DAFs, PRIs, L^{3}Cs - Tools of Social Impact Investing

Social Impact Investing with True Impact

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....where the L^{3}C was created

Introduction

The use of for-profit entities financed by both nonprofit and for-profit dollars provides a nongovernmental, free enterprise way, to solve many social issues, while adding to the wealth of the populace, can herald a bright future; rather than depleting government funds. We commonly call the use of those types of entities, to resolve social issues, Social Enterprise. The outcomes of a social enterprise initiative are not charity, but a fully integrated part of our free enterprise system. Social Enterprise, however, is often less profitable than regular business enterprise and as a result is often challenged when it comes to raising capital. The L3C was created to provide a unique business structure for legally housing a Social Enterprise. This paper outlines an entirely different way to get a significant portion of the capital needed for a social enterprise, while providing a charitable deduction. Truly the best of both worlds - a for-profit, free enterprise that does good, financed by charitable dollars. This paper is divided into two parts - the story and the legal background. You will come away with a new view of these tools and recognize their potential for truly making a difference where it matters most, in your community.

For an example of a perfect Social Enterprise we send the reader to ArtLifting L3C.
http://www.artlifting.com/

ArtLifting is an online site that sells original artwork, prints, and derivatives, all created by homeless and disabled artists. Quote from the ArtUplifting site: "*By earning an income instead of receiving a handout, our artists feel empowered and confident. That confidence has a domino effect on every aspect of their lives. Artists have the energy and drive to apply for housing, gain employment, and get out of bed each morning. It creates hope. We are humbled by the impact that customers have created for our artists and thrilled to continue to grow and uplift individuals worldwide.*"

We too are humbled, knowing that this is the kind of work an L3C can do. And it solves a social problem with a tax paying not a tax exempt, organization, totally free of government regulation and scrutiny as a for profit entity. We hope you will understand the importance of helping to finance Social Enterprise.

– *Robert Lang*

– *Michael D. Martin*

Part 1 - The Story

By Robert Lang

Definitions - The title of this paper uses an alphabet soup of terms. Lets look at some of these terms individually, before we tie them all together.

Social Impact Investment

A quick search for the word investment results in a profusion of meanings. My simplified summation: "To expend money with the expectation of achieving a profit or material result by putting it into financial plans, systems, shares, or property, or by using it to develop a commercial venture". "Impact Investing," which is one of the current buzzwords of the charitable sector, would therefore seem redundant since one would expect all investment to have positive material results. But what if we used the term "Social Impact Investing"? Now we have a unique term, which means investing for the purpose of achieving positive social results. The beneficiaries of Social Impact Investments are often called Social Enterprises.

Words like "financial, develop, & commercial" are key to the concept. The words "grant, or gift" are not part of the verbiage. Clearly an investment has a multiplier effect and if the money in a social impact investment is used properly, there should be benefit to both the investor and the recipient. Investing has risks so the more risky the investment, the more likely the investor is to lose their money.

PRIs (Program Related Investments)

The Ford Foundation, an early user of PRIs defines them thusly: "*In 1968, the Ford Foundation pioneered use of a new tool known in the philanthropic sector as program-related investments (PRIs). Ford-funded PRIs use low-cost loans, loan guarantees and equity investments in a strategic way to strengthen the work of our grantees and to provide risk-capital for cutting-edge initiatives.*

"Financed from the foundation's endowment, PRIs support the work of organizations in the United States and around the world by helping them to establish a loan repayment history, generate earned income, gain access to new funding from mainstream banks and other funders, and to develop new financial management strategies... Program-related investments offer foundations an alternative to the traditional grant. They provide a tool that can help bring long-term financial stability to organizations that are addressing critical social needs." (http:/://www.fordfoundation.org/grants/program-related-investment)

Congress codified the term Program Related Investment, in tax laws written in 1969, and specifically provided for PRIs to replace a grant, as part of a private foundation's required yearly distribution. The IRS states: "*To be program-related, the investments must significantly further the foundation's exempt activities. They must be investments that would not have been made except for their relationship to the exempt purposes. The investments include those made in functionally related activities that are carried on within a larger combination of similar activities related to the exempt purposes.*" (http://www.irs.gov/Charities-&-Non-Profits/Private-Foundations/Program-Related-Investments)

A key concept in the IRS definition is the phrase: "*The Investments must significantly further the foundation's exempt activities".* The PRI does not ultimately have to accomplish a charitable purpose just significantly further it. Failure to achieve a goal can still be considered furthering it, because of the information learned from the failure. One of the great urban myths around PRIs is that it must be a loan. The term investments clearly includes "equity investments", as noted in the Ford Foundation definition above and as spelled out in the IRS's own regulations, implementing the PRI rules. While PRIs do include loans, it is our contention that in many cases the ideal PRI is an equity investment, since it does not come with a repayment schedule (with interest) and the threat of penalties, if not met.

Further insight might be gained from these words by the MacArthur Foundation:
"Program-related investments (PRIs) are a statutorily defined exception in the Internal Revenue Code to the rules prohibiting private foundations from making 'jeopardizing investments. PRIs can take many forms, including loans, equity investments, bank deposits and guarantees. PRIs must be made for the primary purpose of accomplishing a charitable purpose and not primarily for financial gain. One of the tests used is whether an investor solely interested in making a profit would be unwilling to provide capital on similar terms. In practice, this means that the PRI will have an interest rate or financial return objective that is lower than prevailing market rates for loans and investments of similar duration, credit quality and risk.

"Mission-related investments (MRIs) are those that are made with a clear intention to meaningfully contribute to the accomplishment of the Foundation's philanthropic mission and the success of our programmatic strategies, and to achieve a financial return commensurate with the risk and the social impact to be achieved. Unlike PRIs, MRIs are not statutorily prescribed and have no consensus definition. The jeopardizing investment rules and other legal requirements, such as state prudent investor rules, do apply to MRIs." (http://www.macfound.org/programs/program-related-investments/strategy/)

The 1969 law, and subsequent IRS regulations implementing it, clearly show the intent that a PRI (a high risk/low return investment) can replace a grant, as a qualified distribution. For a private foundation, there is no greater risk than a grant, since it is a "giveaway"! It provides no financial reward to the foundation. It has the lowest possible return - zero. The PRI is a form of venture capital investment, used for social impact investment. The IRS imposes a strict set of rules on private foundations, making or intending to make PRIs, since they are designed to be made to private parties and for profit ventures (not traditional 501(c)(3) organizations). These rules (known as the “Private Foundation Excise Rules”, see below and Michael's section) are designed to ensure that the foundation making such an investment: (I) is making it to further one or more of its specific charitable purposes; and (ii) exercises ongoing oversight, to "follow the money" and make sure it is used for the purposes for which it was made. This is known as “ongoing expenditure oversight responsibility”.

So an important distinction should be noted here. Private foundations make grants to qualified, tax exempt public charities. They can also make PRIs to private, for profit enterprises. Both are made (by law must be made) to further the foundation’s charitable purposes. The distinction is, in the former case, once the foundation has established that the public charity is properly qualified and its mission is aligned with the foundation's mission, it makes its grant and its job is done. The public charity must report and use the grant for its operation. In the latter case, when the foundation makes a PRI, 100% of the due diligence, as to whether the foundation can make it and whether it is ultimately used for it intended purpose, falls on the foundation’s managers along with any penalties for not getting it right. But the key here is this concept of the furtherance of a charitable purpose. A private foundation can make a PRI to a large drug company with instructions that would compartmentalize the funds and focus their use on research targeted on orphan diseases, for instance. For the IRS it is important that the profile of a PRI follow the profile of a grant (high risk/low return), in terms of purpose and character.

From the foundation's point of view the PRI has the potential to produce some return even if it is small. This is important since any money a foundation earns provides more money for charitable good works. More importantly the corpus of the PRI may someday be returned to the foundation. This happens when a loan is repaid, the enterprise is sold, or something else causes return of capital. In this case the foundation is required by law to make another PRI or an offsetting grant within one year of the return of capital. This means the foundation has the opportunity to use the same funds to do good all over again.

DAFs (Donor Advised Funds)

DAFs are a way for an individual to create a vehicle, similar to a private foundation, without the administrative or reporting burdens of a foundation. The IRS has published a simple guide to DAFs. A couple of paragraphs from this guide will summarize what DAFs are and how they work:

"Donor-advised funds ('DAFs') have been part of charity for nearly a century, and have long been a staple of community foundations. Prior to the Pension Protection Act of 2006 (Pub. L. No. 109-208), the term 'donor-advised fund' was not defined in the Code or Regulations, but it was understood to include arrangements by which some charitable organizations (including community foundations) established separate funds or accounts

to receive contributions from donors. Donor-advised fund arrangements were comparable to component funds maintained by certain community trusts.

"In general, contributions to a DAF are treated as contributions to a public charity, thus providing donors some advantages over private foundations. For example, donors may claim a higher charitable contribution deduction (up to 50% of adjusted gross income (AGI) to a public charity vs. 30% to a private foundation), and donor-advised funds are not subject to the Chapter 42 restrictions that apply to private foundations, such as the section 4941 self-dealing rules and the section 4942 annual payout requirements. (Note that the Pension Protection Act expanded the taxes on excess business holdings applicable to private foundations to donor-advised funds.) Other advantages touted by promotional literature include: estate planning benefits, donor anonymity, lower start-up costs, and lower expenses in connection with legal, administrative, and accounting services to establish and maintain donor-advised fund accounts as compared to private foundations. While donor-advised funds have been in existence in some form since the 1930s, during the 1990s, for-profit financial investment firms began to establish affiliated nonprofit organizations to maintain donor-advised fund accounts. Typically, these 'commercial' DAFs hire the affiliated for-profit investment firm to manage the investment of the assets in the accounts for a fee that varies based on the balance in the account and the number of annual transactions."
(http://www.irs.gov/pub/irs-tegedonor_advised_explanation_073108.pdf)

Today DAFs are available at many Community Foundations and through large commercial investment companies. As we will see, the ability of a DAF to operate much as a private foundation makes it a perfect vehicle for making Social Impact Investments in a social enterprise. From the perspective of the donor the DAF has significant benefits. They can be created in the space of a day or two, without the need to determine what their eventual charitable use will be, but the donor gets an immediate tax deduction for the entire amount and at the higher public charity rate.

L3Cs (Low-profit Limited Liability Company)

The L3C was created in the mid 2000s by Robert Lang and codified in 2008, when Vermont became the first state to make the L3C part of their Limited Liability Company body of law. The term Low-profit was used since the furtherance of a charitable mission usually requires the entity to sacrifice some portion of the profit. If it could operate at normal profit margins and still further a charitable purpose it would organize as a regular LLC. The key elements of the law, which must be written into the L3C's purpose clause, are:

"L3C" or "low–profit limited liability company" means a person organized under this chapter that is organized for a business purpose that satisfies and is at all times operated to satisfy each of the following requirements:

(A) The company:

(i) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code of 1986, 26 U.S.C. §170(c)(2)(B); and
(ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.

(B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

(C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Internal Revenue Code of 1986, 26 U.S.C. §170(c)(2)(D)."

Robert Lang dubbed the L^3C ***"the for profit with the nonprofit soul"***, since it is a for profit business entity doing the work of a nonprofit. This means that unlike a nonprofit, which normally has to constantly raise money to cover its operational costs, the L^3C, if properly capitalized, while not earning a large profit, will earn more than it spends. This allows the managers to focus 100% of their effort on running the business and 0% of their time on continually raising funds. The L^3C was created because there was no form of a "for profit" business organization specifically designed, by statute, for charitable purposes. The L^3C's statutory purpose clause meshes exactly with the IRS definition of PRIs. The L^3C, a for profit, was designed this way to specifically attract low cost, high risk capital, in the form of PRIs from foundations. Well over a thousand L^3Cs have been created and many are still operating since Vermont passed the first law in 2008. It is now the law in many states and Indian Nations but most importantly, ***like a Delaware corporation, the L^3C can be used in any state.***

The L^3C statutorily mandates that the managers place furthering of its charitable mission ahead of earning a profit, or lose its status as an L^3C. However, unlike a nonprofit, it leaves the managers free to make purely business decisions which encourage efficient management and use of capital for its charitable purposes. The L^3C has owners who can earn a return on their investment, after the mission requirements have been fulfilled. Assets can also be bought and sold, as management determines advisable at a loss or gain. Membership interests in L^3Cs can be bought, sold and merged into another business entity. In other words they operate just like a "for profit" business, but one whose reason for being is the furtherance of a charitable purpose.

Since the L^3C is simply another form of LLC, the organizers, as initial owners, can retain management control and never worry about an "out of control" board that takes them out of the picture. Like any LLC, its organizational structure is built around a governing document called an operating agreement and all the owners (called members, as in an LLC) negotiate and write the operating agreement to fit their needs.

Choosing an L3C creates the additional benefit of branding. Whenever the members of an L3C tell someone they are an L3C, they are saying exactly what they are - a charitable organization that is organized as a for-profit business. Potential employees will know they are joining an organization that is designed to pay its employees market rate for their job and one which can freely pay bonuses and otherwise incentivize their employees, but expects them to put the charitable mission first. The founders of an L3C also have a much wider range of capital formation opportunities to draw from than they would as a nonprofit.

Putting The Pieces Together

Now let's understand how and why all these elements can come together to create a "marriage made in heaven." Let us suppose the organizers of a Social Enterprise have decided they want to further a particular charitable purpose, but they think they can do this as a business venture, which can be sustainable on its income. They also recognize the need for low cost venture capital which is patient, does not want a big piece of the pie, and does not have a particular exit horizon or event. As a result, they pick the L3C as their form of business organization.

Since no business can operate without capital, the first order of business, after creating the entity and adopting an operating agreement, will be to determine how much capital is needed and how to raise it. The importance of venture capital, in the formation of any business enterprise, cannot be overstated. The first few steps in any business, whether a Social Enterprise or a standard for-profit model, are usually raising funds from the founders, their family and their friends. But it is at this point that the L3C and the standard for-profit business come to a fork in the road. The standard for-profit usually begins because the founders have dreams of profit ahead of them. Whether opening a small store or hoping to make their fortune on the "next big thing", they expend all their resources, then clean out their relatives and friends. If it is a big idea, they bring in the venture capitalists and willingly give away a big "piece of the pie", because everyone sees dollar signs. The L3C turns the venture capital model on its head, with the least "needy" capital taking first risk position.

The L3C is taking the other fork, that until now has been the road less traveled. The founders and organizers are going into business to do good and help others and at the same time hoping to "earn a "living." Since there is little chance of recovering title to the house, the kids and the dog, very soon, they do not want and should not want to take these risks. They are in need of the venture capital piece, as the foundation of their capital stack. But since they cannot offer a big piece of the pie, high returns, a big cash out event or other profit making incentive, the normal venture capital market is closed to them. We frequently hear about "angel investors" but this group too, while being maybe a little more patient and willing to take a lower return, is still looking for a decent payout at some point. They are not right for the L3C business model. The founders of the L3C likely plan on being in business for a long time, due to the nature of their social mission, and in order to properly carry out their mission, have limited plans for growth. True they may see substantial profit opportunities along the way but if they are sincere one would expect they would use these to further their charitable mission, not get rich.

So the venture investor we are looking for, for our L3C, must also have a social mission in mind, as its purpose. They must understand that losing their money may still help further the mission, or they may gain from investing the money, even if it is never returned. Let's examine some of these possible players and understand why they fit and also why, in the case of the private foundation, they often still do not play in this arena, i.e., the social enterprise arena.

Private Foundations: Lets start with private foundations because, when the L3C was created it was done with an eye on the PRI law (which was originally written for private foundations). It is the exact verbiage of the PRI rules that Robert Lang and his supporters adapted, to create the language of the law enacted in Vermont and elsewhere, to provide the purpose for the L3C form of business organization. This was done to create an entity which, like a nonprofit, has a charitable purpose. Theoretically, managers of a private foundation looking at an L3C would see a business structure that has the same charitable purpose as a regular nonprofit and treat it as such, i.e., a suitable candidate for a qualifying distribution from the private foundation, in the form of a PRI. As such, the foundation managers could invest in the L3C, feeling comfortable that however it spends its funds, the L3C is doing so to further a charitable purpose. Contrast this with a PRI type investment in a regular "for-profit" business entity which would require the foundation managers to follow the funds around, to make sure the funds are staying in the intended compartment, and being used for a charitable purpose by the business. This is particularly true since it is anticipated that the foundation will become a member of the L3C and therefore have the same access to its operations and financial records as any regular member. The nature of the L3C is that it is, probably by default, operating without direct competition. Therefore, transparency of operation is clearly easier to achieve. The foundation, as a member of an L3C, will always have the right, at any reasonable time, to inspect the books and records of the L3C and if its managers determine the foundation's investment is not being used to further its charitable purpose, the foundation member should always have the right to unilaterally withdraw and get its capital back. This is typically NOT the case for an individual member of a traditional LLC.

Technically, a foundation could make a grant to a for-profit for the same purpose, but it is even more difficult to insure long term use of the funds for charitable purpose, and transparency is a lot tougher. Instead of a grant, a private foundation can decide that it will make a loan, provide an equity investment, loan real estate or equipment, guarantee a loan, provide a below market lease or find some other way to enhance the capital of an L3C. Some of the more creative events such as a loan guarantee, can be very interesting, since they allow the foundation to create a multiplier effect with its funds. The loan guarantee is not actually declared as a PRI, until the time the borrower defaults.

There are other creative examples of how a foundation could make a PRI available, but the truth is, the record of private foundations making PRIs has been very poor, despite their endowments being a powerful potential for good. There are multiple reasons why this is so. Typically, it is the lack of understanding or enlightenment on the part of foundation managers, notwithstanding the fact that PRIs have been authorized by Congress and the IRS since the late sixties and the manner and type that can be made has recently been expanded by IRS rule making. In other cases, foundation managers see them as simply too complicated and burdensome, citing the ongoing expenditure oversight responsibility and the lack of foundation resources to maintain same. And for still others, it is the fear of what happens if "we get it wrong"! To be sure, there are penalties for taxable distributions and jeopardy investments by foundation managers, but the fact is the due diligence does not necessarily require significant effort, if done properly. Nonetheless it is still hoped that foundations will eventually come around, but the L3C founders and advocates are not holding their collective breath. With but a few exceptions, private foundations cannot be counted on to lead the charge, absent legislation at the federal level which relieves foundation managers of their oversight burden or mitigates it to a large extent. Private foundations are, in most cases, managed by individuals who are risk averse and have a mindset more aligned with those in the nonprofit sector than the business sector. The few large foundations that do make PRIs a big part of their giving have developed their own approaches and do not seem inclined to support entrepreneurial activities at the local community level, where the need for L3C type Social Enterprise ventures is most prevalent.

Donor Advised Funds: A DAF can mirror a foundation in its operations, but a DAF is created by the gift of an individual who does not have the time or the desire to manage a charitable enterprise. This presents a unique opportunity. The people who create L3Cs and other for profit social enterprises tend to be of an entrepreneurial bent. They have a clear vision of what they want to accomplish and do not function well under a burdensome bureaucratic umbrella. From a fund raising point of view, this presents a unique opportunity to the founders of the L3C. Their task of finding venture capital is now aligned with the path often followed by the founders of a normal for profit - find wealthy individuals to whom the tale is spun to convince them to invest. The differences are the story and the type of wealthy individuals. The L3C organizers are looking for wealthy individuals who want to do good, want a charitable tax deduction and understand the advantages of using a for profit vehicle for a social enterprise. Often these wealthy individuals being sought out are successful entrepreneurs themselves, who want to give back.

The advantage of finding an individual rather than a foundation to invest cannot be over emphasized. Individuals have passion and once they understand that they will get the charitable tax deduction, at the highest rate possible, they are free to make their own decisions, unfettered by organizational mission, rules, committees, boards, etc. The DAF donor can provide a very promising beginning to the capital stack.

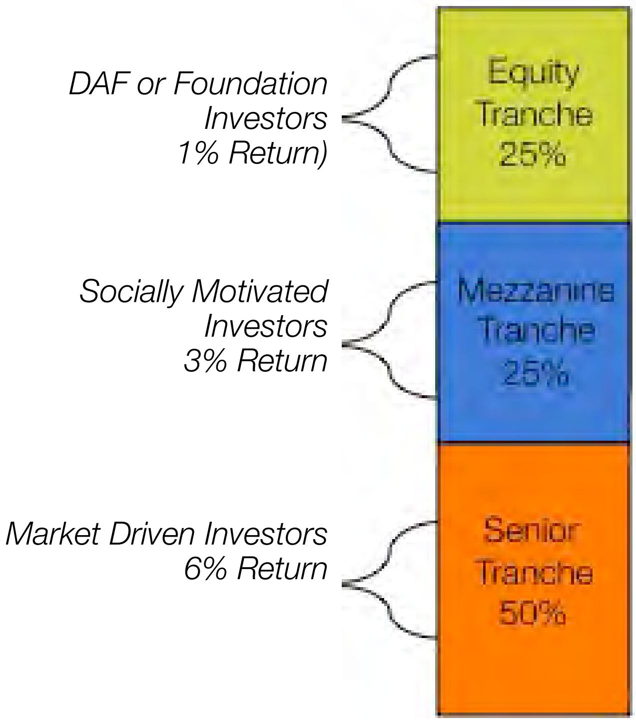
From the DAF's sponsoring organization's perspective, making a PRI type investment rather than a grant is financially beneficial. If the DAF investment earns income, it is the income that comes to the sponsoring organization, not the donor, and accrues to the donor's DAF. The DAF sponsor can take an administrative fee on any funds under its control and since by IRS regulations a PRI investment must be followed by the investor, to insure its charitable purpose is followed, and since the sponsor will be a member of the L3C, they can take an administrative fee against the entire investment. Unlike the foundation model, in which the L3C comes to the foundation hat in hand, looking for dollars, the founders of the L3C will find potential DAF donors on their own and bring them to the DAF sponsor. This not only eliminates sales expenses for the DAF sponsor, but brings them new clients who once they have a DAF might decide to use it for other donations. This creates a win-win arrangement for all concerned and the sponsor essentially has a new financial product to sell to a previously untapped market that the sponsor did not have to solicit.

The L3C or Social Enterprise using DAFs for their venture capital dollars will preferably want to select one sponsor to hold all the DAFs investing in their enterprise, for multiple reasons. In the first place, it is much easier to "tell the story" to one fiduciary and come to a clear understanding. It also creates a substantially lower due diligence cost for the sponsor, since the due diligence costs are spread over all the DAFs investing in the enterprise with that sponsor. Likewise one sponsor means only one addition to the board of the L3C. The last point is very important for the founders to consider. By using DAFs through one sponsor, the managers of the L3C do not have to explain themselves to multiple individuals. Once the donor has made an investment through their DAF, they have less say over how the L3C operates. As an LLC it is expected that the governance structure will give control to the founders, but from a practical point of view, the founders usually gain from not having to explain themselves to multiple individuals or organizations. The concepts explored here make an excellent case for receiving venture capital from DAFs rather than multiple foundations. The DAF sponsor does not have a mission, so they are concerned with legal compliance, not methods of trying to further the mission. Foundations are more likely to "get down in the weeds" and be overly concerned with method.

Additional Funds for the Capital Stack: In most cases, the L3C or social enterprise will need more funds than is practical or wise to get from DAFs or foundations. As a form of LLC, the L3C is designed for tranched or layered investment. Remembering that the operating agreement is merely a contract among the members of the company and the actual investment structure is limited only be the imagination of the members. If the company were to be a delivery service one of the members who, if he or she owned five trucks, could give the title to the trucks to the company in exchange for a percentage of ownership. Since the trucks are the key to the business that individual might also be guaranteed a certain percentage of the revenue each year before any profits were split amongst the rest of the members. Since this member has unique rights their membership might be designated as a class or tranche of membership.

The actual membership of the L3C will likely contain one more tranches which will be occupied by the founders/managers and will likely be structured in such a way as to give them voting control. There can be one tranche or one hundred and the organization, responsibilities, and benefits to each tranche will be covered in the governing document known as the operating agreement. Some tranches, such as the DAF or foundation tranche, may have special privileges such as the right to withdraw or intervene if the furtherance of the charitable mission is no longer the main objective of the organization. Usually the tranches also provide for a priority of payback if the business fails or is liquidated.

The following chart provides an example of a possible L^{3}C capital stack.



- *Foundations or Donor Advised Funds (DAFs) make a 25% investment. They buy the Equity tranche or layer and receive a 1% return.*
- *Mezzanine Investors (corporations, trusts, banks seeking to fill their CRA obligations, and other investors whose social interests allow them to take a less-than-market rate of return accept the mezzanine level of ownership with less than market rates of return.*
- *Pension funds and others requiring safety and market return invest a safe 6%*

Note that the blended rate of return is 4% which is within the capacity of the L^{3}C to generate the needed income.

Raising the Funds: The JOBS Act has made this job so much easier. Although advertising for solicitation of charitable funds has never been restricted, as long as the advertising is factual, the solicitation of investor dollars has been significantly restricted. Since the L^{3}C is a for-profit vehicle, soliciting investors in any tranche, except the DAF or Foundation tranche, is subject to securities laws, both state and federal. Since most L^{3}Cs are not looking for vast sums of money they will find complying with the securities laws fairly easy, now that the JOBS Act is law. The L^{3}C can "advertise" to as many people as it wants, offering memberships in various tranches, and then select only those that qualify for the various tranches. A securities lawyer should be engaged if a full fledged offering will be made. However, in most cases the founders will likely only want the DAF donors and a couple of private equity funds or a few individuals, for the other tranches, if they decide to try to fill the other tranches at the beginning.

Other Sources of Money: The nature of the charitable work of L^{3}Cs also means there is a good chance part of the capital stack could come from tax credits, like New Markets Tax

Credits, Historical Tax Credits, and Low Income Housing Credits. Many of these programs, combined with the work of the L3C, create opportunities for banks to meet their CRA (Community Reinvestment Act) responsibilities. The EB-5 program also presents many opportunities, since the investors are more interested in the continuity of the jobs than the return on investment.

Social Enterprise and L3Cs are new ideas, and, except for new tech toys, the country does not seem to embrace new ideas. There are so many entrenched silos that being noticed is hard, but the L3C founders and advisors believe that Social Enterprise, housed in an L3C business structure, has a very bright future. Prospects for Social Enterprise abound and the local community is a "target rich" environment. One need only walk down the street in their local community and look around or take a slow drive through a local neighborhood. The local infrastructure of the country is falling down around us and the government seems to have no funds for infrastructure repair, nor the manpower or willpower to tackle it. And 3P (public-private partnerships) programs, with standard for-profit businesses, have had very mixed success. The opportunity to use the L3C business structure is ideal. The L3C can raise money and operate as a business, but focus on mission, not profit. Likewise many of our food insecurity issues and environmental problems present golden opportunities for Social Enterprise initiatives. The structure of our large corporations has become corrupt, with a focus on short term, financial gains at the expense of employees and the community. Corporate America is focused on reducing jobs and simplifying the ones that remain, so lower cost employees can do the jobs or worse yet, they can be replaced with robots. Who is going to create good jobs and do the work that needs to be done in the future, in our local communities? Social Enterprise ventures, housed in L3Cs are the future!

Potential

When this author talks to many people about what they see as the ideal investment profile, it seems to that people are more willing to give up return, than take on increased risk in exchange, particularly if they can see a philanthropic return. This seems to make sense because, while current return is precisely quantifiable and future return usually reasonably projectable, risk is much more of a "Ouija Board" thing. So while we draw pretty curves, I think reality is not as pretty. Experience has also shown that well run Social Enterprises are usually more stable than a normal for-profit, since they have no reason to take on the risks associated with trying to make more money. This has led us to develop a theory of financing Social Enterprises, like L3Cs, based on using a capital stack which places DAFs and PRIs in the equity or venture capital slot and puts socially conscious investors willing to take a lower return in the mezzanine slot. The key to financing Social Enterprise is subsidized capital – lower returns for the equity and mezzanine tranches. The result can be a credit profile that allows the senior tranche capital to be accessible at commercial rates and thereby provide a blended rate of return the enterprise can live with. It also sets up Social Enterprises to access much larger pools of capital than are available in both the nonprofit sector and for typical startup for-profit ventures.

I particularly see great promise for P3 projects. The problem with letting normal for-profits take over governmental functions, like running toll roads or airports, is a divergence of ultimate goals. The normal for-profit sees a P3 as a way to use the social mission to make money; the L3C or other for profit Social Enterprise sees it as a way to achieve the social mission, but use good business practices as a way of running the enterprise.

The need for investment in infrastructure, job training, business incubation and many social services, to cite just a few examples, are enormous. Government has neither the money or the ability to accomplish much in this space. The charitable sector talks about impact investing, but has very little in the way of resources to make a significant impact, unless it uses its funds to leverage the trillions of dollars in private funds, many of which typically spend much of their time looking for and chasing the "next big thing." Watch daily changes in the stock market and it is easy see that many trillions are essentially wasted at the craps table. The tools discussed in this paper are designed to get America to invest its money in ways to create a safer, healthier, better educated America, at the local community level, and in a way that has its citizens gainfully employed every day, in good paying jobs that are not only emotionally and physically rewarding and economically satisfying, but shout out for all to see and hear, **“Made in America”!**

Part II – The Legal Background; DAFs, PRIs and the L3C

By Michael D. Martin

Introduction

The Low-profit Limited Liability Company, or "L3C", is a cross between a nonprofit organization and a for-profit company. The entity is designated as a low-profit business structure, with charitable or educational goals. Vermont was the first state to enact this new type of company, in April of 2008. Since then, some eight or nine additional jurisdictions have adopted this legislation and some twenty-one to twenty-two other jurisdictions have it under consideration, either formally or informally. Vermont's legislation creating such a company, modeled the required purpose clause for an L3C, verbatim, upon the Program Related Investment regulations, under the Internal Revenue Code, hence the L3C was designed, from the outset, to attract and hold endowment type investments from private foundations, while at the same time holding for profit type investments, to accomplish its charitable purpose. One might say the L3C 's charitable purposes were built into its very DNA. Accordingly, the L3C can be a valuable tool, when the founders are seeking low cost investments, in the form of Program Related Investments or "PRIs", or when the founders want to lock in a charitable mission and have a set of investors who will support that mission, regardless of whether the L3C attracts charitable investments.

L3Cs and Program Related Investments

However, the ability of the L3C to attract Program Related Investments from private foundations, during its seven or so years of existence, has not translated into actual experience, in the manner the creators of this entity had initially hoped. This is true for at least two major reasons: First, in this authors' personal experiences and observations, working with clients and prospective clients who have formed L3Cs, the "push back" from foundations to making a PRI from their endowment funds has arisen out of either a lack of understanding and education, by private foundation managers and their advisors, as to how PRIs actually work and/or fear of what might happen with regard to the foundations exempt status, if they get it wrong. In addition, the time delay and cost of a private letter ruling or lengthy legal opinion, to garner the necessary comfort level for a foundation to make a PRI, is also frequently cited as a reason to hold back. Second, based on a pure objective and quantifiable analysis, private foundations simply have not been handing out PRIs. Consider the following facts. A 2006 survey of more than 72,000 private foundations showed that private foundations collectively made qualifying distributions in the aggregate amount of $43 billion; however, PRIs accounted for less than 1% of these qualifying distributions (or $430,000,000, at a time when private foundations held in excess of $600,000,000,000 in endowment funds), despite PRIs being a strong tool to advance charitable purposes (see The Private Foundation Center, Aggregate Data by Private Foundation Type, 2006 [released 2008], available at http://private foundationcenter.org). Of course the fact that there is currently no process to confirm that a private foundation's proposed investment will comply, both initially and over time, with the PRI regulations under Treas. Reg. 53.4944-3(a) and, additionally, there is no uniform standard for forming entities to serve as recipients of PRIs (and obtain "determination letters" from the IRS, in the same fashion state formed non-profits currently do), may also contribute significantly to the above result.

Can Donor Advised Funds Invest in L3Cs?

With such a dismal performance and track record, despite such initial high hopes, might there be another source of nonprofit funds and capital for L3C creators and their advisors to explore, beyond private foundations? Indeed, yes. The authors, along with other L3C proponents and commentators alike, have recently been discussing and exploring whether Donor Advised Funds, or "DAFs", might be a more fertile field to examine. So the question raised, straight up, by the author, among his colleagues in the organized tax bar and elsewhere, was "Can Donor Advised Funds make Program Related Investments into an L3C?" Simply stated, can a Donor Advised Fund and an L3C dance together, without getting tangled up in their shoelaces? The response was a resounding; "Well, technically speaking, yes, I think so, if they exercise expenditure oversight." However, the potential issue, the real concern here, is whether such distributions might be considered taxable expenditures or distributions (under IRS rules and regulations governing DAF distributions).

IRS Regulations and Taxable Expenditures

The IRS, as it turns out, is currently looking at the issue of taxable distributions from Donor Advised Funds. However, our own independent analysis of current Internal Revenue Code and regulations, clearly supports the notion that DAFs can make PRI type investments, i.e., investments of the type set out in the examples in the present Program Related Investment regulations. The balance of this paper is a summary of what we found, based on our review.

Donor-Advised Funds

Generally, a donor advised fund is a separately identified fund or account that is maintained and operated by a section 501(c) (3) organization, which is called a Sponsoring Organization. Each account is composed of contributions made by individual donors. Once the donor makes the contribution, the sponsoring organization has legal control over it. However, the donor, or the donor's representative, retains advisory privileges with respect to the distribution of funds and the investment of assets in the account. Examinations of these arrangements may result in the following Service actions, in appropriate cases, if the distribution or investment of these funds is not properly handled. Specifically, the Service can: (a) disallow deductions for charitable contributions under

Internal Revenue Code Section 170, for payments to the fund; (b) impose section 4966 excise taxes on sponsoring organizations and managers of donor-advised funds; (c) impose section 4958 excise taxes on donors or managers of donor advised funds; and/or (d) deny or revoke the charity's 501(c)(3) exemption. The excise taxes referred to in (b) are the "Taxes on Taxable Distributions."

Excise Taxes, Donor Advised Funds and the Pension Protection Act of 2006

Donor Advised Funds became the target of Congressional scrutiny as a result of actual and potential abuses by funds and fund managers, resulting in excise taxes being imposed on Donor Advised Funds and their fund managers. These excise taxes came about as part of the provisions enacted under the 2006 Pension Protection Act ("PPA"), due to Congressional concern about potential abuses associated with the use of Donor Advised Funds. Specifically, the 2006 PPA introduced the terms "donor advised fund" and "sponsoring organization" and enacted or amended various excise taxes designed to penalize improper acts of Donor Advised Funds and their sponsoring organizations, donors, and advisors. For example, the taxes under §4943, on excess business holdings, which primarily apply to private foundations, were extended to cover donor advised funds. The taxes under §4958, on excess benefit transactions, which primarily apply to disqualified persons with respect to public charities, were extended to cover donors of donor advised funds and investment advisors of sponsoring organizations. Likewise, with regard to prohibited distributions. The definition of the term "taxable distribution," and the exceptions to such term, are the key concepts in applying the taxes under §4966. Depending on the particular provisions, the excise taxes involving donor advised funds became effective for transactions occurring after August 17, 2006, or for tax years beginning after August 17, 2006.

Taxable Distributions

IRC §4966, with respect to Taxable Distributions provides:

4966(c) Taxable Distribution

4966(c)(1) In General-The term "taxable distribution" means any distribution from a donor advised fund—

4966(c)(1)(A) to any natural person, or

4966(c)(1)(B) to any other person if—

4966(c)(1)(B)(i) such distribution is for any purpose other than one specified in **section 170(c)(2)(B),** or

4966(c)(1)(B)(ii) the sponsoring organization does not exercise expenditure responsibility with respect to such distribution in accordance with section **4945(h)** - Emphasis added. (AS NOTED: **IRC §4966** was enacted by the **2006 PPA, P.L. 109- 280, §1231(a)**).

Stated another way, a distribution from a Donor Advised Fund to any person other than a natural person (i.e., like an L^3C) which is organized for any of the purposes specified under I**RC §170(c)(2)(B)** is NOT a taxable distribution (Recall that an L^3C under the Vermont statute must be organized in a way that: "(i) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of **IRC §170(c)(2)(B)** of the **IRS Code of 1986, 26 U.S.C. Section 170 (c)(2)(B)**; and (ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes").

IRC §170(c)(2)(B) specifically sets out those purposes as: "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals". So a distribution to an L^3C, properly organized, clearly "flunks" as a taxable distribution on the first prong. However, the Sponsoring Organization MUST "exercise expenditure responsibility in accordance with," with respect to such distribution, to clear the second prong. Accordingly, in construing the definition of a taxable distribution, the purposes specified in **IRC §170(c)(2)(B)** are generally charitable purposes, such as religious, scientific, literary, educational, or other charitable purposes (See **IRC §170(c)(2)(B)**). Thus, a distribution to a corporation for a non-charitable purpose would be a taxable distribution subject to tax under **IRC §4966**. Even if a distribution is for a charitable purpose described in **IRC §170(c)(2)(B)**, such distribution is a taxable distribution, unless the sponsoring organization exercises expenditure responsibility with respect to it (See **IRC §4966(c) (1)(B)(ii)**; and **Staff of J. Comm. on Tax'n, 109th Cong**).

Donor Advised Funds Must Exercise Expenditure Responsibility

The "expenditure responsibility with respect to such distribution in accordance with section 4945(h)" referred to above in **IRC §4966**, is set out in **IRC §4945**, Taxes on Taxable Expenditures, which comes under Subchapter A — Private Foundations (IRC §§ 4940 to 4948), more commonly known as the "Private Foundation Excise Tax Rules". This section provides:

IRC §4945. Taxes on Taxable Expenditures

4945(h) Expenditure Responsibility The expenditure responsibility referred to in subsection **(d)(4)** *means that the private foundation (here in our example, the Donor Advised Fund) is responsible to exert all reasonable efforts and to establish adequate procedures—*

4945(h) (1) *to see that the grant is spent solely for the purpose for which made,*

4945(h)(2) *to obtain full and complete reports from the grantee on how the funds are spent, and*

4945(h)(3) *to make full and detailed reports with respect to such expenditures to the Secretary*-Emphasis added, mine.

Exceptions

A distribution to any of the following organizations is excepted from the scope of the term "taxable distribution": (i) a charitable organization described in **IRC §170(b)(1)(A)** (other than a disqualified supporting organization); (ii) the sponsoring organization of the donor advised fund; or (iii) any other donor advised fund (See **IRC §4966(c)(2)**). Accordingly, a distribution from a Donor Advised Fund must be a qualifying distribution and the Sponsoring Organization must exercise expenditure responsibility, unless one of the forgoing exceptions apply, i.e., a distribution to a public charity, the Sponsoring Organization, or another Donor Advised Fund, as provided in **IRC §4966**. To be clear then, distributions from Donor Advised must be qualifying distributions.

Qualifying Distributions Defined

Qualifying distributions are defined on **IRC §4942** of the Code as:

IRC §4942(g)(1) In General, for purposes of this section, the term "qualifying distribution" means—

4942(g)(1)(A) *any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in* **IRC §170(c)(2)(B)**, other than any contribution to: (i) an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons (as defined in **IRC §4946)** with respect to the foundation, except as provided in paragraph (3), or (ii) a private foundation which is not an operating foundation (as defined in subsection (j) (3)), except as provided in paragraph (3), or **IRC §4942(g)(1)(B)** *any amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in* **IRC §170(c)(2)(B)** - Emphasis added, mine.

Qualifying Distributions in General

A foundation's qualifying distributions generally are either amounts it expends directly for qualifying purposes or grants it makes to other organizations or individuals for qualifying purposes. The same is true for Donor Advised Funds. Qualifying distributions directly made by a foundation (and a Donor Advised Fund) include amounts expended to accomplish **IRC §170(c)(1) or (2)(B)** purposes or amounts paid to acquire assets used directly in carrying out one or more of such purposes (See **IRC §4942(g)(1)(A) and (B)**). It also includes a portion of the foundation's (the Donor Advised Fund's) reasonable and necessary administrative expenses incurred in carrying out its exempt functions (See **IRC §4942(g)(1)(A)**). Most non-operating private foundations typically satisfy the minimum qualifying distribution requirement by making grants to other organizations, rather than making significant amounts of qualifying distributions in the form of exempt asset purchases or direct operating or administrative costs. Traditional Donor Advised Funds follow suit, taking their cue from the Donor in his advisory capacity. In either case, whether or not a grant is a qualifying distribution is determined by the purposes for which it is used, and not necessarily by the status of the individual or entity to which it is made. Whether or not a distribution is a qualifying distribution is, in every instance, a "facts and circumstances" analysis. However, the status of the grantee determines the degree of the foundation's diligence necessary to ensure that its grant is being used for **IRC §170(c)(1) or (2)(B)** purposes and determines whether expenditure responsibility under **IRC §4945** is required. This is also true with respect to a grant by a Donor Advised Fund to an L3C.

Qualifying Distributions to Non-Charitable Organizations

A private foundation can also make qualifying distributions to non-charitable organizations and to individuals, if the distributions are for purposes described in **IRC §170(c)(1) or (2)(B)**. Since a "qualifying distribution" means "any amount paid to accomplish one or more purposes described in **IRC §170(c)(2)(B)".** Based on the foregoing, it seems clear that a Donor Advised Fund can not only make grants to L3Cs, they can likewise make a program related type investment as well, by following the rules discussed herein and exercising proper expenditure oversight.

Conclusion

So from our perspective, based on current laws and regulations, not only can an L3C come to a Donor Advised Fund party; the two should be able to dance together quite nicely, if they each follow the rules and behave themselves.

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