

The Michigan Low-Profit Limited Liability Company – Encouraging Investment in Socially Beneficial Enterprises

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Overview

Amendments to the Michigan Limited Liability Company Act became effective January 15, 2009, allowing a new form of limited liability company known as the “low-profit limited liability company” or “L3C.” The L3C is a hybrid of a for-profit and non-profit organization, and has characteristics of each. As with a non-profit, an L3C must be formed in furtherance of some charitable or educational purpose. However, as with a for-profit entity, an L3C may have equity owners who have the right to receive distributions of profits and appreciation in the value of the business entity. While the entity functions similar to a traditional limited liability company, an L3C is required to carry on a business that has a charitable purpose, yet may generate modest profit in the conduct of that business.

It is important to note that an L3C cannot qualify as a tax-exempt organization under 501(c)(3) of the Internal Revenue Code unless all of its members are themselves tax-exempt organizations.¹ In addition, the IRS has established 11 other criteria that a limited liability company must meet to qualify for federal tax exemption.² While it may be appropriate for certain L3Cs to seek tax-exempt status, assuming they meet the criteria established by the IRS, most L3Cs are expected to be for-profit entities.

In addition to Michigan, the states of Vermont, North Dakota, Wyoming, and Utah have enacted legislation to officially recognize the L3C entity structure and nine other states are currently considering L3C legislation. The creation of L3Cs is expected to encourage investment in socially beneficial enterprises and allow for flexibility with regard to organizational structure. Economic development activities such as combating community deterioration, creating jobs in economically depressed areas, and supporting community revitalization are prime ex-

amples of the charitable purposes that could be furthered by an L3C.³ Due to the current economic crisis, traditional sources of capital for companies wishing to engage in these socially beneficial activities have dwindled, while the need for the social good they can provide has increased dramatically.

It is anticipated that a common charitable purpose furthered by L3Cs will be to promote economic development. Importantly, not all forms of economic development are considered charitable under IRC 501(c)(3). The Treasury Regulations provide that the term “charitable” includes the promotion of social welfare by organizations designed to (1) lessen neighborhood tensions, (2) eliminate prejudice and discrimination, (3) combat community deterioration, or (4) combat juvenile delinquency.⁴ For instance, a community organization formed to plan the rehabilitation and renewal of an area in a deteriorated urban area where the median income level was lower than in other sections of the city and that intended to rehabilitate and rent an apartment house to low and moderate income renters was blessed by the IRS as conducting charitable activities.⁵ An organization formed to construct housing facilities in an area where the high cost of land, increased interest rates, and growing population had produced a shortage of housing for moderate income families was not.⁶

Investments in L3Cs/Program-Related Investments (PRI)

Investment in an L3C can take the form of a loan, a loan guaranty, the purchase of a membership interest, or any other investment that will further the investor’s purpose. Retaining the flexible ownership structure of a traditional limited liability company, together with well developed law and guidance regarding the use and operation of limited liability companies, make the L3C a good

vehicle for mixing different types of investors and social missions. For-profit business organizations, community foundations, private foundations, public charities, governments, and individuals interested in promoting community development and revitalization are all candidates to invest in an L3C.

Like a traditional limited liability company, an L3C is by default classified as a pass-through entity for federal tax purposes and the liability of its members is limited to their investment. Also like a traditional limited liability company, an L3C is formed by filing Articles of Organization with the Michigan Department of Energy, Labor & Economic Growth, Bureau of Commercial Services, Corporation Division. The major differentiation, however, is that the statutory definition of an L3C was specifically designed to mirror certain qualifications for a program related investment⁷ (“PRI”). A PRI is an investment made by a private foundation, the primary purpose of which is to support charitable activities, no significant purpose of which is the production of income or the appreciation of property, and no purpose of which is to accomplish one or more political or legislative purposes.⁸ Therefore, tracking the Internal Revenue Code’s definition of a PRI, the L3C must include in its articles of organization, and at all times conduct its activities in conformance with, a purpose that: 1) significantly furthers the accomplishment of one or more charitable or educational purposes described in IRC 170(c)(2)(B) (and would not have been formed except to accomplish those charitable or educational purposes); 2) does not include as a significant purpose the production of income or appreciation of property; and 3) does not include accomplishing one or more political or legislative purposes described in IRC 170(c)(2)(D).⁹ Additionally, under federal tax law, a private foundation is required to exercise “expenditure responsibility” over the investments made in entities other than public charities and also report information regarding any PRI on its annual tax return.¹⁰ Expenditure responsibility is a type of due diligence performed to account for the investment and to ensure that it is used for charitable purposes.

Private foundations have the potential to benefit greatly from the introduction of the L3C in Michigan. Private foundations are tax-exempt organizations that typically receive all of their support from a small number of sources and rely on investment income

from these sources for ongoing support. Due to risks that a foundation will improperly benefit from those who control it, including substantial contributors, the IRS imposes a variety of restrictions on private foundations to which other tax-exempt organizations are not otherwise subject. It also imposes taxes when these restrictions are violated, one of which relates to nonqualifying PRIs. A private foundation must avoid investments in for-profit enterprises that involve substantial risk (a “jeopardizing investment”) unless the investment qualifies as a PRI. Otherwise, such an investment could result in substantial excise tax penalties being assessed against the private foundation and its managers.¹¹ “Jeopardizing investments” are evaluated in the context of the foundation’s entire portfolio and require “the foundation managers, in making the investment [to] have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the private foundation to carry out its exempt purposes.”¹²

Although not required due to the significant penalties associated with a “jeopardizing investment” that does not qualify as a PRI, private foundations have in the past spent significant sums in legal costs and fees along with waiting a year or more to obtain private letter rulings from the IRS that their investments comply with PRI requirements. The Treasury Regulations provide some examples of acceptable PRIs, but they are not always instructive for a foundation’s creative or unique investment.¹³ For example, one private letter ruling sought a determination that a private foundation’s acquisition of a membership interest in a fund that would invest in businesses owned or controlled by disadvantaged groups in low-income communities would constitute a PRI.¹⁴ In another, two exempt private foundations formed a limited partnership, with a limited liability company as the general partner, and sought to invest in technology businesses that agreed to place their operations in areas designated as blighted or depressed by a governmental body, with the intent to promote a cluster of growth companies in the inner city.¹⁵ Investments to promote economic development and relieve conditions of poverty in foreign countries have also been considered.¹⁶ Since the determination of what constitutes a jeopardizing investment is made on a case-by-

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case basis, many private foundations want assurance that their investments qualify as PRIs. The time and expense required to obtain a private letter ruling, however, has traditionally deterred many foundations from making PRIs. According to the Foundation Center, a 2006 survey revealed that PRIs accounted for less than 1 percent of qualifying distributions made by independent, corporate, operating, and community foundations. Of this amount, 88 percent were made by independent and corporate foundations.¹⁷

Efforts are currently underway to provide a mechanism, short of obtaining a private letter ruling, by which to obtain formal recognition from the IRS that an investment in an L3C qualifies as a PRI. Formal recognition from the IRS that an investment in an L3C constitutes a PRI would obviate the need for a private letter ruling, thus saving organizations interested in making such investments significant resources and time. To that end, national proponents of the L3C are working to introduce federal legislation that would provide an entity seeking to attract PRIs (rather than the foundation seeking to make the PRI) a voluntary process by which to obtain an expedited IRS determination that investments in the entity will qualify as a PRI. The process, as contemplated in the proposed legislation, would be similar to the process entities currently undertake to obtain IRS determination of qualification as a Section 501(c)(3) tax-exempt organization. Although neither the state legislation nor the proposed federal legislation allow private foundations to do anything new, both provide efficient enforcement mechanisms to ensure PRIs accomplish charitable purposes while minimizing undue expense and burden to foundations seeking to make such investments. The designation "L3C" signals to the public and state and federal regulators that the organization is operated to accomplish charitable purposes. In its current form, the proposed federal legislation requires the L3C to provide the IRS with periodic reports thereby making the organization accountable for PRIs.

Even without formal recognition from the IRS, a private foundation's investment in an L3C could constitute both a PRI and a qualifying distribution for purposes of the Internal Revenue Code's five percent minimum distribution requirement.¹⁸ The L3C structure could ultimately provide private foundations with a cost-effective and time saving

approach to furthering their charitable purposes while expanding access to much needed capital for socially conscious ventures.

Conclusion

Although private foundations have a significant interest in L3Cs, the ultimate benefit is for the greater social good. L3Cs present new opportunities for raising capital to support a wide range of charitable activities. Due to the L3C's flexible entity structure, a wide variety of investors may pool their resources and provide the community with substantial benefits.

NOTES

1. Internal Revenue Service Exempt Organizations Continuing Professional Education Training Text for *Fiscal Year 2001*, Richard A. McCray and Ward L. Thomas, "Topic B, Limited Liability Companies As Exempt Organizations—Update."

2. *Id.*

3. See Treas Reg 1.501(c)(3)-1(d)(2).

4. *Id.*

5. Rev Rul 70-585, 1970-2 C.B. 115.

6. *Id.*

7. IRC 4944(c) and related Treas Reg 53.4944-3.

8. *Id.*

9. MCL 450.4102(2)(m).

10. See Treas Reg 53.4945-5.

11. IRC 4944.

12. See IRC 4944(a)(1).

13. See Treas Reg 53.4944-3(b).

14. Priv Ltr Rul 06-10-020 (Dec. 13, 2005).

15. Priv Ltr Rul 99-10-066 (Dec. 15, 1998).

16. Priv Ltr Rul 99-43-058 (Aug. 6, 1999).

17. The Foundation Center, *Aggregate Fiscal Data by Foundation Type*, 2006 (published in 2008).

18. See Treas Reg 53.4942(a)-3(a)(2).

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