



**To:** The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS)

**From:** Office of the Attorney General of Texas – Financial Litigation Division

**Date:** March 10, 2022

**Subject:** Comment - IRS Notice 2021-56: Standards for Section 501(c)(3) Status of Limited Liability Companies

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The Office of the Attorney General of Texas's Financial Litigation Division, submits these comments in response to the Treasury Department's and the IRS's request for comments "with respect to interpretation of state LLC laws, reference to other pertinent laws, and applicability of state charity laws to LLCs formed for charitable purposes (charitable LLCs)."

### **General Comments**

These responses do not reflect an official interpretation of Texas law by the Office of the Attorney General of Texas or other Texas state agencies that may be involved in regulation of limited liability companies.

In addition, these responses are neither an exhaustive analysis of Texas law nor are to be interpreted as an official opinion from the Office of the Attorney General of Texas's Opinion Division on any particular question or issue addressed in these comments.

### **Comments in Response to the Treasury Department's and the IRS's Specific Requests**

**(1) What are the potential advantages and disadvantages of forming an entity for exclusively charitable purposes under a state LLC law rather than under a state not-for-profit (or non-stock) corporation or charitable trust law?**

## Comment

The potential advantages related to forming an exclusively charitable LLC under Texas law would include a lack of public accountability, and the managers or members of the company being the only governing authority pursuant to the company agreement.

The disadvantages include:

### a. Transparency/accountability

- A charitable Texas LLC may be less transparent and accountable to the public than either a Texas nonprofit charitable corporation or a Texas unincorporated charitable association, both of which must make basic records available to the public.
- A Texas LLC managed by a manager rather than the members, does not have to identify its members on the certificate of formation filed with the secretary of state. In addition, a Texas LLC is not required to file the company agreement with the secretary of state.
- A Texas LLC is also not required to make their company agreement or other books and records available to the public. But Texas nonprofit corporations and unincorporated nonprofit organizations are.
- Finally, a Texas LLC is not required to make charitable distributions or file an IRS Form 990 tax. There are also no restrictions for investing in for-profit enterprises as well as charitable or non-charitable causes they support.

### b. Governance/director liability

- A Texas LLC may be managed by one person, whereas a Texas nonprofit corporation requires a minimum of three (3) directors.
- Loans to a director of a charitable nonprofit corporation are statutorily prohibited, but this does not apply to a Texas LLC.

- Under Texas law, the fiduciary duties and related liabilities of members, managers, officers, or other persons may be expanded or restricted without limitation, under the company agreement. (§§ 7.001 and 101.401, Tex. Bus. Org. Code). In contrast, officers and directors of Texas nonprofit corporations are expected, pursuant to statute, to act in good faith, with ordinary care and in the best interest of the corporation.

c. Merger/dissolution/fundamental change

- The Texas Nonprofit Corporation Act, including Chapter 22 of the Business Organizations Code (nonprofit corporations) governs nonprofit corporations and includes specific requirements regarding a decision to wind up, a mandatory distribution plan, limits to distributions on winding up, and other related topics.
- A Texas nonprofit corporation or nonprofit association is also prohibited from merging into another entity if such a merger would cause it to lose or impair its charitable status. (§ 10.010, Tex. Bus. Orgs. Code).
- No such provision exists for a charitable Texas LLC.

**(2) Do state laws regulating charitable assets apply to assets held by charitable LLCs to the same degree as such laws apply to assets held by trusts or state-law corporations formed for charitable purposes?**

Comment

Texas law does not have a specific charitable LLC category, and assets held by an LLC are not maintained to the same degree of accountability as assets held by nonprofit charitable corporations.

Under Texas law, a "[c]haritable entity" means

a corporation, trust, community chest, fund, foundation, *or other entity* organized for scientific, educational, philanthropic, or

environmental purposes, social welfare, the arts and humanities, or another civic or public purpose described by Section 501(c)(3) of the Internal Revenue Code of 1986 (26 U.S.C. 501(c)(3)).

Tex. Prop. Code § 123.001(1) (emphasis added). Further, the Texas Uniform Prudent Management of Institutional Funds Act includes a solely charitable LLC in its definition of "institution" for purposes of the requirements for managing charitable funds. Tex. Prop. Code § 163.003.

However, as noted, Texas's LLC statute is generally written to assume, though not require, that an LLC will be formed for for-profit purposes. The statute contains none of the provisions regarding director liability, prohibition on loans to directors or dividends to members, access to records by the public, disclosure of interested director transactions, or distribution to charitable purposes on dissolution as contained in state statutes governing charitable nonprofit corporations and unincorporated charitable nonprofit associations.

**(3) Most state LLC statutes specify that an LLC may be formed for any lawful purpose. In a few states, however, the LLC statute appears to require that an LLC be a profit-seeking enterprise. In those states, is it permissible as a matter of state law for an LLC to be formed exclusively for section 501(c)(3) purposes?**

Comment

Texas is like most states in that it provides that an LLC may be formed for "any lawful purpose." Section 2.001, Tex. Bus. Orgs. Code provides that a "domestic entity has any lawful purpose or purposes, unless otherwise provided by this code."

No other provision of the code expressly prohibits a Texas LLC from being formed for strictly charitable purposes.

**(4) Most state LLC statutes appear to provide that, upon dissolution and after payment of creditors, an LLC may dispose of its remaining assets among its members or otherwise in whatever manner specified in its articles of organization (also referred to as a certificate of organization or certificate of formation) or operating agreement (also referred to as a limited liability company agreement). In those states, the state LLC statute merely provides**

**default rules that apply in the absence of any provision in the articles or operating agreement. Other state LLC statutes, however, appear to require distributions of net assets only to members upon dissolution, as immutable rules.**

**a. In a state in which the LLC statute appears to require distributions of net assets only to LLC members on dissolution, could LLC members at the time of creation of an LLC effectively disclaim their financial interests in the LLC or assign or transfer their financial interests to the LLC or to another section 501(c)(3) charity as a means of satisfying the dissolution clause requirement under §1.501(c)(3)-1(b)(4), notwithstanding the state dissolution requirements?**

Comment

Texas law requires distribution of net assets only to LLC members on dissolution. Tex. Bus. Orgs. Code §§ 11.053 and 101.054. It is unclear whether a disclaimer of interests considering these statutory requirements would be effective to satisfy federal law requirements.

**b. Would such a disclaimer be enforceable against the LLC members?**

Comment

Unknown.

**c. Would such a disclaimer be enforceable against creditors of the members?**

Comment

Unknown.

**(5) The organizational test regulations under § 1.501(c)(3)-1(b) generally require certain language (in particular, stated charitable purposes and charitable distribution of assets upon dissolution) to appear in the articles of organization, defined as the written instrument by which the organization is created. Private foundations must also include certain language in their**

**articles of organization to be in compliance with section 508(e). See § 1.508-3. In many cases, state law satisfies the dissolution requirements and section 508(e) requirements for charitable trusts and corporations if there is no contrary provision in the articles of organization. State LLC statutes generally provide that an LLC is created upon filing its articles of organization with the state. In addition to the articles of organization, an operating agreement governs the affairs and activities of an LLC. Unlike the articles of organization, the operating agreement is not filed with the state. State laws differ as to which document is controlling. In some states, the articles control. In other states, the articles control as to outside parties to the extent they reasonably rely on the public record, but the operating agreement governs relations among the LLC's members and between the members and the LLC.**

**a. Are there state laws that satisfy the dissolution requirements and section 508(e) requirements for charitable LLCs?**

Comment

Not in Texas.

**b. Is there any reason why an LLC should not be required (except as provided in section 4.01(6)) to include appropriate charitable purpose and dissolution language (and section 508(e) language, if applicable) in both its articles of organization and its operating agreement?**

Comment

No.

**(6) Most state LLC statutes do not restrict the ability of an LLC to include the language required under § 1.501(c)(3)-1(b) (and section 508(e), if applicable) in its articles of organization. However, a few states appear to strictly limit what provisions may be included in an LLC's articles of organization.**

**a. Should the regulations for the section 501(c)(3) organizational test and section 508(e) requirements be revised to accommodate LLCs organized in states that limit what provisions may be included in an LLC's articles of**

**organization if the LLC includes the appropriate language in the LLC's operating agreement?**

Comment

In Texas, this would apply only to LLCs formed before January 1, 2022. For LLCs formed after that time, the "certificate of formation may contain other provisions not inconsistent with law relating to the organization, ownership, governance, business, or affairs of the filing entity." Tex. Bus. Orgs. Code § 3.005(a)(9). (Note, however, that a more thorough analysis of Texas law may conclude that the IRC requirements are inconsistent with the law governing Texas LLCs. See, for example the reference above to dissolution requirements.)

**b. Should it matter that the operating agreement (unlike the articles of organization) is not filed with the state, and therefore may not be readily available to the IRS and the public?**

Comment

Yes.

**(7) Several states have enacted special statutory provisions for nonprofit LLCs (beyond a mere provision in the statute that allows an LLC to be formed for a nonprofit purpose), subjecting them to regulation as nonprofit organizations and, in some cases, limiting membership. In such states, must a charitable LLC form under the state's nonprofit LLC law, or are charitable LLCs permitted to form under the state's general LLC law?**

Comment

There is no nonprofit LLC statute in Texas.

**(8) State laws generally provide an LLC's members with management authority unless the articles of organization (or in some states, the operating agreement) delegate management authority to one or more managers.**

**a. With respect to qualification for section 501(c)(3) status, should LLCs managed by managers be treated the same as LLCs managed by members?**

Comment

That would seem to be appropriate, however, to do so would likely require changes in Texas law.

**b. Should LLC managers be treated as officers for federal exempt organization tax purposes generally, including, for example, the compliance provisions of chapter 42?**

Comment

This appears to be a federal question and would also likely require changes in Texas law.

**(9) Are there any other provisions of the LLC law in one or more states that may affect the ability of an LLC to qualify under section 501(c)(3)?**

Comment

Unknown.

**(10) Are there any specific provisions that should be included in an LLC's articles of organization and operating agreement in addition to, or in lieu of, those discussed in section 3.02 of this notice, to address particular provisions of state LLC law?**

Comment

Unknown.

**(11) Are there circumstances in which an LLC seeking recognition under section 501(c)(3) should be permitted to have members that are not themselves section 501(c)(3) organizations, governmental units, or wholly-owned instrumentalities of governmental units?**

Comment

There are no such circumstances. Such an exception would have the potential effect of rendering the LLC as not being organized and operated solely for a charitable purpose.