

TAX MANAGEMENT ESTATES, GIFTS AND TRUSTS JOURNAL

Reproduced with permission from Tax Management Estates, Gifts, and Trusts Journal, , 9/10/2009. Copyright © 2009 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Low-Profit Limited Liability Companies: An Unlikely Marriage of For-Profit Entities and Private Foundations

by Elizabeth Carrott Minnigh, Esq.
Buchanan Ingersoll & Rooney PC
Washington, D.C.¹

The low-profit limited liability company (L³C) format was created to bridge the gap between the underutilized capacities of non-profit organizations and for-profit entities. The L³C was first introduced in the United States in 2008 when Vermont adopted the L³C as an official legal structure.² The Vermont statute has national applicability because a L³C formed in Vermont can do business in other U.S. jurisdictions. The L³C format is currently authorized in

¹ I would like to thank Robert Lang and David Kempler for their assistance with this Article. However, any mistakes contained in this Article are mine alone.

² Vt. Stat. Tit. 11, Ch. 21, §§3001(27), 3005(a) and 3023(a).

six other jurisdictions,³ and bills have been introduced in a number of other states to legitimize the L³C format.⁴ The L³C itself cannot qualify as a tax-exempt organization under §501(c) of the Internal Revenue Code of 1986, as amended (the “Code”), or under any state law provisions, because more than an insignificant part of its activities is the business of making a profit. At its core, the L³C is a profit-generating entity with a social mission as its primary objective.

However, the usefulness of L³Cs as a format depends primarily on whether L³Cs are deemed to be program-related investments (PRIs) with respect to a private foundation,⁵ so that the private foundations can clearly invest in L³C without fear of incurring excise taxes.

³ Each of the following four states formally adopted L³C legislation in 2009: Illinois (805 ILCS 180/1-5, 805 ILCS 180/1-10, 805 ILCS 180/5-5), Michigan (Mich. Comp. Laws §450.4102), Utah Code (Utah Code §§48-02c-412 and 48-02c-1411) and Wyoming (Wyo. Stat. §17-15-102(a)(ix), *et seq.*). Additionally, the Oglala Sioux Tribe and The Crow Indian Nation of Montana have adopted L³C legislation.

⁴ Including the following other states, which in 2008 or 2009 introduced legislation that would authorize L³Cs: Arkansas (HB 2102); Maine (LD 1265); Missouri (HB 817); Montana (HB 235); North Carolina (SB 308); North Dakota (HB 1545); Oregon (HB 2886); and Tennessee (SB0472/HB0664).

⁵ §4944(c).

A PRI is exempt from excise taxes under the §4944(c) jeopardy investments rules,⁶ and this exemption allows a private foundation to make an investment in a for-profit entity without incurring excise tax, if (i) a return on investment is not a significant purpose of the investment and (ii) it will not jeopardize the carrying out of its exempt purposes. By nature L³Cs are designed to be high-risk entities without profit as a primary goal. It is generally assumed that the L³C will produce less profit than a normal for-profit entity, presuming that commercial investors otherwise would have filled the space, and the subsidy provided by the foundation would be unnecessary — but not all L³C generate low returns. Yet, without private foundation money to bolster the L³C, it is less likely that for-profit companies will be interested in funding the L³C. Rather, a for-profit investor would be more likely to limit its investment in for-profits to those that will result in a greater return and to make charitable contributions directly to public charities.

WHY USE A L³C INSTEAD OF CREATING A JOINT VENTURE?

A public charity may enter into a joint venture⁷ with a for-profit entity without adverse tax consequences if the following requirements are satisfied:

- Participation in the joint venture furthers an exempt purpose of the charitable organization.
- The arrangement permits the charitable organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners or members.

If the governing documents of the joint venture give the public charity sufficient control over the management and operation of the joint venture so that the public charity may ensure that the arrangement serves exclusively to further its exempt purpose and only incidentally to benefit the private interests, then its participation in the venture will not adversely affect its exempt status. Conversely, if the for-profit investors control the decision making, then there is the likelihood that the arrangement confers a more than insubstantial benefit on the private interests, with the result that the joint venture is not considered to further exclusively an exempt purpose. One way to ensure that the public charity has control is if the majority of the directors, members or partners of the new joint ven-

ture entity are from the public charity. These joint ventures are increasingly common among hospitals and real estate developers.

Private foundations are subject to limitations on their investments and business holdings that do not apply to public charities. In this instance §4943(a),⁸ which imposes a 10% excise tax on the value of any “excess business holdings,” prevents a private foundation from investing in a joint venture. Under §4943(c)(1), an excess business holding with respect to a private foundation invested in any business enterprise is the amount of stock or other interest in the enterprise that the private foundation would have to dispose of to a person (other than a disqualified person) in order for the remaining holdings of the private foundation in such enterprise to be permitted business holdings. In a joint venture, the exempt organization must have control of the entity and hold an equal or majority interest in the joint venture, neither of which a private foundation may have without triggering excess business holding taxes under §4943(a). Accordingly, a private foundation may not invest in a joint venture. Even though the L³C format is subject to the same restrictions, it would not trigger excess business holding taxes under §4943(a), if the investment qualifies as a PRI. Additionally, assuming the L³C is a PRI, then investing in the PRI counts as part of its qualified distributions.

HOW TO CREATE A L³C

A L³C may be formed as a new entity or it may be formed by converting an existing entity. Because the L³C format is a relatively recent format, it is advisable to get legal counsel to ensure that the entity is properly established, and make any necessary state filings to do business in a state other than the one in which it is established. Similar to traditional LLCs, the new L³Cs will be governed by an operating agreement.⁹ There may be additional restrictions under state law. For example, Vermont requires that “L³C” appear in the title of the entity and that its articles of organization comply with all of the requirements for a traditional operating agreement.¹⁰ Additionally, the governing documents of the L³C should include language that tracks the provisions of Regs. §53.4944-3(a), which lays out requirements to qualify for the exemption from the jeopardy investment rules.

When parties seek to establish a new L³C, it is important to have a clear business plan in place, and to

⁶ For further discussion of jeopardy investments, see Etheridge, Hasson and Fowler, 878 T.M., *Private Foundations — Section 4940 and Section 4944*.

⁷ For further discussion of joint ventures, see Washlick, 478 T.M., *Joint Ventures Involving Tax-Exempt Organizations*.

⁸ For further discussion of excess business holdings, see Stoneman, 880 T.M., *Private Foundations — Excess Business Holdings*.

⁹ Americans for Community Development has a three model L³C agreement available at <http://americansforcommunitydevelopment.org/legal.html>.

¹⁰ Vt. Stat. Tit. 11, Ch. 21, §3005(a) and 3023(a).

have already shared such business plan with potential investors to gauge interest in the project, prior to actually forming the L³C.¹¹ For an existing entity, the transition to the L³C format can be time-consuming or costly. As only certain states allow L³Cs, when considering whether to convert an existing entity, the entity should consider the potential tax consequences of changing its status and, in some cases, the costs of moving the entity to another state.

- *For-Profit Changing Format to L³C*: State law generally governs the mechanics of changing the entity from one form into another form. However, this can be a costly and time-consuming process involving multiple state filings and payment of state and federal taxes. Below is a brief discussion of the mechanics of changing from one form to another, as well as some of the tax consequences of doing so, assuming that an L³C can be formed in the same state:
 - *LLC to L³C*: As an L³C is merely a new form of LLC, the LLC would merely need to file change-of-name documents with the state of its creation, and revise its operating agreement to state its social mission as its primary objective, rather than generating a profit. The decision whether to become a L³C must be made by a vote of the individuals named in the LLC operating agreement as having voting power. For federal income tax purposes, the conversion should not result in any adverse tax consequences, unless there is a shifting of interests.
 - *Partnership to L³C*: The conversion of a domestic partnership into a domestic LLC taxed as a partnership is not a termination pursuant to §708 of the Code; therefore, the partnership's tax year does not close and the LLC does not need to obtain a new employer identification number.¹² Once the LLC is formed, it would then need to follow the steps outlined in the immediately foregoing paragraph.
 - *S Corporation to L³C*: In changing from an S Corporation to a L³C there is corporate-level recognition of gain

on liquidating distributions of appreciated property. Such gain is passed through to the shareholders and increases each shareholder's basis in his stock, at the cost of an additional shareholder-level tax on the same gain.¹³

- *C Corporation to L³C*: If a C corporation changes to a L³C by transferring its assets and liabilities to the L³C and distributes the L³C interests to its shareholders, then such transfer will be a deemed corporate liquidation if the C corporation goes out of existence. This could result in double tax. As a general rule, a liquidating corporation must recognize gain or loss upon the distribution of property in liquidation as if the property were sold for its fair market value.¹⁴ If property is distributed subject to a liability, then such property is deemed to have a fair market value that is at least equal to the liability. The same rule applies if the property is not subject to a liability but the shareholder assumes a corporate liability in connection with the distribution.¹⁵ The ability of a liquidating corporation to recognize losses is limited in certain circumstances, such as liquidating distributions of property to a related person within the meaning of §267 of the Code, if (a) the distribution is not pro rata to all shareholders, or (b) the property is "disqualified property," which includes (i) property acquired by the corporation in a §351 transaction, or as a contribution to property, during the five-year period ending on the distribution date, or (ii) any property with an adjusted basis determined, in whole or in part, by reference to property described in clause (i).¹⁶
- Changing an organization's legal identity may be time-consuming and costly. Moreover, if the state of organization must be changed to one that permits L³Cs, additional costs will be incurred.

¹¹ Telephone call with Robert Lang, CEO of The Mary Elizabeth and Gordon B. Mannweiler Foundation (Aug. 5, 2009).

¹² Rev. Rul. 95-37, 1995-1 C.B. 130.

¹³ §§1371, 311(b).

¹⁴ §336(a).

¹⁵ §336(b).

¹⁶ §336(d)(1).

In many circumstances, a for-profit entity may find itself better served by creating a new L³C and in exchange for a membership interest transferring assets to the new L³C.

- *Non-Profit Becoming a For-Profit L³C*: Generally, the governing documents of a private foundation require that upon termination the organization must pay out all assets to a tax-exempt organization under §501(c) of the Code.

- *Public Charities*: If a public charity attempts to convert to a L³C, it will generally be subject to state laws governing charitable trust payments. The public charity must pay over the net value of its assets to another tax-exempt organization as a condition to converting to a for-profit entity. For federal income tax purposes, if the sale is at arm's length, there should be minimal tax consequences to the tax-exempt organization depending upon the classification of the assets sold. If the sale is not consummated at fair market value, the IRS may revoke the tax-exempt status of the selling entity on the basis of violation of prohibitions on private investment or other private benefit, which will result in a taxable sale.¹⁷

- *Private Foundations*: Changing from a private foundation to a for-profit L³C will result in a termination of the private foundation. Any liquidation, merger, redemption, recapitalization or other reorganization of a private foundation (voluntarily or involuntarily) will be subject to a "termination tax." A "termination tax" on the terminating private foundation is in an amount equal to the lesser of (i) the aggregate tax benefit derived from its §501(c)(3) status, or (ii) the value of its net assets.¹⁸ The "aggregate tax benefit" consists of the income tax benefit to substantial contributors to the private foundation as a result of the income tax charitable deduction allowed for their contributions, as well as the in-

come tax benefit to the private foundation by reason of not having paid tax on its income during the period that it was tax-exempt, plus interest on these two amounts.¹⁹ After the private foundation has distributed its assets (by assignment to the new L³C), it will need to formally dissolve with the state and file its final Form 990-PF, *Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation*, for the year during which the dissolution occurred. The form must be marked "Final Return" on the top of page one and must provide the following information:²⁰

- A statement explaining the nature of the dissolution, and whether a final distribution of assets was made and, if so, the date made;
- A certified copy of the resolution authorizing dissolution; and
- A schedule listing the names and addresses of all recipients of the assets distributed in dissolution, as well as an explanation of the nature and fair market value of the assets distributed to each recipient.

Given the onerous termination rules, it would be preferable to form a new entity or convert one of the for-profit entities involved with the L³C.

WHAT ARE THE BENEFITS FOR THE PRIVATE FOUNDATION?

Qualifying the L³C as a PRI is a prerequisite to any benefits for a private foundation invested in a L³C. Through the exemption for PRIs from the jeopardy investment rules under §4944(c) of the Code,²¹ a private foundation can make an investment in a for-profit entity without incurring excise tax if (i) a return on investment is not a significant purpose of the investment and (ii) it will not jeopardize the carrying out of the private foundation's exempt purposes. Additionally, if the investment qualifies as a PRI, then it will

¹⁷ §501(c)(3). For further discussion of the restrictions on tax-exempt entities, see Simpson, 869 T.M., *Tax-Exempt Organizations: Organizational and Operational Requirements*.

¹⁸ §507(c).

¹⁹ Regs. §1.507-2(f)(2)(iii).

²⁰ Regs. §1.6043-3.

²¹ For further discussion of jeopardy investments, see Etheridge, Hasson and Fowler, 878 T.M., *Private Foundations — Section 4940 and Section 4944*.

also be a qualifying distribution under §4942,²² which requires a private foundation to distribute annually at least 5% of their assets, or face an excise tax on the amount that remains undistributed. PRIs permit an investment with a socially beneficial purpose that is consistent with and furthers a private foundation's charitable purpose. PRIs include, without limitation, financing methods commonly associated with banks or other private investors, such as loans, loan guarantees, linked deposits, and even equity investments in charitable organizations or in commercial ventures for charitable purposes.

Traditionally, many private foundations have refrained from investing in for-profit ventures due to the uncertainty of whether such investment would qualify as a PRI or because of the cost, time and resources to acquire a legal opinion from counsel or a private letter ruling from the IRS to verify that the particular venture is a valid PRI. To date, all state legislation enacted has provided for the operating agreement to comply with Regs. §53.4944-3(a), with the objective of facilitating greater use of PRI investment. Additionally, the L³C label would make it easier for the public and regulators to identify organizations making use of the exemption for PRIs.²³ As the IRS considers PRIs and foundation grants generally as interchangeable for federal income tax purposes, if private foundations would think of PRIs in the same manner as grants, many of their concerns about subtle differences may not seem as important.²⁴

A survey of more than 72,000 private foundations showed that in 2006 private foundations collectively made qualifying distributions in the aggregate amount of \$43 billion; however, PRIs accounted for less than 1% of these qualifying distributions despite being a strong tool to advance charitable purposes.²⁵ Approximately 75 L³Cs have been formed in the United States since the Vermont legislation took effect in April 2008.²⁶ Utilizing the L³C format would allow a private foundation to invest in a manner that meets its

²² For further discussion of the annual distribution requirement, see Schenkelberg and Gross, 880 T.M., *Private Foundations — Distributions (Section 4942)*.

²³ Marcus Owen, "Response to June 2009 Remarks of IRS TE/GE Advisor Ronald Schultz on Low-Profit LLC Investment," *BNA Daily Tax Rep.* (June 13, 2009).

²⁴ Regs. §53.4942(a)-3(b)(2).

²⁵ The Foundation Center, *Aggregate Data by Private Foundation Type, 2006* (released 2008). Although a large portion of PRIs that have received investments are for the support affordable housing or community development, other PRIs have included preserving historic buildings, repairing churches, providing emergency loans to social service agencies and protecting and preserving open space and wildlife habitats. Foundation Center, FAQs, <http://foundationcenter.org/getstarted/faqs/html/pri.html>.

²⁶ Above, fn. 11.

charitable purposes, while also providing an opportunity for a private foundation to generate a modest return on that investment. This type of investment will allow the private foundation to grow its assets and, ultimately, provide more funds to expend in accordance with its charitable purpose. Also, it is important to remember that the L³C in which the private foundation invests must be consistent with the private foundation's stated purpose.²⁷ For example, if the stated purpose of a private foundation is to further cancer research, that private foundation may not invest in a L³C that has a social purpose of development of a community center, because the community center would not further the private foundation's stated exempt purpose. Conversely, a private foundation with the stated purpose of promoting the arts for young children, could invest in a L³C that has a social purpose development of a community center, if arts programs will be offered there.

WHAT ARE THE RISKS TO PRIVATE FOUNDATION BY INVESTING IN L³Cs?

Unlike public charities, which are not subject to the tax on investment income, the private foundations are subject to the excise taxes imposed by provisions of Chapter 42 of the Code, including the tax on the failure to distribute income under §4942 and the tax on "jeopardy investments" under §4944. Because the IRS has not explicitly ruled on whether L³Cs qualify as PRIs,²⁸ a private foundation's investment in the L³C could be considered a jeopardy investment under §4944 and a 10% excise tax would be imposed on

²⁷ §4944(c).

²⁸ Although the IRS has approved various forms of private foundation investments in for-profit entities as PRIs. Regs. §53.4944-3(b), *Ex.* 1-6. See also Rev. Rul. 2004-51, 2004-1 C.B. 974 (University will continue to qualify for exemption when it contributes to and operates part of its activities through LLC formed with for-profit corporation); PLR 200610020 (private foundation's capital contributions to fund organized to invest in businesses in low-income communities qualify as program-related investment); PLR 199943044 (private foundation's acquisition of stock in a company operating in an economically depressed area will be for charitable purposes and will not give rise to private foundation excise taxes); PLR 199910066 (two private foundations' investment in a limited partnership devoted to encouraging economic development in an economically depressed area did not jeopardize their exempt status); PLR 8810026 (§501(c)(3) organization's loan to risk-pooling organization was considered program-related investment and was a qualifying distribution in year made); PLR 8807048 (purchase of large interest in community organization was a program-related investment, would not jeopardize exempt purposes; would not be excess business holding and would not be taxable expenditure).

both the private foundations and its managers.²⁹ Moreover, under §4942 if the investment were intended as a qualifying distribution then there could also be an excise tax of 30% on the amount distributed to the L³C. Even though the state laws have been written to be compliant with PRI requirements, there is still a possibility that the IRS will deem all L³Cs not to comply with the PRI rules.

At a June 11, 2009 meeting, a senior technical advisor in the Tax Exempt and Government Entities Division, cautioned against use of the L³C format until the Treasury Department and/or the IRS affirmatively states that the L³C format will qualify as a PRI.³⁰ As a L³C is merely a new form of LLC, and the IRS has already approved LLCs for many years, any IRS statement would be merely on whether investments therein qualify as a PRI.³¹ Private foundations interested in L³Cs may lessen the chance that the investment will be treated as a jeopardy investment by ensuring that the directors (or trustees) (i) have done their due diligence, such as reviewing the L³C's business plan and determining that the L³C is fully compliant with any state law requirement, and (ii) clearly document the following with regard to that particular L³Cs investment:

- The investment significantly furthers the accomplishment of one or more purposes, within the meaning §170(c)(2)(B), of the private foundation,³²
- No significant purpose of the L³C will be the production of income or the appreciation of property,³³ and

- No purpose of the L³C is to accomplish one or more political or legislative purposes within the meaning of §170(c)(2)(D).³⁴

At the time of writing of this article, a draft of new proposed federal legislation, “The Program-Related Investment Promotion Act of 2009,” has been drafted but not yet introduced in Congress.³⁵ If this bill (or a similar bill) is introduced and enacted in Congress it should clear up many ambiguities for private foundations seeking to invest in L³C. The principal change in the Program-Related Investment Promotion Act of 2009 expands and clarifies §4944(c).³⁶ This proposed bill clearly defines a PRI as an investment that (i) does not jeopardize the carrying out of exempt purposes; (ii) may receive qualifying distributions under §4942; and (iii) is not excess business holdings under §4943.³⁷ It also states that in order for an investment to qualify as a PRI it must have as a primary purpose the accomplishment of one or more of the purposes described in §170(c)(2)(B), and no significant purpose of the investment may be the production of income or the appreciation of property.³⁸ Private foundations could request determination that a specific investment qualifies as a PRI, and the Secretary would be required to rule on such requests within 90 days of submission.³⁹ If such a determination is made, the private foundation may rely on that determination.⁴⁰ This proposed legislation also provides that a private foundation that chooses not to seek such a determination may invest in a L³C based on its own determination, after due diligence, that the investment qualifies as a PRI.⁴¹ A better way for the IRS to confirm compliance among private foundations investing in PRIs would be to create a national registry of L³Cs and their tax-exempt investors, which would notify the IRS that a foundation was making an investment in a PRI.⁴² Under the present system the IRS receives notice only in the form of information buried in the pri-

²⁹ Section 4944 of the Code may generally be viewed as a restatement of the state law duty of care imposed on directors, without being shielded from liability.

³⁰ “IRS Tax-Exempt Official Urges Caution for Groups Eyeing Low-Profit LLC Investment,” *Daily Tax Rep.* (BNA), No. 126, at G-3 (July 9, 2009).

³¹ Above, fn. 23. Even if the IRS rules that L³Cs are not *per se* PRIs, individual L³Cs could still qualify on a facts-and-circumstances basis.

³² Regs. §53.4944-3(a)(1)(i). An investment will be considered as made primarily to accomplish purposes §170(c)(2)(B), if *but for* the relationship between the for-profit and the private foundation, the private foundation could have achieved its purposes. Treas. Regs. §53.4944-3(a)(2)(i).

³³ Regs. §53.4944-3(b)(1)(ii). “However, the fact that an investment 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. Regs. §53.4944-3(a)(2)(iii).

³⁴ Regs. §53.4944-3(a)(1)(iii).

³⁵ Above, fn. 23.

³⁶ *Id.*

³⁷ *Id.* The “permitted business holdings” (i.e., holdings that are exempt from the §4943(a) excise tax) of any private foundation in a for-profit entity are: (i) 20% (which is increased to 35%, if the entity is controlled by an unrelated person) of the voting stock, reduced by (ii) the percentage of the interest owned by all disqualified persons as defined in §4946(a). §4943(c).

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² Robert Lang has suggested that an organization such as GuideStar would be willing to track these tax-exempt organizations investing in PRIs, which would make the information widely available. E-mail with Robert Lang, CEO of The Mary Elizabeth

vate foundation's Form 990-PF, *Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation*.

WHAT ARE THE BENEFITS TO THE FOR-PROFITS?

Investment in a L³C by a for-profit entity may be attractive because the L³C operating agreement can be drafted to allow for layered interests, delivering returns according to the needs of the investor — i.e., low return to a private foundation, greater returns for the for-profit market-driven investor. Many philanthropic for-profits may be interested in being involved in charity work that may actually generate a profit for them. Private foundations will be taking on more financial risk in exchange for a high social return by furthering their own charitable purpose. Further, if private foundations invest early their funding will attract more market-driven investments in the L³C.

WHAT ARE THE RISKS TO FOR-PROFITS BY INVESTING IN L³Cs?

For many for-profit investors it is their philanthropic intent that enables them to bear the potential risk of a low return. Additionally, to comply with their duties as directors, members or partners, such directors, members or partners should do due diligence on the L³C and keep a clear record of the reason for their decision to invest, especially where the company is publicly held. This will demonstrate that the investors of the L³C have complied with their fiduciary responsibility when investing in the PRI.

HOW WILL L³Cs AND THEIR INVESTORS BE TAXED?

- **L³C:** Because the L³C is merely a new form of limited liability company, it will be taxed in the same manner as a traditional LLC. A LLC is generally treated as a partnership for tax purposes either by default if it has two or more members or by checking the box on Form 8832.⁴³ Unlike a corporation, a LLC is not taxed as an entity in itself. Instead, all gains and losses of the LLC “passthrough” to the members, who pay income tax at their respective marginal rates. The L³C should file Form 1065, *U.S. Return of Partnership Income*, with the IRS, unless the IRS issues a new form for L³C.

- **Private Foundation Investors:** Assuming the L³C qualifies as a PRI, the private foundation will pay no tax on any gains on the distribution from the L³C. The foundation will need to show its investments in the PRI on Form 990-PF, *Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation*, filed with the IRS annually, and may also have to disclose in state filings. If the L³C does not qualify as a PRI, then the private foundation may be liable for excise taxes (and potential interest and penalties) if the investment is deemed to be a jeopardy investment under §4944. The IRS treats any income derived from the PRI in the same manner as any investment considered to be money permanently removed from the private foundation's endowment (such as a grant) and, therefore, if a private foundation receives their investment back that and any gain would have to be invested in another PRI or grant within one year of receipt.⁴⁴

- **For-Profit Investors:** Taxation of the for-profit entities investing in a L³C will depend on their format.

- **Pass Through Entities:** LLCs, partnerships and S corporations each “pass-through” any gains and losses to their individual investors. A LLC or partnership must file Form 1065, *U.S. Return of Partnership Income* with the IRS. S corporations must file Form 1120S, *U.S. Income Tax Return for an S Corporation*.
- **C Corporations:** A C corporation is subject to what is called an “entity-level” tax, which means that the corporation pays taxes itself. As a general rule, graduated tax rates for C corporations range from 15 to 35%.⁴⁵ C corporations must file Form 1120, *U.S. Corporation Income Tax Return*.

HAVE HYBRID COMPANIES BEEN USED SUCCESSFULLY IN OTHER COUNTRIES?

Similar entities, referred to as Community Interest Companies (CICs) have been available in the United

and Gordon B. Mannweiler Foundation (Aug. 21, 2009).

⁴³ Regs. §301.7701-3.

⁴⁴ §4940(C)(4)(D).

⁴⁵ §11(b).

Kingdom since 2004⁴⁶ and have been regulated by a Regulator with the Secretary of State for Trade and Industry since 2005.⁴⁷ However, the Government expects the Regulator to encourage the development of the usage of CICs and provide guidance and assistance on matters relating to CICs.⁴⁸ Like L³Cs, CICs were established for organizations wishing to operate for the benefit of the community rather than solely for the personal gain of a particular person or group of people.

In the United Kingdom, there are specific forms designed for the creation of, or conversion to, the CIC format and dissolution of a CIC.⁴⁹ The Regulator has created a Briefing Pack, similar to an IRS Publication, which provides a plain English discussion of rules relating to CICs.⁵⁰ According to the Foreword of the Briefing Pack, in 2004, the first year CICs were available, over 360 companies were registered as CICs, and, as of March 2007, nearly 850 were formed.⁵¹ All CICs are subject to an “asset lock,” which is a provision included in the organizational documents designed to ensure that the CIC assets (including any profits generated by its activities) are used for the community purposes for which it was formed. Only certain transfers out of the CIC are permitted.

- Transfer is made at fair market value, so that the CIC retains the value of the assets which it transferred;
- Transfer made to another CIC or registered charity that is specified in the CIC’s organizational document;
- Transfer made to another CIC or registered charity not named in the organizational documents, but with the prior consent of the Regulator; or
- Transfer is made directly for the social benefit of the community.⁵²

However, CICs may still distribute dividends to their shareholders subject to a “dividend cap,” which is intended to strike a balance between promoting investments in CICs and the principle that the assets of

a CIC should be devoted to the benefit of the community. The dividend cap has three requirements:

- The maximum dividend per share is no more than 5% points higher than the Bank of England’s base lending rate.⁵³
- The maximum aggregate dividend is limited to 35% of distributable profits.⁵⁴
- The ability to carry forward unused dividend capacity from year to year is limited to five years (including the year the unused dividend capacity first arose).⁵⁵

The United Kingdom model limits the amount of money going out to the various sources; some think this could be one way to address concerns of who will regulate L³Cs. However, some of the framers of the CIC laws have been looking at the L³C for possible guidelines on changing the CIC laws, because they have found the limitations on income and distributions to be inhibitive of the very entrepreneurial activities the CIC laws were established to encourage.⁵⁶

MOVING FORWARD

At first, many private foundations will not be willing to try out the L³C until they have seen others set up and not suffer any adverse tax consequences or until the IRS issues a ruling or regulations addressing L³C qualifying as a PRI. On March 4, 1977, Wyoming was the first state to adopt the LLC format.⁵⁷ The LLC did not immediately become the favored format. The LLC is now the preferred form of business organization.⁵⁸ As more entities used the LLC format and the IRS started issuing private letter rulings and revised regulations regarding treatment of the LLC under the Code, more and more people began to use LLCs over partnerships because of added flexibility. In 10 years the L³C may be as common as the traditional LLC. In fact Sue Woodrow, an attorney for the Federal Reserve Bank, has stated that she ex-

⁴⁶ Companies (Audit, Investigations and Community Enterprise) Act, 2004, Ch. 27 (Eng.).

⁴⁷ Community Interest Company Regulations, 2005 (Eng.).

⁴⁸ Community Interest Company, *About Us*, available at <http://www.cicregulator.gov.uk/aboutUs.shtml>.

⁴⁹ Community Interest Company, *Forms*, available at <http://www.cicregulator.gov.uk/forms.shtml>.

⁵⁰ Community Interest Company, *Briefing Pack*, available at <http://www.cicregulator.gov.uk/CIC%20guidance/CICBriefingPack2.pdf>.

⁵¹ *Id.* at pg. 3, *Foreword*.

⁵² *Id.* at pgs. 17-18, *The Asset Lock*.

⁵³ *Id.* at pg. 22, *The Dividend Cap*.

⁵⁴ *Id.*

⁵⁵ *Id.* at pg. 24-25, *The Dividend Cap*.

⁵⁶ Discussions between Stephen Lloyd, Senior Partner & Head of Charity and Social Enterprise at Bates Wells & Braithwaite Solicitors, and Robert Lang, CEO of The Mary Elizabeth and Gordon B. Mannweiler Foundation (dates unknown).

⁵⁷ Burke and Sessions, “The Wyoming Limited Liability Company: An Alternative to Sub S and Limited Partnerships?” 54 *J. Tax’n* 232, 234 (1981).

⁵⁸ Starr, Case, Garre-Lohnes, Rosenberg, Schmalz, 725 T.M., *Limited Liability Companies*, at A-1.

pects that to happen within five years.⁵⁹ The new L³C, assuming it qualifies as a PRI, could allow a number of private foundations to make a modest return on their assets. Both the modest return as well as the social purpose set forth by the new L³C will further the effectiveness of a private foundation in furthering its charitable purposes.

As L³C develops, new ways of structuring the relationship between the parties may arise. As of the date of this Article, Delaware, Illinois, Iowa, Nevada, Oklahoma, Tennessee, Texas and Utah have adopted the series LLCs.⁶⁰ The majority of state LLC laws already allow an LLC to provide for classes of members with different member rights per class. However, a series LLC goes further by establishing multiple series

of assets, members and managers.⁶¹ The debts and obligations of each series will be enforceable only against the series' assets, and members associated with a series can be given separate rights and duties with regard to the assets of the series.⁶² The series LLC was first introduced by Delaware in 1996, and other states have been slow to follow; accordingly there is no body of case law decisions surrounding their uses.⁶³ However, in the context of L³Cs they offer some interesting opportunities. Imagine, for example, a mixed-use realty project with some purely commercial components and some socially beneficial components.⁶⁴

⁵⁹ Conference call, including Robert Lang and Sue Woodrow (Aug. 7, 2009).

⁶⁰ Del. Code §18-215; 805 ILCS 180/3740; Iowa Code §490A.305; Nev. Stat. §86.296; Okla. Stat. §18-2054.4; Tenn. Code §48-249-309; Tex. Bus. Org. Code §101.601; and Utah Code §48-2c-606.

⁶¹ Doug Batey, *Texas Joins the Series LLC Crowd* (July 28, 2009), available at <http://www.llclawmonitor.com/tags/wyoming/>.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ Above, fn. 42. As of the writing of this Article, only Illinois and Utah permit both L³Cs and series LLCs.