

# **The Economic Viability of the L3C Business Entity**

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## **The Economic viability of the L3c Business Entity**

“I call the L3C the for-profit with the nonprofit soul. The best economic development increases wealth and prosperity without displacing or leaving behind those who need it most.” Robert Lang, the Creator of the L3C.

### **Introduction**

The low profit limited liability company was created with social enterprise in mind. Social enterprise is defined as a business entity, that uses traditional business methods to accomplish charitable or socially beneficial objectives. Traditional methods meaning a for-profit business plan. Since the 1980's, there has been a significant rise in social enterprise driven by social entrepreneurs for numerous reasons. A large reason for this rise is due to dwindling government funding for nonprofit market production. During the 1980s, when federal government grants were cut by 20 percent, the sector lost more than \$30 billion in funding and nonprofits decreased in size and number. Nonprofits responded to the loss in revenue by terminating programs, staff, and by reducing overhead.<sup>1</sup> These social entrepreneurs who were traditionally managing nonprofits were forced to adapt and find alternative sources of funding to ensure their businesses were operational. Since social enterprise and nonprofits produce goods and services that are similar in the sense that both have a socially beneficial bottom line, social enterprises began to form.

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<sup>1</sup> Liebschutz, S. F. “Coping by Nonprofit Organizations During the Reagan Years.” *Nonprofit Management and Leadership*, 1992, 2 (4),363-380.

The decision to switch from a nonprofit to a for-profit business model is not an easy transition. The focus of the switch would be to track down other forms of investment in response to the cuts by government. From an investor standpoint, there is more incentive to invest in a for-profit business entity as opposed to a nonprofit. For-profit businesses are able to pay returns to their investors. While nonprofits may provide tax deductions to donors, there is no return on investment. This poses a problem when there are governmental funding cutbacks or there are not enough donations to sustain operations.

However, the greatest obstacle to operating a socially beneficial company as a for-profit entity is coincidentally raising capital. The problem is that social enterprise is not highly profitable, even though it operates in a for-profit manner. In fact profit is not even the main focus of the business, these companies want to provide the maximum social return possible on the budget they control. As opposed to create the most profit possible through profit maximization. Nevertheless, this dilemma has led to the emergence of a 4<sup>th</sup> sector of the economy, which entails a hybrid model of for-profit companies that produce historically nonprofit output. It is a middle ground as these companies are neither entirely philanthropic nor entirely profit driven. There is demand for a social enterprise business model that solves the obstacle of raising funds. The Low profit limited liability company(L3C) provides the legal structure to facilitate efficient operation in the 4<sup>th</sup> sector.

### **Thesis Statement**

The Low profit Limited liability Company provides an economically viable substitute to traditional nonprofits, for the purpose of socially beneficial work in the market. The legal

structure of the L3C, requires the entity by law to achieve charitable work as proposed through the L3Cs mission statement. This legal legislation aligns with the Internal Revenue Service's program related investment requirement for foundations. In turn, the program related investments induce capital flows that are not available to traditional nonprofits, by facilitating layered investment. This diversifies and increases possible investment from third parties, and builds a better sustaining business model for socially beneficial work.

### **Literature Review**

The literature reviewed below pertains to the economic viability of the L3C business entity. (Murray and Hwang 2011) discuss how L3Cs have proved polarizing. Supporters of L3Cs tout the form as a solution for social entrepreneurs to pursue an overtly social mission, and to access capital more easily from both nonprofit and for-profit sources. The authors argue that there could be three possible forms of outside investors into L3Cs. Accredited investors, which are traditional investors that front large sums of capital. Foundational investors, who have the possibility of the return of their investment rather than grant the money to a nonprofit. The third possible type of investment is from crowd-funding. The most interesting aspect of this paper was the idea of crowd funding for L3Cs and the idea of the warm glow effect. The authors acknowledge that it may be difficult to convince a few individuals to each contribute a large sum of capital to an L3C. However, it may be much easier to raise the same significant sum needed by using crowd-sourcing. Each individual in the "crowd" contributes a small amount of money. With only a small amount of money committed per investor, each individual investor may be satisfied with only the return of their capital, and some additional "warm-glow." Warm-glow giving is an economic concept

developed by James Andreoni in 1990 that attempts to explain impure altruism. Instead of being motivated solely by an interest in the welfare of the recipients of their generosity, "warm-glow givers" also receive utility from the act of giving, and thus have an egoistic motivation for donating. This egoistic motivation may come from the boost to their self-esteem that they get from thinking of themselves as selfless and socially responsible, and/or from other people's recognition of their philanthropy.<sup>2</sup> What is even more interesting is that even the crowd-funders have a chance to earn a return on their investment if the L3C is successful.

(Doeringer 2010) This paper tracks the development of social enterprise in the United States and Europe throughout history. The author ultimately proposes that effective government policies are needed to stimulate capital investment in social enterprise and generate greater public understanding of the sector's potential benefits. The author argues that governmental cutbacks in the early 1980s, caused nonprofits to lose funding while they faced increased demand for their services, due to the dramatic rise in unemployment. This left social entrepreneurs at a stand still and sparked the search for a new business enterprise to respond to the changes in the economy. Since then, social enterprises have exploded and led to the emergence of a new 4<sup>th</sup> sector that combines socially beneficial work with a self-sustaining for-profit business model. Doeringer also sees a problem with a for-profit social enterprise, in that choosing to operate a business with a social purpose often involves making choices that can lower the potential to generate economic profits. As a result of this diminished profit-potential the interest rates associated with raising capital

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<sup>2</sup> Andreoni, James "Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving". *Economic Journal* 100, 1990. (401): 464–477.

through debt markets can be prohibitively high. Yes, in theory, relying on other forms of capital besides governmental funding and donations is critical to sustaining the business. However, tracking down these investors is the hard part.

In the (Brewer) paper, the author writes that many individuals today boast that they are “social entrepreneurs” running “social enterprises,” yet there is no universally accepted legal definition of the term “social enterprise.” Further, there is no single legal entity that customarily is used by the typical social entrepreneur. New legal entity forms are emerging for social enterprise (e.g., L3Cs, B corps, benefit corporations, etc.), but even these new forms generally prove inadequate in one or more respects, particularly their income tax treatment. Brewer argues that a legal definition needs to be established before these new hybrid social enterprises become legitimate. Brewer also believes that because of their inherent contract-like flexibility, liability protection, and malleable tax treatment, limited liability companies are increasingly being used for social enterprise. Brewer also claims that L3Cs are viable for social enterprise even though they are a for-profit entity and are neither tax-exempt nor eligible to receive tax-deductible charitable contributions. This is because the entity is required by statute to have a primary purpose of furthering a charitable or educational mission and not maximizing profits.

## **History**

The L3C model was initially developed by Robert Lang, CEO of The Mary Elizabeth & Gordon B. Mannweiler Foundation Inc., along with the help of many tax, law and finance experts. It shares all of the benefits of a regular LLC, but differs in that it has a mission-

driven operating agreement that guarantees a public benefit orientation.<sup>3</sup> Vermont was the first state in the US to pass L3C legislation in April 2008. Since 2008, similar legislation has been adopted in Illinois, Michigan, Utah and Wyoming. States where legislation is pending include: Arkansas, California, Colorado, Missouri, Montana, North Carolina, North Dakota, Oregon, Tennessee, and Washington.<sup>4</sup>

## **Legal Structure**

The L3C is a form of limited liability company (LLC) and possesses many characteristics of a typical LLC. Like a traditional LLC, the L3C is a for-profit entity. The structure offers flexible ownership, where each member's management responsibility and financial stake may vary according to individual needs. Like a traditional LLC, the L3C's members enjoy limited liability for the actions and debts of the company. In addition, like an LLC, the L3C is classified as a "pass-through entity" for federal tax purposes.<sup>5</sup> This means that no federal income tax is imposed on the L3C itself. Instead, items of income, expense, gain, and loss "pass through" the L3C to its members. These are allocated in proportion to the members' ownership shares, and are reported on members' individual tax returns.<sup>6</sup> There is one major separation of the two business entities. An LLC is organized and operated for any lawful business purpose. An L3C must by law perform socially beneficial work as noted in their business charter. The primary goal of an L3C is to perform charitable work that furthers a social agenda; this implies that profit must be put second in business operations. To sum it up, an L3C is a for-profit in a nonprofits body.

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<sup>3</sup>Lang, Robert. "The L3C & Economic Development" *Americans for Community Development* LLC 2011.

<sup>4</sup> Lang, Robert

<sup>5</sup> Murray, J. Haskell and Hwang, Edward I. , "Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking in Low-Profit Limited Liability Companies"

<sup>6</sup> Murray, J. Haskell and Hwang, Edward I.

The L3C must be organized and operated at all times to satisfy the following requirements:<sup>7</sup>

1. The company must significantly further the accomplishment of one or more charitable or educational purposes, and would not have been formed but for its relationship to the accomplishment of such purpose(s)
2. No significant purpose of the company is the production of income or the appreciation of property(though the company is permitted to make a profit)
3. The company must not be organized to accomplish any political or legislative purposes.

This legislation was specifically written to mirror the federal Internal Revenue Service's (IRS) regulations relevant to Program Related Investments (PRIs) by foundations.

Foundations are key players in bridging the funding obstacles for L3Cs. In return, L3Cs also provide an incentive for foundations to invest because of the possibility of a return.

### **Program Related Investments**

The goal of the L3C is to bring together a mix of investment money from a variety of sources. As opposed to a nonprofit, the L3C relies on more traditional forms of capital for business operations rather than donations. By diversifying the range of capital, this creates a form of tiered investing called tranching investment, which will be described in the subsequent section. To be able to create tranching investment, the capital infusion process starts with investments from Foundations known as Program Related Investments (PRIs).

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<sup>7</sup> Lang, Robert

PRIs are investments made by private foundations, into for-profit business ventures, to support a charitable, educational, or religious project or activity.<sup>8</sup> Federal tax law requires private foundations to distribute approximately five percent of their assets every year in grants or by making Program Related Investments. Program Related Investments have been part of the law since 1969.<sup>9</sup>

Foundations have two basic options for spending their money. Typically, they will donate this money as a grant to a nonprofit, where there is no financial return. The other way foundations can spend their money is through the PRI system. PRIs are defined according to the foundation center as “investments made by foundations to support charitable activities that involve the potential return of capital within an established time frame. PRIs include financing methods commonly associated with banks or other private investors, such as loans, loan guarantees, linked deposits, and even equity investments in charitable organizations or in commercial ventures for charitable purposes.”<sup>10</sup>

However, the use of PRIs by Foundations is limited even with the potential to earn a small return. The transaction costs associated in guaranteeing that the target of the investment will meet PRI requirements are prohibitive. For instance, to guarantee that an investment qualifies as a PRI, private foundations may apply for a private letter ruling from the Internal Revenue Service (IRS), but it is difficult to do so.<sup>11</sup> The IRS requirements are burdensome. Many foundations shy away from investing in for-profit ventures due to the uncertainty of whether they would qualify. This makes sense, as if a foundation made a PRI

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<sup>8</sup>Murray, J. Haskell and Hwang, Edward I.

<sup>9</sup>Murray, J. Haskell and Hwang, Edward I.

<sup>10</sup> Witkin, Jim "The L3C: A More Creative Capitalism". *The Triple Pundit*. 2011.

<sup>11</sup> <http://www.irs.gov/charities/foundations/article/0,,id=137793,00.html>

to a for-profit business without submitting first to the IRS, and the money ended up not allocated for a charitable cause, there would be serious tax penalties for the foundation.

There are also information problems associated with completing a PRI. There is asymmetric information on the receiving side, as the foundation has no control over whether the business will use the money for charitable causes.

The legal structure of the L3C reduces the time cost associated with PRIs by bypassing the IRS all together. The operating agreement of the L3C was set up to mirror the PRI requirements outlined by the IRS.

IRS PRI Requirements:<sup>12</sup>

1. The primary purpose is to accomplish one or more of the foundation's exempt purposes
2. Production of income or appreciation of property is not a significant purpose.
3. Influencing legislation or taking part in political campaigns on behalf of candidates is not a purpose.

To qualify as a PRI, the investment must relate to the Foundation's mission and the risk/reward ratio must exceed that of a standard market-driven investment (i.e. the risk must be higher, and the return lower). PRIs often are structured as below-market-rate loans, but may take other forms as well, including loan guarantees, purchases of stock or other equity security (including membership in an LLC), and letters of credit.<sup>13</sup> The tax rules governing PRIs also permit private foundations to join conventional investors in

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<sup>12</sup> <http://www.irs.gov/charities/foundations/article/0,,id=137793,00.html>

<sup>13</sup> Witkin, Jim "The L3C: A More Creative Capitalism". *The Triple Pundit*. 2011.

financing enterprises that might but are very unlikely to provide the foundation a market-rate return.<sup>14</sup> For example, the federal tax regulations governing PRIs describe a business enterprise in an economically disadvantaged area, that will receive loans from financial institutions only after it receives a below-market loan from a private foundation, and conclude that the foundation's below-market loan qualifies as a PRI.<sup>15</sup> The key to a PRI is the foundation's motivation in making the investment. The legal form of the recipient is not determinative, but does tend to scare foundations away because of risk and uncertainty of credibility of the recipient.

This provides economic benefits for a foundation to invest in an L3C. Because the L3C's legal legislation is written in such a way as to comply with all PRI regulations, the legal structure eliminates the need for private letter rulings or legal opinions for foundation investment in L3Cs. L3Cs are defined by law to preform charitable work. This reduces the risk of tax penalties for a foundation and provides an incentive to invest in an L3C as opposed to a straight for-profit business. It also makes economic sense for a foundation to invest in an L3C because of the possibility for a return on investment, even if it is small. For example, a foundation could make a grant to a nonprofit and this would be included in the five percent spending of annual assets. Conversely, a foundation could make a PRI to an L3C, even if the L3C business failed, the investment would be considered a grant and in the five percent. Not to say that L3Cs fail all the time, the foundation could make a grant to a nonprofit and this business could fail as well. The L3C also reduces transactions costs due to credible information signaled through their business charter. The law prohibits L3Cs from using PRIs in anything but in accordance with the guidelines. This in turn reduces risk

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<sup>14</sup> Brewer, Cass V., "A Novel Approach to Using LLCs for Quasi-Charitable Endeavors (A/K/A 'Social Enterprise')."

<sup>15</sup> Brewer, Cass V

and uncertainty associated with a foundation making a PRI. In addition, a PRI in an L3C would attract outside investors through a tranching or layered investment model.

### **Tranching Investing**

Like the LLC, the L3C is able to form flexible partnerships where ownership rights can be tailored to meet the requirements of each partner. This flexibility permits a tranching or layered investment and ownership structure. The L3C model distributes risks and rewards unevenly (or evenly) over a number of investors, leveraging PRIs to increase returns for other investors. Based on PRI regulations, foundations must make high-risk, low-return investments (as low as 0% return).<sup>16</sup> Because the Foundation can invest through PRIs at less than the market rate while embracing higher risk levels, this lowers the risk to other investors and increases their potential rate of return. So the remaining L3C memberships can then be marketed at risk/return profiles necessary to attract market driven investors, such as state pension funds and private capital.<sup>17</sup> This is important because it opens up the possibility of more traditional investors compared to nonprofits. A traditional investor would not be interested in investing in a nonprofit because the company would not provide a return on investment. An L3C provides an opportunity to invest, make a return, while still accomplishing a social objective. The goals of an L3C and nonprofit are aligned, in that they both provide socially beneficial goods and services. The difference is that the L3C business plan diversifies the range of funding and not only relies on donations. This is a much more

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<sup>16</sup> Witkin, Jim "The L3C: A More Creative Capitalism". *The Triple Pundit*. 2011.

<sup>17</sup> Murray, J. Haskell and Hwang, Edward I.

sustainable business model as opposed to relying on donations and government funding such as nonprofits.

## **Conclusion**

The end result is the L3C is able to leverage Foundation PRIs to access a wide range of investment dollars, through a flexible partnership structure. While the possibility of financial prospects is modest, the possibility of major social impact is high. Additionally, profit and loss flow through the L3C to its members and are taxed according to each investor's particular tax situation, making it easier for nonprofits and for-profits to partner together. The L3C provides assurance that investment money will be used for socially beneficial work, as they are required by law to do so. This eases uncertainty and lowers risk for foundations that are interested in making a PRI. The L3C business charter also reduces cost associated with PRIs for foundations by bypassing the lag time when applying through the IRS.

In a time when government funding for nonprofits is shrinking due to spending cutbacks, the L3C provides an efficient business model to cope with these issues. The problem with nonprofit organizations is that they have very limited access to capital due to IRS regulations that restrict profit-seeking objectives. For social and community conscious business ventures to succeed, they need a flexible, lightly regulated business structure that allows access to investment capital. The L3C format was designed to satisfy this need. L3Cs are able to raise funds by attracting and accessing a range of investment capital that would not be interested in investing in traditional nonprofits. The L3C is an efficient and viable substitute for businesses interested in pursuing a socially beneficial output, while making profit at the same time.

## **Personal Interpretation**

I have laid out arguments in this paper as to how the L3C business model, provides a viable option for socially beneficial work. As a cautionary note, however, the IRS has not ruled whether private foundation investments in L3Cs qualify as PRIs. This is a major problem; the whole reason why the model could be successful is through foundation PRIs. Without PRIs, there is no way for the L3C to leverage the investment to curtail risk and return ratios for other investors. There would be no incentive for traditional investors looking for market returns to invest in L3Cs, because they would not receive a market return. This eliminates the idea that the L3C could attract greater capital than traditional nonprofits.

The problem is then with the IRS. To date, there have been no foundational PRIs in L3Cs. Maybe this is because the nature of the L3C is still relatively new, and the legal structure is being questioned. However, what would solve the questioning of the business model is if the IRS would legalize an L3C as a guaranteed PRI recipient. This would signal to foundations that there would be no tax penalties associated with an investment into an L3C. However, part of the argument against the L3C business entity is enforcement of the charitable purpose of the capital invested. As of right now, even if the investment qualifies as a PRI, the foundation must still ensure that its charitable goals are accomplished and guard against private inurement.<sup>18</sup> Private inurement is prohibited in all nonprofits. It

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<sup>18</sup> "What is private inurement?." BoardSource: Build Effective Nonprofit Boards of Directors through Good Governance. N.p., n.d. Web. 8 Mar. 2012. <<http://www.boardsource.org/Knowledge.asp?ID=3.165>>.

happens when an individual who has significant influence over the organization, enters into an arrangement with the nonprofit and receives benefits greater than she or he provides in return.

The most common example is excessive compensation, which the IRS condemns through intermediate sanctions (significant excise taxes).<sup>19</sup> Individuals referred to in IRS parlance as "disqualified persons" can be high-level managers, board members, founders, major donors, highest paid employees, family members of any of the above, and a business where the listed persons own more than 35 percent of an interest.<sup>20</sup> If any part of the foundation's net earnings accrue to the benefit of a private individual, such as a commercial investor in the L3C, the foundation will lose its tax exemption.<sup>21</sup> To minimize these risks, a private foundation would need approval authority on L3C investments, regular reports and other controls. But who would enforce these controls? The IRS already enforces this in nonprofits, so why not in L3Cs as well?

Currently, foundations will not invest PRIs into L3Cs. This makes economic sense, because the risk of additional costs of potential tax penalties outweighs the social benefit of the investment. I believe the issues that are preventing the L3C to be recognized as an PRI recipient are enforcement and legal structure. There needs to be some kind of enforcement that funds in the L3C are indeed going to a charitable cause rather than profits to investors. The easiest way for this to be done is through the IRS. However, some argue that the IRS is overbooked with enforcement of nonprofits. This may be the case, but some of these nonprofits could turn to the L3C business model with the potential of increased capital.

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<sup>19</sup> "What is private inurement?." BoardSource: Build Effective Nonprofit Boards of Directors through Good Governance. N.p., n.d. Web. 8 Mar. 2012. <<http://www.boardsource.org/Knowledge.asp?ID=3.165>>.

<sup>20</sup> "Capital Structure of the L3C | Citizen Media Law Project." Home | Citizen Media Law Project. N.p., n.d. Web. 8 Mar. 2012. <<http://www.citmedialaw.org/legal-guide/capital-structure-l3c>>.

<sup>21</sup> "What is private inurement?."

This would provide no further burden on the IRS and further benefit the socially beneficial mission. In addition to enforcement there needs to be more legal definition in the L3C model. This would help with enforcement as well by reducing loop holes. An argument against the L3C is there is too much flexibility in the structure. More specifically, the idea that an L3C can change business forms to a traditional LLC with ease. This is a problem because investors who infuse capital to the business for purely social reasons, might not have invested to be apart of a business that is not mandated by law to perform charitable work. There needs to be stricter laws requiring an L3C to either stay an L3C, or legislation for repayment to investors who would oppose the business model switch.

Right Now participating states that have L3C legislation permit the businesses to register and operate as an L3C business entity. This only goes so far though; the only way to utilize the benefits for socially beneficial work is through PRI investment. Until the IRS makes a ruling on L3C PRI investment, there would be no reason to start an L3C as opposed to a traditional nonprofit.

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