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L3CS: NEW KID ON THE COMPANY BLOCK

By: Jack Santaniello

On August 3, 2010, North Carolina became the most recent state to recognize the L3C, a "low-profit limited liability company." An L3C is a legal form of business entity created to bridge the gap between non-profit and for-profit investing by combining the financial advantages of the limited liability company (LLC) with the social advantages of a non-profit entity. An L3C runs like a regular business and generates profits. However, the primary focus of the L3C is not to make money, but to achieve socially beneficial objectives.

The LLC is a hybrid entity which combines the limited liability aspects of a corporation with the pass-through tax aspects of a partnership. Like a corporation, an LLC offers limited liability to its owners. But, like a partnership, an LLC is not subject to two levels of tax. Income or loss of an LLC flows to its owners and is reflected on the owners' tax returns. An LLC is automatically treated as a partnership for tax purposes if it has two or more owners and is automatically disregarded as an entity separate from its owner for tax purposes if it has a single owner. The owner(s) of the LLC must make an affirmative election (opt out) to treat the LLC as a corporation for tax purposes.

Unlike the traditional LLC, the L3C must be formed to accomplish a charitable purpose in addition to a business purpose. However, donations to an L3C are not deductible as a charitable contribution because the L3C is a for-profit entity.

One of the primary reasons for creating an L3C is to attract investments from private foundations. The IRS requires a private foundation to distribute a certain percentage of its income each year for a charitable purpose or be subject to a penalty. A private foundation may also be penalized if its assets are invested in a way that jeopardizes the foundation's charitable purpose. An L3C must be organized and operated at all times to satisfy the following 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.

These requirements must be stated in the L3C's organizing document and deliberately mirror the IRS requirements for program-related investments (PRIs). A PRI allows private foundations to make investments in the form of loans, grants, and equity purchases in socially-motivated for-profit entities. 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, this process is expensive and time consuming and typically results in private foundations refraining from investing in for-profit entities because of the potential risk.

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.

It is not clear how the IRS will treat a North Carolina L3C. The IRS has previously issued favorable rulings on the ability of private foundations to invest in for-profit LLCs with a charitable purpose. However, the IRS has not ruled that a private foundation's investment in a L3C automatically qualifies as a PRI.

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