The Low-profit Limited Liability Company (L3C)

By Marc J. Lane, Esq.

What is an L3C?

A **low-profit limited liability company**, also known as an L3C, is a new kind of limited liability company (LLC) that combines the financial advantages of the traditional LLC form of business with the social benefits of a non-profit entity. In addition, as a variety of LLC, the L3C generally shields its owners from the debts of the enterprise. On January 1, 2010, Illinois became the fifth state to authorize the creation of L3Cs.

An L3C is a for-profit limited liability company which is specifically organized to further one or more *charitable or educational purposes* within the meaning of the Internal Revenue Code (IRC).[1] L3Cs may be formed as free-standing businesses with social purposes. They may also be created by nonprofit organizations as for-profit subsidiaries with social welfare goals.

An L3C can earn income and see its property appreciate in value, but the production of income or the appreciation of property cannot be a significant purpose of the company. In addition, L3Cs are prohibited from pursuing *political or legislative purposes* within the meaning of the IRC.

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What are the advantages of an L3C?

One major advantage of an L3C is that it is specifically designed to facilitate *program-related investments* (PRIs) by private foundations. Generally speaking, each year, private foundations are required under the IRC to distribute 5% of their average net assets for charitable purposes. Qualifying distributions, for this purpose, include not only grants, primarily to public charities, but also PRIs, which may be loans, loan guarantees, lines of credit, linked deposits or even equity investments.

Unlike grants, PRIs can be recovered, along with earnings, and redeployed, over and over again, for charitable purposes. The program-related investment's "multiplier effect" thus expands the foundation's programmatic impact.

Program-related investments have three characteristics: (1) their primary purpose must be to accomplish one of the foundation's charitable purposes; (2) a significant purpose of the investment must not be the production of income or the appreciation of property[2]; and (3) no purpose of the investment can be the accomplishment of political or legislative purposes.

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[1] 26 U.S.C. § 170(c)(2)(B).

[2] The L3C venture might never have been launched but for the private foundation's investment. IRS regulations establish a test: if investors "solely engaged in investment for profit would be likely to make the investment on the same terms as the private foundation," the investment is unlikely to qualify as a PRI. Treas. Reg. §53.4944-3(a).

A foundation's PRI to an L3C can catalyze a potent social-purpose strategy. By taking on higher risk and forgoing market-rate returns, the foundation affords the L3C the opportunity to attract private-sector investment which otherwise might never support a social venture. It also fosters the L3C's long-term sustainability.

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What kinds of activities can an L3C be formed to engage in?

The possible uses for L3Cs are as varied as charity itself. The L3C might be a suitable business form for any of these activities, among others:

- A community development initiative
- A venture which provides employment opportunities for economically disadvantaged minority groups
- An arts group
- A venture organized to revitalize and stimulate economic growth in deteriorated areas where businesses are not providing adequate opportunities
- A charter school
- A social service organization
- A faith-based program
- A child care center
- An educational or other workforce development training opportunity
- A business that develops cutting-edge technology in rapidly changing environmental or health-related fields
- A land conservation or environmental mitigation effort
- A business that finances affordable housing for low-income and other disadvantaged members of society
- A historic preservation group
- A venture that provides low-interest loans and affordable credit to disadvantaged persons and business owners

- A business that provides services to nonprofit organizations in support of their missions

- A health clinic

- A cultural organization

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Who manages an L3C and how is it governed?

Like other LLCs, an L3C is managed either by the "member" or "members" (owners) collectively, or by one or more "managers." The L3C's Articles of Organization must specify whether the company is to be member-managed or manager-managed. If the company is manager-managed, the managers may be members, but are not required to be.

An L3C is governed according to the terms of its "operating agreement." An operating agreement is an agreement signed by the members which regulates the affairs of the company, the conduct of its business, and the relationship among the members, the managers (if any), and the company. If the company has only one member, the sole member may establish an operating agreement in writing, or, if the company has a manager other than the sole member, by oral agreement with the manager.

An L3C's operating agreement sets forth the members' respective rights and obligations; the contributions they are expected to make to the company; the distributions they may be entitled to receive; their voting rights; the rights and responsibilities of managers (including certain obligations which program-related investors are required by Federal law to impose on L3C managers); conditions relating to the members' ability to transfer their membership interests; and other governance provisions.

The members are given broad latitude to determine the governance of the company by means of the operating agreement. The Limited Liability Company Act provides for "default" governance provisions, but most such provisions may be modified by the operating agreement.

The operating agreement establishes substantial rights and obligations. For that reason, legal counsel should be consulted in connection with its negotiation and drafting.

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How is an L3C taxed?

Although L3Cs pursue the same purposes as tax-exempt non-profit organizations, an L3C is not considered a non-profit organization and is not itself eligible for exemption from income tax. Instead, L3Cs, like other LLCs, are treated for tax purposes as sole proprietorships, partnerships or corporations are.

The default status for any LLC, including an L3C, is to be taxed as a partnership if it has more than one member, and as a disregarded entity if it has only one member (in other words, its income and expenses are reported on its owner's tax return similar to a sole proprietorship). However, the company may choose, in either case, to elect to be taxed as a corporation rather than as a partnership or disregarded entity.

Although most LLCs choose to be taxed as partnerships or disregarded entities, it may be advantageous for some L3Cs to elect to be taxed as corporations instead. This is particularly true for L3Cs which are wholly owned by nonprofit corporations. If a nonprofit corporation wholly owns an L3C, and the L3C is treated as a disregarded entity, the L3C's profits (if any) may be taxed as "unrelated business taxable income." However, if the nonprofit wholly owns an L3C which elects to be taxed as a corporation, although the L3C's profits will be subject to tax, any dividends received by the nonprofit from the L3C will not be treated as unrelated business taxable income.

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In summary, an L3C can share risk and leverage co-investment, attracting traditional financial players to a social venture which would otherwise be unattractive to them. At the same time, it invites a flexible governance structure which can harmonize the disparate interests of nonprofit, foundation and for-profit stakeholders.

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