Me Malala*; *The Look of Silence*; *CITIZENFOUR*; *Food, Inc.*; and *An Inconvenient Truth*. Participant Media's films have collectively earned 50 Academy Award® nominations and 11 wins.[104]

The examples provided above include small organizations to multi-national organizations, organizations working in social services to organizations working in the entertainment industry, organizations operating in the nonprofit tax-exempt form to the benefit corporation form to the for-profit form. What ties these organizations together is their desire to put mission first.

B. TAXABLE OR TAX-EXEMPT

Determining whether an organization should be taxable or tax-exempt depends, in the first instance, on whether the organization will have purposes that qualify for exemption. For purposes of Section 501(c)(3) of the Code, purposes that qualify for exempt are as follows:

> "Corporations, in any community chest, fund, or foundation, or 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 inure 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 distribution of statements), any political campaign on behalf of (or in opposition to) any candidate for public office."

Assuming the organization will have such purposes and will avoid the prohibitions on private inurement, excessive lobbying, and political intervention, other factors that should be considered when making the determination whether to operate as a tax-exempt or taxable subsidiary include the necessity of tax exemption (for example, for capitalization or fundraising purposes or avoidance of federal income tax), the goal of creating equity that can be sold in the future, and whether there is consideration of bringing in outside investors.

To the extent a tax-exempt parent is investing in a taxable for-profit subsidiary to carry out the social enterprise, the parent should be mindful of the rules for prudent investments (Uniform Prudent Management of Institutional Funds Act). Further, if the parent is a private foundation, the private foundation parent must be mindful of the private foundation prohibitions, specifically, the prohibition on excess business holdings and the prohibition on jeopardizing investments. Both the excess business holding prohibition and the prohibition on jeopardizing investments are inapplicable to the extent the foundation can treat its investment in the subsidiary as a program-related investment.

[103] *See* about.auntbertha.com/who-is-aunt-bertha (last visited July 13, 2016).
[104] *See* www.participantmedia.com/company-history (last visited July 16, 2016).

C. HYBRID/DUAL PURPOSE STRUCTURE

1. Low Profit Limited Liability Company (L3C)

a. States with L3C Legislation

The first L3C legislation was passed in 2008 in Vermont.[105] Currently, there are a total of eight states with L3C legislation: Illinois, Louisiana, Maine, Michigan, Rhode Island, Utah, Vermont, and Wyoming.[106] While these are currently the only states with L3C legislation, it is possible for an interested party in Texas to form an L3C under the laws of one of these states and register to do business in Texas as a foreign entity.

b. Structure/Purpose

The structure of an L3C does not differ from that of a standard LLC. Specifically, it is structured as a limited liability company with one or more members and can either be member-managed or manager-managed as set forth in the organizing document and company agreement. What makes the L3C unique is the requirement that the governing documents contain specific provisions related to the purpose of the entity. Specifically, L3C legislation will require that, in addition to the state's standard LLC formation requirements, language be added to the governing document that shows the entity is organized and is at all times to be operated in a way that demonstrates that the LLC significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Code and would not have been formed but for the entity's relationship to the accomplishment of these purposes.[107] Further, the documentation must specify that no significant purpose of the L3C is the production of income or the appreciation of property, although that the entity produces significant income or capital appreciation is not, absent other factors, conclusive evidence of a significant purpose involving the production of income or the appreciation of property.[108] Additionally, the L3C governing documents must specify that no purpose of the entity is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Code.[109]

These additional requirements should track the requirements for a private foundation's ability to make a program-related investment which serves as an exception to the jeopardizing investment rules under Section 4944 of the Code and associated Treasury Regulations. [110] It was initially hoped that legislation would be passed at the federal level providing that organizations formed as L3Cs would streamline the ability to receive program-related investments.[111] No such legislation has been passed; however, that an organization has undertaken to form itself as an L3C can be useful in coordinating program-related investments from private foundations and embedding a social purpose into the structure of the entity.

Texas does not have L3C legislation; however, besides the ability to form the entity under the laws of an L3C state, there is no prohibition in the BOC to prevent a party organizing a standard limited liability company under Chapter 101 of the BOC from including these provisions. Unlike some states which statutorily require that a limited liability company be formed for a lawful business purpose, Section 2.001 of the BOC provides that "[a] domestic entity has any lawful purpose or purposes, unless otherwise

[105] *See* Vt. Stat. Tit. 11, Ch. 21, §§ 3001 (23), 3005(a), 3023(a).
[106] *See* Brewer, Minnigh & Wexler, 489 T.M., *Social Enterprise by Non-Profits and Hybrid Organizations*, (Bloomberg BNA Tax Management Portfolio 489-1) at note 270 and accompanying text.
[107] *See id*. at IV.B.3.a.
[108] *See id*.
[109] *See id*.
[110] *See* Treas. Reg. § 53.4944-3(a)(2).
[111] *See, e.g.*, Philanthropic Facilitation Act (2013; 113th Congress H.R. 2832).

provided by this Code."[112] While Section 2.008 of the BOC requires that a corporation formed to operate a nonprofit institution may only be formed and governed as a nonprofit corporation (a provision tempered by the social purpose legislation added in 2013), because a limited liability company is not a corporation, Section 2.008 will not apply in this context.

c. Control/Fiduciary Duties

In those states with L3C legislation, the statutes do not impact upon the control aspects or fiduciary duties of the managing parties (whether members or managers). As with a standard for-profit LLC, the control mechanisms and the applicable fiduciary duties are largely a matter of contract between the parties as dictated by the company agreement.[113] However, where fiduciary duties exist in the LLC context, those obligations will require the managing parties to decide they reasonably believe to be in the best interest of the entity; where an entity has formed under L3C legislation the special provisions will necessarily be the focus of consideration of the fiduciary seeking to act in the entity's best interest. Because of the way the L3C legislation is written to require the primary purpose be a charitable or educational purpose and no significant purpose be profit maximization, the social entrepreneurship nature of the entity is effectively fixed in place as the focused consideration of the managers if the entity operates as an L3C. Rather than merely consider these purposes, the fiduciaries must ensure the charitable or educational purpose is actually pursued.

d. Federal Tax Issues

As indicated above, the L3C was initially formulated in hopes that federal legislation would be passed allowing it to more easily attract program-related investments. That legislation has not been passed, which makes the L3C no different from any other LLC for federal tax purposes. It will be taxed either as a disregarded entity (if it has a single member), as a pass-through entity (if it has multiple members), or as a C corporation (if it so elects).[114] If it has tax-exempt members, those members will generally want the organization to be taxed as a C corporation so that they are not receiving allocations of unrelated business income but rather passive dividends. Private investors will typically prefer the pass-through taxation.

e. State Tax Issues

All limited liability companies operating in Texas (whether foreign L3Cs or domestic LLCs that have utilized the same language) are subject to the Margin Tax absent a specific exception.[115] Because Texas does not follow the federal check-the-box regulations for LLC taxation, the general exception for charitable organizations exempt under Section 501(c)(3) will not apply to these organizations even if they are a disregarded subsidiary of a tax-exempt parent. Rather, only a specific statute covering specific activities might apply.

2. LLC as a Certified B Corp

a. States with Benefit Corporation Legislation

With the signing of HB 3488 on June 14, 2017, Texas became the 33rd state (in addition to the District of Columbia) to adopt benefit corporation legislation.[116] Maryland and Oregon, besides providing for the formation of benefit corporations, offer the benefit LLC based on their benefit corporation

[112] Tex. Bus. Orgs. Code § 2.001.
[113] *See* Brewer, Minnigh & Wexler, 489 T.M. at IV.B.3.C.
[114] *See supra* note 66 and accompanying text.
[115] *See supra* note 86 and accompanying text.
[116] *See* http://www.capitol.state.tx.us/BillLookup/history.aspx?LegSess=85R&Bill=HB3488 (last visited June 19, 2017); B Lab, "*State by State Status of Legislation*," available at www.benefitcorp.net/policymakers/state-by-state-status (last visited July 15, 2016).

legislation.[117] An additional six states have legislation under consideration.[118] This section will highlight the key features of the benefit corporation legislation nationally with an examination of specific Texas issues. The majority of states with benefit corporation legislation follow the Model Benefit Corporation Act ("Model Act") drafted by B Lab, a nonprofit organization providing certification for "B Corps" which may or may not actually be organized as true benefit corporations under benefit corporation legislation.[119] A minority of states with benefit corporation legislation follow what has been referred to as the "Delaware Act" based on benefit corporation legislation passed in Delaware.[120] The Texas version of benefit corporation legislation is based upon the Delaware Act.[121] While this section will describe benefit corporation legislation, it is worth noting that in Texas the benefit corporation legislation only applies to for profit corporations and not LLCs. However, an LLC may be certified by B Lab as a certified B Corp.[122] Thus this section will also explore the B Lab Model Act to understand that certification.

b. Structure/Purpose

To be certified as a B Corp, the LLC must have a purpose of creating general public benefit, which is defined as "[a] material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of a benefit corporation."[123] Besides the general public purpose, the LLC may (but is not required to) identify one or more specific public benefits it intends to accomplish.[124] The term "specific public benefit" includes the following:

1. Providing low-income or underserved individuals or communities with beneficial products or services;

2. Promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business;

3. Protecting or restoring the environment;

4. Improving human health;

5. Promoting the arts, sciences, or advancement or knowledge;

6. Increasing the flow of capital to entities with a purpose to benefit society or the environment; and

7. Conferring any other particular benefit on society or the environment.[125]

The comments to the Model Act explain that the provision requiring creation of general public benefit and/or specific public benefit effectively requires directors to consider these purposes in exercising their duty of care, as discussed below.[126]

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[117] *See* MD. CODE ANN; CORPS. & ASS'NS §§ 4A-1101-1108 (2013); OR. REV. STAT. §§ 60.750-770.
[118] *See supra* note 116.
[119] *See* B Lab, "*The Model Legislation*," available at benefitcorp.net/attorneys/model-legislation (last visited July 15, 2016); "*Benefit Corporations & Certified B Corps*," available at benefitcorp.net/businesses/benefit-corporations-and-certified-b-corps (last visited July 15, 2016).
[120] *See* Del. Code Ann. Tit. 8, §§ 361-368.
[121] *See* http://www.capitol.state.tx.us/BillLookup/history.aspx?LegSess=85R&Bill=HB3488 (last visited June 19, 2017).
[122] *See* https://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/legal-roadmap/llc-legal-roadmap (last visited June 19, 2017).
[123] *See* Model Act §§ 102 ("General Public Benefit"); 201(a).
[124] *See id.* § 201(b).
[125] *See id.* § 102 ("Specific Public Benefit").
[126] *See id.* § 201, Comment.

The term "general public benefit" under the Model Act requires the impact of the benefit corporation to be assessed against an independent third-party standard that is a comprehensive and credible "recognized standard for defining, reporting, and assessing corporate social and environmental performance … ."[127] The result of that assessment under the Model Act is issuance of an annual public report on the methods and results of accomplishing the general public benefit and specific public benefit (as applicable), any circumstances that hindered the organization's ability to create the desired public benefit, and the results of the assessment against the third-party standard.[128] This report must be sent to owners of the LLC and be made publically available on the Internet to promote transparency and accountability.[129]

While the Delaware Act (and thus the new Texas legislation) is based on the Model Act, it contains certain differences.[130] One of the most notable differences is the requirement of identifying one or more specific public benefits intended to be accomplished.[131] At least one commentator has noted this distinction does not seem present in several certificates of incorporation filed in Delaware with the specific public benefit only parroting the language describing general public benefit.[132] In other words, it may be that specifying the general public benefit will satisfy the specific public benefit test. However, due to the language of the statute, it is advisable (at least to the author of this present article) for a specific public benefit to be identified.

In addition to this difference, the Delaware Act does not require the same type of third-party standard for assessment but rather allows the board of directors to adopt standards "to measure the corporation's progress in promoting such public benefit or public benefits in interest … ."[133] Note however, that under the Delaware Act, the certificate of incorporation or bylaws may require that the corporation utilize a third-party standard.[134] Finally, whereas the Model Act requires the assessment to be provided to shareholders and posted publically annually, the Delaware Act requires the assessment and report no less than biennially, and the report must only go to the stockholders, though there is no prohibition on its online publication.[135]

c. Control/Fiduciary Duties

Neither the Model Act nor the Delaware Act changes the fiduciary duties owed by governing persons. As such, the standard fiduciary duty of care, duty of loyalty, and, in states where it is separated from the duty of care, duty of obedience continue to apply. What makes the duties of governing persons unique with respect to benefit corporations (or LLCs seeking B Corp certification) is what interests they are to consider when exercising those fiduciary duties. For example, to the extent the duty of care requires a governing person to act in good faith with ordinary care and in a manner he or she reasonably believes to be in the best interests of the organization, rather than merely considering profit maximization over the short term or long term, a governing person *must* consider other interests. Specifically, under the Model Act governing persons must consider the effects of any action or inaction on the shareholders; the employees and workforce of the organization (its subsidiaries and its suppliers); the interests of customers; the community in which the organization, its subsidiaries, or its suppliers are located; the local and global environment; the short-term and long-term interests of the organization; and the ability of the organization

[127] *See id.* § 102 ("Third Party Standard").
[128] *See id.* § 401(a).
[129] *See id.* § 402.
[130] *See* Brewer, Minnigh & Wexler, 489 T.M. at IV.C.3.d.
[131] *See* Del. Code Ann. Tit. 8 § 362(a).
[132] *See* Brewer, Minnigh & Wexler, 489 T.M. at IV.C.3.d., notes 443-444 and accompanying text.
[133] *See* Del. Code Ann. Tit. 8 § 366(b).
[134] Some states following the Delaware Act (such as Colorado) nevertheless require a third-party assessment.
[135] *See id.*

to accomplish its general public benefit purpose and any specific public benefit purpose.[136] This requirement can lead to significantly different decisions being made. Besides the requirement to consider these issues in making a decision, governing persons may consider other factors or interests they deem pertinent and appropriate.[137] The Model Act specifically provides that in considering those interests that must be considered and may be considered, the governing persons need not give priority to a particular interest or factor unless the governing documents so require.[138] Finally, recall that under the Model Act, the creation of general public benefit and specific public benefit are specifically stated as in the best interest of the organization.[139]

The Delaware Act differs slightly in that, because there is no requirement to create a "general public benefit" but rather to produce a public benefit and operate in a "responsible and sustainable manner" and produce one or more "specific public benefits," benefit directors have a slightly different mandate.[140] In those situations, directors are to balance the "pecuniary" interests of the shareholders, the best interests of "those materially affected by the corporation's conduct," and the "specific public benefits" described in the organizing document.[141] Commentators have referred to this consideration as a "tripartite mandate" and raised the question (yet unanswered) of whether there is a meaningful difference between "considering" factors under the Model Act and "balancing" factors under the Delaware Act.[142] Under both the Model Act and the Delaware Act, the directors' duties run to the shareholders and directors are generally not liable for their decision-making process provided they exercise their business judgment and are not interested in the subject of the business judgment.[143]

One final unique issue in the context of the Model Act is the ability to create a management position for a "benefit director" who, in addition to having the powers and responsibilities of the remaining managers, serves a special role in overseeing the annual reporting and making an annual compliance statement specifying whether the organization acted in accordance with the general public benefit and specific public benefit purposes set forth in its organizing documents, and if it failed to do so, in what respects.[144] The Model Act contains a specific provision exonerating this "special" benefit director from personal liability for acts or omission in the capacity of serving in such role absent self-dealing, willful misconduct, or a knowing violation of the law.[145] The Delaware Act does not contemplate such a unique "benefit director" position.

d. Federal Tax Issues

A benefit corporation receives no tax benefits and will be taxed as a C corporation unless subchapter S status is elected.[146]

e. State Tax Issues

As with any for profit enterprise, a benefit corporation will remain subject to the various state taxes including the margin tax, sales and use tax, and property tax. [147]

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[136] *See* Model Act § 301(a)(1).
[137] *See id*. § 301(a)(2).
[138] *See id*. § 301(a)(3).
[139] *See id*. § 201(c).
[140] *See* Del. Code Ann. Tit. 8 §§ 362(a), 365(a).
[141] *See* Del. Code Ann. Tit. 8 § 365(a).
[142] *See* Brewer, Minnigh & Wexler, 489 T.M. at IV.C.3.d.
[143] *See* Model Act § 301(d); Del. Code Ann. Tit. 8 § 365(b).
[144] *See* Model Act § 302.
[145] *See id.* § 302(e).
[146] *See* IRC § 1366.
[147] *See supra* note 86 and accompanying text.

3. Social Purpose LLC

A social purpose corporation is a for profit corporation that adopts some social purpose in its governing documents but is not subject to the reporting requirements of the benefit corporation. The Texas version of the social purpose corporation came about when the BOC was modified in 2013 to provide that a for-profit corporation could include one or more social purposes (a term specifically defined in the BOC) in addition to the purpose or purposes required to be stated in the corporation's certificate of formation.[148] Specifically, whereas Section 2.008 of the BOC sets out that certain activities can only be conducted by a corporation that is a nonprofit corporation, the BOC now makes an exception for corporations that include a social purpose statement.[149]

Section 1.002 of the BOC provides that "'social purposes' means one or more purposes of a for-profit corporation that are specified in the corporation's certificate of formation and consist of promoting one or more positive impacts on society or the environment or minimizing one or more adverse impacts on the corporation's activities on society or the environment.[150] Those impacts may include:

1. Providing low-income or underserved individuals or communities with beneficial products or services;

2. Promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business;

3. Preserving the environment;

4. Improving human health;

5. Promoting the arts, sciences, or advancement of knowledge;

6. Increasing the flow of capital to entities with a social purpose; and

7. Conferring any particular benefit on society or the environment."[151]

This definition is taken from the definition of "specific public benefit" in the Model Act for benefit corporations.[152]

a. Control/Fiduciary Duties

As referenced above, social purpose corporations, as a variant of the standard for-profit corporation, are governed by a board of directors. Those directors owe the standard fiduciary duties of directors—care, loyalty, and obedience. In social purpose corporations (in all three states) directors *may*, but are not *required* to, consider the specific social purpose(s) unless the governing documents so require. Stated differently, while the statutory regime in each state allows the social purpose corporation to include social purposes and authorizes directors to properly consider those purposes, the statutes do not require the directors to consider those purposes. Rather, the purpose of these statutes is simply to overcome any requirement that directors consider only profit maximization and risk breaching fiduciary duties by considering social purposes. The legislation was not intended to create the mandatory consideration or balancing test required under benefit corporation legislation (Model Act and Delaware Act,

[148] *See* Tex. Bus. Orgs. Code § 3.007(d).
[149] *See id.*
[150] *See id.* § 1.002 (82-a).
[151] *See id.*
[152] *Cf.* Model Act § 102 ("Specific public benefit").

respectively).[153] In California, a benefit corporation would be used for this purpose, though there is no benefit corporation analog in Washington or Texas. As referenced above, although Washington and California both require a social purpose report to be generated (though there is no requirement that a third-party assessment is used, as with benefit corporations), Texas has no reporting requirement.

b. Federal Tax Issues

A social purpose corporation receives no tax benefits and will be taxed as a C corporation unless subchapter S status is elected.[154]

c. State Tax Issues

Social purpose corporations (whether formed in Texas or in Washington or California) receive no special tax benefit under Texas law and will be subject to the Margin Tax.[155]

D. SELECTING THE STRUCTURE—A FLOWCHART OVERVIEW

Selection of an appropriate structure for a social enterprise requires consideration of the key characteristics and distinctions discussed above. In addition, questions such as the source of capitalization, compelling reasons to operate in the nonprofit or for-profit form, and other related questions are all critical. These factors and the decision making process can be helpfully viewed through the lens of a decision tree or flowchart. For a flowchart overview of the decision making process, please see Appendix A.

I. PHILANTHROCAPITALISM AND THE LLC

In 2016 use of the LLC for mission-driven purposes received a new and higher profile when Mark Zuckerberg and Priscilla Chan announced, in a letter to their newborn daughter, the creation of the Chan Zuckerberg Initiative ("CZI"), a limited liability company through which they plan to dispose of more than 99% of their Facebook shares for charitable and mission-driven purposes. This announcement did not represent the first billionaire to use the LLC for this purpose. Other "philanthrocapitalists" had started down a similar path. For example, Pierre Omidyar, founder of Ebay, formed a limited liability company to work alongside his private foundation. Laurene Powell Jobs, the widow of Steve Jobs, has created the Emerson Collective, an LLC working in the areas of education, immigration and innovation. However, the CZI represents the most high profile use of this model.

Immediately, questions arose regarding the benefits to the couple in making this pledge, with members of the media investigating the tax benefit that would accrue to Mr. Zuckerberg and Dr. Chan. They soon discovered the couple received no tax benefit and articles appeared from the New York Times to local newspapers explaining the disregarded status of the LLC, truly riveting front page reading![156]

So why did Mr. Zuckerberg and Dr. Chan create the CZI? The answer to this question appears in the letter penned to their child. As they explained in a Facebook post, "[t]he Chan Zuckerberg Initiative is structured as an LLC rather than a tradition foundation. This enables us to pursue our mission by funding

[153] *See* Texas Bill Analysis, S.B. 849, 7/16/2013 (explaining that "officers and directors of for-profit corporations would violate the duty they owed to shareholders to maximize shareholder profit if they were to pursue business decisions based solely on a social purpose" and noting that the BOC amendment "shields directors and officers from liability from shareholder suits when making a decision based on the stated social purpose").
[154] *See* IRC § 1366.
[155] *See supra* note 86 and accompanying text.
[156] *See, e.g.*, Natasha Singer and Mike Isaac, The New York Times, Dec. 2, 2015, "Mark Zuckerberg's Philanthropy Uses L.L.C. for More Control."

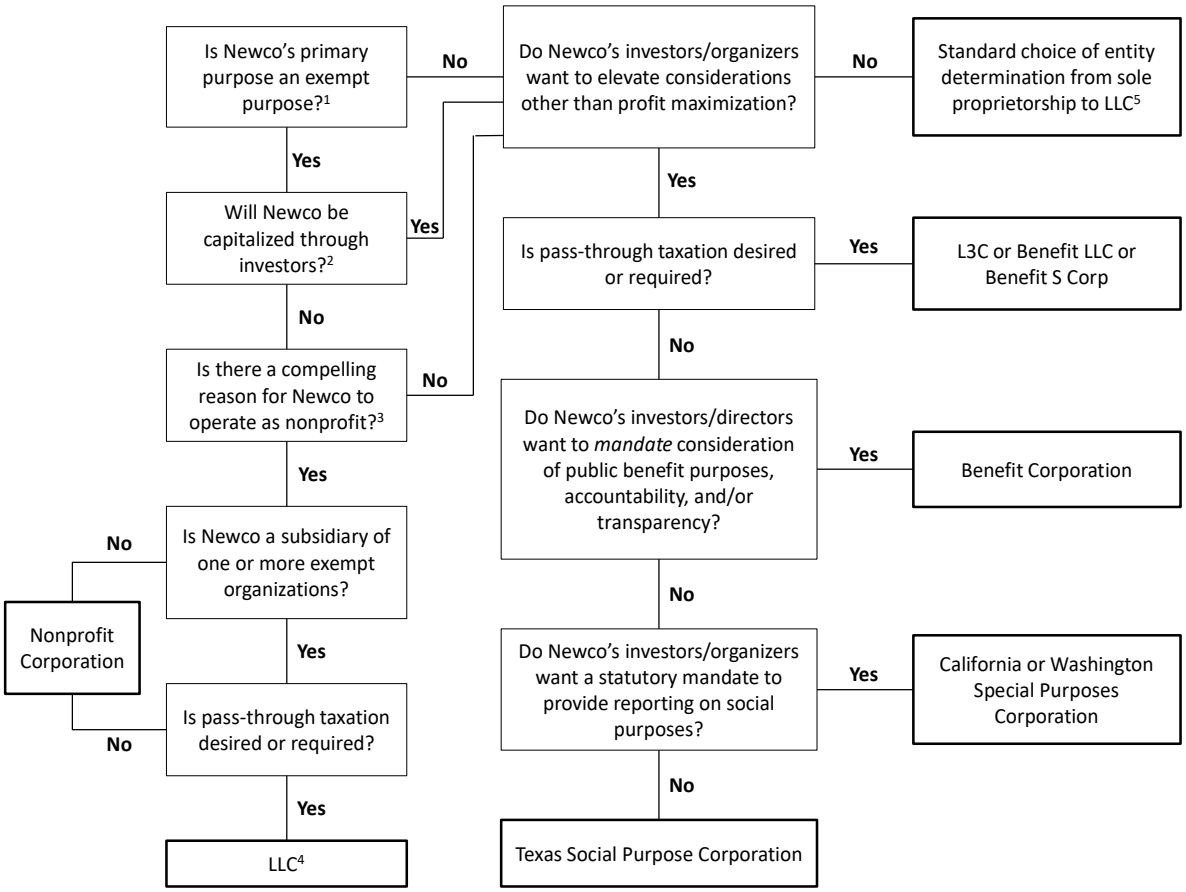
non-profit organizations, making private investments and participating in policy debates—in each case with the goal of generating a positive impact in areas of great need. Any net profits from investments will also be used to advance this mission." This explanation provides a roadmap of sorts for determining when the LLC serves as a real option for philanthropic work. What follows is a list of the benefits and drawbacks (considerations) in utilizing a disregarded LLC as a philanthropic vehicle.

Utilizing the LLC structure allows the donor to avoid the regulatory regime of the private foundation. Thus, there is no prohibition on self-dealing, holding more than twenty percent of an operating business, distributing five percent of the value of the endowment annually in charitable expenditures, making only prudent investments unless the program-related investment avenue is pursued, and making taxable expenditures such as donations to individuals or engaging in lobbying. However, to avoid this regulatory environment, the donor must forego a tax deduction when the funds are placed in the LLC. As funds are dispersed from the LLC, a pass-through of a charitable deduction is possible where the funds are used for a tax-deductible purpose. Should the donor die while the funds are in the LLC, the value is includible in his or her estate absent other planning.

A donor utilizing an LLC as a philanthropic vehicle maintains much more control over the enterprise – a board of directors is not needed – and much greater flexibility. The donor may invest through the LLC in promising technology, start-up companies, and impact investments throughout the world. The donor may incubate new businesses inside the LLC and the concept of relatedness makes no difference. Because the members of the LLC will be taxed on the income of the LLC, the concept of unrelated business income is irrelevant. Finally, the LLC offers the donor a choice in the level of transparency desired. There are no public tax returns, no list of contributors, no list of distributions, and no salary information disclosed. This is not to say a donor using an LLC in this manner will always seek privacy. Some donors may choose to use the LLC to provide transparency on individual philanthropy without disclosing his or her private tax information. However, the choice is the donor's rather than being mandated by law.

Ultimately, the idea of a philanthropic LLC such as CZI is simply an unenforceable pledge made to Charity (large "C"). It is a demonstration of intent to use resources for missional impact. Not every donor will find this useful. Many donors desire an immediate deduction or desire to move funds from an estate. However, for donors looking for ultimate flexibility, the LLC is a choice that should be considered.

APPENDIX A—SELECTING THE STRUCTURE



[1] For purposes of Section 501(c)(3) of the Code, purposes that qualify for exemption include "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 … ." Each purpose is a term of art with regulations and rulings setting forth and clarifying what it takes to qualify.

[2] If the entity is to be capitalized by invested capital from private investors, it will need to be structured as a for-profit entity (traditional for profit or dual purpose); if it is to be capitalized by donated capital, it should be structured as a nonprofit entity (typically a tax-exempt nonprofit corporation). To the extent the organization will seek private investors, it should be mindful of securities laws, which are beyond the scope of this article. Likewise, if the organization is seeking loans or guarantees from the Small Business Administration, it will need to be structured as a for-profit entity pursuant to 13 CRF 1.120.1000(b) (2012).

[3] Compelling reasons may include exemption from federal income tax, ability to participate in government programs requiring nonprofit status, certification or licensure requiring nonprofit status, margin tax exemption availability under Texas law, certain liability protection under Texas law, and, with respect to subsidiaries, potential avoidance of unrelated business taxable income and tax due on dissolution of the entity. For more information on these issues, *see* Darren B. Moore, *"Commercial Activities and Subsidiaries – Issues and Choices in Planning,"* 28 Exempts 4, 12 (Jan/Feb 2017).

[4] If the organization is a subsidiary of a single exempt organization, it will be a disregarded entity as a single member LLC. If the organization is a subsidiary of multiple exempt organizations, it can apply for and receive tax-exempt status. The LLC can be formed as a standard limited liability company; however, if there is a desire for a "nonprofit LLC," the LLC will need to be formed in Kentucky, Minnesota, North Dakota, or Tennessee. Because Texas law does not require a limited liability company to be formed for a "business purpose," the author sees little benefit in forming a nonprofit LLC in one of these states.

[5] Standard choice of for-profit entity decisions are beyond the scope of this article, but factors will generally include federal taxation, state taxation, liability protection, and capitalization issues.

APPENDIX B—SUGGESTED PROVISIONS FOR SMLLC

Private Inurement.
No part of the net earnings of the Company shall inure to the benefit of, or be distributed to, its officers or other private individuals, except that the Company shall be authorized and empowered to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of the purposes as set forth in the Certificate. The Company's assets shall be used to further its charitable purposes as set forth in the Certificate.

Limit on Political Activities.
No substantial part of the activities of the Company shall be the carrying on of propaganda, or otherwise attempting to influence legislation (except as otherwise provided by Code Section 501(h)), and the Company shall not participate in, or intervene in (including the publication or distribution of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Specific Power and Authority of the Managers.
Except for situations in which the approval of the Sole Member is required by this Agreement or by nonwaivable provisions of applicable law, the powers of the Company will be exercised by or under the authority of, and the business and affairs of the Company will be managed under the direction of the Manager; and the Manager may make all decisions and take all actions for the Company not otherwise provided for in this Agreement.

Notwithstanding the provisions of _____ or any other provision of this Agreement, the Manager may not cause the Company to do any of the following without obtaining the consent of the Sole Member:

i. taking such action which may cause the Sole Member to no longer be a Qualified Charitable Organization;
ii. taking such action which may cause the imposition of excise taxes under Sections 4941, 4943, 4944 or 4945 of the Code against the Sole Member; and
iii. taking such action which would create unrelated trade or business income to the Sole Member under Sections 511-514 of the Code.

Compensation.
The Managers (including any Manager who is a "disqualified person" with respect to the Sole Member within the meaning of the applicable provision of the Internal Revenue Code and the regulations promulgated thereunder) shall be entitled to compensation and reimbursement of reasonable expenses (including reasonable advances for expenses anticipated in the immediate future) for the performance of "personal services" as defined in Treasury Regulation Section 51.4942(d)-3(c) which are reasonable and necessary to carry out the exempt purposes of the Company, provided that such compensation and reimbursement of reasonable expenses shall not be excessive.

Amendment or Modification.
This Agreement may be amended or modified from time to time only by a written instrument adopted by the Managers and executed and agreed to by the Sole Member. Notwithstanding any other provisions in this Agreement, to the extent a provision would cause the Sole Member to be engaged in any action which may cause the imposition of excise taxes under Sections 4941, 4943, 4944 or 4945 of the Code, the Managers will have the power to modify such provision so that the act would not constitute a violation of such prohibited conduct. The Managers will only modify such provision to the extent necessary so as to not violate such prohibited conduct.

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