OLR RESEARCH REPORT

October 7, 2011 2011-R-0344

LOW-PROFIT LIMITED LIABILITY COMPANIES OR L3CS

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You asked (1) for information on low-profit limited liability companies (L3Cs), including arguments for and against authorizing the creation of L3Cs as an alternative to existing business entities; (2) which states passed L3C legislation; and (3) how they could work in Connecticut.

SUMMARY

Generally, L3Cs are taxable for-profit businesses with a primary goal of achieving a stated social mission and profit as a secondary goal. They are organized under state law as a limited liability company (LLC) but they must meet certain criteria.

According to promoters of L3C legislation, L3Cs fill a gap between non-profit organizations and for-profit entities and can bring together funding from non-profit, for-profit, and government entities. According to proponents, the L3C designation is intended to signal to private foundations that these entities intend to conduct their activities in a way that qualifies under the federal Internal Revenue Code (IRC) for program-related investments (PRIs). Private foundations can make PRIs, which are loans or investments for charitable or educational projects, even if they are run by for-profit entities.

The criteria for forming a L3C matches the test set out in the IRC for a foundation to make a PRI to a for-profit entity:

1. the L3C must significantly further certain charitable or educational purposes and it would not have been formed except for the relationship to accomplishing the purpose;

2. it cannot have as a significant purpose the production of income or the appreciation of property, but the fact that a person produces significant income or capital appreciation is not, without other factors, conclusive evidence of a significant purpose; and

3. it cannot have a political or legislative purpose.

Proponents also argue that the L3C is a "brand" that will allow these entities to attract more private capital from various sources to serve charitable or education goals. They also argue that L3Cs could structure risks in a way to attract investors. Foundations could assume the highest risk at very low return and make the rest of the investment more secure and attractive to for-profit investors.

Critics of the L3C legislation argue that no federal legislation or Internal Revenue Service (IRS) ruling states that the L3C designation satisfies the PRI requirements and without it there is no benefit to the L3C designation. They also argue that (1) L3Cs could divert charitable assets from nonprofits; (2) creating a new business structure is unnecessary; and (3) there are many questions about how L3Cs will operate, including how they will be monitored to ensure that profit remains secondary to the charitable purpose and for-profit investors do not receive an improper benefit.

Nine states currently have L3C statutes: Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, Vermont, and Wyoming. All of these states amended their LLC statutes to require an entity that wishes to act as a L3C to meet the PRI requirements listed above, either as part of the definition of the L3C in statute or in the L3C's articles of organization. All nine states also (1) require the entity to use some form of "L3C" or low-profit LLC in their name and (2) address a L3C's failure to satisfy the statutory requirements. Individual states have additional provisions.

If the legislature wanted to adopt L3C legislation in Connecticut, it could do so by amending Connecticut's LLC law in a way similar to other states (see CGS § 34-100 et seq.).

PROPONENTS' ARGUMENTS

Proponents argue that a L3C (1) is a "for profit with the nonprofit soul;" (2) can bring together foundations, trusts, endowment funds, pension funds, individuals, corporations, for-profits, and government entities; and (3) can be used for economic development, medical research, operating social services agencies, museums, concert venues, housing, and other activities. As an example, they argue that a L3C could be used for economic development and job creation such as buying a run down industrial building in a depressed area, rehabilitating it, making it "green," equipping it, and leasing it at a low rate to a business willing to locate in the area and create new jobs. They also argue that L3Cs could save dying industries like newspapers.

Proponents argue that the L3C designation helps the entity obtain PRI investments from foundations for the following reasons.

1. Foundations do not make many PRI investments because they (a) face tax penalties if the investment does not qualify as a PRI and (b) must monitor a PRI to ensure it is used for the intended purpose and remains qualified as a PRI. Foundations and their managers, who also face penalties, usually require advice of counsel or a private letter ruling from the IRS before making a PRI, which is a costly and time-consuming process.

2. The L3C is a business structure pre-approved for PRI investments because the L3C requirements mirror those for an entity to receive a PRI. It makes it easier for foundations to identify social-purpose businesses as well as helping them conduct due diligence to ensure that their tax-exemptions remain secure.

3. L3C legislation is a progressive attempt to make establishing PRIs easier and provides an investment vehicle for mixed-motive investors who want to promote a charitable purpose while still having a potential return on their investment.

Proponents argue that L3Cs can consolidate a group of activities, some that will earn significant revenue with some that will earn very little or lose money while the total revenue remains positive and achieves social benefits. They argue that L3Cs could use low-cost capital in high risk ventures, allocate risk and reward unevenly over a number of investors, and ensure some a very safe investment with market return. Foundations could assume the highest risk at very low return and make the rest of the investment more secure.

Some criticize L3Cs because foundation funds could be used to subsidize and attract private, profit-seeking investors. Proponents argue there is private benefit in any PRI in a for-profit entity and the private-benefit doctrine involves weighing public good against private benefit. With a L3C, the primary purpose must be charitable and the L3C must make decisions with that purpose in mind, even though profit may be the result.

They also counter arguments that L3Cs will divert funds from charities and argue that L3Cs will bring more money to the charitable sector. They state that using PRIs can attract more commercial and institutional investors to a project and charities will need to make fewer handouts.

They also counter critics who argue a new legal structure is unnecessary. Proponents argue that the L3C legislation merely amends LLC definitions, does not create a new structure, and while new legal structures may not be necessary there are benefits to them. They argue there is increased interest in new types of business entities and financing structures and states have always adopted new legal forms.

They argue that the L3C legislation is built on the LLC structure to provide flexibility of membership and an organization that can cover a wide range of social enterprises. They also state that it is a simple legislative change and the LLC statutes have the benefit of years of legislation and litigation behind them.

OPPONENTS' ARGUMENTS

Opponents make a number of arguments against L3C legislation. They argue that L3Cs could not automatically qualify for PRIs and foundations would still be required to ensure that a L3C operates properly under the PRI regulations. Regarding PRIs, their arguments include the following.

1. Federal tax authorities have always made the determination about whether an investment qualifies as a PRI. No federal legislation or IRS ruling states that the L3C designation by itself satisfies the PRI requirements and without it there is no benefit to the L3C designation. State law cannot relieve a person of any obligation or standard of conduct under the federal regulation.

2. It is unclear how L3Cs will be monitored to ensure that profit remains a secondary purpose and for-profit investors do not receive an improper benefit. If a significant portion of a L3C's capital is from investors seeking a return, producing income is a significant purpose.

3. If L3Cs are presumed eligible for PRIs, the burden of detecting noncompliance shifts to state regulators instead of the organizations that receive tax benefits from their charitable status.

4. It is unclear whether the L3C designation would reduce a foundation's transaction costs and what the consequences would be if a L3C is not properly structured.

5. Proponents argue that L3Cs could take on economic development projects or job creation programs. It is difficult to determine when these activities are charitable as opposed to business ventures that do not qualify as charitable activities.

Opponents also argue that:

1. a new business structure is unnecessary because a LLC's operating agreement could contain the L3C restrictions and have the same effect;

2. using the L3C as a "brand" to single out these entities is inappropriate because it suggests the concept is straightforward and there are many complexities in federal and state securities law and federal income tax law;

3. L3Cs could divert charitable assets from nonprofits toward new and untried business entities that may lack the supervision that state officials exercise over public charities;

4. it is unclear what safeguards would be in place if, as proponents suggest, securities instruments are marketed based on L3C assets; and

5. if tranch investing is used (where the foundation makes a high risk investment with low potential for returns so that other investors have lower-risk and higher potential returns), foundation assets may benefit commercial or market investors in violation of the foundation's tax exempt status.

STATES

Nine states currently have L3C laws:

1. Illinois (PA 96-126),

2. Louisiana (2010, Act 417),

3. Maine (2009 ch. 629),

4. Michigan (2008, Acts 566 and 567),

5. North Carolina (Session law 2010-187),

6. Rhode Island (2011 Session, ch. 79),

7. Utah 2009 Session, SB 148,

8. Wyoming (2009 Session, Act 55), and

9. Vermont 2008 Act 106.

These states created L3Cs by amending their LLC statutes. In each of these states the laws requires a L3C to meet the following requirements, either as part of the definition of the L3C in statute or in the L3C's articles of organization:

1. the L3C must significantly further certain charitable or educational purposes and it would not have been formed except for the relationship to accomplishing the purpose;

2. it cannot have as a significant purpose the production of income or the appreciation of property, but the fact that a person produces significant income or capital appreciation is not, without other factors, conclusive evidence of a significant purpose; and

3. it cannot have a political or legislative purpose.

The charitable and education purposes include religious, charitable, scientific, literary, or educational purposes; fostering national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment); or preventing cruelty to children or animals (26 USC § 170(c)(2)(B)).

All nine states also require the entity to use some form of L3C or low-profit LLC in their name, but the naming options vary by state.

All nine states address a L3C's failure to satisfy these requirements in some way. Eight states (all but Michigan) state that a L3C that no longer qualifies as a L3C continues to exist as a LLC and it must either amend its name, articles, or both to reflect that change. In Wyoming, if the L3C does not amend its name within 30 days, it is considered to be transacting business without authority and is subject to penalties. In Michigan, the attorney general can sue to dissolve a L3C that no longer meets the statutory requirements and fails to amend its articles for 60 days.

Individual states have additional provisions including the following.

1. Illinois law states that a company operating or holding itself out as a L3C, a company formed as one, and their chief operating officer, director, or manger is a trustee under the charitable trust act.

2. Illinois, Maine, and Rhode Island specify that nothing prevents a LLC not organized as a L3C from electing a charitable or educational purpose.

3. Illinois specifies that an operating agreement regarding the company's affairs cannot eliminate or reduce the obligations or purposes a L3C undertakes when it is organized. Maine similarly prohibits an agreement from changing a L3C member's duties.

4. Maine law makes a certificate organizing the L3C that meets the law's requirements and is filed with the secretary of state conclusive evidence that the statements in the certificate are included in the company's limited liability company agreement.

5. North Carolina specifies that a L3C is considered for-profit and not charitable for tax purposes.

6. Utah specifies that a L3C can convert to another entity or participate in a merger in the same way as LLCs.

Other than the provisions described above, it appears that all of the other statutory provisions generally applicable to LLCs also apply to L3Cs, including any tax provisions.

SOURCES

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