

The New Promise of Low-Profit Limited Liability Companies: Private Foundations' Investment Options have Changed

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Abstract

Prior to creation of the low-profit limited liability company, or an L3C, private foundations rarely invested in program-related investments, even though such investments were beneficial to them on many levels. Most non-profits have shunned away from such investments mostly due to the unpredictability of their treatment by the Internal Revenue Service. However, with the help of the new hybrid entity, the L3C, the world as we know it as it relates to PRIs is about to change. JEL Codes: G11, K10, and K34

1. Introduction

Due to recent economic developments, enterprises today are looking for ways to raise extra capital. One traditional way of increasing capital for nonprofit organizations has always been through grant-funded programs. However, even more so today, grant-funders are looking for ways to insure that programs they are sponsoring remain in existence even after funding ends (Minnis, 2010). Such sustainability is often times difficult to achieve (Minnis, 2010). As such, nonprofit organizations should consider other possible ways of achieving the same goal, one of which could be through program-related investments (or PRIs) under Internal Revenue Code Section 4944(c). Such investments are particularly attractive for the private foundations that could invest their available funds and receive a profit on their investment in the future. Traditionally, investing in PRIs has been a risky business. If not done correctly, private foundations would face a very real threat of losing their tax-exempt status and being charged with penalty taxes (Brewer and Rhim, 2009). In order to safely invest in PRIs, private foundations would almost always need to apply for a costly and time-consuming Private Letter Rulings from the Internal Revenue Service. However, this was the reality prior to the creation of a low-profit limited liability company, or L3C. The world as we know it as it relates to PRIs is about to change. This article outlines the potential of using L3Cs as a vehicle for successful program-related investments without the need for obtaining a Private Letter Ruling.

2. Literature Review

According to the Internal Revenue Section 4944(a), if a non-profit entity invests in another entity in such a way that it compromises the non-profit entity's tax-exempt purpose, a tax will be imposed on the nonprofit organization in the amount of 10 percent of the jeopardizing investment (Brewer and Rhim, 2009). Such nonprofit organization will be subject to an additional 25 percent tax if the jeopardizing investment is not corrected in a timely fashion (Brewer and Rhim, 2009). However, an exception exists for the 10 percent tax imposed on investments if such an investment was program-related. (Brewer and Rhim, 2009). Pursuant to Section 4944(c) and Treasury Regulation 53.4944-3, no tax will be imposed on program-related investments that meet three specific requirements: (1) the primary purpose of the investment is to accomplish one or more of the purposes described in IRC §170(c)(2)(B); (2) no significant purpose of the investment is the production of income or the appreciation of property; and (3) no purpose of the investment is to accomplish one or more of the purposes described in IRC §170(c)(2)(D) (Brewer and Rhim, 2009). Therefore, if a private foundation were to identify an investment that would meet all three of these requirements, its tax-exempt activities could be extended beyond the ordinary grant distributions.

3. The Methodology and Model

PRIs are more beneficial to private foundations than grant distributions. Specifically, PRIs will be repaid and will generally earn a profit (Bishop, 2009). As such, PRIs require greater accountability to non-profit entities than other forms of investment. Moreover, capital gains realized on PRIs are excluded from determining investment income for purposes of the 2 percent annual excise tax on private foundations (Bishop, 2009). PRIs also qualify as an exception to the excess business holdings rule under Internal Revenue Code Section 4943 (Bishop, 2009). Prior to L3Cs, most private foundations were quite justified in turning away from PRIs and looking for other arrangements. To make sure that a desired investment meets the three requirements of Section 4944(c) outlined above and to avoid the 10 percent penalty tax, most non-profit organizations were forced to apply for Private Letter Rulings. Private Letter Rulings, however, could take months to be issued and are costly. As the result, most PRI arrangements were not worth the trouble. The new hybrid entity, the L3C, however, was specifically designed to cure the problem.

Low-profit limited liability company, or an L3C, was first enacted in Vermont in April of 2008 and was drafted as an extension of a limited liability company (LLC). As such, L3C is neither tax-exempt nor eligible to receive tax-deductible charitable contributions (Brewer and Rhim, 2009). L3C, just like a traditional LLC, is a pass-through entity and is not subject to federal income taxes. Instead, items of income, expense, gain, and loss flow through to members of the L3C and would have to be reported on the members' individual income tax returns. Moreover, L3C was intended to be a hybrid entity: organized for-profit, but with a charitable social purpose. Specifically, L3Cs are required by state statutes to have the primary purpose of furthering a charitable or educational mission and not to maximize profits (Brewer and Rhim, 2009).

4. Discussion

One perfect example of utilizing an L3C to achieve such charitable social purpose is a recently-developed Paradigm Project. Paradigm Project is a business organized as an L3C, whose purpose is to address challenges in environment and energy. The idea is simple, but is also quite unique. Paradigm provides efficient cook stoves to the world's poorest communities in Africa, Kenya and Haiti, which will directly impact carbon levels in those communities. The use of such efficient stoves will reduce carbon emissions, which in turn will generate carbon credits that can be sold in the open market. The result is a self-sustaining process: a unique design that will fund itself, thus satisfying the low-profit aspect of the L3Cs, and that will also positively affect the developing communities by serving the immediate needs of the poor. The intended impact on the developing communities promises to be dramatic: "Currently Paradigm is focused on programs in Kenya and Haiti and has identified a pipeline of future projects in at least 10 other countries. Based on forecasts from Food for the Hungry and World Vision in Kenya, Paradigm's current projects could distribute a million or more stoves over the next 10 years. In Haiti, World Vision and Paradigm intend to distribute 100,000 efficient stoves to Internally Displaced Persons over the next 6 to 12 months and long-term, up to 500,000" (Hitt, 2010).

L3C was specifically drafted to act as a safe-harbor for meeting the three requirements of program-related investments exception under Internal Revenue Code Section 4944(c), as outlined above. Specifically, every state statute that authorizes the creation of L3Cs, includes the three PRI requirements as part of the entity's definition. L3C, by its very definition, should become a prima facie case for a safe program-related investment arrangement. According to Robert M. Lang, Jr. of The Mary Elizabeth and Gordon B. Mannweiler Foundation, who is a significant proponent of L3Cs, L3C is a PRI vehicle: "We looked at this and convened a panel of distinguished lawyers, financiers, etc. and asked what would happen if an LLC was chartered from the beginning to be a low profit entity. We wanted to codify the concept that maximization of member (shareholder) profits was not the prime goal. We started there, trying to draw up a law for a special form of LLC called L3C; low-profit, limited liability company, with the hope that after the law passed and had received a few favorable private letter rulings, that the ruling would become automatic or maybe even unnecessary" (Bishop, 2009).

5. Conclusion

Looking back at Paradigm Project, it becomes clear that an investment in such an enterprise satisfies the requirements of Internal Revenue Code Section 4944(c). After all, the very purpose of creating Paradigm Project was to serve the immediate needs of the poor – a clearly justified charitable social purpose. Moreover, the purpose behind such an investment would not be solely profit-driven. Surely, the goal is to make some profit by selling the carbon credits, but only to fund the project itself and to make it self-sustaining. Clearly, the reasons behind such an investment would be to generate low profits. Finally, as designed, Paradigms Project has no political or legislative purpose within the meaning of §170(c)(2)(D) (Brewer and Rhim, 2009). Thus, Paradigm Project is a perfect example of what should be considered a safe PRI for non-profit organizations. Even though Internal Revenue Service has not yet declared that an investment in an L3C constitutes a prima facie evidence of a legitimate PRI, a very strong argument can be made that for such socially responsible investing as in Paradigm, no Private Letter Ruling is needed. Such L3C, by its very definition, meets the requirements of Section 4944(c). Today, L3Cs can be formed in eight states: Maine, Michigan, Vermont, Illinois, Wyoming, Utah, Louisiana, and North Carolina. Once formed in any of these states, such new L3C can legally operate in any state. Legislation allowing the formation of L3Cs is also being considered in numerous other states, including Oregon, Arkansas, Arizona, Hawaii, Indiana, Iowa, Kentucky, Maryland, Montana, New York, Oklahoma, and Rhode Island.

References

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