

The Benefits of Investing in Low-Profit Limited Liability Companies by Not-for-Profit Organizations: The Case of L3Cs in the United States

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Abstract: The low-profit limited liability company (L3C) is a hybrid entity that allows its owners to generate a profit while furthering an important social purpose such as a charitable, educational, religious or benevolent drive. By its very definition, L3Cs are ideal investment options for private foundations. Specifically, as an alternative to grants, private foundations can invest in L3Cs as long as such investments operate within the boundaries of the Internal Revenue Code and continue to fall under the allowed investment for tax-exempt entities. Several states have adopted legislation allowing the creation of L3Cs. However, due to the lack of guidance from the Internal Revenue Service whether L3Cs fall under the allowed investments for tax-exempt entities, it remains to be seen whether private foundations will indeed invest in L3Cs. As part of this research, a survey was conducted to ascertain whether the newly-created L3Cs have benefited from investments from private foundations. Among the survey findings, it was discovered that only seven percent of the surveyed L3Cs received investments from private foundations.

Keywords: Limited liability company; hybrid entity; L3C; private foundations; program-related investments.

Summary: 1. Introduction. – 2. Creation of the L3C. – 3. L3C Legislation. – 4. Survey. – 4.1. Survey Results. – 4.2. Survey Analysis. – 5. Tax Uncertainty of PRIs and Future Developments. – 5.1. Social Impact Investing. – 5.2. Mission-Related Investments. – 5.3. Donor-Advised Funds. – 5.4. Future of L3Cs.

1. *Introduction*

A low-profit limited liability company, or an L3C, is a dynamic entity that statutorily combines such competing characteristics as a social purpose and profit generation. Although not all states have statutes allowing the creation of L3Cs, the entity has proven to be quite popular, especially in the non-for-profit and social enterprise arenas. Presently, there are about 1,000 L3Cs in operation in the United States¹. This article discusses L3C entities which were specifically designed to increase the number of program-related investments (PRIs) that private foundations make to such social-purpose businesses.

Part 2 introduces L3Cs, their social purpose and the use of program-related investments. Part 3 analyses a Vermont L3C statute as an example of L3C legislation. Part 4 examines a survey of L3C entities designed to examine the use of PRIs and profit levels. Finally, Part 5 addresses the tax uncertainty surrounding PRIs and possible future developments.

2. *Creation of the L3C*

The low-profit limited liability company (L3C) is a relatively new business entity allowing owners to marry the flexibility and profit motive of a regular limited liability company (LLC) with a charitable mission or purpose. In the United States, statutes enabling the creation of such a hybrid entity have so far been enacted in eleven states

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1. See Anne Field, *Another Reason to Become an L3C* (Forbes, August 22, 2014), available at <https://www.forbes.com/sites/annefield/2014/08/22/another-reason-to-become-an-l3c> (last visited March 25, 2019).

and two Native American tribes². An L3C organized in any of those jurisdictions can be legally operated in all other states³.

The L3C is one of the most flexible business entities ever envisioned. It combines the elasticity of the LLC, where the business owner is protected against unlimited liability, with a choice of being a taxable or a pass-through entity. In addition, L3Cs allow owners to both generate profits and further a social purpose that they are passionate about⁴. While an L3C is neither tax-exempt nor eligible to receive tax-deductible charitable contributions, the statutes for this new hybrid entity were specifically drafted to encourage a certain type of investing as the foundation for capital contributions to an L3C – program-related investment⁵.

The concept of program-related investment is relevant to private foundations. In order to keep their tax-exempt status, private foundations must generally direct 5 percent of their assets annually for charitable purposes⁶. The primary means to satisfy this requirement has typically been grant giving. PRIs, however, are a much more attractive option for private foundations than grant distributions. PRIs can take many forms; they can be, for example, regular loans with repayment schedule and threat of penalties or, more interestingly, equity investments, bank deposits, or guarantees⁷. Most often, PRIs are repaid and can even earn a profit⁸, if they have an interest rate which is set lower

2. See Madeleine Monson-Rosen, *Companies with Purpose: The L3C Option in the US* (MissionBox, September 25, 2018), available at <https://www.missionbox.com/article/401/companies-with-purpose-the-l3c-option-in-the-us>. The following eleven states have L3C legislation: Illinois, Kansas, Louisiana, Maine, Michigan, Missouri, North Dakota, Rhode Island, Utah, Vermont, and Wyoming. The Crow Tribe of Montana and the Oglala Sioux Tribe have also adopted the L3C. Interestingly, the state of North Carolina has abolished the L3C legislation that it enacted in 2010. For further details, see Ann Field, *North Carolina Officially Abolishes the L3C* (Forbes, January 11, 2014), available at <https://www.forbes.com/sites/annefield/2014/01/11/north-carolina-officially-abolishes-the-l3c>.

3. See Americans for Community Development, *Laws*, available at www.americansforcommunitydevelopment.org/laws (last visited March 25, 2019).

4. See Cassidy V. Brewer and Michael J. Rhim, *Using the "L3C" for Program-Related Investments*, 21 *Taxation of Exempts* 11, 17 (2009).

5. See *id.*

6. See Field, *Another Reason to Become an L3C* (cited in note 1).

7. See *id.*

8. See Brewer and Rhim, *Using the "L3C"* at 12 (cited in note 4).

than the prevailing market rate⁹. In addition, capital gains on such investments are excluded from the definition of gross investment income for the purposes of the 2 percent annual excise tax on private foundations¹⁰. PRIs also qualify as an exception to the excess business holdings rule of section 4943 of the Internal Revenue Code¹¹. Finally, PRIs require greater accountability to the foundation as they will likely be repaid¹².

Despite these advantages, private foundations would shy away from PRIs prior to the creation of L3Cs¹³. Uncertainty can arise as to whether a specific PRI arrangement meets the applicable IRS requirements, will not be subject to the 10 percent tax, and will not cause the foundation to lose its tax-exempt status. In order to overcome such uncertainty, a private foundation not using an investment in an L3C must request a costly and time-consuming private letter ruling from the IRS¹⁴. Private letter rulings can take months to be issued and are very expensive. The new hybrid entity, the L3C, was specifically designed to counter these obstacles and qualify for PRI requirements under the Internal Revenue Code.

3. *L3C Legislation*

In April 2008, Vermont was the first state to enact legislation enabling the creation of an L3C¹⁵. In Vermont, L3Cs are required by statute to have the primary purpose of furthering a charitable or educational mission and not maximizing its profits¹⁶.

9. See Robert Lang and Michael Martin, *DAFs, PRIs, L3Cs – Tools of Social Impact Investing* 6, available at <http://americansforcommunitydevelopment.org/downloads/DAFs.%20PRIs.%20L3Cs%20-%20Tools%20of%20Social%20Impact%20Investing.pdf> (last visited March 25, 2019).

10. See Internal Revenue Code (IRC) § 4940(c)(2).

11. See Lang and Martin, *DAFs, PRIs, L3Cs* at 19 (cited in note 9).

12. See *id.* at 11.

13. See Lang and Martin, *DAFs, PRIs, L3Cs* at 11 (cited in note 9) (stating that the record of private foundations making PRIs has been very poor).

14. See *id.* at 17.

15. See 2008 Vt. Laws 106.

16. See 11 Vt. Stat. Ann. § 3001(27)(i), added by 2008 Vt. Laws 106.

Section 4001 of the Vermont Limited Liability Company Act defines an L3C as "a limited liability company that elects to be a low-profit limited liability company ... and meets the requirements of section 4162 of this title"¹⁷.

Pursuant to Section 4162:

A limited liability company shall be organized for a business purpose that satisfies, and shall at all times be operated to satisfy, each of the following requirements:

- (1) The company:
 - (A) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of 26 U.S.C. § 170(c)(2)(B); and
 - (B) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.
- (2) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person 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.
- (3) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of 26 U.S.C. § 170(c)(2)(D).

In addition, "[t]he name of a low-profit limited liability company shall contain the abbreviation L3C"¹⁸.

Section 4163(a) of the Act further provides that:

A limited liability company that elects to be an L3C and subsequently fails to satisfy any one of the requirements set forth in section 4162 of this title shall immediately cease to be a low-profit limited liability company, but by continuing to meet all the other requirements of this chapter, continues to exist as a limited liability company.

17. 11 Vt. Stat. Ann. § 4001(13).

18. 11 Vt. Stat. Ann. § 4005(a)(2).

Section 4162(1)-(2) of the Vermont statute bears a strong resemblance to the PRI requirements set out under section 4944(c) of the Internal Revenue Code. This is not a coincidence¹⁹, because, as noted above, L3Cs were specifically designed to qualify for the PRI exception²⁰. The drafters of L3C legislation envision that the IRS will issue a corresponding Revenue Ruling, accepting the L3C as a suitable avenue for program-related investments, as well as further guidance regarding the use of L3Cs. Most importantly, the promoters of L3Cs envisage that the IRS will soon accept L3Cs as a legitimate PRI investment vehicle and eliminate the need for private foundations to request private letter rulings every time they wish to enter into a PRI arrangement²¹. Through the increase in investments made by private foundations and the flexibility afforded by the L3C, it is also anticipated that L3Cs will increase the flow of funds from for-profit investors to ventures with a socially beneficial purpose²².

19. As explained by Robert Lang, chief executive officer of the Mary Elizabeth and Gordon B. Mannweiler Foundation and a strong proponent of L3Cs, "Marcus Owens, who has collaborated with Robert Lang on designing the L3C and who earlier in his career was the head of the Exempt Organization Division at the IRS, came up with a simple but elegant way of making the L3C an attractive vehicle for private foundations' PRIs." Thomas A. Kelley, *Law and Choice of Entity on the Social Enterprise Frontier* 41 (2009), available at <http://ssrn.com/abstract=1372313> (last visited March 25, 2019).

20. See *id.* at 41 ("His idea was to draft model legislation – which he hoped would be adopted in at least one state – that closely tracked the language of the PRI requirements laid out in Section 4944(c) of the Internal Revenue Code").

21. See *id.* at 21 ("Alternatively, a foundation considering a PRI could reduce its risk by seeking a private letter ruling from the IRS, which in effect would act as pre-approval").

22. See *id.* at 42 n. 182 ("According to Lang and Owens, the long-term solution would be to create and market L3C securities. According to Lang, if substantial brokerage houses of solid reputation could be convinced to package and market L3C securities, it is possible that primary and secondary markets would evolve and that those wishing to invest in hybrid social ventures – particularly private foundations looking to engage in PRIs – could work through those brokers to pick and choose appropriate investments. Those securities could be bonds, membership units, convertibles, options, loans, or whatever could be sold alone or as part of a package. An added benefit would arise from the due diligence these brokers would perform, which would provide added assurance to investors that the L3C investments were reasonably likely to achieve their multiple bottom line goals").

Since the first L3C statute was enacted in Vermont, ten other states have followed with their own L3C legislation²³. All the statutes that have so far been adopted require the same four key requirements as in Vermont: (1) the entity must further the accomplishment of a charitable or educational purpose within the meaning of IRC § 170(c)(2)(B), (2) the entity would not have been formed but for its relationship to the accomplishment of a charitable or educational purpose, (3) neither the production of income nor the appreciation of property is a significant purpose of the entity, and (4) the entity has no political or legislative purpose within the meaning of IRC § 170(c)(2)(D)²⁴. As discussed above, these requirements are intended to satisfy the PRI requirements under IRC § 4944(c).

In addition, all of the eleven states or Native American tribes that have passed L3C legislation have done so by simply supplementing their existing LLC statutes. This implies that the L3C is a subset of the LLC. Accordingly, an L3C should be treated as a pass-through entity for income tax purposes, provided that it does not elect to be treated as a corporation²⁵. Similarly to the LLC, the L3C provides its members with limited liability protection against the actions and debts of the business. Likewise, L3C membership is open – there being no statutory limitations – to foundations, for-profit entities, public charities, and individuals, among others. Also, private foundations investing in an L3C can, in principle, retain as much control over the management of the L3C as they desire²⁶. Finally, an L3C formed in any state that has passed L3C legislation qualifies to do business in all 50 states.

At the same time, certain differences in the current L3C legislation can be noted. In some states, such as Vermont and Utah, the charitable or educational purpose requirement for an L3C is contained in the definitional section of the state's limited liability company act, and no specific language is required to be included in an L3C's articles

23. See Monson-Rosen, *Companies with Purpose* (cited in note 2).

24. See Brewer and Rhim, *Using the "L3C" for Program-Related Investments* at 17 (cited in note 4).

25. See Monson-Rosen, *Companies with Purpose* (cited in note 2).

26. See Elizabeth Schmidt, *Vermont's Social Hybrid Pioneers: Early Observations and Questions to Ponder*, 35 Vermont Law Review 163, 169 (2010).

of organization²⁷. Conversely, in other states, such as Michigan, the charitable or educational purpose together with the prohibition on lobbying and political campaign activity must be expressly stated in an L3C's articles of organization²⁸. The latter option may probably be more appealing to the IRS, since the articles of organization are a public document whereas the operating agreement is not.

Moreover, the L3C statutes of some states, like Illinois, limit eligibility to charitable or educational purposes of a social nature²⁹. Some promoters of L3Cs have argued that the range of purposes should be expanded so as to include religious, scientific and literary organizations, or even organizations for the prevention of cruelty against children or animals or the promotion of national or international amateur sports competitions³⁰. In any event, most promoters of the L3C tend to agree that its charitable purpose needs to outweigh the entity's profit motive³¹.

4. Survey

In light of the legislative developments discussed above, a hypothesis was formed that, the L3C having become available, a growing number of PRIs would be made available from foundations to newly created L3Cs. After all, according to some promoters of the L3C, a growing number of foundations have started to make PRI investments through this new business entity³².

27. See J. William Callison and Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 Vermont Law Review 273, 284 (2010).

28. See Mich. Comp. Laws § 450.4102(2)(m).

29. See 805 ILCS 180/1-26(a).

30. See Field, *Another Reason to Become an L3C* (cited in note 1).

31. See *id.*

32. See *id.* ("[O]ver the last few years, more [foundations] have been getting their feet wet. The Gates Foundation set up a \$100 million PRI fund several years ago, for example").

In order to test such hypothesis, a survey was conducted³³ using the following questions:

- 1) In what state is your L3C organized?
- 2) In which states do you primarily operate?
- 3) How did you initially raise capital for your business? Check all that apply (owners' personal funds, third party financing, grants, PRIs, other (specify)).
- 4) Have you ever received PRIs?
- 5) Are you actively seeking PRIs or grants?
- 6) Who are your owners-members? Check all that apply (individuals, corporations, partnerships, trusts, private foundations, other tax-exempt organizations, other (specify)).
- 7) On average, how much revenue in US dollars does your entity generate during the year (income less expenses)?³⁴
- 8) How is your L3C currently taxed (partnership, sole proprietorship, corporation, other (specify))?
- 9) If you received funding through PRIs, do you report annually on your expenses to foundations? What are those reporting requirements?
- 10) Did your organization ever apply for Section 501(c)(3) status?

4.1. *Survey Results*

Question 1 (states where L3Cs were organized):

- Michigan: 47 percent;
- Illinois: 20 percent;
- Vermont: 13 percent;
- Maine, Utah, and Wyoming: 7 percent.

33. This survey was conducted by the authors of this article in February 2014 through SurveyMonkey, using a list of existing L3Cs compiled from data available on the website of Americans for Community Development found at <http://www.intersectorl3c.com>. A total of 596 entities were surveyed; of these, 16 percent responded, 7 percent opted out, and 2 percent bounced the survey.

34. The available choices were: "less than \$5,000"; "between \$5,000 and \$10,000"; "between \$10,000 and \$50,000"; "between \$50,000 and \$100,000"; and "more than \$100,000".

Question 2 (states where entities primarily operate):

- Michigan: 47 percent;
- Illinois: 20 percent;
- Maine: 13 percent;
- Utah, Wyoming, and nationally: 7 percent.

Question 3 (how L3Cs raised initial capital):

- Owners' personal funds: 86 percent;
- Third-party financing: 29 percent;
- Grants: 43 percent;
- Program-related investments: 7 percent.

7 percent of the respondents received PRIs (question 4). 40 percent of the respondents were actively seeking PRIs (question 5).

Question 6 (ownership composition):

- Corporations: none;
- Individuals: all;
- Partnerships: 14 percent;
- Trusts, private foundations, and other exempt entities: 7 percent.

Question 7 (net revenue generated annually):

- Less than \$5,000: 40 percent;
- Between \$5,000 and \$10,000: 7 percent;
- Between \$10,000 and \$50,000: 27 percent;
- Between \$50,000 and \$100,000: 7 percent;
- More than \$100,000: 20 percent.

Question 8 (tax treatment of L3Cs):

- Partnerships: 31 percent;
- Corporations: 31 percent;
- Sole proprietorships: 39 percent.

No respondent had reporting requirements for PRIs or grants (question 9).

Only 7 percent of responding L3Cs filed for tax-exempt status (question 10).

4.2. Survey Analysis

While originally hypothesized that, the L3C having become available, a growing number of PRIs would be made available from foundations to newly created L3Cs, the survey results established that only 7 percent of surveyed L3Cs received PRIs. At the same time, the finding that 40 percent of survey respondents are actively seeking PRIs strongly indicates that L3Cs are aware of such funding opportunities and are confident in their efforts.

Furthermore, the noticeable similarity between the percentage of PRI-receiving L3Cs (7 percent) and that of L3Cs having private foundations as their owners (7 percent) strongly suggests that foundations making PRI investments are likely to require accountability from L3Cs; this may take the form of direct control, and perhaps even voting control, over a newly-formed L3C by the investing foundation. The importance of private foundations in this regard cannot be understated. In fact, all of the PRIs received by surveyed L3Cs were from entities of this type. This may lend support to the idea that a combination of greater flexibility in investment decisions and less bureaucracy enables private foundations to make more purpose-related investments³⁵.

Another interesting finding is that, while L3Cs are designed by statute as "low-profit" entities, 20 percent of surveyed L3Cs generated annual net profits in excess of \$100,000. Here it should be noted that there has not been any official guidance aimed at defining the meaning of "low-profit" for the purposes of L3C legislation.

Finally, L3Cs are drafted as a subset of LLCs and as such, they should be as flexible in the choice of its form for tax purposes as any LLC. According to the survey, only 31 percent of L3Cs chose taxable corporate form and all of the others have opted to choose some form of a pass-through entity.

35. See Field, *Another Reason to Become an L3C* (cited in note 1).

5. Tax Uncertainty of PRIs and Future Developments

After reviewing the survey results, it appears that foundations are still very nervous to make PRI investments. As has been noted, "Foundations have dragged their feet in trying PRIs ... because they fear the IRS won't approve of the move"³⁶. After all, the Internal Revenue Service still has not released any guidance as to whether PRI investments made through an L3C will automatically qualify as a proper tax-exempt investment.

5.1. Social Impact Investing

"Social impact investing" is commonly understood as investing for the purpose of achieving positive social results³⁷. PRIs, as a form of venture capital investment, are used for social impact investing³⁸. An early user of PRIs to this end was the Ford Foundation. Ford-funded PRIs, characterized by great accountability³⁹, have typically consisted of low-cost loans, loan guarantees, and equity investments⁴⁰. Such PRI investments do not only provide capital to the newly-created businesses, but also allow L3Cs to gain access to new conventional funding in the future, such as mainstream banks⁴¹.

5.2. Mission-Related Investments

Mission-related investments (MRIs) can be used by foundations alongside PRIs, but they tend to be even riskier for the purposes of satisfying statutory tax exemption requirements⁴². They are investments made with the clear intention of meaningfully contribute to the accomplishment of a foundation's philanthropic mission⁴³. Unlike

36. *Id.*

37. See Lang and Martin, *DAFs, PRIs, L3Cs* at 18 (cited in note 9).

38. See *id.* at 19.

39. See *id.*

40. See *id.*

41. See *id.*

42. See *id.*

43. See *id.*

PRIs, MRIs are not statutorily prescribed and have no consensus definition⁴⁴.

5.3. Donor-Advised Funds

Donor-advised funds (DAFs) are a way for individuals to create an investment vehicle similar to private foundations, but without the administrative or reporting burdens of a foundation⁴⁵. DAFs are statutorily prescribed and IRS has a simple guide to DAFs⁴⁶. Contributions to DAFs are treated as contributions to a public charity, so donors have some advantage over private foundations⁴⁷. The ability of a DAF to operate like a private foundation makes it a perfect vehicle for making social impact investments, including PRIs.

5.4. Future of L3Cs

As described earlier, L3Cs are flexible entities that merge together the profit motive and the need for social impact investing. Specifically, PRIs can be used to give L3Cs that necessary venture capital to start its operations and become self-sustainable. PRIs can be made by private or public foundations or by DAFs. L3Cs create a perfect investment vehicle for foundations to make better investments than grants. Private foundations make grants to qualified tax exempt public charities. However, foundations can make PRI investments to private, for-profit enterprises⁴⁸. Yet, as the survey shows, there is still much work to be done to make L3Cs a recognized vehicle for PRI investments. Many are optimistic that over time, L3Cs will become the primary vehicle for impact investing⁴⁹.

44. See *id.*

45. See Lang and Martin, *DAFs, PRIs, L3Cs* at 20 (cited in note 9).

46. See *id.*

47. See *id.*

48. See *id.*

49. See *id.*