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The Low-Profit Limited Liability Company ('L3C') – North Carolina's New Double Hybrid Entity

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On August 3, 2010, North Carolina created a new type of entity when it adopted legislation recognizing the low-profit limited liability company (also known as the "L3C"). The L3C is a hybrid form of a limited liability company that blends the attributes of a for-profit entity with those of a nonprofit entity. As a for-profit entity, an L3C can have owners (referred to as "members") who can receive profit distributions from the entity. However, like a nonprofit entity, the L3C's primary purpose must be to promote a charitable purpose. The intent is to harness the use of profit-seeking capital for socially-beneficial goals – a hopefully "win-win" scenario.

Overview of Limited Liability Companies

The limited liability company ("LLC") has become a very popular vehicle for the conduct of for-profit business in the United States. The LLC itself is a hybrid entity which combines the limited liability aspects of a corporation with the flow-through tax aspects of a partnership. Like a corporation, an LLC offers limited liability to its owners (called "members"). Only its members' investment in the LLC is at risk; their personal assets are protected from the reach of the LLC's creditors. But, like a partnership, an LLC is not subject to two levels of tax. Income or loss of an LLC flows to its members and is reflected on the members' tax returns. An LLC is automatically treated as a partnership for tax purposes if it has two or more members and is automatically disregarded as an entity separate from its owner for tax purposes if it has a single owner. To opt out of the automatic rules, the member or members of the LLC must make an affirmative election to treat the LLC as a corporation for tax purposes.

An LLC can be formed for any lawful business purpose and is created by filing Articles of Organization with the Secretary of State. One of the most significant benefits of the LLC form is the flexibility in structuring its ownership and in allocating the economic benefits and burdens to its members. The LLC also offers flexibility in its management in that it may be managed by all of its members or it may appoint a manager who need not be a member.

Although an L3C is a limited liability company, it has features that are different from the traditional LLC. Unlike the traditional LLC, the L3C must be formed to accomplish a charitable purpose in addition to a business purpose. Although the L3C must have a charitable purpose, donations to an L3C are not deductible as a charitable contribution because the L3C is a for-profit entity.

Why Use an L3C? The Importance of Private Foundations

One of the primary reasons for creating an L3C is to attract investments from private foundations. Under IRS rules, a private foundation must distribute a certain percentage of its income each year for a charitable purpose or be subject to a penalty. In addition, a private foundation may be penalized if its assets are invested in a way that jeopardizes the foundation's charitable purpose. If an investment qualifies as a program-related investment ("PRI"), the investment will count toward a foundation's mandatory distribution requirement and will not be characterized as a "jeopardizing investment."

The North Carolina L3C and the PRI

To qualify as a PRI, the IRS mandates that the investment meet the following three requirements:

- The primary purpose of the investment must be to accomplish a charitable or educational purpose;
- The production of income or capital appreciation of property cannot be a significant purpose of the investment; and,
- The investment cannot be used for political or legislative purposes.

A PRI allows private foundations to make investments in the form of loans, grants, and equity purchases in socially-motivated for-profit entities. Because of the uncertainty of whether an investment will qualify as a PRI, private foundations generally seek a ruling from the IRS that the proposed investment will qualify as a PRI and not constitute a "jeopardizing investment." However, seeking an IRS ruling is expensive and time consuming. Therefore, private foundations often refrain from investing in for-profit entities because of the potential risk. If the investment does not qualify as a PRI, the private foundation and its directors or trustees may face significant penalties. In addition, the private foundation may lose its tax-exempt status.

It is unclear how the IRS will treat a North Carolina L3C. Although the IRS has issued favorable rulings on the ability of private foundations to invest in for-profit LLCs with a charitable purpose, the IRS has not ruled that a private foundation's investment in an L3C automatically qualifies as a PRI. However, North Carolina's L3C legislation was written specifically to mirror the IRS requirements for a PRI in an effort to provide assurance to private foundations that their investment in a North Carolina L3C will qualify as a PRI. In fact, to qualify as a North Carolina L3C, the three IRS requirements listed above must be included in the L3C's Articles of Organization.

Attracting Investors

The perfect scenario for an L3C is for it to attract investments both from private foundations seeking out charitable endeavors while obtaining some return on capital and from private investors who will be more motivated to seek profits. A private foundation's investment in an L3C may be critical in attracting private investors. A major benefit of the L3C is that it can offer layered ownership in which the investment risk and return are distributed unevenly among its members. Normally, investors with the riskiest investment seek the highest rate of return on their investment. However, to provide an incentive for private investors to participate, the L3C should be structured so that the private foundation would accept the highest risk while receiving a lower rate of return on its investment.

Conclusion

The L3C may become an important tool in achieving socially-beneficial objectives such as developing affordable housing for the poor and providing low-interest loans to businesses relocating to economically distressed areas. While the benefits may be substantial, until the IRS rules that a private foundation's investment in a North Carolina L3C automatically qualifies as a PRI, some private foundations may be hesitant

to invest in these new entities regardless of the fact that they will have the ability to earn a profit while furthering their charitable goals.

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For further information regarding the issues described above, please contact Deborah B. Andrews.

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