Report Regarding Low-profit Limited Liability Companies

Presented to the Joint Standing Committee on Judiciary

January 14, 2010

Prepared by the Office of the Secretary of State
Pursuant to Resolves of 2009, Chapter 93

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I. Executive Summary

As required by the Resolves of 2009, Chapter 97, the Secretary of State examined the concept of low-profit limited liability companies, reviewed the legislation enacted and pending in other states and consulted with members of the Business Law Section of the Maine Bar Association and with other practicing attorneys or law professors knowledgeable about business entity law.

The benefits of a low-profit liability company (L3C) are predicated upon a host of complex issues involving the Internal Revenue Service and the treatment of investments or grants called Program-Related Investments (PRI) within the L3C. The United States Congress has not indicated any immediate plans to make changes to the IRS code to benefit L3Cs specifically, or the treatment of PRIs within L3Cs. If a company will not gain additional tax benefits from its formation as an L3C, there appears to be no need to create a new structure within Maine's limited liability company (LLC) law. Additionally, Maine's current LLC statute (unlike other states) already allows many of the advantages L3C legislation is meant to address. Therefore, the Secretary of State does not recommend that the Legislature proceed with establishing low-profit limited liability companies at this time.

II. Background

1. What is an L3C?

A low-profit limited liability company (L3C) is a legal form of business entity – a limited liability company (LLC) – and possesses many characteristics of a typical LLC. Like a traditional LLC, the L3C is a for-profit entity. Like a traditional LLC, the L3C offers a flexible ownership structure, wherein 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. And, like a traditional LLC, the L3C may be classified as a "pass-through entity" for federal tax purposes. An L3C runs like a regular business. However, unlike a for-profit business, the primary focus of the L3C must not be to make money, but to faciliate and achieve socially beneficial aims (within the meaning of Sec. 170(c)(2)(B) of the IRS Code), with profit-making as a secondary goal. The L3C thus occupies a niche between the for-profit and charitable sectors.[1]

Components of an L3C are as follows:

1. The company does not have the production of income or the appreciation of property as a significant business purpose;

2. The company must significantly further the accomplishment of one or more charitable or educational purposes within the meaning of Sec. 170(c)(2)(B) of the Internal Revenue Code, and must not have been formed but for its relationship to the accomplishment of such charitable or educational purposes; and

3. The company must not have been organized to accomplish any political or legislative process.

These three requirements, which must be specified in the L3C's organizing document, deliberately mirror the requirements in the Internal Revenue Code governing Program-Related Investments (PRIs). PRIs are investments made by private foundations, often into for-profit business ventures, to support a charitable project or activity, that receive favorable tax treatment from the IRS. Thus, the L3C is designed to meet the IRS requirements for qualifying as a recipient of PRIs. However, the IRS has not ruled on whether investments in L3C's will automatically qualify as PRIs and has publicly stated that foundations may not rely

[1] http://en.wikipedia.org/wiki/L3C#Background

on L3C status in determining whether or not an investment qualifies as a PRI.[2] In short, although at least one industry group is working to introduce a bill to Congress that would expedite the process for obtaining a letter ruling that an investment in an L3C automatically qualifies such investment for favorable tax treatment as a PRI, no such legislation has been passed to date.

Although L3Cs are created to advance charitable purposes, they are not charities. Therefore, L3Cs are not exempt from federal or state tax and investments in L3Cs are not tax-deductible. While the L3C is designed to facilitate PRIs by private foundations, these foundation investments are governed by the federal tax rules applicable to PRIs.

Rather, an L3C - like a traditional LLC - is a "pass-through entity," like a partnership or sole proprietorship. This means that no federal income tax is imposed on the L3C itself. Instead, income, expense, gain, and loss "pass through" the L3C to its members, are allocated in proportion to the members' ownership shares, and are reported on members' individual tax returns.

It is important to note that as of July 2009, the IRS had not yet resolved several key questions with respect to the tax treatment of L3Cs.

[2] http://en.wikipedia.org/wiki/L3C#Background

II. Background

2. Legislation in other states.

The first state to enact low-profit limited liability company legislation was Vermont (April, 2008). Since that time, four more states Michigan (January, 2009); Utah (July, 2009); Wyoming (July, 2009); and Illinois (January, 2010) have enacted legislation to create L3Cs.

Legislation was introduced in North Dakota, Missouri and Oregon to study L3Cs, but either the legislation did not get a hearing or it did not pass. There is still pending legislation in North Carolina.

Aside from Vermont, where as many as 78 L3Cs have been formed since the enactment of this legislation, the other states reported that very few L3Cs have been formed.

It is important to note that many LLC laws in the United States permit the formation of an LLC for charitable or educational purposes. Under Maine law, an LLC can be formed for any lawful purpose (which would include charitable or educational purposes).

II. Background

3. What do others think?

i. National Association of State Charity Officials (NASCO). NASCO is an association of state offices charged with oversight of charitable organizations and charitable solicitation in the United States. NASCO is affiliated with the National Association of Attorneys General.

In Appendix A, the letter to the United States Senate Finance Committee (the Committee) and the Committee's response are provided in full. In summary, NASCO's letter asked many significant policy questions, including:

- "…whether the U.S. Senate Finance Committee is planning to pursue changes in federal tax law that would streamline the current process for approving program-related investments (PRI) to accomplish one or more of the purposes described in section 170(c)(2)(B), if such PRI were invested in an entity organized under state law as a low-profit limited liability company?"
- "At a time of great and increasing demands on the financial resources of charitable foundations, the state L3C legislation we are seeing encourages the diversion of charitable assets away from the nonprofit sector and toward new and untried corporate form that may lack the supervision state charity officials now exercise over true public charities."
- "What safeguards and enforcement mechanisms are in place to ensure L3Cs are not only organized for charitable purposes, but they also operate in a manner consistent with those purposes…."
- "How can one determine that the for-profit investors in the L3C venture are not receiving improper private benefit and that charitable purposes are being advanced through the L3C without, at a minimum, reviewing the members' operating agreements?"
- "If a significant portion of an L3C's capital is provided by investors seeking market rates of return, how can it be said the production of income is not a significant purpose of the L3C?"

- "Not all forms of economic development or job creation are charitable. Under what circumstances are economic development projects or job creation programs considered charitable under 501(c)(3), as opposed to tax-exempt activities under 501(c)(4) or 501(c)(6), or simply business ventures that would not qualify as charitable activities?"
- "Are any proposed legislation's reporting and disclosure requirements adequate to verify compliance with L3C requirements and to facilitate state oversight over charitable organizations and assets?"
- "Is it good public policy to shift to regulators the burden of detecting noncompliance by granting L3Cs presumptive charitable status as opposed to requiring those organizations that have received the tax benefits of charitable status to undertake the necessary due diligence to ensure their PRI complies with the law?"

In response to NASCO's letter, Chairman Baucus and Ranking Member Grassley of the Committee stated "…However, we have not had any hearings on this particular matter and do not think that it is ripe for federal legislation…."

3. What do others think?

ii. Professor Daniel S. Kleinberger. Professor Kleinberger is a Professor of Law and the Founding Director of the Mitchell Fellows Program at the William Mitchell College of Law. He was also the Co-Reporter of the Uniform Law Commission's Revised Uniform Limited Liability Act of 2006. Professor Kleinberger is a well-respected legal scholar on business entity law.

Professor Kleinberger has been widely known as an expert on LLC law. As noted above, he was the co-reporter on the LLC drafting committee for the Uniform Law Commission 2006 revision. He has been a featured speaker on the L3C topic for many organizations, including the National Association of State Charity Officials, the National Association of Attorneys General and the International Association of Commercial Administrators (IACA).

As part of Professor Kleinberger's comments to IACA, he stated:

> "If the law of a state does not require that an LLC have a business purpose, then an L3C is unnecessary as a matter of state law. Without some change in the federal tax code there is no benefit that I can see to having this extra apparatus in any LLC statute. Those using the L3C form will still have to satisfy themselves of the favorable tax treatment, just as they do without the apparatus. The idea of a "brand" (i.e., a specialized category) within the LLC act is a bad idea. The brand/statutory category suggests that this concept is a straightforward one. That suggestion is substantially incorrect and inevitably misleading. The concept has many, many complexities – not the least of which are federal and state securities law and federal income tax law pertaining to allocations of profits and losses. The legislation should not signal "there's clear sailing through this channel."

Professor Kleinberger has written an article relating to L3Cs, the full article is found in Appendix B, but in summary, Professor Kleinberger believes L3Cs are unnecessary since the structure is already provided under the LLC laws in every state; unwise because of the lack of changes to federal tax laws; and misleading because of the same issues with federal tax laws.

II. Background

3. What do others think?

iii. LLC Review Subcommittee of the Business Law Section of the Maine Bar Association.

The core members[3] of the LLC Review Subcommittee of the Business Section of the Maine Bar Association have been working with the Secretary of State's office to bring forward a revised LLC Act for Maine. This subcommittee reviewed and discussed adopting L3C provisions into the draft of the revised act. The group concluded that "given that the proposed [L3C] legislation is far less compelling without any companion federal legislation, we recommend that no action be taken until the issue is addressed on a federal level."

[3] Members included in the L3C review were Chris Mcloon, Verrill & Dana, LLP; Aaron Pratt, Drummond Woodsum & Mac Mahon; Nelson Toner, Bernstein Shur; Kevan Lee Rinehart, Bernstein Shur

III. Conclusions and Recommendations

Based on the information gleaned from discussions with members of the LLC Revision Subcommittee of the Maine Bar and other resources, the Secretary of State believes that the "wait and see" approach is the best approach until federal legislation clearly provides a benefit to businesses who wish to create low-profit limited liability companies. We believe that Maine does not need to be on the leading edge of this movement since its LLC statute allows for some of the purported L3C benefits. And, given the low number of filings in other states, outside of Vermont, this issue can be addressed at another time when appropriate federal legislation or regulation is in place.

Appendix A

National Association of State Charity Officials

March 19, 2009

Senator Max Baucus, Chairman
Senator Charles Grassley, Ranking Member
U.S. Senate Finance Committee
219 Dirksen Senate Office Building
Washington, D.C. 20510

RE: "Low-Profit" Limited Liability Company Legislation

Dear Chairman Baucus and Ranking Member Grassley,

I am writing on behalf of the National Association of State Charity Officials ("NASCO"). NASCO is affiliated with the National Association of Attorneys General and serves as a forum for state charity officials to exchange views and experiences related to the regulation of public charities as well as to foster interstate cooperation regarding charitable enforcement efforts.

As you know, state charity officials serve as the primary regulators over public charities and are the parties most likely to pursue breaches of the fiduciary duties of loyalty, care and good faith that our state and common laws impose upon the directors, officers and trustees of charitable assets. Typical regulatory and enforcement actions include, but are not limited to, administering state registration and reporting requirements; correcting inaccurate and misleading financial reports; redressing fraudulent and deceptive charitable solicitations; enforcing charitable trusts and bequests; recovering diverted charitable assets; imposing fines and penalties for violations of state law; and, overseeing corporate mergers, conversions and asset sales.

It is with this regulatory role and the public's interest in nonprofit transparency and accountability in mind that I am writing to seek clarification on a matter of concern to us. Specifically, NASCO asks whether the U.S. Senate Finance Committee is planning to pursue changes in federal law that would streamline the current process for approving program-related investments (PRI) to accomplish one or more of the purposes described in section 170(c)(2)(B), if such PRI were invested in

an entity organized under state law as a low-profit limited liability company?

The question arises because proponents of the low-profit limited liability company (commonly referred to as an "L3C") reportedly have made the case in state legislatures that these changes on the federal level are imminent and therefore the states need to get on board and create this L3C entity. Proponents have distributed a draft bill titled, "*Program-Related Investment Promotion Act of 2008,*" and have said that the Senate Finance Committee approves of the concept and is working on the legislation.

We're concerned that these assertions may lack a basis in fact, yet have proven quite effective in persuading state legislators to pass these bills into law without giving them the close scrutiny they deserve. Vermont, passed the first L3C bill last year, Wyoming and Michigan passed L3C bills quite recently, and several other states are on the verge of enacting L3C bills in the next few weeks. The Montana Legislature is scheduled to hold what may be its final hearing on an L3C bill March 24**, and** bill proponents report that similar bills are moving through the legislatures in Illinois, Indiana, Missouri, North Carolina, North Dakota, Oregon, Tennessee, Utah, and soon the State of Washington. In addition, a state legislator in Colorado has expressed an interest in sponsoring L3C legislation in the 2010 General Assembly.

At a time of great and increasing demands on the financial resources of charitable foundations, the state L3C legislation we are seeing encourages the diversion of charitable assets away from the nonprofit sector and toward a new and untried corporate form that may lack the supervision state charity officials now exercise over true public charities. While NASCO has not taken an official position on such legislation at this time, we believe our state policymakers should be fully and accurately informed of the premises and consequences of the L3C form--something the legislation's sponsors themselves have called a revolutionary change in the law governing charitable assets.

Therefore, we take this opportunity to share some of our questions and concerns with the general concept of investing PRIs in low-profit limited liability companies, so you can take them into account as you're considering such legislation now or in the future. I am enclosing for your

review a preliminary list of questions that were raised during a recent NASCO discussion of the L3C issue and a few general observations that I hope will be helpful to your committee.

We would appreciate learning the committee's position on this proposed federal legislation and/or the prospects that such a proposal would be considered in the current session of Congress.

If NASCO can be of any assistance to the committee on this or other issues related to public charities, please do not hesitate to contact me.

Very Truly Yours,

Chris Cash

Chris Cash
NASCO President

Enclosures (2)

cc The Honorable John Lewis
The Honorable Dave Camp
Emily M. Lam, Steven G. Frost, Office of Tax Policy, Dept. of Treasury

NASCO QUESTIONS
CONCERNING PROPOSED FEDERAL LEGISLATION TO PROMOTE PROGRAM-RELATED INVESTMENTS IN LOW-PROFIT LIMITED LIABILITY COMPANIES (L3Cs) AND STATE L3C LEGISLATION

March 19, 2009

1. From the IRS's perspective, does it matter whether an L3C is considered a charitable or non-charitable entity under state law? The statutory language in some states does not make clear whether all L3Cs will be treated similarly or whether, instead, it would be necessary to review the operating agreements and other creating documents of each L3C to determine whether it should be treated as a charitable organization.

2. What safeguards and enforcement mechanisms are in place to ensure that L3Cs are not only organized for charitable purposes, but they also operate in a manner consistent with those purposes? It appears that an LLC can obtain exempt status only if it is organized exclusively for charitable purposes. The definition of an L3C does not guarantee that this requirement in IRC 501(c)(3) will be satisfied. If safeguards and enforcement mechanisms are limited, why should investments in L3Cs be entitled to any type of rebuttable presumption of compliance with applicable PRI requirements?

3. How can one determine that the for-profit investors in the L3C venture are not receiving improper private benefit and that charitable purposes are being advanced through the L3C without, at a minimum, reviewing the members' operating agreements?

4. Are there any mandatory provisions that would need to be included in L3C operating agreements to ensure that for-profit interests are subordinate to the company's charitable purposes?

5. If a significant portion of an L3C's capital is provided by investors seeking market rates of return, how can it be said that the production of income is not a significant purpose of the L3C? Would for-profit interests have to be limited to a certain percentage of investors (i.e., 15%) to ensure that the production of income is not a significant purpose?

6. Is the L3C concept, in fact, likely to reduce transactional costs associated with PRI? How many small foundations could perform the necessary due diligence and effectively negotiate the terms of an L3C operating agreement without significant and costly assistance from legal counsel, especially if the for-profit investors are large and well-represented?

7. Not all forms of economic development or job creation are charitable. Under what circumstances are economic development projects or job creation programs considered charitable under 501(c)(3), as opposed to tax-exempt activities under 501(c)(4) or 501(c)(6), or simply business ventures that would not qualify as charitable activities?

8. Would terms of an L3C operating agreement that require the charity to cover any loss or a portion of a loss of for-profit investors seeking a "market return" on their portion of the

investment result in an arrangement through which the production of income is a significant purpose? If the terms of an L3C operating agreement include a provision that requires the charity to cover a claim of lost return on investment (or otherwise purport to provide a profit) to the for-profit investors, does that result in an arrangement through which the production of income is a significant purpose? Would terms of an L3C operating agreement that require the charity to pledge additional assets as collateral, require a capital infusion by the charity, or otherwise create a claim on the assets of the charity above the charity's initial capital contribution be a factor in determining whether or not the production of income is a significant purpose of the L3C? In terms of an L3C operating agreement's assignment of risk and returns among the L3C participants, what are the factors that determine whether the production of income is a significant purpose?

9. Most foundations do not face a lack of demand for grants or a lack of charitable beneficiaries for purposes of meeting the 5% distribution requirements. Will the promotion of L3Cs cause foundations to shift funds from existing grants and beneficiaries and what effect would such a shift have on charities that currently rely on foundation support?

10 While there is a minimum distribution requirement of 5%, is there any maximum distribution limitation? Additionally, is there any prohibition against investing all the foundation's assets in PRI, no matter how risky?

11. What are the consequences for the foundation investors if it turns out that the L3C was not properly structured to meet IRS requirements for acceptable forms of PRI? Would the investment be treated as a jeopardizing investment, subjecting the foundations to tax penalties? Could the foundations lose their tax exempt status? What would the consequences be for the for-profit L3C investors?

12. Why not limit L3C participation to nonprofits or entities that are willing to accept a lower rate of financial return in exchange for accomplishing important socially beneficial purposes? Charitable foundations would be economically better off if they were not obligated to subsidize the financial returns of for-profit investors. Accordingly, market rate investors would appear to be L3C partners of last resort, brought into a venture only if the capital demands were so great it was impossible to raise adequate funding from other nonprofits or socially conscious investors. Rather than encouraging foundations to begin their PRI efforts with capital-intensive, high risk joint ventures with for-profit partners, might it not be more appropriate to begin with more conservative approaches that are more clearly charitable and raise less potential for abuse?

13. The proponents of the L3C legislation have indicated their objectives include creating and marketing securities instrument based on L3C assets, similar to mortgage-backed securities. What safeguards should be incorporated into legislation to protect the public from the market failures experienced with respect to mortgage-backed securities? What role would investment bankers play in assessing the charitable nature of the PRI or the value of the L3C's social return? A fair number of financial analysts and investment bankers have a less than stellar track record at valuing the straight-forward for-profit investments (in terms of rating and assessing investment risk). Given what we have witnessed in terms of valuation of financial instruments, the so-called "social return" (which does not lend itself to a lot of objective measurement) has no basis for

evaluation other than the self-representations of those who are parties to the transaction. In other words, are we going to trust investment bankers to provide us with an assessment of the social return? How do we measure the social return (and gauge it relative to the financial investment and risks)? If we do not assess social return, then how can we conclude that a significant purpose of the venture is not the production of income?

14. State regulators have traditionally had oversight authority over charitable organizations and their assets. Given that L3Cs are intended to be predominantly charitable, how can state regulators be assured that they will have appropriate oversight authority over L3Cs?

15. Would the IRS require L3Cs that are not single-owner entities to file separate returns as partnerships or corporations? LLCs are not recognized by the IRS as taxpaying entities and must therefore file as partnerships, proprietorships, or corporations (http://www.irs.gov/businesses/small/article/0,,id=137016,00.html). Under Treas. Reg. §301.7701-3, only LLCs with a single owner may be disregarded for tax purposes.

16. Are any proposed legislation's reporting and disclosure requirements adequate to verify compliance with L3C requirements and to facilitate state oversight over charitable organizations and assets? The only current requirements for reporting on the program-related investment of charitable assets in L3Cs would appear to be on Form 990 (see Schedule D, part VIII) and Form 990-PF (see part IX-B). Neither return requires extensive detail on specific program-related investments. Is there any other current method for the IRS, the states, and the public to receive L3C-specific information from a charitable investor? Could the IRS without Congressional approval require a L3C's partnership or corporate tax filing to be made public?

Some believe that the most efficient method for reporting on an L3C's use of charitable investments may be through a new, expanded schedule that requires detailed reporting on program-related investments, generally, or L3C investments in particular. Would the IRS envision adopting a new reporting procedure regarding L3C investments if the L3Cs are not required to report to the IRS as charitable organizations?

17. Is it good public policy to shift to regulators the burden of detecting noncompliance by granting L3Cs presumptive charitable status as opposed to requiring those organizations that have received the tax benefits of charitable status to undertake the necessary due diligence to ensure their PRI complies with the law?

18. Are special conflict of interest prohibitions necessary, or are existing Internal Revenue Code provisions sufficient, such as a prohibition on participation in a for-profit investment in an L3C by persons related to the managers of the private foundation making the PRI?

19. Is this bill really necessary? The IRS rule on PRI, 26 CFR 53.4944-3 already provides concrete examples of acceptable PRI, and LLCs are already permitted under state law. Also, how many PRIs are made each year without private letter rulings? The L3C proponents do not spend much time discussing the amount of PRI made each day without the L3C (and the corresponding success stories for environmental investment and affordable housing). A quick examination of the top 100 private foundations would seem to suggest that creating L3Cs as a

mechanism to help "the big guys" is not really necessary. Similarly, the L3C as a mechanism to help "the little guys" seems illusory. Might it not be the case that many of those who seek private letter rulings do so not because they are confused about the need for a private letter ruling, but because their particular planned investment may push the envelope of acceptable PRI and may raise the potential legal issues?

20. If there is no federal legislation or change in IRS policy concerning PRI and L3Cs, does state L3C legislation serve any purpose?

Draft 11/05/2008

An Act

Be it enacted by the Senate and the House of Representatives of the United States of America in Congress assembled,

SEC. 1. SHORT TITLE AND TABLE OF CONTENTS.

(a) SHORT TITLE.-This Act may be cited as the "Program-Related I nvestment Promotion Act of 2008."

(b) TABLE OF CONTENTS.-The table of contents for this Act is as follows:

Sec. 1. Short title and table of contents.
Sec. 2. Promotion of program-related investments.
Sec. 3. Declaratory judgment remedy
Sec. 4. Information returns
Sec. 5. Publicity of information
Sec. 6. Conforming amendments.
Sec. 7. Effective date.

SEC. 2. PROMOTION OF PROGRAM-RELATED INVESTMENTS.

Section 4944(c) is amended to read as follows:

"(c) PROGRAM-RELATED INVESTMENTS.-

"(1) TREATMENT OF PROGRAM-RELATED INVESTMENTS.-For purposes of this subchapter, program-related investments:

"(A) are not investments which jeopardize the carrying out of exempt purposes;

"(B) are qualifying distributions under section 4942; and

"(C) are not business holdings under section 4943.

"(2) DEFINITION OF PROGRAM-RELATED INVESTMENT.-For purposes of this subchapter and of chapter 61, an investment made by a private foundation constitutes a program-related investment if:

"(A) the primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B), and

"(B) no significant purpose of the investment is the production of income or the appreciation of property.

Determinations of whether an investment qualifies as a program-related investment shall be based on consideration of all relevant facts and circumstances.

"(3) SAFE HARBOR DETERMINATIONS..-The Secretary shall establish a procedure under which an entity seeking to receive program-related investments may petition the Secretary for a determination that below market rate investments by private foundations in such entity will be program-related investments meeting the requirements of paragraph (2). Under this procedure, the Secretary shall rule on all requests within 90 days of submission. Entities organized under state law as low-profit limited liability companies shall be entitled to a rebuttable presumption that below market rate investments by private foundations in such entities are program-related investments.

"(4) EFFECT OF DETERMINATION.-Once a determination has been made that below market rate investments in an entity qualify as program-related investments, organizations making such investments shall be entitled to rely on the determination, unless and until the Secretary publishes notice of revocation of the determination.

"(5) VOLUNTARY NATURE OF THE PROCESS.-Entities seeking program-related investments are not required to seek a determination under paragraph (3) and the absence of such a determination shall not affect the ability of a private foundation to make a program-related investment based on its own determination that the investment qualifies as a program-related investment.

"(6) ORGANIZATIONS TREATED AS PRIVATE FOUNDATIONS.-For purposes of this subsection and section 6104A, all references to private foundations include organizations that are treated as private foundations under any of the provisions of sections 4940 through 4948, inclusive.

"(7) Below Market Rate Investment. –For purposes of this subsection, a below market rate investment is an investment that would be unlikely to be made on the same terms by an investor engaged in the investment solely for profit.".

SEC. 3. DECLARATORY JUDGMENT REMEDY.

Section 7428(a)(1) is amended by striking "or" at the end of subparagraph (D) and by adding after subparagraph (D) the following new subparagraph:

"(E) with respect to whether investments in an entity are program-related investments (as described in section 4944(c)(2)), or"

SEC. 4. INFORMATION RETURNS.

Part III of subchapter A of chapter 61 of the Internal Revenue Code shall be amended by inserting after section 6033 the following new section:

"SEC. 6033A. INFORMATION REPORTING BY FOR-PROFIT ORGANIZATIONS RECEIVING PROGRAM-RELATED INVESTMENTS.

"(a) ORGANIZATIONS REQUIRED TO FILE.-Any for-profit organization investments in which have been determined to be program-related investments through a determination of the Internal Revenue Service pursuant to section 4944(c)(3), or by a determination of a court pursuant to section 7428(a), shall, in addition to any other applicable filing obligations, file an annual return providing the information specified in subsection (b) for any taxable year in which it receives or retains one or more program-related investments, as defined in section 4944(c)(2).

"(b) REQUIRED REPORTING.-The return described in subsection (a) shall provide, in such manner and at such time as the Secretary may by forms or regulations prescribe, the following information-

"(1) the organization's gross income for the year;

"(2) its expenses attributable to such income incurred within the year;

"(3) its disbursements within the year for the exempt purposes of the organizations holding program-related investments in the organization, together with a narrative statement describing the results obtained from the use of those assets for charitable purposes;

"(4) a balance sheet showing its assets, liabilities, and net worth as of the beginning of such year;

"(5) a statement of the portion of its liabilities and net worth that represent capitalization obtained by means of program-related investments as of the beginning of such year;

"(6) a statement of any interest, dividends, or other distributions paid with respect to any program-related investments during the year;

"(7) such other information as the Secretary may by forms or regulations prescribe.".

SEC. 5. PUBLICITY OF INFORMATION.

Subchapter B of chapter 61 of the Internal Revenue Code is amended by inserting after section 6104 the following new section:

"SEC. 6104A. PUBLICITY OF INFORMATION REGARDING ORGANIZATIONS RECEIVING PROGRAM-RELATED INVESTMENTS.

"(a) INSPECTION OF PETITIONS FOR DETERMINATION OF PROGRAM-RELATED INVESTMENT STATUS.-If an organization seeks a determination pursuant to section 4944(c)(3) that investments by private foundations in such organization will be program-related investments, the petition seeking such a determination, together with any

documents submitted in support of such petition, and any determination or other document issued by the Internal Revenue Service with respect to such petition shall be open to public inspection at the national office of the Internal Revenue Service.

"(b) INSPECTION OF ANNUAL INFORMATION RETURNS.-The information required to be furnished by section 6033A shall be made available to the public at such times and in such places as the Secretary may prescribe.

"(c) PUBLIC INSPECTION OF PETITIONS AND ANNUAL RETURNS.-Any organization that receives a determination from the Internal Revenue Service that private foundation investments shall be program-related investments pursuant to section 4944(c)(3) shall make copies available at the organization's principal office, during regular business hours, of the petition for such determination (together with supporting materials provided with the petition and documents issued by the Internal Revenue Service with respect to such petition), as well as the annual returns required by section 6033A filed by such organization. Upon request of an individual made at such principal office, copies of such petition materials and annual reports shall be provided to such individual without charge other than a reasonable fee for any reproduction and mailing costs. The inspection and duplication rights granted in this subsection shall apply to an annual return only during the three-year period beginning on the last day prescribed for filing such return (determined with regard to any extension of time for filing).".

SEC. 6. CONFORMING AMENDMENTS.

(a) Paragraph (4)(A) of section 501(n) is amended by inserting "paragraph (2) of" before "section 4944(c)."

(b) Paragraph (1) of section 4942(g) is amended by striking "or" at the end of subparagraph (A), by redesignating subparagraph (B) as subparagraph (C) and by inserting after subparagraph (A) the following new subparagraph:

"(B) any program-related investment, as defined in paragraph (2) of section 4944(c), or"

(c) Paragraph (3) of section 4943(d) is amended by striking "or" at the end of subparagraph (A), by redesignating subparagraph (B) as subparagraph (C) and by inserting after subparagraph (A) the following new subparagraph:

"(B) any program-related investment, as defined in paragraph (2) of section 4944(c), or"

SEC. 7. EFFECTIVE DATE.

The amendments made by this Act shall be effective as to investments made and returns filed for tax years beginning after December 31, 2008.

United States Senate
COMMITTEE ON FINANCE
WASHINGTON, DC 20510–6200

March 20, 2009

National Association of State Charity Officials
c/o Chris Cash, President
Charities Program Manager
Colorado Secretary of State's Office
1700 Broadway, Ste. 300
Denver, CO 80290

Dear Mr. Cash:

Thank you for your letter dated March 19 regarding "low-profit" limited liability corporation legislation. We are aware of this legislation and of its movement through a number of state legislatures. We are also aware that the legislation, while it amends state law in the various states, may have indirect implications for the federal rules governing private foundation program-related investments. The latter is an issue over which the Senate Finance Committee has jurisdiction.

As Chair and Ranking Member of the Senate Finance Committee, we are tasked with careful oversight of the tax code, including the rules governing tax–exempt organizations, and we take that duty seriously. In addition, we are committed to strengthening charities and philanthropy. However, we have not had any hearings on this particular matter and do not think that it is ripe for federal legislation. There are many other pressing issues before the Committee which demand our attention, and it is not clear when the Committee will take up consideration of this issue.

Please continue to keep us informed of your questions and concerns as well as the status of the legislation in the various states.

Sincerely,

Max Baucus
Chairman

Charles Grassley
Ranking Member

Attachment
cc: The Honorable John Lewis
The Honorable Dave Camp
Emily Lam, Steve Frost, U.S. Treasury, Office of Tax Policy

Appendix B

The L3C is Unnecessary, Unwise, and Inherently Misleading

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version 1/13/10

The proponents of the "low profit limited liability company" tout the structure as a simple, wise, and useful development in the law of limited liability companies. In fact, the "L3C" is unnecessary, unwise, and inherently misleading. Moreover, the L3C legislation adopted to date is nonsensical and useless.

Unnecessary

According to its proponents:

> The central premise of an L3C 's operation is its use of low-cost capital in high risk ventures and its ability to allocate risk and reward unevenly over a number of investors, thus ensuring some a very safe investment with market return. As is appropriate under the PRI structure,[1] foundations could assume the top risk at very low return, making the rest of the investment far more secure.[2]

In fact, this type of complex structure is possible under every state's regular LLC statute. Flexibility of structure is the hallmark of the limited liability company, and "low profit" qualifies as a permissible purpose even under LLC statutes that require each LLC to have a "business" purpose.

Unwise

The proponents of the L3C claim that:

> "The L3C …. makes it very easy for lawyers and laymen alike to grasp since it does not create a new structure but merely amends the definition section of the llc [sic] acts in most states….Probably more importantly than anything else, the L3C is a brand which stands for all this and more and hopefully as a brand will make the concepts easy to grasp and thereby frequently used. "[3]

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[1] "PRI" stands for "Program Related Investment," a category of investment that the Internal Revenue Code authorizes private foundations to make.
[2] http://www.americansforcommunitydevelopment.org/about.html - last visited 1/11/2010 10:26 AM.
[3] http://www.americansforcommunitydevelopment.org/supportingdownloads/BasicL3CExplanation-History.pdf - last visited 1/11/2010 10:11 AM.

The L3C is described as specifically designed "to dovetail with the federal IRS regulations relevant to Program Related Investments (PRIs) by foundations," but PRI ventures are anything but "easy to grasp." The regulations are complex, and L3C legislation does nothing to remove that complexity. More fundamentally, investments by charitable foundation into profit-making ventures raise a host of complicated issues, including potential conflicts of fiduciary duty for the foundation trustees, securities law concerns, "exit rights" for the foundation, etc. In these circumstances, a "brand" is simplistic and dangerous.

Inherently Misleading

As explained above, the assertion that a PRI can be simple is flatly wrong and substantially misleading. Moreover, there has been considerable misinformation about the relationship between the L3C device and the tax law relating to PRIs.

Until very recently, L3C legislation has been premised on the notion that the Internal Revenue Code would be amended to treat foundation investments into low profit limited liability companies as automatically PRIs. No such amendments are planned or even plausible. Now the proponents assert that L3C "legislation was specifically written to dovetail with the federal IRS regulations relevant to Program Related Investments (PRIs) by foundations." [4] In fact, the enacted L3C legislation does nothing to help foundations seeking to assure themselves of PRI treatment.

L3C Legislation Nonsensical and Useless

The tax regulations concerning PRIs require that "[n]o significant purpose of the [foundation's] investment is the production of income or the appreciation of property."[5] But the presupposition is that the private sector will also invest, seeking a profit. Indeed, the proponents of the L3C device highlight this presupposition: "The central premise of an L3C 's operation is its use of low-cost capital in high risk ventures and its ability to allocate risk and reward unevenly over a number of investors, thus ensuring some a very safe investment with market return." [6]

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[4] http://www.americansforcommunitydevelopment.org/about.html (emphasis added) - last visited 1/11/2010 10:26 AM.
[5] 26 C.F.R. § 53.4944-3(a)(ii) (emphasis added).
[6] http://www.americansforcommunitydevelopment.org/about.html - last visited 1/11/2010 10:26 AM.

Despite this presupposition, the L3C statutes enacted to date do not authorize profit-seeking investment by anyone. The typical L3C statute provides that: "no significant purpose of the company is the production of income or the appreciation of property."[7]

How is it possible to have a low PROFIT limited liability company when NO SIGNIFICANT PURPOSE OF THE COMPANY IS THE PRODUCTION OF INCOME OR THE APPRECIATION OF PROPERTY? Try explaining that to investors. Try doing a private placement memorandum (under securities law) to explain that conundrum.

Even if this flaw were fixed, L3C legislation would not expedite the PRI determination for any particular foundation's investment in any particular L3C enterprise. The PRI determination requires a situation-specific analysis of the relationship among the foundation's mission, the enterprise's purpose and structure, and the terms of the investment. A blanket "brand" does nothing to simplify, speed, or other facilitate that analysis.

[7] 805 ILCS 180/1-26 (emphasis added). *See also, e.g.,* 11 Vt. Stat. Ann. § 3001(27)(B).