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# INTRODUCING THE LOW-PROFIT LIMITED LIABILITY COMPANY (L<sup>3</sup>C): THE NEW KID ON THE BLOCK\*

*Cody Vitello\*\**

## *Introduction*

There is an old Chinese proverb that donors have used to distinguish charity from philanthropy: "Give a man a fish and you feed him for a day. Teach a man to fish and you feed him for a lifetime."<sup>1</sup> The rules that govern charitable organizations, however, constrain philanthropists from teaching their organizations how to fish. In order to address this problem, the low-profit limited liability company ("L<sup>3</sup>C") was designed to create a legally recognized entity that accounts for the best aspects of the for-profit and nonprofit sectors by balancing a charitable purpose with an adequate capitalization structure. By doing so, consumers may benefit from a benevolent organization which serves the public while operating with more financial security and predictability than what otherwise may exist. This Article analyzes the emergence of this new corporate structure.

This Article is broken into several sections. Part I provides the general background of the L<sup>3</sup>C by analyzing how philanthropists have traditionally worked with nonprofit and for-profit companies. Part II discusses the structural makeup of L<sup>3</sup>Cs while Part III discusses the different ways to form L<sup>3</sup>Cs. Finally, Part IV will provide future insights and expose some potential uncertainties of the L<sup>3</sup>C.

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<sup>1</sup> James P. Joseph & Andras Kosaras, *New Strategies for Leveraging Foundation Assets*, 20 TAX'N OF EXEMPTS, July/Aug. 2008, at 22, 29.

*I. Paving the Way for the L<sup>3</sup>C*

A brief analysis of nonprofit and for-profit companies is essential to understanding the evolution of the L<sup>3</sup>C. In 2008, the Internal Revenue Service (“IRS”) estimated that roughly 1.8 million domestic nonprofit corporations (“nonprofits”) were in existence.<sup>2</sup> Nonprofits are exempt from federal income taxation if organized and operated exclusively for one or more of the following purposes: religious, charitable, scientific, public safety testing, literary, educational, fostering certain amateur sporting competitions, and the prevention of cruelty to children or animals.<sup>3</sup> Although nonprofits can earn money, they are limited as to how these profits can be earned and spent.<sup>4</sup> For all intents and purposes, a nonprofit earns income with an annual rate of return of zero to negative 100%.<sup>5</sup>

As a result of a nonprofit’s total lack of return on investment, they seek donations and grants from the philanthropic marketplace by appealing to donors’ emotions and the tax deductions these gifts provide the donors.<sup>6</sup> To generate more capital, many nonprofits also attempt to create for-profit subsidiaries that are tied to a different industry;<sup>7</sup> however, the profits derived from these subsidiaries are bogged down by strict regulations.<sup>8</sup> Because of these deficiencies, an estimated one-third of all nonprofits fail within their first five years and another one-third operate in a zone of insolvency – meaning the company’s liabilities exceed its assets.<sup>9</sup> Therefore, while nonprofits may promote high social value, they operate in an overly-saturated and regulated marketplace, resulting in constant funding shortages.

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<sup>2</sup> Gene Takagi & Emily Chan, *Alternatives to Forming a Charitable Nonprofit: A Start-Up May Not Be in Your Client’s Best Interests*, 18 AUG. BUS. L. TODAY 15, 16 (2009).

<sup>3</sup> IRS, Publication 557: Tax Exempt Status for Your Organization (Oct. 2010), available at <http://apps3.irs.gov/pub/irs-pdf/p557.pdf>.

<sup>4</sup> *Id.*; Am. for Cmty. Dev., THE L<sup>3</sup>C: THE FOR PROFIT WITH THE NONPROFIT SOUL 2 (2008) [hereinafter *Americans*], available at [http://americansforcommunitydevelopment.org/supportingdownloads/Introducing\\_the\\_L3C.ppt](http://americansforcommunitydevelopment.org/supportingdownloads/Introducing_the_L3C.ppt).

<sup>5</sup> *Id.* at 2.

<sup>6</sup> James E. Austin et al., *Capitalizing on Convergence*, STAN. SOC. INNOVATION R., Winter 2007, at 24, 30, available at [http://www.ssireview.org/images/articles/2007WI\\_feature\\_austinetal.pdf](http://www.ssireview.org/images/articles/2007WI_feature_austinetal.pdf).

<sup>7</sup> *Id.* at 29.

<sup>8</sup> Takagi & Chan, *supra* note 2, at 15.

<sup>9</sup> *Id.*

Conversely, for-profit companies must earn an acceptable market rate of return in order to attract investors – generally 5% or more per annum.<sup>10</sup> Within such corporations, shareholder interest must be the top priority because managers are legally obligated to run the business in a manner that maximizes shareholder value.<sup>11</sup> Consequently, for-profit companies cannot easily pursue many charitable purposes due to their total lack of acceptable profitability.

Similarly, Limited Liability Companies (“LLCs”), except under special circumstances, are organized as for-profit companies and must earn a normal rate of return. LLCs offer the protection of a corporation<sup>12</sup> (the members of the LLC are not personally liable for the debts of the company<sup>13</sup>) and the flexibility of a partnership<sup>14</sup> (members can elect to be taxed together as a corporation or individually according to their own personal tax status<sup>15</sup>). LLCs, however, are fundamentally distinguishable from corporations insofar as they may be organized for any lawful purpose, whereas a corporation must be organized for any lawful *business* purpose.<sup>16</sup> The significance of this distinction is considerable and is discussed *infra*.

LLCs can be organized for charitable purposes<sup>17</sup> (circumventing the member interest priority inherent in corporations) by altering their operating agreements. Therefore, an LLC does not have to put its shareholders’ interests above all else. To withstand the potential for undercapitalization, LLCs can have multiple classes of members, each with a different vested interest in the company, and each with a different form of capital return and tax consequence.<sup>18</sup> In fact, the IRS has

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<sup>10</sup> Americans, *supra* note 4, at 2.

<sup>11</sup> Robert M. Lang, Jr., *The L3C: The New Way to Organize Socially Responsible and Mission Driven Organizations*, SN036 ALI-ABA 251, 255 (2007).

<sup>12</sup> *Id.*

<sup>13</sup> In actuality there are situations when members of an LLC, just as certain owners of corporations, may be held liable for the debts of the company. This process is referred to as “piercing the LLC/corporate veil” and is beyond the scope of this article.

<sup>14</sup> Lang, *supra* note 11, at 255.

<sup>15</sup> *Id.*; Rev. Rul. 2004-51, 2004-1 C.B. 974.

<sup>16</sup> Larry E. Ribstein, *Formation of Limited Liability Company*, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 4:10 (2009).

<sup>17</sup> An LLC that is organized to further a charitable purpose does not create a nonprofit corporation that is eligible for 501(c)(3) tax exempt status.

<sup>18</sup> Lang, *supra* note 11, at 256.

recognized de facto L<sup>3</sup>Cs (disguised as complex subsidiary LLCs) for some time.<sup>19</sup> An example of this type of legal structure typically consists of a joint venture between a nonprofit company and a for-profit company, each owning a share in an LLC that pursues a socially beneficial purpose but may not generate substantial revenues. The nonprofit parent contributes capital while the for-profit parent company then manages the LLC and returns any and all profits to itself to avoid forfeiting the nonprofit parent company's tax exemption status.<sup>20</sup>

Theoretically, business organizations like the one just described can accomplish the same goals of an L<sup>3</sup>C, but are often too complex to organize and manage effectively. Not only is it difficult to create a company that pursues a charitable purpose efficiently in the zone between nonprofits and for-profit companies, there is no forward outside public recognition of such companies. Therefore, there is no effective way to attract outside investment from other nonprofit corporations, foundations, charities, companies, or other entities. Essentially, this business structure suffers from a branding problem on the outside and an efficiency problem on the inside. The stage has therefore been set to create a business organization that has the heart of a nonprofit corporation and the vitality of a for-profit corporation.

## *II. The Structural Makeup of the L<sup>3</sup>C*

Understanding some of the more intricate mechanics of the L<sup>3</sup>C, and what makes it attractive as a form of business entity, is necessary to understand the magnitude of the potential positive impact L<sup>3</sup>Cs may have on the philanthropic market and how consumers make take advantage of, and benefit from, these entities. This section of the Article is broken up into four parts: Part A will discuss the legal structure of forming an L<sup>3</sup>C; Part B will discuss program related investments and how they are inextricably linked to the success of the L<sup>3</sup>C; Part C will analyze potential capital structures of L<sup>3</sup>Cs; and Part D will summarize some of the tax implications of L<sup>3</sup>Cs.

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<sup>19</sup> See Rev. Rul. 2004-51, 2004-1 C.B. 974.

<sup>20</sup> Keep in mind the reason this form of LLC can return a profit is because the company is subsidized by the nonprofit parent company. The profit that is generated is not enough to provide a normal rate of return to both parent companies.

### A. Legal Structure

L<sup>3</sup>Cs are a specialized form of the traditional LLC. They offer the protection of a corporation and the flexibility of a partnership, but are explicitly formed to “further a socially beneficial mission and [to] qualify as a Program Related Investment [(“PRI”)] for foundation partners.”<sup>21</sup> Like a traditional LLC, L<sup>3</sup>Cs may operate with a board, officers, and members.<sup>22</sup> However, L<sup>3</sup>Cs must differentiate and layer their owners or members to create separate vested interests in the L<sup>3</sup>C and thereby induce the proper market return. Thus, “each operating agreement can be tailored to meet each member’s own particular needs – profits [and losses] may be allocated in proportions that are different from capital contributions.”<sup>23</sup> Moreover, once organized in an allowing state, an L<sup>3</sup>C will be recognized in all fifty states, U.S. Territories, and many foreign countries.<sup>24</sup>

Statutorily, L<sup>3</sup>Cs have three main pillars: (1) they must be organized to accomplish a charitable purpose; (2) they must not be created primarily to accumulate property or earn a profit; and (3) they must not be created to further any political or legislative objective. The legal structure of L<sup>3</sup>Cs is actually modeled after section 4944(c) of the Internal Revenue Code (the “Code”) and intended to provide foundations with a business entity to which they can safely make PRIs without jeopardizing their exempt status.<sup>25</sup>

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<sup>21</sup> Americans, *supra* note 4, at 4.

<sup>22</sup> *Id.* at 21. For more information regarding the legal structure of an L<sup>3</sup>C refer to one of two L<sup>3</sup>C operating agreements on the Americans for Community Development website, *available at* <http://americansforcommunitydevelopment.org/supportingdownloads/L3COperatingAgreement.pdf>, and [http://americansforcommunitydevelopment.org/supportingdownloads/L3C\\_Prototype\\_Operating\\_Agreement.pdf](http://americansforcommunitydevelopment.org/supportingdownloads/L3C_Prototype_Operating_Agreement.pdf).

<sup>23</sup> Americans, *supra* note 4, at 10.

<sup>24</sup> Lang, *supra* note 11, at 256. “L<sup>3</sup>Cs can file in any of the . . . states that have passed legislation to establish the entity, and then can file as a foreign corporate entity in the state in which they are based, similar to Delaware corporations.” Mark Hrywna, *The L3C Status: Groups Explore Structure that Limits Liability for Program-Related Investing*, THE NONPROFIT TIMES, Sept. 1, 2009, at 2, *available at* [http://www.intersectorl3c.com/goopages/pages\\_downloadgallery/download.php?filename=8139\\_8859156.pdf&orig\\_name=20090901\\_Nonprofit\\_Times\\_Article.pdf](http://www.intersectorl3c.com/goopages/pages_downloadgallery/download.php?filename=8139_8859156.pdf&orig_name=20090901_Nonprofit_Times_Article.pdf).

<sup>25</sup> See I.R.C. § 4944(c) (2006).

## B. Program Related Investments

PRIs are a hybrid between investments and grants.<sup>26</sup> They are made with the primary purpose of accomplishing a charitable goal;<sup>27</sup> additionally, section 4942 of the Code requires private foundations to pay out at least 5% of their net investment income annually in “qualifying distributions” in order to maintain their exempt status.<sup>28</sup> Failing to make qualifying distributions in excess of 5% of the foundation’s net investment income will subject the foundation to a penalty tax.<sup>29</sup> Like grants, PRIs are qualifying distributions and therefore fulfill the foundation’s 5% goal when made.<sup>30</sup> But unlike grants, PRIs may be structured in ways other than gifts. PRIs also have the potential to reduce a foundation’s excise tax rate.<sup>31</sup> Thus, foundations have a large incentive to distribute PRIs whenever possible.

Because PRIs and L<sup>3</sup>Cs are composed of the same statutory requirements, L<sup>3</sup>Cs are immediately attractive to foundations that need to make PRIs.<sup>32</sup> Additionally, L<sup>3</sup>Cs are identifiable companies that have social missions that also may qualify as PRIs.<sup>33</sup> For example, PRIs may be: below-market-rate loans, loan guarantees, low-cost leases, letters of credit, deposits in a community development bank that lends to a specific class, or equity investments.<sup>34</sup> Rather than giving a grant as a gift, foundations can invest wholeheartedly in an L<sup>3</sup>C as a PRI and maintain a relationship with the investment, nurturing it and

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<sup>26</sup> Joseph & Kosaras, *supra* note 1, at 22.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 23; see I.R.C. § 4942.

<sup>29</sup> Joseph & Kosaras, *supra* note 1, at 23.

<sup>30</sup> *Id.* at 22.

<sup>31</sup> *Id.* at 23.

<sup>32</sup> In fact, Robert Lang, the CEO of the Mary Elizabeth & Gordon Mannweiler Foundation, first conjugated the idea of the L<sup>3</sup>C by envisioning a legal entity that automatically qualified as a PRI. *Id.* at 29. Lang was the driving force behind Vermont to pass the first L<sup>3</sup>C legislation and continues to be a big promoter in helping more L<sup>3</sup>Cs get off the ground. COMTY. WEALTH VENTURES, INC., THE L3C: LOW-PROFIT LIMITED LIABILITY COMPANY RESEARCH BRIEF 2 (2008) [hereinafter RESEARCH BRIEF], available at <http://www.americansforcommunitydevelopment.org/supportingdownloads/CWVBrief-Updated.pdf>.

<sup>33</sup> Doug Batey, *Low-Profit LLCs – The Newest Limited Liability Company Structure*, LLC LAW MONITOR, Aug. 21, 2009, available at <http://www.llclawmonitor.com/2009/08/articles/lowprofit-llcs/lowprofit-llcs-the-newest-limited-liability-company-structure/>.

<sup>34</sup> Joseph & Kosaras, *supra* note 1, at 23; Lang, *supra* note 11, at 254.

potentially receiving their money and a little profit back only to initiate the process again, potentially into perpetuity all while still maintaining their primary charitable purpose.<sup>35</sup> Consequently, PRIs are very beneficial to both the foundation and the recipient.

### C. Capital Structure

L<sup>3</sup>Cs occupy a niche between for-profit and nonprofit corporations, averaging profits ranging from 0 to 5%.<sup>36</sup> In order for an L<sup>3</sup>C to become financially successful it must attract a sufficient amount of investors or members who are willing to forego normal profit returns in lieu of a social return – that is, investors who will derive a measurable marginal benefit by investing in a company that accomplishes a charitable purpose. It is this concept that allows L<sup>3</sup>Cs to operate a business that, under normal market influences, may fail for a lack of capital.

L<sup>3</sup>Cs can also attract regular for-profit investors if the company has its members' investments layered, or tranching. Tranching investments are layered vested member ownership interests within the L<sup>3</sup>C. Simplified, tranching investments involve different classes of investors that can be structured any way the L<sup>3</sup>C's members want.<sup>37</sup> To illustrate, an L<sup>3</sup>C may have three tranches: (1) an Equity Tranche, composed primarily of foundation investors contributing grants or PRIs and carrying the most risk, paid last (subordinated to all other tranches), and returning the lowest rate of return (e.g., 1%); (2) the Mezzanine Tranche, reserved for socially-minded investors composed of corporations, trusts, banks seeking to fulfill their Community Reinvestment Act obligations, or other individual investors seeking to fulfill goodwill by carrying the middle amount of risk, paid second (subordinated only to the Senior Tranche), and returning between 0 and 5% returns (e.g., 3%); and (3) the Senior Tranche, composed of market-driven investors, pension funds, or others requiring a safe and average investment carrying the least amount of risk (AAA investment grade rating), paid first, and returning the largest annual return (e.g., 6%).<sup>38</sup> For example, if the Equity Tranche makes up 25% of a hypothetical L<sup>3</sup>C

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<sup>35</sup> TOM MOODY, THE L3C – FACILITATING SOCIALLY BENEFICIAL INVESTING, 2 (2008), available at <http://www.proctorconsulting.org/documents/L3CArticle-Moody.pdf>.

<sup>36</sup> RESEARCH BRIEF, *supra* note 32, at 1.

<sup>37</sup> Americans, *supra* note 4, at 11.

<sup>38</sup> *Id.* at 14.



structure, the Mezzanine Tranche another 25%, and the Senior Tranche the remaining 50%, then the blended rate of return is 4% (and well within the initial target range of 0-5%).

Another possible way to layer an L<sup>3</sup>C's capital structure would be to maintain the 25-25-50% (Equity-Mezzanine-Senior Tranches, respectively) tranche ratios and compose the Equity Tranche with development agencies and other governmental partners who will accept a 0% return, essentially making a grant; foundation PRIs will occupy the Mezzanine Tranche, receiving a 2% annual return; and finally, the market driven investors will receive a 7% return.<sup>39</sup> Again, here the L<sup>3</sup>C has a blended rate of 4%, but the foundation investors receive a slightly higher rate of return. Lastly, an L<sup>3</sup>C with a 15-35-50% split may provide the Equity Tranche with 15% ownership rights and the potential to get an annual return if the L<sup>3</sup>C's profits exceed 6% of total capital; the Mezzanine Tranche will be composed of foundation investors receiving a 3% return; and the Senior Tranche will secure a 6% return releasing all excess profits to the Equity Tranche investors.<sup>40</sup> This latter model provides foundation investors with even a higher rate of return while still maintaining market rates of return for the average investor. These examples highlight just a few of the nearly endless amount of capital structures available to L<sup>3</sup>Cs.

This type of member ownership structure ensures that those investing in the L<sup>3</sup>C will have a chance to take control of their funds and manage accordingly.<sup>41</sup> No longer will donors escape adverse publicity if the company strays away from its charter by pleading ignorance.<sup>42</sup> Owners will have an incentive to manage effectively and achieve the company's charitable goals without risking the chance of a complacent perpetual board of directors.<sup>43</sup>

From a macro perspective, L<sup>3</sup>Cs may yield even larger gains by securitizing their PRI interests. Currently, PRIs are made on a one-on-one basis between the donor and the company.<sup>44</sup> By securitizing the PRI interests in L<sup>3</sup>Cs, the costs of procuring ownership shares could be diminished. Marketing L<sup>3</sup>C securities on a primary and secondary market could revolutionize

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<sup>39</sup> *Id.* at 15.

<sup>40</sup> *Id.* at 16.

<sup>41</sup> Lang, *supra* note 11, at 257.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* at 258.

the way PRIs are bought and sold.<sup>45</sup> L<sup>3</sup>C securities could be packaged with other bonds, options, loans, convertibles, or placed in a group of similar themed investments and made into a mutual fund.<sup>46</sup> Not only would this allow small foundations and everyday consumers to become involved in projects that would normally be too big for them, but all involved may generate a small rate of return.<sup>47</sup> The marketability and transactional ease of L<sup>3</sup>C securities would reduce barriers to entry and transaction costs for all investor types. This could enable average consumers to invest in a variety of socially beneficial enterprises with great simplicity.

#### D. Tax Implications

L<sup>3</sup>Cs are technically for-profit ventures and will have to pay property, state, and federal income taxes,<sup>48</sup> unless they meet the IRS's requirements to qualify as a tax-exempt entity.<sup>49</sup> As a form of LLC,<sup>50</sup> an L<sup>3</sup>C can either elect to be taxed as a corporation and file Form 1120, or be taxed as a partnership and file Form 1065.<sup>51</sup> L<sup>3</sup>Cs are normally conduit entities likened to a partnership, meaning as far as tax consequences go, the income distributed to each member will be taxed in the same way that member is usually taxed on its individual income tax return.<sup>52</sup> Because L<sup>3</sup>C members may receive a rate of return different from the ratio of their capital contribution, members avoid forfeiting their current tax-exempt status when investing in an L<sup>3</sup>C. In order to retain such benefits, "[t]he L<sup>3</sup>C's operating agreement specifically outlines the PRI-qualified purpose for which it's being formed, helping ensure that the nonprofit partner's tax exempt [sic] status is secure."<sup>53</sup> However, due to the low-profit

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<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> Lang, *supra* note 11, at 262.

<sup>49</sup> Letter from Marcus S. Owens, Partner, Caplin & Drysdale, Chartered, to Nat'l Ass'n for State Charity Officials (NASCO), 12 (Apr. 17, 2009) [hereinafter NASCO], available at <http://americansforcommunitydevelopment.org/downloads/nascoQ-A.pdf>.

<sup>50</sup> Elizabeth C. Minnigh, *Low-Profit Limited Liability Companies: An Unlikely Marriage of For-Profit Entities and Private Foundations*, TAX MGM'T ESTATES, GIFTS AND TRUSTS J., Sept. 10, 2009, at 7, available at <http://americansforcommunitydevelopment.org/downloads/MinnighPDFArtic.pdf>.

<sup>51</sup> NASCO, *supra* note 49, at 12.

<sup>52</sup> Lang, *supra* note 11, at 262.

<sup>53</sup> Americans, *supra* note 4, at 8.

nature of the L<sup>3</sup>C, the income tax consequences that materialize are unlikely to be significant.

It should be noted that in the event the L<sup>3</sup>C's organization is improper, then it will cease to exist as an L<sup>3</sup>C and continue as a traditional LLC.<sup>54</sup> Alarming, an L<sup>3</sup>C with an improper charter, failing to meet the PRI requirements, may be considered a jeopardizing investment by a foundation and may forfeit an investing foundation's tax-exempt status.<sup>55</sup> This process is looked at in the context of the foundation's entire portfolio and requires the foundation managers to have failed to exercise ordinary business care.<sup>56</sup> Consequently, "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."<sup>57</sup>

### III. L<sup>3</sup>Cs in Action

By August 20, 2009, over sixty L<sup>3</sup>Cs had been formed in Vermont alone – the first state to create L<sup>3</sup>C-enabling legislation.<sup>58</sup> L<sup>3</sup>Cs can be created in a variety of ways, but four stand out: (1) newly created L<sup>3</sup>Cs; (2) existing entities that reorganize and convert to L<sup>3</sup>Cs; (3) L<sup>3</sup>Cs that are created as a subsidiary of an existing entity; and (4) the creation of social and charitable-centered investment vehicles or private equity funds.<sup>59</sup>

Newly created L<sup>3</sup>Cs are likely to be created by many existing organizations as their operations expand.<sup>60</sup> For example, the National Cancer Coalition is planning on operating a clinic in Paraguay to offer low-cost, early-detection cancer treatment for women.<sup>61</sup> Similarly, the Montana Food Bank is in the process of forming an L<sup>3</sup>C that offers training to Montana prisoners and access to food processing plants for Montana farmers to deliver fresh, local food to Montana grocery stores.<sup>62</sup> If either of these proposed L<sup>3</sup>Cs makes a profit they can funnel the money back into the mission or donate it as a grant back to the foundations

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<sup>54</sup> NASCO, *supra* note 49, at 9-10.

<sup>55</sup> *Id.*

<sup>56</sup> See Treas. Reg. § 53.4944-1(a)(2)(i).

<sup>57</sup> NASCO, *supra* note 49, at 9-10.

<sup>58</sup> Batey, *supra* note 33.

<sup>59</sup> MOODY, *supra* note 35, at 3.

<sup>60</sup> *Id.*

<sup>61</sup> RESEARCH BRIEF, *supra* note 32, at 2.

<sup>62</sup> *Id.* at 3.

that originally provided the capital.<sup>63</sup>

Converting an existing business into an L<sup>3</sup>C is predicted to be less common for existing for-profit or nonprofit corporations that think they can attract more capital as an L<sup>3</sup>C.<sup>64</sup> A conversion can be accomplished by merging the existing entity into an L<sup>3</sup>C.<sup>65</sup> This process is simplest when an existing LLC becomes an L<sup>3</sup>C by, after a member vote, changing its charter and filing status.<sup>66</sup> Similarly, a partnership wishing to convert into an L<sup>3</sup>C must first convert into an LLC and then complete the process by amending its charter.<sup>67</sup> Converting an S-Corporation or C-Corporation into an L<sup>3</sup>C is likely time consuming and costly.<sup>68</sup> Thus, to avoid liquidating the corporation and accruing complex tax liabilities, it is probably more beneficial for an S-Corporation and a C-Corporation to create a new L<sup>3</sup>C.<sup>69</sup> Finally, converting a nonprofit public charity or private foundation into an L<sup>3</sup>C will require the entity either to pay over the net value of its assets to another nonprofit (public charity), or to liquidate and pay a termination tax (private foundation).<sup>70</sup> Again, this process may be time consuming and costly and would not be preferred to creating a new L<sup>3</sup>C.<sup>71</sup>

Existing entities creating a spin-off or subsidiary L<sup>3</sup>C will probably become the most popular method of creation.<sup>72</sup> Nonprofit corporations that have identified a profitable arm of their operation or for-profit corporations that have recognized a valuable, but unprofitable, arm of their company may wish to form a subsidiary L<sup>3</sup>C. Nonprofit corporations, under this model, will be able to maintain their current stream of donors and for-profit corporations will maintain a regular rate of return while

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<sup>63</sup> Mark Hrywna, *Montana Foodbank Uses L3C Status*, 23 THE NONPROFIT TIMES, Sept. 1, 2009, at 1 (“When an L3C makes profit from its operating business, the funds can be funneled to the mission, or back to the organization, in the form of a grant from the business to the nonprofit. It’s not considered unrelated business income and therefore not taxable for nonprofits.”).

<sup>64</sup> MOODY, *supra* note 35, at 3.

<sup>65</sup> *Id.*

<sup>66</sup> Minnigh, *supra* note 50, at 3.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

<sup>69</sup> *Id.* at 3-4.

<sup>70</sup> *Id.* at 4.

<sup>71</sup> *Id.*

<sup>72</sup> MOODY, *supra* note 35, at 3.

benefiting their local community.<sup>73</sup> Some examples might include a recycling company that wants to expand its revenue by selling certain metals that it receives,<sup>74</sup> or a news corporation that wants to maintain their newspaper presence in a local community but cannot afford their subscription's market revenue.<sup>75</sup> Other examples may include museums that lose money but benefit the community by providing community access, or companies that want to supply low-income financing, student loans, or micro-financing in third-world nations. As illustrated, consumers stand to benefit tremendously from L<sup>3</sup>Cs.

Investment equity funds are also an attractive option for creating an L<sup>3</sup>C.<sup>76</sup> These funds can be managed to satisfy the objectives of their participants for the purpose of making PRIs.<sup>77</sup> The investors of these equity funds would be members of the L<sup>3</sup>C benefiting from the limited liability and pass-through tax treatment accorded to traditional LLCs.<sup>78</sup> The L<sup>3</sup>C, in all ordinary aspects, would function like any other private equity fund, but would make investments that would normally go unfunded for their lack of an adequate market rate of return.<sup>79</sup> "A socially-oriented L<sup>3</sup>C venture investment fund would serve the very useful function of creating a pool of PRI capital to be deployed for the benefit of important social and charitable causes."<sup>80</sup> This form of L<sup>3</sup>C can easily provide below-market interest rate loans and equity investments to companies that are within the L<sup>3</sup>C's mission.<sup>81</sup>

These are just four possible examples of forms likely to be used by L<sup>3</sup>Cs. There are many other possible structures an L<sup>3</sup>C could take to allow it to mold and adapt to its capital market without compromising its social mission and purpose.

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<sup>73</sup> *Id.* A for-profit that opts to form a subsidiary L<sup>3</sup>C rather than closing down or moving to a new territory will benefit the local community by maintaining the jobs the company has created and the supporting industry around it.

<sup>74</sup> *Id.*

<sup>75</sup> Jim Barnett, *What's Keeping News Organizations from Trying the "Low-Profit" Model?*, NIEMAN JOURNALISM LAB, Aug. 20, 2009, available at <http://www.niemanlab.org/2009/08/whats-keeping-news-organizations-from-trying-the-low-profit-model/>.

<sup>76</sup> MOODY, *supra* note 35, at 3.

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* at 4.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

*IV. All That Glitters is Not Gold*

L<sup>3</sup>Cs are not flawless and have some uncertainties that have not yet been formally and conclusively addressed. Among the most notable of these uncertainties is whether L<sup>3</sup>Cs will undeniably qualify as a PRI. Until the IRS conclusively addresses the status of L<sup>3</sup>Cs as a PRI, foundations risk penalties imposed by the IRS for “jeopardizing investments” and failing to distribute income.<sup>82</sup> Currently, the IRS has not expressly ruled on this issue, and as such, foundations may be exposed to a 10% excise tax on both itself and its managers for investing in an L<sup>3</sup>C.<sup>83</sup> Moreover, the foundation’s investment in the L<sup>3</sup>C may be subjected to a 30% excise tax if it were intended as a qualifying distribution and the L<sup>3</sup>C was held to not qualify as a PRI.<sup>84</sup> In fact, Ron Schultz, an IRS senior technical advisor in the Tax Exempt Entities Division, warned foundations from prematurely embracing L<sup>3</sup>Cs as PRIs.<sup>85</sup> He stated:

The point I want to make today is that, at the federal level, no one has really signed off on this yet. . . . So if you are out there hearing about L<sup>3</sup>Cs and you have a private foundation that wants to invest in it, and you think the jeopardy investment issue is a slam dunk and you don’t need to concern yourself with it, that would be premature.<sup>86</sup>

Schultz gave his warning on June 11, 2009 at the American Institute of Certified Public Accountants national not-for-profit industry conference<sup>87</sup> and concluded by stating, “[T]he I.R.S. is in the process of studying the issue to determine the tax consequences of L<sup>3</sup>Cs.”<sup>88</sup>

However, Marcus Owens, a former director of the IRS’s Exempt Organizations Division and now an attorney with Caplin & Drysdale in Washington, D.C., advised the creation of

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<sup>82</sup> Minnigh, *supra* note 50, at 5.

<sup>83</sup> *Id.* at 5-6. See also I.R.C. §§ 4942, 4944 (2006).

<sup>84</sup> Minnigh, *supra* note 50, at 6.

<sup>85</sup> Diane Freda, *IRS Tax-Exempt Official Urges Caution for Groups Eying Low-Profit LLC Investment*, DAILY TAX REPORT, no. 126, July 6, 2009, at G-3, available at [http://news.bna.com/dtln/DTLNWB/split\\_display.adp?fedfid=13741364&vname=dtrnot&fn=13741364&jd=a0b8y7k7z7&split=0](http://news.bna.com/dtln/DTLNWB/split_display.adp?fedfid=13741364&vname=dtrnot&fn=13741364&jd=a0b8y7k7z7&split=0).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> Hrywna, *supra* note 24, at 1.

Vermont's L<sup>3</sup>C founding legislation and wrote an extensive letter to Schultz that refutes his warning and counters that the IRS "has issued considerable guidance addressing the federal tax consequences . . . for a private foundation . . . that invests in a limited liability company . . . that is organized and operated for a primary charitable purpose."<sup>89</sup> Owens' five-page letter proceeds to exemplify two Revenue Rulings<sup>90</sup> allowing a foundation and other tax exempt organization to invest in a for-profit LLC having a charitable purpose for its primary goal without forfeiting its tax-exempt status, or without making a jeopardizing investment.<sup>91</sup>

Others are concerned that L<sup>3</sup>Cs will have unintended negative consequences. Most widely recognized is the potential for L<sup>3</sup>Cs to effectively compete with nonprofits for donations.<sup>92</sup> Some worry that foundations will be more willing to make a PRI to an L<sup>3</sup>C rather than making a grant to a nonprofit.<sup>93</sup> Although theoretically possible, the N.C. Center for Nonprofits does not think this is a realistic concern.<sup>94</sup> While there are uncertainties that lay ahead for L<sup>3</sup>Cs, they are not insurmountable and should not deter the creation of L<sup>3</sup>Cs or their success.

### V. Conclusion

The advent of L<sup>3</sup>Cs – to occupy a niche market between nonprofit and for-profit corporations, to qualify as PRIs, and to sustainably further a social purpose – advances a new generation of philanthropy. L<sup>3</sup>Cs provide philanthropists, charities, and other altruistic entities a brand that attracts and perpetuates their very existence. Blending for-profit motives, and adequate capitalization, with a legally binding nonprofit soul has the potential to beneficially impact a number of consumers and their

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<sup>89</sup> Letter from Marcus S. Owens, Partner, Caplin & Drysdale, Chartered, to Ronald Schultz, Senior Technical Advisor, Tax Exempt and Gov't Entities, IRS, 1-2 (July 8, 2009) [hereinafter Letter], available at [http://www.americansforcommunitydevelopment.org/downloads/im4511\\_20090708\\_164517.pdf](http://www.americansforcommunitydevelopment.org/downloads/im4511_20090708_164517.pdf).

<sup>90</sup> See Rev. Rul. 2004-51, 2004-1 C.B. 974; see also Rev. Rul. 98-15, 1998-1 C.B. 718.

<sup>91</sup> Letter, *supra* note 89, at 2.

<sup>92</sup> David Heinen, *Summary of Low-Profit Limited Liability Company (L3C) Legislation*, N.C. CENTER FOR NONPROFITS, Aug. 2009, at 3, available at <http://www.ncnonprofits.org/advocacy/l3csummary.pdf>.

<sup>93</sup> *Id.* at 3-4.

<sup>94</sup> *Id.* at 4.

communities. Moreover, L<sup>3</sup>Cs are simply another form of LLC, and as such, are easy to form, convert, and predict. While there is some pause that the primary funding source of L<sup>3</sup>Cs, PRIs, are not “conclusively” determined, there is adequate precedential evidence to suggest this concern is not a serious threat. After five states have relatively recently adopted L<sup>3</sup>C-authorizing legislation, more states are sure to follow. The resulting advantages that L<sup>3</sup>Cs provide to consumers and their communities may take years to materialize, but as long as L<sup>3</sup>Cs continue to spread to new states, these advantages are certain to follow.



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