

Understanding Low Profit Limited Liability Companies

Thomas S. Flickinger, Attorney at Law
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In early 2009, Michigan authorized the creation and use of “low-profit limited liability companies” (“L3Cs”). As part of these statutory changes, MCL 450.4102(m) was added, which provides:

"Low-profit limited liability company" means a limited liability company that has included in its articles of organization a purpose that meets, and that at all times conducts its activities to meet, all of the following requirements:

(i) The limited liability company significantly furthers the accomplishment of 1 or more charitable or educational purposes described in section 170(c)(2)(B) of the internal revenue code, 26 USC 170, and would not have been formed except to accomplish those charitable or educational purposes.

(ii) The production of income or appreciation of property is not a significant purpose of the limited liability company. However, in the absence of other factors, the fact that a limited liability company produces significant income or capital appreciation is not conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

(iii) The purposes of the limited liability company do not include accomplishing 1 or more political or legislative purposes described in section 170(c)(2)(D) of the internal revenue code, 26 USC 170.

I. WHAT IS A LOW-PROFIT LIMITED LIABILITY COMPANY?

An L3C is a “hybrid” of “for-profit” and “nonprofit” companies. As noted above, the primary purpose of the company must be for “charitable or educational purposes” and wealth accumulation cannot be “a significant purpose” of the L3C. However, it is not a violation of the statute for an L3C to have even “significant income”.

Except for the requirement that the L3C meet the statutory requirements found in MCL 450.4102(m), the L3C is similar to any other limited liability company. It has members (owners), can be managed by the members or by a manager, and can have multiple classes of members.

II. WHY WERE THE L3C STATUTES ENACTED?

The L3C statutes were enacted to spur investments by foundations into for-profit ventures. Historically, there were two roadblocks to such ventures:

1. Those managing the affairs of for-profit entities have fiduciary duties requiring the maximization of wealth for the business owners. If the manager neglects this duty and instead seeks charitable or educational purposes over wealth accumulation, it can lead to disputes over the direction of the company and possible lawsuits.
2. The IRS requires nonprofit foundations to avoid investments which have substantial risk unless the investment is considered a “program-related investment” (a “PRI”). The IRS has defined PRIs as investments in which: (a) the primary purpose is to accomplish one or more goals of the foundation’s exempt purpose; (b) the production of income or appreciation of property is not a significant purpose; and (c) influencing legislation or taking part in political campaigns is not a purpose. Previously, foundations were hesitant to invest in PRIs because the only way it could be sure that the investment was a PRI was to seek a private letter ruling from the Internal Revenue Service. These rulings cost money and take a significant amount of time to obtain.

The L3C attempts to address each of these concerns. First, as to the for-profit entity, the L3C statute specifically provides that production of income is not the primary purpose of the entity. This provides its managers with the right to promote charitable or educational purposes. Secondly, for the foundation, the statute is intended to give the foundation peace of mind that the L3C will meet the definition of a PRI.

The drafters of this statute hope that the availability of this entity, which by statute mimics the IRS’ requirements for a PRI, spurs foundations to invest in for-profit ventures that coincide with the foundation’s mission. Time will tell whether this mission is accomplished - to date, fewer than 15 of these entities appear to have been formed in Michigan based on a search of the State’s records.

III. HOW COULD THE L3C ENTITY BE UTILIZED BY A STARTUP COMPANY?

The L3C is intended to allow foundations to make investments without requiring a private letter ruling from the IRS providing that the investment is a PRI. The L3C’s articles of organization and operating agreement minimize the risk to foundations by specifically detailing the purposes for the L3C.

A startup company could use this entity to its advantage in seeking funding from foundations. To do so, the startup company should create an L3C and work with a foundation willing to provide capital to the entity. An L3C, like any other limited liability company, can have different classes of owners. L3Cs are flexible and can be structured to allocate risks according to the parties’ goals. For example, an L3C can be organized to move most of the risk of the entity to the foundation and away from the for-profit investors.

The capital from the foundation could come in the form of a loan, a loan guaranty, an equity purchase, or another investment, so long as it significantly furthers the foundation’s purposes. One option would be to form an L3C with two owners. One owner would be a for-profit entity and the

other owner would be a nonprofit foundation. The ownership rights between the two members could be allocated in any way agreeable to both parties and the two members could actually own different classes of the membership interests in the company. The L3C would then pursue the charitable or educational purpose. If the venture is profitable, income would be distributed to the members as outlined in the company's operating agreement. If the venture is unprofitable, it could be wound up and dissolved as any other limited liability company.

Another option would be to form an L3C with only one member: the for-profit entity. The L3C would then receive a loan from the charitable foundation. The loan would provide for a reasonable rate of interest but the foundation would acknowledge that it is a risky venture and that it may not receive any returns whatsoever. The L3C would then seek to accomplish its charitable or educational purposes. If it is successful, the loan would be repaid. If it is not successful, the loan would remain unpaid.

IV. POSSIBLE CONCERNS TO THE FOUNDATION

L3Cs were created to minimize risk to both the for-profit entity and the nonprofit foundation. However, foundations should not generally assume that an L3C will be considered a PRI by the IRS. The IRS has not yet recognized that all L3Cs will be considered PRIs. Those behind the L3C movement hope that this will happen, but it has not as of today's date.

Foundations may be slow to make investments in L3Cs in an effort to "play it safe" and avoid being the subject of IRS challenges. If, for example, a foundation invests in an entity that does not qualify as a PRI, it could lead to punitive excise taxes. Foundations would be well-advised to closely evaluate each and every proposed L3C to make an educated judgment about whether it constitutes a PRI. This point is not raised to deter the use of L3Cs, but simply to advise the for-profit entity that foundations may be hesitant and may need additional information to determine that a proposed L3C will be considered a PRI.

V. CONCLUSION

The L3C can be a valuable tool to be used by for-profit entities with charitable or educational goals. The L3C may allow such an entity to locate capital to undertake large projects that would not have otherwise been possible. The L3C allows for flexibility between the for-profit and nonprofit sectors and, with careful planning, should be able to accomplish each of their goals.

Thomas S. Flickinger [vCard](mailto:tsf@rhoadesmckee.com)
tsf@rhoadesmckee.com

Rhoades McKee PC

attorneys & counselors

161 Ottawa NW, Suite 600, Grand Rapids, MI 49503
p (616) 233-5135 f (616) 459-5102