

# Papa's Brand New Bag: The Need for IRS Recognition of an Independent Nonprofit Limited Liability Company (NLLC)

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**PAPA’S BRAND NEW BAG:  
THE NEED FOR IRS RECOGNITION OF AN  
INDEPENDENT NONPROFIT LIMITED  
LIABILITY COMPANY  
(NLLC)**

KENYA JH SMITH\*

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## I. INTRODUCTION

Nonprofit organizations (nonprofits)<sup>1</sup> are an important part of the economic, social, and civic fabric of American society, often serving the neediest in communities across the nation. Despite that fact, nonprofits often struggle to meet their missions in the face of cyclical, and often steep, declines in funding sources, increased competition from for-profit businesses for those resources, increased demand for the social services traditionally supplied by nonprofits, and increased demand from government and philanthropic stakeholders to streamline operations and find ways to deliver more services with the same or fewer resources. These challenges are exacerbated by the fact that nonprofits are currently deprived of the full panoply of entity options afforded to for-profit enterprises. Federal and state statutory laws as well as state common law provide for-profit ventures with many entity options in balancing flexible management, liability protection, and tax concerns.<sup>2</sup> These options include the recently developed and celebrated limited liability company (LLC).<sup>3</sup> Like the traditional corporation, LLC statutes have now been adopted in some form in all fifty states.<sup>4</sup> A ration of entity options is also available to nonprofits, and some of those

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1. There is some debate around the exact meaning of the term “nonprofit organization.” Collectively, they are sometimes referred to as “the independent sector, the third sector, the voluntary sector, and the philanthropic sector.” See BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 5 (10th ed. 2011) (“The English language has yet to capture the precise nature of this sector; in a sense, none of these appellations is appropriate.”). These organizations are hereinafter referred to collectively as “nonprofits” and singularly each as a “nonprofit.” However, experts widely accept the premise that incumbent in the term, at least in the United States, is recognition by the United States Internal Revenue Service as an organization qualifying for exemption from federal income tax under Internal Revenue Code § 501(c)(3) or other applicable sections. See 26 U.S.C. § 501 (2012); INTERNAL REVENUE SERV., *APPLYING FOR 501(C)(3) TAX-EXEMPT STATUS* (2014), <http://www.irs.gov/pub/irs-pdf/p4220.pdf>, archived at <http://perma.cc/4S86-VUS6> (describing the requirements for tax exemption).

2. See DAVID G. EPSTEIN, RICHARD D. FREER, MICHAEL J. ROBERTS & GEORGE B. SHEPHERD, *BUSINESS STRUCTURES* 27–30 (3d ed. 2010).

3. See WILLIAM K. SJOSTROM, JR., *BUSINESS ORGANIZATIONS: A TRANSACTIONAL APPROACH* 16–17 (2013).

4. See *Weddell v. H2O, Inc.*, 271 P.3d 743, 748 (Nev. 2012) (acknowledging the origins of the limited liability company and Wyoming’s prominence as the first state to enact a statute validating the entity); see also Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387, 389–91 (1991). All 50 states have now enacted LLC statutes. ROBERT W. HAMILTON, JONATHAN R. MACEY & DOUGLASS K. MOLL, *CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES* 1183 (11th ed. 2010).

options are comparable to the aforementioned for-profit ventures.<sup>5</sup> However, a potentially important option that should be available to nonprofits has been largely ignored.<sup>6</sup> The nonprofit limited liability company (NLLC) does not enjoy the same statutory, common law, and tax recognition as for-profit or other nonprofit options, particularly the nonprofit corporation.<sup>7</sup>

This Article explores the important role that nonprofits serve in the American economy and society at large, as well as the growing business and financial pressures faced by non-profits that justify the utility of the NLLC. Part II of this Article surveys a representative selection of the common for-profit and nonprofit entities and the key characteristics and comparable development trajectory of each that support recognition of the NLLC. It further explores the ineluctable roles tax law and accompanying IRS recognition play in the lives of nonprofits and for-profit entities alike. Part III makes the public policy case for the NLLC and for full recognition of the NLLC as an independent entity by the U.S. Internal Revenue Service (IRS), which should serve as a catalyst for formal adoption of more specific state NLLC statutes and greater utilization of NLLC by nonprofits. The Article concludes that IRS recognition of the NLLC as an independent entity, and corollary enactment of specific NLLC laws, should provide justified relief to nonprofits through seamless unification of three important benefits: (1) assured recognition of the NLLC's tax exempt status, (2) maintenance of the intrinsic liability protections traditional nonprofit corporations enjoy, and (3) greater management flexibility and alleviation of burdensome corporate governance requirements, freeing precious resources that nonprofits currently spend on management and governance to be committed to furthering the core mission and goals of the nonprofits. This evolution will provide these organizations with

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5. In-depth discussion and analysis of the sole proprietorship, various forms of partnership, the S-corporation as for-profit options, as well as discussion of the low profit limited liability company (L3C), benefit corporation, and other hybrid tax entity options are beyond the scope of this Article.

6. Mitchell F. Crusto, *Extending the Veil to Solo Entrepreneurs: A Limited Liability Sole Proprietorship Act (LLSP)*, 2001 COLUM. BUS. L. REV. 381, 384-85 (explaining that the expansion of limited liability protection has yet to reach the sole proprietorship, leaving owners of sole proprietorships at a level of risk that other entities are protected from). Similarly, nonprofits have not received the same options allotted to for-profits.

7. See 1 JAMES D. COX & THOMAS LEE HAZEN, *THE LAW OF CORPORATIONS* § 1:18, at 110 (3d ed. 2010).

another important tool bag to further aid their work in providing valuable social services to American society.

## II. THE NONPROFIT: THE CAUSE AND THE STRUGGLE

### A. *Nonprofit History, Mission and Relevance*

Nonprofits,<sup>8</sup> or substantially similar styled social aid organizations, have been an important part of the American economic and social aid fabric since the settling of the original colonies.<sup>9</sup> Their history and evolution—including manner of organizational structure, the targeted social need, and relationship to government—have been the subject of study and debate among historians and social scientists.<sup>10</sup> Nonprofits have received far less treatment by legal scholars in business law casebooks, especially as compared to other entities.<sup>11</sup> Those that do

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8. *See supra* note 1.

9. *See* Peter Dobkin Hall, *Historical Perspectives on Nonprofit Organizations in the United States*, in THE JOSSEY-BASS HANDBOOK OF NONPROFIT LEADERSHIP AND MANAGEMENT 3, 4–5 (David O. Renz ed., 3d ed. 2010). This Article focuses primarily on the development and treatment of nonprofits in the United States of America. The treatment of nonprofits in foreign jurisdictions, some of which are progenitors of American law and its corresponding nonprofits, while important, is beyond the scope of this Article. *See generally, id.* at 3.

10. *See, e.g.*, MAKING THE NONPROFIT SECTOR IN THE UNITED STATES (David C. Hammack ed., 1998).

11. *See, e.g.*, DOUGLAS M. BRANSON ET AL., BUSINESS ENTERPRISES: LEGAL STRUCTURES, GOVERNANCE, AND POLICY: CASES, MATERIALS, AND PROBLEMS (2009) (discussing the conversion of a business stock corporation to a nonstock, nonprofit corporation, but providing no other references to nonprofit entities); JAMES D. COX & THOMAS LEE HAZEN, BUSINESS ORGANIZATIONS LAW 41–43, 235 (3d ed. 2011) (three pages briefly explaining the definition of the nonprofit corporation, distinguishing it from the public corporation and business corporation, and touching upon director liability for tortious conduct); JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS (2d ed. 2003) (no references to nonprofit entities); DWIGHT DRAKE, BUSINESS ORGANIZATIONS IN A PLANNING CONTEXT: CASES, MATERIALS AND STUDY PROBLEMS 141–45 (2013) (reprinting *Citizens United v. Federal Elections Commission*, 130 S. Ct. 876 (2010), in the context of corporate campaign speech); EPSTEIN ET AL., *supra* note 2 (no references to nonprofit entities); FRANKLIN A. GEVURTZ, CORPORATION LAW 791–92 (2d ed. 2010) (referencing the American Bar Association Guide to Nonprofit Corporate Governance in the Wake of Sarbanes–Oxley and Nonprofit Corporation Forms Handbook); HAMILTON ET AL., *supra* note 4, at 1099 (containing one reference to inspection rights concerning, *inter alia*, nonprofit corporations); LEE HARRIS, CASES AND MATERIALS ON CORPORATIONS AND OTHER BUSINESS ENTITIES: A PRACTICAL APPROACH (2011) (omitting any mention of or reference to nonprofit entities); WILLIAM A. KLEIN, J. MARK RAMSMEYER & STEPHEN M. BAINBRIDGE, BUSINESS ASSOCIATIONS: AGENCY, PARTNERSHIPS, AND CORPORATIONS (8th ed. 2012) (no references to nonprofit entities); DANIEL Q. POSIN, CASES AND ANALYSES ON THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTITIES: A SOCRATIC

specifically make nonprofit organizations the center of their texts and articles seem to focus more heavily on traditionally accepted nonprofit entity forms, treating the nonprofit limited liability company, at best, as a peripheral part of their discussion.<sup>12</sup> Nevertheless, there seems to be general consensus that today's nonprofit organizations still largely serve purposes largely similar to those that formed a key part of earliest American society.<sup>13</sup> Further, nonprofits continue to have a significant impact in various aspects of our everyday lives.<sup>14</sup>

Today, nonprofits come in all sizes. Among their ranks are sophisticated multibillion dollar enterprises such as the YMCA, the United Way, and the American Red Cross.<sup>15</sup> Also included are small, thinly staffed operations that are not required to report to the IRS.<sup>16</sup> Experts acknowledge that estimating the exact number of nonprofits

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APPROACH (2005) (no references to nonprofit entities); STEPHEN B. PRESSER, AN INTRODUCTION TO THE LAW OF BUSINESS ORGANIZATIONS: CASES, NOTES AND QUESTIONS (3d ed. 2010) (no references to nonprofit entities); ROBERTA ROMANO, FOUNDATIONS OF CORPORATE LAW (2d ed. 2010) (includes a brief section with the heading "Firms Without Owners: Nonprofit Enterprise"); SJOSTROM, *supra* note 3, at 22 (one brief paragraph describing the nonprofit corporation); D. GORDON SMITH & CYNTHIA A. WILLIAMS, BUSINESS ORGANIZATIONS: CASES, PROBLEMS, AND CASE STUDIES (3d ed. 2012) (no discussion of nonprofit entities as forms of business organizations).

12. See JAMES J. FISHMAN & STEPHEN SCHWARZ, CASES AND MATERIALS: NONPROFIT ORGANIZATIONS 49, 667-89 (4th ed. 2010) (twenty-four pages primarily treating the use of a nonprofit LLC in joint ventures involving nonprofit corporations already recognized as exempt organizations by the Internal Revenue Service); WILLIAM A. GREGORY, THOMAS R. HURST & JACK F. WILLIAMS, UNINCORPORATED BUSINESS ASSOCIATIONS INCLUDING AGENCY, PARTNERSHIP AND LIMITED LIABILITY COMPANIES: CASES AND MATERIALS 825-48 (4th ed. 2009) (twenty-four pages devoted to treating the unincorporated nonprofit association, only mentioning the nonprofit corporation tangentially and omitting the nonprofit LLC); MARILYN E. PHELAN & ROBERT J. DESIDERIO, NONPROFIT ORGANIZATIONS LAW AND POLICY 679-86 (3d ed. 2010) (eight pages dedicated to reproduction of Revenue Ruling 98-15 recognizing LLC as a disregarded entity); SCOTT A. TAYLOR, THE LAW OF TAX-EXEMPT ORGANIZATIONS IN A NUTSHELL 38, 48-49, 57-58 (2011) (five pages addressing utility of LLC in nonprofit context).

13. See Hall, *supra* note 9, at 4-5.

14. See HOPKINS, *supra* note 1, at 11.

15. See Mark Hrywna, *Billion Dollar Babies: Mega-Revenue Charities Get Bigger as Economy Rebounds*, NONPROFIT TIMES, Nov. 1, 2013, at 1, 3-4, [http://www.thenonprofittimes.com/wp-content/uploads/2013/11/11-1-13\\_Top100.pdf](http://www.thenonprofittimes.com/wp-content/uploads/2013/11/11-1-13_Top100.pdf), archived at <http://perma.cc/U9QN-GHLF>.

16. Exempt organizations having annual gross receipts \$50,000 or less (\$25,000 or less for tax years ending before December 31, 2010) are among those not required to file a Form 990 informational return. See *Annual Exempt Organization Return: Who Must File*, INTERNAL REVENUE SERV., <http://www.irs.gov/Charities-&-Non-Profits/Annual-Exempt-Organization-Return:-Who-Must-File> (last updated Apr. 18, 2014), archived at <http://perma.cc/65BK-QWAD>.

that operate in America is nearly impossible due to the large number of small nonprofits that are not required to report on their activities.<sup>17</sup> However, recognition by the IRS of exemption from income tax seems to be a reliable, if incomplete, measure used in discourse concerning nonprofits. Approximately 1.6 million nonprofits are listed with the IRS as exempt entities.<sup>18</sup> If churches and smaller organizations, neither of which are required to file with the IRS,<sup>19</sup> are taken into account, that number likely grows closer to 2.3 million organizations, or one nonprofit for every 175 Americans.<sup>20</sup> This might provide at least a partial explanation as to why much of their scholarship and analysis seems to revolve around IRS-recognized exempt organizations. The value of nonprofit organizations in our society is evident in the wide-ranging impact that nonprofits have in our communities and our daily life as essential features of civic, social, and economic life today.<sup>21</sup> They are our houses of worship.<sup>22</sup> They operate hospitals and educational institutions.<sup>23</sup> They feed the hungry, provide shelter to the homeless, clothe the destitute, and provide a variety of other critical and fundamental human and social services needed by millions of Americans.<sup>24</sup> They are also local neighborhood associations<sup>25</sup> and

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17. See Lester M. Salamon, *The Resilient Sector: The Future of Nonprofit America*, in *THE STATE OF NONPROFIT AMERICA* 3, 7 (Lester M. Salamon ed., 2d. ed. 2012).

18. See DEP'T OF THE TREASURY, INTERNAL REVENUE SERVICE DATA BOOK 56 tbl.25 (2013).

19. See *Annual Exempt Organization Return*, *supra* note 16.

20. See KATIE L. ROEGER, AMY S. BLACKWOOD & SARAH L. PETTIJOHN, *THE NONPROFIT ALMANAC* 2012, at 2 (2012).

21. See Gita Gulati-Partee, *A Primer for Nonprofit Organizations*, *POPULAR GOV'T*, Summer 2001, at 31, 31 (2001) (noting that many of the organizations with which we come into regular contact fit our notions and casual definitions of "nonprofit," often without our realizing the connection).

22. See Treas. Reg. § 1.6033-2(g)(1)(i) (2009) (categorizing churches, and their integrated auxiliaries, conventions, and other controlled affiliates, as exempt organizations not required to file Form 990); Rev. Proc. 95-48, 1995-2 C.B. 418 (same).

23. See 26 U.S.C. § 501(c)(3) (2012); Salamon, *supra* note 17, at 6. We note that that nonprofits are not the sole or exclusive service providers in these sectors, and we are seeing a proliferation of for-profit (or proprietary) education providers in today's marketplace.

24. See 26 U.S.C. § 501(c)(4)(A).

25. Many of the neighborhood associations researched fall below the revenue/asset threshold for reporting on Form 990. *But see Exempt Organizations Select Check*, INTERNAL REVENUE SERV., available at <http://apps.irs.gov/app/eos/> (last visited June 3, 2015), archived at <http://perma.cc/UG6F-8MFU> (select "Are eligible to receive tax-deductible charitable contributions" query; then search "neighborhood association," including quotation marks, in the Name entry field). A search within this database yielded 595 results. *Id.*

community theatres.<sup>26</sup> But not all nonprofits can be said to focus on relief of the poor as their main thrust. Nonprofits qualifying for tax exemption also include chambers of commerce, other business associations, and even the National Football League (NFL).<sup>27</sup>

The importance of the nonprofit sector can be seen beyond the goodwill created by its activities. Their impact is evident in the quantifiable economic role nonprofits play in our society. The nonprofit sector represents a large part of the national economy. In 2010, the nonprofit sector was reported to have produced 5.5% of the national gross domestic product (GDP),<sup>28</sup> ranking ahead of the federal government as well as the construction and utilities industries.<sup>29</sup> In fact, between 2000 and 2010, the nonprofit sector experienced steady GDP growth while other sectors struggled while facing severe market conditions in the aftermath of the 2007–2008 financial crisis,<sup>30</sup> reinforcing the nonprofit sector's role as an integral part of the American economy. Total revenue reported by nonprofits in 2010 was \$2.06 trillion, while reported expenses totaled \$1.94 trillion, or roughly 94% of revenue.<sup>31</sup> This is particularly important when considering nonprofit impact during a decade in which the nation experienced perhaps the worst fiscal downturn since the Great Depression.<sup>32</sup> In fact,

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26. See Central Louisiana Community Theatre, IRS Form 990-EZ, Return of Organization Exempt from Income Tax (OMB No. 1545-0047) (2008).

27. 26 U.S.C. § 501(c)(6); see also ELIZABETH SCHMIDT, *NONPROFIT LAW: THE LIFE CYCLE OF A CHARITABLE ORGANIZATION* 3 (2011) (noting that industry associations like the NFL seem to serve the rich through a mechanism generally thought designed to incentivize service of the poor).

28. See AMY S. BLACKWOOD, KATIE L. ROEGER & SARAH L. PETTIJOHN, URBAN INST., *THE NON-PROFIT SECTOR IN BRIEF: PUBLIC CHARITIES, GIVING AND VOLUNTEERING* 2012, at 1 (2012), available at <http://www.urban.org/sites/default/files/alfresco/publication-pdfs/412674-The-Nonprofit-Sector-in-Brief-Public-Charities-Giving-and-Volunteering-.PDF>, archived at <http://perma.cc/HV52-49GP>.

29. See *Gross Domestic Product (GDP) by Industry Data*, U.S. DEP'T COM. BUREAU ECON. ANALYSIS, [http://www.bea.gov/industry/gdpbyind\\_data.htm](http://www.bea.gov/industry/gdpbyind_data.htm) (last modified Apr. 23, 2015), archived at <http://perma.cc/Z6JE-WFQK>.

30. See BLACKWOOD ET AL., *supra* note 28, at 4 (noting that nonprofit finances “increased from 2000 to 2010”).

31. See *id.* at 2 tbl.1.

32. See Brian Domitrovic, *The Worst Economic Crisis Since When?*, FORBES (Feb. 5, 2013, 8:00 AM), <http://www.forbes.com/sites/briandomitrovic/2013/02/05/the-worst-economic-crisis-since-when>, archived at <http://perma.cc/7ZCT-7PCJ>; Heather Stewart, *We Are in The Worst Financial Crisis Since Depression, Says IMF*, GUARDIAN (Apr. 9, 2008, 7:07 PM), <http://www.theguardian.com/business/2008/apr/10/useconomy.subprimecrisis>, archived at <http://perma.cc/8XMH-722P>; Cambridge Energy Research Assocs., *Three Top Economists Agree 2009 Worst Financial Crisis Since Great Depression; Risks Increase if Right Steps Are Not*

nonprofits reported expenses as a percentage of revenue increased by 6% in this ten-year period, while the number of nonprofits registered with the IRS increased by almost 24%.<sup>33</sup>

### B. Workforce & Volunteers

The economic importance of the nonprofit sector is also revealed in the human resource contributions reflected in sector productivity, both in employment and volunteer contexts. In 2010, nonprofits employed 10.7 million workers, representing 10% of the nation's workforce and making the nonprofit workforce the third largest of all U.S. industries behind retail trade and manufacturing.<sup>34</sup> For added perspective, in 1998, the nonprofit sector employed an estimated 11 million workers, representing 7% of the U.S. workforce.<sup>35</sup> By 2005, that number had more than doubled to 16.4%, whereas the employment growth in the nation during the same time grew only 6.2%.<sup>36</sup> This increase in workforce representation by the nonprofit sector further emphasizes the important role nonprofits served in steadying the national economy in an important time following the aforementioned 2007–2008 financial crisis.<sup>37</sup>

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*Taken*, REUTERS, Feb. 27, 2009, available at <http://www.reuters.com/article/2009/02/27/idUS193520+27-Feb-2009+BW20090227>, archived at <http://perma.cc/FW55-9P6P>.

33. See BLACKWOOD ET AL., *supra* note 28, at 4 (“While the finances of [nonprofits] increased from 2000 to 2010, much of the growth occurred during . . . [2000–2005], before the recession hit the nonprofit sector. From 2000 to 2005, the percentage change in revenue was 24 percent. The growth slowed to 16 percent between 2005 and 2010.” (citation omitted)).

34. LESTER M. SALAMON, S. WOJCIECH SOKOLOWSKI & STEPHANIE S. GELLER, JOHNS HOPKINS UNIV., *HOLDING THE FORT: NONPROFIT EMPLOYMENT DURING A DECADE OF TURMOIL 2* (2012) (noting that the nonprofit sector employs “18 times more workers than the nation’s utilities industry[;] [f]ifteen times more workers than the nation’s mining industry[;] [n]early 10 times more workers than the nation’s agriculture industry[;] [a]bout five and a half times more workers than the nation’s real estate industry[;] [n]early three times more workers than the nation’s transportation industry[;] and [a]bout twice as many workers as the nation’s wholesale trade, finance and insurance, and construction industries” (emphasis omitted)).

35. Lester M. Salamon, *The Resilient Sector: The State of Nonprofit America*, in *THE STATE OF NONPROFIT AMERICA* 3, 7 (Lester M. Salamon ed., 2002).

36. MOLLY F. SHERLOCK & JANE G. GRAVELLE, CONG. RESEARCH SERV., R40919, *AN OVERVIEW OF THE NONPROFIT AND CHARITABLE SECTOR* 5 (2009).

37. See *Nonprofits a Surprising Bright Spot in the National Jobs Picture*, JOHNS HOPKINS U. (Sept. 2, 2010), [http://releases.jhu.edu/2010/09/02/nonprofit\\_employment\\_up/](http://releases.jhu.edu/2010/09/02/nonprofit_employment_up/), archived at <http://perma.cc/L7VN-2DZJ> (reporting analysis of data showing that employment in the nonprofit sector grew by 2.5% during the second quarters of 2007 and 2009, faster than the 2.3% nonprofit jobs growth between 2001 and 2007 and coming at a time when for-profit employment fell by an average of 3.3%).

Nonprofit labor statistics are further magnified when volunteer efforts are included. Volunteerism and its impact on the efforts of nonprofits is a distinguishing feature of nonprofit efforts vis-a-vis business ventures, providing a supplemental workforce to further nonprofit goals.<sup>38</sup> That impact can be seen in the production yields of the nonprofit sector. In 2012, more than 64 million Americans age sixteen and older volunteered for or through a nonprofit, representing at least a quarter of the nation's population.<sup>39</sup> Those volunteers contributed almost 8 billion hours of service, creating \$175 billion of value.<sup>40</sup>

### C. Limited Resources for Growing Demands

Despite their demonstrated economic and social importance, nonprofits face the ongoing challenge of balancing a confluence of financial, commercial, and management demands and are forced to rethink how they meet their stated goals in today's economic realities. As mentioned, the average citizen often thinks of larger, better known nonprofits when engaged in discussions of the nonprofit sector.<sup>41</sup> Of 1.56 million nonprofits registered with the IRS in 2010, approximately 600,000, or just over a third of those organizations, filed a Form 990.<sup>42</sup> Further, according to a recent Urban Institute report on the nonprofit sector, 75% of nonprofits reporting to the IRS in 2010 received less than \$100,000 in revenues.<sup>43</sup>

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38. See SARAH JANE REHNBORG WITH ASSISTANCE FROM WANDA LEE BAILEY, MEG MOORE & CHRISTINE SINATRA, *STRATEGIC VOLUNTEER ENGAGEMENT: A GUIDE FOR NONPROFIT AND PUBLIC SECTOR LEADERS 2* (2009).

39. See *Economic News Release: Volunteering in the United States, 2013*, U.S. DEPT. LAB. BUREAU LAB. STAT. (Feb. 25, 2014, 10:00 AM), <http://www.bls.gov/news.release/volun.nr0.htm>, archived at <http://perma.cc/K66R-6T5X>.

40. See *Volunteering and Civic Engagement in the United States 2012*, CORP. FOR NAT'L & COMMUNITY SERVICE, <http://www.volunteeringinamerica.gov/national> (last visited June 3, 2015), archived at <http://perma.cc/P99L-9GME>. Volunteer value was calculated using a \$22/hour wage standard. *Independent Sector's Value of Volunteer Time*, INDEP. SECTOR, [https://www.independentsector.org/volunteer\\_time](https://www.independentsector.org/volunteer_time) (last visited June 3, 2015), archived at <https://perma.cc/ZKT6-TDHG>.

41. See *Top 100 Nonprofits on the Web*, TOP NONPROFITS, <http://topnonprofits.com/list/s/best-nonprofits-on-the-web> (last visited June 3, 2015), archived at <http://perma.cc/T4B2-BZC5> (measuring popularity using more current measures including Twitter followers, Facebook likes, and Google Opinion).

42. See BLACKWOOD ET AL., *supra* note 28, at 2.

43. See *id.* at 3.

Another popular misconception is that nonprofits derive most if not all of their revenues from private business and individual philanthropy.<sup>44</sup> While this may be more true in certain parts of the sector, the nonprofit sector as a whole consistently derives half of its revenue through fees for services provided, while less than 40% comes from government sources and 10% from philanthropy.<sup>45</sup>

The dominance of federal, state, and local government grants and contracts—especially federal grants and funding as nonprofit funding sources, as well as the corresponding growth of nonprofits in the U.S.—is a phenomenon that traces its roots primarily to expanded government programming during World War II and the Great Society programming of President Johnson’s administration in the 1960s.<sup>46</sup> However, in the 1980s, government support began a sharp decline as a result of the fiscal restraint policies instituted in the administrations of Presidents Reagan and Bush.<sup>47</sup> The policies of President Clinton in the 1990s revived a more modest federal focus on funding of the social programs that provided much of the prior era funding for nonprofits, embodied in expansion of entitlement programs and re-characterization of certain aid programs and welfare reform.<sup>48</sup> These Clintonian efforts did not alter certain lasting effects of the Reagan–Bush era policies. Federal support to nonprofits shifted from a previous system of direct grants and contracts between the government and service providers to the form of consumer subsidies.<sup>49</sup> This paradigm shift moved significant streams of funding away from direct payments to the provider of the services (nonprofits) to voucher payments directly to the recipients of the service (consumers), forcing nonprofits to compete for these funds and introducing for-profit competition in markets once dominated by nonprofits.<sup>50</sup> Given the traditional for-profit entities’ flexibility in raising needed capital by issuing stock, nonprofits were placed at an immediate disadvantage and found themselves needing to master

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44. Salamon, *supra* note 17, at 10.

45. *Id.* at 10–11.

46. *See id.* at 21–22.

47. *See id.* at 22.

48. *See id.* at 23.

49. *See id.* at 24–25 (describing consumer subsidies primarily in the form of loan guarantees, tax benefits, and vouchers, all of which provided creative legislative tools in providing government assistance that did not as overtly and visibly impact the federal budget in the appropriations process, a chief criticism of the direct subsidies to nonprofits).

50. *See id.* at 24–25.

complex billing systems, develop marketing plans, and secure financing to manage lagging reimbursements and economic down cycles—all of which arguably drain resources that should have been committed to the social service purposes for which the nonprofit was established.<sup>51</sup> This trend of austerity and government spending retrenchment has again spiked in the wake of the most recent 2007–2008 banking crisis and financial recession.<sup>52</sup> The 2012 Nonprofit Finance Fund national survey of nonprofit organizations found that 55% of nonprofits surveyed did not have or did not receive federal government contracts or funding.<sup>53</sup> Underscoring the continued decline in government funding, the survey also found that over 75% of nonprofits that reported receiving government contracts reported that the government contracts do not pay the full cost of their organizations' programs.<sup>54</sup>

Government grants and contracting are not the only areas where nonprofits are enduring a decline in revenues. Similar trends have surfaced in philanthropic giving as well. According to GuideStar's 2012 national survey of nonprofit organizations, 37% of nonprofits reported a decrease in funding, while 34% reported an increase and 28% reported that funding levels remained the same from the previous year.<sup>55</sup> The Urban Institute's profile of individual charitable contributions shows that the volume of charitable contributions in 2011, totaling \$298 billion, represented a 10% overall reduction when compared to giving in 2005.<sup>56</sup> Charitable contributions experienced the largest decline of 9.5% between 2007 and 2008, with only modest increases in giving from 2008 to 2011.<sup>57</sup> The Chronicle of Philanthropy reported that in 2009 contributions to the nation's largest charities dropped 11%: the United

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51. *See id.* at 26.

52. *See id.* at 24.

53. NONPROFIT FIN. FUND, 2012 STATE OF THE SECTOR SURVEY (2012), available at <http://nonprofitfinancefund.org/>, archived at <http://perma.cc/P842-SX3E>.

54. *Id.*

55. GUIDESTAR, THE EFFECT OF THE ECONOMY ON THE NONPROFIT SECTOR: AN OCTOBER 2012 SURVEY (2012), available at <https://www.guidestar.org/ViewCmsFile.aspx?ContentID=4781>, archived at <https://perma.cc/C9M3-SG2S?type=live>.

56. *See* BLACKWOOD ET AL., *supra* note 28, at 4–5 (2005 charitable contributions totaled \$331 billion).

57. *See id.* (reporting that giving decreased by less than 4% from 2008 to 2009 and increased by 1% between 2010 and 2011).

Way experienced a 4.5% decrease, Salvation Army received an 8.4% decrease, and Food for the Poor a 27% decrease in contributions.<sup>58</sup>

Despite the decline in resources and contributions, nonprofits continue to experience an increase in the demand in services.<sup>59</sup> The increase in the demand for services can be traced to fluctuations in the national economy and its negative impact on the national poverty rate.<sup>60</sup> The poverty threshold represents the minimal amount of cash required to support families.<sup>61</sup>

After reaching a low of 11% in 1973 and maintaining this level throughout that decade, poverty in America began rising again in the early 1980s, spiking in 1983 at 15.2%.<sup>62</sup> The rate stubbornly hovered above 12% for the remainder of that decade into the early 1990s, returning to 15.1% in 1993 before dropping below 12% for the rest of 1990s.<sup>63</sup> Despite an uptick in the early 2000s, it was not until 2010, in the wake of the 2007–2008 recession, that poverty in America returned to 15.1%, a rate the country had not experienced in seventeen years and only twice seen since the 1950s and 1960s.<sup>64</sup> This corresponds to a report by the Nonprofit Finance Fund finding that, between 2008 and 2012, 85% of nonprofits across the country reported an increase in the demand for services.<sup>65</sup>

#### *D. Meeting the Mandate of Efficiency and Effectiveness*

In his speech delivered before the Minnesota Council of Nonprofits, Pablo Eisenberg outlined the three major challenges facing nonprofits: increasing responsibilities and demand for service; higher public and funder expectations; and limited public and private resources to achieve organizations goals. Eisenberg argued that these challenges have caused nonprofits to turn to other methods to raise funds, including the adoption of the fee for service model and the creation of profit-making

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58. Noelle Barton & Holly Hall, *Donations Dropped 11% at Nation's Biggest Charities Last Year*, CHRONICLE PHILANTHROPY (Oct. 17, 2010), <https://philanthropy.com/article/A-Sharp-Donation-Drop-at-Big/125004>, archived at <https://perma.cc/Y6WH-WDQZ>.

59. See NONPROFIT FIN. FUND, *supra* note 54; cf. *Poverty in the United States Frequently Asked Questions*, UNIV. MICH. NAT'L. POVERTY CENTER, <http://npc.umich.edu/poverty> (last visited June 3, 2015), archived at <http://perma.cc/VM3S-37PD>.

60. See *Poverty in the United States Frequently Asked Questions*, *supra* note 59.

61. See *id.*

62. See *id.*

63. See *id.*

64. See *id.*

65. See NONPROFIT FIN. FUND, *supra* note 53.

businesses and commercial ventures to secure needed income.<sup>66</sup> The Foundation Center's review of nonprofit trends between 2008 and 2010 shows that "growth of the sector is being financed largely by borrowing or drawing down of reserves, trends that are likely to weaken affected parts of the sector over the long haul."<sup>67</sup>

According to the Nonprofit Overhead Cost Project study, "[n]onprofits are responding to perceived and explicit pressure to keep real and reported administrative and fundraising costs low."<sup>68</sup> The study cited an example of a nonprofit being "threatened" by a funder to withhold funds because administrative and fundraising costs were too high.<sup>69</sup> This pressure is evident in the "[d]onors . . . and watchdog agencies" that rely on the audited financial statements and IRS Forms 990 as a performance measurement.<sup>70</sup> The report warns that use of simplistic overhead ratios found on the IRS Form 990 to make efficiency assessments can produce "flawed conclusions."<sup>71</sup> As a result, the management of nonprofits has become a "delicate dance" of administrative, organizational, and leadership skills to keep funders, volunteers, and grant agencies engaged to help nonprofits achieve their goals.<sup>72</sup>

A review of the nonprofit literature over the last decade reveals how the impact of a fluctuating economy – impacting both the slowing rate

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66. See Pablo Eisenberg, *Citizen Engagement: The Nonprofit Challenge*, NONPROFIT Q., Winter 2004, at 32, 32. Pablo Eisenberg is a Senior Fellow at the Georgetown University McCourt School of Public Policy. *Center for Public & Nonprofit Leadership: Who We Are*, GEO. U. MCCOURT SCH. PUB. POL'Y, <https://cpnl.georgetown.edu/about-us/who-we-are> (last visited June 4, 2015), *archived at* <https://perma.cc/WB5Z-8RZQ>. "Eisenberg has published numerous articles and chapters of books, and is a regular contributor to the *Huffington Post*, *Inside Higher Education*, and has a regular monthly column in *The Chronicle of Philanthropy*." Pablo Eisenberg, GEO. U., <https://georgetown.app.box.com/s/4mjnjedar8cbtcpebcpk> (last visited June 4, 2015), *archived at* <https://perma.cc/C24A-5LLB>.

67. Rob Bruno, *Nonprofit Almanac: Sector Trends and Statistics*, NONPROFIT LITERATURE BLOG (Dec. 14, 2012, 9:18 AM), <http://literature.foundationcenter.org/2012/12/2012-nonprofit-almanac.html>, *archived at* <http://perma.cc/R99Y-4G86>.

68. URBAN INST. CTR. ON NONPROFITS AND PHILANTHROPY & IND. UNIV. CTR. OF PHILANTHROPY, *THE QUALITY OF FINANCIAL REPORTING BY NONPROFITS: FINDINGS AND IMPLICATIONS 2* (2004), *available at* [http://webarchive.urban.org/UploadedPDF/311045\\_NOCP\\_4.pdf](http://webarchive.urban.org/UploadedPDF/311045_NOCP_4.pdf), *archived at* <http://perma.cc/534C-E36M>.

69. *Id.*

70. *Id.* at 1.

71. *Id.* at 3.

72. Tom Chmielewski, *Issues Surrounding Non-for-Profit Organizations*, HOUS. CHRON., <http://smallbusiness.chron.com/issues-surrounding-not-for-profit-organizations-4758.html> (last visited June 3, 2015), *archived at* <http://perma.cc/4M5R-PFZE>.

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and flow of contributions, increasing demands for services, as well as competition from for-profit entities and other nonprofits for shrinking dollars—has forced nonprofits to rethink how they are managed and positioned in a competitive marketplace.<sup>73</sup> The following description of one Texas nonprofit situation further illustrates the pressure faced by nonprofits and the means by which they attempt to meet these challenges:

Seeing foundation and other grant support dwindle along with individual giving, Affordable Homes of South Texas, Inc. (AHST) tweaked its funding model last year. The community development corporation . . . builds about 100 units of housing each year for low-income families, and rehabilitates housing for the elderly or disabled. The annual budget remained about \$4 million, but how they came up with those dollars has changed.

Individual giving only makes up about 5 percent of the budget, but it was off by as much as 10 percent last year, according to Director of Strategic Initiatives Martin Medina.

. . . “Because of the way that we’re set up for housing, as a construction developer, it’s easier for us to . . . transition into developing other loan products,” said Medina. AHST also has been able to augment revenues from government funding like Housing and Urban Development (HUD) grants and diversified into non-traditional sources.

Instead of borrowing money from banks and turning around to do a project for low-income families, the organization now has banks investing in it. AHST pays the bank a return over the term while lending that money at a higher rate to their clients, but still lower than they likely are to find.

. . . .  
“It is looking a little brighter for us,” said Medina. He believes the new funding model will be a selling point to banks since he can make the pitch that they’re not investing just to help the nonprofit survive but to help them grow and provide more services.<sup>74</sup>

Faced with continuing economic changes that have impacted funding and contributions, and have caused an increased demand for services,

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73. See, e.g., Hrywna, *supra* note 15, at 9.

74. Paul Clolery & Mark Hrywna, *2011 Giving Estimated at \$298.42B*, NONPROFIT TIMES, July 1, 2012, at 1, 3–4, [http://www.thenonproffitimes.com/wp-content/uploads/2013/02/1341236609\\_GivingUSA\\_2011.pdf](http://www.thenonproffitimes.com/wp-content/uploads/2013/02/1341236609_GivingUSA_2011.pdf), archived at <http://perma.cc/E494-AMFD>.

nonprofits continue to look for internal strategies to improve performance and to find efficiencies in fundraising and operating to continue services to communities in need while surviving in a new market place. While giving may appear to have stabilized in certain instances and other nonprofits have experienced a slight uptick in giving, the fluctuation and instability nevertheless underscores the need to provide consistent financial relief to these important institutions.

### III. ENTITY ANALYSIS

This section compares the key characteristics of today's predominant entities: the corporation, the nonprofit corporation, the unincorporated association, the trust, and the limited liability company.<sup>75</sup> This section will focus on comparing, in the aforementioned context, the entity structures available to nonprofits with those available to for-profits, demonstrating that nonprofits are not afforded the same treatment as for-profits. This disparity in treatment is problematic because nonprofits require tax, liability, and governance resources similar to those available to for-profits in order to continue meeting the needs of society, particularly as the nonprofit sector grows.

Typically, the two most important considerations of any business structure analysis, be it for-profit or nonprofit, are tax treatment and liability protection, whether driven purely by profit incentives, social incentives, or the two combined.<sup>76</sup> Business planning generally involves three objectives: "(1) minimization of income taxes; (2) limitation of individual liability; and (3) provision of flexibility and ease in operation."<sup>77</sup> The main options typically available to for-profit ventures are the sole proprietorship, the partnership, the limited partnership, the

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75. See *supra* note 11 and accompanying text.

76. William H. Clark, Jr., *The Relationship of the Model Business Corporation Act to Other Entity Laws*, 74 LAW & CONTEMP. PROBS. 57, 57 (2011).

77. See Crusto, *supra* note 6, at 384 (quoting Kenneth D. Esch & Pamela L. Spaccarotella, *Limited Liability Companies as an Alternative Choice of Entity for Farming and Ranching Operations in the State of Nebraska*, 28 CREIGHTON L. REV. 19, 20 (1994)) (internal quotation mark omitted). In this article, author Crusto argues for a Limited Liability Sole Proprietorship Act. *Id.* at 417–28. Crusto bases his thesis and analysis on the fact that the sole proprietorship is the most commonly used business structure in the United States and should be recognized with flexibility and protection accordingly. *Id.* at 383. Crusto argues that said flexibility and protection is best afforded through an act or model that protects business entities. *Id.* at 385. Moreover, this article "explores the issue of shielding a sole proprietor's assets from business liability." *Id.* at 384 (footnote omitted). Crusto's case for the limited liability sole proprietorship lends itself to the idea that other business entities valuable and integral to American society should have the same protections. See *id.* at 417.

corporation, the s-corporation, and the limited liability company.<sup>78</sup> While for-profit business forms carry unique and distinguishing features, they also possess key similarities. Often the objectives of a new business would find its needs met through multiple business forms, making the unique and sometimes slight distinctions between business forms important to consider. The key distinctions between business structures “are based upon who the owners are (a sole proprietor, partners, shareholders, etc.), what rights and obligations the owners have, and whether the business itself is a legal ‘entity’ separate from the owners.”<sup>79</sup> Unlike the sole proprietorship and partnership, which are the general default entities under law, a corporation does not exist until articles of incorporation are filed with the secretary of state.<sup>80</sup> However, in considering their similarities, “businesses—regardless of their legal structure—are the forum for economic activity, the objective of which is often, but not always, to earn an economic return, profit, or other increased value to the proprietor.”<sup>81</sup> A primary reason there seems to be a variety of business forms stems from the fact that federal and state laws continue to evolve, often in an uncoordinated fashion.<sup>82</sup> The continual evolution of business forms does not seem to be ending in the near future. It is important to note that a business can create value without making money or having profit as its main objective.<sup>83</sup> “[T]he goals of businesses can be broader than just earning profit. Businesses can be established not only to make money, but also—or even primarily—to help people. Some people who are not the least bit greedy start, invest in, and run corporations and other businesses.”<sup>84</sup> Just as for-profit business structures have unique and sometimes overlapping characteristics, nonprofit entity structures also have common features. The most pronounced feature linking nonprofit entities and distinguishing them from any of their seemingly similar for-profit counterparts is the private inurement doctrine.<sup>85</sup> Contrary to

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78. See Susannah Camic Tahk, *Crossing the Tax Code’s For-Profit/Nonprofit Border*, 118 PENN ST. L. REV. 489, 491 n.2 (2014).

79. EPSTEIN ET AL., *supra* note 2, at 2–3.

80. *Id.* at 31, 62–63, 115.

81. *Id.* at 3.

82. *Id.* at 28.

83. See HOPKINS, *supra* note 1, at 4.

84. EPSTEIN ET AL., *supra* note 2, at 2.

85. See HOPKINS, *supra* note 1, at 505; Jill S. Manny, *Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit?*, 76 FORDHAM L. REV. 735, 744–46 (2007).

popular misconception, the doctrine is not primarily focused on whether the nonprofit makes a profit.<sup>86</sup> Rather, the doctrine embodies the restrictions on who may receive the profit and the purposes for which it may be used.<sup>87</sup> Other distinctions between nonprofit and for-profit entity options will be addressed below.

### A. *The Corporation*

The corporation is, perhaps, the most recognizable and, historically, the most commonly used business organization in the United States.<sup>88</sup> A corporation is a legal entity created under the respective laws of the state in which it is incorporated. Accordingly, the corporation exists primarily “because of legislative grace” and therefore “possess[es] authority as granted by the legislature.”<sup>89</sup> Accordingly, each state has the ability to limit (or enhance) the powers available to a corporation domiciled therein.<sup>90</sup> However, the corporate structure is shaped and driven globally by a more comprehensive body of corporate law

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86. See HOPKINS, *supra* note 1, at 505–08.

87. See *id.*; see also Christopher M. Riser, *Nonprofit LLCs: Time for a New Experiment?*, MAYER & RISER, PLLC, <http://www.mayer-riser.com/Articles/nonprofit/npllc.htm>, archived at <http://perma.cc/9NHS-8CF3> (“No distributions of profits from a nonprofit tax-exempt organization may be made to members, directors, officers, or managers. This restriction does not mean that nonprofit tax-exempt organizations cannot earn profits nor does it limit nonprofit tax-exempt organizations to charitable purposes. In fact, many nonprofit tax-exempt organizations earn significant profits. So, perhaps it may be argued that nonprofit organizations can, in fact, conduct ‘business.’”).

88. As discussed later, the LLC now rivals the corporation in entity selection. See *infra* notes 96–100 and accompanying text. But see THOMSONREUTERS, BUSINESS COUNSELOR UPDATE 3 (2012), available at <http://blog.legalsolutions.thomsonreuters.com/wp-content/uploads/2012/05/Business-Counsel-Update-Final.doc>, available at <http://perma.cc/XN6Z-79NX> (“The corporation is the most widely used form of business organization in the United States. Several different types of corporations are recognized in most jurisdictions: general business or profit corporations; statutory close corporations, which offer the opportunity for shareholders of a small closely held enterprise to combine the flexibility of the partnership form with the advantages of the corporate form; non-profit corporations; cooperative corporations; and professional corporations. Also, many jurisdictions provide for the creation of special purpose corporations.”); see also Note, *Piercing the Corporate Law Veil: The Alter Ego Doctrine Under Federal Common Law*, 95 HARV. L. REV. 853, 854 (1982) (observing that one of the main reasons the corporation has become the “‘dominant form of organization and production’ in the United States” is because of the commonly accepted liability shield it provides to investors (quoting ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION & PRIVATE PROPERTY*, at xxv–xxvi (rev. ed. 1968))).

89. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981), as reprinted in EPSTEIN ET AL., *supra* note 2, at 295.

90. See EPSTEIN ET AL., *supra* note 2, at 112 (“A corporation is whatever the relevant state law says it is.”).

consisting of: “(1) state statutes, (2) articles of incorporation, bylaws and other agreements, (3) case law, and (4) federal statutes.”<sup>91</sup>

The corporation is often thought of as a large, imposing business structure. While most large domestic and multinational businesses are indeed corporations, not all corporations assume this role.<sup>92</sup> Both small and large entities chose to organize as a corporation.<sup>93</sup> Though designed primarily to produce revenue for their shareholders, corporations commonly find themselves in philosophical debates concerning the appropriate corporate role in society.<sup>94</sup>

The history of the corporation is long and relatively complex.<sup>95</sup> However, from its earliest uses in colonial America, the advantage was clear: “[C]orporations would allow businesses to take risks and expand in ways they had been unable to do before. The concept spread and grew, and by the seventeenth century, the corporation was well on its way to being an acclaimed and established business model.”<sup>96</sup>

The corporation continued to gain popularity and arguably more intricacy with time and industrialization. During the twentieth century,

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91. *See id.* at 114 (footnote omitted).

92. *See id.* at 109 (“[Hence, M]ost corporations are not big; many are owned and run by one person. Perhaps surprisingly, though, most statutes concerning the formation and running of corporations do not distinguish between large and small businesses. [However, c]ourts sometimes do make the distinction.”).

93. *See id.* at 109–10. Epstein et al. distinguish a small versus a large corporation as follows:

As a matter of terminology, small corporations are often called “close” or “closely-held.” They have relatively few shareholders . . . [and] no public market for buying or selling interests in them. On the other hand, large corporations are often called “public,” for the simple reason that they have many shareholders and the interests in them are publicly traded (for instance, on stock exchanges). There are many corporations somewhere in the middle, but lawyers tend to group corporations into these two categories—close and public.

*Id.*

94. *See* Brian M. McCall, *The Corporation as Imperfect Society*, 36 DEL. J. CORP. L. 509, 509 (2011) (“[T]he corporation is one of the many imperfect societies that form the perfect society of the nation. The implications of such understanding involve a recognition that the corporation must be governed consistently with the common good of the corporation but with due attention paid to the common good of the perfect society of which the corporation is a part.”).

95. For a thorough discussion, see *The History of the Corporation*, HIST. BUS., [http://www.historyofbusiness.net/history\\_of\\_corporations.html](http://www.historyofbusiness.net/history_of_corporations.html) (last visited June 3, 2015), archived at <http://perma.cc/MBW9-9WF5>.

96. *Id.*

the corporation continued to change, and so did its role, with the growing population of the United States. Emerging as a force not only in world government, but also in world economy, the US suddenly saw a rise in what was to eventually shape the identity of the entire nation: consumerism. As the country rose, grew, and prospered, it became one of the most powerful and successful nations in the world—and consequently, the nation with the highest economic demands, largely being met by—you guessed it—corporations. The very nature of these massive businesses allowed them to produce huge quantities of product with minimal cost, meaning that they could manufacture and distribute for the least cost and the maximum profit. This would also serve them well on the international level, where American corporations became quickly known as not only producers but also buyers—consumers in themselves, who would buy material or products, then turn around, and distribute them among the American people.<sup>97</sup>

Although not the oldest form of business in the American economy,<sup>98</sup> the corporation has grown to be an integral part of American entrepreneurship and the history of the American economy.<sup>99</sup> Retired

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97. *Id.*

98. See SJOSTROM, *supra* note 3, at 19.

99. See EPSTEIN ET AL., *supra* note 2, at 110.

For as long as America has existed, the primary authority over the creation of business organizations has resided with the individual states. At America's beginnings, only two business forms existed [in addition to the sole proprietorship]: the general partnership, which requires no formal sovereign recognition, and the corporation, which has always required formal recognition by a sovereign person or government.

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... During America's colonial period and for a few years thereafter, the vast majority of the people in America's agriculturally based society labored on family farms producing the goods necessary for their own survival and occasional surplus to be bartered. The manufacture of goods produced by artisans in small shops and the business of merchants engaged in importing and exporting grew steadily . . . , with the sole proprietorship and the partnership serving as the legal forms for conducting these businesses. . . . Business [discrepancy] had not yet evolved to a point where the legal benefits of forming a corporation proved useful. The colonial assemblies and the early state legislatures granted corporate charters primarily for public purposes, including the establishment of towns, churches, cemeteries, colleges, and charities.

*Id.* (first alteration in original) (footnote omitted) (quoting Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1484, 1487–89 (1998)).

Delaware Judge William T. Allen provided the following additional guidance concerning the objectives and essence of the corporation:

Stated broadly, but I think accurately, the elemental purpose of corporation law is the facilitation of cooperative activity that produces wealth. A net increase in total wealth, other things remaining unchanged, is an absolute good. With increased wealth, all other things remaining the same, there is a greater ability to relieve human suffering and enhance life. That is an unqualified good. While we no longer take much notice of the fact, the corporate form is a powerful engine for wealth production. . . .

Corporation law facilitates wealth creation principally by creating a legal structure that makes it substantially cheaper for investors to commit their capital to risky ventures. It does this through the innovation of tradable share interests, centralized management, limited liability, and the entity concept itself. The interaction of these legal characteristics facilitates diversification of investments and centralization of management. This allows capital to subject itself to greater risk. It is the ability to increase the degree of risk that can be rationally accepted that provides the greatest source of the efficiency of the corporate form.

Much of this utility depends upon investors allowing themselves to be safely passive.<sup>100</sup>

One substantial advantage of the corporation, especially when compared to the sole proprietorship and partnership, is that a corporation's owners (stockholders or shareholders) are generally protected from personal liability.<sup>101</sup> The corporate shield is not absolute and can be pierced by application of the alter ego doctrine.<sup>102</sup> The alter ego doctrine is designed to police and prevent management and shareholder abuses of the corporate liability shield and commonly consists of a two-prong test.<sup>103</sup> The first prong requires that "such unity

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100. William T. Allen, *Ambiguity in Corporation Law*, 22 DEL. J. CORP. L. 894, 895–96 (1997). Judge Allen is currently serving as Nusbaum Professor of Law and Business and Director of the Pollack center of Law and Business at New York University School of Law. William T. Allen, N.Y.U. L., <https://its.law.nyu.edu/facultyprofiles/profile.cfm?personID=19739> (last visited June 3, 2015), archived at <https://perma.cc/XQ2R-Y7BH>.

101. Note, *supra* note 88, at 854 ("Under extreme circumstances, . . . corporate law will abrogate limited liability through the equitable doctrine of piercing the corporate veil.").

102. *See id.* at 854–55.

103. *Id.* at 853–55.

of interest and ownership that the separate personalities of the corporation and the individual no longer exist.”<sup>104</sup> The second prong is an equitable test and requires proof that attributing the acts in question solely to the corporation, not the individual, will produce an unfair and unjust result.<sup>105</sup> This inquiry tends to be fact-specific, and standards can vary widely among the states. Perhaps the most significant tradeoff for the liability shield afforded to corporate shareholders is that, “[i]n exchange for this protection, the corporation is considered a tax-paying entity.”<sup>106</sup> A corporation must pay taxes on its income as a separately recognized legal entity, “[a]nd, because the business does not get any deduction for dividends paid, the earning of a corporation are, in essence, taxed twice.”<sup>107</sup>

The “personhood” of a corporation creates yet another unique distinguishing byproduct not generally shared with other traditional business entities: a segregated management structure.<sup>108</sup> In a corporation, the shareholders do not manage the corporation’s affairs as such. The corporate model is designed for the elections of directors who are charged with fiduciary duties of managing the corporation’s business affairs.<sup>109</sup>

### B. The Nonprofit Corporation

Despite its prominence and inherent power, the business corporation is not the only legal entity with a significant impact on

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104. *Automotriz Del Golfo De California S. A. De C. V. v. Resnick*, 306 P.2d 1, 3 (Cal. 1957). Also, according to a *Harvard Law Review* note, “[t]he first prong may be satisfied by a showing of domination and control of the corporation, which occurs most often in the context of a parent-subsidiary relationship.” Note, *supra* note 88, at 854.

105. Note, *supra* note 88, at 855 (“The second prong is less well-defined, but cases have held it to be satisfied when a corporation is so undercapitalized that it is unable to meet debts that may reasonably be expected to arise in the normal course of business. . . .” (footnote omitted))

106. EPSTEIN ET AL., *supra* note 2, at 28.

107. *Id.*

108. *Id.* at 148. “[T]here is no Mr. or Ms. McDonald,” as some would say. *Id.*

109. JAMES D. COX, THOMAS LEE HAZEN & F. HODGE O’NEAL, *CORPORATIONS* 146 (1997) (“The traditional corporate pattern is triangular, with the shareholders at the base. The shareholders, who are generally viewed as the ultimate or residual owners of the business, select the personnel at the next level—namely, the board of directors. According to accepted wisdom, the board of directors appoints the chief executive officer and other corporate officers, determines corporate policies, oversees the officers’ work, and in general manages the corporation or supervises the management of its affairs. . . . In legal theory the directors are supreme during their term of office (usually one year).” (footnote omitted)).

society. The nonprofit corporation holds a similarly historic position of dominance in the nonprofit choice of entity discussion. The likely explanation for this comparable entity dominance is the close resemblance the nonprofit corporation bears to its progenitor, the business corporation.<sup>110</sup> The two entity forms share many similar characteristics. Two of the primary characteristics that distinguish the respective corporations from other entity forms are the corporate liability shield they provide<sup>111</sup> with accompanying piercing considerations and governance requirements typically required of both under state law.<sup>112</sup> Notwithstanding their similarities, there are notable differences between the for-profit corporation and nonprofit corporation.<sup>113</sup> One of the key distinguishing features of the nonprofit corporation is the prohibition against private inurement.<sup>114</sup> This doctrine distinguishes the business corporation, generally designed and intended to produce financial wealth for its owners, from the nonprofit corporation, which is prohibited, primarily by state statute and federal tax law, from creating wealth for the benefit of its members as the case may be.<sup>115</sup> The nonprofit corporation, by definition, embodies a different role from the for-profit corporation.<sup>116</sup>

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110. COX & HAZEN, *supra* note 7, § 1:18, at 108. “The nonprofit corporation statutes grew helter-skelter over the years without reference to any statutory model, and at one time they existed in great variety and astonishing combinations.” *Id.*

111. Jonathan T. Tan, Comment, *Nonprofit Organizations, For-Profit Corporations, and the HHS Mandate: Why the Mandate Does Not Satisfy RFRA’s Requirements*, 47 U. RICH. L. REV. 1301, 1355–56 (2013). These protections are provided for the officers and directors in both the business and the nonprofit corporate forms. *Id.* The other protected stakeholders receiving liability shield protection are the shareholders (primarily in the business corporation) and members of the nonprofit corporation (as most nonprofit corporations do not have shareholders and, as is discussed in more detail below, are restricted from advancing the private pecuniary interests of those individuals). *See id.*

112. The meeting, notice, quorum, voting, minutes, and resolution requirements that accompany the business corporate form are also required of the nonprofit corporation. *See* SCHMIDT, *supra* note 27, at 48.

113. Lizabeth A. Moody, *Board Liability: Guide for Nonprofit Directors* by Daniel L. Kurtz, 43 BUS. LAW. 1605, 1606 (1988) (book review).

114. *See* 1 WILLIAM MEADE FLETCHER & CAROL A. JONES, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 68.05 (rev. ed. 2006).

115. *Id.* (“Profit[,] . . . used in a pecuniary sense, [that] does not extend to intangible benefits, and the existence or nonexistence of stock or the declaration in the articles of the nature of the corporation is not necessarily determinat.” (footnote omitted)).

116. *Id.* (“[I]n a nonprofit corporation, shareholders or members do not have a proprietary interest in the corporation, as they do in a for-profit corporation.”).

Despite differences in treatment of “profits,” tax considerations tend to be as important a part of the nonprofit corporation’s existence as it is to the for-profit corporation. Tax considerations drive behavior and often serve as the determining factor(s) in reaching a decision on entity choice in both sectors.<sup>117</sup> This is reflected in the way tax law affecting the nonprofit corporation has emerged and developed over the last century.<sup>118</sup> Management and governance issues concerning the nonprofit corporation can also prove more challenging, as nonprofit corporation boards tend to be “large, uncompensated, and dominated by outsiders who are not employees of the corporation.”<sup>119</sup> Those persons are often left to grapple with issues surrounding the duties and responsibilities of directors of nonprofit corporations that are often more querulous and labyrinthine than those of their for-profit peers.<sup>120</sup> The absence of a developed body of statutory or common law in the nonprofit context continues as a source of frustration for attorneys who volunteer on nonprofit boards of directors, as well as those who seek to provide solid legal advice to nonprofit clients.<sup>121</sup>

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117. See Clark, *supra* note 76, at 57.

118. HOPKINS, *supra* note 1, at 35 (“The statutory law of tax-exempt organizations was initiated in 1913 and given major boosts in 1950 and 1969.”). Between that time period was the Tax Revenue Act of 1943, eventually followed by the Internal Revenue Code in 1954—all of which were instrumental to the nonprofit sector and the recognition of its benefit to society. See *id.* at 36.

119. Moody, *supra* note 113, at 1606. (“Most of the case law interpreting director duties has arisen out of cases involving business corporations (or, in some jurisdictions, trusts). Where the standard to be applied is derived from business law, the author has been careful to identify areas where special conditions apply to nonprofits, such as the passive donor who contributes substantial amounts but pays little attention to directorial duties.”).

120. Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 632 (1998) (“Consideration of the fiduciary duties of directors and officers of nonprofit institutions necessitates grappling with a series of problematic paradoxes. Nonprofit directors and officers generally operate under the same legal standards under state law in terms of managerial obligations and the duties of loyalty and care as their for-profit peers. However, in contrast to the for-profit world, the law plays little role, other than aspirational, in assuring accountability in the nonprofit sector. . . . There would be no reason for concern about these paradoxes, particularly about the relative absence of accountability constraints, if one could assume that a personal sense of responsibility, pride, decency, peer pressures, and similar factors were making the nonprofit governance system work effectively. But there is much evidence, largely anecdotal, to the contrary.” (footnote omitted)).

121. Moody, *supra* note 113, at 1605.

### C. *The Unincorporated Association*

Many smaller nonprofits are organized as an unincorporated association.<sup>122</sup> Like the partnership in the for-profit context, the unincorporated association structure allows multiple people loosely organized to advance a common goal or purpose.<sup>123</sup> The entity availability is not limited to smaller nonprofits, as prominent and substantial labor unions, political organizations, and sports leagues intentionally organize as unincorporated associations.<sup>124</sup> Primary advantages of the unincorporated association include relaxed governance requirements and management flexibility.<sup>125</sup> Unlike the nonprofit corporation, formal organizational filings with the secretary of state for its domiciliary jurisdiction, as well as other governance documents, are not required to validate the existence, administration, and effective termination of the association.<sup>126</sup> Experts warn that the intrinsic disadvantages of the unincorporated association status outweigh comparable benefits.<sup>127</sup> In weighing its relative advantages and disadvantages, the unincorporated association is rarely preferred over other nonprofit entity options, particularly the nonprofit corporation.

### D. *The Charitable Trust*

Charitable trust use dates back to the earliest religious organizations in America, understandably stemming from a common English

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122. See FISHMAN & SCHWARZ, *supra* note 12, at 49.

123. Sarah J. Hastings, Note, *Cinderella's New Dress: A Better Organizational Option for Churches and Other Small Nonprofits*, 55 *DRAKE L. REV.* 813, 820 (2007).

124. See, e.g., CONSTITUTION AND BYLAWS OF THE NATIONAL FOOTBALL LEAGUE 2 (2006 rev.).

125. See Hastings, *supra* note 125, at 820.

126. The IRS tends to more closely examine the unincorporated association seeking exempt entity status and often requires organizational documents and certifications the association seemed to escape. See 3 *INTERNAL REVENUE MANUAL* 7.25.3.2.4 (Jan 23, 1999).

127. FISHMAN & SCHWARZ, *supra* note 12, at 49–50 (“Few statutory rules govern or guide unincorporated associations, and there is little case law. The law of agency governs most legal relationships. Unincorporated associations have no separate legal existence apart from their members, and individual members may be found personally liable. Absent an enabling statute, an unincorporated association cannot receive or hold property in the association’s name. The organization has no perpetual duration, nor can it contract in its own name or hold title to property. Upon dissolution, members are entitled to their pro rata share of assets unless the articles of association provide otherwise. Since an unincorporated association is not a separate legal entity, all members are parties defendant of an alleged liability of the association.”).

tradition.<sup>128</sup> The key charitable trust advantages include ease and efficiency of formation and administration, potential infinite existence, and lasting authority for the grantor.<sup>129</sup> Charities and churches still use charitable trusts, but it is still considered a much more limited option when compared to the nonprofit corporation.<sup>130</sup>

#### *E. The Limited Liability Company*

The limited liability company (LLC) has been acclaimed as “a triumph of comparative law in action.”<sup>131</sup> While tracing its roots to flexibly styled entities established under German, Panamanian, and English laws and resembling limited liability firms in Europe and Latin America,<sup>132</sup> the LLC is still considered an original and uniquely American invention.<sup>133</sup>

The LLC was developed for, and is credited with, providing the ideal combination of the tax benefits and management flexibility inherent in partnerships and sole proprietorships with the entity level liability shield historically provided in the corporate form.<sup>134</sup> When compared to the corporate business structure, one of the key management flexibility features of the LLC structure is its escape from the formalities required as a part of established legal corporate governance requirements.<sup>135</sup> Whereas failure to follow corporate

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128. Hall, *supra* note 9, at 4.

129. See generally RESTATEMENT (THIRD) OF TRUSTS §§ 10, 28 (2003); see also Hastings, *supra* note 123, at 822 (“The charitable trust form requires the appointment of specific trustees who exercise absolute control over the property involved. Because charitable trusts are not formed under legislative authority, their internal organization may be more informal and flexible than that of a nonprofit corporation. Yet, because charitable trusts are governed under the general law of trusts, the trustee’s freedom of action is more rigidly circumscribed than that of a director.” (footnotes omitted)).

130. Hastings, *supra* note 123, at 822.

131. *LLC History*, LLC REPORTER, <http://www.llc-reporter.com/16.htm> (last visited June 3, 2015), archived at <http://perma.cc/BY3S-GDHR>.

132. See *id.*

133. See Hamill, *supra* note 99, at 1518–19.

134. See EPSTEIN ET AL., *supra* note 2, at 608. The owners of a limited liability company are not individually liable for the company’s debts. *Id.* The limited liability company is not a tax-paying entity. See *id.* Income taxes are only paid once – by the owners of the limited liability company when a part of the company’s earnings is distributed to them. See *id.* The existence of an LLC depends on compliance with the state limited liability company law. *Id.*

135. See Karin Schwindt, Comment, *Limited Liability Companies: Issues in Member Liability*, 44 UCLA L. REV. 1541, 1561–62 (1997) (noting that issuance of shares representing

formalities could expose corporate shareholders, officers, and directors to personal liability for debts of the corporation, such liability generally does not exist for managers and members of an LLC.<sup>136</sup>

The LLC's American genesis took place in 1977 when Wyoming became the first American state to enact an LLC statute.<sup>137</sup> While management flexibility and liability protection were important to legislative promoters of the LLC, tax considerations proved to be the true catalyst in the LLC entity evolution.<sup>138</sup> In the ten years following the Wyoming LLC act, relatively few states followed suit, and businesses exercised caution in recognizing the LLC as a viable option.<sup>139</sup> This all changed in 1988 when the IRS clarified that an LLC would be treated as a partnership for federal income tax purposes.<sup>140</sup> This recognition caused a wave of favorable legislative activity, and LLC statutes of some form have now been enacted in all fifty states.<sup>141</sup> The IRS further solidified the LLC's positioning in the entity pantheon with the establishment of the "check the box" regulations.<sup>142</sup> This development was incredibly important because it gave LLC members a choice as to

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ownership, shareholder and director meetings, minutes, and bylaws are a few corporate legal requirements which typically are not mandated of an LLC).

136. See *NVK Spinning Co. v. Nichols*, No. 12-2904, 2014 WL 28831, at \*6 (W.D. Tenn. Jan. 2, 2014).

137. See Thomas Earl Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer* (Pt. 1), 37 S.D. L. REV. 44, 45 (1992); see also Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 537 (codified as amended at WYO. STAT. ANN. § 17-15-101 to -147 (2013), *repealed by* Act of Mar. 9, 2010, ch. 94, § 3, 2010 Wyo. Sess. Laws, 429, 487). The Wyoming LLC Act generally permitted the formation of LLCs organized for any lawful purpose except the business of banking and insurance. See ch. 158, § 1, 17-297, 1977 Wyo. Sess. Laws 537, 538.

138. Clark, *supra* note 76, at 58 ("[Essentially,] [t]he Wyoming statute was designed to create an entity with limited liability that would also be subject to flow-through taxation under the regulations of the Internal Revenue Service.").

139. See Geu, *supra* note 137, at 45.

140. See Rev. Rul. 88-76, 1988-2 C.B. 360 (ruled obsolete by Rev. Rul. 98-37, 1998-2 C.B. 133).

141. See STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., REVIEW OF SELECTED ENTITY CLASSIFICATION AND PARTNERSHIP TAX ISSUES 1 (Comm. Print 1997).

142. See Treas. Reg. § 301.7701-3 (2014); see also Clark, *supra* note 76, at 59 ("[T]he Treasury Department rendered the *Kintner* regulations obsolete when it adopted the 'check the box' regulations, under which an unincorporated organization with two or more owners was taxed as a partnership by default, unless the business elected to be taxed as a corporation by 'checking the box.' The adoption of the check-the-box regulations is important not just because it confirmed the favorable tax treatment of LLCs, but also because it represents the final resolution of the tension between the desires for limited liability and flow-through taxation. In an LLC, all of the owners may have full limited liability, and the entity may simultaneously be taxed as a partnership." (footnote omitted)).

whether they desired to have tax benefits and consequences flow directly to them and have the entity disregarded or have the LLC maintain its separate identity for tax purposes.<sup>143</sup> In the wake of these significant IRS pronouncements, LLC popularity continued to soar, and it now rivals the corporation for preferred business entity status.<sup>144</sup>

#### IV. IRS RECOGNITION OF AN INDEPENDENT NLLC

##### A. Support for IRS Recognition of an Independent NLLC

Despite its growing popularity in the business world, the LLC, or NLLC for purposes of this Article, has enjoyed far less attention, recognition, and utilization in the nonprofit context. Scholars commonly observe that the nonprofit corporation is the generally preferred entity, with the unincorporated association and the trust less considered entities for reasons discussed above.<sup>145</sup> Even scholars who more openly discuss the viability of the NLLC exhibit a healthy level of skepticism.<sup>146</sup> Perhaps a primary reason for its continued dominance is the nonprofit corporation's deep history and resistance to novel approaches.<sup>147</sup> But that does not mean change and evolution to meet new technological, economic, and social challenges are not in order.<sup>148</sup> In fact, concerns regarding the NLLC seem to resemble those expressed in discussions of yesteryear surrounding applicability of the LLC in the business context.<sup>149</sup> And even those expressing doubts concerning

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143. See Clark, *supra* note 76, at 59.

144. See SJOSTROM, *supra* note 3, at 18 (noting that LLCs represented 5.7% of all business tax filers for tax year 2007 while corporations settled at 5.9%). The 2012 annual report of the Delaware Division of Corporations discloses that there were, on average, more than three times the number of LLCs formed compared to corporations for the years 2010 (82,027 versus 28,181), 2011 (93,222 versus 31,472), and 2012 (103,271 versus 32,394). See DELAWARE DIVISION OF CORPORATIONS 2012 ANNUAL REPORT (2012), available at <http://corp.delaware.gov/pdfs/2012CorpAR.pdf>, archived at <http://perma.cc/5B8Q-YY43>.

145. See FISHMAN & SCHWARZ, *supra* note 12, at 52; SCHMIDT, *supra* note 27, at 45–47.

146. See, e.g., David S. Walker, *A Consideration of an LLC for a 501(c)(3) Nonprofit Organization*, 38 WM. MITCHELL L. REV. 627, 674–75 (2012) (opining that while the IRS is showing evolutionary tendencies, pushing for LLC membership for individuals, *inter alia*, might not be worth the time, money, and effort).

147. See James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 619 (1985).

148. See *id.* at 683.

149. See Geu, *supra* note 137, at 44–50.

NLLC viability acknowledge the fact that nonprofit use of the LLC form is not a completely new or foreign concept.<sup>150</sup>

The limited liability company model has been used in other nonprofit contexts, further evidencing its continued transformation and advancement.<sup>151</sup> Perhaps the doubt and acknowledgement both stem from the deliberate speed of the IRS and its pronouncements regarding the LLC, particularly in the nonprofit context. At the same time the IRS began allowing LLC owners the flexibility to choose between taxation as corporation or as a disregarded entity with tax benefits and consequences flowing to the owners, that same flexibility was not extended fully or immediately to nonprofit interests.<sup>152</sup> However, the IRS took a step forward in 1999 by clearly providing that a single member LLC whose sole member has already been granted federal exemption can also qualify for exemption.<sup>153</sup> The LLC would be disregarded and treated as a part of the parent nonprofit's operations. The IRS further provided that the LLC could claim and maintain its own exemption by filing the appropriate application for exemption.<sup>154</sup> However, membership in the NLLC must still be restricted to recognized exempt organizations.<sup>155</sup> This solution provides little comfort and may seem counterintuitive to start-up nonprofit promoters seeking to avail themselves of the NLLC's complete package of entity virtues.

Three primary issues are largely unaddressed. First, the nonprofit stakeholders are now managing two entities and the accompanying complexities. This could prove particularly troublesome for the many small and unsophisticated nonprofits that dot the national landscape who are already facing financial and administrative challenges in meeting their charitable missions.

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150. See James M. McCarten & Kevin N. Perkey, *Tennessee Nonprofit LLCs—A New Option for Tax-Exempt Organizations*, 3 *TRANSACTIONS: TENN. J. BUS. L.* 15, 15 (2001).

151. See Rev. Rul. 98-15, 1998-1 C.B. 718 (describing a situation in which a joint venture between an nonprofit and a for-profit was permissible, and distinguishing it from another joint venture that was not approved by the IRS).

152. See RICHARD A. MCCRAY & WARD L. THOMAS, *LIMITED LIABILITY COMPANIES AS EXEMPT ORGANIZATIONS* 117 (1999).

153. See I.R.S. Announcement 99-102, 1999-43 I.R.B. 545 (Oct. 25, 1999).

154. See U.S. DEPT OF THE TREASURY, *INSTRUCTIONS FOR FORM 1023: APPLICATION FOR RECOGNITION OF EXEMPTION UNDER SECTION 501(C)(3) OF THE INTERNAL REVENUE CODE 2* (2006), available at <http://www.irs.gov/pub/irs-pdf/i1023.pdf>, archived at <http://perma.cc/6GBR-ZHP8>.

155. See *id.*

Second, the governance structures and liability concerns the LLC was created to address will remain because the parent entities themselves are only allowed to be one of the preexisting entity forms.<sup>156</sup> The members of the unincorporated association will still face the liability issues related to operation of the unincorporated association.<sup>157</sup> The officers, directors, and members, as the case may be, of the parent corporation will be left with maintenance of the same corporate formalities and corporate piercing dangers they likely are attempting to avoid with the LLC. One might respond that in both instances the parent organization can serve as a holding company with the NLLC engaged in the meaningful operational activities. However, it still seems counterintuitive to have the parent organization put forth the effort required for exemption recognition only to serve as a holding company for the NLLC. Further, if that were the only reason for the parent organization's existence, it would seem more efficient and cost effective to allow nonprofits the choice of an independent NLLC.

Finally, the NLLC electing to be taxed as an association, and by extension a corporation, would still be subject to the IRS organizational and operational tests.<sup>158</sup> Not only will the nonprofit stakeholders be faced with managing two entities, but they will face the constant pressure of maintaining two separate exemptions. Again, this seems a maladroit means of employing an entity designed for simplicity and efficiency. This is perhaps the most important of these considerations because tax treatment, meaning IRS approval, seemingly remains the overriding consideration for nonprofit and for-profit business interests alike.

#### *B. Arguments Against IRS Recognition of an Independent NLLC*

Some experts might be concerned that the NLLC presents the potential for opening a Pandora's box of sorts, a tipping point on the slippery slope of potential abuses that traditional entity forms are

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156. See 26 U.S.C. § 501(c)(3) (2012). This section is generally interpreted by the IRS to allow corporations, trusts, and unincorporated associations, but not LLCs, exemption coverage.

157. See *supra* note 127 and accompanying text.

158. See U.S. DEP'T OF THE TREASURY, LIMITED LIABILITY COMPANY REFERENCE GUIDE SHEET, available at [http://www.irs.gov/pub/irs-tege/llc\\_guide\\_sheet.pdf](http://www.irs.gov/pub/irs-tege/llc_guide_sheet.pdf), archived at <http://perma.cc/7WWW-QWM9>.

designed to protect against.<sup>159</sup> It should be acknowledged that fraud and abuse can occur in any business entity context.<sup>160</sup> These losses can easily occur despite governance safeguards articulated in the Model Nonprofit Corporation Act (MNCA) that are specifically designed to meet the requirements of the IRS for recognition as a tax exempt entity.<sup>161</sup> As recent scandals in the American business world show, scandals stemming from breaches of fiduciary duties are by no means limited to the nonprofit sector.<sup>162</sup> The foregoing aid in showing that there are no guarantees associated with a particular entity. Accordingly, any discussion on ensuring that the resources entrusted to the management of an organization might be advised to focus less on whether it is a corporation or an LLC and more on safeguards similar to those embodied in the IRS's operational and organizational tests. As discussed, potential loss of organizational exemption is perhaps one of

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159. See Walker, *supra* note 146, at 652 (observing that the LLC format allows for much more flexibility than that traditionally provided in the corporate context, filling in details under contracts principles and allowing the parties to fashion their business arrangements in a manner that suits them).

160. A cursory review of nonprofit scholarship shows that no one segment of the nonprofit sector has cornered the market on scandal or concern for ensuring that the nonprofits, and those charged with fiduciary duties regarding its resources and missions, are of broad concern. See generally Robert C. DeGaudenzi, *Tax-Exempt Public Charities: Increasing Accountability and Compliance*, 36 CATH. LAW. 203 (1995); James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218 (2003); Melanie B. Leslie, *The Wisdom of Crowds? Groupthink and Nonprofit Governance*, 62 U. FLA. L. REV. 1179, 1179 (2010). See also Joe Stephens & Mary Pat Flaherty, *Inside the Hidden World of Thefts, Scams and Phantom Purchases at the Nation's Nonprofits*, WASH. POST (Oct. 26, 2013), [http://www.washingtonpost.com/investigations/inside-the-hidden-world-of-thefts-scams-and-phantom-purchases-at-the-nations-nonprofits/2013/10/26/825a82ca-0c26-11e3-9941-6711ed662e71\\_story.html](http://www.washingtonpost.com/investigations/inside-the-hidden-world-of-thefts-scams-and-phantom-purchases-at-the-nations-nonprofits/2013/10/26/825a82ca-0c26-11e3-9941-6711ed662e71_story.html), archived at <http://perma.cc/37VU-SYTF>, for information detailing the multimillion dollar losses due to insider theft at some of the most notable charities, including the American Legacy Foundation, AARP, and Georgetown and Columbia Universities.

161. See MODEL NONPROFIT CORPORATION ACT §§ 8.04-.05, .07-.09, .41-.43 (William H. Clark, Jr. ed., 3d ed. 2009). The MNCA establishes procedures for selection, resignation, and removal of directors, setting director terms, officers' duties, standards of conduct, resignation, and removal. *Id.*

162. See, e.g., PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON GOVERNMENTAL AFFAIRS U.S. SENATE, 107TH CONG., THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE 3 (Comm. Print 2002); DENNIS R. BERESFORD, NICHOLAS DEB. KATZENBACH & C.B. ROGERS, JR., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLD COM, INC. (2003).

the sharpest conduct-regulating tools.<sup>163</sup> Some scholars have called for increased IRS oversight of exempt nonprofits, but this oversight would likely not be based on entity type.<sup>164</sup>

Further protections can be provided through mandatory and default provisions in state law.<sup>165</sup> A cursory review of the key differences between laws governing the for-profit corporation and those governing the nonprofit corporation show the purposes for which nonprofit corporate laws were established and continue to serve.<sup>166</sup> Mandatory state law NLLC provisions similar to those included in the MNCA and its state statutory progeny should satisfy operational and organizational tests, making the NLLC's relationship to the LLC comparable to that shared by nonprofit and for-profit corporations.<sup>167</sup> Specific NLLC laws have already been enacted in certain states.<sup>168</sup> Many other states have allowed for interpretation of LLC-enabling statutory language "any lawful purpose" to include nonprofit instead of, as well as in addition to, for-profit purposes.<sup>169</sup> But this does not come without significant risk of violating the organizational test established by the IRS.<sup>170</sup> This is because the LLC default rules do not necessarily guarantee that the profits and corpus of the nonprofits organized under these laws will always be committed to the exempt purposes.<sup>171</sup>

These provisions can serve the dual purpose of ensuring that tax and other important social policies are observed while protecting less sophisticated NLLCs from accidental violations of state and federal law.

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163. See Walker, *supra* note 146, at 649 (noting that NLLC promoters might be very willing to surrender part of flexibility the LLC provides in order to satisfy the IRS and secure the desired tax exemption).

164. See Johnny Rex Buckles, *The Federalization of Fiduciary Obedience Norms in Tax Laws Governing Charities: An Introduction to State Law Concepts and an Analysis of Their Implications for Federal Tax Law*, 4 EST. PLAN. & COMMUNITY PROP. L.J. 197 (2012).

165. An in depth comparison and discussion of state NLLC laws is an important topic but is beyond the scope of this Article.

166. See MODEL NONPROFIT CORPORATION ACT, *supra* note 161, §§ 6.40, 12.03 (prohibition against private inurement); see also *id.* § 8.42 (fiduciary responsibilities).

167. See, e.g., *id.* §§ 2.02, 6.40, 14.05.

168. See TENN. CODE ANN. §§ 48-101-701 to -707 (2012); MINN. STAT. ANN. § 322B.975 (West 2011), *repealed by* Revised Uniform Limited Liability Company Act, ch. 157, art. 1, § 91, 2014 Minn. Laws 122, 185 (effective Jan. 1, 2018); N.D. CENT. CODE. §§ 10-36-01 to -09 (2012).

169. See DEL. CODE ANN. tit. 6, § 18-106(a) (2013); KY. REV. STAT. ANN. § 275.015 (LexisNexis 2012).

170. See Treas. Reg. § 1.501(c)(3)-1(a)-(b) (2013).

171. See *id.*

These laws would provide a safety net to help protect against inadvertent omissions that could jeopardize one or more of the nonprofits' valuable objectives. These protections can be most important for smaller, less capitalized nonprofits seeking to avoid the high costs associated with lawyers, accountants, and other professionals often needed to help manage the web of administrative red tape that accompanies more formal nonprofit options.

Another tool that should continue aiding in the prevention comes in the form of the attorney general. In most states, the attorney general is legally granted oversight of nonprofits, especially in the nonprofit corporate context.<sup>172</sup> Certain states that have enacted more-specific NLLC laws have continued this practice, some including strong notice requirements before an NLLC is allowed to change, showing a level of confidence in the enforcement capacity of the office.<sup>173</sup> One would struggle to think of a reason the State Attorney General should not continue in this important role, applying another layer of protection.<sup>174</sup>

The NLLC might be seen by other critics as another unnecessary and unwarranted addition to an already crowded field of legal entities.<sup>175</sup> However, choice is a fundamental thread in the fabric of America.<sup>176</sup> Business law scholars have also rebutted the entity rationalization and simplification arguments with the caution that attempts to narrow the field of entity may cause unintended consequences and the frustrating nuances that make some entity forms more appropriate than others in

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172. See Walker, *supra* note 146, at 671–674.

173. See, e.g., KY. REV. STAT. ANN. § 275.025(6) (LexisNexis 2012); MINN. STAT. ANN. § 322B.975(6) (West 2011); N.D. CENT. CODE § 10-36-06; TENN. CODE ANN. § 48-101-707 (2012); see also Walker, *supra* note 148, at 667 (noting that most states do not include this type of notice provision in their LLC statutes).

174. See Marion Fremont-Smith, *Attorney General Oversight of Charities* (Hauser Ctr. for Nonprofit Orgs., Working Paper No. 41, 2007), as reprinted in SCHMIDT, *supra* note 27, at 618.

175. See generally Harry J. Haynsworth, *The Unified Business Organizations Code: The Next Generation*, 29 DEL. J. CORP. L. 83 (2004) (discussing the proliferation of business forms and proposing a unified business code solution).

176. See Lynn Hanley, Student Article, *Wireless Communications and the Telecommunications Act of 1996: An Experiment in Federalism*, 12 LOY. CONSUMER L. REV. 48, 54 (2000) (noting that the concept of choice is as old as the nation itself and is “[t]he idea that once given an array of options, individuals can best decide what is best for them” (quoting William E. Kennard, Chairman, Fed. Commc’ns Comm’n, *The Telecom Act at Three: Seeing the Face of the Future*, Address at the Comptel 1999 Annual Meeting and Trade Exposition (Feb. 8, 1999))).

particular situations.<sup>177</sup> Further, the enactment of state statutes regarding the NLLC provides evidence of its importance to the residents of those states as expressed through their duly elected representatives.<sup>178</sup> The range of specificity in treatment by particular states demonstrates the diversity of opinion among states on the need for specificity.<sup>179</sup>

A third argument against IRS independent recognition of the NLLC seems to question the value of committing the time, effort, and resources necessary to convince the IRS to adjust its position yet again and recognize a freestanding NLLC entity with individuals as members.<sup>180</sup> Critics might argue that the IRS is unlikely to change its position and such change is unimportant because the nonprofit corporation already conforms to IRS requirements. These arguments overlook the fact that the nonprofit corporation is not the sole and exclusive entity currently recognized by the IRS. As discussed above, the trust and unincorporated associations have long histories in the nonprofit world as well.<sup>181</sup> The IRS has demonstrated consistent movement towards permitting a greater range of entity options, as opposed to a retrenchment in recognition.<sup>182</sup> Not long ago, it was more reasonable to doubt the LLC as a viable business entity than to believe it would grow in popularity as it has in the last thirty-five years. As evidenced by the proliferation in LLC legislation post IRS recognition, the trailblazers who enacted pre-recognition LLC legislation likely represented the minority view that the IRS would change its view of the LLC at that time.<sup>183</sup> The IRS' evolution on the NLLC also creates cause for optimism that an independent NLLC is a real possibility. Within two years of issuing its "check the box" regulations, the IRS evolved from a position of declining private letter ruling requests involving an LLC as a disregarded entity to approving the structure in

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177. See Richard A. Booth, *Form and Function in Business Organizations*, 58 Bus. Law. 1433, (2003).

178. See, e.g., TENN. CODE ANN. §§ 48-101-701 to -707; MINN. STAT. ANN. § 322B.975 (West 2011), *repealed by* Revised Uniform Limited Liability Company Act, ch. 157, art. 1, § 91, 2014 Minn. Laws 122, 185 (effective Jan. 1, 2018), N.D. CENT. CODE. §§ 10-36-01 to -09 (2012); DEL. CODE ANN. tit. 6, § 18-106(a) (2013); KY. REV. STAT. ANN. § 275.015 (LexisNexis 2012).

179. See *supra* note 178.

180. See Walker, *supra* note 146, at 675.

181. See *supra* Parts III.C–D.

182. See *supra* Part III.E.

183. See Geu, *supra* note 137, at 45.

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Announcement 99-102.<sup>184</sup> The IRS has articulated no policy that would justify a belief that it plans to limit its recognition to the aforementioned structures.

#### V. CONCLUSION

The current restriction by the IRS on the NLLC to members that are already exempt entities deprives nonprofits full use of an entity option that could help relieve the administrative and financial burdens they presently endure. For-profit ventures enjoy the combination of management flexibility, tax benefits, and a secure entity level liability shield that the LLC uniquely provides. Nonprofit stakeholders are denied full enjoyment of this tool bag because restricting membership to existing nonprofit organizations forces those stakeholders to maintain the entity structures they seek to avoid in favor of the LLC. The IRS's position on the LLC has evolved significantly in at least the last thirty-five years, and recognizing the NLLC as an independent entity is the next logical step.

IRS recognition could have the catalytic impact on state NLLC legislative activity similar to the impact Revenue Ruling 88-76 had on the LLC in the business context, providing the ideal combination of three primary benefits for nonprofits: (1) greater management flexibility and relief from burdensome corporate governance requirements, (2) assurance of the liability protections incumbent of traditional nonprofit corporation laws, and (3) exemption from federal income taxes.<sup>185</sup> This ideal combination would free precious resources that nonprofits currently spend on management and governance to be committed to furthering the core mission and goals of the nonprofit. This evolution will provide these organizations with another important tool bag to further aid their work in providing valuable social services to the American society.

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184. See *supra* note 153 and accompanying text.

185. See *supra* notes 140–41 and accompanying text.