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Nonprofit Topic

New Nonprofit as Successor to Founder's LLC

Some nonprofit founders begin by operating a charitable project through a for-profit limited liability company (LLC). They may be eager to get started---or they may want to pilot the project before deciding whether to form a nonprofit corporation. If the founder decides to continue the charitable project through a nonprofit organization that is tax-exempt under Section 501(c)(3) of the Internal Revenue Code, they must transfer the project to a new nonprofit corporation and comply with various legal requirements. This Nonprofit Topic provides a brief overview of some of the issues. Please note:

→ *This discussion assumes that the LLC is owned by one or more individuals who are entitled to its profits.*

→ *If Lawyers Clearinghouse refers the founder to a pro bono attorney to advise on forming the nonprofit, the pro bono attorney will represent the nonprofit corporation (not the founder) in transferring the project.*

→ *The founder should consult their own attorney and accountant for guidance on how to structure the transition and any tax consequences for the founder.*

Continuing the Project as a New Nonprofit – Some Key Considerations

Forming a New Nonprofit Corporation with Exempt Purposes

An LLC cannot be tax-exempt under Section 501(c)(3) unless every member of the LLC is either a qualified tax-exempt organization or a governmental unit or instrumentality, and certain other conditions are met. For this reason, the founder's charitable project must be transferred to a new nonprofit corporation organized and operated exclusively for charitable or other specified purposes in Section 501(c)(3).

"Successor Organization"

An organization is a "successor organization" if any of the following applies: (1) it took over activities previously conducted by another organization, (2) it took over 25% or more of the fair market value of the net assets of another organization, or (3) it was established upon the conversion of an organization from for-profit to nonprofit status.

The IRS refers to the original organization as the “predecessor organization.” A predecessor organization is “for-profit” if it is an organization in which persons are permitted to have an ownership or partnership interest. This includes LLCs with one or more individual members entitled to the LLC’s profits.

A “successor organization” is required to provide detailed information to the IRS on Schedule G of its Form 1023 application for determination of tax-exempt status. The IRS website has an extensive list of follow-up questions that the IRS may ask. https://www.irs.gov/charities-non-profits/selective-questions-for-a-successor-to-a-for-profit-organization-schedule-g Many of the questions focus on transfers of assets and liabilities to the new nonprofit, payments by the successor nonprofit to its predecessor’s officers or governing body members (or entities owned by them), and future relationships or transactions with them. The questions are geared toward assessing whether the transfer could result in impermissible private benefit or private inurement.

Transferring Project from LLC to New Nonprofit Corporation

Transferring the project to the new nonprofit will require careful consideration. The LLC’s assets could include money, equipment or a lease, and intangible assets such as a website, a name and logo, customer lists and program materials. The complexity of the transfer will depend on the scope of the LLC’s activities and its existing assets and liabilities. If the founder wants the nonprofit’s name to be the same as the name of the LLC, it’s advisable to consult an attorney about how to do this without potentially confusing the public.

The new nonprofit should also obtain advice from an attorney and accountant experienced in nonprofit matters regarding how to transfer the project to the nonprofit and document the transfer. The owner of the LLC should consult their own attorney and accountant for guidance on how to structure the transition and any tax consequences for the owner.

Independent Board of Directors and Conflict of Interest Policy

It’s especially important for the new nonprofit’s Board of Directors to have a majority of independent directors and to adopt a conflict of interest policy. Accepting a project previously operated by a for-profit LLC may raise unique issues for the new nonprofit, including successor organization considerations, the structure and documents for transferring the project, and founder compensation.

Founder Compensation

Although a nonprofit is permitted to pay individuals reasonable compensation for services (subject to the nonprofit’s conflict of interest policy), the founder’s compensation must not violate the private benefit rule or the private inurement rule or trigger the excess benefit tax, described below.

The IRS recommends a three-step process for a nonprofit to determine compensation. https://www.irs.gov/charities-non-profits/charitable-organizations/rebuttable-presumption-intermediate-sanctions

Broadly speaking, the steps are (1) prior approval of compensation by independent directors who do not have a conflict of interest concerning the compensation, (2) obtaining and relying on appropriate compensation comparability data and (3) concurrent documentation by the board of the basis for the decision.

The National Council of Nonprofits provides information on this topic. https://www.councilofnonprofits.org/running-nonprofit/governance-leadership/executive-compensation

Private Benefit Rule; Private Inurement Rule; Excess Benefit Transactions

Unlike a for-profit LLC operating for the financial benefit of its owner(s), the new nonprofit will not have owners and will be subject to restrictions due to its charitable purpose and tax-exempt status. The fundamental principle of these rules is to prevent unjust enrichment.

The IRS may deny the nonprofit's application for tax-exempt status or revoke its tax-exemption if the private benefit rule or private inurement rule is violated, and penalty taxes may be imposed on individuals if the nonprofit engages in an excess benefit transaction.

Private Benefit Rule. Section 501(c)(3) organizations must engage primarily in activities that accomplish their exempt purposes and must serve public interests, not private ones. The nonprofit may benefit the "charitable class" that is eligible to be assisted by the nonprofit's tax-exempt activities, but benefits to other individuals or entities must be incidental. Whether the private benefit is incidental depends on how the tax law applies to a particular nonprofit's purposes and activities.

No Private Inurement Rule. Tax law also prohibits Section 501(c)(3) organizations from using their net earnings to benefit any person who has a "personal and private interest in the activities of the organization." This includes anyone who has significant influence over the organization, such as founders, directors, officers, members, key employees or independent contractors and substantial donors. The benefit to the insider could be direct or indirect, such as benefits to a founder's family member or an entity affiliated with a founder or their family member. Nonprofits should be cautious; even a small amount of private inurement is impermissible, and the consequences of violating the rule against private inurement can be severe.

Excess Benefit Transactions. Certain tax-exempt organizations (including Section 501(c)(3) public charities) can trigger penalty taxes if they directly or indirectly give an economic benefit to a "disqualified person" that exceeds what the disqualified person provides to the organization in return. Disqualified persons include anyone who is or was (during the five years before the transaction) in a position to exercise substantial influence over the organization, plus their family members and entities they control. The economic benefit received by the disqualified person may include unreasonable compensation for services, excess payments in exchange for assets, rentals, loans, or rights to use assets of the organization. The penalty tax is imposed on the disqualified person and potentially also on the organization's managers. The IRS may also revoke the organization's tax-exempt status.

Public Support Test

All Section 501(c)(3) organizations are classified as either *public charities* or *private foundations*. Private foundations are subject to additional rules, including limitations on deductible contributions, strict requirements regarding distributions and rigid constraints on transactions with disqualified persons. For this reason, most Section 501(c)(3) organizations want to be classified as public charities.

To maintain their public charity classification, many nonprofits must demonstrate that they meet the IRS's "public support test." The new nonprofit should work with an attorney or accountant who specializes in tax-exempt organizations to understand how the public support test applies to the nonprofit and what it must do to meet the test.

Disclaimer: This information is provided for educational purposes only. It is not intended or offered as legal advice. Please consult an attorney for the latest and most accurate information, and advice on how it may apply to your organization.