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Adding Another Trick to Your Bag of Tricks

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I have worked for several years now with an attorney who every time he asks me to undertake something I have never done before, says "Well it is always good to have another trick in your bag of tricks." One of the relatively recent additions to my "bag of tricks" is the low-profit limited liability company, or L3C. Since the first L3C statute was only adopted in 2008, I am lucky enough to be one of only a small group of attorneys nationwide with the L3C in my bag of tricks. As I have traveled around the country speaking on the L3C, it has become clear that even for folks very familiar with the program related investments (PRIs), there are still a lot of questions on how and when to utilize an L3C. So what do you need to know to add the L3C to your bag of tricks?

Where can an L3C be formed?

The L3C was first introduced in the United States in April 2008 when Vermont adopted the L3C as an official legal structure. Subsequently, the following jurisdictions have followed suit: Illinois, Louisiana, Maine, Michigan, North Carolina, Utah and Wyoming. Additionally, the Oglala Sioux Tribe and the Crow Indian Nation of Montana have adopted L3C legislation. Bills have also been introduced in the state legislatures in the following eleven jurisdictions: Colorado, Kentucky, Maryland, Massachusetts, Missouri, Montana, New York, North Dakota, Oregon, Tennessee and Virginia.

Where should an L3C be formed?

Although the state legislation on L3C is relatively uniform, it is not identical. Additionally, it is imbedded in the state LLC laws, which vary from state to state. So the first step in picking a jurisdiction for an L3C is to look at the law and see which variation best fits your needs.

An additional consideration may be where you have relationships to assist with filing the articles of organization and/or perform local review of the operating agreement. Personally, I have a firm in Vermont that has done several L3Cs for me and I am comfortable with them and the quality of their work, so I tend to think of Vermont first. If you went to law school at Duke and have an old law school buddy practicing in North Carolina, then maybe North Carolina is a better fit for you. However, in picking a jurisdiction, you should be aware that the Illinois L3C legislation requires an L3C to register with the Attorney General. The other jurisdictions permitting L3Cs do not currently impose such a registration process. This additional administrative burden may make Illinois a less desirable jurisdiction to L3Cs not planning to operate in Illinois.

Where can an L3C do business?

Since the L3C is a variant form of LLC, it can be qualified as a foreign LLC in a state that has not yet adopted the L3C legislation. Generally, if an entity registers to do business in a state that does not have L3C legislation, the abbreviations "LLC" will need to be added to the entity's name for purposes of its business in that state. I have been personally involved with registering L3Cs as foreign LLCs, and promise the process is pretty painless.

For what purposes can an L3C be formed?

Although the L3C is a for-profit entity, the state legislation authorizing L3C requires that the entity have as its primary purpose the accomplishment of one or more purposes described in [§170\(c\)\(2\)\(B\)](#) of the Internal Revenue Code (e.g., religious, charitable, scientific, literary, or educational purposes). So while the L3C can make a profit and distribute that profit to its members, the making of a profit must be a side benefit of the primary purpose.

So when first considering an L3C as a potential vehicle for a new project, you should

examine the proposed purposes from the vantage point of whether this would pass muster with the IRS if the client submitted a [Form 1023](#). Because the L3C legislation refers to §170(c)(2)(B) of the Internal Revenue Code, you are not alone in determining what will and will not pass muster, but rather, in addition to drawing on personal experience and the "smell test", you can draw on decades of IRS guidance.

For example, [Rev. Rul. 71-529, 1971-2 C.B. 234](#) and [Rev. Rul. 72-369, 1972-2 CB 245](#) shed light on when providing services to non-profits can qualify as an exempt purpose.

Does an L3C need a foundation investment?

Although the L3C was originally envisioned as a vehicle into which a private foundation would make a PRI, a PRI by a foundation is not required. In fact many L3Cs are being formed with no intention of ever receiving a PRI. Why? Because the L3C provides charitable branding for the organization. This has been especially attractive to some public charities forming related for-profits.

Does an L3C automatically qualify as a recipient of a PRI?

No, there is no automatic qualification. Any private foundation that is considering making a PRI into an L3C must analyze whether such investment would qualify as a PRI under the same rules that apply when making any PRI. However, since the L3C itself has one or more exempt purposes, it should be a more straightforward determination for the foundation to figure out if the investment will further its own exempt purposes.

At the request of [Americans for Community Development LLC](#), I have drafted a proposal for federal legislation, tentatively titled the "[Philanthropic Facilitation Act](#)," which would allow L3Cs (or other entities looking to receive a PRI) to register with the IRS and require that they file annual information returns regarding the use of any PRI funds. While this federal legislation is not necessary to the use of L3Cs, it would give private foundations considering a PRI into an L3C a more streamlined process for determining whether their investment would qualify as a PRI. Keep your eyes open for an introduction of the bill in 2011.

Will an L3C always be taxed as a partnership?

If the L3C has more than one member it will be taxed as a partnership unless it elects on [Form 8832](#), *Entity Classification Election*, to be taxed as a corporation. Each member will include its proportionate share of the partnership's revenues and expenses in its income and the IRS would attribute the activities of the L3C to its members.

Generally, this will be the tax treatment a multi-member L3C will want. However, where a public charity is a member of an L3C, the L3C may want to consider electing to be treated as a corporation to shield its public charity member from unrelated business taxable income. Where all of the members are exempt organizations, the L3C may also want to consider being an exempt organization itself by filing a Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*. "[Limited](#)

[Liability Companies as Exempt Organizations: Update](#)," by Richard A. McCray and Ward L. Thomas, 2001 EO CPE Text, provides an overview of the rules for how to qualify an LLC as an exempt organization.

Where the L3C has only one member, it will be a disregarded entity unless it elects otherwise. There are two ways for the eligible entity to elect separate entity treatment: by filing for separate entity treatment on Form 8832 or by claiming exemption as an entity separate from its owner by filing a separate Form 1023.

How does an L3C differ from a B-Corp or Benefit Corporation?

First, it is important to understand the difference between a B-Corp and a Benefit Corporation. A B-Corp is a voluntary certification process run by [B Lab](#). Any entity that meets the comprehensive and transparent social and environmental standards of the B Rating System and ensures that its governing documents incorporate the interests of employees, community and the environment may become a B-Corp. Accordingly, an L3C could also be certified as a B-Corp.

Whereas, the Benefit Corporation is a new statutory form of corporation that is currently been adopted in Maryland and Vermont. Unlike an L3C that must have a §170(c)(2)(B) exempt purpose, a Benefit Corporation is a corporation created to provide a general public benefit. A general public benefit is defined as "a material, positive impact on society and the environment, as measured by a third-party standard, through activities that promote a combination of specific public benefits." A Benefit Corporation may also elect to include one of the following specific public purpose in its organization documents:

- Providing individuals or communities with beneficial products or services;
- Promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business;
- Preserving the environment;
- Improving human health;
- Promoting the arts, sciences, or advancement of knowledge;
- Increasing the flow of capital to entities with a public benefit purpose; or
- The accomplishment of any other particular benefit for society or the environment.

Accordingly, a Benefit Corporation has more flexibility in what purposes it can pursue than an L3C. However, an L3C has more flexibility in its tax treatment. Additionally, the L3C legislation requires that the members put the exempt purposes before profit making, while the Benefit Corporation calls for a balancing of the various interests.

To me, the L3C and the Benefit Corporation are both great tools and not direct competitors because they have different benefits and drawbacks. So when looking to add social enterprise to your bag of tricks, both the L3C and the Benefit Corporation

should be on your agenda.

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