

The *Fatal* Design Defects of L3Cs

by Daniel S. Kleinberger

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Editors' note: This article is adapted from the article "A Myth Deconstructed: 'The Emperor's New Clothes'" by Daniel Kleinberger, which is forthcoming in the Delaware Journal of Corporate Law, as well as from "When the Law Is Understood: L3C No," which was coauthored by Kleinberger and J. William Callison and was published June 2010 in Community Dividend, a publication of the Ninth Federal Reserve District.

IN 2008, VERMONT ENACTED THE FIRST LOW-PROFIT limited-liability company (L3C) statute. L3Cs are supposed to combine charitable giving and for-profit investing to empower socially productive enterprises. Since the passing of the Vermont statute, five other states have enacted parallel legislation.

L3C proponents laud L3Cs as a breakthrough in charitable giving that will permit private foundations to help fund for-profit entities with socially conscious aims. Advocates have claimed that L3Cs are destined to be fast-tracked for special

treatment under provisions of the Internal Revenue Code (known as the Code, or IRC) that address charitable foundations' program-related investments (PRIs). PRIs include equity investments as well as loans and loan guarantees and other kinds of nongrant investments in private enterprises.

Unfortunately, the glowing characterizations of L3Cs are flatly wrong.

The L3C is an unnecessary and unwise contrivance, and its very existence is inherently misleading. The notion that an L3C should have privileged status under the Code for access to tax-exempt foundation resources is inescapably at odds with the key policies that underpin the relevant Code sections, and L3Cs are not on track—let alone on a fast track—to receive special status under the Code. An ordinary limited-liability company (LLC) can perform precisely the same functions proclaimed of L3Cs. In addition, because of technical flaws, the L3C legislation adopted to date is nonsensical and useless.

A False Panacea

This assessment may seem harsh—even Grinch-like—given our nation's current economic woes and the bright prospects painted by L3C

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proponents. Who wants to oppose benevolent efforts to “save existing farms . . . help an otherwise struggling company in today’s competitive environment or . . . buy an empty factory, re-equip it to be a source for many jobs . . . make a museum or other non-profit self sufficient . . . address food and housing issues . . . provide sustainable solutions to medical, sanitation, conservation, energy, and environmental issues”?¹

Much better to agree with those who see L3Cs as providing a new horizon. “The arrival of the L3C potentially is a watershed moment for individuals and organizations that are dedicated to achieving social change,” write Cassady Brewer and Michael Rhim. “By combining the unique features of an LLC with the ‘soul’ of a nonprofit, the L3C may result in dramatic increases in the availability of both private and philanthropic capital for ventures that are designed to further charitable and educational purposes.”²

The reality, however, is starkly to the contrary, and growing ranks of L3C opponents have emerged to demystify the L3C model. These opponents include tax law experts, academics, and practitioners in the law of limited-liability companies; expert practitioners who work with nonprofit organizations; low-income housing and community-development financing; and charity officials. Authors of the country’s three leading treatises on LLC law have cosponsored a resolution to the American Bar Association Business Law Sections Committee on Limited Liability Companies, Partnerships and Unincorporated Entities that opposes the incorporation of L3C amendments into existing LLC acts and urges state legislatures not to adopt L3C legislation. An associate general counsel of a famous charitable foundation has identified six “myths” purveyed by L3C proponents and has described L3Cs as “less than meets the eye.”³

This article identifies and dissects the principal claims of L3C proponents to demonstrate that L3Cs are neither beneficial nor useful. Proponents’ principal claims are the following:

- L3Cs “dovetail” IRS rules on PRIs, thereby enabling private-foundation investment in qualifying businesses that operate for socially beneficial purposes.

- L3Cs permit “tranching investment” through which foundations can make high-risk, low-return investments, enabling profit seekers to make low-risk, high-return investments and bringing market-rate capital into socially beneficial enterprises.
- L3Cs create a “brand” that enables easy comprehension and use of PRIs.

In fact, none of these claims is correct.

Current Law: The Crucial Context

L3C proponents argue that L3Cs will revolutionize the relationship between nonprofits and the marketplace by freeing up tax-advantaged PRIs. Before we can address that argument, though, we must understand the status of private charitable foundations under the IRC as well as the protective limitations the Code and the Treasury regulations place on private charitable foundations.⁴ In particular, we must understand the prohibitions on speculative investments and the requirement that foundations annually distribute a specified portion of their assets.

Private foundations enjoy tax-exempt status and must navigate myriad tax regulations designed to protect charitable assets from poor management and diversion to noncharitable purposes or private persons. These regulations have strong teeth; contravention brings excise taxes so heavy that they have been described as “toxic.”⁵ Speculative investments and investments for improper purposes—known as “jeopardizing investments”⁶—trigger substantial excise taxes not only for foundations⁷ but also for foundation managers who make these investments with the knowledge that they may jeopardize the carrying out of a foundation’s exempt purposes.⁸ Moreover, “private inurement” (i.e., benefits to ineligible purposes or persons) can destroy a foundation’s tax-exempt status,⁹ and in theory at least, this prohibition comes with “zero tolerance.”¹⁰ In addition, foundations face nearly confiscatory taxes to the extent that they fail to properly distribute at least 5 percent of their assets annually.¹¹

These strictures provide the context in which PRIs make sense. The virtue of program-related investments is that they permit private foundations to make investments rather than grants in

mission-appropriate enterprises (1) without these investments being considered speculative or otherwise “jeopardizing”; and (2) with the investments counting toward the minimum annual payout required of foundations.¹²

But PRI regulations are strict and specific. The following conditions must be met for an investment to qualify as a PRI:

1. an investment’s primary purpose must be to accomplish one or more of the purposes described in the IRC’s section on charitable purposes (section 170(c)(2)(B));
2. no significant purpose of an investment can be production of income or appreciation of property; and
3. no purpose of the investment can be to influence legislation or elections.¹³

While all three requirements may initially seem generic, the first is, in fact, foundation mission-specific. According to the Code, “[A]n investment shall be considered as made primarily to accomplish one or more of the [acceptable charitable] purposes . . . if it significantly furthers the accomplishment of the private foundation’s exempt activities and if the investment would not have been made but for such a relationship between the investment and the accomplishment of the foundation’s exempt activities”¹⁴

Consequently, every time a foundation considers making a PRI, the foundation must make a situation-specific determination that carefully considers the foundation’s mission, the purpose of the organization receiving the investment, the relationship of the receiving organization’s purpose to the foundation’s mission, and how the governance and financial structure of the receiving organization ensures that the receiving organization will operate within PRI requirements.

At minimum, this final determination requires the foundation to carefully monitor the activities of the receiving organization. Indeed, prudence likely requires at least some control. Either way, devising a PRI arrangement requires careful and individualized investigation, deliberation, negotiation, and drafting. An opinion of counsel is almost de rigueur, and prudence sometimes warrants seeking a private-letter ruling from the IRS.

Thus, as an *Exempt Organization Tax Review*

article makes clear, there is nothing automatic or off the shelf about making PRIs.

Perhaps the reason many private foundations approach some PRI transactions with caution is that they realize arrangements between charitable entities and for-profit entities can be very complex, and it is inherently risky to intentionally invest assets in their portfolio in transactions expected to produce below-market returns. The reason many private foundations seek private-letter rulings may be because they understand that PRI transactions that push the envelope in terms of producing income or the appreciation of property should be approached with caution.¹⁵

Compare this view with the insouciance of L3C proponents, who apparently consider private-letter rulings a waste of time: “We honestly believe if an L3C is used and the IRS regulations are followed, there will not be an issue,” Robert Lang writes. “No one asks permission to drive the posted speed limit. Why ask the IRS if you can follow their regulations?”¹⁶

The Dangerous “Benefits” of L3Cs

With this background, we can now examine the three principal benefits that proponents claim are derived from L3Cs.

1. **Consider the supposed “special” connection between L3Cs and PRIs.** According to L3C proponents, an L3C is a brand-new tool in the foundation toolbox designed to expand the use of PRIs,¹⁷ thereby “opening up PRIs and the whole socially beneficial sector . . . [so that an L3C] will become a vehicle for bringing in more money to socially beneficial entities without compromising the return.”¹⁸

L3C proponents initially buttressed these claims by asserting that pro-L3C changes to the Internal Revenue Code were on a “fast track” to enactment.¹⁹ In fact, Congress has not created a special category of PRI treatment for low-profit limited liability companies and appears unlikely to do so.

Indeed, Congress cannot do so without turning the PRI concept upside down. To constitute a PRI, a foundation’s investment must fit the program of the investing foundation.

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Every time a foundation considers making a PRI, the foundation must follow the painstaking, situation-specific determination described previously. It thus makes no sense for the Code to provide a categorical preference for a particular type of PRI-receiving organization. In other words, making L3Cs a specially favored or pre-qualified recipient of PRIs would undo, if not negate, the Code's mandate to examine and validate the content and purpose of the PRI investment itself.

2. Consider “tranching investment,” which L3C proponents extol as the way to leverage foundations’ PRIs to access trillions of dollars of market-driven capital.²⁰ Under a tranching approach, a foundation makes a low-return, high-risk investment in a venture with modest financial prospects but major possible social impact.

The first tranche enables a venture to draw investments from a second tranche: socially conscious investors who are willing to take below-market return to participate in a progressive form of free enterprise that betters the world. At the next level, a venture can attract regular, profit-maximizing investors, whose participation at market rates is made possible by the other two tranches.

According to proponents, L3Cs facilitate tranching investing with PRIs by “usually taking first risk position, thereby taking much of the risk out of the venture for other investors in lower tranches.” Further investment then occurs as follows:

The rest of the investment levels, or tranches, become more attractive to commercial investment by improving the credit rating and thereby lowering the cost of capital. It is particularly favorable to equity investment. Because the foundations take the highest risk at little or no return, it essentially turns the venture capital model on its head and gives many social enterprises a low enough cost of capital that they are able to be self sustainable.²¹

But experts are skeptical that L3Cs will open the floodgates to billions of dollars.²² In addition, tranching investing raises serious policy concerns and is dangerous as a tax matter. Foundations have the privileges of tax-exempt status and can receive deductible contributions. Tranching investing runs the risk of exporting these privileges to benefit noncharitable businesses, managers, and investors.

Tax law has a term for this sort of private benefit—known as *private inurement*—and transactions that create private inurement can create debilitating problems for charitable organizations. Properly constructed, a tranching investment arrangement might survive IRS scrutiny, but it is dangerous to advocate tranching investing by foundations as a generic, easy, and readily available device for social progress.

3. Consider the supposed “branding” value of the L3C label. As portrayed by L3C advocates, the L3C concept, or brand, connotes simplicity, even new offerings, such as “L3Cs (or PRIs through L3Cs) for Dummies.” But applying simplicity and templates to PRIs is a dangerous impediment, not a facilitator. When a private charitable foundation makes a PRI, the decision-making process should involve careful and individualized investigation, deliberation, negotiation, and drafting.

In this realm, due diligence is a serious matter and carries risk of substantial excise taxes for foundations and managers for inaccurate claims that an investment is a PRI. An L3C is not an easy—much less an automatic—avenue to foundation PRI due diligence. Thus, contrary to the assertions of L3C proponents, L3Cs neither facilitate nor provide efficiency for foundations considering PRIs. It is misleading to those who might establish L3Cs in expectation of foundation investment to promote L3Cs as a way to bypass the situation-specific determinations that foundations must make when deciding whether a proposed investment furthers a foundation's tax-exempt purposes and otherwise qualifies as a PRI for that foundation.

4. Finally, L3C legislation contains a fundamental drafting error. The typical L3C statute extrapolates from language in the federal regulations on PRIs and provides that “no significant purpose of *the company* [can be] the production of income or the appreciation of property” (emphasis added).

But how can tranching investing possibly work under these constraints? The key tranche of investors comprises those seeking a market-rate return; their investment is premised on the expectation of profit. More generally, how is it possible to have a low-profit limited-liability company *when no significant purpose of the company is the production of income or the appreciation of property*? Viewed against the claims of L3C proponents, the statutory language evokes thoughts of Lewis Carroll’s White Queen, who “sometimes . . . believed as many as six impossible things before breakfast.”²³

Rejecting the Mirage

While advocates have touted the L3C model as a low-risk, efficient, and flexible way to achieve social progress, the facts are to the contrary. PRIs are an important tool for foundations willing to devote the care and time to look wisely for “social investment” opportunities. But nothing in the L3C model creates an entity any more eligible for PRIs than LLCs without the L3C “brand.” Worse, spreading the L3C delusion could damage the concept and practice of legitimate PRIs. The L3C adds nothing and risks much. Rather than providing real benefits, L3C legislation invites simplistic thinking and fosters false hopes.

ENDNOTES

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3. David S. Chernoff, “L3Cs: Less Than Meets the Eye,” *Taxation of Exempts*, vol. 22, no. 6, 131, 2010.
4. For a detailed analysis of this topic, see Carter G. Bishop, “The Low-Profit Limited Liability Company (L3C): Program Related Investment Proxy or Perversion,” the *University of Arkansas Law Review*, vol.

63, 243, 2010.

5. Bishop, Bishop, “The Low-Profit Limited Liability Company (L3C).”
6. 26 Code of Federal Regulations (CFR) § 53.4944-1(a)(2).
7. 26 C.F.R. § 53.4944-1(a).
8. 26 CFR § 53.4944-(b).
9. *United Cancer Council, Inc. v. Comm’r*, 165 F.3d 1173, 1179, 7th Circuit 1999.
10. *Wendy L. Parker Rehab. Found., Inc. v. Comm’r*, 52 T.C.M. (CCH) 51, no. 2 1986.
11. 26 U.S.C. § 4942(d)–(e).
12. Treasury Regulation § 53.4942(a)-3(a)(2)(ii) recognizes PRIs as qualifying distributions to satisfy the required minimum payout of 5 percent.
13. 26 C.F.R. § 53.4944-3(a).
14. 26 CFR § 53.4944-3(a)(2)(i), emphasis added.
15. Edward Spenard, “Panacea or Problem: A State Regulator’s Perspective on the L3C Model,” the *Exempt Organization Tax Review*, vol. 65, 131, 133, 2010.
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21. Americans for Community Development Web site (www.americansforcommunitydevelopment.org/about.html).
22. David Edward Spenard, “Panacea or Problem,” 131, 133.
23. Lewis Carroll, *Through the Looking Glass*, chapter five.

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