The L3C Law - Background & Legislative Issues

by Robert Lang

Introduction

Technological changes allow all of us to do things that were impossible 25 years ago. Many things that were routine are also changed by new policies and procedures. When was the last time someone pumped your gas or washed your windshield? One area that is untouched by new technologies or policies is access to capital for solving social problems. This paper is a presentation on a solution to that problem that has been developing over the last four years—the L3C, a model of business structure to encourage capital marketsto invest in solving social problems. With any new model there are questions about the short and long term implications. This paper ends with a listing of question and answers to advance the discussion and implementation of this new business structure.

There is no one in the social sector who is not aware of the difficulties of raising enough money to keep the doors open. Even the large portion of the nonprofit sector that provide services to government agencies in exchange for fees is woefully undercapitalized. Nonprofits are often forced to borrow money or take other drastic measures just to keep their heads above water. Individual donors and foundation supporters frequently want their money to be used for "programs" not general overhead. All of this leaves nonprofit leaders feeling they are always making sub-optimal decisions.

I created the L3C to overcome many of the problems facing the social sector by creating a vehicle which was a for profit but was legally committed to charitable activities. I call the L3C the ***for profit with the nonprofit soul***. The L3C is not a nonprofit. It is a for profit venture that under its state charter must have a primary goal of performing a socially beneficial purpose not maximizing income.

The legislation establishing the L3C was specifically written to dovetail with IRS regulations relevant to Program Related Investments (PRIs) by ffoundations to promote increased use of these investment forms. L3C's facilitate PRI investment along with tranched (layered) investing where the PRI usually takes the first risk position thereby reducing risk for other investors in higher return tranches. These tranches become more attractive to commercial investment by improving the credit rating and thereby lowering the cost of capital. The multiplier effect potential here is very important since foundations have a total endowment of about 500 billion dollars but the market rate sector represents a pool of over 13 trillion dollars. The leveraging potential foundation dollars could bring if just a small piece of that money could be brought to bear on social issues is huge. The L3C is particularly favorable to equity investment, because foundations or other charitable investors take the highest risk at little or no return, the venture capital model is essentially turned on its head and many social enterprises will now have a low enough cost of capital that they are able to be self-sustaining. It is the perfect vehicle for economic development, medical research, operation of social service agencies, museums, concert venues, housing and any other activity with both a charitable purpose and an ability to produce a revenue stream.

The LLC platform was used to build the L3C to take advantage of the LLC's structural flexibility. Because it is a variant form of LLC the L3C is now legal in all 50 states as a result of legislation signed into law in Vermont in April 2008, Michigan in Jan. 2009, the Crow Indian Nation in January 2009, Wyoming in February 2009, Utah in March 2009, the Oglala Sioux in July 2009, Illinois in August 2009, Maine in April 2010, Louisiana

in June 2010, and North Carolina in August 2010. A Vermont, Wyoming, Utah, Illinois, Louisiana, North Carolina, Maine (after July 1, 2011) or Michigan L3C, like a Delaware corporation, can be used anywhere. The L3C bill is now active in the legislatures of Arkansas, Arizona, Colorado,Hawaii, Indiana, Oklahoma, Kentucky, Montana, New York, Rhode Island, Oregon, Iowa, The District of Columbia, California and Maryland.

So it is a firmly established, 100% legal alternative way of creating a vehicle to perform socially beneficial activities. As of March 2011 over 350 have already been formed just since mid 2008. Many of these were formed with the same entrepreneurial spirit that forms small business. Rather than go through the expensive and lengthy process needed to form a nonprofit they formed an L3C. Their total cost was as little as $100 (Vermont fee) and they were in business. They are operating out of their spare room, garage or basement much in the spirit of Steve Jobs, Bill Gates or Henry Ford. They can rent their garage from themselves, hire their spouses or otherwise do the things that small businesses do without worrying about IRS rules on personal inurement. They can keep their books on Quick Books and have the L3C treated as a pass through for tax purposes. In many cases they will not even need an accountant. Like the standard for profit entrepreneur who is planning on looking for more financing later they can invest their own money, get it back at an appropriate time and wait to ask a foundation for a PRI. So they can test out their idea without having to begin with a complex fund raising campaign after having waited months for the IRS to approve their 1023.

Others wanted or needed a very structured organization from day one. No problem, the L3C works just as well. I have been working with an educational support nonprofit in Florida that is a 150 million dollar a year operation that has formed an L3C. Likewise we have formed an L3C in Montana to process food for the Montana Food Bank Network. In all cases these entities will operate as a for profit business with one important exception. Under the state law of the state they are registered in they must put mission before profit although there are no strict limits on what is an acceptable level of profit. IRS regulations and examples on PRIs make it clear that a high profit result is acceptable as long as it was not the primary goal.

The money used to capitalize an L3C is not tax deductible nor is it usually solicited from the general public. If it were to be it would be in the form of a public offering and be under the auspices of the SEC (another tough regulator.) So there is no danger of an L3C using its status to defraud the public out of donation dollars. It must have a charitable purpose that comes before profit and that is in the various state laws and is subject to enforcement by the various States Attorneys General. So the confluence of nonprofit purpose with a specially designed for profit vehicle manifests itself in the L3C. For more detail on the L3C visit ***http://americansforcommunitydevelopment.org/***

The following issues and responses are a result of the input of many people over the last few years. The L3C is a new idea but we built it on a solid business and legal foundation.

1. Federal Legislation

Although federal legislation to support L3Cs and PRIs is under consideration, given the absence of federal legislation how should this impact state legislation? Although IRS private letter rulings are not required, many suggest the IRS process for obtaining private letter rulings is a key barrier to increased use of PRIs by private foundations. Will the L3C which is purported to facilitate use of PRIs without Private Letter Rulings be enough or should we wait for federal legislation?

The L3C legislation is independent of federal legislation and stands on its own. Congress is not in the innovation business. They react to events they do not try to create new concepts. So they will not pass legislation until they see the need. That means every time another state passes the L3C bill there is more pressure on DC. But the federal piece is not required. The IRS has long approved LLCs as PRI recipients and as the Section on Taxation of the ABA has pointed out the L3C as a variant form of LLC would not raise any issues of applicability. (*http://americansforcommunitydevelopment.org/publications.php • ABA Section of Taxation - Comments on Proposed Additional Examples on Program-Related Investments)*

2. "Off The Shelf"

The L3C concept risks creating confusion by suggesting there is an "off the shelf" solution for complex PRI transactions. PRIs are complex endeavors, but the L3C legislation could potentially give tax-exempt entities the false impression that investments in such entities would automatically qualify as program-related investments under IRC § 4944(c). If not structured properly private foundations risk losing their exempt status and incurring excise taxes. In addition, foundations that invest in for-profits are required to exercise expenditure responsibility, including obtaining annual reports from the L3C that account for foundations' investments. This bill does not change any of those facts. The potential for abuse of this new business model is not yet fully understood, and it is unclear how to regulate the charitable piece of L3Cs. The L3C bill raises several concerns relating to the protection of charitable assets. There is no clear existing guidance as to how much of an L3C's profits could lawfully be distributed before those distributions might be deemed to interfere with the accomplishment of the L3C's charitable objectives. L3Cs are allowed to distribute some portion of their profits to individual investors, rather than utilizing those profits to advance the entity's charitable objectives. Traditional nonprofit entities are required to reinvest all of their net earnings to further their charitable purposes.

Neither ACD or any other reputable supporter of the L3C has ever made "off the shelf" claims. What we have said and continue to say is that by creating a template and a vehicle the L3C will facilitate structuring of PRIs. The legal profession deals in forms and templates everyday. There are forms for contracts, wills, prenuptial agreements, etc. A vehicle especially designed for PRIs around which there is an ever growing body of legal history, examples and suggested media will reduce transactional costs, make the process more transparent and more understandable. Some PRIs are very complex, some are not, but the fact that so many PRIs are one offs leads to many complications. This is compounded by the fact that there are not a lot done so the attorneys involved are often inexperienced. The risk is on the foundation side and the IRS expects them to carry the responsibility for compliance so it is a non issue from a state law perspective.

Many states have Charitable Solicitations Acts and it is often thought that because the L3C performs a charitable activity it needs to meet these standards. False. The acts are not concerned with whether or not the alleged charity performs charitable acts. They are concerned with whether or not the alleged charity solicits money from the public promising the public that the money will be used for charitable purposes.

The L3C is a for profit. If we extend the law to cover the charitable acts of for profits where does it stop? Charitable laws are designed to protect the public from being defrauded not to judge the work of an organization. There is no need to judge the amount of charitable work done by an L3C. Even a nonprofit is not judged on how much work it does. Many nonprofits are extremely inefficient. There is little any regulation can do to promote efficiency. Again if there is a foundation investor then they will be the responsible party since the IRS holds them responsible.

3. State Charitable Registration Required?

The L3C legislation could potentially give the false impression that because they are obligated to further charitable objectives, L3Cs fit the definition of *charitable organization* and should register under relevant state laws or be subject to regulation by appropriate state officials who regulate charities. There are no enforcement mechanisms to insure that the L3C carries out a charitable purpose. Foundations may be defrauded and get in trouble with the IRS.

There are no charitable investments in the sense we understand charitable investment. The only money that is charitable is that of a Foundation or a Donor Advised Fund (DAF) which are not donations solicited from the public at large. In the business world investors are separated essentially by law according to assets and expectation of expertise and ability to loose their investment without suffering. The so called sophisticated investor takes higher risk and gets far less help and sympathy from regulators if the investment goes south. We make the same case for foundation investment of a PRI in an L3C. The foundation has or is supposed to have trained personnel or available consultants and attorneys who are capable of investigating and making informed decisions as to whether or not any given PRI is within the parameters established by the IRS. The foundation is not risking its endowment on the PRI. It is required by law to grant, make PRIs or perform other charitable acts with 5% of its asset value each year. So if it lost all of its investment in a PRI in any given year it would not jeopardize its ability to perform in any way. In fact foundations frequently make grants that can be labeled as failures.

As the ultimate regulator of foundations, the IRS has made it clear that it places the foundation in the sophisticated investor role and holds the foundation responsible if it makes a *bad* PRI. There is generally no enforcement action taken against the other parties involved in a bad PRI any more than there is action taken against a private equity fund that sells an investor an investment that goes south. The only time action is taken is when there is a clear cut case of fraud. In that case there are more than adequate civil and criminal fraud remedies on the books to handle the situation. These laws are all predicated on the basis that the government need only step in if innocent parties are hurt by the actions of others.

4. UPMIFA

The PRIs made by a foundation into an L3C would be a violation of the Uniform Prudent Management of Institutional Funds Act. (UPMIFA)

The opposite is true. Under IRS regulations PRIs must be the equivalent of a jeopardizing investment because it otherwise would not have a profile similar to a grant and could not be used to replace a grant to meet the 5% rule. Also foundation dollars should not be used to compete with for profit businesses. Nonprofits are supposed to operate in a space that for profit businesses cannot or will not operate in a way that makes their services available to those who need them.

The terms Low-profit Limited Liability Company and Program Related Investments apply to expected outcomes only. They are not meant to be all inclusive descriptions. The money a foundation is using for a PRI is not endowment funds to be invested. It is money that has already been selected to be used by the

foundation for grants, PRIs or other charitable activities. The IRS has a whole separate set of regulations that apply to the use of those funds. The funds that are invested in PRIs are often referred to as *off the books* investments. Once removed from the endowment and allocated to PRIs the funds are no longer carried on the foundation books as an asset covered by the 5% rule and cannot be returned to the endowment. If the PRI eventually returns to the foundation for whatever reason the foundation has one year to use it for a grant, another PRI or other charitable purpose.

I have written before that a foundation that has a long term goal such as building a museum for 10 million dollars after 10 years might make a one million dollar PRI loan every year for 10 years such that all the loans will become due at the end of year ten. It will have performed a charitable act for all 10 years and then used the money again in year 11 for another charitable act. The PRI is the use of already designated charitable dollars for charitable purposes that happen to embody making an investment rather than giving a grant, etc. The name L3C creates confusion because it is not meant to imply that the L3C is restricted to making a small profit. The name signifies that the entity will operate in a space where normal to high levels of profit are not normally expected and therefore discourage for profit investors to invest. However, the IRS regulations that the L3C is based on make it clear that an outcome that results in high profit is acceptable as long as it was generally not planned for or expected. Some of the investors in an L3C may make market rate of return. In fact this is true in many PRIs. The Gates Foundation makes PRIs to drug companies because the drug companies are concerned with the ROI they would receive on their investment if they put research dollars in to finding a cure for an orphan disease. They use Gates' money to fund the research and then are very happy to manufacture and distribute the drug because now they have an extremely high ROI on the investment they make in the drug. One of the reasons I used the LLC platform as a basis for the L3C was to create a platform that was conducive to tranched investment in order to attract market rate capital to invest alongside subsidized capital.

5. Further UPMIFA

To what extent do directors of charitable foundations or members of L3Cs have fiduciary duties under UPMIFA to investigate and select investment partners that require the least subsidization?

None. As stated in section 4 above, UPMIFA does not apply to PRIs since a PRI is made with funds that have been removed from the endowment and designated for distribution as a grant, PRI, or spent on a charitable program. In any for profit business deal there are many factors that determine investment decisions. And clearly the foundation may select a partner(s) that requires more subsidization if they feel the mission will be best served and the L3C most likely to remain sustainable even if that partner requires a greater investment.

6. Foundations and For Profit Partners

A similar question often asked is: Should foundations be undertaking capital-intensive, high risk joint ventures with for-profit partners?

PRIs were intended to facilitate joint investments by foundations and commercial interests in a way that accomplished charitable purposes, and have been permitted since 1969. 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),
- *Conventional sources of funds are unwilling to provide funds…at reasonable rates…* Treas. Reg. §53.4944-

• *conventional sources of funds are unwilling or unable to provide funds … at reasonable rates.…* Treas. Reg. § 53.4944-3(b)

• *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)

• *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)

• *Y, a private foundation, makes a high-risk investment in low-income housing...* Treas. Reg. §53.4944-3(b),

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. Moreover, current economic conditions suggest a need for greater deployment of foundation funds in PRIs in order to help alleviate economic and social distress.

7. Compatibility of Low Profit & market Rate of Return Investors

If a significant portion of an L3Cs 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? There is no clear existing guidance as to how much of an L3C's profits could lawfully be distributed before those distributions might be deemed to interfere with the accomplishment of the L3C's charitable objectives. L3Cs are allowed to distribute some portion of their profits to individual investors, rather than utilizing those profits to advance the entity's charitable objectives. Traditional nonprofit entities are required to reinvest all of their net earnings to further their charitable purposes.

First there is a misunderstanding between the terms *profit* and *cost of money.* If a nonprofit borrows money, it must pay market rate for this money and no regulator ever questions it as long as it is market rate. The L3C concept provides that the primary purpose of the organization must be charitable, with the production of *net* income permitted to be a secondary purpose. It must generate sufficient revenue to pay the cost of attracting equity investment or pay interest on borrowed funds. Investors in a normal for profit business who take high risk demand very high return on their investment. The L3C with high risk investors who are willing to take a low return is able to operate as a for profit where a normal for profit cannot. 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 L3Cs overarching charitable purpose in mind. In many cases the *blended rate of return* in an L3C may be below market but individual rates at market and others below market. The L3C should avoid planning on paying above market rates of return in any tranche. Thus, the L3C brings together foundations PRIs, Donor Advised Funds and other charitable investments with investments by non-exempt parties to accomplish the L3C's primary charitable purpose through a business that, because of its inherent risk and low likelihood of significant 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, Treas.

Reg. § 53.4944-3(a)(2)(iii) states that is *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*. However the fact that an investment produces significant income or appreciation in the absence of other factors, is not conclusive evidence of a significant purpose involving the production of income or the appreciation of property. In fact, Treas. Reg. § 53.4944-3(b), Ex. 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.*

8. State Legislation and the IRS

Does the state legislation allowing for the formation of L3Cs create an opportunity for foundations to circumvent the IRS rules?

No. The state L3C legislation, as well as the proposed federal legislation are exclusively anti-abuse measures. Neither creates a legal benefit that does not already exist. Further, both legislative initiatives preserve the existing safeguards in chapter 42 of the Code while creating additional safeguards and enforcement mechanisms to ensure that PRIs accomplish charitable purposes.

9. Safeguards to Insure Charitable Purpose

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?

An L3C is not automatically, and does not seek to qualify as, a tax-exempt entity 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 many L3Cs will be structured to qualify as recipients of equity PRIs, with both taxable and tax-exempt owners. The L3Cs are, themselves, 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 PRI oversight mechanisms as all other for-profit 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. The L3C structure will further facilitate this monitoring because as a member of the L3C the foundation, if it feels the need, will be able to require one or more seats on the management board of the L3C. In addition, the foundation is required to report the PRI to the IRS on its annual information return (Form 990-PF).

By enacting legislation that recognizes the L3C, states are creating a business form with an identifiable designation - *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 currently identify taxable entities operating under a charitable purpose unless the organizations have been formed as L3Cs.

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, 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.

10. Is Economic Develpoment Charitable?

Under what circumstances are economic development projects or job creation programs considered charitable under § 501(c)(3) of the Code?

Reg. § 1.501(c)(3)-1(d)(2) provides 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. 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 § 501(c)(3) of the Code.

In Rev. Rul. 70-585 (1970-2 C.B. 115) 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 *since 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 § 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, 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 § 501(c)(3).*

In Rev. Rul. 74-587 (1974-2 C.B. 162) the IRS 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 qualified 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* 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 since 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

11. Foundations, For Profit Investors & Significant PIncome

If a private foundation investor is required under the terms of an L3C operating agreement to cover any loss or a portion of a loss to for-profit investors seeking a *market return* on their investment, does this arrangement make the production of income a significant purpose? If a private foundation investor is required under the terms of an L3C operating agreement to make an additional capital investment, does this arrangement make the production of income a significant purpose?

tax policy, which 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.

Treas. Reg. § 53.4944-3(b), Ex. 8, 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, 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, such contractual provisions such as being required to cover a loss or make additional capital contributions, are in fact, legally appropriate in the context of a PRI under long-standing federal and state charity law by virtue of the incorporation of the private foundation excise tax regime into state law. (For examples see, Colo. Rev. Stat. § 7-121-501 (2008); N.C. Gen. Stat. § 55A-1-150 (2008); Wyo. Stat. § 17-19-150.)

In practice 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. 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 is 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.

12. Production of Income

What are the factors that determine whether the production of income is a significant purpose?

The IRS does not identify a set of factors to determine whether the production of income is a significant purpose of a PRI. However,Treas. Reg. § 53.4944-3(a)(2)(iii) explains 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*.

For example, in Priv. Ltr Rul. 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 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.

13. State Legislation in the Absense of Federal Legislation

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 L3Cs concept into LLC statutes at the state level provides a consistent legal structure for socially-beneficial enterprises and a means, through the *L3Cs* 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. Additionally the state regulation creates a fiduciary responsibility upon the managers of the L3C to carry out the charitable mission at the expense of profits. Presumably this would permit a state AG to take action against the mangers of an L3C that were not in compliance.

14. Do We Need Better Reporting Requirements?

There seem to be inadequate reporting requirements concerning the accomplishment of *significant* charitable or educational purposes by the L3C and the amount of distributions to private individuals. The combination of charitable assets in ventures with for-profit partners should be done in an open, transparent manner. The L3C stands to make such combinations more complex and more difficult to understand and monitor. L3Cs that sell goods or services to the public may promote themselves as deserving of public support and patronage because of their L3C status and their stated commitment to advance socially beneficial purposes. Existing law does not contain adequate public reporting

requirements or other mechanisms through which the public could obtain and evaluate information about how L3Cs are accomplishing the promoted charitable or educational purposes and the extent to which the L3C's profits are being reinvested for public purposes or distributed to private individuals.

Interestingly enough the L3C designation actually significantly improves transparency. The PRI regulations have been law since 1969 and during that time it has been generally impossible for either the states or the IRS to track all the PRIs that have been made, know who they were made to, or have any idea of the outcomes. The L3C as a branding mechanism will serve to announce an organization that promises charitable purpose and flag the possibility that a PRI is in place here. The mechanism for tracking L3C performance is via a foundation investor if there is one. If there is not there is no reason that public examination should be required since there is no charitable investor. It is up to the foundation to be sure its PRI is being used properly and to this end the foundation is responsible to the IRS. The L3C is a for profit that happens to do good but so what. As for public perception if a toy company says its toy will make a child happy for hundreds of hours there are no toy police which go out and check on child pleasures. This is a matter of free enterprise response. Dozens of companies claim to give all or some portion of their profits to charity. Others claim a portion of revenue goes to a cause. I personally am influenced by the latter and not the former. In the case of the former the ability to control expenses makes profit promises suspect. We seem to be locked into the misguided idea that we all have the right to know how an organization that claims to do good is performing. We don't. It runs entirely contrary to our basic free enterprise, capitalist system. We make our own independent decisions every day among the thousands of goods and services in front of us. We make look to others for advice or recommendations but the decisions are ours. If we do not think the L3C museum is offering enough value for its purported claims then we will not go there.

15. L3Cs Absent Nonprofit Partners

Is it possible for an L3C to operate without a foundation or other charitable investor?

Yes. It is important to mote that many of the L3Cs that are being formed have no intention of asking foundations for money. Many of the early adopters have looked at the L3C for its social branding and simplicity vs. forming a nonprofit. It is really a social entrepreneur's dream. Sit down this afternoon and decide there is a societal need that can be filled by a properly run for profit. Go on line to a state like Vermont and form an L3C for $100. Get up tomorrow morning and start doing business - no lawyers, no lengthy IRS registration process, no burdensome regulations which really are most appropriate for a public charity asking the public for donations. Finally social entrepreneurs can organically grow a charitable organization in the same manner as a standard for profit. It might be a part time business for the first two years. If they get big enough to require significant capital they can then go the foundation route.

16. L3Cs and Security Regulations

If an L3C needs to raise money from the commercial markets what regulations regarding securities registration and regulation are needed.

None. As a variant form of LLC the L3C is subject to the same state and federal securities regulations as any LLC. These regulations are very extensive and cover every possible eventuality. Nothing in the L3C legislation gives an L3C any new rights or exemptions in this area.

17. Why Not Special Purpose LLCs ?

Attorneys, consultants, accountants and foundations have been using LLCs, corporations, partnerships, operating agreements and PRIs for years to create organizations that function the same as an L3C. Why do we need L3Cs?

For years doctors have used traditional surgical methods to resolve many medical issues. In the last couple of decades many doctors have started using the far less invasive arthroscopic techniques which reduce pain, risk, and recovery time. Given the option most patients choose arthroscopic surgery. The L3C as previously stated creates a brand which makes recognition of an organization created for charitable purposes easy to find. It also is allowing the creation of standardized materials such as operating agreement templates, suggested best practices, etc. which create a framework for L3Cs. Just as there is an ***LLC for Dummies*** in the not too distant future there will be an ***L3C for Dummies.*** The growing body of information is, for the most part, in the public realm or easily accessible to the public. 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 grantmakers 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.

The transactional costs are constantly coming down vs the old method in which most of the intellectual property belongs to professionals who charge hundreds of dollars per hour for access. The concept, if it exists solely in state law, may not significantly 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. Our proposed federal legislation directs the IRS to implement a process that will be a cost-efficient and far more effective process for screening proposed PRI investments. The more L3Cs that are formed the more likely federal legislation to this effect will pass.

18. IRS & L3C Tax Issues

Is the IRS studying the issue to determine the tax consequences of L3Cs?

The IRS has not issued a ruling specifically analyzing whether a foundation's investment in an L3C qualifies as a PRI and is extremely unlikely to do so. However, the IRS has long approved foundation investments in for-profit entities, including importantly, LLCs, as PRIs, where the entity satisfied the PRI requirements. While these authorities do not reference the L3C by name, they are helpful nonetheless because they analyze the federal tax consequences of charitable investments in entities that are similar to, if not indistinguishable from L3Cs. The IRS is charged with reviewing individual PRIs after they are made. They do this by noting the foundation's listing of their PRIs on their 990PFs. The IRS does not make advance rulings unless so requested in a particular situation via a request for a private letter ruling. They will never give blanket approval to L3Cs as a category since this runs contrary to their review mandate. ACD does not support and has never asked the IRS for a blanket ruling. This would interfere with their ability to do their job properly and provide necessary oversight. The Section on Taxation of the ABA has taken notice of the L3C as a possible PRI vehicle and blessed same.

19. Compliance Issues

Are there any proposed reporting and disclosure requirements that would facilitate the verification of and compliance with L3C requirements and state oversight over charitable organizations and assets? Is there any other current method for the IRS, the states and the public to receive L3C specific information from a charitable investor?

Our 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 § 501(c)(3) of the Code 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:

• Add a new section to Chapter 60 of the Code to require information returns for for-profit entities receiving PRIs requiring disclosure of:

• Its gross income for the year;

• Its expenses attributable to such income, incurred within the year;

•A narrative statement describing the disbursements for and the results obtained from the use of assets for the exempt purposes of the entity;

• A balance sheet showing its assets, liabilities and net worth as of the beginning of such year;

• The names and addresses of all private foundations investing PRIs in the for-profit entity.

• A statement of the portion of its liabilities and net worth that represent capitalization from PRIs as of the beginning of such year;

• A statement of any interest, dividends or other distributions paid with respect to any PRIs during the year;

• Such other information as the Secretary may by forms or regulations prescribe and

• Add a new section to Chapter 61 of the Code to require publication of aforementioned information returns for for-profit entities receiving PRIs. GuideStar has already agreed to post L3C annual reports to the IRS on its website.

This information, together with the information disclosed on the foundations' Form 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 the IRS does not currently have another method for tracking information concerning PRIs in any entity. Further, absent a congressional amendment to the Code, the IRS could not publicly disclose or require an L3C to disclose the L3Cs partnership or corporate tax filings

20. IRS Approved PRIs

Are there other examples of IRS approved PRIs?

Treas. Reg. § 53.4944-3(b) Example 5 describes 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. Due to the high risks involved, the company would be unwilling to locate a plant in this area absent the private foundation's

inducement. Example 5 concludes that the investment is program-related, even though the loan is made to a large, established, publicly-traded company.

Similarly, in Priv. Ltr. Rul. 199943044 (July 26, 1999), the IRS approved an arrangement wherein a private foundation purchased stock 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.

In Priv. Ltr. Rul. 8807048 (Nov. 23, 1987), the IRS has ruled that a private 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 qualified as a PRI.

In Priv. Ltr. Rul. 199910066, the IRS considered the investment by two private foundations in a limited partnership having an LLC as the general partner. The LLC members were local universities. The purpose of the partnership and LLC was to exploit technology developed by the universities and support new companies in the economically depressed area in which they were located. The IRS ruled that the foundations' proposed investments would qualify as PRIs.

Recently, in Priv. Ltr. Rul. 200610020 (December 13, 2005) the IRS ruled that a private foundation's capital 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, qualified as a PRI.

The foregoing authorities reveal that the IRS has ruled on multiple occasions that a foundation's investment in a for-profit entity—including an investment in a charitable-purpose LLC—may qualify as a PRI, provided that the entity satisfies the requirements set forth in Treas. Reg. § 53.4944-3(c). The fact that the entity's name contains the *L3C* designation does not alter the legal framework for analyzing whether the foundation's investment in the entity would qualify as a PRI.

I am proud to have created the L3C and hope more and more states will pass the enabling legislation and that more and more people will find value in its use every year.

This paper was prepared by Robert Lang, CEO of the Mary Elizabeth & Gordon B. Mannweiler Foundation, CEO of L3C Advisors L3C, and Founder of Americans for Community Development. Some of the information contained herein was based on material provided by Elizabeth Minnigh of Buchanan, Ingersol & Rooney and Marcus Owens of Caplin & Drysdale.

Contact: robert.lang@americansforcommunitydevelopment.org

021011-02

Proposal for Mississippi L3C Act

The following is our bill proposal to be used to create a law for L3Cs in Missisippi. Most of the bill should be self-explanatory. Because we are trying to have conformity among the states we have kept the bill simple and have tried as much as possible to conform the law with the L3C statutes in all the other states that have passed the law. The intention is to make the L3C a variant form of LLC with all the other conditions and benefits of the LLC remaining intact.We ask that any drafters who wish to alter the language in any way please discuss it with us.

Contact: Elizabeth Carrott Minigh, 202-452-6048, elizabethminnigh@bipc.com

Robert Lang, 914-248-8443, robert.lang@americans forcommunitydevelopment.org

Proposed Amendments to
the Mississippi Code,
Revised Mississippi Limited Liability Company Act,
to Implement the Low-Profit Limited Liability Company

MISS. CODE §79-29-105 is hereby amended by revising Subsection (o), as follows:

(o) "Limited liability company" or "domestic limited liability company" means an entity having one or more members that is an unincorporated company or unincorporated association formed and existing under this chapter and is not subject to Section 97-13-15, <u>including without limitation a low-profit limited liability company.</u>

MISS. CODE §79-29-105 is hereby further amended by inserting a new Subsection (p), as follows:

<u>(p) "Low-profit limited liability company" means a limited liability company that is organized for a business purpose that satisfies, and is at all times operated to satisfy, each of the requirements set forth in Section 79-29-117.</u>

MISS. CODE §79-29-105 is hereby further amended by renumbering current Subsections (p) through (bb) as Subsections (q) through (cc), respectively.

MISS. CODE §79-29-109 is hereby amended by revising Subsection (1)(a), as follows:

(a) Must contain the following words:

(i) for a limited liability company other than a low-profit limited liability company, must contain the words “limited liability company” or the abbreviation “L.L.C.” or “LLC”; and

(ii) for a low-profit limited liability company, must contain the words “low-profit limited liability company” or the abbreviation “L.3.C.” or “L3C”;

MISS. CODE §79-29-117 is hereby amended by revising Subsection (1), as follows:

(1) Subject to the provisions of its certificate of formation or the operating agreement and subject to any other laws of this state which govern or limit the conduct of a particular business or activity, a limited liability company may carry on any lawful business, purpose or activity. Notwithstanding the immediately preceding sentence, a low-profit limited liability company must at all times be operated for a business purpose that satisfies the requirements of subsection (3).

MISS. CODE §79-29-117 is hereby amended by inserting a new Subsection (3), as follows:

(3) If a limited liability company is a low-profit limited liability company, it must at all times be operated for a business purpose that satisfies each of the following requirements:

(a) The limited liability company (i) significantly furthers the accomplishment of one or more purposes set forth in Section 170(c)(2)(B) of the Internal Revenue Code, and (ii) would not have been formed but for the entity’s relationship to the accomplishment of such one or more purposes;

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

(c) No purpose of the limited liability company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Internal Revenue Code.

If a limited liability company that met the requirements of (a) through (c) of this Section at its formation at any time ceases to satisfy any one or more of those requirements, then the company shall cease to be a low-profit limited liability company; provided, however, that if the company otherwise complies with this title, the company shall continue to exist as a limited liability company and its name shall be changed to satisfy the requirements for a limited liability company other than a low-profit limited liability company under Section 79-29-109.

MISS. CODE §79-29-801 is hereby amended by revising Subsection (1), as follows:

(1) A limited liability company is dissolved and its affairs must be wound up upon the first of the following to occur:

(a) At the time specified in the certificate of formation;

(b) Upon the occurrence of the event specified in the certificate of formation or the written operating agreement;

(c) Upon the consent of all members, or such lesser number as may be provided in the certificate of formation or operating agreement;

(d) At any time there are no members; provided, that the limited liability company is not dissolved and is not required to be wound up if:

(i) Within one hundred eighty (180) days or such other period as is provided for in the certificate of formation or operating agreement after the occurrence of the event that terminated the continued membership of the last remaining member, the personal representative of the last remaining member agrees in writing to continue the limited liability company and to the admission of the personal representative of the member or its nominee or designee to the limited liability company as member, effective as of the occurrence of the event that terminated the continued membership of the last remaining member; however, an operating agreement may provide that the personal representative of the last remaining member shall be obligated to agree in writing to continue the limited liability company and to the admission of the personal representative of such member or its nominee or designee to the limited liability company as a member, effective as of the occurrence of the event that terminated the continued membership of the last remaining member; or

(ii) A member is admitted to the limited liability company in the manner provided in the operating agreement, effective as of the occurrence of the event that terminated the continued membership of the last remaining member, within one hundred eighty (180) days or such other period as is provided in the operating agreement after the occurrence of the event that terminated the continued membership of the last remaining member, pursuant to a provision of the operating agreement that specifically provides for the admission of a member to the limited liability company after there is no longer a remaining member of the limited liability company.

(e) if a low-profit limited liability company fails to meet any of the requirements in Section 79-29-117 and does not file a certificate of amendment pursuant to Section 79-29-203 amending its name to conform with the requirements governing limited liability company names other than a low-profit limited liability company under Section 79-29-109 within sixty (60) days after; or

~~(e)~~ (f) Upon the entry of a decree of judicial dissolution under Section 79-29-803.

1009761.1

Preston Goff

From: Robert Lang
Sent: Tuesday, August 28, 2012 4:17 PM
To: Scott A. Hodges; Drew Snyder;

Cc: Tom Riley; Justin Fitch; Kay Earles
Subject: RE: Follow-Up to L3C Study Group Meeting

Scott, we appreciate the time and thought you are giving this but I would like to like to comment and also explain how a few words got into the draft.

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* *Without limitation* is really just to emphasize that the L3C is a normal LLC business in every way. The fact that it has unique additional requirements should not in any way imply that it is any less a business than any other LLC.

* The term *set forth* and the lack of the terms *charitable or educational* are the result of our desire to clearly make the requirements for the L3C mirror the Interneal Revenue Code on this issue. Our intent is to reduce barriers to PRIs (Progran Related Investments) by foundations.More words can lead to new interpretations.

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E-mail: sahodges@tannbrownruss.com
Website: www.tannbrownruss.com

From: Scott A. Hodges
Sent: Friday, August 24, 2012 9:46 AM
To: 'Drew Snyder';

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I would suggest that a separate annual registration form be used for L3Cs in order to require an officer of the entity to reaffirm (or update) the stated purpose of the L3C and also to certify that the entity continues to operate in accordance with the L3C statute.

Attached is the Vermont Secretary of State's listing of the L3C entities and their stated purposes. There are about 250 on the list, and the purposes are quite varied.

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Thank you again for your effort and your time.

Best,

Drew

Drew L. Snyder

Assistant Secretary of State

Division of Policy and Research

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