LLC Bill of Interest to Nonprofits

Senate Bill 482, ratified by the General Assembly on July 1, makes technical and clarifying changes to the NC Limited Liability Company Act that includes a provision of interest to nonprofits organized under Chapter 55A, NC Nonprofit Corporation Act.

The provision should add flexibility for nonprofits contemplating a strategic merger, and provide a new option for entities threatened by loss of public charity status.

The new law authorizes conversion of a nonprofit corporation to a limited liability company (LLC), with a nonprofit corporation as sole LLC member. Key features of such a conversion include:

- Strategic and functional advantages typically available through merger
- Consolidated Form 990 reporting
- Preservation of separate legal entities
- Treatment as separate organizations for wage and employment tax purposes

The NC Limited Liability Company Act, codified as Chapter 57D of the General Statutes, governs the creation, operation, and dissolution of LLCs. Section 3 of the Bill rewrites G.S. Section 57D-9-20 to provide that an entity may convert to an LLC if the following apply:

- The law governing the organization and internal affairs of the entity permit the conversion
- The entity complies with Part 2 of Chapter 55D of the General Statutes, regarding filing requirements with the Secretary of State
- In the case of a nonprofit corporation, that the sole member of the LLC of the surviving entity is a religious or charitable organization

For this purpose, a “religious or charitable organization” is any corporation that is exempt under Section 501(c)(3) of the Internal Revenue Code, or that is organized exclusively for one or more of the purposes specified in section 501(c)(3), and that upon dissolution must distribute its assets to a charitable or religious corporation, the United States, a state, or an entity that is exempt under section 501(c)(3).

It is not unusual for nonprofit organizations to use controlled entities for the conduct of charitable or income-producing activities, which may be related or unrelated to accomplishment of their exempt purposes. Typical reasons for multi-entity arrangements include protection of assets from exposure to liability where an organization conducts multiple program or commercial activities, or to facilitate future sale or other transfer of an activity to an entity other than a nonprofit corporation.

Before recommending a conversion under the new NC law, however, it is vital that advisors consider federal tax law implications for the converted entity and its exempt member.

A nonprofit organization exempt from tax under Section 501(a), which includes a charitable organization exempt under Section 501(c)(3), and that chooses an entity form that is disregarded as separate from its owner for federal tax purposes, is deemed to have elected to be classified as an association that is taxed as a corporation. Such an entity reports as a separate organization on the applicable IRS Form 990.

In contrast, a disregarded entity not exempt under Section 501(a) retains disregarded entity status unless it elects to be taxed separately as an association. An interest in a disregarded entity held by an exempt organization must therefore be consolidated for Form 990 reporting purposes.

In addition, when an exempt organization changes its legal entity form, such as converting from a corporation to an LLC, under IRS Revenue Ruling 67-390 a new application for tax-exempt status must be filed with the IRS in order to obtain exemption for the converted entity.

Accordingly, if an existing nonprofit corporation is converted to LLC form and elects to retain default disregarded status, i.e. it does not apply for separate exemption, then it will be treated as an activity of its exempt member.

The IRS has stated in the past that for an LLC with an exempt organization as its sole member, that the LLC articles of organization do not need to satisfy the Section 501(c)(3) organizational test. The organizing documents of the exempt member control, providing considerable flexibility for design and operation of the LLC. But there should be nothing in the LLC articles of organization that prohibit it from operating exclusively for Section 501(c)(3) purposes.

Satisfaction of the separate Section 501(c)(3) operational test will be determined by looking at the activities of the reporting organization as a whole, including the activities of the LLC. Advisors will need to consider issues such as the compatibility of exempt purposes of the separate entities as well as the effect of combining income-producing activities as relating to the accomplishment of exempt purposes.

Consolidated IRS Form 990 reporting may be preferable where projecting related nonprofits as a single unified organization is desired. It may also have a beneficial impact on satisfaction of the applicable public support test in situations where maintaining public charity status is in doubt for an organization computing support individually.

Consolidated tax reporting also combines political and lobbying activities of the individual entities. For charities active in legislative advocacy, thought should be given to whether joint lobbying activities are likely to be viewed as more than insubstantial, or whether consolidated reporting may result in excess lobbying expenditures where a Section 501(h) election is in place.

Highlights of other effects of consolidated reporting of a disregarded entity interest can be found in Appendix F of the Form 990 instructions.

There have been several IRS private letter rulings in recent years indicating that re-application for exempt status may not be required in all entity conversion situations, as generally mandated by IRS Revenue Ruling 67-390. This could potentially call into question an entity's disregarded status upon conversion to an LLC. Until there is an authoritative pronouncement from the IRS, advisors may wish to consider obtaining a private letter ruling where warranted by materiality and related risk before undertaking an LLC conversion.

Also, it is not known at this time whether the charitable immunity protections for uncompensated officers and directors of a nonprofit corporation under NC G.S. Section 55A-8-60 would extend to those governing an LLC converted from a nonprofit corporation, by virtue of its prior nonprofit corporation status or by relationship with its nonprofit corporation member.

Additionally, since an LLC created under the new provision must have a sole member that is a religious or charitable organization, a conversion would not be appropriate or permissible where control of the new LLC is to be shared by two or more organizations.

Finally, the new law addresses only the conversion of a nonprofit corporation to an LLC. There is no similar provision for the conversion of any other type of tax-exempt entity that is currently permitted under federal law, such as an unincorporated association.

Advisors should watch for future legislative and judicial guidance, and seek to identify other potential implications before recommending such an entity conversion for a particular organization.

David Heinen, Director of Public Policy for the NC Center for Nonprofits, is monitoring implementation of the law and may be contacted at dheinen@ncnonprofits.org regarding future developments.

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