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LOW-PROFIT LIMITED LIABILITY COMPANIES: HIGH-RISK TAX FAD OR LEGITIMATE SOCIAL INVESTMENT PLANNING OPPORTUNITY?

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INTRODUCTION

Any entrepreneur starting a new venture will inevitably have to address issues of entity formation as well as fundamental tax and legal planning. Prior to existence of the Low-Profit Limited Liability Company, commonly referred to as the "L3C," entrepreneurs with social objectives seeking to formalize their businesses legally were limited in choice between either nonprofit or for-profit private company structures. While each of these organizational structures has their own benefits and drawbacks, social entrepreneurs are often left without a business form designed for their unique business models. In order to address this dilemma, the L3C is designed to combine benefits of both the non-profit and for-profit business structure into one single entity.

The L3C is a corporate hybrid between a 501(c)(3) nonprofit organization and a limited liability company[1] and is recognized in all 50 states.[2] An L3C is identical to an LLC in that it provides for a limited

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[1] Karla W. Simon, *International NGO and NPO Committee*, 43 INT'L LAW. 695, 699 (2009).

[2] Lydia Dishman, *The New Double Bottom Line: The L3C Designation Is Helping Entrepreneurs Start For-Profit Businesses with Non-Profit Souls*, ENTREPRENEUR (Mar. 3, 2010), www.entrepreneur.com/article/205338.

liability protection and pass-through tax treatment.[3] After Vermont became the first state to allow formation of L3Cs in April 30, 2008,[4] other states such as Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, Wyoming and two American Indian Nations, the Oglala Sioux Tribe and the Crow Indian Nation of Montana, have enacted laws permitting the L3Cs structure.[5] Currently a total of nine states have enacted L3C statutes, and another handful are still considering legislation.[6] L3C supporters are hoping that passage of federal legislation, such as the Philanthropic Facilitation Act of 2010, would nationalize the use of the L3C structure for companies with a social agenda.[7] As of April 16, 2013, there were approximately 802 companies organized as L3Cs in a wide spectrum of industries,[8] with the majority of L3C businesses being located in Vermont (181), Michigan (170), Illinois (128), and Louisiana (127).[9]

Currently the L3C form can be used by entrepreneurs and any existing organization with charitable and social objectives seeking to formalize as an entity and obtain financial support from interested investors for sustainability and profit generation. As such, social entrepreneurs have adopted the use of the L3C for a wide range of businesses. Entities using the L3C structure "have included financiers, builders, and a wide range of environmental companies, including a solar farm and a budding marine research outfit."[10] L3C structure also permits investment by private foundations while qualifying them for tax purposes as program-related investments (PRIs).[11] PRIs are investments made by nonprofit tax-exempt private foundations that are intended to support a charitable project or activity, which lies between an outright grant to a public charity and investment in a public company's capital.[12] Tax professionals envision future utilization of

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3 Rosemary E. Fei, *A Guide to Social Enterprise Vehicles*, 22 TAX'N OF EXEMPTS 37, 39.

4 Simon, *supra* note 1 at 699; *see* VT. STAT. ANN. tit. 11 § 3001(27) (West 2013).

5 Elizabeth Carrott Minnigh, *Adding Another Trick to Your Bag of Tricks*, 36 ESTATES, GIFTS & TRUSTS J. 91.

6 *Id*. For information pertaining to developments in L3C legislation, see AMERICANS FOR COMMUNITY DEVELOPMENT, *Legislation*, http://www.americansforcommunitydevelopment.org (last visited Nov. 20, 2013).

7 *See* AMERICANS FOR COMMUNITY DEVELOPMENT, *Proposed Federal Legislation*, *supra* (linking to a copy of the final draft of the Philanthropic Facilitation Act of 2010).

8 *See* INTERSECTOR PARTNERS, L3C, www.intersectorl3c.com/l3c_tally.html (last visited Nov. 20, 2013). *See also* CARYN CAPRICCIOSO, ET. AL, INTERSECTOR PARTNERS, L3C, WHO IS THE L3C ENTREPRENEUR? (2010), *available at* http://www.americansforcommunitydevelopment.org/publications.html.

9 INTERSECTOR PARTNERS, *supra*.

10 Alexander Soule, *L3Cs are Gaining National Footing*, 47 WESTCHESTER CNTY. BUS. J. 1, 1 (2011).

11 *Low-Profit Limited Liability Companies and Their Potential Uses*, 25 REAL ESTATE J. 226 (2009).

12 Lawrence I. Richman, *The L3C: A Hybrid Passthrough*, J. PASSTHROUGH ENTITIES, Jan.

L3Cs in circumstances where a business's primary source of income comes from government funds, as is true for many museums, publishers and newspapers, energy conservation groups substantially participating in the green movement, organizations that provide low-interest financial assistance to low-income housing and individuals of need,[13] and organizations with environmental and health-related missions.[14]

L3Cs: Profit-Making Structure with a Social Purpose

While L3Cs are primarily formed with the objective of pursuing social charitable missions, they do have a secondary goal of profit creation.[15] The structure of L3Cs can be set up to consist of three investment tranches: (1) an equity tranche consisting of investment from private foundations and private donors;[16] (2) a mezzanine tranche congregating investors willing to accept below-market financial returns for the opportunity to invest in a socially responsible business;[17] and (3) a senior tranche consisting of investors expecting market-rate returns.[18] However, just as with LLCs, there is no limit to the number of tranches or investor levels.[19] Multiple levels would create increased complexity for these organizations, which often gravitate to the L3C structure because of its simplicity. The L3Cs' flexible three-tier organization is designed to facilitate investment,[20] allowing its investors to have different levels of entity ownership, participation rights, and involvement in management, while simultaneously providing for ample opportunities for risk diversification, and varying types of investment goals, terms and rights to distribution.[21] The above described tranche

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2010, at 11, 12.

13 Dennise Bayona and Ken Milani, *The L3C Low-Profit Limited Liability Company: Investment Option for Societal Impact,* 86 PRACTICAL TAX STRATEGIES 66, 70 (2011).

14 David Heinen, *Summary of Low-profit Limited Liability Company (L3C) Legislation*, *available at* http://www.docstoc.com/docs/38256222/Summary-of-Low-profit-Limited-Liability-Company-(L3C)-Legislation.

15 AMERICANS FOR COMMUNITY DEVELOPMENT, *The Concept of the L3C*, *supra* note 6; *see* Thomas H. Moody, *The Promise of the L3C*, TRUSTS & ESTATES, Sept. 2008, at 18, *available at* http://www.drm.com/uploads/The_Promise_of_the_L3C.pdf.

16 Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV 619, 646 (2010).

17 *Id*. at 647.

18 *Id*.

19 *See*, *e.g.* Benjamin H. Nissim, *A Mutually Beneficial Relationship: How the Low-Profit Limited Liability Company Can Build a Brand and Grow America's Wind Energy Infrastructure*, 27 NOTRE DAME J.L. ETHICS & PUB. POL'Y 247 (2013).

20 Grace Allison, Janne G. Gallagher & Ramsay H. Slugg, *Governance Issues in 2011*, 25 PROBATE & PROPERTY 52, 57 (2011).

21 Kerrin Slattery, *Illinois Recognizes Low-Profit Limited Liability Companies*, STATE TAX NOTES, Oct. 5, 2009, at 61. *See also* Timothy J. Galpin & R. Greg Bell, *Social Entrepreneurship and the L3C Structure: Bridging the Gap between Non-Profit and For-Profit*

format gives the private equity investors, who desire high performance results, a priority in distribution of capital gains,[22] while simultaneously allowing the private foundations, who may be content with lower financial returns, to receive any remaining benefits.[23] As such, this structure essentially shifts risk from profit-seeking investors onto charitable return-seeking investors. This increased level of funding and risk sharing enables larger pooled funds to provide a greater social return for the charitable return-seeking investors and a higher financial return for the equity investors.

MOOMilk, one of Maine's most famous L3C companies, exemplifies the successful application of the L3C three-tier ownership and profit-sharing structure. Rather than providing large returns for its equity investors, the company prioritizes distribution of earnings to its owner-farmers.[24] According to MOOMilk's operating documents, the investors become 45 percent company owners and receive only 10 percent of the profits after $1 million of capital is raised, the farmers own 45 percent of the company and receive 90 percent of its profits,[25] and the remaining 10 percent of the company is owned by individuals who provided services associated with its creation or is reserved for future members.[26]

L3C FORMATION REQUIREMENTS

An L3C can be formed as a new entity or through a conversion of an already existing business.[27] Costs associated with L3C formation are relatively low, generally consisting of registration fee filing with the jurisdiction permitting the L3C formation and registration with the home state.[28] The formation prerequisites for L3Cs mimic the requirements for PRIs under Code

Sec. 4944(c), which allow private foundations to make qualifying distributions in the form of PRIs even if they can be defined and viewed as jeopardy investments.[29] In general, the L3C statutes require compliance with the following four requirements: (1) inclusion of the

Ventures, 22 J. BUSINESS & ENTREPRENEURSHIP, Oct. 2010, at 29.

22 Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 374 (2009).

23 *Low-Profit Limited Liability Companies and Their Potential Uses*, *supra* note 11.

24 Malika Zouhali-Worrall, *For L3C Companies, Profit Isn't the Point*, CNNMONEY (Feb. 9, 2010), http://money.cnn.com/2010/02/08/smallbusiness/l3c_low_profit_companies/.

25 Nancy Artz & John Sutherland, *Low Profit Limited Liability Companies (L3Cs): Competitiveness Implications*, 8 COMPETITION FORUM 279, 282–83.

26 *Id*. at 283.

27 Galpin & Bell, *supra* note 21, at 29.

28 *See* Dishman, *supra* note 2.

29 I.R.C. § 4944(c) (West 2013).

L3C designation in the articles of incorporation and as part of the organization's Name; (2) compliance with the provision that L3C does not seek to accomplish political or legislative purpose within the meaning of Code Sec. 170(c)(2)(D); (3) affirmation that L3C was formed to only significantly further the accomplishment of one or more charitable or educational purposes within the meaning of Code Sec. 170(c)(2)(B); and (4) a declaration that the production of income or the appreciation of property is not the L3C's significant business purpose.[30] When any of these four formation prerequisites change, the L3C will convert into an LLC[31] without alteration in its membership and with the invested and earned assets remaining in the LLC.[32]

TAXATION OF L3CS

Due to their for-profit nature, L3Cs cannot qualify for Code Sec. 501(c)(3) tax-exempt status, and are treated as pass-through entities.[33] However, L3Cs have the ability to elect on a Form 8832, *Entity Classification Election*, to be taxed as a corporation.[34] Although L3Cs can often circumvent taxes on the entity level, it may be subject to property tax in circumstances where state and local laws disallow pass-through treatment.[35] Similar to the LLC, the L3C's operating agreement and the respective capital contributions govern the tax consequences for its members. In the L3C's multi-tiered investment structure, the for-profit members will be subject to tax on income received during the distribution, while other nonprofit members enjoy tax-free participation.[36]

Any conversion to the L3C form may have significant tax consequences depending on the original structure of the entity. When converting to an L3C from a partnership or an LLC, there should be no federal tax consequence, unless there is a change of ownership interest between its members.[37] However, when an S corporation is converted to an L3C, the S corporation recognizes any gain on liquidated distributions of appreciated property, which is then passed through to its shareholders.[38] A conversion from a C corporation creates a taxable

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30 Slattery, *supra* note 21, at 61.

31 Richman, *supra* note 12, at 12.

32 Reiser, *supra* note 16, at 650.

33 Rebecca H. Dent, *PRI, MRI, SRI, L3C—A Short Review for Private Foundation Counsel*, 19 OHIO PROB. L. J. 137 (2009).

34 Minnigh, *supra* note 5.

35 Reiser, *supra* note 16, at 623–625.

36 *Id*.

37 Elizabeth Carrott Minnigh, *Low-Profit Limited Liability Companies: An Unlikely Marriage of For-Profit Entitles and Private Foundations*, WEEKLY STATE TAX REPORT, Nov. 6, 2009.

38 *Id*.

liquidation that results in a double taxation: (1) corporate distribution of assets and liabilities to an L3C under Code Sec. 336, causing the C corporation to recognize gain or loss upon distribution of property as if it was sold at its fair market value; and (2) distribution to the shareholders under Code Sec. 331.[39] Lastly, any taxes associated with the termination of private foundation status, which will be the amount lesser of the aggregate tax benefits derived from its Code Sec. 501(c)(3) status or the value of the net assets of its formation.[40]

As a significant portion of L3C investment is expected to come from private foundations in the form of PRI, private foundations must carefully comply with the federal PRI tax laws and regulations.[41] PRIs are considered grants for the purpose of the private foundation's five percent annual distribution and are excluded from the excess business holding rules of Code Sec. 4943. Under Code Sec. 4942, private foundations are required to distribute at least five percent of their income or be subjected to excise taxes of 30 percent on the undistributed amounts,[42] which become 100 percent if amounts remain undistributed at the close of the taxable period.[43]

However, the private foundations are prohibited and penalized for making jeopardy investments.[44] An investment is considered to jeopardize a private foundation's exempt purposes if it is determined that, in making the investment, foundation managers have failed to exercise ordinary business care, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.[45] The private foundation's entire portfolio will be considered on a case-by-case basis at the time of the investment to determine if the investment was a jeopardy investment.[46]

Regulations state that particular types of investments, such as trading in securities on margin; trading in commodity futures; investments in working interests in oil and gas wells; purchase of puts, calls and straddles; and purchase of warrants and selling shorts will receive additional close scrutiny to determine whether the foundation

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39 *Id*.

40 I.R.C. § 507(c) (West 2013).

41 Every organization that receives Code Sec. 501(c)(3) exempt status is classified as either a public charity or a private foundation, where the organization is automatically classified as a private foundation unless it meets exceptions listed in Code Sec. 509(a). *See e.g.*, EDMUND G. BROWN, JR., CALIFORNIA ATTORNEY GENERAL'S GUIDE TO CHARITIES (2005), *available at https://oag.ca.gov/sites/all/files/pdfs/charities/publications/guide_for_charities.pdf*.

42 I.R.C. § 4942(a) (West 2013).

43 I.R.C. § 4942(b) (West 2013).

44 I.R.C. § 4943 (West 2013).

45 26 C.F.R. § 53.4944-1(a)(2).

46 *Id*.

managers have met the requisite standard of care and prudence.[47] However, if it has been ascertained that an investment does not jeopardize the carrying out of a foundation's exempt purposes, the investment shall never be considered to jeopardize the carrying out of such purposes, even if as a result of such investment the foundation subsequently realizes a loss.[48]

If a private foundation makes an investment that jeopardizes its ability to carry out any of its exempt purposes, the IRS has the authority to impose a tax equal to 10 percent of the amount of that invested for each year in the taxable period.[49] If the foundation's manager knowingly, willfully, and without a reasonable cause participates in making an investment that jeopardizes the carrying out of any of the foundation's exempt purposes, the manager will be subjected to a personal 10 percent tax of the invested amount for each year in the taxable period.[50] The manager's penalty is limited to $10,000 per investment.[51] Additional penalizing taxes equal to 25 percent of the amount of the investment may be imposed on the foundation if it fails to remove the investment from jeopardy within the taxable period.[52]

If a private foundation's manager refuses to agree to part or all of the removal from the jeopardy, the IRS has the authority to impose a tax equal to five percent of the amount of the investment on that manager[53] and up to $20,000 per any investment.[54] A private foundation's failure to exercise expenditure responsibility over its L3C investment may result in qualification of its investment as a taxable expenditure, even if the investment qualifies as a PRI.[55] Under Code Sec. 4945 private foundations are subjected to a 20 percent excise tax on taxable expenditures.[56] Similarly, any foundation manager who knowingly, willfully and without a reasonable cause makes a taxable expenditure is subject to a five percent excise tax of the investment amount up to $10,000.[57] If a taxable expenditure is not corrected within the taxable period, the IRS has the authority to impose a 100 percent tax of the amount of the expenditure against a private foundation,[58] and 50-percent tax of the amount of the expenditure against the private foundation's manager up to $20,000 if the manager refuses to comply with the

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47 *Id*.
48 *Id*.
49 I.R.C. § 4944(a)(1) (West 2013).
50 I.R.C. § 4944(a)(2) (West 2013).
51 I.R.C. § 4944(d)(2) (West 2013).
52 I.R.C. § 4944(b)(1) (West 2013).
53 I.R.C. § 4944(b)(2) (West 2013).
54 I.R.C. § 4944(d)(2) (West 2013).
55 I.R.C. § 4945(h) (West 2013).
56 I.R.C. § 4945(a)(1) (West 2013).
57 I.R.C. § 4945(a)(2) (West 2013).
58 I.R.C. § 4945(b)(1) (West 2013).

correction.[59] Thus, even after a PRI is made to an L3C, the private foundation must carefully monitor the use of funds by the L3C to make certain that the PRI's charitable mission is accomplished—or risk paying potential excise tax on taxable expenditures.[60]

TAX UNCERTAINTY AND LONG-TERM VIABILITY ISSUES SURROUNDING L3CS

Since the L3C is a novel structure with competing social and profit interests, many questions about its tax treatment and long-term viability remain unidentified. Additionally, the L3C has been widely criticized by scholars for a variety of reasons.[61] First, the IRS has never expressly announced that L3Cs will qualify as PRIs,[62] which leaves the door open for state regulators to make their own determinations as to if and when an L3C may qualify as an entity for the purposes of PRIs.[63] Existing private letter rulings (LTRs) on the topic have not considered important factors such as L3C's tranche investment structures.[64] Thus, the series of LTRs only provide practitioners with authoritative hope that private foundation's' PRIs to L3Cs constitute a valid annual distribution that should not have any adverse tax effects.[65] Any additional guidance may be limited because, after issuing only four LTRs[66] and two revenue rulings,[67] the IRS announced that it will not provide rulings pertaining to how unrelated business income may affect an entity's tax-exempt status.[68] However, in 2012, the IRS clarified that PRIs would be allowed to L3Cs under certain conditions, as set forth in their proposed

59 I.R.C. § 4945(b)(2) (West 2013).

60 Carter G. Bishop, *The Low Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243 (2010).

61 *See generally* Daniel S. Kleinberger, *A Myth Deconstructed: "The Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879 (2010).

62 See Mark Hrywna, *The L3C Status: Groups Explore Structure that Limits Liability for Program-Related Investing*, THE NON-PROFIT TIMES, Sept. 1, 2009, *available at* http://www.thefreelibrary.com/The+L3C+status%3A+groups+explore+structure+that+limits+liability+for.%20.%20.-a0208056187 (reporting comments made by the IRS's Ron Schultz, who "warned against jumping on the LC3 bandwagon too early because of unresolved tax questions"); Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591 (2011).

63 Celia R. Taylor, *Carpe Crisis: Capitalizing On the Breakdown of Capitalism to Consider the Creation of Social Businesses*, 54 N.Y.L. SCH. L. REV. 743, 763 (2009/2010).

64 LTR 200610020 (Mar. 6, 2006), *available at* www.irs.gov/pub/irs-wd/0610020.pdf.

65 LTR 200610020 (Mar. 10, 2006). *See* LTR 200218037 (Mar. 27, 2001), LTR 200123033 (Mar. 7, 2001), LTR 9637050 (Jun. 18, 1996) and LTR 9517029 (Jan. 27, 1995).

66 LTR 200218037 (Mar. 27, 2001), LTR 200123033 (Mar. 7, 2001), LTR 9637050 (Jun. 18, 1996) and. LTR 9517029 (Jan. 27, 1995).

67 Rev. Rul. 78-90, 1978-1 CB 380; Rev. Rul. 2004-51, 2004-1 CB 974.

68 Richman, *supra* note 12, at 10.

guidance.[69] Absence of clear tax authority questions whether donations contributed to L3C are allowed to be deducted, and if investments in L3C are protected from taxation or could jeopardize a donor's charitable activities.[70]

Second, lack of clear, unified financial goals and internally competing nonprofit and for-profit interests within the same entity may cause conflict among investors. It has been suggested that a departure from a well-established nonprofit mission concept can create tension among its sponsors and cause them to question whether and how effectively a hybrid entity can enforce its dual mission.[71] Some donors may not be inclined to donate to a charity that departs from and jeopardizes its traditional philanthropic activities in order to gain additional profits.[72] This same conflict may create confusion for the investors as to potential returns of investing into the L3C. For instance, to attract substantial capital from the business world, "the L3C must offer market risks and returns, [which] is a difficult task for a hybrid social entity."[73] Furthermore, this could create serious fiduciary problems as the L3C would end up serving two masters—a non-profit and for-profit mission.

Third, due to the novelty of the L3C as an entity, it has not yet been tested by the courts. This creates uncertainty as to how the courts will treat L3Cs when they face liability.[74] Although state legislation surrounding L3Cs is similar, "it is not identical."[75] Accordingly, individuals looking to form an L3C should carefully study existing legislation and relevant LLC laws to determine if they satisfy the organization's liability protection goals.

Even though serious limitations and concerns exist with regards to the long-term sustainability of the L3C business model, it should not be so quickly dismissed as useless and irrelevant. Too many scholars were quick to write articles condemning the use of L3Cs because it made for an easy target and novel paper.[76] Instead, lawyers, lawmakers, the IRS, and others should view L3Cs as a call for help from social entrepreneurs. Social entrepreneurs want a different form of business, which is clearly demonstrated by the over 500 L3C registrations that

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[69] *See* IRS, Proposed Guidelines, *Examples of Program Related Investments*, 26 CFR 53, (IRS-2012-0015), https://federalregister.gov/a/2012-9468.

[70] Bishop, *supra* note 60, at 250.

[71] Anne-Marie Rhodes, *The Law of Philanthropy in the Twenty-First Century*, 85 CHI.-KENT L. REV. 469, 471 (2010).

[72] Soule, *supra* note 10.

[73] Bishop, *supra* note 60, at 243.

[74] Jennifer Larino, *'Low-profit' a New Option for Social Entrepreneurs in LA.*, NEW ORLEANS CITY BUS., 2011.

[75] Minnigh, *supra* note 5, at 91.

[76] *See e.g.*, Kleinberger, *supra* note 61.

have issued in just a few years.[77] Additionally, some of these companies are making a significant social impact, such as Paradigm Project L3C, which provides energy efficient stoves to Kenya and Guatemala.[78] The Paradigm Project sells the carbon credits it creates through the energy efficient stoves to make a profit and also solicits donations, PRIs, and investor support to fund its operations.[79] As of April 2013, the organization has delivered over 65,000 stoves to these counties.[80]

As such, L3Cs are an exciting new entity choice that attempts to satisfy the desires of entrepreneurs and investors with social and profit making goals. However, until the IRS offers formalized guidance on L3C and its taxation, it is suggested that practitioners consider the issues described in this article and advise their clients about all potential tax liabilities, questions regarding the long-term viability of the L3Cs as a social business entity, and other concerns. Despite these uncertainties, the widespread adoption and limited success of the L3C in a short period of time clearly demonstrate the market demand for a business entity that can blend the for-profit agenda with the nonprofit mission.

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77 *See supra*, note 9.

78 *See* PARADIGM PROJECT, *Our Commitment* (2013), http://theparadigmproject.org/our-commitment/.

79 *Id*.

80 *Id*.