L3C: Will New Business Entity Attract Foundation Investment?

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On April 30, 2008, Vermont led the nation by enacting legislation to create the low-profit limited liability company (L3C), a business entity designed to further charitable objectives without having income production serve as a significant purpose.

This new entity is treated like a limited liability company in all legal respects, including taxation. The primary purpose of the legislation is to encourage private foundation funding of business ventures that improve public welfare. Currently, program-related investments in business enterprises (LLCs or otherwise) are legally complex and time-consuming. L3C advocates hope that L3C status will reduce the costs associated with such investments so that foundations will provide capital to a larger set of socially beneficial ventures.

Faced with dwindling endowment returns, private foundations across the country must evaluate all options in order to best leverage available resources. Because business entities may organize as L3Cs under a given state’s law and conduct business in other jurisdictions, the recent L3C legislation has national scope. Accordingly, exempt organizations and practitioners need to familiarize themselves with the L3C option. Further, federal lawmakers need to consider if and how they will respond to these new hybrid entities that combine for-profit and nonprofit motives.

This article describes L3Cs and their relation to program-related investments. We conclude that, while L3C status can serve a role in branding social ventures, it does not remove the barriers to foundation investment.

Defining an L3C

Following Vermont’s lead, Michigan and Wyoming passed legislation in 2009 allowing some types of business entities to organize as L3Cs. In all three states, to qualify as an L3C, the business entity needs to be organized and operated at all times such that it satisfies the following requirements:

- First, it significantly furthers the accomplishment of a charitable or educational purpose within the meaning of IRC section 170(c)(2)(B), including religious, charitable, scientific, literary, or educational purposes, fostering amateur sports, or the prevention of cruelty to children or animals.
- Second, its formation occurs solely as a result of its relation to the accomplishment of the charitable or educational purposes. In other words, but for the charitable or educational purpose, the entity would not exist.
- Third, it does not have income production or property appreciation as a significant purpose. However, the actual production of significant income or capital appreciation alone does not automatically demonstrate a profit motive.
- Fourth, its purpose is not to influence any legislation or any political campaign within the meaning of section 170(c)(2)(D).

In Vermont, once a business entity determines that it meets these requirements, it files its LLC Articles of Organization with the state and declares itself an L3C on that form. It also must include “L3C” or “l3c” in its name. Vermont’s secretary of state, has clarified that her office “plays a registration role, not a regulation role.” Thus, Vermont does not validate that an entity meets all L3C requirements but simply processes the L3C filing.

A duly organized and operated L3C secures the same powers and assumes the same obligations as any LLC. In particular, L3Cs are not tax exempt, but are taxed in the same manner as traditional LLCs. If an L3C fails to meet...
any of the above requirements at any time after formation, it immediately loses its L3C status but continues as an LLC. The LLC presumably cannot later reclaim L3C status because it did not operate at all times in satisfaction of the requirements. The fact that an LLC can continue to exist despite its loss of L3C status suggests the relative insignificance of the status under state law in many respects. The L3C designation may be significant, however, to the extent that it helps the entity obtain funding. Specifically, the primary purpose of the L3C designation is to attract capital from tax-exempt foundations in the form of a program-related investment (PRI).4

Program-Related Investments in L3Cs

The state requirements for an L3C directly parallel the federal criteria for PRIs.3 Instead of simply granting away their money, foundations can lend or invest that money in a way that advances their exempt mission and possibly provides a modest return. The primary benefit of a PRI is that the principal and any income it generates can be recycled in additional mission-related projects.

However, there are nontrivial costs associated with PRIs. If a foundation makes what it believes to be a PRI but the IRS ultimately determines that it does not meet the PRI criteria, the foundation and its managers are exposed to jeopardizing investment penalties. Also, a foundation that uses the improper investment as a qualifying distribution to meet the minimum payout requirements is subject to additional taxes.

To mitigate those risks, a foundation may request an advance ruling from the IRS to ensure that a particular investment qualifies as a PRI. Although a private letter ruling reduces uncertainty surrounding the investment, the process inevitably involves significant additional costs, such as legal and filing fees, as well as time.

Another disadvantage of some PRIs is that foundations face expenditure responsibility requirements. When the recipient organization is not a public charity, the foundation must conduct additional due diligence to ensure the funds go toward a charitable purpose.

A foundation weighing those costs against the benefits of the investment ultimately may conclude that a grant makes more sense than a potential PRI or that no PRI is worthwhile. However, foundations are more likely to provide capital to socially worthwhile business ventures that might not otherwise receive any funding if the foundations have assurance that the investments will qualify as PRIs. The match between the state legislation and the federal criteria reflects the intent to provide foundations with comfort that investments in L3Cs will indeed qualify as PRIs.

To better understand the possible role of a foundation’s PRI in an L3C, consider the following hypothetical example used to motivate proposed L3C legislation in North Carolina. Once a robust and important part of the state’s economy, furniture makers are now struggling because of increased competition from low-cost manufacturers abroad. Suppose an L3C is formed to purchase and upgrade factories to make them more energy efficient and less expensive to operate. The L3C then leases the factories to the furniture manufacturers at a competitive rate. The arrangement helps the manufacturers stay in business, providing jobs and other community benefits.

Who provides the initial capital to the L3C? Most profit-seeking investors will not assume the additional risk associated with this speculative project that is not accompanied by an overall higher return. However, a foundation is not concerned primarily with profit, but with its charitable mission. Consequently, assuming the L3C qualifies as a legitimate PRI, a foundation likely will be willing to invest in the L3C.

Similar to LLCs, the operating agreement of an L3C can be tailored to meet the particular needs of each member. The foundation makes the initial, risky investment but restricts itself to a below-market return in the operating agreement. The L3C then leverages the investment to attract additional for-profit investors, who are now able to avoid the upfront risk and enjoy a higher return because of the explicit investment tiers detailed in the operating agreement.

By pooling capital from several investment sources, including possibly pension funds and other socially conscious institutional investors, the L3C may generate income sufficient to satisfy the objectives of the for-profit investors to the financial detriment of the foundation, which may receive little or no return on its investment. However, because the L3C activities are consistent with the exempt purposes of the foundation and the PRI requirements, the arrangement still proves acceptable to the foundation. The L3C, in turn, has access to more resources to support economic growth in depressed rural areas.

Although it is possible that the creation of L3Cs will encourage more foundation investment in social ventures, there are two important caveats. First, a foundation already is able to invest in an LLC, irrespective of its L3C status, and have that investment qualify as a PRI. There is nothing unique about acquiring a membership interest in an LLC that prevents it from qualifying as a PRI. Any LLC can declare and/or restrict itself to a charitable purpose through its operating agreement or articles of organization; the L3C status introduces nothing more than a formalized way to accomplish the same objective.

Second, L3C status is not sufficient evidence that an enterprise qualifies as a PRI. Just because a state registers a business entity as an L3C does not mean the IRS will deem that business entity to be an appropriate PRI. Further, an L3C that qualifies as a PRI for one foundation

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4Available at http://americansforcommunitydevelopment.org/index.html.


6See Private Letter Ruling 200610020 (Dec. 13, 2005), which concludes that a membership interest acquired in an LLC, which was organized to act as an angel fund for investing in businesses in low-income communities, qualifies as a PRI.
does not necessarily qualify as a PRI for another foundation. Each foundation still must consider the risks of a particular investment carefully. Also, foundations still must exercise expenditure responsibility when investing in an L3C. Thus, foundations cannot avoid the transaction costs associated with other types of PRIs by investing in L3Cs.

L3C proponents contend that investments in state-approved L3Cs that mirror federal PRI requirements eventually will reduce those costs. Specifically, they believe foundations will be able to more easily secure comfort letters for these investments from accounting and law firms because of the L3C designation. Also, proponents would like the IRS to rule that any L3C by definition meets the PRI requirements, thus eliminating the need for private letter rulings. At minimum, they would like some L3Cs to receive IRS preapproval.

Finally, L3C advocates hope that L3C status will automatically exempt foundations from the time-consuming expenditure responsibility requirements. In
late 2008 the Council on Foundations lobbied Congress to include legislation supporting L3Cs in the stimulus package.7

Achieving conformity between federal tax requirements and state laws may reduce a foundation’s risks regarding investments in L3Cs. However, it is unlikely the IRS will issue a blanket approval of every entity that declares itself an L3C in its state Articles of Organization.

Also, the fact that an L3C met the PRI requirements at formation does not prove that the L3C continues to meet the requirements. The IRS plays an important oversight role, ensuring foundation investments are appropriate. Eliminating IRS scrutiny would mean that foundations would be able to meet their minimum payout requirement by investing in any entity that claims to have a primarily charitable purpose, whether or not it actually does. As of this writing, the IRS has not issued any comments or guidance on L3Cs or L3C investments.

Current Status of L3C Adoption

As of February 28, 2009, 42 business entities had registered as L3Cs in Vermont.8 The number of L3Cs will continue to grow as more states follow Vermont, Wyoming, and Michigan by legalizing L3Cs. As indicated in the list of Vermont L3Cs on the previous page, the organizations have a variety of missions, underscoring the difficulty that the IRS would have providing an unconditional endorsement of all L3Cs as PRIs.

Conclusions

L3Cs were expressly created to facilitate foundation investment, and subsequent commercial investment, in socially beneficial business ventures. It is too early to tell whether L3Cs will indeed attract additional, or any, foundation support. Certainly, L3C status provides a significant opportunity for branding. Specifically, the L3C designation allows socially conscious business enterprises to signal to foundations that they intend to operate in such a way that should qualify as a PRI. L3Cs also may be attractive to socially conscious customers, employees, and the communities in which they operate.

Although L3C status might help foundations identify new PRI opportunities, it does not provide any new legal benefits or any additional tax benefits to foundations. The new status essentially repackages existing opportunities for PRIs under a standard label. Unless the IRS approves particular L3Cs, or issues guidance that categorically accepts all L3Cs, foundations should continue to request rulings about their investments in L3Cs. Consequently, although Vermont’s L3C legislation was a first step toward alleviating PRI risk and increasing foundation investment in socially beneficial businesses, the legislation does not accomplish those goals itself. Federal legislators, interested in new ideas for economic stimulus, must now begin the L3C discussion and decide how to treat this new business form.

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8Available at http://www.sec.state.vt.us/corps/lc.htm.