



CITIZEN MEDIA
LAW PROJECT

**Primer on
Low-Profit Limited Liability Companies (L3Cs)**

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What is a Low-Profit Limited Liability Company?

The Low-Profit Limited Liability Company (L3C) is a hybrid business form, combining a socially beneficial mission with a for-profit business entity. First established in Vermont in 2008, L3Cs can now also be formed in Illinois, Michigan, Utah, Wyoming, and North Carolina. Maine has also passed legislation authorizing L3Cs (2009 Maine House Paper No. 1118), which does not become effective until July 1, 2011. L3Cs can be operated for a range of purposes including religious, educational, scientific, or literary ones. Currently, there are over 100 [Vermont L3Cs](#), including news organizations like [Point Reyes Light](#).

Given the newspaper industry's financial difficulties and the social significance of news reporting and analysis, many journalism start-ups are considering the L3C business form. Proponents argue that the L3C offers journalism ventures a [sustainable business model](#) with the potential to [save newspapers](#). Yet, there are serious limitations to the L3C, including a [capital structure](#) largely dependent on an uncommon type of private foundation investment. For more information on whether forming an L3C is right for your project, see the [Should You Form an L3C?](#) section of this Guide.

L3C Business Form Basics

The L3C is a variation on the [Limited Liability Company](#) designed to take advantage of both non-profit and for-profit sources of capital. As the term "Low-Profit" suggests, an L3C typically engages in socially-beneficial activities which may not be lucrative enough to attract sufficient commercial investment. By using a tiered [capital structure](#), the L3C can potentially attract a diverse group of creditors to finance its operations, including private foundations and socially-conscious for-profit entities.

In addition to the financing benefits, an L3C may offer a marketing advantage over the standard LLC in attracting socially-conscious investors and consumers. In contrast to a standard LLC, which can be organized for any lawful business purpose, an L3C must operate to significantly further a charitable goal as required by [IRS Regs. Sec. 53.4944-3\(a\)](#). Still, any LLC can function exactly like an L3C if its [articles of organization](#) and [operating agreement](#) are drafted to track the provisions of Regs. Sec. 53.4944-3(a).

Tax Treatment of the L3C

Despite its socially-conscious mission, an L3C is not a tax-exempt organization under Section 501(c) of the Internal Revenue Code, and donations and investments in L3Cs are not tax deductible. Since the profits of an L3C "pass through" to its members and are taxed at individual rates, L3Cs operate like [standard LLCs](#) for federal tax purposes.

The L3C's primary advantage is its ability to attract private foundation [Program-Related Investments](#)(PRIs) though its formal compliance with the PRI requirements set out in [Regs. Sec. 53.4944-3\(a\)](#). PRIs are a means for private foundations to invest in for-profit entities without incurring certain penalty taxes. State laws authorizing L3Cs require their organizing documents to track the provisions of Regs. Sec. 53.4944-3(a).

As a cautionary note, however, the IRS has not ruled whether private foundation investments in L3Cs qualify as PRIs. State laws authorizing L3Cs do not bind the federal tax authorities regarding PRIs, which may limit the utility of the business form until the IRS makes its determination.

Capital Structure of the L3C

Like the [standard LLC](#), the L3C has a flexible ownership structure. Membership interests in an L3C are governed by rules set out in the L3C's [articles of organization](#) and [operating agreement](#).

An L3C can create a tiered capital structure, allocating risk and returns differently across different types of members. In an L3C, [Program Related Investments](#) by private foundations can be allocated the highest risk and lowest rates of return. Thus, the investing foundations are essentially subsidizing returns on commercial investment. In exchange, private foundations may retain decision-making powers in the L3C in order to ensure that the investment qualifies as a PRI.

Private socially responsible investors may be willing to accept below-market returns from a venture with charitable goals. In an L3C, these investors may assume less risk and receive a higher share of profits than private foundations, but in general they may also have fewer management powers. Private commercial investors seeking market-rate returns may be allocated the highest returns and lowest risk in an L3C. Such investors may include pension funds, banks, insurance companies, or endowments.

Whether or not the L3C's tiered capital structure imposes excessive risk on private foundations remains an open question. If the IRS determines a private foundation's investment in an L3C to be a [jeopardy investment](#), the foundation is subject to significant penalty taxes. Even if the investment qualifies as a PRI, the foundation must still ensure that its charitable goals are accomplished and guard against [private inurement](#). 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. To minimize these risks, a private foundation may require approval authority on L3C investments, regular reports and other controls.

Should You Form an L3C?

In determining whether the L3C is the right business form for your venture, you may want to consider the following factors:

Advantages

- L3Cs are [designed](#) to take advantage of [Program Related Investments](#) (PRIs) by private foundations and could allow a venture to tap into new sources of capital.
- The L3C's tiered [capital structure](#) could guarantee market-rate returns to senior-tier members and may attract more commercial investors than a traditional LLC would.

- The L3C may be an attractive option for entities with a clear business plan identifying committed private foundation investors whose charitable purpose is consistent with the L3C's social objectives.
- The L3C brand communicates the media entity's commitment to a social goal and may serve as a marketing tool for attracting nonprofit and socially-conscious for-profit investors as well as consumers.

Disadvantages

- An L3C may not be organized for political or legislative purposes. This restriction may be limiting to the types of publishing in which an online media L3C may engage.
- PRIs are not common among private foundations and securing them may be difficult. A survey of over 72,000 private foundations shows that PRIs of \$10,000 or more accounted for less than 1% of private foundations' qualifying distributions in 2006 and 2007.
- To qualify for PRIs, an L3C must further the investing private foundation's charitable goals. For online media ventures, this narrows the pool of potential private foundation investors to those whose missions can be accomplished through online publications. The "mission furtherance" requirement may also limit the kinds of materials and online media L3C can publish to those that conform with and further the private foundations' goals.
- Even if a private foundation agrees to invest in an L3C, there is a significant risk the investment will be considered a jeopardy investment and subject the foundation to federal penalty taxes. So long as state laws authorizing L3Cs do not bind the IRS on the PRI issue, there is no federal tax benefit to forming an L3C as opposed to an LLC. Private foundation managers must be equally cautious when investing in L3Cs and LLCs. In general, this means seeking either the written opinion of counsel or a private letter ruling by the IRS, both of which are costly.
- Given the challenges of securing investments from private foundations, the efforts necessary to provide market-rate returns on commercial investments in the L3C could be significant. This could compromise an L3C's commitment to keep profit-making a secondary concern, which could make it even more difficult to obtain investments from private foundations.
- Private foundation investors will require management rights in an L3C in order to ensure that their charitable purposes are accomplished and guard against private inurement. If any part of the foundation's net earnings accrue to the benefit of a private individual, the foundation will lose its tax exemption.
- Compared to a non-profit, an L3C may make it more difficult for a venture to receive donations since such contributions will not be tax deductible.

Forming an L3C

An L3C can be formed as a new entity or by converting an existing one. The procedure to establish a new L3C is very similar to the one for forming an LLC. Like a standard LLC, an L3C is established by filing articles of organization with the state and executing a formal operating agreement. The main difference is that an L3C's organizing documents need to define its purpose in accordance with the provisions of Regs. Sec. 53.4944-3(a):

- (1) an L3C must significantly further the accomplishment of one or more charitable purpose;
- (2) the production of income and appreciation of property cannot be a significant purpose of the L3C; and
- (3) an L3C cannot seek to accomplish any political or legislative purposes.

The provisions of Regs. Sec. 53.4944-3(a) can be incorporated in a [sample L3C operating agreement](#) with a statement such as:

(i) the Company shall be organized and operated primarily for religious, charitable, scientific, literary, or educational purposes [...] within the meaning of Section 170(c)(2)(B) of [the United States Internal Revenue Code of 1986 (the Code)]; (ii) no significant purpose of the Company shall be the production of income or the appreciation of property; and (iii) the Company shall not attempt to influence legislation, or participate or intervene in (including the publishing or distributing of statements) any political campaign on behalf of (or in opposition to) any candidate for public office, all within the meaning of Section 170(c)(2)(D) of the Code.

In addition to Regs. Sec. 53.4944-3(a), there may be state-specific requirements governing L3C formation. For instance, in Vermont the label "L3C" must appear in the name of the organization and the articles of organization must conform to the standards for traditional LLCs. For more information, check our [L3C state pages](#).

If you choose to covert an existing entity to an L3C, it would be prudent to consider the tax implications. There should be no adverse federal tax consequences if you are converting a standard LLC to an L3C without shifting membership interests. However, converting a corporation or a non-profit organization to an L3C can be burdensome and costly, requiring legal counsel. If the existing entity is formed in a state which does not allow L3Cs, you would also have to consider the cost of relocating your venture.

State Law: Forming an L3C

The Low-Profit Limited Liability Company is a hybrid business form that only a few states recognize. The following states are covered in our Legal Guide:

- [Illinois](#)
- [Maine](#)
- [Michigan](#)
- [North Carolina](#)
- [Utah](#)
- [Vermont](#)
- [Wyoming](#)

To give you an overview of the process in Illinois, we have reprinted the Illinois page below.

Forming an L3C in Illinois

Effective on January 1, 2010, the Illinois Limited Liability Company Act, 805 ILL. COMP. STAT. ANN. 180/1-1 to 60-1 (West 2010), authorizes the formation of L3Cs. Here is an outline of the steps you need to follow in order to form an [L3C](#) in Illinois. The process is very similar to the one for [forming an LLC in Illinois](#). You should also read the general section on [forming an L3C](#) for information that is applicable in any state.

1. Choose a business name for the L3C and check for availability.

- Please see our [section on choosing and checking the availability of a name for your small business](#), as well as our [section on the trademark law aspects of choosing a name](#).
- Illinois law requires an L3C name to contain the abbreviation "L3C." Additionally, your business name may not be the same as, or deceptively similar to, that of any other Illinois business entity or any foreign business entity registered in the state.
- Although you are not required to do so, consider registering your business name as a [federal and/or state trademark](#).

2. Prepare and file articles of organization with the Secretary of State.

- If your L3C has no more than 8 managers, you can file your articles of organization [online](#). The fee for filing online is \$600, including a basic \$500 filing fee and a \$100 fee for expedited service. The Secretary of State's [website](#) has a simple, fill-in-the-blank [form](#) for the articles of organization. Be sure to include the following statements in the definition of your business purpose (Article 5 on the form):
 1. The company intends to qualify as a low-profit limited liability company pursuant to Section 1-26 of the Limited Liability Company Act and shall at all times significantly further the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code of 1986, or its successor, and would not have been formed but for the relationship to the accomplishment of such charitable or educational purposes.
 2. No significant purpose of the company is the production of income or the appreciation of property.
 3. No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Internal Revenue Code of 1986.For general information on articles of organization, see the section on [forming an L3C](#) and the [Articles of Organization](#) section of this Guide.
- If you are converting an Illinois LLC in good standing to an L3C, you can file a simple, fill-in-the-blank [form](#) for your restated articles of organization. Be sure to include the abbreviation "L3C" in the new entity's name (Article 1 on the form) and the

following statements in the definition of your business purpose (Article 6 on the form):

1. The company intends to qualify as a low-profit limited liability company pursuant to Section 1-26 of the Limited Liability Company Act and shall at all times significantly further the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code of 1986, or its successor, and would not have been formed but for the relationship to the accomplishment of such charitable or educational purposes.
2. No significant purpose of the company is the production of income or the appreciation of property.
3. No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Internal Revenue Code of 1986.

Restated articles of organization cannot be filed online, and the filing fee is \$500.

3. Negotiate and execute an operating agreement.

- Illinois does not require an operating agreement in order to form an L3C, but executing one is highly advisable. Please see the section on [forming an L3C](#) in this Guide for details. The operating agreement does not need to be filed with the state.

4. File an annual report with the Department of Business Services.

- An Illinois L3C needs to file an [annual report](#) with the [Department of Business Services](#). If your L3C has no more than 8 managers, you can file your annual report [online](#) (scroll all the way down). The fee for filing the report online is \$300, including a basic \$250 filing fee and a \$50 fee for expedited service.

5. Obtain any required local licenses.

- See the general section on [forming a LLC](#) for details.

6. Determine what tax and other regulatory obligations the L3C has, and take care of any necessary registrations.

- Consult with an attorney to ensure that the L3C is fulfilling its tax obligations and the necessary tax and registration paperwork is properly filed. For general information on the tax treatment of L3Cs, see the [L3C](#) section of this guide.

7. Open a bank account for your business.

- It is a good idea to keep your business's finances separate from your personal accounts. You may want to do this early on by opening a bank account for your business.

8. Other Notable Requirements for Maintaining an L3C in Illinois

- Illinois requires certain documents to be kept at an L3C's principal place of business. A list of the required documents is located in [805 Ill. Comp. Stat. 180/1-40](#).