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L3Cs: LESS THAN MEETS THE EYE

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Low-profit limited liability companies have received a lot of attention lately—probably more than they deserve.

Briefly stated, low-profit limited liability companies (commonly referred to as L3Cs) are a sub-set of limited liability companies (LLCs), and have been authorized by amendments to existing LLC statutes in seven jurisdictions over the last 24 months.[1] L3Cs have charitable purposes and offer a lower level of return to their member-owners than LLCs organized for profit—hence, inclusion of "low-profit" in their name. L3Cs, which are intended to have both for-profit and tax-exempt investors, are being touted as a wonderful new opportunity for program-related investments (PRIs) by private foundations.

The purpose of this article is not to explain the mechanics of L3Cs[2] or PRIs,[3] which are an exception to the jeopardizing investment rule,[4] but to point out that there is much less to L3Cs than meets the eye.

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Program-Related Investment Promotion Act of 2009

In 2008, prominent Washington, DC tax *S. Chernoff.* Marcus Owens drafted proposed legislation entitled "The Program-Related Investment Promotion Act of 2009" (PRIPA).[5] PRIPA, which deals with PRIs to L3Cs, would have established:

> ... a procedure under which an entity seeking to receive program-related investments may petition the Secretary [of the Treasury] for a determination that below market rate investments by private foundations in such entity will be program-related investments meeting the requirements of [essentially, Section 4944(c)].[6]

Further, in clear contrast to the non-precedential provisions of Section 6110(k)(3), PRIPA would provide that:

> ... once a determination has been made that below market rate investments in an entity qualify as a program-related investment, organizations making such investments shall be entitled to rely on such determination.

In remarks made to the American Institute of Certified Public Accountants on 6/11/09,[7] Ronald Schultz, Senior Technical Advisor, Tax Exempt and Government Entities Division of the IRS, cautioned the tax-exempt sector about "ambiguities" and "unresolved tax questions" associated with L3Cs. Mr. Schultz said:

> The point I want to make today is that, at the federal level, no one has really signed off on this yet.... So if you are out there hearing about L3Cs and you have a private founda-

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tion that wants to invest in it, and you think the jeopardy investment issue is a slam dunk and you don't need to concern yourself with it, that would be premature.

In a five-page letter dated 7/8/09, Mr. Owens took exception to Mr. Schultz' remarks and cited favorable regulations, revenue rulings, and private letter rulings dealing with PRIs in for-profit entities, *including* LLCs, where the PRI requirements were met.[8]

The draft PRIPA was presented to the staffs of the Senate Finance Committee in late 2008 and Joint Committee on Taxation in early 2009. No action was taken during 2009, and at last report there appears little chance that it will be introduced in Congress.

L3C myths

There are a number of myths floating around the tax exempt sector about PRIs. Some of the reasons given by proponents of L3Cs for their use by private foundations for PRIs are based on those myths.

Myth #1—A private foundation must get a private letter ruling for a PRI. There is nothing in the Code or regulations that requires a private foundation to obtain a letter ruling for a PRI. In practice, letter rulings are sometimes sought where the particular PRI involves a large amount of money, is unusually complex, or is unique.[9] While it may be comforting to obtain letter rulings, they are not required.

It is ironic that the one thing needed for an L3C to offer any real advantage to foundation investors over a regular LLC is a letter ruling from the IRS recognizing the charitable purpose to be accomplished in a particular transaction, as provided in the draft PRIPA. Even if the Code were amended to provide for such rulings—which does not appear likely—the costs of preparing and filing a request for a letter ruling are not transactional costs normally associated with the typical PRIs now being made or contemplated by small and medium-size private foundations.

Myth #2—A private foundation must get an attorney's tax opinion letter for a PRI. Similarly, there is nothing in the Code or regulations that requires obtaining an attorney's opinion for a PRI.[10] What the regulations do say about the advice of counsel in tax opinion letters—in the context of abating an excise tax on a foundation manager under Section 4944(a)(2)[11]—is as follows:

> If a foundation manager, after full disclosure of the factual situation to legal counsel (including house counsel), relies on the advice of such counsel expressed in a reasoned written legal opinion that a particular investment would not jeopardize the carrying out of any of the foundation's exempt purposes (because, as a matter of law, the investment is excepted from such classification, for example, as a program-related investment under section 4944(c)), then although such investment is subsequently held to be a jeopardizing investment under paragraph (a)(2) of this section, the foundation manager's participation in such investment will ordinarily not be considered "knowing" or "willful" and will ordinarily be considered "due to reasonable cause" within the meaning of section 4944(a)(2). * * * However, the absence of advice of legal counsel or qualified investment counsel with respect to the investment shall not, by itself, give rise to any inference that a foundation manager participated in such investment knowingly, willfully, or without reasonable cause.[12]

That having been said, foundations often require tax opinion letters for PRIs that involve a large amount of money, or are unusually complex or unique.[13]

Myth #3—Making a PRI to an L3C solves all tax issues. Because L3Cs will be structured to allow for-profit as well as non-profit investor members, they cannot obtain tax exemption under Section 501(c)(3). Therefore—and this is something that proponents of L3Cs allude to only vaguely, if at all—even if Congress were to adopt PRIPA, and an L3C obtained a favorable PRI letter ruling from the Service, a private foundation investing in that L3C would still be required to exercise "expenditure responsibility" under Sections 4945(d)(4) and (h).[14]

Myth #4—A private foundation could not make a PRI in an LLC before L3Cs were authorized. Nonsense! For years, tax practitioners—both in-house and outside legal counsel—have structured and closed PRIs in the form of purchases of membership interests in regular LLCs with multiple members. They have often done this by including charitable purposes language and prohibitions against use of funds for political purposes or lobbying in the LLC's operating agreement and pur-

1 The first L3C legislation was adopted in Vermont on 4/30/08. Since then, L3C legislation has been adopted in Illinois, Michigan, Utah, and Wyoming, and by the Crow Nation and Oglala Sioux.

2 For an excellent article explaining the origins, state statutory provisions, and purposes of L3Cs, see Brewer and Rhim, "Using the 'L3C' for Program-Related Investments," 21 Exempts 3, page 11 (Nov/Dec 2009).

3 For an explanation of program-related investments, see Chernoff, "Program-Related Investments: A User-Friendly Guide," 5 Family Foundation Advisor 1 (November/December 2005), page 3.

4 Section 4944(c). See also Reg. 53.4944-3(a).

5 A copy of PRIPA is available on the Web site of Americans for Community Development, an organization promoting adoption of L3C legislation. It is appended to americansforcommunitydevelopment.org/downloads/im4511_20090708_164517.pdf.

6 Those requirements are that (1) the primary purpose of the investment must be to accomplish one or more of the purposes described in Section 170(c)(2)(B), and (2) the production of income or appreciation of property must not be a significant purpose of the investment.

7 See "IRS Tax-Exempt Official Urges Caution for Groups Eying Low-Profit LLC Investment," BNA Daily Tax Rep. (BNA), 7/6/09, page G-3.

chase agreement for the membership interests. While L3C supporters have not promoted this myth, it is ironic that Mr. Owens' letter[15] provides ample authority for private foundations to continue to make PRIs in regular LLCs—without state L3C legislation and without the passage of PRIPA.

Myth #5—Many private foundations that would not make a PRI in an LLC will make a PRI in an L3C. There is no evidence to support this notion. To the contrary, numerous foundation officers and program staff, as well as exempt organization practitioners, have confirmed that the treasuries of the nation's private foundations were not bulging with money just waiting to be invested in L3C-type vehicles prior to the current economic downturn if only someone had invented the L3C. The events of the last two years have not changed this situation.

Myth #6—Making a PRI in an L3C will require less documentation, cost less, and take less time than a PRI in a regular LLC. Not so. The same basic documents are involved in both situations:

- Articles of organization of LLC or L3C.
- Operating agreement of LLC or L3C.
- Private placement memo.
- Purchase agreement.
- Side letter (common).

While the same due diligence will be required for both, the document costs may actually be higher for an L3C because some of the operating agreements suggested for L3Cs are much longer—up to 49 pages![16] There would also be additional costs incurred in applying for a letter ruling for a particular L3C, and additional time spent waiting for the Service to issue the ruling, which is not required for a PRI in a regular LLC. The claimed benefits of L3Cs would therefore be no more than a possibility in the relatively rare (in the author's experience) situations involving complex or unusual PRIs, where both complex operating agreements and seeking an IRS letter ruling are necessary or advisable.

Unintended consequences

The Office of the Illinois Attorney General took notice of the L3C legislation when it was pending in that state's legislature. Based on the required charitable purposes of an L3C, and the fact that L3Cs would, in effect, be holding charitable assets, the Attorney General's Office requested the legislature to include language in the final statute[17] to require L3Cs holding more than the $4,000 statutory minimum to register and file reports under the Illinois Charitable Trust Act.[18] Conventional LLCs in Illinois are not similarly burdened. It is possible that other jurisdictions will follow Illinois' lead.

Conclusion

While the proponents of L3Cs speak of providing an opportunity for private foundations to make investments in charitable projects that will also produce a modest return—which is no improvement over any other PRI—they are asking us to look in the wrong end of the telescope. This author is just cynical enough to suggest that some people supporting L3Cs are doing so because L3Cs would provide opportunities for entrepreneurs and for-profit developers to tap into a new market for low-cost funding for projects that do well for them and also happen to do some public good. This includes many well-intentioned but misinformed state legislators voting in favor of L3Cs, most of whom would respond with a quizzical look at anyone who mentioned Reg. 53.4944-3(a).

Without an unlikely change in the Code allowing a private foundation making a PRI in an L3C to rely on a favorable PRI ruling obtained by that L3C, we are no better off than we were before the first L3C legislation was adopted in Vermont. Perhaps instead of referring to a low-*profit* limited liability company, a better name would be low-*income* limited liability company. That name would yield the acronym "LILLAC." Such bushes are indeed eye-catching and produce a seductively sweet fragrance—for a while. Then they just fade away. ■

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[8] Available at americansforcommunitydevelopment.org/downloads/im4511_20090708_164517.pdf.

[9] The author has thought it necessary to seek letter rulings in only three out of the more than 250 PRIs he has handled. These transactions were all out of the ordinary. See, e.g., Ltr. Ruls. 8810026, 8906062, 200136026.

[10] Nothing in this article should, however, be deemed to negate the good sense and common practice of obtaining an opinion by counsel for the PRI borrower or investee that the loan or transaction documents were duly authorized and executed and are valid and binding on the borrower or investee.

[11] Section 4944(a)(2) provides for imposing an excise tax on any "foundation manager" who participates in the making of an investment *knowing* that it is jeopardizing the carrying out of any of the foundation's exempt purposes.

[12] Reg. 53.4944-1(b)(2)(v).

[13] Because the PRIs the author handles average in excess of $1 million each, and often are complex or have unique features, he customarily prepares in-house tax opinions.

[14] See Reg. 53.4945-5(b)(4) for expenditure responsibility requirements with respect to PRIs.

[15] Note 8, *supra*.

[16] See specimen posted on the Web site of Americans for Community Development, americansforcommunitydevelopment.org/supportingdownloads/L3C_Prototype_Operating_Agreement.pdf.

[17] 805 ILCS 180/1-26(d), effective 1/1/10.

[18] 760 ILCS 55/1 *et seq*.