CAN THE L3C SPUR PRIVATE FOUNDATION PROGRAM-RELATED INVESTMENT?

Edward Xia*

The L3C, a modified form of the LLC, is a new hybrid entity that has been formed in several states. Its major aim is to facilitate capital-raising for social causes in both non-profit and for-profit sectors. In order to accomplish this, the L3C must attract significant program-related investments ("PRIs"), which are investments private foundations can make that further the foundation's social mission, and thus do not subject the foundation to a variety of penalty taxes.

This Note argues, however, that the L3C will not cause private foundations to make significantly more PRIs. The IRS standard for PRIs requires private foundations to make a case-by-case determination of the nature of the investment, which L3C legislation does not respond to. Additionally, expenditure-responsibility requirements impose on private foundations a level of due diligence that is at odds with L3C advocates' claims of a more streamlined decision-making process for making PRIs into L3Cs. Federal legislation is necessary to make the L3C more effective in spurring PRI, but such legislation is unlikely to be passed.

---

* J.D. Candidate 2013, Columbia Law School; A.B. Woodrow Wilson School of Public & International Affairs 2008, Princeton University. The author would like to thank Professor Barbara Schatz for her invaluable guidance, and the staff of the *Columbia Business Law Review* for their hard work and assistance in the publication of this Note.

I. INTRODUCTION

The United States has traditionally been described as having three economic sectors: government, business, and non-profit.[1] However, commentators have noted the recent rise of a "fourth sector," a zone between non-profit and business that manifests itself in socially responsible businesses, charitable joint ventures, and mission-related investing, among other forms of social enterprise.[2] This fourth sector has arisen in response to capital-raising challenges in the non-profit sector, as well as restrictions on social aims in the for-profit sector.[3] Rejecting the traditional boundary between the non-profit and for-profit sectors, fourth sector entities measure success both in terms of profit

1 J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking in Low-Profit Limited Liability Companies*, 66 U. MIAMI L. REV. 1, 6 (2011).

2 *Id.* at 6–7.

3 *See generally* Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 352–53 (2009).

and social impact.[4] One particular manifestation of this fourth sector includes new organizational forms that various states have developed.

The low-profit limited liability company ("L3C"), a modified form of the traditional limited liability company ("LLC") that has been accepted in all fifty states, is one of these new organizational forms. Its major aim is to facilitate capital-raising for social causes in both the non-profit (e.g., foundations) and for-profit sectors (e.g., venture capital and other investors).[5] Specifically, the L3C aims to attract program-related investments ("PRIs") from private foundations.[6] As explained in greater detail below, PRIs are investments that foundations make to further the foundation's social mission, and thus do not subject the foundation to a variety of penalty taxes. PRIs, by definition, cannot have a significant profit motive. As a result, social enterprises that can attract PRIs can make use of a tiered investment strategy, where foundations making PRIs take on the most risk and accept the lowest return; this then facilitates investment by for-profit investors, who could receive a market rate of return, even though the social enterprise, as a whole, does not offer a market return.[7]

However, as L3C legislation has spread to nine different states, some critics have begun to question whether, given the case-by-case analysis required in a typical determination of whether a PRI meets IRS standards, the L3C facilitates the making of PRIs any more than a typical LLC does. This Note will attempt to answer the question of whether the L3C can in fact be as successful as its advocates hope in raising capital for the social sector. If foundations maintain a

4 Kelly, *supra* note 3, at 346–47. *See also* JOHN ELKINGTON, CANNIBALS WITH FORKS: THE TRIPLE BOTTOM LINE OF 21ST CENTURY BUSINESS 69–70 (1998).

5 Sue Woodrow & Steve Davis, *The L3C: A New Business Model for Socially Responsible Investing,* CMTY. DIVIDEND, no. 4, 2009 at 4, *available at* http://www.minneapolisfed.org/ pubs/cd/09-4/CommDiv_2009_4.pdf.

6 *Id.*

7 *Id.* at 4–5.

cautious approach to PRIs, the L3C model will not live up to its promise.

Part II of this Note provides context, by outlining the basics of the L3C and how its tiered investment strategy aims to facilitate funding from both non-profit and for-profit sources. It will then outline the current doctrine surrounding PRIs and the implications for foundations making inappropriate PRI decisions.

Part III outlines the major arguments against utilizing the L3C model. First, Part III shows how meeting PRI requirements requires a case-by-case determination by foundations of the nature of the investment, something that L3C legislation does not respond to. Second, Part III demonstrates how expenditure-responsibility requirements impose on private foundations a level of due diligence that is at odds with L3C advocates' claims of a more streamlined decision-making process for making PRIs into L3Cs. Third, Part III explains why the IRS is unlikely to promulgate a rule giving categorical preference to L3Cs over other legal forms. Lastly, Part III notes how proposed federal legislation could obviate some of these issues, but that it appears such legislation will likely not be passed.

II. BACKGROUND OF THE L3C

A. Social Sector Funding Limitations

Social entrepreneurs report that their most pressing challenge has been gaining access to capital. Social enterprise, with both social and profit motives, does not fit neatly into the expectations of existing sources of capital.[8] Social enterprises can be formed directly as non-profits, which seek out government and private foundations for grant funding. However, there has been a significant decrease in government funding over the past two decades.[9]

---

8 *See* Kelley, *supra* note 3, at 352–53.

9 Approximately one-third of non-profits fail within their first five years, while another one-third operate in a "zone of insolvency" where liabilities exceed assets. Gene Takagi & Emily Chan, *Alternatives to*

Commentators have also noted a decrease in overall foundation funding, as well as the growing preference of foundations to make grants for a limited period of time, after which the non-profit is expected to be financially self-sufficient.[10] Furthermore, as noted below, foundations are also heavily regulated with regard to their spending activity. Non-profits that attempt to become more entrepreneurial and diversify their capitalization strategies find limitations in non-profit law. Specifically, non-profits exist to benefit the public, meaning that all profits generated must be used to serve the organization's mission, preventing venture capitalists and other traditional for-profit investors from providing equity to the organization.[11] In addition, traditional lenders, such as banks, are often reluctant to provide loans to non-profits on competitive terms because a non-profit's ability to repay is constrained by its lack of access to certain types of capital.[12]

On the other hand, if an organization decides to create a for-profit company, it is then generally excluded from foundation grants and government assistance.[13] Additionally, for-profit investors (e.g., venture capital and institutional investors) typically expect market-rate returns and profit maximization.[14] Organizations with social missions are rarely in a position to meet these expectations, as their social goals often take away from their ability to

---

Forming a Charitable Nonprofit: A Start-Up May Not Be in Your Client's Best Interests, 18 BUS. L. TODAY, no. 6, 2009 at 15, 15.

10 *See* William Foster & Jeffrey Bradach, *Should Nonprofits Seek Profits?*, HARV. BUS. REV., Feb. 2005, at 2 (noting that foundations want non-profits to be "sustainable"); Arthur Wood, *New Legal Structures to Address the Social Capital Famine*, 35 VT. L. REV. 45, 45 (2010) (noting that since the financial crisis, foundations have seen their funds shrink by thirty to thirty-five percent).

11 *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 2008) (prohibiting tax-exempt public charities from distributing profits to equity investors).

12 *See* Kelley, *supra* note 3, at 354.

13 *See* Woodrow & Davis, *supra* note 5, at 4.

14 *See id.*

make significant profits.[15] The L3C is one of several hybrid organizational forms that have been developed in state law in order to facilitate raising capital from *both* the non-profit and for-profit sectors.[16]

B. Rise of L3C Legislation

The concept of the L3C, a modified form of an LLC, was developed in the mid-2000s by Robert Lang, a prominent foundation manager; Marcus Owners, the former director of the Exempt Organizations Division of the IRS; and Arthur Wood, director of an international organization promoting social entrepreneurship.[17] Since then, the group—along with other L3C advocates—has pushed many states to adopt the entity into law. Vermont became the first state to enact legislation establishing L3Cs in April 2008.[18] Subsequently, eight other states have followed in adopting L3C statutes, including Illinois, Louisiana, Maine, Michigan, North Carolina, Utah, Wyoming, and Rhode Island;[19] two federal

---

15 For example, many of these organizations provide discount services in underserved communities. *See* Kelley, *supra* note 3, at 354–55.

16 Other examples include B-Corporations and flexible purpose corporations. *See generally* Robert R. Keatinge, *LLCs and Nonprofit Organizations—For-Profits, Nonprofits, and Hybrids*, 42 SUFFOLK U. L. REV. 553, 579–80, 583 (2009); Rosemary E. Fei, *Beyond Taxation: A Guide to Social Enterprise Vehicles*, 22 TAX'N EXEMPTS 37, 37–39 (2011). There have also been new social enterprise forms in the United Kingdom, Belgium and France. *See* Linda O. Smiddy, *Introduction, Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship*, 35 VT. L. REV. 3, 3 (2010).

17 Robert Lang & Elizabeth Carrott Minnigh, *The L3C, History, Basic Construct, and Legal Framework*, 35 VT. L. REV. 15, 19–20 (2010).

18 *Low-Profit Limited Liability Company*, VT. SEC'Y OF STATE: CORPS. DIV., http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm (last visited Mar. 22, 2013).

19 *See* 805 ILL. COMP. STAT. ANN. 180/1-26 (West 2013); LA. REV. STAT. ANN. § 12:1302 (2012); ME. REV. STAT. ANN. tit. 31, § 1611 (2012); MICH. COMP. LAWS ANN. § 450.4102(m) (West 2012); N.C. GEN. STAT. ANN. § 57C-2-01(d) (West 2013); R.I. GEN. LAWS ANN. § 7-16-76 (West 2012); UTAH CODE ANN. § 48-2c-412 (West 2012); WYO. STAT. ANN. § 17-29-102(a)(ix) (West 2012).

Indian jurisdictions have as well.[20] Additionally, as of this writing, over a dozen states have L3C legislation under consideration,[21] indicating the growing popularity of the L3C form. Importantly, an L3C chartered in one state will be recognized as a lawful business in all other state jurisdictions in the United States, whether or not that state has enacted L3C legislation.[22]

The L3C is similar to a traditional LLC in that it is a for-profit entity that offers a flexible structure in which each member's management and financial interest may vary.[23] The "structural flexibility" of LLCs permits individuals, foundations, non-governmental organizations, corporations, and government agencies to be part of the same entity.[24] While both LLCs and L3Cs may generate profits, the major difference between the two is that L3C statutes require L3Cs to prioritize socially beneficial goals, with generating profit as a secondary priority. By contrast, a party can organize an LLC for *any* lawful purpose.[25] Typically, L3C legislation amends a state's existing LLC statute to create a subcategory of LLCs that effectively retains the LLC's flexible nature but adds a requirement of meeting social goals.[26] A regular LLC becomes an L3C by noting its status

20 The Crow Indian Nation and the Ogala Sioux Indian Tribe have authorized the L3C. Elizabeth Schmidt, *Vermont's Social Hybrid Pioneers: Early Observations and Questions to Ponder*, 35 VT. L. REV. 163, 163 n.4 (2010).

21 *See* Daniel Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 881 (2010).

22 *See* Woodrow & Davis, *supra* note 5, at 5. This is based on the Full Faith and Credit Clause of the U.S. Constitution. Mark R. Krogstad, Note, *Filling the Gap: Addressing the Potential Impact of North Dakota Adopting Legislation Creating a New Identity—The Low Profit Limited Liability Company*, 86 N.D. L. REV. 535, 547 (2010).

23 *See* Kelley, *supra* note 3, at 370; Dennise Bayona & Ken Milani, *The L3C Low-Profit Limited Liability Company: Investment Option for Societal Impact*, 86 PRAC. TAX STRATEGIES 66, 67 (2011).

24 Lang & Minnigh, *supra* note 17, at 21.

25 *See* Bayona & Milani, *supra* note 23, at 67.

26 Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV. 619, 621 (2010).

in its articles of organization,[27] and by including a special L3C designation in the company name.[28] The Vermont L3C statute is illustrative, as most L3C legislation contains exactly the same language.[29] The Vermont statute outlines the following requirements for an L3C:

> (A) The company:
> (i) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(B); and
> (ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.
> (B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.
> (C) No purpose of the company is to accomplish one or more political or legislative purposes within the

27 *E.g.*, VT. STAT. ANN. tit. 11, § 3023(a)(6) (West 2012) ("Articles of organization of a limited liability company shall set forth . . . whether the company is an L3C . . . ."); 805 ILL. COMP. STAT. ANN. 180/1-26(b) (West 2013) ("A limited liability company which intends to qualify as a low-profit limited liability company pursuant to the provisions of this Section shall so indicate in its articles of organization . . . .").

28 *E.g.*, VT. STAT. ANN. tit. 11 § 3005(a)(2) (West 2012) ("The name of a low-profit limited liability company . . . shall contain the abbreviation L3C or l3c."); UTAH CODE ANN. § 48-2c-106(8) (West 2012) ("The name of a low-profit limited liability company shall contain the abbreviation 'L3C' or 'l3c.'").

29 Similarities among existing L3C legislation is due, in part, to advocates of L3Cs pushing for the so-called "basic L3C model," which aims to fit easily within existing state LLC legislation, while also containing language that mirrors the IRS rules regarding program-related investment. *See The Concept of the L3C*, AMS. FOR CMTY. DEV., http://www.americansforcommunitydevelopment.org/concept.html (last visited Mar. 23, 2013).

> meaning of Section 170(c)(2)(D) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(D).[30]

Beyond these requirements, there is virtually no additional doctrine regarding L3C structure and governance, whether statutory or jurisprudential.[31] Given the flexibility with regard to purpose in the LLC form, an LLC can enshrine the statutory limitations imposed on the L3C form in its operating agreement, making the LLC's form functionally equivalent to the L3C form.[32] Additionally, as explained below, the language of L3C legislation mirrors the language the Internal Revenue Code uses to define the requirements for making a Program-Related Investment.[33] It is estimated that over 250 L3Cs have been created nationwide.[34]

L3C advocates envision the typical L3C to be a "for-profit with a non-profit soul," meaning the venture aims to pay for itself through the revenue it generates, but will not make significant profit.[35] L3Cs can be created in several ways: (1) creating a new organization as an L3C; (2) reorganizing and converting an existing LLC to an L3C; or (3) creating an L3C as a subsidiary of an existing entity.[36] One example of a real-life L3C is MOOMilkCo., an L3C created by a group of organic dairy farmers in Maine with the mission of providing high-quality organic milk to consumers.[37] Their aim is to obtain capital from private investors, supplemented with

---

30 VT. STAT. ANN. tit. 11 § 3001(27) (West 2012).

31 *See* Dana Brakman Reiser, *Blended Enterprise and the Dual Mission Dilemma*, 35 VT. L. REV. 105, 109 (2010).

32 The sole difference would be that only a statute can create an L3C. In contrast, an operating agreement can create an LLC. Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 249 (2010).

33 *See* Lang & Minnigh, *supra* note 17, at 16–17.

34 Schmidt, *supra* note 20, at 192.

35 *Id.* at 177.

36 TOM MOODY, DOWNS RACHLIN MARTIN PLLC, THE L3C—FACILITATING SOCIALLY BENEFICIAL INVESTING 3 (2010), *available at* http://www.linkingmissiontomoney.com/documents/L3CArticle-Moody.pdf.

37 Bayona & Milani, *supra* note 23, at 69–70.

funding from foundations that have a mission of promoting organic food.[38] Another example is Sustainable Timber Investment Exchange, a timber harvesting company that uses sustainable and ecological harvesting techniques. Owning timber-harvesting equipment is expensive and usually cannot be done at an adequate level of profit for investors without using "traditional" techniques. Therefore, the L3C aims to attract both for-profit investors as well as foundations willing to take a lower rate of return.[39]

C. Tiered Investment: How L3Cs Aim to Increase Funding to the Social Sector

As noted above, a typical L3C provides a social benefit and some level of return, although the return is typically less than market returns. The L3C structure aims to bring in the complete spectrum of supporters, including private foundations making program-related investments, for-profit investors looking for a market return, and "mixed-motive" investors willing to take a lesser rate of return to promote a charitable purpose.[40] The way that an L3C can accomplish this goal is through a tiered investment strategy. The L3C's flexibility allows for members to assume different interests in the venture, and the tiered investment strategy permits an uneven allocation of risk versus reward for the L3C's members.[41]

Three tiers of capital are involved in an L3C: the junior, senior, and intermediate tiers. The junior tier, also known as the equity tranche, is taken up by foundations, which have last claim on the assets of the enterprise upon termination, and also take a below-market rate of return.[42]

38 Bayona & Milani, *supra* note 23, at 69–70.

39 Schmidt, *supra* note 20, at 180.

40 E-mail from Marcus S. Owens, Partner, Caplin & Drysdale, et al., to Willard L. Boyd III, Chair, ABA Bus. Section Nonprofit Orgs. Comm., et al. (July 13, 2011), *available at* http://www.americansforcommunitydevelopment.org/downloads/Letter%20regarding%20L3C%20%2800339893-2%29.pdf.

41 Bayona & Milani, *supra* note 23, at 68–69.

42 *Id.* at 69.

Foundations can afford to risk incurring a loss on the investment, since the L3C is furthering a charitable purpose the foundation wants to promote, and, at worst, the foundation has provided a grant to the L3C (if no money is paid back). The junior tier, through PRI capital, provides the L3C with an underlying "financial backbone," strengthening its balance sheet, and allowing it to attract investment from for-profit investors.[43] The senior tier in the L3C, in contrast, is designed for for-profit investors who seek market rates of return. L3C advocates envision these as institutional investors—such as pension funds, insurance companies, or endowments—and the presence of PRI capital is what allows the L3C to offer these higher rates of return (in effect, the PRI is a capital subsidy).[44] The intermediate tier, or the mezzanine tranche, is designed to attract investors who have a social mission, and who define "return on investment" more broadly to include the achievement of a social purpose, including socially-minded investors or banks seeking to fulfill Community Reinvestment Act obligations.[45]

---

43 Bayona & Milani, *supra* note 23, at 69.

44 The principle of profit maximization for shareholders means that for-profit investors often cannot invest if the rate of return is not in line with market rates. *See* Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

> To illustrate . . . use a simplified structure and assume that no market-oriented investor will, in most cases, invest with a return that is projected from zero to somewhere around 5 or 6%. If a socially-driven enterprise will only earn a 6% return, how do we get adequate capital into the enterprise? If a foundation invests 50% of the capital required and takes first risk position, but only asks for a 1% return, then the commercial investors can receive their 6% plus the 5% the foundation has given up for a total return of 11%.

Lang & Minnigh, *supra* note 17, at 18.

45 Bayona & Milani, *supra* note 23, at 69. The Community Revinstment Act is a federal statute that requires banks to meet the credit needs of all community members, especially low-income and moderate-income residents. Under the statute, banks are periodically evaluated by the Office of the Comptroller of Current for compliance with providing credit to these residents. *See generally* Community Reinvestment Act, 12 U.S.C. §§ 2901–2908 (2012).

It is important to note that a tiered investment strategy could be set up using the standard LLC structure due to the LLC's inherent flexibility.[46] However, advocates are especially hopeful for the success of the L3C form because what is essential to this tiered investment system is the ability of private foundations to provide support in the junior tier in the form of PRIs.[47] Indeed, L3Cs are expected to encourage more program-related investment.

D. Program-Related Investments as the Key to the Effectiveness of L3Cs

Section 501(c)(3) of the Internal Revenue Code provides an exemption from federal income tax for entities that are: (1) "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes;" and (2) follow restrictions regarding private inurement, private benefit, lobbying, and electioneering.[48] There are two subsets of 501(c)(3) organizations: public charities and private foundations.[49] Although both public charities and private foundations are exempt from federal income tax[50] and may receive tax-deductible charitable donations subject to donor-income limitations,[51] public charities are not subject to a series of

46 One example is a joint venture between a non-profit and a for-profit company, each owning shares in an LLC with a social mission that generates below-market returns. The for-profit gets market-rate returns, while the non-profit does not, but the non-profit has management oversight to ensure the social goals are met. The LLC agreement would most likely need to limit its purposes to meeting certain social goals. *See* Bishop, *supra* note 32, at 246.

47 Some have even argued that securitizing PRI interests in L3Cs could reduce the cost of procuring ownership shares, allowing smaller foundations and average consumers to invest in a variety of socially beneficial enterprises. Cody Vitello, Consumer News, *Introducing the Low-Profit Limited Liability Company (L3C): The New Kid on the Block*, 23 LOY. CONSUMER L. REV. 565, 572–73 (2011).

48 I.R.C. § 501(c)(3) (2011).

49 *See id.* § 509.

50 *See id.* § 501(a).

51 *See id.* § 170(a)–(b).

excise taxes applicable to foundations and their managers regarding their investments.[52]

More specifically, if a private foundation makes an investment in such a manner as to jeopardize the carrying out of any of its exempt purposes, the foundation may be subject to an initial tax equal to ten percent of the amount invested.[53] An investment is considered a "jeopardy investment" if it is determined that the foundation managers "failed to exercise ordinary business care and prudence"—under the facts and circumstances at the time of investment—In providing for the short- and long-term needs of the foundation, considering expected return, risk, and the need for diversification.[54] The determination is made on an investment-by-investment basis.[55] The ten percent tax is imposed for every taxable year from when the investment was made until the tax is assessed or the investment is corrected,[56] meaning that the tax will often reach thirty percent or more while it remains outstanding.[57] Additionally, once the IRS has determined that a jeopardy investment has been made, a private foundation will incur an additional tax equal to twenty-five percent of the jeopardy investment if it is not removed from jeopardy (i.e., sold or otherwise disposed) as directed.[58] This means that the total aggregate tax can often be in excess of fifty percent of the investment.[59]

Managers of foundations also face penalties. Initially, there is a ten percent tax imposed on any foundation manager who made the investment knowing it was a jeopardy investment unless the manager's participation was not willful and was due to reasonable cause.[60] An additional

52 *See* I.R.C. §§ 4940–45 (2011).

53 *See id.* § 4944(a)(1).

54 Treas. Reg. § 53.4944-1(a)(2)(i) (2012).

55 *Id.*

56 I.R.C. § 4944(e) (2011).

57 Bishop, *supra* note 32, at 256.

58 I.R.C. § 4944(b)(1), (e) (2011).

59 Bishop, *supra* note 32, at 257.

60 I.R.C. § 4944(a)(2) (2011).

five percent tax is imposed on any manager who does not remove the investment from jeopardy.[61] The legislative history suggests Congress, in passing these rules, was primarily concerned with the possibility of loss on risky investments.[62]

Significantly, jeopardy investment excise taxes will not be imposed where the investment is a PRI. PRIs were developed to enable private foundations to support risky for-profit business activities intended to achieve charitable goals.[63] PRIs are not intended to generate a market rate of return.[64] Specifically, a private foundation investment is a PRI when: (1) the primary purpose of the investment is to accomplish one or more of the purposes described in Section 170(c)(2)(B);[65] (2) no significant purpose of the investment is the production of income or the appreciation of property;[66] and (3) no purpose of the investment is to engage in a political campaign or influence legislation.[67] More detail on these specific tests will be outlined below, but the key feature of the L3C is how L3C statutory requirements mirror this PRI language. Common examples of PRIs include loans bearing interest at a below-market rate, zero interest loans (i.e., a "recoverable grant"), loan guarantees made by another entity, leases and property conveyances, and direct

---

61 I.R.C. § 4944(b)(2) (2011).

62 Bishop, *supra* note 32, at 255; *see also* H.R. REP. NO. 91-413, at 31 (1969); S. REP. NO. 91-552, at 45 (1969).

63 Rebecca H. Dent, *PRI, MRI, SRI, L3C—A Short Review for Private Foundation Counsel*, 19 OHIO PROB. L.J. 137, 138 (2009).

64 *Id.* However, the fact that the PRI eventually earns a good return is not determinative of whether the investment is a PRI. Treas. Reg. § 53.4944-3(a)(2)(iii) (2012).

65 I.R.C. § 4944(c) (2011); Treas. Reg. § 53.4944-3(a)(1)(i) (2012). The test is satisfied if the investment furthers the private foundation's charitable purpose and, *but for that fact*, the investment would not have been made. Treas. Reg. § 53.4944-3(a)(2)(i) (2012).

66 I.R.C. § 4944(c) (2011); Treas. Reg. § 53.4944-3(a)(1)(ii) (2012).

67 Treas. Reg. § 53.4944-3(a)(1)(iii) (2012).

investments carrying subordinated return for a long period of time before any return is due.[68]

Additionally, a PRI has the additional benefit of counting toward satisfying the minimum distribution requirement of private foundations. Non-operating private foundations (i.e., foundations that do not engage in their own programs in addition to making distributions)[69] must make distributions of at least five percent of their excess investment assets for charitable purposes each year (these distributions are called "qualifying distributions").[70] Usually, this is done in the form of grants to public charities, but a foundation can also make a PRI to a for-profit entity if certain requirements are met.[71] A PRI counts as a qualifying distribution if the private foundation exercises "expenditure responsibility" for the investment.[72] Of course, a PRI does not have to count toward the qualifying distribution to be made, if the foundation can satisfy the minimum distribution requirement through other grants. However, if the PRI is not made with "expenditure responsibility," such that it counts toward the qualifying distribution, the PRI is then considered a "taxable expenditure" that is subject to a severe excise tax.[73] The result is that expenditure responsibility is generally *required* for any foundation making a PRI. Expenditure responsibility, outlined in greater detail below, requires that the foundation "exert all reasonable efforts and to establish adequate procedures" to: (1) ensure the PRI is

---

68 *See* Benjamin N. Feit, *What IRS Private Letter Rulings Reveal about Program-Related Investments*, 23 TAX'N EXEMPTS 3, 5–6 (2011).

69 *See* I.R.C. § 4942(j)(3) (2011).

70 Excess investment assets are determined by calculating the difference between assets "other than those used (or held for use) in carrying out the foundation's exempt purpose" and acquisition indebtedness (i.e., debt incurred to acquire the assets). I.R.C. § 4942(e) (2011).

71 Dent, *supra* note 63, at 139.

72 I.R.C. § 4945(d) (2011).

73 *See id.* § 4945(d)(4)(B) (defining taxable expenditures to include grants to non-public charities, among other types of organizations, through which the entity does not exercise expenditure responsibility); Treas. Reg. § 53.4945-4(a)(2) (2012) (defining grants as including PRIs).

spent only for the purpose for which it was made; (2) obtain reports on how the investment funds are being used; and (3) provide reports to the IRS regarding the PRI.[74]

PRIs are also beneficial because they are not subject to the excess business holdings tax,[75] a ten percent tax which the IRS imposes on a private foundation's excess business holdings.[76] An excess business holding is defined as ownership of more than twenty percent of the voting stock in a corporation, or more than twenty percent profit interest in a partnership or unincorporated enterprise, such as an LLC.[77] The excise tax can be increased to 200 percent if the foundation does not remedy the problem.[78] Foundations can thus make PRIs that result in a significant ownership share of the recipient entity, which is of particular importance for start-up ventures, where the relative amount of foundation investment is often high.[79]

In theory, PRIs should be very attractive to foundations—they further foundations' social missions, allow foundations to recover a significant portion of their investments in order to support other initiatives, can count toward foundations' distribution requirements, and do not subject foundations to certain onerous excise taxes. However, of the nearly 80,000 private foundations operating in the United Sates, only about five percent make PRIs, and these PRIs come primarily in the form of loans to non-profit organizations.[80]

---

74 I.R.C. § 4945(h)(1)–(3) (2011).

75 Treas. Reg. § 53.4943-10(b) (2012).

76 I.R.C. § 4943(a)(1) (2011).

77 *See id.* § 4943(c).

78 *See id.* § 4943(b).

79 J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273, 278 (2010).

80 Woodrow & Davis, *supra* note 5, at 4. For example, while F.B. Heron Foundation is considered one of the few foundations with a large commitment to making PRIs, PRIs only account for eight percent of its assets. Luther M. Ragin Jr., *Program Related Investments in Practice*, 35 VT. L. REV. 53, 54 (2010).

PRIs, and the laws and regulations surrounding them, were developed in the 1960s when the concept of social enterprise was very limited.[81] For the most part, the IRS and private foundations envisaged PRIs as making capital investments in job-creating ventures in inner cities; when these urban ventures became economically viable and capable of attracting market capital, private foundations would withdraw their investments.[82] Today, even though PRIs can be very useful for a wide variety of social enterprises, many private foundations are not aware of the breadth of their possible use. This explains why awareness of PRIs on the part of foundation managers and board members is often low.[83]

Foundations also perceive PRIs to be burdensome and risky.[84] Due to the possibility of significant excise taxes, the majority of private foundation managers rarely proceed with a potential PRI without a private letter ruling from the IRS (essentially IRS pre-approval), or a letter from expert counsel.[85] Obtaining a private letter ruling is time consuming and costly; it is estimated that the process of getting private letter rulings can take up to eighteen months,

---

81 Kelley, *supra* note 3, at 357.

82 *Id.*

83 As one major foundation manager notes, "[W]hether it is CEOs, board members, or others, they all generally have a very low level of awareness of the [PRI] tool." Ragin, *supra* note 80, at 56.

84 Kelley, *supra* note 3, at 356. Some other reasons for reluctance to use PRIs include discomfort with underwriting risk on the part of foundation managers, and the belief that only grant making creates social impact. Ragin, *supra* note 80, at 56–57.

85 Private foundation managers may make a PRI without approval from the IRS or expert counsel, but "the draconian sanctions leveled against foundations that make investments subsequently classified as 'jeopardizing' likely dissuade the great preponderance of private foundation managers from proceeding without such preclearance except in the plainest of plain vanilla situations." Feit, *supra* note 68, at 4 n.1. However, L3C advocates note that the IRS "probably does not know much of anything about most of the PRIs out there." Minnigh & Lang, *supra* note 17, at 22. Marc Owens, former head of the exempt division of the IRS, has stated, "We never saw a problem with PRIs the entire time that I was at the IRS. We never saw that as an enforcement issue." *Id.*

and cost $8,700 in IRS fees, and $50,000 to $100,000 in legal fees.[86] If the foundation does not want to get pre-approval from the IRS, it may choose to do its own due diligence and then obtain a confirmation letter from tax counsel stating the PRI is appropriate.[87] This process is also costly—aside from attorney's fees, it places a large administrative burden on the foundation and its managers, and, given the alternatives available for foundations, is often avoided.[88] Additionally, tax counsel opinion is not binding upon the IRS.[89]

L3C advocates note that L3Cs are more than just a "vehicle for PRIs." They point out that the main value-add of the L3C is the dovetailing of L3C language with PRI language, which facilitates increased PRI by foundations.[90] L3C advocates claim that because L3C "legislation was written in such a way as to comply with all PRI regulations, the structure eliminates the need for private letter rulings or legal opinions for foundation investment in L3Cs."[91] Indeed, the creators of the L3C envisage a master list, possibly maintained by the IRS, which would track the organizations that had qualified under state law as L3Cs; private

86 Minnigh & Lang, *supra* note 17, at 24.

87 Kelley, *supra* note 3, at 356.

88 *Id.* L3C advocates note that the IRS does not pay much attention to enforcing PRIs. Minnigh & Lang, *supra* note 17, at 22 ("the IRS does not go through the forms, pick out and itemize PRIs, and somewhere publish a list of them").

89 Cassady V. Brewer & Michael J. Rhim, *Using the "L3C" for Program-Related Investments*, 21 TAX'N EXEMPTS 11, 12 (2009).

90 "One of the primary initial goals for the L3C was to make PRIs more accessible, simpler, less expensive, and less mysterious by codifying the elements into a new business form and injecting those elements into the form's genetic code, rather than something merely peripheral." John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 122 (2010). The L3C's tiered investment strategy could be replicated using an LLC, but the LLC form would be unlikely to draw foundation support.

91 COMMUNITY WEALTH VENTURES, INC., THE L3C: LOW-PROFIT LIMITED LIABILITY COMPANY RESEARCH BRIEF 3 (2008), *available at* http://www.cof.org/files/Documents/Conferences/LegislativeandRegulatory01.pdf [hereinafter RESEARCH BRIEF].

foundations can consult this list to ensure that the organizations they are interested in supporting have qualified for a PRI.[92] However, it is important to note that the tiered investment strategy could be set up using a regular LLC structure due to the LLC model's inherent flexibility. If there are L3C statutory restrictions on regular LLCs that in some way discourage foundations from making more PRIs, the L3C form might not live up to its advocates' promises.[93] The following section analyzes whether this could be the case.

III. ANALYSIS

Essential to the L3Cs' success is the organizational form's ability to facilitate the formation of PRI by private foundations. Generally, there is a dearth of material on PRIs, as published interpretations through revenue rulings are rare.[94] However, given the requirements outlined in treasury regulations, as well as the IRS's approach to interpreting PRIs—through private letter rulings which cannot be cited as precedent, but nevertheless serve as support for the argument that the IRS has endorsed a particular principle[95]—it is unlikely that the language of

92 Kelley, *supra* note 3, at 373.

93 Commentators note that L3Cs have "branding" value, allowing social entrepreneurs to represent to foundations that they are dedicated to the social mission from a statutory perspective, as opposed to the operating agreement (the former being more difficult to change than the latter). *See* Kelley, *supra* note 3, at 371. As Rich Zwetsch of interSector Partners, L3C, pointed out, "There are millions of LLCs out there. How can you tell, just from their name, that they have a social mission?" Schmidt, *supra* note 20, at 183. However, early L3Cs report that the newness of the L3C form has generated some confusion when L3Cs have sought funding. *Id.* at 187. Additionally, without some legal basis for establishing that L3Cs will facilitate the making of PRIs by private foundations, one can expect the branding value to diminish over time.

94 Bishop, *supra* note 32, at 261.

95 *See* Woods Inv. Co. v. Comm'r, 85 T.C. 274, 281 n.15 (1985) (stating that "private letter rulings and technical advice memoranda may not be cited for their precedential value, but they 'do reveal the interpretation put upon the statute by the agency charged with the responsibility of

L3C legislation dovetailing with PRI requirements will significantly alter how private foundations approach PRIs. As noted by Daniel Kleinberger, there is nothing "off the shelf" about a PRI transaction.[96] A private foundation looking to make a PRI into a L3C must carefully structure the PRI to meet IRS standards, as well as engage in ongoing due diligence to ensure the PRI is being made properly. L3C legislation does not obviate these steps.

A. PRI Decisions Require a Case-by-Case Determination Based on Particularized Facts that L3C Legislation Cannot Allay

To qualify as a PRI, an investment must meet three requirements: (1) the primary purpose of the investment must be the accomplishment of one or more of the purposes described in Section 170(c)(2)(B);[97] (2) no significant purpose of the investment can be the production of income or the appreciation of property;[98] and (3) no purpose of the investment can be to engage in a political campaign or influence legislation.[99] Meeting these requirements involves a case-by-case inquiry based on the facts and circumstances of the investment.[100] The fact that L3C legislation imposes specific purposes on the recipient of the investment does not change the underlying calculus for private foundations; they will still need to carefully study the investment itself in order to ensure IRS requirements are met. The following section focuses on the first two requirements, as the third requirement of the PRI not having the purpose of engaging

administering the revenue laws'") (quoting Hanover Bank v. Comm'r, 369 U.S. 672, 686–87 (1962)).

96 Kleinberger, *supra* note 21, at 899.

97 I.R.C. § 4944(c) (2011); Treas. Reg. § 53.4944-3(a)(1)(i) (2012).

98 I.R.C. § 4944(c) (2011); Treas. Reg. § 53.4944-3(a)(1)(ii) (2012).

99 Treas. Reg. § 53.4944-3(a)(1)(iii) (2012).

100 A permissible PRI includes a private foundation making a below-market loan to a *business corporation* whose stock is listed on a national exchange in order to induce the corporation to establish a new plant in a deteriorated urban area; the corporation would not have opened the plant without the investment. *See id.* § 53.4944-3(b).

in political campaigning or lobbying is generally not applicable to the majority of L3Cs.

1. Primary Purpose Requirement

For an investment to qualify as a PRI, its "primary purpose" must be to "accomplish one or more of the purposes described in [S]ection 170(c)(2)(B)."[101] The regulations, in providing a gloss over this requirement, have stated that the PRI must "significantly further the accomplishment of the private foundation's exempt activities," and "would not have been made *but for* such relationship between the investment and the accomplishment of the foundation's exempt activities."[102] Traditionally, the IRS has been fairly permissive in allowing a wide variety of charitable purposes,[103] and private letter rulings denying PRIs have been rare, though some commentators suggest that most foundations will withdraw their request before a formal denial.[104] Additionally, given the costs, most foundations will not apply for a private letter ruling unless they are reasonably sure they will be successful.

L3C legislation aims to facilitate this process; the hope is that foundations will more readily provide PRIs to L3Cs knowing L3Cs, by statutory mandate, must have a charitable primary purpose. In essence, foundations can reduce their transaction costs because they "know" that the

---

101 I.R.C. § 4944(c) (2011). These purposes are those required for forming a 501(c)(3) non-profit: "religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to animals." *See id.* § 170(c)(2)(B).

102 Treas. Reg. § 53.4944-3(a)(2)(i) (2012) (emphasis added).

103 *See, e.g.*, I.R.S. Priv. Ltr. Rul. 87-28-053 (Apr. 15, 1987) (constructing and furnishing a research center); I.R.S. Priv. Ltr. Rul. 83-13-105 (Dec. 29, 1982) (preserving historically significant edifices); I.R.S. Priv. Ltr. Rul. 2000-43-050 (July 25, 2000) (operating child-care facilities); I.R.S. Priv. Ltr. Rul. 2003-47-017 (Nov. 21, 2003) (providing medical malpractice reinsurance); I.R.S. Priv. Ltr. Rul. 84-26-066 (Mar. 28, 1984) (propping up indigent creative artists; providing communications services to non-profits).

104 *See* Feit, *supra* note 68, at 8.

recipient of the investment will meet the primary purpose test.[105] However, this reasoning is flawed because the IRS, in assessing primary purpose, looks into whether the following three factors are met: (1) there is a "nexus" between the investment and the foundation's exempt mission; (2) the PRI is "necessary"; and (3) the underlying activity is not fundamentally "commercial."[106] These factors do not constitute a formal "test" articulated by the IRS, but rather, are factors important to the IRS, as indicated in private letter rulings. As noted above, the IRS has rarely rejected a proposed PRI that has actually applied for a private letter ruling—although most foundations will not apply unless they are reasonably certain they will succeed—but the IRS analysis, when provided, focuses on the nature of the *investment* more broadly. Indeed, the listed factors are not dependent on the goals of the *recipient organization* alone.

First, in analyzing the primary purpose requirement, the IRS focuses on the "nexus" between the investment and the foundation's exempt mission.[107] This factor is satisfied when an investment is directly related to the foundation's core focus.[108] The IRS has permitted investments in a wide variety of recipient organizations, so long as there existed a match in purpose between the investment and the foundation's mission. For example, the IRS has permitted a

105 Some suggest that holding the entire company to the high standards of the PRI is a very difficult burden that not all companies can meet. Murray & Hwang, *supra* note 1, at 26–27.

106 *See* Feit, *supra* note 68, at 7–9.

107 *See* I.R.S. Priv. Ltr. Rul. 87-28-053 (Apr. 15, 1987) ("An investment shall be considered as made primarily to accomplish a purpose described in [S]ection 170(c)(2)(B) . . . if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities.").

108 A foundation that purchases an equity stake in a corporation and funnels the payments toward the exempt mission is not a proper PRI; even though there is a relationship between the return on investment and the accomplishment of the foundation's exempt activities, there is no relationship between the investment *per se* and the accomplishment of the foundation's charitable goals. *See* Treas. Reg. § 53.4944-3(b) (2012).

foundation loaning funds to a foreign government, which would then make loans to private banks, for the purpose of allowing the banks to make loans to businesses pursuing community economic development.[109] Even though the foreign government—an entity without an express charitable purpose—received the PRI, the fact that the investment funds would be used to further the foundation's charitable purpose was sufficient. In another case, a foundation with a mission of supporting "biodiversity and environmental sustainability" goals made a proper PRI to a completely for-profit financial intermediary that reinvested in environmentally-oriented businesses.[110]

On the other hand, the IRS will reject a PRI if there is *no* relationship between the specific investment and the foundation's mission—as when a foundation purchases an equity stake in a corporation, which has no connection to the foundation's mission, but then directs the payments it receives as dividends toward its own exempt goals.[111] Thus, with regard to the primary purpose requirement, the L3C language is problematic because it focuses on the wrong actor.[112] No matter what the recipient organization's mission is, the IRS inquiry will be on the match between the foundation's charitable purpose and the goals of the specific PRI. As Kleinberger notes, to allow L3Cs to become de facto PRIs would be to "ignore the core tenet of PRI law" that there must be this connection in purpose.[113]

Second, in analyzing the proper purpose requirement, the IRS also inquires into the necessity of the PRI. Necessity looks at the relationship between the investment and the goals of the recipient organization and foundation. Necessity can be proven in two ways: (1) the recipient organization is

109 I.R.S. Priv. Ltr. Rul. 1999-43-058 (Oct. 29, 1999).

110 I.R.S. Priv. Ltr. Rul. 2001-36-026 (Sept. 7, 2001).

111 Treas. Reg. § 53.4944-3(b) (2012) (noting that while there exists a relationship between the return on investment and the accomplishment of the foundation's mission, there exists no relationship between the investment per se and such accomplishment).

112 *See* Callison & Vestal, *supra* note 79, at 283.

113 Kleinberger, *supra* note 21, at 907.

unable to finance the activity without the investment;[114] or (2) the foundation is not able to pursue its charitable mission through other types of activity.[115] Under the former standard, there must be some level of support from the foundation to other sources of financing. For example, a commercial developer undertaking a charitable construction project received a PRI in the form of a loan guaranty because the bank would not provide financing otherwise.[116] Another example involved a foundation providing capital to a small business investment corporation because its returns were so low that foundation involvement was "essential" to its success.[117] A foundation looking to take on the junior tier of an investment in the L3C must therefore present evidence of mezzanine tier and senior tier investors who would not invest but for foundation involvement. An LLC can just as easily produce this type of financing structure, and the L3C form does not provide the IRS with any per se evidence that the recipient organization would not be successful but for foundation involvement.[118]

In analyzing the latter inquiry, the IRS undergoes a similar "nexus" analysis as it tries to determine whether there is any other way for the foundation to succeed in its goals. For example, a foundation with the aim of assisting the "development of non-governmental, non-partisan, pluralistic, tolerant and non-extremist . . . press . . . in societies that have historically been 'closed'" could not achieve its goals without providing assistance—in the form

---

114 *See* I.R.S. Priv. Ltr. Rul. 2002-22-034 (May 31, 2002) (noting that a developer could not create the easement "without the Grant from the [foundation]").

115 *See* I.R.S. Priv. Ltr. Rul. 955-10-05 (Dec. 22, 1995).

116 I.R.S. Priv. Ltr. Rul. 2000-43-050 (Oct. 27, 2000).

117 I.R.S. Priv. Ltr. Rul. 85-26-084 (Apr. 5, 1985).

118 Take the situation where an L3C is providing job-assistance programs to low-income residents. At the same time, there is a government stimulus program in place to help underserved communities, which allows the L3C to make a fairly significant profit. This particular L3C may be able to fund itself with entirely for-profit investors. A foundation attempting to make a PRI into this L3C may fail the necessity prong. *See* Murray & Hwang, *supra* note 1, at 29–30.

of low-interest loans—to foreign media organizations so they could become autonomous.[119] Under this inquiry, a private foundation must also look past whether the recipient organization has proper charitable purposes, and focus instead on the relationship between the foundation's goals and what the investment is intended to accomplish within the recipient organization.

Lastly, in analyzing the proper purpose requirement the IRS will look beyond the stated purpose of the investment and into the underlying activity being performed. For example, in one case, the IRS denied a PRI in two corporations that operated a horseracing facility.[120] Although the foundation framed the investment in terms of promotion of the arts (the "equine arts"), the IRS noted that the operation of a racetrack was a "classically commercial endeavor."[121] In another case, the IRS denied a PRI in a for-profit hotel.[122] The foundation claimed that the hotel was designed to stimulate the economy in a depressed area, but the IRS viewed hotel ownership as a fundamentally commercial venture.[123] Commentators have noted that since community betterment schemes are often accepted as PRIs, this ruling "serves as a warning to a foundation unduly confident that it can finesse a commercial endeavor into a purportedly holistic development plan."[124] Thus, an L3C with a stated charitable goal could nonetheless be running a type of business that the IRS considers fundamentally commercial. Even though L3C legislation imposes a charitable purpose on a potential PRI recipient, the IRS will

119 I.R.S. Priv. Ltr. Rul. 955-10-05 (Dec. 22, 1995).

120 I.R.S. Priv. Ltr. Rul. 82-01-050 (Oct. 7, 1981).

121 *Id.*

122 I.R.S. Tech. Adv. Mem. 93-40-002 (Oct. 8, 1993).

123 The foundation's arguments—that it purchased the hotel not to make a profit but to stimulate the economy through the provision of employment opportunities for local citizens, and that the operation sustained losses in 1986 and 1987—did not change the IRS's view that ownership of a for-profit hotel was not an activity in furtherance of exempt charitable purposes. *Id.*

124 Feit, *supra* note 68, at 7.

nonetheless analyze the *type of activity* in which the recipient is to engage. L3C legislation, therefore, does not obviate the concerns the IRS has in determining whether a PRI meets the primary purpose requirement.

2. Income Production Requirement

The second requirement foundations must meet in making PRIs is that "no significant purpose" of a proposed PRI be "the production of income or the appreciation of property."[125] L3C legislation is focused on the L3C entity's low-profit motive. Ostensibly, for L3Cs to facilitate the making of PRIs, the form of the recipient organization should be an important consideration for the IRS. Private letter rulings, as noted below, show otherwise. Rather, the crucial determinant is whether investors "solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation."[126] In assessing this factor, the IRS determines either: (1) whether, *in fact*, traditional for-profit investors have either refused to invest in the project, or are investing on more favorable terms than the foundation; or (2) whether, after engaging in a cost-benefit analysis, for-profit investors *theoretically* would not make an investment on the same terms as the foundation.[127]

In the former case, the foundation must have demonstrable proof that their investment is on worse terms than those of a for-profit investor, such as a commercial lending institution,[128] or that for-profit investors have rejected investments in the recipient of the PRI.[129] Under a tiered investment strategy, the L3C would be able to show this through the presence of a for-profit investor whose investment is on better terms than the foundation's. However, this can be—and has been—demonstrated just as

125 Treas. Reg. § 53.4944-3(a)(1)(ii) (2012).

126 *See id.* § 53.4944-2(a)(2)(iii).

127 Feit, *supra* note 68, at 10.

128 *See* I.R.S. Priv. Ltr. Rul. 89-43-022 (Oct. 27, 1989).

129 *See* I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006).

easily with a regular LLC structure.[130] The fact that the L3C, by statute, cannot have the production of income as a significant purpose does not obviate the IRS's requirement of showing that an actual for-profit investor is investing on better terms.

In the latter case, the IRS will engage in a cost-benefit analysis to determine the difference between the heightened risk and below-market returns associated with the investment.[131] In the L3C's tiered investment strategy, without the presence of an actual for-profit investor to demonstrate to the IRS the difference in returns, the foundation must submit its investment to the IRS's cost-benefit analysis. The IRS looks at factors such as whether the investment has high transaction or monitoring costs,[132] involves inexperienced recipients,[133] or is riddled with uncertainty.[134] This analysis looks beyond the nature of the recipient organization and into the details of the underlying investment.[135] In either case, the fact that the L3C is mandated by statute to have certain profit motive limitations does not reduce the depth of inquiry the IRS—and thus the private foundation—is forced to engage in before agreeing to the PRI.

In fact, most PRIs are structured in certain ways to signal to the IRS that the PRI is in a facially disadvantageous position.[136] For example, PRI loans are universally offered at either no interest or below-market interest rates, and are generally unsecured.[137] PRI leases are ordinarily granted for

---

130 *See* I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006).

131 Feit, *supra* note 68, at 11.

132 I.R.S. Priv. Ltr. Rul. 98-26-048 (June 26, 1998).

133 I.R.S. Priv. Ltr. Rul. 78-13-108 (Dec. 30, 1977).

134 *See* I.R.S. Priv. Ltr. Rul. 90-33-063 (Aug. 20, 1990).

135 Feit, *supra* note 68, at 11.

136 *Id.* at 10.

137 *E.g.*, I.R.S. Priv. Ltr. Rul. 89-23-071 (June 9, 1989) (no-interest loan); I.R.S. Priv. Ltr. Rul. 87-33-043 (May 22, 1987) (same); I.R.S. Priv. Ltr. Rul. 95-51-005 (Dec. 22, 1995) (low-interest loan); I.R.S. Priv. Ltr. Rul. 94-34-031 (Aug. 26, 1994) (same); I.R.S. Priv. Ltr. Rul. 90-16-078 (Apr. 20, 1990) (unsecured loan).

much less than fair market value, or for nominal consideration only, and in no way reflect commercial rates.[138] A foundation might also place a ceiling on potential return,[139] obligate itself to purchase bonds on the occurrence of a triggering contingency,[140] convert a loan into a grant upon a demonstrated inability to repay,[141] or provide for flexible modifications to the agreement.[142] These features will often assuage IRS skepticism.[143] Therefore, before a private foundation makes a PRI, it will carefully determine whether the investment meets the statutory requirements for a PRI, as well as structure the agreement carefully to ensure that it signals to the IRS that the foundation is put at a disadvantage relative to for-profit investors. Each PRI, therefore, is unique and requires individual analysis. This creates significant transaction costs, which cannot easily be obviated by state L3C legislation.[144]

138 *E.g.*, I.R.S. Priv. Ltr. Rul. 89-06-062 (Feb. 10, 1989) (charging one dollar annually for rent); I.R.S. Priv. Ltr. Rul. 1999-33-051 (Aug. 20, 1999) (nominal rent at two percent of fair market value).

139 I.R.S. Priv. Ltr. Rul. 88-07-048 (Nov. 23, 1987) (capping returns at five percent).

140 I.R.S. Priv. Ltr. Rul. 91-48-049 (Nov. 29, 1991) (including provision in which the foundation was obligated to purchase the bonds it guaranteed in event of default).

141 I.R.S. Priv. Ltr. Rul. 84-26-066 (Mar. 28, 1984) (permitting artists supported by the foundation to forgo repayment of loans if their work was not commercially successful).

142 *E.g.*, I.R.S. Priv. Ltr. Rul. 96-08-039 (Feb. 23, 1996) (allowing foundation to forgive some or all loan payments as they came due); I.R.S. Priv. Ltr. Rul. 83-13-105 (Dec. 29, 1982) (providinging foundation discretion to waive loan payments); I.R.S. Priv. Ltr. Rul. 81-41-025 (July 20, 1981) (permitting recipient to alter terms of the loan, including increasing the term or lowering the interest rate).

143 Feit, *supra* note 68, at 10.

144 *See* Keatinge, *supra* note 16, at 584–85 (outlining how LLC operating agreements generally have to be drafted carefully in order to meet foundation standards for providing grants or investment generally).

3. The IRS Is Unlikely to Promulgate a Formal Rule Facilitating PRIs in L3Cs

This fact-specific, case-by-case determination by the IRS regarding PRIs is unlikely to change in the future, as the IRS will not likely promulgate a rule giving *preference* to the L3C in the PRI decision-making process. First, Treasury regulations defining jeopardy investments note that no state law can "exempt or relieve any person from any obligation, duty, responsibility, or other standard of conduct provided in [Section] 4944 and regulations thereunder."[145] This means that states cannot promulgate rules to override IRS criteria in the PRI sphere.[146] Second, as noted by Callison and Vestal, there is no "administrative gatekeeper" with regards to L3Cs, as opposed to Section 501(c)(3) non-profits, at the federal level.[147] In order to receive and maintain 501(c)(3) status, an organization must file a lengthy application with the IRS, which, after granting non-profit status, gives the non-profit certain presumptions with regard to federal tax exemption.[148] L3Cs, because they are self-actualizing at the state level, do not give the IRS the same level of assurance.[149] This is especially relevant because it is currently unclear how states will enforce maintenance of L3C statutory requirements.[150]

Given all of these factors, it seems unlikely that the IRS will issue a categorical rule giving preference to the L3C status in a PRI determination. Due to the risk-averse nature of foundations, even a smaller change to IRS regulations concluding that investment in an L3C is an *example* of a

145 *See* Treas. Reg. § 53.4944-1(a)(2)(i) (as amended in 1973).

146 *See* Bishop, *supra* note 32, at 256.

147 Callison & Vestal, *supra* note 79, at 284.

148 *Id.*

149 Callison & Vestal note that in Colorado, both the Attorney General and the Secretary of State testified against adopting the L3C form due to concerns regarding the potential for fraud and abuse by organizations that adopt the L3C label, but do not act for legitimate charitable and educational purposes. *Id.*

150 *See* Keatinge, *supra* note 16, at 582.

permissible PRI may not be enough to dissuade foundations from getting private letter rulings or opinions from tax counsel, as they do currently. For example, under the Treasury regulations, a private foundation making a high-risk investment in low-income housing for the purpose of providing affordable housing is an explicit example of a permissible PRI.[151] Nonetheless, many PRIs made for similar purposes have sought prior approval via private letter ruling, given the variety of other factors that the IRS looks to—other than the purpose of investment alone.[152]

Foundations already recognize that the legal form of the recipient organization is not a critical driver in IRS decision making.[153] L3C advocates have asked for more support regarding the L3C structure, specifically instead of regular LLCs, but as one IRS official noted, "[A]t the federal level, no one has really signed off" on the use of L3Cs for PRIs.[154] When state L3C legislation was first enacted, the Council on Foundations considered applying for a blanket private letter or revenue ruling from the IRS on L3Cs automatically qualifying as PRIs; however, the organization backed off from the idea soon afterward.[155] Additionally, the American Bar Association Section of Taxation, Committee on Exempt Organizations, submitted updated examples to IRS regulations governing PRIs in 2010.[156] The examples specifically state that L3Cs provide no particular benefit over LLCs:

151 Treas. Reg. § 53.4944-3(b)(10) (2012).

152 *See, e.g.*, I.R.S. Priv. Ltr. Rul. 91-48-052 (Nov. 29, 1991); I.R.S. Priv. Ltr. Rul. 90-16-078 (Apr. 20, 1990); I.R.S. Priv. Ltr. Rul. 89-23-070 (June 9, 1989).

153 Ragin, *supra* note 80, at 55 ("[W]e find that under the existing rules . . . you can apply them and reach positive decisions on making PRIs to a for-profit, nonprofit, cooperative, or other form of legal organization.").

154 Fei, *supra* note 16, at 40.

155 RESEARCH BRIEF, *supra* note 91, at 2.

156 *See* Letter from Stuart M. Lewis, Chair, Section of Taxation, Am. Bar Assoc., to Hon. Douglas Shulman, Comm'r, IRS (Mar. 3, 2010), *available at* http://www.americansforcommunitydevelopment.org/downloads/ABASectionofTaxationComments.pdf.

> LLCs have been more commonly used for PRIs in recent years. Low-profit LLCs, also known as L3Cs, have received significant recent attention but are merely a subset of regular LLCs. The various state statutes authorizing L3Cs all require the organization's organizational documents to include suitable "charitable purposes" language. Exempt-organization tax practitioners typically also include these provisions in loan or investment documents for a regular LLC (even without any statutory mandate). We believe that, if a particular loan to, or investment in, an ordinary LLC would qualify as a PRI, then, *a fortiori*, a loan to, or investment in, an L3C should also so qualify. We also believe that LLCs do not warrant specific guidance.[157]

B. Expenditure Responsibility Obligations Impose upon Foundations Significant Oversight Duties

Additionally, to have the PRI "count" for purposes of qualifying distributions, private foundations must exercise "expenditure responsibility." Although the Treasury regulations state that foundations are "not [the] insurer[s] of the activity of the organization[s]" in which they make PRIs,[158] there are several continuing duties required of foundations in order to meet expenditure responsibility obligations. First, as outlined above, there must be a pre-investment inquiry into the organization receiving the PRI concerning the "identity, prior history and experience (if any) of the grantee organization and its managers," in addition to any "information which is readily available concerning the management, activities, and practices of the grantee organization."[159] The inquiry should be comprehensive enough to "give a reasonable man assurance that the [organization] will use the [PRI] for the proper purposes."[160] If the pre-investment inquiry is adequate, the foundation

157 Letter from Stuart M. Lewis, *supra* note 156, at 7.

158 Treas. Reg. § 53.4945-5(b)(1) (2012).

159 *See id.* § 53.4945-5(b)(2)(i).

160 *Id.*

then imposes ongoing requirements on the recipient organization. The foundation requires the submission of a "written commitment signed by an appropriate officer, director, or trustee" specifying the purpose of the investment.[161] Additionally, the PRI recipient must: (1) agree to use all funds from the foundation only for the purposes of the investment;[162] (2) submit full and complete financial reports at least once per year for the duration of the PRI;[163] (3) maintain books and records adequate to provide information ordinarily required by commercial investors under similar circumstances, and allow the foundation reasonable access to those books;[164] and (4) not use those funds for political or lobbying purposes.[165] Throughout the duration of the PRI, the foundation must report the PRI's status to the IRS through reports,[166] which involve reviewing evidence supplied by the recipient organization.[167] These general obligations make it unlikely that a foundation manager will reduce the level of due diligence necessary for making a PRI, even when investing in a L3C.

Private letter rulings regarding investments in organizations with both profit and social motives are instructive in showing the extent of the duty imposed upon foundations making PRIs. In one case, a foundation invested in an angel investment fund, organized as an LLC, dedicated to investing in businesses in low-income communities.[168] The foundation funding would provide the financial subsidy (in the form of taking on below-market returns) to encourage professional athletes to invest and receive market returns.[169] This capital structure is similar to the tiered investment

161 Treas. Reg. § 53.4945-5(b)(3) (2012)

162 *See id.* § 53.4945-5(b)(4)(i).

163 *See id.* § 53.4945-5(b)(4)(ii).

164 *See id.* § 53.4945-5(b)(4)(iii).

165 *See id.* § 53.4945-5(b)(4)(iv).

166 *See id.* § 53.4945-5(d)(1).

167 Treas. Reg. § 53.4945-5(c)(4) (2012).

168 I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006).

169 *Id.*

strategy envisaged by L3C advocates.[170] To satisfy its expenditure responsibility obligations, the foundation undertook to make a significant pre-investment inquiry into the investment fund.[171] In addition, the foundation created a thorough oversight system to ensure the PRI was used for its intended purposes.[172] The foundation had final say on any use of investment funds that would threaten the exempt status of the foundation.[173] The foundation also had the right to require liquidation of certain investments by the fund, and to withdraw from the fund under certain circumstances—for example, when the business reached some level of success such that it no longer required the PRI.[174] Moreover, the angel investment fund was required to provide written reports to the foundation before and after any investment, in addition to periodic progress reports.[175] Lastly, the fund needed the foundation's approval to make any fundamental changes to its operation and structure.[176] Since the foundation took these steps in advance, the IRS declared the PRI to be proper.

In another private letter ruling, a private foundation invested in a for-profit corporation with the purpose of promoting environmentally oriented businesses.[177] The corporation had dual goals of providing a market rate of return to investors, and providing a benefit to the

170 In fact, many of the provisions found in the LLC agreement were very similar to statutory provisions imposed upon L3Cs. For example, there was a requirement that the fund have a charitable purpose, and limitations on lobbying and political campaign activities were imposed as well. I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006). *See also* Brewer & Rhim, *supra* note 89, at 15.

171 I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006).

172 *Id.*

173 *Id.*

174 *Id.*

175 *Id.*

176 *Id.* Some commentators note that it is not necessary for foundations to be involved in the L3C's day-to-day operations. Foundations do, however, need to preserve certain rights to protect PRI status. Tyler, *supra* note 90, at 125–26.

177 I.R.S. Priv. Ltr. Rul. 2001-36-026 (June 11, 2001).

environment through the businesses it supported.[178] The shareholders in the corporation included foundations and for-profit investors, with the foundations receiving returns that were "significantly less than the acceptable rate of return" for similar investments.[179] The structure, although in a corporate form, was functionally similar to the L3C. Furthermore, the foundation undertook extensive oversight duties. It also took an active role in ensuring the corporation's projects would meet certain environmental considerations, and that the foundation would be informed of any investment made by the corporation.[180] Additionally, the foundation received reports describing the use of funds and had a right to monitor and evaluate operations pursuant investment.[181] Any funds provided by the foundation but not committed to environmental purposes would be returned to the foundation.[182]

Given the significant excise taxes imposed for failure to exercise proper expenditure responsibility, foundation managers must either pay significant ongoing due diligence costs, or accept the risk of paying excise taxes that result from making an improper PRI. But these ongoing expenditure responsibility obligations cannot be obviated by L3C legislation, and it is thus unlikely that the amount of PRI made will significantly increase, even with the passage of L3C legislation.

C. Federal Legislation Is Required to Fill in the Gaps

There is no formal requirement that foundations get prior approval from the IRS for making a PRI, and actual enforcement on PRIs has been rare.[183] However, in practice, foundations have been risk averse, given the severe penalties for making an improper PRI. As a result, foundations still

178 I.R.S. Priv. Ltr. Rul. 2001-36-026 (June 11, 2001).

179 *Id.*

180 *Id.*

181 *Id.*

182 *Id.*

183 Lang & Minnigh, *supra* note 17, at 22.

tend to do fairly extensive due diligence in the form of applying for a private letter ruling or getting an opinion from tax counsel.[184] L3C advocates thus believed that foundations were too cautious regarding PRI. L3C advocates hoped that by creating the L3C structure and encouraging its use by social entrepreneurs, forward-thinking foundations would begin funding these entities in greater numbers and with greater confidence, establishing a proof of concept so that other foundations would follow.[185] If enough foundations accepted that making PRIs into L3Cs was generally not problematic, there would be a "culture change," whereby foundations would be more willing to make PRIs into L3Cs, perhaps skipping the private letter ruling or letter-of-expert-counsel step and the related transaction costs.[186] As noted above, this thinking is problematic because the IRS looks at many factors beyond to the nature of the recipient organization alone when determining whether a PRI is appropriate.

The idea that the L3C structure would change the calculus of private foundations has also not been borne out in practice. According to Steven G. Frost, a partner at Chapman and Cutler LLP, "[I]t is dangerous to assume that simply because you've created an L3C, you're going to satisfy a tax requirement."[187] Frost advises practitioners working with L3Cs to proceed as though they were working with a regular LLC when analyzing the tax implications of an investment.[188] Ron Schultz, an IRS senior technical advisor in the Tax Exempt and Government Entities Division, cautioned against heedless embrace of L3Cs by private foundations by noting, "[I]f you are out there hearing about L3Cs and you have a private foundation 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

184 Lang & Minnigh, *supra* note 17, at 24.

185 *Id.* at 22.

186 *Id.* at 21.

187 Amy S. Elliott, *Practitioners Denounce Low-Profit LLC Entity as "Trap for the Unwary,"* 67 EXEMPT ORG. TAX REV. 334, 334 (2011).

188 *Id.*

would be premature."[189] Vermont L3Cs report a generally negative response from foundations when seeking PRI. L3C managers in Vermont reported that they expected foundations to be "up to speed" on the concept of L3Cs and their relation to PRIs.[190] However, many foundations remained wary; in a 2010 survey of L3Cs, none reported receiving a PRI from a private foundation.[191] Of twenty-eight L3Cs surveyed in Vermont, only three received any support from foundations (in the form of grants).[192] To get this foundation support, the three organizations were forced to set up complex legal structures: one needed to set up an affiliated 501(c)(3) to receive grant funding, while two others created fiscal sponsorship relationships.[193]

Many L3C advocates have even acknowledged these problems with the L3C model, and now believe some form of federal legislation is required.[194] Proposed legislation would call for a fairly significant overhaul of the entire PRI-making process, in order to make the nature of the recipient organization a significant factor in PRI determinations by the IRS.[195] To that end, the Program-Related Promotion Act of 2008 was presented to and discussed with the staffs of both the Senate Finance Committee and the Joint Committee on Taxation.[196] The legislation, and amendments proposed within the past two years, seek to amend Section 4944(c) of the IRS Code to provide that the *PRI recipient* (i.e., the L3C) may apply to the IRS for a "safe harbor determination."[197] Once the L3C has received a safe harbor

189 Vitello, *supra* note 47, at 577.

190 *See* Schmidt, *supra* note 20, at 187–88.

191 *Id.*

192 *Id.*

193 *Id.*

194 *See* Murray & Hwang, *supra* note 1, at 25.

195 As one L3C advocate notes, "I think federal legislation is a huge part of making [L3C] numbers grow." Lang & Minnigh, *supra* note 17, at 24.

196 Brewer & Rhim, *supra* note 89, at 18.

197 Letter from Marcus S. Owens, Partner, Caplin & Drysdale, to Ronald J. Schultz, Senior Technical Advisor, Tax Exempt and Gov't

determination, any below-market investment into the entity by a private foundation automatically meets PRI requirements.[198] The legislation also institutes a reporting requirement for for-profit entities, such as L3Cs, receiving PRIs (although none currently exist).[199] This reporting requirement would serve as ex post facto review to ensure that foundations are not abusing PRIs by providing support to L3Cs completely unrelated to the foundations' missions. Another proposed bill, the Philanthropic Facilitation Act of 2010, seeks to modify Section 4944(c) of the IRS Code to provide for a rebuttable presumption that investment in *all* entities organized as L3Cs under state or federally recognized tribal law qualifies as PRI.[200] Such federal legislation would eliminate the need for private letter rulings or legal opinions, and thus truly streamline the process for making PRI.[201]

The fact that these proposed changes focus on either making the form of the recipient organization an important—if not dispositive—factor, or allowing the recipient organization to apply for "special status," lends credence to the argument that state L3C legislation, as currently drafted, will not facilitate PRIs. However, at this moment the chance of any federal legislation being enacted appears minimal.[202] Congress has a few countervailing concerns. First, a simplified process for PRIs would increase the risk of charitable funds being used for commercial purposes including the production of income.[203] Similarly, a simplified L3C process would encourage private foundations

---

Entities Div., IRS (July 8, 2009), *available at* http://americansforcommunitydevelopment.org/downloads/nascoQ-A.pdf.

198 Letter from Marcus S. Owens, *supra* note 197.

199 *Id.*

200 AMS. FOR CMTY. DEV., PHILANTHROPIC FACILITATION ACT OF 2010, at 8 (2010), *available at* http://www.americansforcommunitydevelopment.org/downloads/PhilanthropicFacilitationAct2010.pdf.

201 Brewer & Rhim, *supra* note 89, at 18. However, this would not reduce the expenditure responsibility obligations in which foundations must engage.

202 Callison & Vestal, *supra* note 79, at 286.

203 Kleinberger, *supra* note 21, at 907 n.113.

to "leap before they look," and not take the proper precaution regarding PRI.[204] Additionally, proposed legislation would make the IRS the administrative gatekeeper for L3Cs, creating additional cost for the federal government. It is not at all clear that eliminating the costs associated with private letter rulings or legal counsel opinions outweighs these concerns.

IV. CONCLUSION

Promotion of the L3C structure can, in the absence of a thorough understanding of the legal realities, have negative implications for the social enterprise sector. L3C promotional materials often emphasize how the form facilitates PRI investment on a greater scale, reducing the extensive due diligence required for standard PRI.[205] Many commentators fear that this type of promotion will mislead smaller foundations—which do not have the same expertise and guidance as do larger foundations—into giving undue credence to the L3C "brand."[206] These foundations would then face significant excise taxes and possibly loss of tax-exempt status.[207] Critics of the L3C model also fear that the time and energy spent on L3Cs removes focus from other methods for facilitating PRI, such as advocating for changes in the IRS regulations that promote broader usage in general.[208] Professor Thomas Geu has even compared L3C

204 Kleinberger, *supra* note 21, at 907 n.114.

205 *See* Callison & Vestal, *supra* note 79, at 291.

206 *Id.*

207 *See id.* at 292 ("Thus, we believe that there is positive harm to unleashing a business form that does not serve its intended purpose. Someone is going to use the L3C improperly and will get burned, and there is no countervailing benefit to the form.").

208 *Id.* Recently, both the Treasury Department and the IRS have proposed changes to PRI regulations that would outline nine new examples of what constitutes an appropriate PRI. These include initiatives in rural areas and countries outside the United States, as well as initiatives for the purpose of advancing science or promoting the arts. Suzanne Perry, *White House Seeks to Spur Innovative Spending by Foundations*, CHRON. PHILANTHROPY (May 10, 2012), *available at*

legislation to a parasite free-riding on the success of the LLC form (the L3C is a quick and easy "add on" for legislators) that may, over time, burden the LLC entity with too much complexity.[209]

There are some indications that social entrepreneurs have formed L3Cs for reasons other than the possible PRI benefit. In fact, a survey of early adopters of the L3C form in Vermont found that although all were aware of the possible implications for PRI, most actually never considered the possibility of obtaining that type of funding.[210] However, the L3C, as a special form distinct from the traditional LLC, will only find long-term success if it can attract more PRI. Given the way the statutes and regulations are currently written, attracting PRI seems unlikely, and legislation at the federal level is sorely needed to alleviate this problem. Otherwise, due to foundations' limited resources, PRI will be made on a very limited basis.[211]

---

http://philanthropy.com/article/White-House-Seeks-to-Spur/131840/?sid =pt&utm_source=pt&utm_medium=en.

209 Callison & Vestal, *supra* note 79, at 289–90.

210 Many remarked that they wanted to create an organization that "aligned with [their] values" or was a "for-profit with a nonprofit soul." Others believed the L3C format to be simple to adopt and flexible in its structure. *See* Schmidt, *supra* note 20, at 177–80.

211 *See* David S. Chernoff, *L3Cs: Less than Meets the Eye*, 21 TAX'N EXEMPTS 3, 5 (2010) ("[N]umerous 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.").