The L3C: A For-Profit with a Non-Profit Soul

The Foundation Center

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Basic Characteristics of L3Cs

INTRODUCTION:

- **What is a low-profit limited liability company (i.e., an "L3C")?**
- **It is a for-profit entity, although it has been described as having the "soul" of a nonprofit because of its charitable or educational purpose, as discussed further below.**
- **It is not an IRC Section 501(c)(3) organization and is not tax-exempt.**
- **It is not eligible to receive tax deductible charitable contributions under IRC Section 170.**

Basic Characteristics of L3Cs

INTRODUCTION:

- Fundamentally, an L3C is a limited liability company ("LLC"), which is a type of for-profit legal entity that has existed throughout the US for approximately 15-20 years.
- LLCs are widely accepted and used, and generally are treated as partnerships for income tax purposes.
- Likewise, L3Cs generally will be treated as partnerships for income tax purposes and generally will file an IRS Form 1065.

Basic Characteristics of L3Cs

LEGISLATION:

- In April 2008, Vermont became the first state to enact L3C legislation.
- Since then, six other states – Illinois, Michigan, Utah, and Wyoming – have adopted some form of L3C legislation.
- Maine and North Dakota have approved legislation to study L3Cs for adoption.
- The Crow Indian Nation and the Oglala Sioux Tribe also have enacted L3C legislation.

Basic Characteristics of L3Cs

LEGISLATION:

- Many other states reportedly are considering L3C legislation, including Arkansas, Louisiana, Missouri, Montana, North Carolina, Oregon, Tennessee, and Washington.
- The Partnership and LLC Committee of the Business Law Section of the State Bar of Georgia continues to monitor and study L3C legislation across the U.S., but to date has not proposed legislation to amend Georgia's LLC Act.

Basic Characteristics of L3Cs

HAS TRADITIONAL LLC STRENGTHS:

- Since an L3C fundamentally is an LLC, then absent a special election to be treated as a corporation for tax purposes, an L3C will be treated as a "pass-through" or "flow-through" entity for federal (and generally state) income tax purposes.
- Provides members with liability protection against the actions and debts of the L3C.
- Provides great flexibility – (1) no limitations as to who may be a member; (2) few restrictions on management; and (3) varying investment objectives and financial considerations of members can be accounted for.

Basic Characteristics of L3Cs

OTHER IMPORTANT POINTS:

- All of the state statutes require that each L3C contain the abbreviation "L3C" or "l3c" in its name. At least one statute permits the use of other abbreviations, such as "low profit ltd. liability company," low profit ltd. liability co." or "low profit limited liability co."
- An L3C formed in one state seeking to qualify to do business in a non-L3C state most likely will be required to append "LLC" to its name. This is similar to how many states allow a Tennessee PLLC to qualify to do business in other states.

Basic Characteristics of L3Cs

OTHER IMPORTANT POINTS:

- For example, a Vermont L3C named "Doing Well by Doing Good, L3C" likely would qualify to do business in Georgia as "Doing Well by Doing Good, L3C (LLC)".
- The major difference between an L3C and an LLC is that the L3C is intended to be a special subcategory designed to accomplish charitable and/or educational purposes, especially through the use of so-called program related investments ("PRIs").

What Is a PRI?

- **What is a program related investment (i.e., a "PRI")?**
- **PRIs are hybrids between grants and investments. They are investments made with the primary motive of accomplishing a charitable purpose.**
- **But, unlike grants, PRIs can be repaid and can produce a modest return on the investment.**
- **Classic example of a PRI: No interest or low interest loan to economically disadvantaged business that is unable to obtain conventional financing.**

Requirements of Program Related Investments

- **Specifically, PRIs must meet the following requirements under IRC § 4944(c) and corresponding tax regulations:**
  - ❖Primary motive is to accomplish religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of the activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, all within the meaning of Section 170(c)(2)(B) of the IRC; [and, as clarified by the Regulations, <u>the investment would not have been made but for the relationship between the investment and accomplishment of the foundation's exempt purpose</u>];

Requirements of Program Related Investments

❖No significant purpose of the investment shall be the production of income or the appreciation of property [with the Regulations clarifying that PRI status is not disqualified by the fact that the investment actually does produce income or appreciate]; and

❖The investment shall not be used to attempt to influence legislation, or participate or intervene in (including the publishing or distributing of statements) any political campaign on behalf of (or in opposition to) any candidate for public office, all within the meaning of Section 170(c)(2)(D) of the Code.

Why Make a PRI?

- **Private foundations can make PRIs without violating the special excise tax rules applicable to private foundations.**
- **Furthermore, PRIs have certain advantages over other investments under the private foundation excise tax rules.**
- **Some private foundations feel PRIs—which are not outright grants but generally are required to be repaid—may be more effective in motivating an organization to accomplish its mission in an economically efficient manner.**

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Recent Trends Seem to Favor PRIs and L3Cs

- Recently, there has been increased emphasis upon social enterprise organizations. See, for example, recent news concerning Bill Gates and his focus on "creative capitalism."
- L3Cs capitalized with PRIs have the potential to fill this desire to grow social enterprise organizations.

Recent Trends Seem to Favor PRIs and L3Cs

- Although not formed as L3Cs, examples already exist:
  - IRS PLR 200603031 (investments/ transactions with for-profit pharmaceutical companies to spur discovery of drugs and treatments for diseases that disproportionately impact the developing world).
  - PLR 200610020 (angel investment fund consisting of foundation and professional athletes intended to invest in and spur development of minority-owned businesses in low income communities).
- See also www.angelcapitaleducation.org.

Why Not Make a PRI?

- PRIs are not well understood by most private foundations. According to the Foundation Center, of the thousands of private foundations across the country, only a few hundred ever make PRIs.
- PRIs require more sophisticated legal and accounting expertise than normal investments. Often, a private letter ruling or legal opinion is obtained, making PRIs time-consuming and expensive.
- PRIs are also generally more costly to administer than grants.

Why Not Make a PRI?

- Because PRIs are inherently risky, low-return investments, if a PRI is disqualified, then it potentially runs afoul of the private foundation excise tax rules, especially the tax on jeopardizing investments.
- PRIs potentially can generate unrelated business income tax or UBIT (although proper structuring may eliminate or mitigate UBIT).
- PRIs also can raise uncomfortable private benefit issues.

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Why Not Make a PRI?

- By way of contrast, grants to public charities are easy to make and generally require very little due diligence or, even better, no continued monitoring after the grant has been made.
- Of course, effective grants require much more due diligence and monitoring—like PRIs.
- With a PRI, one must be mindful of compliance with the private foundation excise tax rules, as discussed below.

Private Foundation Rules

- Section 4940
  (Tax on Net Investment Income)
- Section 4941
  (Self-Dealing)
- Section 4942
  (Mandatory Minimum Payout)

Private Foundation Rules

- Section 4943

  (Excess Business Holdings)

- Section 4944

  (Jeopardy Investments)

- Section 4945

  (Taxable Expenditures)

Focus on Section 4944: Jeopardy Investments

- Section 4944 penalizes and effectively prohibits investments that would jeopardize the carrying out of a foundation's tax exempt purpose.
- Example: Rev. Rul. 80-133 held that premium payments on a whole life insurance policy on the life of a donor to a foundation were jeopardy investments because, under the terms of the policy and based upon the life expectancy of the donor, the premium payments would exceed the face value of the policy.

Focus on Section 4944: Jeopardy Investments

- But, Program Related Investments ("PRIs") are not jeopardizing investments. IRC Section 4944(c).
- Properly structured, PRIs also either avoid or obtain certain advantages under the other private foundation excise tax rules.

Tax Advantages of PRIs Versus Normal Investments

- Section 4942 requires a private foundation to pay out annually at least 5% of its net investment income in "qualifying distributions" or pay a 30% penalty tax.
- PRIs and administrative expenses incurred in making them count toward meeting a foundation's annual 5% minimum distribution requirement.
- Further, PRIs are excluded from the foundation's asset base used to calculate the minimum payout amount.

Tax Advantages of PRIs Versus Normal Investments

- If and when a PRI is repaid, the entire amount of the PRI is added to the foundation's asset base and the foundation's distributable amount is increased for the tax year by the amount of the PRI repaid.
- Section 4940 requires foundations to pay an annual excise tax on net investment income — generally 2% but can be reduced to 1% if foundation increases its annual payout.

Tax Advantages of PRIs Versus Normal Investments

- Interest and dividend income from PRIs count as investment income for purposes of the Section 4940 tax, but capital gains and losses from PRIs are excluded.
- Finally, PRIs do not run afoul of the 20% limit on excess business holdings under Section 4943.

The L3C Includes the Basic Requirements of a PRI in Its Articles

- **Each state's law is slightly different, but in each state's statute that we have examined L3Cs generally must include in either their Articles of Organization or Operating Agreement the same essential requirements applicable to PRIs:**
  - ❖Primary motive is to accomplish charitable or educational purposes, all within the meaning of Section 170(c)(2)(B) of the IRC;
  - ❖The L3C would not have been formed but for the entity's relationship to the accomplishment of the exempt entity's charitable or educational purpose;

The L3C Includes the Basic Requirements of a PRI in Its Articles

- ❖No significant purpose of the L3C shall be the production of income or the appreciation of property, but the fact that the L3C produces income or appreciates is not considered conclusive evidence that a significant purpose of the L3C is to produce income or appreciate; and
- ❖The L3C shall not be used to attempt to influence legislation, or participate or intervene in (including the publishing or distributing of statements) any political campaign on behalf of (or in opposition to) any candidate for public office, all within the meaning of Section 170(c)(2)(D) of the Code.

Examples of Potential L3Cs

- Pharmaceutical Venture to Develop Inexpensive Drugs for So-Called "Neglected Diseases."
- High-Tech Furniture Factory Established to Restore Lost Jobs in Rural North Carolina Town.
- Green Restaurants Exclusively Serving Locally Grown, Organic Food and Employing Underprivileged Youth.
- Blended Charitable/Commercial Purpose Organizations Like Hospitals, Museums, and Arts Centers.
- Low-Income Housing Projects Also Might Be Owned and Developed Via L3Cs.
- Newspapers?

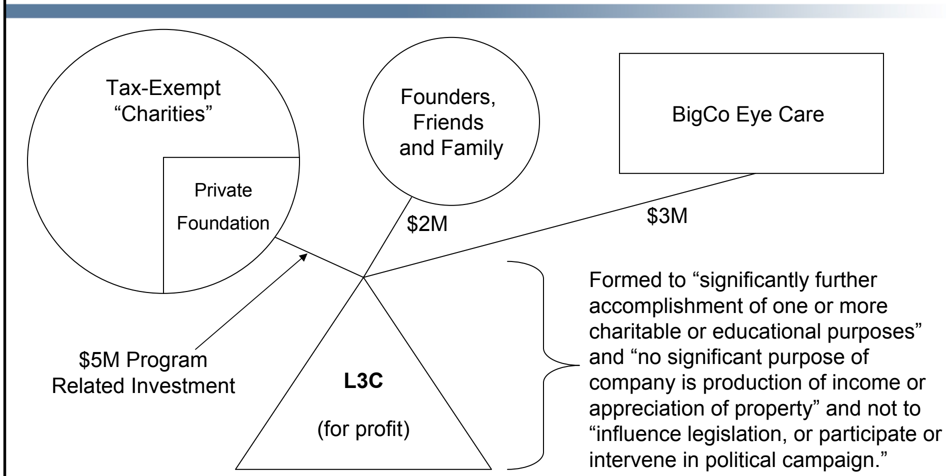
An Example of Layered Investing Through an L3C

- Financing an L3C can be accomplished through the same layered investment technique that has been utilized in the for-profit sector for decades.
- For example, assume an L3C venture requires $10M in start-up capital. The venture will develop inexpensive, self-adjusting eyeglasses to be sold to the poor.
- Rationale: The poor in the developing world do not have access to eye-care professionals, much less the funds to buy eyeglasses. See www.vdw.ox.ac.uk/index.htm for more information.

An Example of Layered Investing Through an L3C

- **Further assume that founders (with their friends and family) can raise $2M of investment capital.**
- **Large private Foundation with a mission of improving health care for the poor and underprivileged is willing to invest $5M.**
- **BigCo Eye Care company is willing to invest $3M, but generally must earn its normal rate of return for such a risky, nontraditional investment.**

L3Cs: Possible New Vehicle for PRIs and Social Enterprise



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An Example of Layered Investing Through an L3C

- If it is successful, the venture is expected to produce (i) a 4% annual rate of return on the $10M of invested capital (i.e., net profits of $400K per year), and (ii) a 1.5 times multiple on all capital upon a sale (i.e., net sale proceeds of $15M).
- Foundation is willing to subordinate its capital to the private investors and is willing to accept a 0% rate of return; however, Foundation eventually would like to be repaid its investment (such as upon any future sale of the L3C) if the venture is very successful.

An Example of Layered Investing Through an L3C

- BigCo Eye Care demands a 10% rate of return (i.e., $300K annually) on its invested capital plus a 3.0 times multiple on its invested capital upon a sale (i.e., net sale proceeds of $9M).
- Founders expect a 5% rate of return (i.e., $100K annually) on their invested capital plus a 2.0 times multiple on their invested capital upon a sale (i.e., net sale proceeds of $4M).

An Example of Layered Investing Through an L3C

The flexibility of the L3C format allows us to accommodate these competing economic demands as follows:

- If L3C achieves its expected annual return of 4% (or $400K), then $300K will be allocated to BigCo Eye Care to satisfy its 10% return requirement, and $100K will be allocated to founders to satisfy their 5% return requirement.
- If L3C performs better than expected (e.g., $500K), then the extra $100K of net profit is split between Foundation ($50K), BigCo Eye Care ($30K), and founders ($20K).

An Example of Layered Investing Through an L3C

- If L3C eventually sells for $15M (i.e., its expected sale amount), then BigCo Eye Care will receive $9M (i.e., 3 X $3M), founders will receive $4M (i.e., 2 X $2M), and Foundation will receive $2M.
- On the other hand, if the L3C does not achieve expected sale results and sells for only $13M (or less), then BigCo Eye Care and founders receive all $13M or such lesser amount as is realized in the sale.

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An Example of Layered Investing Through an L3C

- The Foundation would receive $0, <u>which is exactly the same economic result if Foundation had made a conventional grant of $5M</u>.

- IMPORTANT -- This business venture would not have taken place but for the private foundation's investment, the relationship of that investment to the foundation's exempt purpose, and the flexibility offered by the L3C format.

An Example of Layered Investing Through an L3C

- If a foundation has concerns about an economic structure that is either too rich for the private investors (thus creating a potential private benefit problem) or too rich for the foundation (thus jeopardizing PRI status), then there are possible solutions:
  - Upon sale of the company, require a return of the private foundation's capital ($5 million in our example) before any profits are distributed to the other investors.
  - Cap the private foundation's return to a below market rate (e.g., 2% annual return) regardless of the profits of the L3C or allow the foundation to demand to be bought out at fair market value once profitability is achieved.

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L3Cs: Other Possible Uses

- There are other possible uses for L3Cs that are completely unrelated to facilitating PRIs.
- For example, tax-exempt hospital/physician joint ventures that currently are structured as LLCs could be formed as L3Cs instead. The statutorily mandated charitable or educational purpose of an L3C could help protect the tax-exempt status of the hospital.
- Further, L3C format may guard against claims by physician investors that the managers of the joint venture violated their fiduciary duties when emphasizing mission over profitability.

L3Cs: Other Possible Uses

- A L3C could work well as a single-purpose, wholly-owned subsidiary of a tax-exempt organization.
- For example, an L3C could be formed to own and operate an off-campus surgery center or clinic of an exempt hospital.
- None of these examples involve PRIs, but the L3C nevertheless could be a good fit.

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Concluding Thoughts

The L3C combines the unique features of an LLC with the “soul” of a nonprofit.

A primary goal of the L3C is to increase the flow of both private and philanthropic capital to ventures that further a charitable or educational purpose.

The L3C hopes to accomplish this goal by addressing some of the legal challenges associated with PRIs.

By creating a vehicle that by law complies with the requirements for a PRI, the L3C holds the potential of furthering social enterprise.

Concluding Thoughts

Nevertheless, significant uncertainty remains. Reliance on L3C status alone will not ensure that a foundation has made a valid PRI. Only compliance with federal law—not a state L3C statute—can ensure that a PRI is valid.

If the L3C receives support from the federal government or the IRS, then this uncertainty may be alleviated and PRIs may be encouraged.

Concluding Thoughts

In this regard, legislation that would create an IRS approval process for L3Cs has been drafted and circulated among a number of interested parties.

The so-called Program-Related Promotion Act of 2009 would allow an L3C to apply to the IRS for advance approval as a valid PRI vehicle. Of couse, the L3C still must comply with federal law in actual operation to ensure that a foundation's investment qualifies as a PRI.

For additional information, see the following website: www.americansforcommunitydevelopment.org

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Thank You for Listening to "The L3C: A For-Profit with a Non-Profit Soul"

Questions????

Please ask questions now, or you may contact Cass Brewer with any questions after the presentation.

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