

# Estate & Succession Planning Corner

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*By Lawrence I. Richman*

## The L3C: A Hybrid Passthrough



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At the juncture of the for-profit and not-for-profit worlds rests a new form of limited liability company, the L3C, the low profit limited liability company. By combining for-profit business-like returns with socially responsible noneconomic objectives, the L3C is a hybrid passthrough organization. This column is intended to provide a structural overview of the low profit limited liability company and some ways in which this hybrid can respond to today's economic and social environment.<sup>1</sup>

First enacted into law in Vermont,<sup>2</sup> and now present in several states such as Michigan, Utah, North Dakota, Wyoming and Illinois, L3Cs have national reach. As creatures of state law under our federal system, an L3C established in one state can do business in any state; this is the case with Delaware LLCs, for example. In general, the L3C statutes provide as follows:

1. The L3C may not have as a significant purpose the production of income or the appreciation of property. However, should this occur, L3C status is not voided in the absence of other factors.
2. The L3C is to significantly further at all times the accomplishment of one or more charitable or educational purposes.
3. The L3C would not have been formed, but for its relationship to the accomplishment of such one or more charitable or educational purposes.
4. The L3C may not have a political or legislative purpose within the meaning of Code Sec. 170(c)(2)(D).
5. L3Cs are identified by having the term "L3C" appear as part of the entity's name.

Given that the low profit objectives of the organization may not occur, and given the possibility that



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the organization may experience significant profit or appreciation, the L3C legislation provides the organization with an exit strategy. Since an L3C is a subset of LLC law, the exit for a L3C that no longer meets the statutory test is to provide that such an L3C continues to exist as a regular LLC, albeit one without the L3C designation as part of its name.

Understanding why L3Cs are structured as they are, and why such a structure would appeal to the not-for-profit private foundation community, requires an understanding of Program Related Investments (“PRIs”) under Code Sec. 4944(c). While Code Sec. 4944 generally prohibits private foundations from making risky or “jeopardy” investments, the exception to this rule is the Program Related Investment. PRIs are the hybrids of the philanthropic grant-making universe. They lie somewhere between an outright grant to a public charity and an investment in the capital of a public company. PRIs, as the term implies, are investments, albeit investments intended to support a charitable project or activity. On account of their philanthropic aspect, PRIs count as grants for purposes of the required five-percent minimum payout requirement of private foundations<sup>3</sup> and the PRI is not considered as part of the private foundation’s assets for purposes of calculating its asset base subject to the five-percent payout requirement. The hybrid nature of a PRI also exempts it from the excess business holding rules under Code Sec. 4943 since PRIs are not considered business holdings.

Accordingly, in order to qualify as a PRI, the investment must meet the following requirements:

1. It significantly furthers the organization’s tax-exempt purposes; in other words, the PRI must be in alignment with the foundation’s mission.
2. The investment would not be made but for the fact that it furthers those philanthropic purposes of the organization.
3. The investment is of a kind that profit-oriented investors would not make on account of the risk/reward nature of the investment.
4. The investment is not made for purposes of substantial income or significant appreciation.

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This is an intent-based requirement; the intent of the private foundation as investor versus actual economic results is what is determinative.

5. The investment does not support lobbying or a political campaign.

The fact that the requirements for a PRI dovetail with the requirements for an L3C reflects the L3C’s origins as a way to support the making of PRIs. Notwithstanding the added legal and administrative burdens associated with PRIs,<sup>4</sup> these investments

often occur when private foundations seek to foster economic development in low-income areas. The marriage of the philanthropy-driven investment (the PRI) and the philanthropy-motivated business (the L3C) can provide a unified structure for accomplishing

some of the following practical goals:

1. brownfield redevelopment;
2. retrofitting and restarting abandoned factories in poor urban areas as part of an employment program for the disadvantaged;
3. newspaper publication as a means of furthering an organization’s community service mission;
4. low-income housing projects; or
5. providing reduced rent for nonprofits as part of a program to combat community deterioration.

Hopefully, the L3C legislation will spur the IRS into reengaging on the issue of approved private foundation investment in for-profit entities. After the issuance of several private letter rulings<sup>5</sup> and one revenue ruling,<sup>6</sup> in 2006, the IRS announced it would cease issuing private letter rulings on whether a joint venture with a for-profit organization would result in unrelated business income or adversely affect an organization’s exempt status (except when part of the application process for recognition of exempt status).<sup>7</sup>

In today’s economically challenging times, foundations are asked to do more, and that more includes engaging communities in need on a deeper level than mere grant-making. The L3C provides an opportunity to bridge the gap between grant-making and maximizing investment profit through the accomplishment of philanthropic purposes by a business entity.

## ENDNOTES

- <sup>1</sup> In the C corporation arena, B, Lab ([www.bcorporation.net](http://www.bcorporation.net)) provides certification as a B Corp for corporations that are purpose driven and create benefits not only for its shareholders, but also for its stakeholders. Unlike the L3C, the B Corp designation appears to be a network/marketing driven organization of like-minded socially and environmentally driven companies. It is instructive, however, regarding the need for recognition and the appeal of hybrid organizations.
- <sup>2</sup> According to its website, the L3C originated through the work of The Mary Elizabeth and Gordon B. Mannweiler Foundation Inc.
- <sup>3</sup> Code Sec. 4942 requires a private foundation to pay out annually at least five percent of its net investment income as “qualifying distributions” for its exempt purposes. Failure to do so subjects private foundations to a penalty excise tax.
- <sup>4</sup> These burdens can include the need for an expenditure responsibility agreement and legal documentation to support the investment including records of how the investment is in accord with IRS guidelines.
- <sup>5</sup> See, e.g., LTRs 9517029 (Jan. 27, 1995), 9637050 (Jun. 18, 1996), 200123033 (Mar. 7, 2001) and 200218037 (Mar. 27, 2001).
- <sup>6</sup> Rev. Rul. 2004-51, IRB 2004-22, 974; 2004-1 CB 974.
- <sup>7</sup> Rev. Rul. 2006-4, IRB 2006-2, 264; 2006-1 CB 264 at Section 6.12.

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