THE TAX CONSEQUENCES OF ACCEPTING CHARITABLE CONTRIBUTIONS THROUGH A SINGLE-MEMBER LLC

A gift to a single-member LLC, of which a Section 501(c)(3) charity is the sole member, is a gift 'to' the charity.

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From a charity's perspective, a gift of real estate can be a mixed blessing. The gift may be worth a substantial sum after the property is liquidated, or it may provide the charity with property it can use directly. However, environmental liabilities tend to run with the land. If the charity is in the chain of title, all of the assets owned by the charitable entity—whether a nonprofit corporation or a charitable trust—could be vulnerable to claims holding it responsible for environmental cleanup costs.[1] To avoid these consequences while still accepting gifts of real estate, charities have become interested in using single-member limited liability companies (LLCs) to receive and hold these gifts.[2] To date, however, the IRS has yet to take a public position on the question of whether the donor will receive a charitable contribution deduction if the donor makes a gift to an LLC whose sole member is a charitable organization described in Section 170(c)(1) and recognized as exempt from tax under Section 501(c)(3).

The IRS has announced that it intends to publish guidance answering this question by 6/30/02, which will be the end of the period covered by the most recent Treasury/IRS business plan.[3] Based on the regulations and other statements the IRS has made about the tax treatment of single-member LLCs—in particular, LLCs of which a charity is the single member—there is a sound basis for concluding that the donor should receive the same deduction when contributing real estate, or any other property, to a charity's single-member LLC as to the charity itself.

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The author wishes to thank James B. Lyon of Hartford, Connecticut for his help with this article.

LLCs

The LLC is a relatively new type of business entity created by state statute. All 50 states and the District of Columbia have LLC laws.[4] Traditionally, businesses that were organized as separate entities were formed as corporations or partnerships. Corporations engaged in business offer limited liability to their owners but are generally subject to federal income tax on their income at the entity level.[5] Partnerships do not offer limited liability, but do avoid federal income tax at the entity level. LLCs were devised to offer business owners limited liability without triggering an entity level of income tax.

LLCs are very flexible structures. In many states, an LLC can have a single member or many members.

WHAT IF A GIFT IS DELIVERED TO AN ENTITY THAT IS NOT AN ELIGIBLE DONEE UNDER THE CONDITION THAT IT BE USED FOR THE BENEFIT OF CHARITY?

Deductibility of a gift to an LLC

To be deductible as a charitable contribution under Section 170, a contribution or gift must be "to or for the use of" one of a short list of eligible donees.[6] The list includes most domestic governmental entities and some other private nonprofit entities that are not charities.[7] A private charity qualifies as an eligible donee only if it (1) is a "corporation, trust, or community chest, fund, or foundation" organized under U.S. law; (2) is organized and operated exclusively for any of several specified purposes (charitable, religious, scientific, literary, or educational purposes; fostering national or international amateur sports competition; or preventing cruelty to animals or children); and (3) otherwise meets the requirements of Section 501(c)(3) with respect to the limitations on inurement, lobbying, and political activity.

A gift transferred directly into the possession of such an organization—for simplicity, a Section 501(c)(3) charity—for it to use for its own benefit is a gift "to" an eligible donee. The tax consequences of a direct gift of this sort have not been disputed. However, deductibility has been questioned when a gift is delivered, not to a Section 501(c)(3) charity, but to an entity that is not an eligible donee for purposes of Section 170 on the condition that the gift be used for the benefit of a Section 501(c)(3) charity. If the entity that initially receives the gift from the donor accepts the gift as an agent for a Section 501(c)(3) organization, the gift will be treated as made "to" the Section 501(c)(3) charity.[8] If a donor places a gift into a trust, and one or more Section 501(c)(3) charities are the only beneficiaries of the trust, the gift will be treated as made "for the use of" a Section 501(c)(3) charity and will be deductible as such.[9]

If the donor makes a gift to a party that is not an eligible donee with an understanding or expectation that it will be used for charity, but imposes no legally binding condition that it be used that way, the gift will be neither to nor for the use of charity, and no charitable contribution deduction will be available.[10] The Supreme Court announced this conclusion definitively in *Davis,* 495 U.S. 472, 65 AFTR2d 90-1050 (1990), a case in which a couple who were members of the Church of Jesus Christ

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[1] For an excellent discussion of potential environmental liabilities and the potential for using a single-member LLC to avoid that liability, see Berry, Eifler, and Anderson, "Charity from Nothing: Protection from Environmental and Premises Liability Under Check-the-Box," 24 Exempt Org. Tax Rev. 481 (June 1999).

[2] The chain of title problem is specially associated with real estate. Charities are typically not concerned about liability simply from being in the chain of title for other sorts of gifts. If a charity is concerned about generating liability from the way it may use property it has been given, it can create a single-member LLC and drop the property and the associated activity into the separate LLC entity. This strategy will not work for real estate and environmental liabilities, however. The charity will be listed in the chain of title and will be assigned liability even if it drops the real estate into a single-member LLC immediately after receiving the gift.

[3] Department of the Treasury, *2001 Priorities for Tax Regulations and Other Administrative Guidance,* (4/26/01).

[4] Ribstein and Keatinge, *Ribstein and Keatinge on Limited Liability Companies* (West Group, 2001), § 1.02.

[5] The principal exception is the Subchapter S corporation, which is not taxed at the entity level. Shareholders in Subchapter S corporations must include their pro rata share of the corporation's income in their personal incomes each year, irrespective of whether the corporate income has been distributed.

[6] See Section 170(c).

[7] Other eligible donees include the U.S. government, state and local governments, certain posts or associations of war veterans, certain cemetery companies, and certain fraternal lodges (but only if the gift is to be used exclusively for charitable purposes). See Sections 170(c)(1), (3), (4) and (5).

[8] See Rev. Rul. 85-184, 1985-2 CB 84. In the ruling, a utility company was held to be serving as agent for a charity when it collected charitable contributions in conjunction with collecting payments of utility bills.

[9] See Davis, 495 U.S. 472, 65 AFTR2d 90-1050 (1990) . See also Estate of Hubert, TCM 1993-482. Note that the percentage limitations that affect the maximum amount a donor may deduct in a given year are lower for gifts "for the use of" charity than for gifts "to" charity. Compare Sections 170(b)(1)(A) and (B).

[10] See Davis, *supra,* note 9 at fn. 9.

of Latter Day Saints gave money to their sons to cover living expenses while the sons were on official church missions. The leaders of the missions had informed the taxpayers of how much money was needed, and the money was deposited into the sons' personal bank accounts. The Court held that the amounts spent by the parents were not gifts "for the use of" the church because there was no trust or "similar legal arrangement" that created a binding legal duty to use the contributions for the benefit of a Section 501(c)(3) charity or other eligible donee, and gave the charity or other donee the legal power to enforce the terms of the trust.

Although the holding in *Davis* is limited to defining when a gift is made "for the use of" a Section 501(c)(3) charity, the reasoning in the opinion opens the door further to provide a basis for concluding that a gift to a single-member LLC, of which a Section 501(c)(3) charity is the sole member, is a gift "to" the charity. Specifically, the Court stated that a "contribution made in trust for a charity does not give the charity immediate possession and control, as does a donation directly to a charity." The charity lacks control because a trustee who is a party distinct from the charity retains discretion, or else the trust instrument specifies how the trust will be administered. Where the charity is the single member of an LLC, it is as if the charity were serving as the trustee of a trust for its own benefit. The charity has control over assets held in a single-member LLC just as it would over assets contributed to it directly. It can decide whether, when, to what extent, and for what purpose it wants to use the contributed assets. Thus, based on the reasoning in *Davis*, a gift to a single-member LLC of which a Section 501(c)(3) charity is the sole member is reasonably treated as a gift to the Section 501(c)(3) charity. [11]

Admittedly, *Davis* alone may not be enough to support the definitive conclusion that a gift to a Section 501(c)(3) charity's single-member LLC is a gift to the charity. If the charity's absolute control and right to assets were sufficient to achieve that result, a gift to a charity's wholly owned for-profit subsidiary corporation would be considered a gift to charity. That result would be contrary to the policy of Section 170, which relies on the nonprofit charitable structure of the donee to ensure that the contribution is used for charitable purposes. It would also be contrary to *Moline Properties*, 319 U.S. 436, 30 AFTR 1291 (1943), the seminal decision requiring that separate corporations be respected as separate entities for tax purposes. When *Davis* is combined with the special characterization of single-member LLCs under the entity classification regulations, however, it becomes clear that this is a unique circumstance in which a contribution to an entity that is not an eligible donee is nonetheless a contribution to a Section 501(c)(3) charity.

In 1996, the Treasury issued final regulations on classification of business entities, answering definitively what had been persistent questions about the taxation of LLCs. The regulations interpret the definitions of "corporation" and "association" in Section 7701 and classify entities "for federal tax purposes." [12] The regulations require entities that are corporations under state law or certain foreign laws and certain categories of business enterprises, such as insurance companies and banks, to be classified as corporations because of their activities. [13]

A business entity that is not required to be classified as a corporation can elect its classification. If the entity has two or more members, it can elect to be classified as an association (which will be taxed as a corporation) or as a partnership. [14] If the entity has a single owner, it can elect to be classified as an association or "to be disregarded as an entity separate from its owner." To simplify administration, the regulations create default classifications and require the owners to make an affirmative election only if they wish to avoid the default classification. [15] For entities with two or more members, the default classification is as a partnership. [16] For entities with a single owner, the default classification is to be disregarded as an entity separate from its owner. [17] The regulations also say that "if the entity is disregarded,

THE REGULATIONS DO NOT DISTINGUISH BETWEEN TAX-EXEMPT AND TAXABLE MEMBERS OF SINGLE-MEMBER LLCS.

[11] At the minimum, Davis supports the conclusion that a gift to a Section 501(c)(3) charity's single-member LLC is a gift for the use of the charity. The Court explicitly says that a gift is for the use of a Section 501(c)(3) charity if made "in trust or in some similar legal arrangement." An LLC is a legal arrangement. It gives the charity at least the same rights it would have as the beneficiary of a trust.

[12] See Reg. 301.7701-1(a)(1). The preamble to the final regulations also states that "Section 301.7701-1 provides an overview of the rules applicable in determining an organization's classification for federal tax purposes." T.D. 8697, 1997-1 CB 215.

[13] Regs. 301.7701-2(b)(1), (4), (5), and (8).

[14] Reg. 301.7701-3(a).

[15] See Reg. 301.7701-3(b)(1)(ii).

[16] Reg. 301.7701-3(b)(1).

[17] Reg. 301.7701-3(b)(ii).

its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner."[18]

The regulations do not distinguish between LLCs with a single member that is a taxable entity and LLCs with a single member that is a tax-exempt entity. The regulations discuss entities that are exempt from tax under Section 501(a) only for the purpose of clarifying that an entity's claim of exempt status is a deemed election to be classified as an association taxed as a corporation.[19]

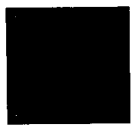
If a donor made a gift to a branch or division of a charity—such as the local chapter of a national charity—the donor would be making a gift "to" the charity and could deduct it as such. A branch or division is not viewed as a separate entity for federal tax purposes. If a single-member LLC is to be treated as a branch or division, gifts to the single-member LLC should be treated like gifts to a branch or division.

The IRS has already confirmed the implications of this branch or division treatment for exemption and reporting purposes. In Ltr. Rul. 200134025 and in a general information letter issued to the author,[20] the IRS stated definitively that a charity may include its single-member LLC under its exemption umbrella without filing a separate exemption application for the LLC. This answer is consistent with what the business entity classification regulations would predict. Generally, Section 508 requires an organization to apply for and receive recognition from the IRS that it is described in Section 501(c)(3) before the IRS may treat it as a Section 501(c)(3) organization.[21] The IRS recognizes the exemption of the legal entity that has submitted the application, whether it is a nonprofit corporation, a trust, or an unincorporated association. The opening of a new branch or division that is not a separate legal entity for tax purposes does not affect the organization's exemption, provided that its activities do not cause the organization to violate the substantive requirements of Section 501(c)(3).

Thus, if the charity's single-member LLC is to be treated as a branch or division for federal tax purposes, it follows that the LLC should be exempt from federal income tax on its income without being required to apply separately for tax-exempt status. It follows further that the charity should include the LLC's activities among those it must report to the IRS each year on Form 990, an outcome the IRS confirmed in Announcement 99-102, 1999-43 IRB 1. The IRS reviewed these positions and confirmed them again in two CPE Text articles authored by Richard A. McCray and Ward Thomas.[22]

The ability to avoid a separate application process and separate annual Form 990 filings make the single-member LLC an attractive solution to the problem of gifts of real property. Charities have long known they could establish separate controlled corporations and qualify them as Section 501(c)(3) organizations that would also be supporting organizations under Section 509(a)(3) and, accordingly, could receive deductible contributions. However, the additional administrative burdens made this type of solution less than ideal. Furthermore, a separate corporation would have to be formed for each gift of real property, proliferating the burdens until they could become daunting.[23]

The entity classification regulations determine how an entity is to be classified "for federal tax purposes." They do not limit the tax purposes they affect. They apply for purposes of tax exemption and information reporting as the IRS has already made clear, and they should also apply for purposes of establishing the consequences of a gift. They apply outside the exempt organizations area where the iden-



IF A DONOR MADE A GIFT TO A BRANCH OR DIVISION OF A CHARITY, HE OR SHE WOULD BE MAKING THE GIFT 'TO' THE CHARITY.

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[18] Reg. 301.7701-2(a).

[19] See Reg. 301.7701-3(c)(1)(v).

[20] Letter from Marvin Friedlander to Catherine E. Livingston, 10/27/99.

[21] The statute does not require the IRS to give advance approval of an organization's status before contributions to the organization can be deductible as charitable contributions. Nevertheless, the IRS will not treat a donee as being organized and operated exclusively for charitable purposes as required by Section 170(c)(1) unless it has recognized the donee as a Section 501(c)(3) organization.

[22] McCray and Thomas, "Limited Liability Companies as Exempt Organizations," *Continuing Professional Education, Exempt Organizations—Technical Instruction Program for FY 2000* (1999), "Limited Liability Companies as Exempt Organizations—Update," *Continuing Professional Education, Exempt Organizations—Technical Instruction Program for FY 2001* (2000) (hereinafter, "McCray and Thomas Update"). The more recent article concludes that an LLC could apply independently for recognition as a Section 501(c)(3) organization if it could meet 12 separate criteria. If the LLC qualified in this fashion and met the other criteria to be an eligible donee, gifts to it would have to be deductible contributions. Thus, the IRS has confirmed that there is nothing about the LLC form, per se, that makes it impossible for an LLC to received a charitable contribution as that term is defined in Section 170.

[23] See Berry et al., *supra* note 1 at 485, for a more detailed discussion of the problems of supporting organizations and title-holding companies as a mechanism for accepting real property gifts.

tity of the recipient is a dispositive factor for tax treatment.[24] For federal tax purposes, a gift to a single-member LLC that has not elected to be classified as an association is a gift to a branch or division of the LLC's single member. On the specific question of whether gifts to a charity's single-member LLC are deductible, the CPE Text states that the IRS is "considering whether the same treatment applies for purposes of IRC 170."[25] One would hope the consideration could be expedited because the regulations answer this question.

The treatment of the single-member LLC for exemption purposes should provide the IRS with comfort in announcing this result. If the single-member LLC engages in activities that are contrary to the requirements a Section 501(c)(3) organization must meet to qualify as an eligible donee, it will jeopardize the deductibility of contributions delivered not only to the LLC but also to the charity itself.

Finally, whether or not a gift is a charitable contribution does not depend on how the charitable beneficiary uses the gift.[26] In some discrete instances, the charity's use of the gift may have an effect on the deduction. For example, if the gift consists of tangible personal property, and the charity uses it for a purpose unrelated to its exempt function, the donor's deduction is limited to his or her basis in the property.[27] The unrelated use does *not* take away the character of the gift as a charitable contribution, however. Thus, the fact that a charity's single-member LLC might be involved in unrelated business activities or investment activities that do not directly further its exempt purpose should have no bearing on the question of whether a gift to that LLC is a contribution to the charity.

Conclusion

A gift to a single-member LLC of which a Section 501(c)(3) charity is the sole member should be considered a gift "to" the charity for purposes of Section 170. This result follows directly from the entity classification regulations under Section 7701 and is consistent with the Supreme Court's reasoning in the *Davis* case, the principal case addressing whether a gift is to or for the use of a charity. It would be of great benefit to charities and donors if the IRS would acknowledge this result. ■

[24] See Ltr. Ruls. 9807013 and 9751012, holding that a taxpayer qualifies for nonrecognition treatment under Section 1031 if that taxpayer transfers property to another party, and replacement property is transferred to an LLC in which taxpayer is the sole member. See also, Berry et al., *supra* note 1, for discussion of these rulings

[25] McCray and Thomas Update, *supra* note 22

[26] The more recent CPE Text article (McCray and Thomas Update, *supra* note 22), makes a complementary point. It states that the articles of organization of a disregarded entity do not need to meet the organizational test for Section 501(c)(3) status because the entity is treated "as an activity of the owner," making it the owner's organizational documents that matter. Thus, the fact that the LLC may be pursuing a business purpose should not affect the conclusion that a gift to the LLC is a gift to the charity.

[27] See Section 170(e)(1)(B)(i).