

April 17, 2009

A year has passed since Vermont enacted pioneer legislation recognizing the L3C as a legal business entity. Since that exciting day, five other jurisdictions have amended their limited liability company acts to recognize the L3C, and similar legislation is in various stages of consideration in more than a dozen other states. At the same time, proponents of program-related investments (“PRIs”) have prepared draft legislation that, if enacted by Congress, would not only facilitate PRIs, but also would create additional safeguards and enforcement mechanisms to ensure that those investments accomplish charitable purposes.

In light of this activity and the complexity of the subject matter, it’s not surprising that some have stepped forward to raise questions regarding both the L3C and the proposed federal legislation. We have had conversations with the National Association for State Charity Officials (NASCO) and asked that they forward us any questions. Last month they sent us 20 questions from their members, who are state regulators charged with the oversight of charitable organizations at the state level.

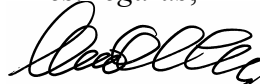
Given its mission, NASCO is clearly an important part of our process. We believe that now, more than ever, regulators and organizations accomplishing charitable objectives must work together to maximize the good accomplished using charitable assets, while ensuring that these assets are managed responsibly. Therefore, we welcomed the opportunity to respond to NASCO’s questions—and we welcome questions from other stakeholders as well—to ensure that our purpose, process, and objectives are not misunderstood.

NASCO’s questions and our responses appear on the pages that follow. The responses were prepared by our attorneys:

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This document answers many questions that have been asked not only by NASCO, but also by others. We hope that you find it useful and we will post similar documents in the future, as appropriate.

Best regards,



*Robert M. Lang, CEO
The Mary Elizabeth and
Gordon B. Mannweiler Foundation*

Enclosures

Response to Questions Posed in NASCO's Letter Dated March 19, 2009

1. From the IRS's perspective, does it matter whether an L3C is considered a charitable or non-charitable entity under state law? The statutory language in some states does not make clear whether all L3Cs will be treated similarly or whether, instead, it would be necessary to review the operating agreements and other creating documents of each L3C to determine whether it should be treated as a charitable organization.

It is important to remember that an L3C (or an LLC) can not qualify as a charity under section 501(c)(3) of the Internal Revenue Code (the "Code") unless its owners/members are exclusively tax-exempt charities themselves.¹ While tax-exempt status might be appropriate for certain organizations, assuming that they meet the conditions set forth by the IRS for that status, it is more likely that L3C organizations will have one or more taxable member/owners. This type of LLC—a for-profit, taxable entity—would be organized and operated to accomplish one or more charitable purposes and satisfy the other requirements for qualifying as a program-related investment ("PRI") under section 4944(c) of the Code.

When reviewing the purpose and activities of an L3C, the IRS would not consider whether the entity should be treated as a tax-exempt charity unless the L3C met the Code's requirements, just as non-stock, non-profit corporations must do. Rather, the IRS would focus on whether a foundation's investment in an L3C qualifies as a PRI. This assessment would turn on whether the investment in the L3C satisfies the three requirements in section 53.4944-3(a)(1) of the Treasury Regulations, namely:

- that its primary purpose was to accomplish one or more purposes described in section 170(c)(2)(B) of the Code (*e.g.*, religious, charitable, scientific, literary, or educational purposes);
- that no significant purpose of the investment is the production of income or the appreciation of property; and
- that no purpose of the investment is to accomplish one or more of the political and legislative purposes described in section 170(c)(2)(D) of the Code.

Thus, the IRS's evaluation of the L3C would not be affected by the classification of the L3C as "charitable" or "non-charitable" under state law. In fact, both the Treasury Regulations describing PRIs, and numerous IRS rulings, make clear that investments in non-charitable entities

¹ The IRS has established twelve criteria that must be met for an LLC to qualify for federal tax exemption under section 501(c)(3). One of the criteria is that all the members/owners of the LLC be themselves tax-exempt charities, governmental units, or wholly-owned instrumentalities of a state or political subdivision. *Internal Revenue Service Exempt Organizations Continuing Professional Education Training Text for Fiscal Year 2001*, Richard A. McCray and Ward L. Thomas, "Topic B, Limited Liability Companies As Exempt Organizations—Update."

that accomplish charitable purposes (including, importantly, LLCs), as well as investments in charitable entities, may qualify as PRIs.²

2. What safeguards and enforcement mechanisms are in place to ensure that L3Cs are not only organized for charitable purposes, but they also operate in a manner consistent with those purposes? It appears that an LLC can obtain exempt status only if it is organized exclusively for charitable purposes. The definition of an L3C does not guarantee that this requirement in IRC 501(c)(3) will be satisfied. If safeguards and enforcement mechanisms are limited, why should investments in L3Cs be entitled to any type of rebuttable presumption of compliance with applicable PRI requirements?

As noted in our response to Question 1, an L3C is not automatically, and does not seek to qualify as, a tax-exempt entity described in section 501(c)(3)—and it could not do so unless all the requirements for that status are met, as has been made clear by the IRS. Rather, it is anticipated that most, if not virtually all, L3Cs will be structured to qualify as recipients of PRIs, with both taxable and tax-exempt ownership interests. Such organizations would, themselves, be taxable entities. In every version of the state L3C legislation that has been enacted, the definition of an L3C was carefully drafted to encompass the PRI requirements set out in the Treasury Regulations.

Presently, such taxable L3Cs are subject to the same oversight mechanisms as other entities (including traditional LLCs and corporations) that receive PRIs from foundations: Before making an investment, the foundation may—but is not required to—secure a private letter ruling from the IRS, or an opinion of counsel, stating that the investment will qualify as a PRI. Once the PRI has been made, the foundation is required to exercise “expenditure responsibility” (due diligence) over the investment. This includes obtaining annual financial reports from the PRI recipient, which account for the foundation’s investment, and a statement that the PRI recipient complied with the terms of the investment.³ In addition, the foundation is required to report the PRI to the IRS on its annual information return (Form 990-PF, Part IX-B).

It is very important to understand that both the state L3C legislation and the federal legislation proposed by PRI proponents are exclusively anti-abuse measures. Neither the state nor the

² *E.g.*, Treas. Reg. § 53.4944-3(b), Ex. 5 (stating that a below-market interest loan by a private foundation to a business enterprise that is financially secure and the stock of which is traded on a national exchange, made to induce the company to establish a new plant in a deteriorated urban area, qualifies as a PRI); Priv. Ltr. Rul. 200610020 (Dec. 13, 2005) (approving as a PRI a private foundation’s contributions to a for-profit fund structured as an LLC dedicated to angel investing in low-income communities, as well as providing educational programs and technical training); Priv. Ltr. Rul. 199943044 (July 26, 1999) (approving as a PRI a private foundation’s equity investment in a for-profit business that operated in a region designated as economically depressed pursuant to an agreement that required a set percentage of the for-profit’s employees to have been previously unemployed or underemployed); Priv. Ltr. Rul. 8807048 (Nov. 23, 1987) (approving as a PRI a foundation’s purchase of a large equity interest in a company that would, through two subsidiaries, make substantial investments in new or expanding business ventures in an economically depressed region and provide small local businesses with access to debt financing).

³ *See* Treas. Reg. § 53.4945-5(b)(4).

federal legislation creates any legal benefit that does not already exist. To the contrary, both legislations create additional safeguards and enforcement mechanisms to ensure that PRIs accomplish charitable purposes. First, by enacting legislation that recognizes the low-profit limited liability company, states are creating a business form with an identifiable designation—*i.e.*, “L3C.” The presence of the “L3C” designation signals to state regulators that the entity is organized and operated to accomplish charitable or educational purposes, and regulators may implement programs or mechanisms to monitor whether these requirements are being met. Indeed, it is virtually impossible for state regulators to identify taxable entities operating under a charitable purpose unless the organizations have been formed as L3Cs.

Second, the proposed federal legislation creates a new mechanism for IRS oversight and approval of PRIs that consumes fewer IRS and foundation resources than the private letter ruling process by providing that the PRI recipient (rather than each foundation) requests IRS approval of the proposed PRI. The proposed approval process, like the current private letter ruling process, is voluntary. However, because the process is streamlined and because the PRI recipient can anticipate more funding if it has received IRS approval, the regime proposed in draft legislation should encourage voluntary requests for IRS review of these arrangements. In addition—and as described in detail in our response to Question 16—the draft federal legislation creates a mandatory reporting requirement for entities that have been approved to receive PRIs where none currently exists under either federal or state law. Thus, the federal legislation should improve both the transparency of the PRI process and the accountability of organizations that receive charitable funding by establishing a clearly-defined screening mechanism within the IRS.

Because it appears that you do not have the current draft of the federal legislation, we have enclosed a copy with this submission. As you will see, the proposed federal legislation contains no rebuttable presumption or preference for the L3C or any other entity.

3. How can one determine that the for-profit investors in the L3C venture are not receiving improper private benefit and that charitable purposes are being advanced through the L3C without, at a minimum, reviewing the members’ operating agreements?

The IRS, state regulators, and private foundations would utilize the same oversight mechanisms currently used to evaluate and monitor existing PRIs. These mechanisms are described our response to Question 2. In addition, the oversight mechanisms proposed in the draft federal legislation—the determination process and annual reporting requirement for PRI recipients (such as L3Cs)—also could illuminate private benefit and self-dealing issues. Finally, if there were a change of circumstances whereby an L3C began to serve an illegal purpose or the private purpose of its managers, such entity would cease, under the terms of the state’s L3C statute, to qualify as an L3C and would cease, by operation of the federal tax law, to qualify as a PRI. In addition, it is important to remember that any foundation or charity investment in an L3C or other PRI is still governed by the restrictions in section 4941, addressing self-dealing, or section 4958, addressing excess benefit transactions.

4. Are there any mandatory provisions that would need to be included in L3C operating agreements to ensure that for-profit interests are subordinate to the company's charitable purposes?

While the L3C operating agreement is a flexible document, such agreements should include a “charitable purpose” clause that clearly articulated a primary purpose for the L3C that comes within section 170(c)(2)(B) of the Code, as well as language prohibiting legislative or political campaign activity.

5. If a significant portion of an L3C's capital is provided by investors seeking market rates of return, how can it be said that the production of income is not a significant purpose of the L3C? Would for-profit interests have to be limited to a certain percentage of investors (i.e., 15%) to ensure that the production of income is not a significant purpose?

The L3C concept provides that the primary purpose of the organization must be charitable, with the production of income permitted to be a secondary purpose. As with a tax-exempt charity that must have a charitable purpose by law, yet also must, from an economic standpoint, have sufficient revenue to conduct operations, institutional decisions must be made with the L3C's overarching charitable purpose in mind. Thus, the L3C brings together foundations' PRIs and investments by non-exempt parties to accomplish L3C's primary charitable purpose through a business that, because of its inherent risk and low likelihood of profit, simply would not be attractive solely to for-profit investors.

Precisely the same analytic framework that applies under current law to assess the purpose and fiscal operations of a tax-exempt charity will apply to an L3C. When assessing whether a “significant purpose” of a foundation's proposed investment is the production of income for purposes of the PRI rules, the IRS finds it “relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation.”⁴ However, the fact that an investment produces significant income or appreciation does not, in the absence of other factors, is not conclusive evidence of a significant purpose involving the production of income or the appreciation of property.⁵ In fact, Treasury Regulations § 53.4944-3(b), Example 1, states, in analyzing an investment by foundation “Y,” that the investment “is a program-related investment even though Y may earn income from the investment in an amount comparable to or higher than earnings from conventional portfolio investments.”

⁴ Treas. Reg. § 53.4944-3(a)(2)(iii).

⁵ *Id.*

6. Is the L3C concept, in fact, likely to reduce transactional costs associated with PRI? How many small foundations could perform the necessary due diligence and effectively negotiate the terms of an L3C operating agreement without significant and costly assistance from legal counsel, especially if the for-profit investors are large and well-represented?

This question precisely reflects the purpose and focus of the proposed federal legislation. The L3C concept, if existing solely in state law, will do little to reduce the current transactional costs associated with a foundation making a PRI investment. Those transactional costs, primarily a result of current cumbersome and inefficient IRS administrative rulings procedures, inhibit foundations from employing their resources in socially-beneficial ways permitted under existing state and federal law. The proposed federal legislation directs the IRS to implement a process (described in our responses to Questions 2, 16, and 17) that will be a cost-efficient and far more effective process for screening proposed PRI investments

7. Not all forms of economic development or job creation are charitable. Under what circumstances are economic development projects or job creation programs considered charitable under 501(c)(3), as opposed to tax-exempt activities under 501(c)(4) or 501(c)(6), or simply business ventures that would not qualify as charitable activities?

The Treasury Regulations provide that the term “charitable” includes the promotion of social welfare by organizations designed to (1) lessen neighborhood tensions, (2) eliminate prejudice and discrimination, (3) combat community deterioration, or (4) combat juvenile delinquency.⁶ As the following examples illustrate, the IRS generally draws on these criteria when evaluating whether jobs creation and economic development activities qualify as “charitable” under section 501(c)(3).

In Revenue Ruling 70-585,⁷ a community organization was formed to plan the rehabilitation and renewal of an area in a deteriorated urban area where the median income level was lower than in other sections of the city. The organization purchased an apartment house that it planned to rehabilitate and rent to low- and moderate-income families, with preference given to residents of the area. The IRS ruled that “[s]ince the organization’s purposes and activities combat community deterioration by assisting in the rehabilitation of an old and run-down residential area, they are charitable within the meaning of section 501(c)(3) of the Code.” In the same ruling, the IRS considered an organization that was formed to construct housing facilities that would help families to secure safe and affordable homes in an area where the high cost of land, increased interest rates, and the growing population had produced a shortage of housing for moderate income families. In contrast to the first example, the IRS ruled that this organization did not qualify for exemption because its “program is not designed to provide relief to the poor or to carry out any other charitable purpose within the meaning of the Treasury Regulations applicable to section 501(c)(3).”

⁶ Treas. Reg. § 1.501(c)(3)-1(d)(2).

⁷ Rev. Rul. 70-585, 1970-2 C.B. 115.

In Revenue Ruling 74-587,⁸ the IRS it considered whether an organization formed to stimulate economic development in high-density urban areas inhabited mainly by low-income minority or other disadvantaged groups qualified as charitable. The organization provided funds and working capital to corporations or individual proprietors who were not able to obtain conventional financing because of the poor financial risks involved in establishing and operating enterprises in communities or because of their membership in minority or other disadvantaged groups. The IRS ruled that the organization was exempt under section 501(c)(3) because it (1) demonstrated that the disadvantaged residents of an impoverished area can operate businesses successfully if given the opportunity and proper guidance, (2) assisted local businesses that would provide a means of livelihood and expanded job opportunities for unemployed or underemployed area residents, and (3) helped to establish businesses in the area and rehabilitated existing businesses that had deteriorated. The IRS specifically explained:

Although some of the individuals receiving financial assistance in their business endeavors under the organization's program may not themselves qualify for charitable assistance as such, that fact does not detract from the charitable character of the organization's program. The recipients of loans and working capital in such cases are merely the instruments by which the charitable purposes are sought to be accomplished.

Thus, even though the organization did not provide financial support directly to members of a traditional charitable class, its activities still were deemed “charitable” they benefited the disadvantaged community as a whole. It is worth noting that the preceding IRS rulings have been in place and operating as effective guidance for more than 35 years.

8. Would terms of an L3C operating agreement that require the charity to cover any loss or a portion of a loss to for-profit investors seeking a “market return” on their portion of the investment result in an arrangement through which the production of income is a significant purpose? If the terms of an L3C operating agreement include a provision that requires the charity to cover a claim of lost return on investment (or otherwise provide a profit) to the for-profit investors, does that result in an arrangement through which the production of income is a significant purpose? Would the terms of an L3C operating agreement that require the charity to pledge additional assets as collateral require a capital infusion by the charity, or otherwise create a claim on the assets of the charity above the charity’s initial capital contribution be a factor in determining whether or not the production of income is a significant purpose of the L3C? In terms of an L3C operating agreement’s assignment of risk and returns among the L3C participants, what are the factors that determine whether the production of income is a significant purpose?

The response to these questions requires a technical discussion of the long-standing rules governing foundation investments in PRIs, so I apologize in advance for the inherent complexity of the analysis.

⁸ Rev. Rul. 74-587, 1974-2 C.B. 162.

It is important to understand the tax policy that has been in place since 1969 and that underlies the concept of a PRI—namely, that private interests will benefit, but in the course of deriving that benefit, a far greater public benefit will be attained through the overarching charitable purpose of the PRI. Under federal tax law, such private benefit is deemed “incidental” and regularly occurs in many charitable relationships. For example, when a student receives a scholarship to attend college, the student receives a benefit that will result in life-long personal financial return, yet the act of granting the scholarship assistance is a traditional charitable act.

In the context of a PRI, Treasury Regulations § 53.4944-3(b), Example 8, is instructive. That regulation describes a situation in which a foundation makes an appropriate PRI in the form of an equity investment in a business that subsequently experiences financial and management problems. The business is managed by a third-party under a contract that provides “broad operating authority” to the manager and compensation provisions that include a “share of the profits” and an “option to buy the stock” held by the foundation or the assets of the corporation. Most importantly for your question, the management agreement obligates the foundation to “contribute toward working capital requirements.” Viewed in the context of an agreement that provides for a profit share and right of purchase, a contractual duty to provide working capital is essentially a guarantee of an economic return to the for-profit manager. The regulation goes on to conclude that none of the terms and conditions jeopardizes the continuing treatment of the foundation’s investment as a PRI. As a consequence, the sorts of contractual provisions outlined in your questions are, in fact, legally appropriate in the context of a PRI under long-standing federal and, importantly for NASCO, state charity law by virtue of the incorporation of the private foundation excise tax regime into state law.⁹

In practice regarding foundations and PRIs, however, the foundation wields considerable authority to negotiate the terms of the L3C operating agreement because the foundation’s high-risk and low-return PRIs serve as the “financial backbone” of the entity, strengthening its balance sheet, improving its credit rating, thereby making it possible for the other investors to earn higher returns. As you note in Question 9, foundations have many worthwhile options for investing or donating their charitable assets—and foundation managers are required by law to be prudent stewards of those assets. Given these realities, it seems unlikely that a foundation would agree to an arrangement where it was subsidizing the returns to profit-seeking investors, unless such a provision was necessary to attract significant capital infusion into the socially-beneficial enterprise to achieve the charitable goals of the PRI.

The IRS does not identify a set of factors to determine whether the production of income is a significant purpose of a PRI. However, the Treasury Regulations explain that the IRS finds it “relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation.”¹⁰ For example, in Private Letter Ruling 199910066, a private foundation interested in assisting in the revitalization of blighted communities entered into a limited partnership with a limited liability company as the general partner. The partnership raised funds to use as seed capital and first stage financing for start-up

⁹ See, e.g., Colo. Rev. Stat. § 7-121-501 (2008); N.C. Gen. Stat. § 55A-1-150 (2008); Wyo. Stat. § 17-19-150.

¹⁰ Treas. Reg. § 53.4944-3(a)(2)(iii).

high technology ventures. Some of the companies in which the partnership invested would have been unable to obtain conventional financing. The funds invested by the foundation, as a limited partner, were used to invest in technology businesses that agreed to place their operations in areas of the community determined by a governmental body to be blighted or depressed. The companies had to agree that the investment could be redeemed or repaid if they failed to maintain operations in the community. Because these restrictions were imposed on the use of the foundation's invested funds, the IRS concluded that the purpose of the investment was not the production of income or the appreciation of property and that the investment qualified as a PRI.

9. Most foundations do not face a lack of demand for grants or a lack of charitable beneficiaries for purposes of meeting the 5% distribution requirement. Will the promotion of L3Cs cause foundations to shift funds from existing grants and beneficiaries and what effect would such a shift have on charities that rely on foundation support?

The decision whether to make a grant or a PRI is a “business” decision of the foundation, and neither form of charitable distribution is favored or disfavored over the other under either federal or state law; it is simply that grant-making is traditionally more common and thus more familiar to state regulators and the public. Whether a private foundation makes grants to charities or PRIs in L3Cs, charities, or other entities, the funds must be used to accomplish charitable purposes. If the PRI is in the form of a loan, the foundation eventually recovers its principal and perhaps earns interest. If the PRI is in the form of an equity investment, then the foundation may earn a return on that investment and eventually recover its capital contribution. Unlike a grant that is never recovered, PRIs may be repaid and then used by the foundation to make additional grants or PRIs. Thus, PRIs actually increase the funds available to accomplish charitable purposes over time.

We understand that charities might be concerned that private foundations will abandon grant-making in favor of making PRIs. Although it is impossible to project how foundations might array their charitable activities in the future, a significant shift away from grants is unlikely to occur, simply because of the traditional focus of many foundations on grant-oriented charity. However, your question suggests an economic analysis focused on a variation of “opportunity cost.” Viewed from that perspective, it may make more sense for a foundation to invest—rather than give away—its charitable funds because the foundation will be able to recover and redeploy the funds to accomplish additional charitable purposes in the future.

Foundations will be in the best position to determine whether their funds will have the most impact if granted or invested in a PRI. Based on the above considerations, if a foundation's charitable portfolio consists of a thoughtful mix of grants and PRIs, the foundation could actually increase its funds available to accomplish charitable purposes over time.

10. While there is a minimum distribution requirement of 5%, is there any maximum distribution limitation? Additionally, is there any prohibition against investing all the foundation's assets in PRI, no matter how risky?

Neither federal nor state law imposes a maximum limitation on a foundation's annual distributions. While both federal and state law prohibit a foundation from making investments that "jeopardize the carrying out of any of its exempt purposes,"¹¹ they do not prohibit a foundation from investing any—or all—of its assets in PRIs, which, by definition, accomplish the carrying out of the foundation's charitable purposes, and are specifically excepted from jeopardizing investment rules. Just as the current law permits a foundation to give away all of its assets in the form of grants, the current law also permits the foundation to invest those assets in PRIs.

11. What are the consequences for the foundation investors if it turns out the L3C was not properly structured to meet the IRS requirements for acceptable forms of PRI? Would the investment be treated as a jeopardizing investment, subjecting the foundations to tax penalties? Could the foundations lose their tax exempt status? What would the consequences be for the for-profit L3C investors?

If an L3C was not organized or operated to satisfy the requirements for qualifying as a PRI, the foundation's investment in the L3C would not qualify as meeting the foundation's distribution requirement and might be treated as a jeopardizing investment if the investment, in fact, jeopardized the foundation's ability to carry out its exempt purposes. The "jeopardizing investment" rules evaluate an investment in the context of the foundation's entire portfolio, and require "the foundation managers, in making the investment, [to] have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the private foundation to carry out its exempt purposes."¹²

One can envision hypothetical scenarios under which a particularly large investment fails to qualify as a PRI because of, for example, massive self-dealing, which could theoretically trigger the so-called "third tier" termination excise tax under section 507 of the Code. However, from a practical perspective, absent connivance or gross dereliction of responsibility by a foundation board, a failed PRI would not be expected to jeopardize the overall tax-exempt status of a foundation. Nor should a foundation's exempt status be threatened merely because the L3C was not structured to meet the requirements for qualifying as a PRI. Rather, the consequences to the foundation would depend on the circumstances of the investment. For example:

¹¹ See section 4944(a)(1) of the Code.

¹² Treas. Reg § 53.4944-1(a)(2)(i). "[T]he following are examples of types or methods of investment which will be closely scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence: Trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of 'puts,' 'calls,' and 'straddles,' the purchase of warrants, and selling short." *Id.*

- If the L3C failed to qualify as such because it was organized for a commercial purpose or had real profit potential, the foundation could retain its LLC interest as part of its portfolio.
- If the L3C failed to qualify as such because it was organized to accomplish a political or legislative purpose described in section 170(c)(2)(D), then the foundation's investment could be treated as a "taxable expenditure," subjecting the foundation to penalty taxes under section 4945 of the Code.

Insofar as the L3C's investors are concerned, if the L3C was not structured to qualify as such, the investors would be members in an LLC, rather than an L3C, and their investments would be treated in accordance with the LLC operating agreement.

12. Why not limit L3C participation to nonprofits or entities that are willing to accept a lower rate of financial return in exchange for accomplishing important socially beneficial purposes? Charitable foundations would be economically better off if they were not obligated to subsidize the financial returns of for-profit investors. Accordingly, market rate investors would appear to be L3C partners of last resort, brought into a venture only if the capital demands were so great it was impossible to raise adequate funding from other nonprofits or socially-conscious investors. Rather than encouraging foundations to begin their PRI efforts with capital-intensive, high risk joint ventures with for-profit partners, might it not be more appropriate to begin with more conservative approaches that are more clearly charitable and raise less potential for abuse?

This question is difficult to address because it misconstrues the concept of a PRI in a fundamental way. For example, the question recommends against "encouraging foundations to begin their PRI efforts with capital-intensive, high risk joint ventures with for-profit partners." However, this recommendation suggests the diametric opposite of a PRI, as described in the examples set forth in Treasury Regulations § 53.4944-3(b).

When describing approved PRIs, the examples in the regulations use phrases such as:

- "conventional sources of funds are unwilling or unable to provide funds...." Treas. Reg. § 53.4944-3(b), Example (1);
- "conventional sources of funds are unwilling to provide funds...at reasonable rates...." Treas. Reg. § 53.4944-3(b), Example (3);
- "conventional sources of funds are unwilling or unable to provide funds ...at reasonable rates...." Treas. Reg. § 53.4944-3(b), Example (4);
- "Y, a private foundation, makes a loan to X [a business enterprise] at an interest rate below the market rate for commercial loans of comparable risk." Treas. Reg. § 53.4944-3(b), Example (4);

- “Y, a private foundation, makes a loan to X [described as a business enterprise which is financially secure and the stock of which is listed and traded on a national exchange] at an interest rate below the market rate to induce X to establish a new plant in a deteriorated urban area which, because of the high risks involved, X would be unwilling to establish absent such inducement.” Treas. Reg. § 53.4944-3(b), Example (5); and
- “Y, a private foundation, makes a high-risk investment in low-income housing...” Treas. Reg. § 53.4944-3(b), Example (10).

In fact, all of the examples of approved PRIs in the Treasury Regulations involve risk levels that are unacceptable to normal financial investors, and all of the examples involve highly capital-intensive projects such as the construction of manufacturing plants and low-income housing.

By recommending a restriction on the longstanding rules for PRIs, which were intended to facilitate joint investments by foundations and commercial interests in a way that accomplished charitable purposes, this question proposes a dramatic retrenchment of policy decisions made by Congress in 1969 to encourage foundations to use socially-beneficial investments as one of the tools for accomplishing charitable purposes. There is simply no evidence that would support a need for revisiting a basic component of the Tax Reform Act of 1969—itsself a product of years of hearings and studies by Congress and the Treasury Department. In fact, current economic conditions suggest a need for greater deployment of foundation funds in PRIs in order to help alleviate economic and social distress.

13. The proponents of the L3C legislation have indicated that their objectives include creating and marketing securities instrument based on L3C assets, similar to mortgage-backed securities. What safeguards should be incorporated into legislation to protect the public from the market failures experienced with respect to mortgage-backed securities? What role would investment bankers play in assessing the charitable nature of the PRI or the value of the L3C social return? A fair number of financial analysts and investment bankers have a less than stellar track record at valuing straight-forward for-profit investments (in terms of rating and assessing investment risk). Given what we have witnessed in terms of valuation of financial instruments, the so-called “social return” (which does not lend itself to a lot of objective measurement) has no basis for evaluation other than self-representations of those who are parties to the transaction. In other words, are we going to trust investment bankers to provide us with an assessment of the social return? How do we measure the social return (and gauge it relative to the financial investment and risks)? If we do not assess social return, then how can we conclude that a significant purpose of the venture is not the production of income?

A number of foundations and charities are considering efforts to help alleviate the problems created by the collapse of the housing markets and the attendant social dislocation resulting from widespread foreclosures. Such efforts should be applauded and encouraged, as they reflect a positive response from the tax-exempt sector to current economic and social distress. However, as your question suggests, foundations and charities need to proceed carefully.

The proposed federal legislation provides an enforcement and oversight mechanism designed to protect the public and charitable sector from the potentially abusive practices implied by your questions. These anti-abuse measures would provide the IRS with an opportunity to screen such investments, initially through the determination process and on an ongoing basis through the audit process, as informed by the mandatory reporting requirements for approved PRIs. Because these reports would be public documents, an unprecedented amount of information about the PRI projects would be available to the public, regulators, and the media. This stands in sharp contrast to the current absence of information about PRIs, other than a brief description required to be provided by foundations on their Form 990-PF returns.

14. State regulators have traditionally had authority over charitable organizations and their assets. Given that L3Cs are intended to be predominantly charitable, how can state regulators be assured that they will have appropriate oversight over L3Cs?

The L3C legislation at the state level provides the initial basis for state regulatory oversight by creating a mechanism—that is, the “L3C” designation—through which to identify the organizations. Currently, state regulators have no systematic way to even identify commercial entities with a charitable purpose, much less to develop legally sustainable procedures for reviewing them.

Such oversight procedures would be most effectively addressed through the legislative process; however, under current law, L3C entities may be required to register with state regulators on the grounds that the entities are making “charitable appeals.” Certainly, the public information return requirement set out in the proposed federal legislation would provide a substantial amount of organizational and operational information to assist both federal and state regulators in addressing any inappropriate situations.

15. Would the IRS require L3Cs that are not single-owner entities to file separate returns as partnerships or corporations? LLCs are not recognized by the IRS as taxpaying entities and must therefore file as partnerships, proprietorships, or corporations. Under Treas. Reg. § 301.7701-3, only LLCs with a single owner may be disregarded for tax purposes.

The proposed federal legislation creates a publicly-available information return filing requirement for L3Cs and any other entities that seek determination letters from the IRS confirming that they are appropriate recipients of PRIs. Because the L3C is a type of LLC, it is subject to federal and state income tax, unless it meets the requirements that the IRS has set forth for such organizations to qualify as tax-exempt charities. Thus, the L3C would be required to file either a Form 1120 (if it elected to be taxed as a corporation) or Form 1065 (if it elected to be taxed as a partnership) with the IRS, as well as the relevant state income tax returns, in addition to the information return contemplated under the proposed federal legislation.

16. Are any proposed legislation’s reporting and disclosure requirements adequate to verify compliance with L3C requirements and to facilitate state oversight over charitable organizations and assets? The only current requirements for reporting on the program-

related investment of charitable assets in L3Cs would appear to be on Form 990 (see Schedule D, Part VIII) and Form 990-PF (see part IX-B). Neither return requires extensive detail on specific program-related investments. Is there any other current method for the IRS, the states, and the public to receive L3C-specific information from a charitable investor? Could the IRS without Congressional approval require a L3C's partnership or corporate tax filing to be made public?

The proposed federal legislation provides for a voluntary process wherein an entity seeking to receive PRIs (*e.g.*, an L3C) may request an IRS determination that foundation investments in the entity will qualify as PRIs. This process is analogous to the IRS determination process for entities seeking to qualify as tax-exempt under section 501(c)(3) and should ensure that the structure and proposed activities of the entity comply with the PRI requirements. In addition, the proposed federal legislation requires each PRI-qualified entity that has received an IRS determination to file an information return with the IRS for any taxable year in which it receives or retains one or more PRIs. The return must contain the following information about the entity:

- its gross income for the year;
- its expenses attributable to such income incurred within the year;
- its disbursements within the year for the exempt purposes of organizations holding PRIs in the entity, together with a narrative statement describing the results obtained from the use of those assets for charitable purposes;
- a balance sheet showing its assets, liabilities, and net worth as of the beginning of such year;
- a statement of the portion of its liabilities and net worth that represent capitalization obtained by means of program-related investments as of the beginning of such year;
- a statement of any interest, dividends, or other distributions paid with respect to any program-related investments during the year; and
- any other information that the IRS may require.

This information, together with the information disclosed on the foundations' Forms 990-PF, should enable the IRS to verify an L3C's compliance with the PRI requirements and facilitate oversight over the entity by state regulators.

Thus, the proposed federal legislation provides a mechanism for regulatory oversight of PRI recipients where none currently exists. Aside from the Form 990 and Form 990-PF disclosures you mention, the IRS does not currently have another method for tracking information concerning PRIs in an L3C. Further, absent a congressional amendment to the Internal Revenue Code, the

IRS could not publicly disclose—or require an L3C to disclose—the L3C’s partnership or corporate tax filings.¹³

17. Is it good public policy to shift to regulators the burden of detecting noncompliance by granting L3Cs presumptive charitable status as opposed to requiring those organizations that have received the tax benefits of charitable status to undertake the necessary due diligence to ensure their PRI complies with the law?

Rather than increase the burden on state and federal regulators, the proposed federal legislation is an anti-abuse measure designed to prevent and detect the “noncompliance” to which you refer:

- First, under the latest draft federal legislation, no entity, including any L3C, would presumptively qualify as a recipient of PRIs.
- Second, the draft federal legislation creates a new oversight and approval process at the IRS that enables entities seeking to receive PRIs (such as L3Cs) to request an IRS determination that foundation investments in the entity will qualify as PRIs. Once an entity has received an IRS determination that it qualifies as a PRI recipient, foundations would be entitled to rely on the determination when making PRIs. Although the proposed determination process, like the current private letter ruling process, is not mandatory, we believe that L3Cs and other PRI-seeking entities will voluntarily seek IRS review and approval because foundations will be more likely to make PRIs in entities that have been approved by the IRS as PRI-qualified.
- Third, as described in our response to Question 16, the draft federal legislation creates a mandatory reporting requirement for entities that receive PRIs where none currently exists.
- Finally, the federal legislation does not relieve foundations from their existing obligation to exercise due diligence and expenditure responsibility when making PRIs that have not been reviewed in advance by the IRS.

Indeed, the proposed legislation should assist state regulators in exercising their oversight function. State regulators, if they desired, could require L3Cs to submit copies of their IRS determination and information return, much as some states require charities to provide copies of their IRS determination letters and Forms 990. Thus, rather than increasing the burden on state regulators, the federal legislation should increase the transparency of the PRI process and the

¹³ See section 6103(a) of the Code (“Returns and return information shall be confidential, and except as authorized by this title—(1) no officer or employee of the United States, (2) no officer or employee of any State . . . , and (3) no other person (or officer or employee thereof) who has or had access to returns or return information . . . shall disclose any return or return information obtained by him in any manner in connection with his service as such an officer or an employee or otherwise or under the provisions of this section. For purposes of this subsection, the term “officer or employee” includes a former officer or employee.”).

accountability of organizations that receive charitable funding, thereby facilitating regulatory oversight.

18. Are special conflict of interest prohibitions necessary, or are existing Internal Revenue Code provisions sufficient, such as a prohibition on participation in a for-profit investment in an L3C by persons related to the managers of the private foundation making the PRI?

Section 4941 or section 4958 of the Internal Revenue Code, which respectively impose penalty taxes on self-dealing transactions by private foundations and excess benefit transactions by section 501(c)(3) organizations other than private foundations and section 501(c)(4) organizations, provide a remedy in such situations.

19. Is this bill really necessary? The IRS rules on PRI, 26 CFR 53.4944-3 already provides concrete examples of acceptable PRI, and LLCs are already permitted under state law. Also, how many PRIs are made each year without private letter rulings? The L3C proponents do not spend much time discussing the amount of PRI made each day without the L3C (and the corresponding success stories for environmental investment and affordable housing). A quick examination of the top 100 private foundations would seem to suggest that creating L3Cs as a mechanism to help “the big guys” is not really necessary. Similarly, the L3C as a mechanism to help “the little guys” seems illusory. Might it not be the case that many of those who seek private letter rulings do so not because they are concerned about the need for a private letter ruling, but because their particular planned investment may push the envelope of acceptable PRI and may raise the potential legal issues?

PRIs have existed since 1969 and there are numerous examples in the Treasury Regulations and rulings of approved PRIs—including PRIs in limited liability companies. Thus, as a technical matter, one could create the “effect” of an L3C by forming up an LLC and ensuring that its operating agreement and activities satisfy the requirements in Treasury Regulations § 53.4944-3. However, there would be no IRS screening mechanism or public information return filing requirement in the absence of the proposed federal legislation. These procedures would help ensure that foundation and charity investments in PRIs are appropriate and accomplish charitable purposes.

In addition, the L3C legislation and draft PRI legislation is designed to help facilitate PRIs and, accordingly, the flow of capital from foundations to organizations providing charitable services to the community—a particularly important objective in the current economy. While your question assumes that foundations (in particular, “the big guys”) make significant PRIs, recent data reveal that the opposite may be true. According to a survey of more than 72,000 independent, corporate, operating, and community foundations, qualifying distributions in 2006 were approximately \$43 billion. PRIs accounted for only \$310.5 million (0.72%) of these qualifying distributions.¹⁴ 88% of the 2006 PRIs were made by independent and corporate foundations.

¹⁴ The Foundation Center, *Aggregate Fiscal Data by Foundation Type, 2006* (published in 2008), available at http://foundationcenter.org/findfunders/statistics/pdf/01_found_fin_data/2006/02_06.pdf.

However, even for these organizations, PRIs accounted for only 0.81% of their total qualifying distributions. What the statistics do show is that foundations of all sizes are simply not using the full array of tools available to them under federal and state law to accomplish their charitable missions, and, in particular, are not utilizing the PRI concept to enlist resources from the taxable sector to leverage charitable dollars in furtherance of those goals.

We are not aware of any statistics showing how many of these PRIs are made with, or without, out a private letter ruling; however, we note that all private letter rulings involving PRIs must be publicly released under section 6110 of the Code, and relatively few such rulings have been so released.¹⁵ We do understand, however, that the disproportionately low number of PRIs relative to grants is caused in part by foundations' perception that the transaction costs associated with making PRIs are quite high. Given the fiduciary obligations imposed on foundation managers by state and federal laws, it is highly improbable that a foundation would deliberately avoid seeking a private letter ruling because it feared that its proposed investment would not be approved by the IRS as a PRI. It is far more likely that the time and expense associated with seeking a private letter ruling (time spent by counsel preparing the request, plus an \$8,700 IRS user fee, plus a wait of up to a year to receive the ruling) deter foundations from making PRIs.

20. If there is no federal legislation or change in IRS policy concerning PRI and L3Cs, does state L3C legislation serve any purpose?

Yes. The incorporation of the L3C concept into LLC statutes at the state level provides a consistent legal structure for socially-beneficial enterprises and a means, through the "L3C" designation, for the public, regulators and grant-makers to identify them. Without such statutes in place, regulators would have no ability to identify such enterprises and determine whether or not they should register under state charitable solicitation rules or other regulatory regimes.

¹⁵ According to our research, the IRS has released between 20 and 25 rulings addressing PRIs during the past 10 years.

An Act

Be it enacted by the Senate and the House of Representatives of the United States of America in Congress assembled,

SEC. 1. SHORT TITLE AND TABLE OF CONTENTS.

(a) SHORT TITLE.-This Act may be cited as the “Program-Related Investment Promotion Act of 2009.”

(b) TABLE OF CONTENTS.-The table of contents for this Act is as follows:

- Sec. 1. Short title and table of contents.
- Sec. 2. Promotion of program-related investments.
- Sec. 3. Declaratory judgment remedy
- Sec. 4. Information returns
- Sec. 5. Publicity of information
- Sec. 6. Conforming amendments.
- Sec. 7. Effective date.

SEC. 2. PROMOTION OF PROGRAM-RELATED INVESTMENTS.

Section 4944(c) is amended to read as follows:

“(c) PROGRAM-RELATED INVESTMENTS.-

“(1) TREATMENT OF PROGRAM-RELATED INVESTMENTS.-For purposes of this subchapter, program-related investments:

“(A) are not investments which jeopardize the carrying out of exempt purposes;

“(B) are qualifying distributions under section 4942; and

“(C) are not business holdings under section 4943.

“(2) DEFINITION OF PROGRAM-RELATED INVESTMENT.-For purposes of this subchapter and of chapter 61, an investment made by a private foundation constitutes a program-related investment if:

“(A) the primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B), and

“(B) no significant purpose of the investment is the production of income or the appreciation of property.

Determinations of whether an investment qualifies as a program-related investment shall be based on consideration of all relevant facts and circumstances.

“(3) **SAFE HARBOR DETERMINATIONS.**—The Secretary shall establish a procedure under which an entity seeking to receive program-related investments may petition the Secretary for a determination that below market rate investments by private foundations in such entity will be program-related investments meeting the requirements of paragraph (2). Under this procedure, the Secretary shall rule on all requests within 90 days of submission.

“(4) **EFFECT OF DETERMINATION.**—Once a determination has been made that below market rate investments in an entity qualify as program-related investments, organizations making such investments shall be entitled to rely on the determination, unless and until the Secretary publishes notice of revocation of the determination.

“(5) **VOLUNTARY NATURE OF THE PROCESS.**—Entities seeking program-related investments are not required to seek a determination under paragraph (3) and the absence of such a determination shall not affect the ability of a private foundation to make a program-related investment based on its own determination that the investment qualifies as a program-related investment.

“(6) **ORGANIZATIONS TREATED AS PRIVATE FOUNDATIONS.**—For purposes of this subsection and section 6104A, all references to private foundations include organizations that are treated as private foundations under any of the provisions of sections 4940 through 4948, inclusive, whether created under state law or the law of any federally-recognized tribe.

“(7) **BELOW MARKET RATE INVESTMENT.**—For purposes of this subsection, a below market rate investment is an investment that would be unlikely to be made on the same terms by an investor engaged in the investment solely for profit.”.

SEC. 3. DECLARATORY JUDGMENT REMEDY.

Section 7428(a)(1) is amended by striking “or” at the end of subparagraph (D) and by adding after subparagraph (D) the following new subparagraph:

"(E) with respect to whether investments in an entity are program-related investments (as described in section 4944(c)(2)), or"

SEC. 4. INFORMATION RETURNS.

Part III of subchapter A of chapter 61 of the Internal Revenue Code shall be amended by inserting after section 6033 the following new section:

“SEC. 6033A. INFORMATION REPORTING BY FOR-PROFIT ORGANIZATIONS RECEIVING PROGRAM-RELATED INVESTMENTS.

“(a) **ORGANIZATIONS REQUIRED TO FILE.**—Any for-profit organization investments in which have been determined to be program-related investments through a determination of the Internal Revenue Service pursuant to section 4944(c)(3), or by a determination of a court pursuant to section 7428(a), shall, in addition to any other applicable filing obligations, file an annual return providing the information specified in subsection (b) for any taxable year in which it receives or retains one or more program-related investments, as defined in section 4944(c)(2).

“(b) **REQUIRED REPORTING.**—The return described in subsection (a) shall provide, in such manner and at such time as the Secretary may by forms or regulations prescribe, the following information-

“(1) the organization's gross income for the year;

“(2) its expenses attributable to such income incurred within the year;

“(3) its disbursements within the year for the exempt purposes of the organizations holding program-related investments in the organization, together with a narrative statement describing the results obtained from the use of those assets for charitable purposes;

“(4) a balance sheet showing its assets, liabilities, and net worth as of the beginning of such year;

“(5) a statement of the portion of its liabilities and net worth that represent capitalization obtained by means of program-related investments as of the beginning of such year;

“(6) a statement of any interest, dividends, or other distributions paid with respect to any program-related investments during the year;

“(7) such other information as the Secretary may by forms or regulations prescribe.”.

SEC. 5. PUBLICITY OF INFORMATION.

Subchapter B of chapter 61 of the Internal Revenue Code is amended by inserting after section 6104 the following new section:

“SEC. 6104A. PUBLICITY OF INFORMATION REGARDING ORGANIZATIONS RECEIVING PROGRAM-RELATED INVESTMENTS.

“(a) **INSPECTION OF PETITIONS FOR DETERMINATION OF PROGRAM-RELATED INVESTMENT STATUS.**—If an organization seeks a determination pursuant to section 4944(c)(3) that investments

by private foundations in such organization will be program-related investments, the petition seeking such a determination, together with any documents submitted in support of such petition, and any determination or other document issued by the Internal Revenue Service with respect to such petition shall be open to public inspection at the national office of the Internal Revenue Service.

“(b) INSPECTION OF ANNUAL INFORMATION RETURNS.—The information required to be furnished by section 6033A shall be made available to the public at such times and in such places as the Secretary may prescribe.

“(c) PUBLIC INSPECTION OF PETITIONS AND ANNUAL RETURNS.—Any organization that receives a determination from the Internal Revenue Service that private foundation investments shall be program-related investments pursuant to section 4944(c)(3) shall make copies available at the organization's principal office, during regular business hours, of the petition for such determination (together with supporting materials provided with the petition and documents issued by the Internal Revenue Service with respect to such petition), as well as the annual returns required by section 6033A filed by such organization. Upon request of an individual made at such principal office, copies of such petition materials and annual reports shall be provided to such individual without charge other than a reasonable fee for any reproduction and mailing costs. The inspection and duplication rights granted in this subsection shall apply to an annual return only during the three-year period beginning on the last day prescribed for filing such return (determined with regard to any extension of time for filing).”.

SEC. 6. CONFORMING AMENDMENTS.

(a) Paragraph (4)(A) of section 501(n) is amended by inserting “paragraph (2) of” before “section 4944(c).”

(b) Paragraph (1) of section 514(b) is amended by redesignating subparagraphs (D) and (E) as subparagraphs (F) and (G) and by inserting after subparagraph (C) the following new subparagraph:

“(D) any property owned or treated as owned by a private foundation by virtue of its having made a below market rate investment (within the meaning of section 4944(c)(7)) in an entity that has received a determination from the Internal Revenue Service pursuant to section 4944(c)(3), or by a court pursuant to section 7428(a), that below market rate investments in such entity qualify as program-related investments;”

(c) Paragraph (1) of section 4942(g) is amended by striking “or” at the end of subparagraph (A), by redesignating subparagraph (B) as subparagraph (C) and by inserting after subparagraph (A) the following new subparagraph:

“(B) any program-related investment, as defined in paragraph (2) of section 4944(c), or”

(d) Paragraph (3) of section 4943(d) is amended by striking “or” at the end of subparagraph (A), by redesignating subparagraph (B) as subparagraph (C) and by inserting after subparagraph (A) the following new subparagraph:

“(B) any program-related investment, as defined in paragraph (2) of section 4944(c), or”

SEC. 7. EFFECTIVE DATE.

The amendments made by this Act shall be effective as to investments made and returns filed for tax years beginning after December 31, 2008.