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CLIENT ALERT

Section 501(c)(3) Status for Limited Liability Companies: New Guidance Issued

The Internal Revenue Service ("IRS") recently issued Notice 2021-56, providing new guidance as to how limited liability companies ("LLCs") may qualify independently for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code. Prior to issuance of this Notice, the IRS issued two nonbinding continuing professional education texts addressing how LLCs may qualify under Section 501(c)(3) (one relating to LLCs as disregarded entity subsidiaries of Section 501(c)(3) parent organizations, and the other relating to LLCs seeking independent tax-exempt status under Section 501(c)(3)). Notice 2021-56 constitutes the IRS's first formal guidance on this topic.

As set forth in Notice 2021-56, in order to obtain independent tax-exempt status under Section 501(c)(3), an LLC must satisfy the general requirements under Section 501(c)(3) and the LLC's organizational documents must contain the following:

1. Provisions requiring that each member of the LLC be either (i) a tax-exempt organization described in Section 501(c)(3), or (ii) a governmental unit or wholly-owned instrumentality of a governmental unit;

2. Provisions setting forth charitable purposes and requiring that any assets remaining upon the LLC's dissolution will be distributed for tax-exempt purposes as described in the Treasury Regulations;

3. If the LLC is a private foundation, provisions that require compliance with the excise tax rules for private foundations; and

4. An acceptable contingency plan (such as suspension of membership rights until a member regains recognition of Section 501(c)(3) status) in the event that one or more members

cease to be Section 501(c)(3) organizations or governmental units (or wholly-owned instrumentalities thereof).

Additionally, the LLC must represent in its application for tax exemption that all provisions of its organizational documents are consistent with applicable state law and are legally enforceable.

The provisions listed above must generally be included in an LLC's organizing document (referred to in Massachusetts as a Certificate of Organization, but known by other names in other states) and in its operating agreement. Recognizing a significant degree of variation between state laws governing LLCs, however, Notice 2021-56 provides flexibility for situations where state law will not permit inclusion of the required provisions in the organizing document. In such cases, the required provisions may be set forth solely in the LLC's operating agreement.

Notice 2021-56 does not affect the status of organizations currently recognized as exempt under Section 501(c)(3), and is silent as to whether LLCs may qualify as tax exempt under other subsections of Section 501(c). The IRS has requested public comment on the proposed standards and certain questions relating to the intersection of state LLC laws and Section 501(c)(3). Comments may be submitted until February 6, 2022.

If you have any questions about Notice 2021-56 or the use of limited liability companies for tax-exempt purposes, please contact Attorneys Elka Sachs (esachs@kb-law.com) or Eric Reustle (ereustle@kb-law.com).