

Department of Legislative Services
Maryland General Assembly
2011 Session

FISCAL AND POLICY NOTE

Senate Bill 209 (Senators Kelley and Raskin)
Judicial Proceedings

Corporations and Associations - Low-Profit Limited Liability Companies

This bill amends the Maryland Limited Liability Company Act (Act) to authorize the formation of a low-profit limited liability company (L3C).

Fiscal Summary

State Effect: Potential minimal general fund revenue increase for the State Department of Assessments and Taxation (SDAT) from document filing fees associated with L3Cs in FY 2012 and annually thereafter. Expenditures are not affected.

Local Effect: None.

Small Business Effect: Potential minimal.

Analysis

Bill Summary: A limited liability company (LLC) may be formed as an L3C if (1) its business purpose is to significantly further one or more charitable or educational purposes within the meaning of § 170(c)(2)(B) of the Internal Revenue Code (IRC); (2) it does not have as a significant purpose the production of income or the appreciation of property; and (3) it does not have as a purpose the accomplishment of one or more political or legislative purposes within the meaning of § 170(c)(2)(D) of the IRC. The fact that an L3C generates significant income or capital appreciation, absent any other factors, is not conclusive evidence that a significant purpose of the L3C is the production of income or appreciation of property.

If an L3C no longer meets the aforementioned requirements, but complies with all other requirements of the Act, the entity ceases to exist as an L3C and reverts to an LLC. The articles of organization, as filed with the corporate charter division of SDAT, must state whether the LLC is an L3C. The legal name of an L3C must include the words “low-profit limited liability company,” the abbreviation “L3C,” or the abbreviation “l3c.”

Current Law: L3Cs may not currently be formed in the State. Other legal entities that may incorporate or organize in the State with limited liability include corporations, benefit corporations, LLCs, limited liability partnerships, limited partnerships, and limited liability limited partnerships. An LLC may be organized under the Act and may conduct activities in any state related to any lawful business, purpose, investment, or activity, whether or not for profit, except the business of acting as an insurer.

The charitable and educational purposes described in § 170(c)(2)(B) of the IRC are religious, charitable, scientific, literary, or educational purposes; fostering national or international amateur sports competition; or the prevention of cruelty to children or animals.

Benefit corporations may have a similar purpose as an L3C. A Maryland corporation may elect to be a benefit corporation provided that its purpose is to create a general public benefit. A general public benefit is defined as a material, positive impact on society and the environment, as measured by a third-party standard, through activities that promote specific public benefits. Specific public benefits include providing individuals or communities with beneficial products or services; promoting economic opportunity for individuals or communities; preserving the environment; improving human health; promoting the arts, sciences, or advancement of knowledge; increasing the flow of capital to entities with a public benefit purpose; or the accomplishment of any other particular benefit for society or the environment.

Background: An L3C is a for-profit LLC with a primary goal of achieving a charitable or educational purpose. An L3C is not recognized as a tax-exempt organization under federal tax laws (unless it otherwise meets certain requirements of the IRC) and investments in L3Cs are not tax deductible. Instead, an L3C is similar to a traditional LLC, where the profits and losses are allocated to members on the basis of capital contributions, unless the operating agreement states otherwise.

As shown in **Exhibit 1**, 8 states allowed the formation of L3Cs as of January 27, 2011, while another 11 states, including Maryland, have introduced legislation within the past two years. Vermont became the first state to allow the formation of L3Cs in 2008.

Exhibit 1
Status of L3Cs in Other States
As of January 27, 2011

<u>States with L3C Statutes</u>	<u>Introduced L3C Legislation</u>
Illinois	Arkansas
Michigan	Colorado
Utah	Kentucky
Vermont	Massachusetts
Wyoming	Missouri
Louisiana	New York
Maine	Tennessee
North Carolina	Montana
	Maryland
	Virginia
	North Dakota

Source: Americans for Community Development, Department of Legislative Services

Each year, private foundations are required by federal law to make eligible charitable contributions of at least 5% of the net asset value of their endowments. Qualifying distributions include, among other things, charitable grants, foundation activities, administrative expenses, and program-related investments (PRIs).

A foundation's investment qualifies as PRI if:

- the primary purpose of the investment is to accomplish one or more of the foundation's tax-exempt purposes;
- the production of income or appreciation of property is not a significant purpose; and
- influencing legislation or taking part in political campaigns on behalf of candidates is not a purpose of the investment.

The bill's provisions relating to an L3C's business purpose mirror PRI requirements under federal tax laws. Thus, L3Cs are designed to facilitate a foundation's ability to meet its federally required 5% annual distribution obligation by acting in a manner consistent with PRI requirements.

Unlike a traditional nonprofit, an L3C may have different classes of members ranging from individuals and foundations, to nonprofit and for-profit investors, each with varying degrees of financial risk and desired investment return. The structure of an L3C operating agreement may allow for a layered investment strategy. For example, an L3C may seek to leverage a foundation's PRI investment (with the highest risk and lowest rate of return) into additional financing by for-profit investors who may be seeking a market rate return on their investment with a lower tolerance for risk.

Additional Information

Prior Introductions: HB 5 of 2010 passed the House but received an unfavorable report from the Senate Judicial Proceedings Committee. Its cross file, SB 430, received an unfavorable report from the Senate Judicial Proceedings Committee.

Cross File: Although designated as a cross file, HB 552 (Delegate Braveboy, *et al* – Economic Matters) is not identical.

Information Source(s): Americans for Community Development, Internal Revenue Service, Vermont Secretary of State, *Chicago Tribune*, Federal Reserve Bank of Minneapolis, State Department of Assessments and Taxation, Department of Legislative Services

Fiscal Note History: First Reader - February 15, 2011
ncs/ljm

Analysis by: Michael F. Bender

Direct Inquiries to:
(410) 946-5510
(301) 970-5510