CLIENT ADVISORY:

THE LOW-PROFIT LIMITED LIABILITY COMPANY: NEW FRONTIER FOR NONPROFIT ORGANIZATIONS

Rhode Island has joined a minority of states in adopting legislation that permits the creation of what is called the “Low Profit Limited Liability Company,” a new entity unique to the nonprofit world. Vermont was the first state to permit the creation of this statutory entity, frequently referred to as an “L3C”. The L3C business model is expected by many in the nonprofit world to be cutting edge in that it combines the structural and financial advantages of a limited liability company with the social benefi ts of a nonprofit enterprise. Others in the nonprofit sector, however, hesitate to celebrate the birth of the L3C praise and are reserving judgment until this structure has been battle tested through real world application. Regardless, the L3C is gaining momentum throughout the nation with pending legislation in several states, with the Rhode Island’s L3C legislation to become effective on July 1st of 2012.

The Basics of the Low Profit Limited Liability Company

The motivation for the L3C’s business structure is to encourage investment in the social enterprise by incentivizing investments from private foundations and entrepreneurs. The combination of social enterprise development with capital investment requires a format that is more attractive than historical entity archetypes. The L3C is a deviation from a pure limited liability company and provides for a flexible ownership structure in which management responsibility and financial stake may vary according to each member’s individual needs. In addition, this structure provides members with limited liability for actions and debts of the company and is treated as a “pass through” entity for purposes of federal taxation.

A major distinction between the L3C and the limited liability company is that the primary purpose of the L3C must be to achieve a socially beneficial objective with profit seeking serving as an ancillary motive. In order to qualify as an L3C entity three criteria must be met:

- The company must significantly further the accomplishment of one or more charitable or educational purposes, and would not have been formed but for the goal to accomplish such purposes;
- Operation of the company for the purpose of generating income or recognizing an appreciation on investments cannot be a significant purpose of the entity; and
- The company cannot be organized to accomplish legislative or political objectives.

The newly minted Rhode Island law makes it clear that in the absence of other factors, the production of significant income or capital appreciation by the L3C is not conclusive evidence of a significant purpose involving the production of income or the appreciation of property. Implicitly therefore, an L3C could generate large profits without fear of violating its charter, provided that the profit is in proportion to the tangible charitable benefits which the company provides.

Intended Funding Benefits for Private Foundations

One of the unique benefits of an L3C is that it is statutorily fashioned in a manner that is intended to encourage investment by private foundations. Because private foundations enjoy federal tax exempt status, they are highly regulated to ensure their charitable assets are not subject to mismanagement, used for non-charitable purposes or otherwise inure to the benefit of individuals. To this end, a violation of the Internal Revenue Code may result in a significant excise tax to the private foundation and may jeopardize a foundation's federal tax-exempt status. Private foundations are required to distribute five percent of their assets annually; otherwise they are subject to confiscatory taxation.

In order to meet annual distribution requirements, private foundations generally make qualifying grants and donations but are precluded from earning a monetary return on these distributions of assets. The Internal Revenue Code also permit a private foundations to distribute assets through qualifying Program Related Investments ("PRIs"). Despite the availability of this vehicle, however, PRIs have not been frequently used because applicable Treasury regulations are ambiguous and make it difficult for private foundations to obtain assurance that a particular investment will qualify as a PRI. If an investment does not qualify the private foundation may be faced with significant adverse tax consequences and possible revocation of the foundation's tax exempt status.

At present, the only manner by which a private foundation may be assured that a prospective investment will be attributed to its yearly distribution requirement is to apply for a Private Letter Ruling from the IRS, a process which is both costly and time consuming. The L3C statutory structure is intended to guaranty an investment's qualification under the Internal Revenue Code as a PRI, thereby making the L3C an attractive investment to private foundations, particularly since the L3C structure also permits a private foundation to recognize a financial' return on investment. The jury is out, however, on how the IRS will view L3Cs and whether the L3C will cure the ambiguities that have historically plagued qualification of PRIs. The IRS has yet to provide guidance on its treatment of the L3C, and until it has the opportunity to do so, investments made by private foundations in an L3C is unchartered territory.

The L3C structure combines the efficiencies of a for profit entity while serving the purpose of a social enterprise. Assuming the IRS indicates favorable treatment of the L3C, this new entity may be the savior for the nonprofit organization, providing a vehicle for critically needed funding to operate during difficult economic times. Investors who may have otherwise been reluctant to contribute to the nonprofit may be willing to invest in it which serves both a capitalistic and social enterprise purpose.

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