
COMMENTS

PRIVATE BENEFIT FOR THE PUBLIC GOOD: PROMOTING FOUNDATION INVESTMENT IN THE “FOURTH SECTOR” TO PROVIDE MORE EFFICIENT AND EFFECTIVE SOCIAL MISSIONS*

Despite the sincere dedication and best efforts of those who work in the nonprofit sector, there is little reason to assume that they have the ability to solve society’s large-scale problems.

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However generous the donors or hardworking the nonprofit staff, there is no assurance—nor even any likelihood—that supporting the underfunded, non-collaborative, and unaccountable approaches of the countless small nonprofits struggling to tackle an issue will actually lead to workable solutions for large-scale social problems. The contributions of conventional donors and the good work of effective nonprofits may temporarily improve matters at a particular place and time, but they are unlikely to create the lasting reform that society so urgently requires.¹

I. INTRODUCTION

The traditionally rigid view of society as structured in three distinct sectors—business, government, and nonprofit—has failed to adequately address the social problems of modern times.² People tend to think that the nonprofit sector and its “IRS-sanctioned philanthropy is the *only* way to solve social problems.”³ There is a growing recognition, however, that to achieve the type of social impact that is now required,

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1. Mark R. Kramer, *Catalytic Philanthropy*, STAN. SOC. INNOVATION REV., Fall 2009, at 30, 32.

2. See HEERAD SABETI, FOURTH SECTOR NETWORK CONCEPT WORKING GRP., THE EMERGING FOURTH SECTOR: A NEW SECTOR OF ORGANIZATIONS AT THE INTERSECTION OF THE PUBLIC, PRIVATE, AND SOCIAL SECTORS: EXECUTIVE SUMMARY 1 (2009), available at http://www.fourthsector.net/attachments/39/original/The_Emerging_Fourth_Sector_-_Exec_Summary.pdf (declaring that modern society’s “complex systemic problems are rooted in structural failures at the organizational level”). See generally MUHAMMAD YUNUS, CREATING A WORLD WITHOUT POVERTY: SOCIAL BUSINESS AND THE FUTURE OF CAPITALISM 5–11, 18–19 (2007).

3. Kramer, *supra* note 1, at 34 (emphasis added).

philanthropy needs a new approach that incorporates resources typically unavailable to the nonprofit sector.⁴ Indeed, a new “fourth sector” is emerging, as a hybrid between the for-profit and nonprofit sectors,⁵ with a “double bottom line” of providing social benefit and earning a financial return.⁶ Commonly referred to as “social enterprise,”⁷ the reasons for this development are the nonprofit sector’s general lack of market efficiency in raising capital and the restrictive duty on for-profit businesses to maximize profits for shareholders.⁸ New models of legal entities have been devised to help solve the problem of attracting and accessing capital for charitable purposes⁹ by merging key attributes of both the nonprofit and for-profit sectors.¹⁰

One particular model that has gained significant momentum over the last few years is the low-profit limited liability company (L3C).¹¹ The L3C aims to solve the capital formation problem by utilizing the substantial assets held by private foundations.¹² According to the Foundation Center, the combined assets of all private foundations in the United States totaled about \$565 billion at the end of 2008.¹³ Yet, foundation leaders find it difficult to align their charitable work with their financial resources,¹⁴ and the effectiveness of foundations’ traditional grantmaking strategies has been questioned.¹⁵ To take advantage of foundation resources and provide for more efficient charity, the L3C is designed to tap into the potential of program-related investments (PRIs) as “social enterprise vehicles.”¹⁶ Specifically, the L3C blueprint

4. *Id.* at 32.

5. Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 340 (2009).

6. Sue Woodrow & Steve Davis, *The L3C: A New Business Model for Socially Responsible Investing*, COMMUNITY DIVIDEND, (Fed. Reserve Bank of Minneapolis, Minn.), Nov. 2009, at 1, available at http://www.minneapolisfed.org/pubs/cd/09-4/CommDiv_2009_4.pdf. See generally Matthew F. Doeringer, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT’L L. 291, 292–94 (2010).

7. Social enterprise can be defined as “the harnessing of profit-making organizations in the service of fully charitable ends.” James R. Hines Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179, 1188 (2010). The terms “social enterprise,” “hybrid organization,” “social entrepreneur,” and “fourth sector” can be used interchangeably. Kelley, *supra* note 5, at 340 n.7.

8. THOMAS J. BILLITTERI, ASPEN INSTITUTE, MIXING MISSION AND BUSINESS: DOES SOCIAL ENTERPRISE NEED A NEW LEGAL APPROACH? 2 (2007).

9. *Id.* at 10; SABETI, *supra* note 2, at 6.

10. SABETI, *supra* note 2, at 2.

11. See *infra* notes 166–74 and accompanying text for a discussion of the current state of, and purpose behind, L3C legislation. See Kelley, *supra* note 5, at 342, 371–75 (arguing that the L3C “holds particular promise for responding to the legal needs of the emerging fourth sector”).

12. Woodrow & Davis, *supra* note 6, at 4.

13. FC Stats: The Foundation Center’s Statistical Information Service, *Change in Foundation Assets Adjusted for Inflation, 1975 to 2008*, FOUND. CENTER (2010), http://www.foundationcenter.org/findfunders/statistics/pdf/02_found_growth/2008/06_08.pdf.

14. THOMAS J. BILLITTERI, ASPEN INSTITUTE, LINKING PAYOUT AND MISSION: A NATIONAL DIALOGUE WITH FOUNDATION LEADERS 2 (Sept. 2007).

15. See Christine W. Letts et al., *Virtuous Capital: What Foundations Can Learn from Venture Capitalists*, HARV. BUS. REV., Mar.–Apr. 1997, at 36, 36–37 (finding that foundations focus too much on program efficacy and not enough on long-term sustainability in providing grants).

16. BILLITTERI, *supra* note 8, at 6.

uses a PRI to leverage a market return for profit-seeking investors in a tranching, that is, multi-layered, investment strategy.¹⁷

One of the primary issues in using this strategy is whether a foundation's participation in the L3C's tranching investment structure violates fundamental rules regarding nonprofit operations, thereby threatening the foundation's exempt status. Congress and the IRS are particularly concerned about the provision of private benefit, both to the "insiders" of a charitable organization as well as to "outsiders."¹⁸ In that respect, the private inurement rule "serves to prevent anyone in a position to do so from siphoning off any of a charity's income or assets for personal use."¹⁹ Additionally, under the private benefit doctrine, the IRS balances public versus private benefit to ensure that exempt organizations are operating primarily for charitable purposes.²⁰ If foundation leaders perceive either the inurement or private benefit risks to be too high, and thus decline to make PRIs, the L3C model will find it more difficult to obtain the leveraging capability that is necessary to attract for-profit investors.²¹

This Comment suggests that the private benefit doctrine poses a greater risk than private inurement for a foundation that makes a PRI in an L3C. It then contends that the expenditure responsibility requirements that private foundations must follow when making PRIs are sufficient to satisfy the control standard of the private benefit doctrine. Furthermore, this Comment argues that from a policy perspective, the private benefit received by for-profit investors in the L3C should be permitted by the IRS as a necessary means for achieving more efficient and effective charity.

To provide the proper context for the discussion, Part II.A of this Comment presents the current issues facing private foundations and their grantmaking strategies. Part II.B outlines the PRI and expenditure responsibility rules and demonstrates the potential of PRIs by reviewing two private letter rulings issued by the IRS. Part II.C examines the current state of L3C legislation and explains the operation of the tranching investment strategy. Part II.D identifies the crucial difference between the private benefit doctrine and private inurement, explains the control standard of the private benefit doctrine, explores the doctrine's scope, and summarizes the scholarship in response to the doctrine's current state of uncertainty. Part II.E reviews the criticisms set forth by scholars regarding the inherent risks foundations face by participating in the L3C's tranching investment structure.

Part III.A begins the Discussion by clarifying that the private benefit doctrine presents a more likely problem than private inurement for foundations seeking to make PRIs in L3Cs. Part III.B evaluates the extent to which the expenditure responsibility rules overlap with the private benefit control standard and reveals their functional equivalency. Finally, Part III.C argues that from a policy perspective, the private benefit received by the L3C's for-profit investors should not threaten the exempt status

17. Woodrow & Davis, *supra* note 6, at 4–5.

18. See *infra* notes 208–11, 217, and 223–25 for a discussion of the differences between "insiders" and "outsiders."

19. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991), 1991 GCM LEXIS 39, at *17.

20. See *infra* Part II.D for a discussion and explanation of the private benefit doctrine.

21. See *infra* notes 183–91 and accompanying text for a discussion of how PRIs provide the L3C model with the opportunity to attract for-profit investors.

of private foundations that provide the PRIs which facilitate capital formation. Without this risk, foundations will be encouraged to furnish the essential start-up capital to social entrepreneurs who seek to find more efficient solutions to society's most pressing problems.

II. OVERVIEW

A. *Private Foundations and the Shortcomings of Traditional Grantmaking*

Private foundations are subject to a complex and unique set of tax laws under the Internal Revenue Code (the "Code").²² The Code does not explicitly define what constitutes a private foundation.²³ Rather, the Code establishes that all charitable organizations are private foundations unless they qualify for one of the enumerated exceptions.²⁴ A typical private foundation has four basic characteristics: (1) it is a charitable organization, (2) its initial funding usually comes from one source or a limited number of sources, (3) its ongoing funding comes from investment income rather than contributions from the public or grants from other charitable organizations, and (4) instead of running its own programs, it makes grants to other persons or entities for charitable purposes.²⁵

The legislation giving rise to the complex private foundation laws was the Tax Reform Act of 1969,²⁶ which was enacted at a time when foundations were not viewed favorably.²⁷ Critics of foundations alleged "irresponsive governance and inadequate responses to perceived needs."²⁸ Additional criticisms included the belief that foundations "further[ed] various tax inequities, [were] created for private rather than philanthropic purposes, and [did] not actually achieve charitable ends."²⁹ Each of these inadequacies and abuses was thought cured with the new set of foundation-focused tax laws.³⁰

One of the most unique of these laws is the mandatory distribution requirement,³¹ which requires a private foundation to distribute at least five percent of its net asset value annually to further its exempt purposes.³² In addition, a private foundation cannot

22. See generally BRUCE R. HOPKINS & JODY BLAZEK, PRIVATE FOUNDATIONS: TAX LAW AND COMPLIANCE § 1.1 (2d ed. 2003).

23. See I.R.C. § 509(a) (2006) (defining private foundation as "a domestic or foreign organization described in section 501(c)(3) *other than*" the exceptions listed (emphasis added)).

24. See *id.* § 509(a)(1)–(4) (listing the types of organizations that do not constitute private foundations).

25. BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS § 11.3, at 352 (9th ed. 2007).

26. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified as amended in scattered sections of I.R.C.).

27. See HOPKINS & BLAZEK, *supra* note 22, § 1.1, at 1 (stating that "the mood of Congress during the course of 1969 was very anti-private foundation").

28. *Id.* § 1.3, at 7.

29. *Id.* § 1.3, at 8.

30. *Id.*

31. See *id.* at 202 n.2 (stating that private foundations are one of only two types of exempt organizations with mandatory distribution requirements).

32. I.R.C. § 4942(e)(1) (2006). The term "exempt purposes" is synonymous with "charitable purposes." The term "charitable" is defined in the tax law by recognition that the term is used in its "generally accepted

make an investment “in such a manner as to jeopardize the carrying out of any of its exempt purposes” without being penalized,³³ a restriction that I will refer to as the “jeopardy investment rule.” Other governance and operational laws are in place to protect against, among other things, self-dealing,³⁴ excess business holdings,³⁵ and taxable expenditures.³⁶

Despite the allegations of abuse and the resulting increase of regulatory oversight, government support for the existence and purpose of private foundations continues.³⁷ Indeed, “foundations are an integral component of a society that values individual responsibility and private efforts for the public good.”³⁸ For the majority of their existences, foundations’ charitable efforts have been focused on “making large grants to nonprofit organizations in the hope of meeting a wide range of society’s most pressing and vital needs.”³⁹ Because grants to other charitable organizations are not subject to the jeopardy investment rule,⁴⁰ foundations often view these types of grants as a safe way to satisfy the five percent payout requirement.⁴¹

However, the effectiveness of traditional grantmaking by foundations has been called into question.⁴² Those who work in the nonprofit sector are growing increasingly frustrated with the lack of success generated from foundation grants,⁴³ and “[m]any social programs begin with high hopes and great promise, only to end up with limited impact and uncertain prospects.”⁴⁴ Foundation leaders also recognize the difficulty in aligning their substantial financial resources with their charitable missions.⁴⁵ Although foundations cannot be blamed fully for the limited impact of their grants, a significant cause of the overall lack of effectiveness is the process by which the grants are made.⁴⁶ Under the traditional approach, “foundations make grants based on their assessment of the potential efficacy of a program. . . . [which] creates an incentive for nonprofits to

legal sense.” Treas. Reg. § 1.501(c)(3)–1(d)(2) (2010). Courts have had significant difficulty in defining the term “charitable” over the years. *See generally* Mary Kay Lundwall, *Inconsistency and Uncertainty in the Charitable Purposes Doctrine*, 41 WAYNE L. REV. 1341 (1995).

33. I.R.C. § 4944(a)(1).

34. *Id.* § 4941.

35. *Id.* § 4943.

36. *Id.* § 4945.

37. *See generally* HOPKINS & BLAZEK, *supra* note 22, § 1.3, at 9.

38. *Id.*

39. Letts et al., *supra* note 15, at 36.

40. The Code imposes an excise tax on a foundation that makes an investment “in such a manner as to jeopardize the carrying out of any of its exempt purposes.” I.R.C. § 4944(a)(1). Meanwhile, a foundation can rely on a recipient’s public charity status as “proof of the charitable nature of the grant made.” HOPKINS & BLAZEK, *supra* note 22, § 1.1, at 4. Thus, grants to charitable organizations are inherently non-jeopardizing.

41. *See* Letts et al., *supra* note 15, at 38 (“Foundations generally face little risk when making grants.”); Cassady V. Brewer & Michael J. Rhim, *Using the ‘L3C’ for Program-Related Investments*, TAX’N OF EXEMPTS, Nov.–Dec. 2009, at 11, 12 (noting that grants are “normal” and “relatively safe” from a tax perspective as compared to PRIs).

42. Letts et al., *supra* note 15, at 36.

43. *Id.*

44. *Id.*

45. BILLITTERI, *supra* note 14, at 2.

46. Letts et al., *supra* note 15, at 36–37.

devise innovative programs.”⁴⁷ The problem is that nonprofits fail to recognize their own lack of organizational resources and capabilities to sustain the programs they design and achieve the goals they set.⁴⁸

Thus, a new approach is needed to avoid wasteful grantmaking and to find ways to deliver and sustain a positive impact.⁴⁹ Fortunately, the Code provides an exception to the jeopardy investment rule that allows foundations to make grants in the form of program-related investments in for-profit organizations.⁵⁰

B. *Program-Related Investments and Expenditure Responsibility*

Most of the rules designed to regulate private foundations are beyond the scope of this Comment. This Section focuses only on those provisions that apply when a private foundation enters into a relationship with a hybrid entity, such as the low-profit limited liability company (L3C). Specifically, this Section explains the program-related investment (PRI) exception to jeopardizing investments, which is the L3C’s statutory method of facilitating private foundation funding.⁵¹ This Section also explains the expenditure responsibility rules that a private foundation must follow when making a PRI in a for-profit entity.⁵² Finally, two examples of how PRIs have been used are presented through an examination of private letter rulings.⁵³

1. Program-Related Investments (PRIs)

The PRI exception to the jeopardy investment rule allows foundations to make certain investments without facing the corresponding jeopardy investment penalties.⁵⁴ PRIs are essentially “a hybrid between grants and investments.”⁵⁵ Importantly, there are many advantages for foundations to use PRIs in place of traditional grants,⁵⁶ including the ability to expand their charitable impact by recycling PRI returns over and over again for charitable purposes.⁵⁷

To qualify as a PRI, an investment must satisfy three conditions. First, the primary purpose of the investment must be to accomplish one or more charitable purposes.⁵⁸

47. *Id.* at 37.

48. *Id.*

49. *Id.*

50. I.R.C. § 4944(c) (2006). The use of program-related investments also offers numerous advantages for foundations in meeting their annual payout requirement. *See generally* James P. Joseph & Andras Kosaras, *New Strategies for Leveraging Foundation Assets*, TAX’N OF EXEMPTS, July–Aug. 2008, at 22, 23–24.

51. *See infra* Part II.C for an explanation of how the L3C is structured.

52. I.R.C. § 4945(h); Treas. Reg. § 53.4945-5(b) (2010).

53. *See infra* Part II.B.3 for a discussion of PRIs in action.

54. I.R.C. § 4944(c).

55. Joseph & Kosaras, *supra* note 50, at 22.

56. *See generally id.* at 23–24.

57. Marc J. Lane, *The Low-Profit Limited Liability Company (L3C)* (2010), available at http://www.intersectorl3c.com/goopages/pages_downloadgallery/download.php?filename=13688.pdf&orig_name=basic_l3c_primer.pdf&cdpath=/files/basic_l3c_primer.pdf. Lane describes this PRI characteristic as the “multiplier effect.” *Id.*

58. Treas. Reg. § 53.4944-3(a)(1)(i); *see also* I.R.C. § 170(c)(2)(B) (describing charitable purposes); Treas. Reg. § 1.501(c)(3)-1(d)(2) (same).

The Regulations provide that an investment will be considered as having a primarily charitable purpose “if it significantly furthers the accomplishment of the private foundation’s exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation’s exempt activities.”⁵⁹ In other words, this “but for” test requires that a PRI “support an activity that qualifies as charitable.”⁶⁰ The term “charitable” in the PRI context can have a number of meanings, including “[r]elief of the poor and distressed,” “lessening of the burdens of [g]overnment,” and the “promotion of social welfare.”⁶¹ Furthermore, the charitable purpose that the PRI supports must be one that is within the foundation’s own charitable purposes as stated in its organizing documents.⁶²

Second, the investment cannot have the production of income or the appreciation of property as a significant purpose.⁶³ The Regulations provide further guidance by stating that “it shall be relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation.”⁶⁴ But, if an investment does produce significant income or capital appreciation, it will not automatically fail to qualify as a PRI, absent other factors.⁶⁵ PRIs that take the form of equity investments could, however, have a particularly difficult time getting past this requirement because of their potential for increasing profits.⁶⁶ For instance, although the Regulations provide that an equity investment can appreciate in value without losing PRI status,⁶⁷ they “do not . . . indicate if there is a threshold beyond which the investment may fail to qualify as a PRI.”⁶⁸

The third and final condition is that the purposes of the investment cannot include lobbying or political activities.⁶⁹ This last condition is usually met as long as the PRI is not earmarked for such purposes.⁷⁰

Once an investment meets these three requirements and qualifies as “program-related,” there are additional regulatory guidelines that must be followed regarding changes to the terms of the investment.⁷¹ If changes to the terms are made “primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property,”⁷² then the investment will continue to qualify as program-related.⁷³ Similarly, the investment is unlikely to lose its program-related

59. Treas. Reg. § 53.4944-3(a)(2)(i).

60. Joseph & Kosaras, *supra* note 50, at 24.

61. Treas. Reg. § 1.501(c)(3)-1(d)(2).

62. Joseph & Kosaras, *supra* note 50, at 24.

63. Treas. Reg. § 53.4944-3(a)(1)(ii).

64. *Id.* § 53.4944-3(a)(2)(iii).

65. *Id.*

66. Joseph & Kosaras, *supra* note 50, at 25.

67. *See* Treas. Reg. § 53.4944-3(b) (illustrating in example three how a common stock investment could be a valid PRI even though the stock could appreciate in value).

68. Joseph & Kosaras, *supra* note 50, at 25.

69. Treas. Reg. § 53.4944-3(a)(1)(iii).

70. Joseph & Kosaras, *supra* note 50, at 24 n.15.

71. Treas. Reg. § 53.4944-3(a)(3)(i).

72. *Id.*

73. *Id.*

status if a change is made for the “prudent protection of the foundation’s investment.”⁷⁴ However, an investment could lose its program-related status if there is a “critical change in circumstances, as, for example, where it is serving an illegal purpose or the private purpose of the foundation or its managers.”⁷⁵ If such a “critical change” takes place and the program-related status of the investment ceases, the foundation and its managers will not be subject to jeopardy investment taxes “before the [thirtieth] day after the date on which [they have] actual knowledge of [the] critical change in circumstances.”⁷⁶

Although an investment need only meet these requirements to qualify as a PRI, private foundations often seek prior approval from the IRS before making such investments, despite the time and cost involved.⁷⁷ The risk—and the common reason for seeking advance private letter rulings—is that when an investment is determined to not qualify as a PRI, the jeopardy investment penalties imposed on the investing foundation are severe.⁷⁸ Moreover, IRS approval of PRIs comes mostly in the form of private letter rulings, which lack precedential value for anyone except the party receiving the ruling at the time.⁷⁹ However, it is important to note that an IRS private letter ruling is not necessary for a PRI to be valid.⁸⁰

2. Expenditure Responsibility

In addition to satisfying the PRI requirements, private foundations must exercise “expenditure responsibility” when making such investments.⁸¹ The expenditure responsibility rules are relatively straightforward. As a general operative rule, section 4945 of the Code prohibits private foundations from making “taxable expenditures.”⁸² A taxable expenditure, in the context relevant to this Comment, is “any amount paid or

74. *Id.*

75. *Id.*

76. *Id.*

77. See Robert M. Lang, Jr., *The L3C: The New Way to Organize Socially Responsible and Mission Driven Organizations* (ALI-ABA Course of Study, Nov. 29–30, 2007), WL SN036 ALI-ABA 251, 255 (explaining that the IRS will issue private letter rulings in advance of specific investments, but such rulings can take over a year to obtain and cost \$8,700 plus a minimum of \$25,000 in legal fees).

78. See I.R.C. § 4944(a)–(b) (2006) (imposing jeopardy investment excise taxes on foundations and their managers of up to thirty-five and fifteen percent, respectively, of the amount of the investment).

79. *Id.* § 6110(k)(3); Joseph & Kosaras, *supra* note 50, at 24 n.16.

80. Robert Lang, *PRIs and Private Letter Rulings*, AMS. FOR COMMUNITY DEV., <http://www.americansforcommunitydevelopment.org/downloads/PRIsAndPrivateLetterRulings.pdf> (last visited Nov. 11, 2011) (“[T]here is not now and never has been any requirement in either federal law or IRS regulation that specifies that a foundation must get the approval of the IRS in any way, shape, or form before making a PRI.”).

81. I.R.C. § 4945(d)(4)(B).

82. *Id.* § 4945. Much like the excise taxes on jeopardy investments, the penalties for taxable expenditures are quite severe. Section 4945(a) imposes an initial tax on the foundation equal to twenty percent of the amount of the expenditure and a five percent tax on the foundation managers who agreed to the taxable expenditure unless such agreement was not willful and due to a reasonable cause. Section 4945(b) imposes an additional one hundred percent tax on the foundation if the expenditure is not corrected within the taxable period and a fifty percent tax on the foundation managers who do not agree to make the correction. Hence, the importance of expenditure responsibility when making PRIs is clear.

incurred by a private foundation . . . as a grant to an organization.”⁸³ The Regulations define the term “grant” as including program-related investments.⁸⁴ Therefore, a PRI will be considered a taxable expenditure unless the “private foundation exercises expenditure responsibility with respect to such [an investment].”⁸⁵

When making a PRI, the expenditure responsibility rules require a foundation to “exert all reasonable efforts and to establish adequate procedures” to (1) ensure that the PRI is spent only for the purpose for which it was made, (2) obtain full and complete reports on how the investment funds are spent, and (3) provide full and complete reports to the IRS with respect to the PRI.⁸⁶ The Treasury Regulations offer further guidance on how a foundation should exercise expenditure responsibility, beginning with the general principle that foundations are not “insurer[s] of the activity of the organization[s]” in which they make PRIs.⁸⁷ Therefore, satisfying the three statutory requirements⁸⁸ and the procedures described in the Regulations will “ordinarily mean that the [investing] foundation will not have violated” the taxable expenditure rule.⁸⁹

The first step in exercising expenditure responsibility is to conduct a preinvestment inquiry into the organization that will be receiving the PRI.⁹⁰ Although the scope of this inquiry will vary from case to case,⁹¹ the inquiry should consider the “identity, prior history and experience (if any) of the [recipient] organization and its managers” as well as any “information which is readily available concerning, the management, activities, and practices of the [recipient] organization.”⁹² This “inquiry should be complete enough to give a reasonable man assurance that the [recipient] will use the [investment] for the proper purposes.”⁹³

If the preinvestment inquiry satisfies the reasonableness standard, the foundation must then set out the terms of the PRI.⁹⁴ To start, the foundation must require the submission of a “written commitment signed by an appropriate officer, director, or trustee of the recipient organization” specifying the purpose of the investment.⁹⁵ This commitment must also include a four-part procedural agreement.⁹⁶ Under this procedure, the organization must first agree to “use all the funds received from the

83. *Id.* § 4945(d)(4). Section 4945(d) includes other meanings of “taxable expenditure” that are not relevant to the scope of this Comment.

84. Treas. Reg. § 53.4945-4(a)(2) (2010). To maintain clarity and consistency, I will use either the term “program-related investment” or “PRI” when the Code or Regulations refer to “grants” in the expenditure responsibility context.

85. I.R.C. § 4945(d)(4)(B). The Code also provides a catch-all provision, whereby any amount paid or incurred by a private foundation for any non-charitable purpose will be considered a taxable expenditure. *Id.* § 4945(d)(5).

86. *Id.* § 4945(h)(1)–(3).

87. Treas. Reg. § 53.4945-5(b)(1).

88. I.R.C. § 4945(h).

89. Treas. Reg. § 53.4945-5(b)(1).

90. *Id.* § 53.4945-5(b)(2)(i).

91. *Id.*

92. *Id.*

93. *Id.*

94. *Id.* § 53.4945-5(b)(4).

95. *Id.*

96. *Id.* § 53.4945-5(b)(4)(i)–(iv).

private foundation . . . only for the purposes of the investment.”⁹⁷ Second, the organization must “submit full and complete financial reports” at least once per year when the PRI is in existence.⁹⁸ Third, the organization must “maintain books and records adequate to provide information ordinarily required by commercial investors under similar circumstances.”⁹⁹ The foundation must also have reasonable access to these books and records.¹⁰⁰ Fourth, the organization cannot use any of the funds for political or lobbying purposes.¹⁰¹

Once the PRI is in effect and the foundation has begun receiving reports from the recipient organization, the foundation itself must report the PRI’s status to the IRS on its annual information return.¹⁰² Each report must contain certain information,¹⁰³ and a specific recordkeeping process must be followed.¹⁰⁴ In making these annual reports, the foundation “may rely on adequate records or other sufficient evidence supplied by the [recipient] organization.”¹⁰⁵

The expenditure responsibility requirements pertaining to PRIs can be summed up with three general steps. The first step is the preinvestment inquiry into the organization that will potentially receive the PRI.¹⁰⁶ If after following the regulation guidelines the foundation believes the reasonableness standard for the inquiry has been met, the foundation must establish and follow a procedure with the recipient organization to ensure that the PRI is used for the proper purposes.¹⁰⁷ Finally, the foundation must submit complete and accurate reports to the IRS about the status of the PRI in accordance with the Regulations.¹⁰⁸

3. PRIs and Expenditure Responsibility in Action

There are many ways for foundations to utilize PRIs.¹⁰⁹ Some of the more common examples are below-market-rate loans to other charities, loan guarantees, and equity investments.¹¹⁰ PRIs can even be made to international organizations.¹¹¹ Although private letter rulings cannot be relied on by anyone other than the requesting party,¹¹² letter rulings can still provide guidance for the types of investments that will

97. *Id.* § 53.4945-5(b)(4)(i).

98. *Id.* § 53.4945-5(b)(4)(ii).

99. *Id.* § 53.4945-5(b)(4)(iii).

100. *Id.*

101. *Id.* § 53.4945-5(b)(4)(iv).

102. *Id.* § 53.4945-5(d)(1).

103. *See id.* § 53.4945-5(d)(2)(i)–(vii).

104. *See id.* § 53.4945-5(d)(3)(i)–(iii).

105. *Id.* § 53.4945-5(c)(4).

106. *Id.* § 53.4945-5(b)(2).

107. *Id.* § 53.4945-5(b)(4)(i)–(iv).

108. *Id.* § 53.4945-5(d).

109. Joseph & Kosaras, *supra* note 50, at 23.

110. *Id.*

111. *Id.*

112. I.R.C. § 6110(k)(3) (2006).

qualify as PRIs and for understanding what a foundation must do to exercise expenditure responsibility.¹¹³

This Subsection breaks down two private letter rulings regarding companies with a primarily charitable purpose and a secondary profit motive. Marcus Owens, an attorney with Caplin & Drysdale in Washington, D.C., and a former director in the IRS Exempt Organizations Division, has asserted that a company with such a structure is a “[p]aradigmatic L3C.”¹¹⁴ Thus, the following letter rulings “provide[] important guidance regarding the federal tax treatment of investments in L3Cs.”¹¹⁵

In one letter ruling, a private foundation with a charitable interest in biodiversity and environmental sustainability wanted to invest in a for-profit corporation.¹¹⁶ The corporation “was formed for the purpose of financing and promoting the expansion of environmentally oriented businesses that will contribute to conservation and economic development in economically and/or environmentally sensitive areas [of a particular location].”¹¹⁷ The shareholders in the corporation included “governments, international development aid agencies, and some private investors.”¹¹⁸ In its request for the private letter ruling, the private foundation represented that the corporation had two goals: to provide a rate of return for investors and to “demonstrate a clear environmental benefit through each investment.”¹¹⁹

Although the foundation did not have a representative on the corporation’s board of directors, it did retain voting rights.¹²⁰ In addition, the foundation took an active role in ensuring that the for-profit’s investment projects would meet certain environmental considerations and further its charitable purpose.¹²¹ Meanwhile, the for-profit’s investments were under the guidance of an investment advisor, and had to be approved by a special investment committee appointed by its board of directors.¹²² This investment advisor was responsible for performing the necessary due diligence and “for ensuring proper distribution of funds and for monitoring all financial and environmental aspects of each investment” made by the for-profit corporation.¹²³ Additionally, the advisor was to document all aspects of the investments.¹²⁴

To ensure the validity and compliance of its PRI, the foundation drafted a special agreement with the corporation.¹²⁵ Under this agreement, the foundation had the right “to monitor and evaluate operations under the investment” and to receive “full and

113. See Joseph & Kosaras, *supra* note 50, at 24 n.16 (“Much of the ‘law’ on PRIs comes from private letter rulings that offer some insights into how the Service may treat a particular investment.”).

114. Susan A. Maslow & Timothy White, *Enlightened Capitalism and L3Cs*, N.J. LAWYER, Apr. 2010, at 63, 67.

115. *Id.*

116. I.R.S. Priv. Ltr. Rul. 2001-36-026 (June 11, 2001), at 2.

117. *Id.* at 2.

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.* at 2–3.

122. *Id.*

123. *Id.* at 3.

124. *Id.*

125. *Id.* at 3–4.

complete financial reports” describing the uses of the funds.¹²⁶ Furthermore, any “substantial variation” in the investment required the written approval of the foundation.¹²⁷ Lastly, “any portion of the investment not committed to environmental purposes must be returned” to the foundation.¹²⁸

As for the rate of return, the private foundation admitted that the rate was “significantly less than the acceptable rate of return” for similar investments of comparable risk and “well below the rate that [the private foundation] would require under its normal investment standards.”¹²⁹ Moreover, the foundation acknowledged that

the targeted rate [of return], . . . taken as a factor by itself . . . in a normal investment strategy (not in conjunction with a program related investment), would not compensate for the speculative nature of the investment and the overall risk associated with [the corporation’s] unique investment characteristics.¹³⁰

The IRS ruled that this was a valid PRI.¹³¹ The distinctive characteristic of the for-profit, as observed by the IRS, was that its investments were “limited to achieving environmental and economic development goals, subject to environmental guidelines and oversight.”¹³² In its analysis, the IRS found that the corporation’s investments “will significantly further the accomplishment of [the foundation’s] exempt purposes and that the investments would not have been made but for the relationship between [the corporation’s] investments and the accomplishment of [the foundation’s] exempt purposes.”¹³³ The IRS analogized the investment to two examples in the Treasury Regulations “where the investments were made to directly accomplish charitable goals.”¹³⁴ Although the foundation did expect a return on its investment, the IRS concluded that “no significant purpose of the investment is the production of income or the appreciation of property.”¹³⁵

Turning to expenditure responsibility, the IRS recognized that the investment advisory committee would “carefully scrutinize the investments funded by [the for-profit].”¹³⁶ Through the due diligence and documentation responsibilities of the investment committee, the foundation would be timely informed of the operations of its investment.¹³⁷ Most importantly, the special agreement established between the foundation and the for-profit conformed to the procedural and reporting requirements of the expenditure responsibility statute and regulations, giving the foundation a

126. *Id.* at 4.

127. *Id.*

128. *Id.*

129. *Id.* at 2.

130. *Id.*

131. *Id.* at 8.

132. *Id.* at 7.

133. *Id.*

134. *Id.* (citing Treas. Reg. § 53.4944-3(b) (1972) (examples three and five)).

135. *Id.* at 7.

136. *Id.*

137. *Id.*

significant degree of control over the direction of its PRI.¹³⁸ Therefore, the IRS concluded that all of the proper expenditure responsibility measures were in place for the foundation to avoid the taxable expenditure penalties.¹³⁹

Another private letter ruling involving a foundation investment in a limited liability company (LLC) provides further insight on how PRIs can be used.¹⁴⁰ The foundation wanted to make a PRI in an angel investment fund, organized as an LLC, “for the purpose of investing in businesses in low-income communities . . . [which were unable] to obtain conventional financing on reasonable terms.”¹⁴¹ The private investors in the fund were professional athletes on teams in the targeted metropolitan area.¹⁴² Both the foundation’s and the athletes’ capital contributions were to be combined to provide the necessary financial support to the businesses and to reduce poverty in the community.¹⁴³ In addition to this primary charitable purpose, there was a secondary educational aspect of the program whereby the foundation would educate the athlete members of the fund on angel investing and entrepreneurship.¹⁴⁴ If the program proved successful, the foundation intended to expand it to low-income communities in other cities.¹⁴⁵

Most importantly, the foundation believed that were it not for its own “commitment to become a significant investor in the Fund, the athletes would not invest in these communities.”¹⁴⁶ In other words, the foundation represented to the IRS that its capital contribution to the fund was necessary to attract capital contributions from the private sector. Moreover, the foundation expected that the program would encourage additional private investors to provide capital to the targeted businesses on reasonable terms, thereby eliminating the need for such initiatives.¹⁴⁷

In addition to providing the social benefit of helping poor communities, the fund was expected to be financially successful, although the return for all members of the fund was expected to be “substantially lower than for typical angel investments.”¹⁴⁸ To account for the fund’s mixed mission of charity and profit, the foundation had numerous checks in place to ensure that its investment would qualify as a PRI and that its exempt status would not be put at risk.¹⁴⁹ Under the fund’s operating agreement, the foundation had the final say on any action that could put its exempt status at risk.¹⁵⁰ Furthermore, the foundation reserved the right to terminate its participation in an investment if its economic success reached a level that would threaten its PRI status.¹⁵¹

138. *Id.*

139. *Id.* at 7–8.

140. I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006), at 8.

141. *Id.* at 2.

142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.*

146. *Id.* at 5.

147. *Id.*

148. *Id.*

149. *Id.* at 5–6.

150. *Id.* at 6.

151. *Id.*

Alternatively, the foundation could accept a cap on the amount of its investment return.¹⁵² Lastly, in accordance with the expenditure responsibility rules, the foundation had the power to require written reports regarding potential fund investments and periodic reports to keep the foundation informed of the fund's operations.¹⁵³

The IRS concluded that the foundation's investment in the fund met all of the PRI requirements.¹⁵⁴ Along with supporting a proper charitable purpose, the IRS found that none of the members of the fund were "investing solely for profit."¹⁵⁵ Additionally, the IRS recognized that all of the fund's members were "willing to accept the risks and expected lower returns because they have charitable agendas."¹⁵⁶ Moreover, the IRS emphasized the importance of the "control mechanisms" that the foundation had in place to ensure its investment continued to meet the PRI criteria.¹⁵⁷ Although the foundation was not required to provide itself with an exit in the event of economic success, the "totality of the circumstances" led to the IRS's conclusion "that no significant purpose of the [foundation's investment was for] the production of income or the appreciation of property."¹⁵⁸ Finally, the IRS found that all expenses incurred by the foundation in complying with the PRI and expenditure responsibility rules were "reasonable and necessary" because the fund would not have been established without the foundation's efforts.¹⁵⁹

As these examples illustrate, PRIs afford foundations a unique opportunity to further their charitable missions in creative ways. Through the use of PRIs, foundations can enter into relationships with the for-profit sector and receive a return on their investments, all in the name of charity.¹⁶⁰ These features and benefits demonstrate why the L3C movement has focused on presenting the entity as a vehicle for streamlining the use of PRIs.¹⁶¹

C. *The Low-Profit Limited Liability Company (L3C)*

The motivation behind the L3C is to have an entity that occupies the traditionally empty space between nonprofits and for-profits.¹⁶² Many believe that such a hybrid

152. *Id.* at 6–7.

153. *Id.* at 7. The foundation also agreed to reimburse the fund for expenses associated with these reports. *Id.*

154. *Id.* at 14.

155. *Id.* at 12.

156. *Id.* Note that the text attached to this and the previous footnote discuss features distinct from a prototypical L3C.

157. *Id.* at 12–13.

158. *Id.* at 13.

159. *Id.* at 13–14. Specifically, the expenses were "reasonable and necessary" within the meaning of I.R.C. § 4942(g). *Id.* As an added bonus, the foundation was able to include these expenses as qualifying distributions toward the five percent annual payout requirement in each year the expenses were made. *Id.* at 14.

160. Woodrow & Davis, *supra* note 6, at 4.

161. *See id.* (stating that "[a]t the core of the L3C concept is the use of PRIs as part of a multiple-tiered, or layered investment strategy that, theoretically, will help attract a wide range of both socially motivated and profit-oriented investments").

162. BILLITTERI, *supra* note 8, at 2.

organization will be better suited for solving the social challenges of the modern world.¹⁶³ The innovator of the L3C model, Robert Lang, stated that its goal is to integrate “business and mission in a self-sufficient, profit-making venture.”¹⁶⁴ To accomplish this purpose, the L3C puts the social mission ahead of profit maximization in the strategic decision-making process.¹⁶⁵

In view of private foundations’ general reluctance to make PRIs without assurance from the IRS, proponents of the L3C drafted model legislation designed to facilitate the use of PRIs by aligning the legislation’s operational requirements with the PRI regulations.¹⁶⁶ In 2008, Vermont became the first state to enact L3C legislation.¹⁶⁷ In doing so, the Vermont legislature amended its existing LLC statute to include the L3C as a recognized legal entity,¹⁶⁸ thus maintaining the LLC’s flexible features for management and distribution of profits as well as its income tax treatment.¹⁶⁹ The Vermont statute uses the precise language of the PRI regulations in defining how the L3C is organized and operated.¹⁷⁰

Following Vermont, seven states have enacted L3C laws.¹⁷¹ In an effort to enhance the ability of L3Cs to facilitate PRIs, federal legislation has been introduced and discussed in the Senate Finance Committee and the Joint Committee on Taxation.¹⁷² The Philanthropic Facilitation Act of 2010 proposes to amend section 4944(c) of the Code to provide L3Cs with a rebuttable presumption of status as a qualifying PRI-vehicle.¹⁷³ It is hoped that such an amendment will help remove the risk

163. See Woodrow & Davis, *supra* note 6, at 4 (“There is a growing body of thought that new business models and possibly new tax incentives or structures are needed to effectively bridge the ‘sector’ gap.”); E-mail from Marcus S. Owens, Attorney, Caplin & Drysdale, et al., to Willard L. Boyd III, Chair, ABA Bus. Section Nonprofit Orgs. Comm., et al. (July 13, 2001), available at [http://americansforcommunitydevelopment.org/TDE_CMS/database/userfiles/file/Letter%20regarding%20L3C%20\(00339893-2\).pdf](http://americansforcommunitydevelopment.org/TDE_CMS/database/userfiles/file/Letter%20regarding%20L3C%20(00339893-2).pdf) (“[W]e believe that in many cases L3C[s] will make it easier for foundation investors to make the findings that they need to make for a proper PRI and for compliance with expenditure responsibility.”) For example, in light of dwindling hard-copy newspaper sales, one commentator has suggested that the L3C could be used as a business model for struggling newspapers. Richard Schmalbeck, *Financing the American Newspaper in the Twenty-First Century*, 35 VT. L. REV. 251, 269 (2010).

164. Lang, *supra* note 77, at 253.

165. *Id.*

166. *What is the L3C?*, AMS. FOR COMMUNITY DEV., <http://americansforcommunitydevelopment.org/downloads/WhatIsTheL3C.pdf> (last visited Nov. 11, 2011).

167. VT. STAT. ANN. tit. 11, § 3001 (West 2011).

168. *Id.* § 3001(27).

169. Woodrow & Davis, *supra* note 6, at 4.

170. *Id.* at 4. Whether the statute is effective in achieving congruity with the federal PRI laws has been called into question. See J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273, 283 (2010).

171. 805 ILL. COMP. STAT. ANN. 180/1-26 (West 2011); LA. REV. STAT. ANN. § 12:1302 (2010); ME. REV. STAT. ANN. tit. 31, § 1611 (2011); MICH. COMP. LAWS ANN. § 450.4102(m) (West 2011); N.C. GEN. STAT. ANN. § 57C-2-01(d) (West 2010); UTAH CODE ANN. § 48-3-1302 (West 2011); WYO. STAT. ANN. § 17-29-102(a)(ix) (West 2010).

172. *What is the L3C?*, *supra* note 166, at 2.

173. Philanthropic Facilitation Act of 2010 (proposed final draft), available at <http://www.americansforcommunitydevelopment.org/downloads/PhilanthropicFacilitationAct2010.pdf> (last visited Nov. 11, 2011).

and transaction costs that private foundations associate with making PRIs, thus promoting the growth of L3Cs.¹⁷⁴

Much has already been written on how the L3C works in practice.¹⁷⁵ An L3C is designed to pursue charitable purposes, but is not designed to be a tax-exempt nonprofit.¹⁷⁶ Therefore, L3Cs are similar to LLCs in that they are taxed as partnerships if they have more than one member.¹⁷⁷ Furthermore, like an LLC, an L3C is governed by the terms of its “operating agreement.”¹⁷⁸ This agreement establishes the governance of the L3C by providing for the members’ respective rights and obligations, their respective contributions and distributions, and voting rights, among other rights and responsibilities.¹⁷⁹ Model operating agreements have been drafted to assist L3C start-ups,¹⁸⁰ but members are free to modify the default operating arrangements to fit their specific needs.¹⁸¹ Most importantly, the governing documents must set forth one or more charitable purposes as the L3C’s primary objective.¹⁸²

At the heart of the L3C’s design is the use of PRIs in a tranching investment structure.¹⁸³ Under this strategy, the PRI is used to absorb the highest risk level of the investment, while receiving a lower than market rate of return.¹⁸⁴ The L3C can then attract for-profit investors who would usually avoid investing in a social venture by offering a market rate of return with low risk.¹⁸⁵ For example, suppose an L3C develops a business plan that will accomplish a charitable purpose and will be able to distribute a ten percent total return to all of its members.¹⁸⁶ The private foundation member contributes a twenty-five percent capital investment through a PRI, takes on the highest risk, and receives a one percent return.¹⁸⁷ In the middle tranche, a socially responsible investor¹⁸⁸ contributes a twenty-five percent capital investment with

174. *What is the L3C?*, *supra* note 166, at 2.

175. *See, e.g.*, Lane, *supra* note 57, at 1–3; Woodrow & Davis, *supra* note 6, at 3–4.

176. Lane, *supra* note 57, at 3.

177. *Id.* at 4. Although this is the default treatment, an L3C can still choose to be taxed as a corporation. *Id.* The reasons for making this choice are beyond the scope of this Comment.

178. *Id.* at 3.

179. *Id.*

180. *See Legal, AMS. FOR COMMUNITY DEV.*, <http://americansforcommunitydevelopment.org/legal.php> (last visited Nov. 11, 2011) (providing short form and long form model operating agreements).

181. Lane, *supra* note 57, at 3.

182. Woodrow & Davis, *supra* note 6, at 4. The L3C’s charitable purpose must be in line with the definition provided in I.R.C. § 501(c)(3). *See id.*

183. *Id.* Although a key feature of the L3C’s design, it is important to note that a tranching investment structure is not a requirement for L3Cs and is not addressed in the legislation. *See* E-mail from Marcus S. Owens et al. to Willard L. Boyd III et al., *supra* note 163.

184. Woodrow & Davis, *supra* note 6, at 4.

185. Lane, *supra* note 57, at 2.

186. This example of a possible risk-return arrangement is based directly on the illustrative example used in Woodrow & Davis, *supra* note 6, at 5.

187. *Id.*

188. Socially responsible investors (SRI) “seek to screen the companies they invest in based on products or practices to avoid . . . or products or practices to promote.” D. GORDON SMITH & CYNTHIA A. WILLIAMS, *BUSINESS ORGANIZATIONS: CASES, PROBLEMS, AND CASE STUDIES* 460 (2d ed. 2008). SRI investors represent a significant amount of available investment capital. In fact, “[e]ach of the big ‘fund families’ (such as Fidelity, Magellan, and Vanguard) now has SRI funds. Altogether, assets in socially screened investment

moderate risk in exchange for a three percent return.¹⁸⁹ This arrangement then allows for a profit-sector investor to make a fifty percent capital investment in the L3C with the lowest risk, and still receive a market-competitive six percent rate of return.¹⁹⁰ Clearly, the for-profit investor would be unwilling to invest without the private foundation's involvement.¹⁹¹

The tranching investment structure of the L3C is a powerful concept that allows a socially motivated business to attract capital from a variety of sources.¹⁹² The basic assumption behind this strategy is that private foundations will be able to make PRIs in an L3C without facing negative consequences.¹⁹³ Assuming the PRI obstacle can be overcome, however, there are still major IRS regulatory concerns that need to be addressed before a private foundation can safely participate in the high-risk, low-return investment tranche.¹⁹⁴

D. *The Private Benefit Doctrine*

Although the L3C's tranching investment structure is attractive and potentially powerful, it is necessary to examine what risk, if any, a private foundation could face in losing its exempt status by participating in the high-risk, low-return tranche. In the law of tax-exempt organizations, the IRS uses two main doctrines to analyze the effect of joint venture participation on an organization's exempt status.¹⁹⁵ The private inurement doctrine evaluates benefits received by persons or individuals with a direct interest in the operations of the organization.¹⁹⁶ The private benefit doctrine evaluates whether an exempt organization confers a substantial private benefit to disinterested persons or unrelated third parties.¹⁹⁷ Although the two doctrines share overlapping characteristics, the private benefit doctrine has a broader application and subsumes the private inurement doctrine.¹⁹⁸

This Section of the Comment explores the contours of the private benefit doctrine in light of its applicability to the relationship between private foundations, L3Cs, and for-profit investors. The Section begins by explaining the essential differences between

portfolios under professional management rose by more than a third from 1999 to 2001 to \$2.034 trillion, comprising about 12 percent of money under professional management." *Id.* at 461.

189. Woodrow & Davis, *supra* note 6, at 5.

190. *Id.*

191. See Lane, *supra* note 57, at 2 ("By taking on higher risk and forgoing market-rate returns, the foundation affords the L3C the opportunity to attract private-sector investment which otherwise might never support a social venture.").

192. See Woodrow & Davis, *supra* note 6, at 4 (explaining how the tranching investment structure leverages foundation capital to attract private sector investment).

193. See *supra* Part II.B.1 for a discussion of the PRI requirements.

194. See Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 263-67 (2010) (arguing that the private inurement and private benefit restrictions present dangerous issues for foundation participation in an L3C's tranching investment structure).

195. See generally HOPKINS, *supra* note 25, §§ 20.1-11.

196. See *id.* § 20.1.

197. *Id.* § 20.11, at 600.

198. See *infra* notes 258-60 and accompanying text for a discussion of *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989), and the principle that the private benefit doctrine subsumes the private inurement restriction.

private benefit and private inurement. It then discusses the heart of the private benefit analysis. Next, it examines the application of the private benefit doctrine to joint ventures between exempt organizations and for-profit entities in the context of partnerships and LLCs. The Section concludes by summarizing the current state of the doctrine and the scholarly response to its standards.

1. The Difference Between Private Benefit and Private Inurement

To understand the context in which the IRS applies the private benefit doctrine, it is important to differentiate between private benefit and private inurement. As a fundamental statutory requirement for tax-exempt status, a charitable organization must be organized and operated so that “no part of [its] net earnings . . . inures to the benefit of any private shareholder or individual.”¹⁹⁹ This principle of exemption has also been called the “nondistribution constraint.”²⁰⁰ Although it may seem obvious that a nonprofit organization is forbidden from distributing net earnings like a for-profit organization, the meaning of the statutory language goes beyond the simplicity its plain form suggests.²⁰¹

The private inurement provision encompasses a number of terms and elements that are each worth brief discussion in order to fully understand the concept.²⁰² First, the phrase “no part” has been interpreted as creating a zero-tolerance standard, meaning the rule is violated regardless of the size of the benefit.²⁰³ Second, the “net earnings” element—which is not defined in the Code—has taken on an expanded meaning,²⁰⁴ so that all income or assets of an exempt organization are evaluated.²⁰⁵ The modern interpretation “goes far beyond any mechanical computation and dissemination of net earnings, and embraces a much wider range of transactions and other activities.”²⁰⁶ Third, in the context of exempt organizations, the word “inure” signifies the flow or transfer of economic benefits from or through an exempt organization to a recipient.²⁰⁷ Lastly, the private inurement rule applies only to “insiders,” a term that includes not only private shareholders, but an organization’s “founder, or the members of its board,

199. I.R.C. § 501(c)(3) (2006).

200. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

201. See HOPKINS, *supra* note 25, § 20.1, at 561 (noting that the term “inure” has not been precisely defined in the Code, and that the private inurement doctrine is “broad and wide-ranging”).

202. I.R.C. § 501(c)(3).

203. See *Founding Church of Scientology v. United States*, 412 F.2d 1197, 1202 (Ct. Cl. 1969) (“It is our opinion, from an examination of the statute and the decided cases, that Congress, when conditioning the exemption upon ‘no part’ of the earnings being of benefit to a private individual, specifically intended that the amount or extent of benefit should not be the determining factor.”).

204. State and federal courts initially defined “net earnings” in the typical accounting sense of gross earnings minus expenses. See, e.g., *United States v. Riely*, 169 F.2d 542, 543–44 (4th Cir. 1948) (citing multiple dictionaries and cases for the proposition that “net earnings” means gross earnings in excess of the cost); *Winkelman v. Gen. Motors Corp.*, 44 F. Supp. 960, 999–1000 (S.D.N.Y. 1942) (approving an agreement between the parties defining “net earnings” as gross earnings less charges and expenses); *Bank of Commerce & Trust Co. v. Senter*, 260 S.W. 144, 151 (Tenn. 1924) (defining “net earnings” as “what is left of earnings after deducting . . . items of expense”).

205. See HOPKINS, *supra* note 25, § 20.2, at 563–64.

206. *Id.* § 20.2, at 564.

207. *Id.* § 20.1, at 561.

or their families, or anyone else fairly to be described as an insider, that is, as the equivalent of an owner or manager.”²⁰⁸ In other words, an insider is a person or entity that is in a position of control over the organization.²⁰⁹

The IRS summarized its view of the doctrine by stating that private inurement is “likely to arise where the financial benefit represents a transfer of the organization’s financial resources to an individual solely by virtue of the individual’s relationship with the organization, and without regard to accomplishing exempt purposes.”²¹⁰ Put another way, the “inurement prohibition serves to prevent anyone in a position to do so from siphoning off any of a charity’s income or assets for personal use.”²¹¹ Compared to private benefit, the IRS interpretation of private inurement is fairly well-defined, and the activities giving rise to the application of the inurement prohibition can be described using two general paradigms.²¹² The first paradigm is when an exempt organization purchases property or services from an insider at a higher than fair market value price.²¹³ The second is when the organization sells property or services to an insider for less than fair market value.²¹⁴

In contrast, the private benefit doctrine does not appear in the Code.²¹⁵ Rather, the basis of this doctrine derives from the operational test set forth in the Treasury Regulations, which provide that

[a]n organization is not organized or operated exclusively for [exempt purposes] unless it serves a public rather than a private interest. Thus . . . it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.²¹⁶

Although this language appears to be similar to the private inurement doctrine, the IRS has used this test to expand the scope of its policing power beyond the insiders of an exempt organization to outside parties.²¹⁷

The IRS’s official private benefit approach originates in a 1987 General Counsel Memorandum.²¹⁸ Here, the IRS stated that an organization is not exempt “if it serves a private interest more than incidentally. . . . If an activity serves both exempt and nonexempt purposes, the organization will be exempt only if the predominant

208. *United Cancer Council, Inc. v. Comm’r*, 165 F.3d 1173, 1176 (7th Cir. 1999). The *United Cancer Council* court further stated that an insider could be an employee “or even a nominal outsider, such as a physician with hospital privileges in a charitable hospital.” *Id.*

209. *Id.*; see also I.R.C. § 4958(f)(1)(A) (2006) (defining “disqualified person,” that is, an “insider,” as an individual “in a position to exercise substantial influence over the affairs of [an exempt organization]”).

210. I.R.S. Gen. Couns. Mem. 38,459 (July 31, 1980), 1980 GCM LEXIS 71, at *18–19.

211. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991), 1991 GCM LEXIS 39, at *17.

212. John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063, 1067–68 (2006).

213. *Id.*

214. *Id.*

215. *Id.*

216. Treas. Reg. § 1.501(c)(3)–1(d)(1)(ii) (as amended in 1990).

217. See Colombo, *supra* note 212, at 1064.

218. I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987), 1987 GCM LEXIS 2.

motivation underlying the activity is an exempt purpose.”²¹⁹ Elaborating further, the IRS introduced an incidental benefit balancing test, stating that:

A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals. . . . To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.²²⁰

This balancing test highlights two important differences between private benefit and private inurement.²²¹ First, unlike the zero-tolerance inurement rule, the IRS will permit incidental private benefit so long as the exempt purpose is the dominant purpose.²²² Second, the private benefit test applies to arrangements between exempt organizations and persons or entities who are not “insiders.”²²³

The seminal case, *United Cancer Council, Inc. v. Commissioner*,²²⁴ illustrates that the distinction between “insiders” and “outsiders” is critical.²²⁵ In this case, a charity on the verge of bankruptcy hired a fundraising specialist to help it survive.²²⁶ The charity and fundraiser agreed to a contract whereby the fundraiser would front all expenses for the fundraising campaign in exchange for exclusive fundraising privileges over a five-year term.²²⁷ The campaign succeeded in raising \$28.8 million, but after \$26.5 million was reimbursed to the fundraiser for expenses, only \$2.3 million remained to be spent on the charitable purpose.²²⁸

The IRS revoked the charity’s exempt status, claiming that it was operating for the private benefit of the fundraising company and that the charity’s net earnings had inured to the benefit of the fundraiser.²²⁹ The tax court upheld the IRS’s revocation on the private inurement ground but refrained from addressing the merits of the private benefit issue.²³⁰ On appeal, Judge Posner, for the Seventh Circuit, noted that the fundraiser’s characterization as an insider was based on the advantageous contract in its favor.²³¹ The IRS took the position that because the charity was out of money, the fundraiser’s agreement to front all expenses essentially made it “a founder, or rather refounder . . . of the charity.”²³² Moreover, since ninety percent of all contributions to the charity went to the fundraiser, the fundraiser “was the real recipient of the

219. *Id.* at *14–15.

220. *Id.* at *15–16.

221. HOPKINS, *supra* note 25, § 20.11, at 600.

222. *Id.*

223. *Id.*

224. 165 F.3d 1173 (7th Cir. 1999).

225. *United Cancer Council*, 165 F.3d at 1176–78.

226. *Id.* at 1175.

227. *Id.*

228. *Id.*

229. *Id.* at 1174–75.

230. *Id.* at 1175.

231. *Id.* at 1176.

232. *Id.*

contributions.”²³³ The IRS emphasized that the contract was more favorable to the fundraiser than the average fundraising contract, and that because the fundraiser had exclusive fundraising privileges for five years, it had “effective control over the charity.”²³⁴

Since the tax court had addressed only the private inurement issue, Judge Posner was limited to reviewing the case within the inurement context.²³⁵ Posner rejected the tax court’s agreement with the IRS’s theory that the contract had allowed the fundraiser to effectively seize control of the charity, purportedly leading the fundraiser to become an insider of the charity and thus eliminating its exempt status.²³⁶ The court acknowledged that the contract was favorable, but only because the charity was in desperate financial circumstances, not because of any common control.²³⁷ Moreover, Judge Posner hinted strongly that the private benefit doctrine provided a better means to analyze the case.²³⁸ He posited:

Suppose that [the charity] was so irresponsibly managed that it paid [the fundraiser] twice as much . . . [as it] would have been happy to accept Then it could be argued that [the charity] was in fact being operated to a significant degree for the private benefit of [the fundraiser], though not because it was the latter’s creature.²³⁹

Posner opined that such a circumstance would justify “using tax law to deal with the problem of improvident or extravagant expenditures by a charitable organization that do not, however, inure to the benefit of insiders.”²⁴⁰ Posner also noted that the typical private benefit case is one where the organization has “dual public and private goals,”²⁴¹ a characterization very much resembling the L3C.²⁴²

In sum, the lessons from *United Cancer Council* are that (1) a for-profit entity cannot be considered an “insider” of an exempt organization unless it is in a position of control over the organization’s operations, and (2) if a for-profit entity receives a benefit through its relationship with a charitable organization over which it has no control, the private benefit analysis should be used to determine whether the organization can retain its exempt status.²⁴³

2. The Essence of Modern Private Benefit Law

The IRS’s private benefit approach received its most significant judicial treatment in *American Campaign Academy v. Commissioner*.²⁴⁴ In this case, a school was

233. *Id.*

234. *Id.*

235. *Id.* at 1175.

236. *Id.* at 1178.

237. *Id.*

238. *Id.* at 1179–80.

239. *Id.* at 1179.

240. *Id.*

241. *Id.*

242. See Lang, *supra* note 77, at 253 (stating that the L3C is designed to integrate “business and mission in a self-sufficient, profit-making venture”).

243. See *United Cancer Council*, 165 F.3d at 1179–80.

244. 92 T.C. 1053 (1989).

training its students to become political campaign professionals.²⁴⁵ The IRS determined that the school was organized exclusively for educational purposes, did not violate the private inurement prohibition, and was not involved in any political, lobbying, or campaign activities.²⁴⁶ However, because the majority of the school's students worked for the Republican Party upon graduation, the IRS concluded that the school was not operating exclusively for exempt purposes, and thus denied the school's application for exempt status.²⁴⁷ The IRS's final letter ruling to the school reflected the private benefit approach by stating:

You are operated for a substantial non-exempt private purpose. You benefit Republican Party entities and candidates more than incidentally. Also, your activities serve the private interests of Republican Party entities rather than public interests exclusively.²⁴⁸

When the case reached the tax court, the school's position tracked the requirements of private inurement and argued that the private benefit doctrine "is limited to situations in which an organization's insiders are benefited. . . . [And] since Republican Party entities and candidates cannot be construed as insiders of its organization, no transgression of the operational test exists."²⁴⁹ To support this contention, the school compared the class of persons described in the regulatory language of the private benefit test²⁵⁰ to the class of persons described in the statutory and regulatory language of the private inurement test²⁵¹ and pointed out a significant overlap between the two.²⁵² Thus, the school argued that the "overlap clearly indicates that both the prohibition against private inurement and the prohibition against conferral of substantial private benefits exclusively target the same class of persons."²⁵³ The school then claimed that because unrelated third parties are excluded from the scope of the private inurement rule,²⁵⁴ they should be excluded from the scope of the private benefit rule as well.²⁵⁵ Therefore, the school concluded that the private benefit analysis should not apply because Republican organizations and candidates did not qualify as interested insiders.²⁵⁶

The IRS enjoyed a major victory when the tax court disagreed with the school and sided with its position.²⁵⁷ The court outlined the backbone of the modern private benefit doctrine, stating first that it has "consistently recognized that while the prohibitions against private inurement and private benefits share common and often overlapping elements, the two are distinct requirements which must independently be

245. *Am. Campaign Acad.*, 92 T.C. at 1055.

246. *Id.* at 1063.

247. *Id.* at 1063, 1071.

248. *Id.* at 1063.

249. *Id.* at 1067 (internal quotation marks omitted).

250. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (2009).

251. I.R.C. § 501(c)(3) (2006); Treas. Reg. §§ 1.501(a)-1(c), 1.501(c)(3)-1(c)(2).

252. *Am. Campaign Acad.*, 92 T.C. at 1067.

253. *Id.* (internal quotation marks omitted).

254. *Id.* at 1068 (citing *People of God Cmty. v. Comm'r*, 75 T.C. 127, 133 (1980)).

255. *Id.*

256. *Id.*

257. *Id.*

satisfied.”²⁵⁸ The court then declared that the private benefit analysis is broader than, and thus subsumes, the private inurement analysis, and therefore, when a court “concludes that no prohibited inurement of earnings exists, it cannot stop there but must inquire further and determine whether a prohibited private benefit is conferred.”²⁵⁹ Finally, the tax court established that “an organization’s conferral of benefits on disinterested persons,” meaning, “persons who are not private shareholders or individuals having a personal and private interest in the activities of the organization,” may lead to a violation of the private benefit doctrine and loss of exempt status.²⁶⁰

In applying this analysis to the school, the court compared the “primary” private benefit received by the students and the “secondary” private benefit conferred on the Republican Party.²⁶¹ Since there was no evidence that the school limited its admissions to a narrow pool of applicants, the IRS asserted, and the court agreed, that the students were the class of people who would naturally receive a private benefit from the educational organization.²⁶² On the other hand, since most of the graduates worked for the Republican Party, the court found there to be a substantial secondary benefit that supported the IRS’s contention that the school was not operated exclusively for exempt purposes.²⁶³ In this respect, the court held that the school was in fact “operated for the benefit of private interests” and was not privy to a charitable exemption.²⁶⁴

The *American Campaign Academy* decision gave the IRS a powerful tool to regulate exempt organizations.²⁶⁵ The IRS is now able to use private benefit as a separate requirement from private inurement, which, as explained below, can have a significant impact on the relationships between exempt organizations and for-profit entities.²⁶⁶

3. Application to Joint Ventures: Partnerships and LLCs

It is not uncommon for charitable organizations to enter into joint ventures with for-profit entities.²⁶⁷ Initially, the IRS took the position that an exempt organization could not act as a general partner in a partnership because of the conflict between its own exempt purposes and the duty of the partnership to maximize profits.²⁶⁸ However, a significant turning point came in *Plumstead Theatre Society, Inc. v. Commissioner*.²⁶⁹ In *Plumstead*, the nonprofit theatrical production company was short on the capital it

258. *Id.* (citations omitted).

259. *Id.* at 1068–69.

260. *Id.* at 1069.

261. *Id.* at 1074–76.

262. *Id.* at 1074.

263. *Id.* at 1075.

264. *Id.* at 1079.

265. Colombo, *supra* note 212, at 1074.

266. *Id.* at 1073–74.

267. *See id.* at 1074 (describing the common use of joint ventures in the healthcare sector).

268. *See* I.R.S. Gen. Couns. Mem. 36,293 (May 30, 1975), 1975 GCM LEXIS 215, at *28–29 (explaining that an organization may not retain its exempt status when a private corporate duty arising out of a for-profit partnership would conflict with its charitable purpose).

269. 74 T.C. 1324 (1980).

needed to produce a play.²⁷⁰ To solve this problem, the theatre entered into a limited partnership with outside investors who provided \$100,000 in exchange for a 63.5% return on profits from the production.²⁷¹ The theatre made no capital contribution and acted only as general partner.²⁷² The IRS revoked the theatre's exempt status, claiming that it was operated for private instead of public interests.²⁷³ The tax court disagreed, finding that the theatre company obtained the funds in an "arm's-length transaction . . . for a reasonable price."²⁷⁴ Furthermore, the court determined that "[t]he limited partners have no control over the way [the theatre] operates or manages its affairs."²⁷⁵ Thus, the nonprofit theatre was not in violation of the private benefit rule and was entitled to retain its exempt status.²⁷⁶

The IRS changed its position following its ruling on Plumstead Theatre's status,²⁷⁷ beginning with an acknowledgement that joint ventures with for-profit entities would not automatically result in a loss of exemption.²⁷⁸ Rather, the IRS would assess each arrangement case by case.²⁷⁹ The revised IRS position centers on who controls operations. This position is reflected in a two-pronged test, requiring that (1) the joint venture serve a charitable purpose and (2) the arrangement of the partnership permit the exempt organization to act exclusively in furtherance of its charitable purpose.²⁸⁰

In the landmark Revenue Ruling 98-15, the IRS addressed the issue of whether a hospital could retain its exempt status after forming an LLC with a for-profit corporation.²⁸¹ The hypothetical arrangement was that the hospital would contribute all of its assets to the LLC and the for-profit would finance the joint venture.²⁸² The LLC would then control the hospital's activities.²⁸³ The ruling, building off of this basic fact pattern, described two possible "situations," each leading to different results.²⁸⁴

In the first situation, the governing board of the LLC was made up of five members, three chosen by the hospital and two chosen by the for-profit, which gave the hospital voting control.²⁸⁵ Furthermore, the governing documents were set up in such a way that when a conflict arose between the overarching charitable purpose and the duty to maximize profits, the board's first priority was to act in a way to satisfy the

270. *Plumstead*, 74 T.C. at 1328.

271. *Id.*

272. *Id.*

273. *Id.* at 1325.

274. *Id.* at 1333.

275. *Id.* at 1334.

276. *Id.*

277. To avoid confusion, this "ruling" refers to the IRS's final letter ruling issued to Plumstead Theatre revoking its exempt status, not the *Plumstead* court's ruling.

278. I.R.S. Gen. Couns. Mem. 37,852 (Feb. 9, 1979), 1979 GCM LEXIS 53, at *2.

279. *Id.* at *18.

280. I.R.S. Gen. Couns. Mem. 39,005 (June 28, 1983), 1983 GCM LEXIS 56, at *8-9.

281. Rev. Rul. 98-15, 1998-1 C.B. 718, 718.

282. *Id.*

283. *Id.*

284. *Id.* at 718-19.

285. *Id.* at 718.

charitable goal, even if profits would not be maximized.²⁸⁶ In its analysis, the IRS established that when evaluating an organization's qualification for exemption, "the activities of an LLC treated as a partnership for federal income tax purposes are considered to be the activities of a nonprofit organization that is an owner of the LLC."²⁸⁷ Using a private benefit test, the IRS concluded that in a situation like this, where the hospital retains control over the management of the joint venture, the hospital would not lose its exempt status.²⁸⁸

In contrast, the second situation described a scenario where the hospital and for-profit had equal voting control and where there were no governing documents requiring the charitable purpose to take precedent over the maximization of profits.²⁸⁹ Consequently, the LLC was operating primarily as a business enterprise and would not prioritize the hospital's charitable purpose over the duty to maximize profits.²⁹⁰ The IRS concluded that the hospital in this situation lacked control over the LLC's management, thus violating the private benefit doctrine and resulting in the loss of exempt status.²⁹¹

The tax court, in *Redlands Surgical Services v. Commissioner*,²⁹² subsequently affirmed the IRS's position in Revenue Ruling 98-15. The sole activity of the nonprofit hospital in *Redlands* was its participation as co-general partner with a for-profit corporation in a general partnership.²⁹³ This partnership itself was general partner of an operating limited partnership, which ran a surgical center.²⁹⁴ The IRS denied the hospital exempt status on the basis that it had relinquished control of its sole activity to the for-profit partners.²⁹⁵ The IRS asserted that the "arrangement is indicative of a substantial nonexempt purpose, whereby [the hospital] impermissibly benefits private interests."²⁹⁶ After stating that "[a]n organization's purposes may be inferred from its manner of operations,"²⁹⁷ the court's reasoning closely tracked that of the IRS described in the second situation depicted in Revenue Ruling 98-15.²⁹⁸ The court stated that:

To the extent that [the hospital] cedes control over its sole activity to for-profit parties having an independent economic interest in the same activity and having no obligation to put charitable purposes ahead of profit-making objectives, [the hospital] cannot be assured that the partnerships will in fact be operated in furtherance of charitable purposes.²⁹⁹

286. *Id.*

287. *Id.* at 721.

288. *Id.*

289. *Id.* at 719.

290. *Id.* at 721.

291. *Id.*

292. 113 T.C. 47 (1999), *aff'd per curiam*, 242 F.3d 904 (9th Cir. 2001).

293. *Redlands*, 113 T.C. at 48.

294. *Id.*

295. *Id.* at 76.

296. *Id.*

297. *Id.* at 78.

298. Rev. Rul. 98-15, 1998-1 C.B. 718, 721.

299. *Redlands*, 113 T.C. at 78.

Thus, the court upheld the IRS's denial of exemption on private benefit grounds.³⁰⁰

The next development in this doctrinal line was Revenue Ruling 2004-51, in which the IRS addressed a situation where an exempt organization enters into a joint venture with a for-profit entity as an insubstantial part of its activities.³⁰¹ The factual scenario involved an exempt university that formed an LLC with a for-profit company specializing in interactive video training for teachers.³⁰² The university's goal in the joint venture was to expand the reach of its teacher training programs.³⁰³ Both the university and the for-profit company held a fifty percent interest in the LLC, which was proportionate to their capital contributions.³⁰⁴ Like the impermissible second situation of Revenue Ruling 98-15, the LLC's governing documents provided that each entity had three directors on the board, meaning the university lacked complete managing control.³⁰⁵ While the university had the exclusive right to guide the LLC's educational policy, the for-profit company had the exclusive right to conduct the essential business operations of the LLC.³⁰⁶ Furthermore, the governing documents required that all transactions be at fair market value and the LLC be prohibited from engaging in any activity that would put the university's exemption at risk.³⁰⁷

The IRS began its analysis by establishing that since the LLC was a partnership for federal tax purposes, its activities were attributed to the university for purposes of evaluating its qualification for exemption.³⁰⁸ The IRS concluded that the university's participation in the LLC did not destroy its exempt status, despite its lack of voting control.³⁰⁹ However, the IRS's reasoning omitted any mention of the private benefit doctrine's control standard.³¹⁰ Instead, its analysis consisted of only the following two sentences:

The activities [the university] is treated as conducting through [the LLC] are not a substantial part of [the university's] activities within the meaning of § 501(c)(3) and § 1.501(c)(3)-1(c)(1). Therefore, based on all the facts and circumstances, [the university's] participation in [the LLC], taken alone, will not affect [the university's] continued qualification for exemption as an organization described in § 501(c)(3).³¹¹

300. *Id.*

301. Rev. Rul. 2004-51, 2004-1 C.B. 974, 975. The main factual difference between this sort of circumstance and the "sole activity" line of cases and rulings is that, here, the exempt organization "contributes a *portion* of its assets to and conducts a *portion* of its activities through" the joint venture. *Id.* (emphasis added). This type of joint venture is commonly referred to as an ancillary joint venture. Colombo, *supra* note 212, at 1077; Nicholas A. Mirkay, *Relinquish Control! Why the IRS Should Change Its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. L.J. 21, 25-26 (2005).

302. Rev. Rul. 2004-51, 2004-1 C.B. 974, 975.

303. *Id.*

304. *Id.*

305. *Id.*

306. *Id.*

307. *Id.*

308. *Id.* at 976.

309. *Id.*

310. *Id.*

311. *Id.*

It is unclear why the IRS avoided the use of the private benefit test in this ruling.³¹² One scholar has suggested that the IRS did not want to weaken the court-approved control standard of Revenue Ruling 98-15,³¹³ and simply decided to relax the control requirement for ancillary joint ventures where the charitable purpose was still controlled by the exempt organization.³¹⁴ Nonetheless, “the IRS should have explained in the ruling why this transaction passed the private benefit test despite the lack of control by the exempt institution over the partnership.”³¹⁵ Another scholar essentially sided with the IRS, arguing that the control standard is inapplicable when applied to ancillary joint ventures because these activities are only a small part of the exempt organization’s overall activities.³¹⁶ Thus, application of the control standard to an organization’s non-primary activity is “less appropriate and economically unrealistic.”³¹⁷

4. Summary of the Private Benefit Doctrine and Existing Commentary

The modern IRS interpretation and use of the private benefit doctrine remains unclear, both as a whole and as specifically applied to joint ventures between nonprofits and for-profits where the venture is only an “insubstantial” part of the nonprofit’s activities.³¹⁸ Because the IRS prefers a case-by-case method of analysis, as opposed to a clear bright-line standard, the scope of the private benefit doctrine is confusing and difficult to predict.³¹⁹

The lack of clarity in Revenue Ruling 2004-51 left the nonprofit sector debating how to proceed.³²⁰ The majority of practitioners viewed ancillary joint ventures as posing no risk to exempt status,³²¹ while a minority believed that substantial or excessive private benefit could threaten exemption.³²² Judging from the words of an IRS employee who had a hand in drafting Revenue Ruling 2004-51, it appears that the IRS intended the ruling to side with the majority view.³²³ The employee described the ruling as an attempt “to show that even if [the joint venture] hadn’t furthered [the nonprofit’s] charitable purposes, their exemption would not have been in question

312. Colombo, *supra* note 212, at 1078.

313. *Id.* at 1078–79.

314. *Id.* at 1079 n.81.

315. *Id.* at 1078.

316. Mirkay, *supra* note 301, at 68.

317. *Id.*

318. Colombo, *supra* note 212, at 1064.

319. *Id.* at 1069.

320. Paul Streckfus, *Ancillary Joint Ventures May Involve Exemption Risk*, EXEMPT ORG. TAX REV., Mar. 2005, at 327, 327.

321. *Id.* The majority viewed the possibility of being subject to unrelated business income tax (UBIT) as the only real risk of ancillary joint ventures. *Id.* UBIT is a complicated topic that is beyond the scope of this Comment and probably deserves its own analysis within the context of foundation participation in social enterprise.

322. *Id.*

323. *Id.*; see also Colombo, *supra* note 212, at 1094 (suggesting that the ruling may be “an acknowledgement by the IRS that no private benefit issues are raised in economic transactions that involve ‘insubstantial’ services”).

because [it] was an insubstantial part of their activities.”³²⁴ Furthermore, the employee said the IRS intended the ruling to demonstrate what level of control is necessary “to ensure that [the joint venture was] operating for charitable purposes and not for private benefit” such that the nonprofit’s exempt status would not be threatened.³²⁵ However, scholars argue that Revenue Ruling 2004-51 did not explicitly define the application of the private benefit standard for ancillary joint ventures as anticipated.³²⁶ Consequently, practitioners are left with the task of interpreting private benefit law in view of their own particular circumstances and without a clearly defined doctrine.³²⁷

At least one scholar, Professor John Colombo, has attempted to provide a better understanding of the private benefit doctrine’s contours.³²⁸ Colombo suggests that the problem lies in the doctrine’s lack of a theoretical grounding by which to set its boundaries.³²⁹ In an effort to define the doctrine’s outer limits, Colombo examines the policy aspects behind the doctrine, pointing out that the historical use of the private benefit doctrine, as derived from the operational test for exemption, has been “to identify whether a charity was actually engaged in a charitable purpose at all.”³³⁰ In other words, the whole reason nonprofits are granted exempt status is because their primary purpose is to pursue charity, and the private benefit doctrine serves to ensure that reality.³³¹

Colombo observes that the rise of joint ventures between nonprofits and for-profits caused the IRS to use the private benefit doctrine with greater frequency in evaluating whether an exempt organization had become a “for-profit in disguise.”³³² The IRS expanded the use of the doctrine to ensure that charity had not become secondary to private interests.³³³ Colombo notes that the development of the doctrine, through additional IRS rulings and judicial approval, demonstrated that a problem exists “even when [the] charitable purpose[] might globally outweigh a private benefit transaction.”³³⁴ He suggests that since the IRS does not use the private benefit doctrine as simply a substitute for the primary purpose test, there must be a more useful explanation for the doctrine’s broad scope.³³⁵

324. Streckfus, *supra* note 320, at 327 (quoting Judy Kindell, Senior Technical Adviser to the Director of the I.R.S., Remarks at the American Health Lawyers Association: Annual Tax Program (Oct. 21, 2004)).

325. *Id.*

326. Colombo, *supra* note 212, at 1078.

327. *See id.* at 1065 (stating that nonprofits are left “completely at sea” and “no one even knows what to balance” under the private benefit balancing test); Streckfus, *supra* note 320, at 328 (observing that “practitioners are on their own in interpreting the law to their particular facts”).

328. Colombo, *supra* note 212, at 1080–90.

329. *Id.* at 1080.

330. *Id.* at 1081. In contrast to the doctrine’s historical use, the operational test for exemption is described in section 1.501(c)(3)-1(d)(1)(ii) of the Treasury Regulations. Additionally, for a detailed discussion of the policy aspects behind the private benefit doctrine, see *id.* at 1080–90.

331. *Id.*

332. *Id.* at 1082 (quoting Burton A. Weisbrod, *The Nonprofit Mission and Its Financing: Growing Links Between Nonprofits and the Rest of the Economy*, in *TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR* 1, 11 (Burton A. Weisbrod ed., 1998)).

333. *Id.*

334. *Id.* at 1083.

335. *Id.*

Continuing with his analysis of the private benefit doctrine's boundaries, Colombo identifies a more promising basis for its use as a separate requirement for exemption.³³⁶ The key, he argues, lies in the limitation of the private inurement prohibition.³³⁷ That is, there must be a way for the IRS to account for a nonprofit's diversion of assets to an outsider, rather than an insider, at less than fair market value.³³⁸ Colombo describes this possibility as a "failure to conserve assets for the benefit of the charitable class."³³⁹ The main concern in this situation is protecting against the "unnecessary outflow of assets to non-charitable interests."³⁴⁰ Colombo asserts that because this problem is not covered by the primary purpose test or the inurement prohibition, it provides a sound justification for the use of a separate private benefit test.³⁴¹

Using this "failure to conserve" rationale, Colombo offers his own version of a doctrinal test for private benefit. He asserts that

private benefit analysis should come into play primarily when a charity contracts with a for-profit entity for core services—that is, in situations in which an exempt entity outsources the delivery of core services to its charitable class, or situations in which the exempt entity enters into an economic arrangement with a for-profit involving core services and the arrangement arguably grants a competitive advantage to the for-profit.³⁴²

It is these types of situations that generate a legitimate suspicion as to whether the charitable purpose is being pursued in the most efficient manner.³⁴³ Colombo recommends, however, that it is important to allow the nonprofit the opportunity to provide a "reasonable justification" that such an arrangement is in fact a "better" way of achieving its charitable purposes.³⁴⁴

Despite the seeming disappearance of the private benefit analysis in Revenue Ruling 2004-51,³⁴⁵ the doctrine continues to be a major IRS enforcement tool and must still be accounted for when nonprofits engage with for-profits.³⁴⁶ An important fact to keep in mind, though, is that none of the private benefit rulings and cases involved a private foundation making a program-related investment and exercising expenditure responsibility. It is not clear how much control of the L3C's operations, if any, the IRS would require of a private foundation in order to maintain its exempt status. However, it is likely that the L3C's activities will be attributed to a private foundation for purposes of evaluating its continued exempt status because of the fact that the L3C is

336. *Id.* at 1083–84.

337. *See id.* at 1083.

338. *Id.* at 1084.

339. *Id.*

340. *Id.* at 1085.

341. *Id.* at 1088.

342. *Id.* at 1089.

343. *Id.*

344. *Id.*

345. Rev. Rul. 2004-51, 2004-1 C.B. 974.

346. *See* Colombo, *supra* note 212, at 1079–80 (describing the IRS's recent use of the private benefit doctrine in the credit counseling and down-payment assistance contexts).

treated as a partnership for federal income tax purposes.³⁴⁷ Therefore, since the tranching investment structure calls for the involvement of for-profit investors obtaining a rate of return higher than that received by the private foundation, the foundation's participation in the L3C is ripe for private benefit analysis.³⁴⁸

E. Critics of the L3C Identify the Tranching Investment Structure as a Risk to a Foundation's Exempt Status

Critics of the L3C model argue that foundations that make PRIs in the high-risk, low-return tranche are in danger of losing their exempt status.³⁴⁹ Two of these critics argue that by making such a PRI, a foundation may violate the private inurement rule.³⁵⁰ One critic, Professor Carter Bishop, specifically argues that the foundation would be "undercharging for the use of its capital."³⁵¹ Because the PRI's low return would not be proportionate to the high risk involved, Bishop asserts that the situation "raises the specter of impropriety regarding whether the foundation is allowing its assets to be used to inure private benefit to the commercial or market tranche in the L3C."³⁵² Similarly, Professor Daniel Kleinberger argues that "the investing foundation risks being seen as benefitting—even as a side effect—substantial numbers of individuals distinct from the foundation's purpose."³⁵³ Kleinberger further claims that "the foundation's benevolent purpose will not save it from a private inurement problem."³⁵⁴

In a joint article published as part of a recent symposium at Vermont Law School, attorney J. William Callison and Professor Allan Vestal argue that the risk to a foundation's exempt status is posed by the private benefit doctrine.³⁵⁵ Callison and Vestal consider the private benefit doctrine to be "problematic when a private foundation invests in a venture with profit-seeking participants, particularly when the foundation takes a high-risk, low-return position relative to the investors."³⁵⁶ Continuing, they suggest that "L3Cs have been marketed as a device to encourage this tranching-type investment and are therefore suspect."³⁵⁷ Their article stops short of a

347. See Lane, *supra* note 57, at 4 (explaining that L3Cs are taxed as partnerships); Rev. Rul. 2004-51, 2004-1 C.B. 974, 976 (explaining that the activities of an LLC taxed as a partnership are attributed to the exempt organization for purposes of evaluating its exempt status).

348. See *infra* Parts III.B and III.C for a discussion of the private benefit doctrine as applied to the L3C's tranching investment structure.

349. E.g., Bishop, *supra* note 194, at 265-67; Callison & Vestal, *supra* note 170, at 292; Daniel S. Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 893 (2010).

350. Bishop, *supra* note 194, at 265-67; Kleinberger, *supra* note 349, at 893.

351. Bishop, *supra* note 194, at 265.

352. *Id.*

353. Kleinberger, *supra* note 349, at 893.

354. *Id.*

355. Callison & Vestal, *supra* note 170, at 292. It appears that Kleinberger has also recently joined in an argument that PRIs in L3Cs amount to a per se violation of the private benefit doctrine. See E-mail from Marcus S. Owens et al. to Willard L. Boyd et al., *supra* note 163.

356. Callison & Vestal, *supra* note 170, at 292.

357. *Id.*

full private benefit analysis, noting that their purpose is simply to point out the problem.³⁵⁸

III. DISCUSSION

This Comment argues that the IRS should apply the private benefit doctrine in a manner that will allow for private foundations to make PRIs in hybrids such as L3Cs. The argument is broken into three parts. The first part briefly discusses why the private inurement restriction should be inapplicable to foundations that make PRIs in L3Cs, and shifts the focus to private benefit. Second, this Comment examines the degree of overlap between the expenditure responsibility rules and the private benefit control standard and argues that, due to strong functional equivalency, a foundation can satisfy the control mandate by simply exercising the necessary expenditure responsibility for PRIs. Third, this Comment argues that the IRS should view the private benefit received by the market investors in L3Cs as a necessary cost in the progression toward a more efficient charitable sector. In other words, the outflow of forgone profit from foundations to private investors should not be considered an impermissible private benefit. Rather, this private benefit should be viewed as the cost of doing “better.”

The focus of this Comment is limited to private benefit issues and does not attempt to provide a new solution to the specific subject of PRI validity in L3Cs. The resolution of the legal problems associated with PRIs is left to other scholars. As an aside, though, PRIs deserve a brief preliminary discussion. If Congress were to amend the Code to provide a PRI presumption for L3Cs, one of the most significant hurdles would surely be eliminated for foundations. However, the chances of this happening in the near future are low.³⁵⁹

As prior private letter rulings illustrate, it is possible for a private foundation to make a PRI in a for-profit company that provides a return to both the foundation and to private investors without facing adverse consequences from the IRS.³⁶⁰ When a private foundation makes a PRI in a hybrid entity, the foundation must exercise expenditure responsibility with respect to that investment to ensure its continued status as a PRI and to avoid the jeopardy investment penalties.³⁶¹ Furthermore, it is not necessary for foundations to obtain a letter ruling approving a PRI in advance.³⁶² Accordingly, the proposed federal legislation³⁶³ is not an essential prerequisite for foundations to make

358. *Id.* Callison and Vestal go even further in their criticism of the L3C, asserting that “L3Cs can produce positive harm” and calling the L3C an “illusion.” *Id.* at 293. These arguments are not within the scope of this Comment.

359. See G. Ann Baker, *Did You Know?: Low-Profit Limited Liability Company Legislation*, MICH. BUS. L.J., Summer 2009, at 5, 6 (“We are committed to strengthening charities and philanthropy. However, we have not had any hearings on [the PRI presumption for L3Cs] and do not think that it is ripe for federal legislation.” (quoting the Senate Finance Committee)).

360. See *supra* Part II.B.3 for a discussion of private letter rulings approving PRIs in for-profit entities.

361. See *supra* Parts II.B.1–2 for a discussion of the jeopardy investment exception for program-related investments and the expenditure responsibility requirements.

362. See Lang, *supra* note 80, at 1 (“[T]here is not now and never has been any requirement in either federal law or IRS regulation that specifies that a foundation must get the approval of the IRS in any way, shape, or form before making a PRI.”).

363. Philanthropic Facilitation Act of 2010, *supra* note 173.

PRI in L3Cs, since they are already a real possibility under current law. Thus, this Part of the Comment explores what risks, if any, foundations may face beyond the jeopardy investment penalties when making PRIs in L3Cs.

A. *Why Private Inurement Should Not Apply*

The initial criticism of the L3C's tranching investment structure was that private foundations are at risk of violating the private inurement rule and could lose their exempt status if they participate in the high-risk, low-return tranche.³⁶⁴ More recently, the threat to exempt status was presented within the scope of the private benefit doctrine.³⁶⁵ Both of these criticisms recognize an inherent problem for foundations making PRIs in L3Cs. The essential thrust of these criticisms is that solving or alleviating the difficulties that come with making PRIs is not enough for foundations to comfortably invest in hybrids such as L3Cs. Although this is true, the arguments posed by Bishop and Kleinberger focus on the wrong IRS enforcement tool. Therefore, the first step of my analysis is to shift the discussion away from private inurement and to clarify why the private benefit doctrine is the real concern for foundations, as identified by Callison and Vestal.

The reason why the private inurement prohibition should generally not apply in the L3C context is straightforward. The private investors in the L3C's market tranche will normally be considered "outsiders" because they lack direct influence over the foundation's affairs.³⁶⁶ It is well established that the inurement rule is designed to prevent an individual who is in a position of control over the foundation from siphoning off the foundation's assets or income for personal use.³⁶⁷ As long as there are no foundation insiders participating in the market tranche of an L3C funded by the same foundation's PRI, the insider designation should not apply and inurement should not be an issue.

In addition, the economic arrangement of the tranching investment structure is not the same type of insider transaction usually recognized to constitute inurement.³⁶⁸ The paradigm inurement transaction occurs when an exempt organization either pays more than fair market value to acquire property or services from, or charges less than fair market value when selling property or services to, an insider of the organization.³⁶⁹ Furthermore, it is possible that an ancillary joint venture between doctors and their affiliated hospital or professors and their universities could create inurement concerns.³⁷⁰ In these instances, the doctors and professors may qualify as insiders due

364. Bishop, *supra* note 194, at 265–67; Kleinberger, *supra* note 349, at 893.

365. Callison & Vestal, *supra* note 170, at 292.

366. See *United Cancer Council, Inc. v. Comm'r*, 165 F.3d 1173, 1176 (7th Cir. 1999) (stating that the test to determine insider status is functional and looks to the reality of an individual's control over the organization rather than to an individual's formal relationship to the organization); I.R.C. § 4958 (2006) (determining that disqualified individuals include those in a position to exercise substantial influence over the affairs of an organization).

367. Colombo, *supra* note 212, at 1067.

368. See *id.* at 1067–68 (noting that inurement concerns typically arise when insiders benefit "via non-arm's-length transactions" with exempt organizations).

369. *Id.* at 1068.

370. Streckfus, *supra* note 320, at 328.

to their relationships with their respective institutions and their abilities to acquire favorable terms in the joint venture.³⁷¹ In contrast, the private investors in the market tranche of the L3C have no position of influence over the foundation's affairs and are receiving a fair market rate of return on their capital investment.³⁷² Thus, the fundamental nature of the L3C's economic arrangement is distinguishable from the typical inurement transactions.

The limitation of the inurement rule to individuals possessing an "insider" relationship with the foundation is of crucial importance. If no such relationship exists, the IRS and courts will use the private benefit doctrine in place of the inurement restriction to determine a transaction's effect on the foundation's exempt status.³⁷³ This clarification is necessary to determine how a foundation should proceed, if at all, when considering a PRI in an L3C because each rule is defined with different standards.³⁷⁴ To avoid violating the inurement restriction, a foundation must only ensure that no individuals with personal or professional ties to the foundation take part in the market tranche of the L3C. Determining what a foundation must do to avoid a private benefit violation requires a more in-depth analysis of the prevailing law.³⁷⁵

B. Is Expenditure Responsibility the Functional Equivalent to the Private Benefit Control Standard?

The concept of control is dominant throughout the PRI and expenditure responsibility rules as well as the private benefit doctrine.³⁷⁶ The degree in which the expenditure responsibility requirements function as control mechanisms for PRIs could very well satisfy the necessary level of control that the IRS will require to avoid a private benefit violation. This Section evaluates the extent to which the control concepts of expenditure responsibility and private benefit overlap. The two main subjects of foundation control—purpose and operations—are evaluated with the goal of determining whether a foundation will need additional control measures in place to ensure its full compliance with the private benefit doctrine.

371. See *id.* (explaining that if hospitals and universities do not agree to such joint ventures, doctors and professors would start own their businesses, and institutions would lose significant revenue).

372. See *supra* notes 183–94 and accompanying text for a discussion of the L3C's tranching investment structure.

373. See *Am. Campaign Acad. v. Comm'r*, 92 T.C. 1053, 1069 (1989) (determining that a court must analyze the private benefit doctrine when there is an absence of inurement); Colombo, *supra* note 212, at 1073–74 (noting that the private inurement rule is limited to insiders whereas the private benefit doctrine is not).

374. See *supra* Part II.D.1 for a discussion of the differences between private benefit and private inurement.

375. An important point that should not be forgotten is that the private benefit doctrine is broader than and subsumes the prohibition on private inurement. *Am. Campaign Acad.*, 92 T.C. at 1068–69. This is important because if a foundation can satisfy the higher standards of the private benefit doctrine, then it will also satisfy the requirements of private inurement. *Id.*

376. See *supra* Parts II.B.2 and II.D.2 for a discussion of the expenditure responsibility rules and the control standard of the private benefit doctrine.

1. Identifying the Overlap

There are three general requirements of expenditure responsibility. A foundation must first perform a preinvestment inquiry to determine whether a reasonable man would be assured that the entity will use the PRI for the proper purposes.³⁷⁷ If this reasonableness standard is met, the foundation must then establish and follow a procedure with the entity that ensures the PRI is used for proper purposes.³⁷⁸ Third, the foundation must report the status of the PRI to the IRS.³⁷⁹

Although the first and third requirements are unique to expenditure responsibility, the second requirement contains significant overlap with the control standard of the private benefit doctrine. This requirement necessitates an agreement between the foundation and the PRI-recipient that gives the foundation ultimate control over how the PRI is used.³⁸⁰ The Regulations provide greater detail for how this is accomplished. The first step is to obtain a written commitment from the recipient that specifies the purpose of the investment.³⁸¹ This agreement must also state that the recipient will use the PRI for only this purpose, and the foundation must have sufficient monitoring tools in place to ensure that the recipient does not stray from the specified purpose.³⁸²

Under the private benefit doctrine, if an exempt organization has “an activity [that] serves both exempt and nonexempt purposes, the organization will be exempt only if the predominant motivation underlying the activity is an exempt purpose.”³⁸³ This primary purpose test requires that a foundation’s activities primarily achieve public good, rather than serve private interests.³⁸⁴

Putting these requirements side by side, it is clear that if a foundation ensures that its PRI is used primarily for an exempt purpose, then it will also comply with the private benefit doctrine.³⁸⁵ It is logical to infer, therefore, that if a foundation is able to satisfy its expenditure responsibility obligations, and if the PRI remains valid, then the foundation can also be certain that its exempt status will not be threatened under the private benefit doctrine.³⁸⁶ The next step is to determine how this dual compliance can be achieved.

377. Treas. Reg. § 53.4945-5(b)(2) (2010).

378. *Id.* § 53.4945-5(b)(4)(i)–(iv).

379. *Id.* § 53.4945-5(d).

380. *Id.* § 53.4945-5(b)(4)(i)–(iv).

381. *Id.* § 53.4945-5(b)(4).

382. *Id.* § 53.4945-5(b)(4)(i)–(iii).

383. I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987), 1987 GCM LEXIS 2, at *15.

384. Colombo, *supra* note 212, at 1081.

385. The expenditure responsibility rules and the private benefit doctrine are both designed to ensure that charity remains the primary purpose of an exempt organization’s investment activities with for-profit entities. *See* Treas. Reg. § 53.4945-5(b)(4)(i)–(iii) (stating that the expenditure responsibility rules were designed to make sure that PRI funds are used only for exempt purposes); I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987), 1987 GCM LEXIS 2, at *15 (stating that the private benefit doctrine requires exempt organizations’ activities to be motivated by charitable purposes).

386. *See supra* notes 136–39 and accompanying text for a discussion of how a foundation satisfied the expenditure responsibility requirements when making a PRI in a for-profit entity without any private benefit concerns from the IRS.

2. The Essential Control Mechanisms

It is useful to examine how foundations have been able to satisfy the expenditure responsibility rules and compare their methods to those required by the IRS in the private benefit law of joint ventures. Of specific importance are the various oversight mechanisms that charities and foundations have put in place to ensure that their investments have been used for charitable purposes.

The IRS has approved PRIs in for-profit ventures that are similar to the L3C. Each letter ruling involved a foundation that invested in a corporation or LLC with a mixed mission of profit and charity.³⁸⁷ The structure of each investment was very similar. To start, the foundation in each letter ruling made it clear to the IRS that the rates of return on their investments were lower than would be expected in the circumstances.³⁸⁸ This is also true for a foundation's PRI in an L3C.³⁸⁹ The key difference, however, is that neither of the PRIs discussed in the letter rulings involved the same type of tranching investment design of the L3C. Nonetheless, the comparison is helpful.

To satisfy their expenditure responsibility obligations, each foundation in the letter rulings had a system in place to monitor the PRI and control its ultimate direction.³⁹⁰ Both foundations drafted a special agreement with the PRI-recipient that granted the foundation special rights in the relationship.³⁹¹ Most importantly, each foundation reserved the right to make the final decision on any substantial variation in the use of the investment funds and on any action that would threaten the exempt status of the foundation.³⁹² This ultimate decision-making authority, coupled with the right to monitor the use of the PRI, gave each foundation effective control over all PRI-related activities. Thus, in each instance, the IRS concluded that the expenditure responsibility requirements had been met.³⁹³

In the joint venture line of private benefit rulings, the IRS described similar measures to ensure that joint ventures would maintain a primarily charitable purpose.³⁹⁴ The necessary level of operational control varies depending on whether the joint venture is the organization's sole activity or if it is an insubstantial part of its activities.³⁹⁵ The sole activity standard is governed by Revenue Ruling 98-15³⁹⁶ and

387. I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006); I.R.S. Priv. Ltr. Rul. 2001-36-026 (June 11, 2001).

388. I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006); I.R.S. Priv. Ltr. Rul. 2001-36-026 (June 11, 2001).

389. Woodrow & Davis, *supra* note 6, at 4.

390. I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006); I.R.S. Priv. Ltr. Rul. 2001-36-026 (June 11, 2001).

391. I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006); I.R.S. Priv. Ltr. Rul. 2001-36-026 (June 11, 2001).

392. See I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006) (noting that the foundation had final say on any action that would threaten its exempt status); I.R.S. Priv. Ltr. Rul. 2001-36-026 (June 11, 2001) (noting that the foundation's written approval was required for any substantial variation of its PRI).

393. I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006); I.R.S. Priv. Ltr. Rul. 2001-36-026 (June 11, 2001).

394. Rev. Rul. 98-15, 1998-1 C.B. 718; Rev. Rul. 2004-51, 2004-1 C.B. 974.

395. See *supra* Part II.D.3 for a discussion of the private benefit revenue rulings issued on joint ventures between exempt organizations and for-profits.

Redlands Surgical Services v. Commissioner.³⁹⁷ The IRS and the courts are in agreement that when a charitable organization forms a joint venture with a for-profit and contributes all of its assets to that joint venture, the charitable organization must control the entity's operations to the point that guarantees charity will take priority over profit.³⁹⁸

The IRS specifically provided that the best way to accomplish this level of control is for the charitable organization to have majority voting power.³⁹⁹ Furthermore, the governing documents of the joint venture must state that when a conflict exists between achieving charity and maximizing profit, the board will act in furtherance of the charitable mission.⁴⁰⁰ If these mechanisms are not in place, the IRS and courts will conclude that the joint venture impermissibly benefits private interests and the organization's exempt status will be in danger.⁴⁰¹

Only the IRS has addressed the situation where the joint venture is an insubstantial part of the charity's activities.⁴⁰² Here, the standard of control is less clear.⁴⁰³ All that was required of the charitable organization was control over the charitable aspects of the joint venture.⁴⁰⁴ The for-profit partner had exclusive control over business operations, but all transactions were to be at fair market value and no action could be taken that would threaten the charitable organization's exempt status.⁴⁰⁵ Interestingly, the charitable organization did not have majority voting control, but the IRS still concluded that this situation would not affect the organization's exemption.⁴⁰⁶ Despite the absence of express private benefit reasoning, Revenue Ruling 2004-51 is still enlightening because an IRS employee who contributed to the drafting of the ruling has stated that the ruling was intended to show the amount of control that would be necessary in an ancillary joint venture.⁴⁰⁷

Because PRIs normally involve a low percentage of a foundation's assets, a PRI in an L3C would most likely be considered an insubstantial part of the foundation's

396. Rev. Rul. 98-15, 1998-1 C.B. 718, 719-20.

397. 113 T.C. 47 (1999), *aff'd per curiam*, 242 F.3d 904 (9th Cir. 2001).

398. See *supra* notes 281-300 and accompanying text for a discussion of the private benefit doctrine's "sole activity" standard for joint ventures.

399. See Rev. Rul. 98-15, 1998-1 C.B. 718, 721 (concluding that a hospital retains its exempt status with majority voting power but loses its exempt status when voting power is split with a for-profit partner).

400. See *id.* (concluding that a hospital retains its exempt status when the governing documents provide that the conflict between profit and charity is resolved in favor of charity, and a hospital loses its exempt status when the governing documents are silent on such conflict).

401. See *id.* (finding that a hospital without majority voting power in a joint venture with a for-profit will lose its exempt status); *Redlands Surgical Servs. v. Comm'r*, 113 T.C. 47, 78 (1999) (same).

402. Rev. Rul. 2004-51, 2004-1 C.B. 974, 974.

403. Colombo, *supra* note 212, at 1065 (stating that nonprofits are left "completely at sea" and "no one even knows what to balance" in the context of ancillary joint ventures); Streckfus, *supra* note 320, at 328 (observing that "practitioners are on their own in interpreting the law to their particular facts").

404. Rev. Rul. 2004-51, 2004-1 C.B. 974, 976.

405. *Id.* at 975.

406. *Id.* at 975-76.

407. Streckfus, *supra* note 320, at 327 (quoting an IRS employee who stated that the ruling was intended to demonstrate the necessary level of control "to ensure [the joint venture was] operating for charitable purposes and not for private benefit").

activities.⁴⁰⁸ Accordingly, Revenue Ruling 2004-51 is the most analogous private benefit authority, evidencing that the IRS would likely require the foundation to have exclusive control over the charitable aspects of its PRI.⁴⁰⁹ However, the sole activity standard may still be relevant because foundations do not usually operate their own charitable programs.⁴¹⁰ Therefore, it is possible that the IRS could apply the sole activity standard to PRIs in L3Cs because it could very well be the sole activity of the foundation.⁴¹¹ This possibility is not too farfetched given the already unpredictable nature of the private benefit doctrine.

3. Expenditure Responsibility is the Only Control Necessary

Having identified the overlapping elements, it appears that the control mandate of the private benefit doctrine can be satisfied by simply following the necessary expenditure responsibility rules. As a result, foundations should not be concerned with the need to undertake additional safeguards to protect their exempt status when making a PRI in an L3C. The terms of the L3C's operating agreement should set forth specific rights for the foundation that is contributing the PRI. These rights can serve the same function as the special agreements that were negotiated by the foundations in the private letter rulings and should define the foundation's role in the operations of the L3C in a way that will meet the private benefit doctrine's standard of control.

While the details of these agreements will be tailored to the particular circumstances of each L3C, it is important that each agreement grant the foundation ultimate decision-making authority for the use of its PRI.⁴¹² The foundation need not micro-manage the daily operations of the L3C to satisfy the private benefit control standard.⁴¹³ Theoretically, the expenditure responsibility agreement will preclude the L3C from engaging in any activity that will threaten a foundation's exempt status.⁴¹⁴ This essentially provides the foundation with contractual control over its PRI, which should be sufficient to avoid a private benefit violation. However, clarity is still lacking as to whether the IRS will require some level of board voting power, regardless of this

408. Compare Rev. Rul. 2004-51, 2004-1 C.B. 974, 975 (stating that when an exempt organization "contributes a *portion* of its assets to and conducts a *portion* of its activities through" a joint venture, it is considered an "insubstantial part" of the organization's activities (emphasis added)), with Woodrow & Davis, *supra* note 6, at 4-5 (noting that PRIs satisfy foundations' *five percent* minimum payout requirement and that the model tranching investment structure of an L3C includes a twenty-five percent start-up investment from a foundation).

409. See Rev. Rul. 2004-51, 2004-1 C.B. 974, 976 (concluding that an exempt organization must have exclusive control over the charitable activities of an ancillary joint venture to maintain exempt status, but majority voting power is unnecessary).

410. See HOPKINS, *supra* note 25, § 12.1, at 352 (explaining that, instead of running their own charitable programs, foundations typically make grants to other persons or entities).

411. See *supra* notes 281-300 and accompanying text for a discussion of the "sole activity" standard of control under the private benefit doctrine.

412. See I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006) (validating a PRI when the foundation retained final say on all PRI-related activities); I.R.S. Priv. Ltr. Rul. 2001-36-026 (June 11, 2001) (same).

413. See Rev. Rul. 2004-51, 2004-1 C.B. 974, 976 (concluding that an active role in the business operations of a joint venture is not necessary for an organization to protect its exempt status).

414. See *supra* Part II.B.2 for a discussion of how the expenditure responsibility rules limit the activities of PRI recipients.

contractual control.⁴¹⁵ In any case, the existence of an expenditure responsibility agreement and the level of control it provides would arguably make it unnecessary for a foundation to secure the additional protection afforded by majority voting power, if any at all, on an L3C's board of directors.⁴¹⁶

It is imperative, therefore, for the IRS to issue a revenue ruling clarifying the interplay between expenditure responsibility and the control standard of the private benefit doctrine. This Comment proposes that as long as the purpose of the PRI is clearly specified from the outset, the foundation remains informed of how the funds are spent, and the foundation retains final say on any PRI activity that could jeopardize its exempt status, then there should be a sufficient degree of control to satisfy both the expenditure responsibility obligations and the private benefit doctrine. Furthermore, because the L3C distinguishes itself from other legal entities by requiring a charitable purpose in its organizing documents, the IRS should recognize it as a preferred governing structure for mixed-mission enterprises.

C. The L3C's Tranched Investment Structure Should Be Viewed As a Permissible Private Benefit that Does Not Threaten a Foundation's Exempt Status

Aside from analyzing and comparing the necessary component parts of expenditure responsibility and the private benefit control standard, it is important to consider whether the L3C's tranched investment structure amounts to a per se violation of the private benefit doctrine. The starting point of this analysis is the original balancing test,⁴¹⁷ which is essentially the IRS's official definition of the private benefit doctrine.⁴¹⁸ The purpose of the balancing test is to ensure that charitable organizations operate primarily to serve the public good.⁴¹⁹ The IRS recognizes that charitable operations will sometimes generate private benefits, but these private benefits must be incidental both qualitatively and quantitatively.⁴²⁰ Through the lens of this balancing test, this Section argues that the L3C's conferral of a private benefit should be viewed as "incidental," given that the tranched investment structure is designed to solve the broader problem of inefficiency within the charitable sector as a whole.⁴²¹

The historical purpose of the private benefit doctrine is to ensure that the primary purpose of an exempt organization is the pursuit of charity.⁴²² The IRS created a

415. *Cf.* Rev. Rul. 2004-51, 2004-1 C.B. 974, 976 (finding that a charity that retains half of a joint venture's board voting power is sufficient to maintain exempt status when it is not the exempt organization's sole activity).

416. *Cf. id.* (finding that majority voting power is not required when the joint venture is only an insubstantial part of the foundation's activities).

417. I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987), 1987 GCM LEXIS 2, at *15-16.

418. Colombo, *supra* note 212, at 1064-65.

419. *Id.* at 1081.

420. I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987), 1987 GCM LEXIS 2, at *15.

421. *See generally* Letts et al., *supra* note 15 (discussing the inefficiencies of the charitable sector); Kramer, *supra* note 1 (same). The debate concerning whether a PRI in an L3C confers impermissible private benefit, or merely "incidental" (and therefore permissible) private benefit, has recently been casually circulated in the nonprofit community. *See* E-mail from Marcus S. Owens et al. to Willard L. Boyd III et al., *supra* note 163.

422. Colombo, *supra* note 212, at 1081.

balancing test to serve as its analytical tool for the doctrine.⁴²³ The test requires that when a charitable activity provides both public and private benefits, the private benefit must be necessary to accomplish the charitable goal and must not be substantial after considering the overall public benefits that result from the activity.⁴²⁴ The “balancing” is essentially the comparison of private and public benefits that the activity confers.⁴²⁵

In over two decades since the IRS originally fashioned this test, both courts and the IRS have yet to provide adequate guidance in establishing the test’s requirements while simultaneously expanding the scope of the test’s use.⁴²⁶ Just two years after the test’s creation came the judicially created distinction between “primary” and “secondary” private benefits,⁴²⁷ a concept “not previously or subsequently articulated.”⁴²⁸ Moreover, in response to the rise of joint ventures between nonprofits and for-profits, the IRS expanded the doctrine to the point where it now endangers exempt status, even if the overall public benefit of an organization’s activity outweighs the private benefit it confers.⁴²⁹ With the outer boundaries of the private benefit doctrine seemingly limitless, it is uncertain how the IRS will approach foundation involvement in the L3C’s tranced investment structure from a private benefit standpoint.⁴³⁰

A recent attempt by Professor John Colombo to provide a sensible grounding for the expansive private benefit doctrine offers helpful analytical guidance in approaching this uncharted territory.⁴³¹ Colombo’s essential argument is that the private benefit doctrine is a test of efficiency, designed to protect against the “unnecessary outflow of assets to non-charitable interests.”⁴³² When a charitable activity results in unnecessary private benefit, there is a legitimate suspicion that the charitable organization is “fail[ing] to conserve assets” for the charitable class it alleges to serve.⁴³³ This suspicion will most often arise when an exempt organization “outsources”⁴³⁴ its charitable activities to a for-profit entity or when a for-profit entity gains a competitive

423. I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987), 1987 GCM LEXIS 2, at *15–16.

424. *Id.*

425. Colombo, *supra* note 212, at 1074.

426. *See, e.g., id.* at 1065 (stating that nonprofits are left “completely at sea” and “no one even knows what to balance” under the test); Streckfus, *supra* note 320, at 328 (observing that, post-Revenue Ruling 2004-51, “practitioners are on their own in interpreting the law to their particular facts”).

427. *Am. Campaign Acad. v. Comm’r*, 92 T.C. 1053, 1074–76 (1989). *See supra* Part II.D.2 for a discussion of *American Campaign Academy* and its effect on the private benefit doctrine.

428. HOPKINS, *supra* note 25, § 20.11, at 600.

429. Colombo, *supra* note 212, at 1083.

430. *See HOPKINS, supra* note 25, § 20.11, at 601 (describing the IRS’s application of the private benefit doctrine to the private foundation setting as the “most striking recent example” of the doctrine’s expanded scope).

431. *See generally* Colombo, *supra* note 212, 1083–90.

432. *Id.* at 1085, 1089.

433. *Id.* at 1084, 1089.

434. The L3C could be seen as a way for foundations to “outsource” their charitable activities. The distinguishing factor is that foundations do not normally operate their own charitable programs. HOPKINS, *supra* note 25, § 12.1, at 352. Their main purpose is to provide grants (or PRIs) to other charitable organizations that actually deliver the charitable programs. *Id.* In this sense, then, the foundation is merely switching its funding to a different operator.

advantage⁴³⁵ from its economic relationship with the exempt entity.⁴³⁶ Importantly, Colombo's efficiency rationale allows for the possibility that untraditional arrangements between nonprofits and for-profits may, with "reasonable justification," be the "better" way of accomplishing the charitable goal.⁴³⁷

This efficiency rationale gives a much-needed gloss to the IRS's balancing test, and its application to the L3C's tranced investment structure tends to favor a positive outcome for foundations. To be a qualitative incidental benefit, the benefit received by the market investors must be a necessary concomitant of the L3C's charitable purpose.⁴³⁸ In other words, the "outflow" of forgone profit from the foundation that is used to provide a higher rate of return for market investors must be necessary to accomplish the charitable mission.⁴³⁹

The key to the L3C model is the ability to combine capital from both the charitable and the private sectors. The only way to get capital from the private sector is to provide a market return.⁴⁴⁰ Under normal circumstances, the private sector is unlikely to invest in a socially motivated business because the return is too low and the risk is too high.⁴⁴¹ The L3C model is designed to use a foundation PRI to leverage capital from the private sector by laying off the lowest return and highest risk to the foundation.⁴⁴² Without the outflow of profit from the foundation to the private investors, the L3C model will not work and many social entrepreneurs will be denied the opportunity to provide a public benefit.⁴⁴³ Therefore, it is reasonable to conclude that the private benefit in this instance is necessary.⁴⁴⁴

435. The "competitive advantage" concern might not be relevant for L3Cs. The market investors would essentially be getting the same return they could get anywhere else on the market. As long as the market investors take on a comparable risk to other market investments, then there is not likely to be an investment advantage. In fact, the private investors are probably taking on more risk than in normal circumstances due to limited exit options. *See* Kleinberger, *supra* note 349, at 902 (describing the problem of "exit rights" in businesses that are not publicly traded). *But see* Lang *supra* note 77, at 258 (describing the possibility of a market for L3C securities that would provide private investors with an exit strategy).

436. Colombo, *supra* note 212, at 1089.

437. *Id.*

438. I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987), 1987 GCM LEXIS 2, at *15.

439. *See id.* (stating that the private benefit must be necessary to accomplish the charitable goal).

440. *See* Lane, *supra* note 57, at 2 (indicating that private investors will not normally support a social venture without a market rate of return).

441. *See* Woodrow & Davis, *supra* note 6, at 4 ("There [is] a whole portion of the for-profit sector which, while self-sustaining, produce[] too low a profit to induce normal for-profit investors to engage on their own.").

442. *Id.*

443. *See* Lane, *supra* note 57, at 2 ("By taking on higher risk and forgoing market-rate returns, the foundation affords the L3C the opportunity to attract private-sector investment which otherwise might never support a social venture.").

444. A good comparison can be made to the private letter ruling involving the angel investment fund and professional athletes. I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006). The private foundation specifically represented to the IRS that the fund would not be able to exist and provide a social benefit without the foundation's capital commitment and involvement. *Id.* at 5-7. Although compliance with the private benefit doctrine was not a requested ruling, it appears that the IRS implicitly recognized the necessity of the private benefit in its analysis. The main difference is that everyone in the angel investment fund received the same rate of return, whereas the private investors in the L3C would be getting a higher rate of return than the foundation.

The quantitative incidental benefit prong is more difficult to evaluate.⁴⁴⁵ To be incidental, the private benefit must not be “substantial” when taking into account the overall public benefit that is achieved by the activity.⁴⁴⁶ Again, the clarity of this balancing test is lacking.⁴⁴⁷ If an L3C is successful and is able to provide a market return to the private investors, then the private benefit can be measured with a numerical value. But how does one measure the public benefit? Can the value of a charitable activity be measured in numerical terms?

A possible solution to this problem is to consider the observation that the nonprofit sector as a whole is struggling to accomplish social missions in an efficient manner.⁴⁴⁸ To change this current landscape and improve efficiency, the L3C model is designed to combine charity and business in a “self-sufficient, profit-making venture.”⁴⁴⁹ Maybe the best way to solve the social problems of the modern world is through the use of hybrid entities such as the L3C. Under this view, the public benefit of providing more efficient charity would surely outweigh the private benefit of a market return on an investment.

The IRS should find it difficult to deny that using PRIs to facilitate the tranching investment structure is a reasonably justified and better way for foundations to satisfy their annual distribution requirement.⁴⁵⁰ Because the L3C model maintains charity as its primary goal, the danger of foundations becoming “for-profit[s] in disguise”⁴⁵¹ and the need for private benefit policing are both low.⁴⁵² As long as charity is actually accomplished, there is no apparent reason to deny foundations the opportunity to supply a crucial source of funding for the social enterprise movement. The IRS should foster the effort to provide more sustainable charity by issuing a revenue ruling on the exemption implications for foundations that make PRIs in L3Cs. In this ruling, the IRS should conclude that the private benefit doctrine does not threaten the exempt status of foundations because the public will be better off, regardless of the profit earned in the process.

445. The IRS has stated, “[t]o be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.” I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987), 1987 GCM LEXIS 2, at *16.

446. *Id.*

447. See Colombo, *supra* note 212, at 1065 (stating that nonprofits are left “completely at sea” and “no one even knows what to balance” under the test).

448. See generally Letts et al., *supra* note 15; Kramer, *supra* note 1.

449. Lang, *supra* note 77, at 253; see also Woodrow & Davis, *supra* note 6, at 4 (noting that the L3C was developed “as a self-sustaining means to achieve a social mission at the lowest possible cost and with the greatest efficiency”).

450. See *supra* notes 42–48 and accompanying text for a discussion of the inefficiencies of traditional private foundation grantmaking strategies.

451. Colombo, *supra* note 212, at 1082 (quoting Burton A. Weisbrod, *The Nonprofit Mission and its Financing: Growing Links Between Nonprofits and the Rest of the Economy*, in *TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR* 1, 11 (Burton A. Weisbrod ed., 1998)).

452. See *id.* at 1081–82 (positing that one of the expanded private benefit doctrine’s motives is to ensure that a charitable organization primarily serves charitable purposes rather than private interests).

IV. CONCLUSION

Social enterprise is a recent development that strives to solve the capital formation problems faced by the nonprofit sector by incorporating the incentives found in for-profit business models. The participation of exempt organizations in the movement is a subject that has not yet experienced extensive IRS analysis.⁴⁵³ There is a need for clarity on the issue of private benefit and its effect on a foundation's exempt status. If the IRS imposes a high standard of control reminiscent of the whole-entity line of joint venture cases and rulings,⁴⁵⁴ foundations will face a difficult oversight burden that they will be unlikely to embrace.⁴⁵⁵ If the IRS instead requires a standard of control equivalent to that of an ancillary joint venture,⁴⁵⁶ foundations will be left with little to no guidance on how to avoid a loss of exempt status.⁴⁵⁷

To provide clarity and promote more efficient charity, the IRS should view the benefit received by the for-profit investors in the high-return tranche of the L3C's investment structure as a necessary outflow of foundation assets. Moreover, the IRS should recognize that the expenditure responsibility requirements imposed on foundations when making PRIs serve the equivalent function of the private benefit doctrine's control standard in ensuring that charity remains the primary purpose.

Without the ability to use a foundation's PRI to leverage the inherent risks associated with a socially motivated business plan, the L3C will find it challenging to raise enough capital to pursue its social mission in a sustainable and self-sufficient manner. As a result, the nonprofit sector will be left in its current position with inefficient, unsustainable, and low-impact charitable programs.⁴⁵⁸ The leveraging of foundation assets to provide a fair market return to private investors should be construed as the cost of doing "better," because the overall public good that results outweighs the benefit conferred to private investors.

453. See Bishop, *supra* note 194, at 264 ("Given the novelty of the L3C in general and tranche investing specifically, these questions are yet unanswered, and general guidance is sought from related authorities.").

454. See *supra* notes 281–300 and accompanying text for a discussion of the private benefit control standard that the IRS applies to whole-entity joint ventures.

455. See HOPKINS, *supra* note 25, § 12.1, at 352 (noting that private foundations typically do not operate their own charitable programs).

456. See *supra* notes 301–17 and accompanying text for a discussion of the private benefit control standard for ancillary joint ventures.

457. See *supra* Part II.D.4 for a discussion of the uncertain state of the private benefit doctrine as applied to ancillary joint ventures.

458. See Letts et al., *supra* note 15, at 36–37 (explaining the current problems nonprofits face in achieving charitable goals).