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Cassady V. Brewer

A NOVEL APPROACH TO USING LLCS FOR QUASI-CHARITABLE ENDEAVORS (A/K/A "SOCIAL ENTERPRISE")

Cassady V. ("Cass") Brewer†

† Assistant Professor, Georgia State University College of Law. The author thanks the following individuals who provided helpful comments to outlines and early drafts of this article: Professor Ronald Blasi, Elizabeth Minnigh, Allen Bromberger, and Robert Wexler. Any errors or omissions are entirely the responsibility of the author.

I. INTRODUCTION

"Social enterprise" is on the rise.[1] Many individuals today boast that they are "social entrepreneurs" running "social enterprises,"[2] yet there is no universally accepted legal meaning of the term "social enterprise."[3] Popularly defined, social enterprise means using traditional business methods to accomplish charitable or socially beneficial objectives. Social enterprise is quasi-charitable. It is a hybrid. It is neither entirely profit-driven nor entirely philanthropic. Social enterprise may be conducted by either for-profit organizations or nonprofit organizations. Rather than being defined by any particular type of legal entity or

1. *See* Adam Bluestein, *Six Ways to Save the World: A Practical Guide to Social Entrepreneurship*, INC. MAG., May 2011, at 71, 71.

2. A recent Internet search for the term "social enterprise" produced 24,000,000 hits, including a Wikipedia article. *See, e.g.*, *Social Enterprise*, WIKIPEDIA.COM, http://en.wikipedia.org/wiki/Social_enterprise (last visited Oct. 30, 2011). National organizations are emerging to support social enterprise. *See, e.g.*, SOC. ENTERPRISE ALLIANCE, https://www.se-alliance.org (last visited Oct. 30, 2011) (providing a range of services and information as a membership organization for social enterprises and related organizations); THE HUB, http://the-hub.net (last visited Oct. 30, 2011) (hosting the websites for twenty-six offices worldwide).

3. MARC J. LANE, SOCIAL ENTERPRISE: EMPOWERING MISSION-DRIVEN ENTREPRENEURS 1 (2011); Allen R. Bromberger, *A New Type of Hybrid*, STAN. SOC. INNOVATION REV., Spring 2011, at 49; Rosemary E. Fei, *A Guide to Social Enterprise Vehicles*, TAX'N EXEMPTS, Jan.–Feb. 2011, at 37, 37; Robert A. Wexler, *Effective Social Enterprise—A Menu of Legal Structures*, 63 EXEMPT ORG. TAX REV. 565, 565 (2009).

construct, a social enterprise is any organization that generates recurring revenue and that *coextensively* (not subordinately) benefits society at large.[4]

Because of their inherent contract-like flexibility, liability protection, and malleable tax treatment, limited liability companies are increasingly being used for social enterprise.[5] Another reason limited liability companies are better suited for social enterprise than other types of business organizations is that under the laws of most states, a limited liability company may have "any lawful purpose,"[6] including a charitable purpose. The virtually unlimited

4. *See* Linda O. Smiddy, *Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship*, 35 VT. L. REV. 3 (2010). This article does not attempt to define "social enterprise" any more than it might attempt to define what is "socially beneficial." Such precision is not important to this article's hypothesis. For a very lucid explanation, however, of what generally is meant by use of the term "social enterprise," see *id.* at 5–6. Professor Smiddy writes:

> The working definition . . . is that a social enterprise is one organized and operated for the dual purposes of engaging in profit-making activity and furthering a social good. The dual purposes must at least be co-equal. If they are not, then the balance between the two must weigh in favor of furthering the charitable goal. Yet, the balance must not be tipped so far that the profit-making activity is only incidental to serving eleemosynary objectives, with the company's revenues depending primarily on grants, PRIs, and private donations.
>
> Social enterprises therefore occupy the middle range of a continuum extending from the traditional for-profit company that only secondarily serves social purposes to the traditional charitable not-for-profit organization that serves social purposes exclusively and relies significantly on grants, donations, and PRIs for funding. Companies at either end of this spectrum are excluded from the definition of social enterprise. For example, many commercial enterprises are not social enterprises even though they donate to charity, provide health and pension benefits to their employees, and in other ways serve the communities in which they do business. In these cases, furthering a social good is secondary to advancing commercial objectives, although these companies may be good corporate citizens and although providing needed goods and services is a social benefit.
>
> This definition of social enterprise also excludes not-for-profit enterprises formed for the sole purpose of serving a social purpose and whose financial well being depends primarily on grants, PRIs, and private donations even if the organization occasionally engages in profit-making activities, as, for example, a library that sponsors book sales to raise money. However, a charitable organization engaging in significant profit-making activities to support and further its social mission would be considered a social enterprise.

Id. at 5–6.

5. Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 370–71 (2009).

6. Daniel S. Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on*

ability to create varying classes of membership interests with varying voting and economic rights also makes limited liability companies appealing for social enterprise.[7]

As additional evidence of this trend toward the use of limited liability companies for social enterprise, witness the promulgation of so-called "low-profit limited liability company," or "L3C," statutes since 2008. As of the date of publication of this article, nine states have enacted L3C legislation.[8] The L3C is a special type of limited liability company designed to facilitate the flow of both private and philanthropic capital to ventures that further a charitable or educational purpose but that may be profitable as well. Although an L3C is a for-profit entity and is neither tax-exempt nor eligible to receive tax-deductible charitable contributions, it is required by statute to have a primary purpose of furthering a charitable or educational mission and not maximizing profits. In this manner, the L3C is intended to encourage private foundations (as distinct from public charities)[9] to make certain expenditures that qualify as program-related investments, or "PRIs," under the Internal Revenue Code.[10] On the other hand, the L3C enjoys no special tax

the Low-Profit Limited Liability Company, 35 DEL. J. CORP. L. 879, 897 n.82 (2010) (quoting REVISED UNIF. LTD. LIAB. CO. ACT § 104(b) (2006)).

7. *See* Cassady V. Brewer & Michael J. Rhim, *Using the 'L3C' for Program-Related Investments*, TAX'N EXEMPTS, Nov.–Dec. 2009, at 11, 16.

8. CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 1.09[4][g] tbl.1.3 (1994 & Supp. 2011-1). *See generally* Bromberger, *supra* note 3, at 50 (explaining the purpose and utility of a "low-profit" limited liability company, or L3C). Rhode Island's L3C statute is not effective until July 1, 2012. 2011 R.I. Pub. Laws 11-079.

9. Organizations that are organized and operated exclusively for charitable, religious, educational, or other specified purposes are generally exempt from income tax under I.R.C. § 501(a) as organizations described in I.R.C. § 501(c)(3). I.R.C. § 509(a) divides I.R.C. § 501(c)(3) organizations into two subcategories: private foundations and organizations that are not private foundations, which are commonly known as public charities. To be categorized as a public charity and not a private foundation, an organization must be described in I.R.C. § 509(a). To be described in I.R.C. § 509(a)(1) or (2), an organization must receive a substantial amount of broad-based public support to fund its operations. I.R.C. § 509(a)(1) and (2) contain certain rules that test whether an organization's support is broad-based and therefore "public." To be described in I.R.C. § 509(a)(3), an organization must have a particular type of structural relationship with a publicly supported § 501(c)(3), (4), (5), or (6) organization. *See* I.R.C. § 509(a) (2011).

10. PRIs are special types of investments available to private foundations under narrow circumstances. *See* I.R.C. § 4944(c) (2011); Treas. Reg. § 53.4944-3 (2011). With respect to the L3C statutes, the precise language varies among the several states that have enacted legislation, but essentially, an L3C must meet the

status under federal law, and therefore many commentators argue that the L3C is no more useful in facilitating PRIs than an ordinary limited liability company.[11] Even though there is a fairly vigorous, ongoing debate about the usefulness of the L3C,[12] both the proponents and opponents generally recognize that PRIs are underutilized and that limited liability companies offer a unique opportunity to blend private and philanthropic dollars in a manner that is encouraged by the PRI rules.[13]

"B corporations" are another indicator of the rise of social enterprise. B corporations are for-profit business organizations that have been certified by B Lab (a Pennsylvania-based nonprofit organization), as serving social and environmental purposes, along with generating profits and shareholder value.[14] Put another way, a B corporation responds to the demands of stakeholders, not just shareholders, and stakeholders include employees, vendors, and the community at large, as well as shareholders. The phrase "doing well by doing good" often is overused, but in the case of B

same requirements that are imposed upon PRIs qualifying under I.R.C. § 4944(c): (1) the entity must "further the accomplishment of a charitable or educational purpose within the meaning I.R.C. § 170(c)(2)(B)"; (2) the entity "would not have been formed but for its relationship to the accomplishment of a charitable or educational purpose"; (3) the entity has no significant purpose of "the production of income or the appreciation of property"; and (4) the entity has no "political or legislative purpose within the meaning of I.R.C. § 170(c)(2)(D)." Brewer & Rhim, *supra* note 7, at 13; *see infra* Part IV.B (discussing PRIs in greater detail). *See generally* BISHOP & KLEINBERGER, *supra* note 8, ¶ 1.09[4][a] (discussing the L3C historical architecture).

11. BISHOP & KLEINBERGER, *supra* note 8, ¶ 1.09[4][f].

12. *Compare* Brewer & Rhim, *supra* note 7; Robert A. Katz & Antony Page, *The Role of Social Enterprise*, 35 VT. L. REV. 59 (2010); Kelley, *supra* note 5; Robert Lang & Elizabeth Carrott Minnigh, *The L3C, History, Basic Concept, and Legal Framework*, 35 VT. L. REV. 15 (2010); John Tyler, *Negating the Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117 (2010); *and* Wexler, *supra* note 3, *with* Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment By Proxy or Perversion?*, 63 ARK. L. REV. 243 (2010); J. William Callison, *L3Cs: Useless Gadgets*, BUS. L. TODAY, Nov.–Dec. 2009, *available at* http://apps.americanbar.org/buslaw/blt/2009-11-12/nonbindingopinions.shtml; 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 (2010); James Hines Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179 (2010); Kleinberger, *supra* note 6; *and* David Edward Spenard, *Panacea or Problem: A State Regulator's Perspective on the L3C Model*, 65 EXEMPT ORG. TAX REV. 131 (2010).

13. Luther M. Ragin, Jr., *Program-Related Investments in Practice*, 35 VT. L. REV. 53, 53 (2010).

14. *See About Certified B Corps*, CERTIFIED B CORP., http://www.bcorporation.net/about (last visited Oct. 30, 2011).

corporations, it perhaps fits.

To earn B corporation status, a business organization must achieve and maintain a certain score on a scale developed by B Lab.[15] Scoring is based upon numerous factors such as facilitating employee ownership, providing retirement and health plans, encouraging sustainability and other environmentally friendly practices, and serving the community.[16] B Lab monitors and audits its B corporations to ensure that they continue to meet the requirements for certification.[17] As the reader might suspect, in order to be certified, a B corporation must pay B Lab a yearly licensing fee calculated on the basis of the corporation's annual sales.[18]

B corporations generally do not have any special legal status. Rather, B corporation certification is more akin to a good business seal of approval. Furthermore, despite their name, B corporations are not confined strictly to state-law *corporations*. Limited liability companies (including L3Cs) and partnerships may qualify as "B corporations" as well.[19]

In addition, somewhat akin to B corporations, yet different because they are creatures of statute rather than license, "benefit" corporations recently have been authorized by a few states. In particular, a "benefit" corporation is not merely a unique brand of business, but instead is a state-law corporation with the following special features: (1) the corporation's charter specifies that it is formed to pursue a social purpose, (2) the corporation has at least one "benefit" director on its board who is charged with carrying out the corporation's mission without regard to profit, (3) the corporation is certified by an independent third-party agency as compliant with the agency's social benefit rating standards, and (4)

15. *See The B Impact Rating System*, CERTIFIED B CORP., http://www.bcorporation.net/become/BRS (follow "How are companies Certified and Audited as B Corporations?" hyperlink) (last visited Oct. 30, 2011).

16. *B Impact Assessment 2010 Version 2.0*, CERTIFIED B CORP. (2010), http://www.bcorporation.net/resources/bcorp/documents/2010-B-Impact-Assessment%20(1).pdf (providing an example of the factors that are important when rating manufacturing businesses with more than thirty employees where the factors may vary depending on the nature of the business completing the survey).

17. *The B Impact Rating System*, *supra* note 15.

18. *About Certified B Corps*, *supra* note 14; *Make It Official*, CERTIFIED B CORP., http://www.bcorporation.net/become/official (last visited Oct. 30, 2011); *see also* Wexler, *supra* note 3.

19. A limited liability company is hereinafter referred to in this article as an "LLC."

the corporation issues an annual report detailing its accomplishments with respect to fulfilling its social mission. If a benefit corporation meets the above requirements, then its directors are protected from liability for decisions that advance the corporation's social mission, even if such decisions sacrifice profit. Moreover, Maryland not only authorizes "benefit" corporations, but also authorizes "benefit" limited liability companies. "Benefit" limited liability companies essentially must meet the same special requirements as "benefit" corporations.[20]

Despite its potential, however, a single, free-standing LLC—even a beneficial LLC that simultaneously is a B corporation, or even an L3C that simultaneously is a B corporation—created to own and operate a social enterprise often does not meet all the legal-entity needs of the typical social entrepreneur.[21] The reason LLCs, L3Cs, B corporations, and benefit corporations alone do not meet these needs is because the typical social entrepreneur wants the tax and capital-raising advantages of both the for-profit and the nonprofit worlds. That is, like most other businesses, social entrepreneurs desperately need capital, but because of their hybrid nature, they generally cannot access normal financing sources.[22] Ordinary for-profit enterprises access capital through commercial loans and private investment. Nonprofit organizations can and do

20. As of the date of submission of this article for publication, six states reportedly have enacted beneficial corporation legislation: California, Hawaii, Maryland, New Jersey, Vermont, and Virginia. For additional information, see Maureen Gorsen, *California Governor Signs Bills Creating New Corporate Entity for Environmentally/Socially Responsible Companies,* LEXOLOGY.COM (Oct. 11, 2011), http://www.lexology.com/library/detail.aspx?g=2290373f-add9-4865-bbb4-1cce30dbff87&l=7FWRH05; *see also Senate Bill 595, An Act Concerning Corporations – Limited Liability Companies – Election to be a Benefit Corporation: Hearing on Senate Bill 595 Before the S. Judicial Proceedings Comm.*, (Md. 2011) (statement of Laura E. Jordan, Esq., The Capital Law Firm), *available at* http://www.montgomerycountymd.gov/content/ded/pdf/b-corp-testimony_Senate.pdf; *Benefit Corporation – Legal Provisions and FAQs*, CERTIFIED B CORP., http://www.bcorporation.net/resources/bcorp/documents/Benefit%20Corporation%20-%20Legal%20Provisions%20and%20FAQ.pdf (last visited Oct. 30, 2011).

21. *See generally* Bromberger, *supra* note 3; J. Haskell Murray & Edward I. Hwang, *Governance, Enforcement, and Capital-Raising in the Low-Profit Limited Liability Company*, 66 U. MIAMI L. REV. 601 (2011) (outlining the potential drawbacks a social entrepreneur may face in starting an LLC); Wexler, *supra* note 3 (discussing factors relevant to the choice of tax structure for a new legal enterprise).

22. Arthur Wood, *New Legal Structures to Address the Social Capital Famine*, 35 VT. L. REV. 45, 46 (2010) (noting the lack of financing options that allow organizations to move from the not-for-profit world into the for-profit world).

borrow money, but they do not permit private investment and, thus, rely upon grants and charitable contributions for much of their capital needs.[23] PRIs offer some hope to combine private and philanthropic dollars, but with the exception of a small number of sophisticated and relatively large private foundations, most private foundations will not undertake a PRI and prefer to engage in traditional grant-making to other charitable organizations. Thus, rather than being hybrids, social enterprises are orphans when it comes to ready sources of capital.[24]

Desperately in need of capital, a social entrepreneur therefore dreams about a legal vehicle that not only allows private ownership and investment, but one that also may receive private foundation grants and charitable contributions. Currently, there is no such legal entity.[25] LLCs and L3Cs are flexible but not flexible enough to completely blend within one entity the best attributes of both for-profit and nonprofit organizations. It is possible, though, to create a structure that makes use of multiple organizations acting in concert to achieve the goal of blending philanthropic and private dollars to fund a social enterprise. These multiple entity structures have been referred to as "contract hybrids."[26]

This article proposes one such novel "contract hybrid" for social enterprise. The "contract hybrid" described herein makes use of multiple LLCs to achieve, to the extent reasonably possible, the "best of both worlds" for a hypothetical social enterprise project. This new, unique structure relies heavily on the flexible nature of the LLC, particularly the LLC's ability to accommodate competing legal rights and duties among members with very diverse objectives. The "contract hybrid" described in this article also exploits the extraordinarily malleable nature of LLCs with respect to their income tax treatment. Finally, the keystone to the structure described herein is a relatively recent Internal Revenue

23. Bromberger, *supra* note 3, at 49.

24. This may change soon. In November 2010, J.P. Morgan released an extensive report entitled *Impact Investments: An Emerging Asset Class.* Nick O'Donohoe et al., *Impact Investments: An Emerging Asset Class*, J.P. MORGAN GLOBAL RES., Nov. 29, 2010, at 5, *available at* http://www.jpmorgan.com/cm/cs?pagename=JPM/DirectDoc&urlname=impact_investments_nov2010.pdf. Defining impact investments as investments that "create positive impact beyond financial return," the report further stated that due to the demands of its wealthy clients, "impact investing will reveal itself to be one of the most powerful changes within the asset management industry in the years to come." *Id.* at 13.

25. Bromberger, *supra* note 3, at 49.

26. *Id.*

Service information letter that permits private foundations to make grants directly to wholly owned LLC subsidiaries of public charities.[27]

This article proceeds in four parts. Part II sets forth a hypothetical social enterprise project in need of capital. Part III summarizes the principal advantages and disadvantages of using a nonprofit entity to pursue the project. Part IV summarizes the principal advantages and disadvantages of using a for-profit entity to pursue the project. Finally, Part V describes a new, proposed "contract hybrid" LLC structure that potentially reconciles the competing for-profit and nonprofit capital and other demands of the project.

II. THE PEOPLE'S MARKET

The city of Terminus has had a history of separate neighborhoods for the "haves" and the "have-nots." Generally speaking, the "haves" live in the suburbs while the "have-nots" live within the city limits. Due to increasing traffic, rising gas prices, and baby-boomers turned empty nesters, however, more affluent individuals are selling their suburban homes and moving into condominiums and other multi-family housing units within the Terminus city limits. This shift from suburban to in-town living has led to substantial redevelopment within Terminus with some of the new, affluent developments bordering upon neighborhoods that are economically disadvantaged and deteriorating.

Seeing the trend toward urban living, Sam Developer is interested in acquiring a large, abandoned warehouse that is located between a new, multi-family development and a historically poor, troubled neighborhood. The warehouse also borders the campus of Terminus College, or "TC," a small, private college with approximately five thousand students. Sam's vision is to acquire the warehouse, restore it, and then turn the warehouse into "The People's Market," a large, open-air structure with many small retail businesses operating under one roof. The People's Market primarily expects to attract local farmers and other food vendors, but all types of small retail businesses will be welcome. Each retail business that locates in The People's Market will rent[28] space in the

27. I.R.S. Info. Ltr. 2010-0052 (June 25, 2010).

28. For the sake of brevity, this article ignores whether the legal relationship between TPM Owner and each retail business is properly characterized as that of

warehouse from Sam's to-be-formed company, which he tentatively is calling "TPM Owner." Further, Sam will insist that the tenants conduct their businesses in an environmentally conscious manner and that most of the food sold at The People's Market be organic and locally grown. To set an example, Sam intends to implement a state of the art recycling system and install solar panels on the roof of The People's Market.

The rental payments each tenant will pay TPM Owner will consist of substantially below-market base rent plus additional rent determined by the net revenues of each particular tenant. Sam's intent by offering lease rates that are heavily tied to net revenue is to entice the residents of the nearby poor neighborhood to become the principal business owners and tenants of The People's Market. In turn, Sam expects that these new business owners will create jobs and spur positive economic development for the entire area.

More than just being a community marketplace and a job-creation vehicle, though, Sam wants The People's Market to transform the way small retailers do business in order to benefit the nearby poor, troubled neighborhood. In particular, Sam has decided that each tenant's lease with TPM Owner will require the retailer to participate in a "name-your-price" program that, on an alternating basis, allows customers to pay any amount they believe is "fair" when buying products and services at that retailer's establishment. Thus, during any given month, a small portion of the retailers in The People's Market will sell their goods and services for whatever price a customer desires to pay. Each retailer will have suggested prices for the goods or services offered, but during the month the retailer is part of the "name-your-price" program, each customer may pay whatever price he or she feels is appropriate.[29] Sam believes the "name-your-price" program will

landlord-tenant or as licensor-licensee. Although important in practice, the distinction between the two relationships is not particularly relevant to the analysis in this article.

29. There is precedent for such a program. In 2010, Panera Bread Company began conducting a "pay-as-you-go" experiment at some of its outlets where customers could pay more or less than the retail value of their meals. These Panera Cares Community Cafes, run by the Panera Bread Foundation, have been a success, according to the former CEO and board chairman Ron Schaich. The foundation reported that sixty percent to seventy percent of the Panera Cares customers pay full price, while fifteen percent pay more and the rest pay less or nothing. *See* Valerie Killifer, *Panera Bread Prepares to Open Third Pay-As-You-Go*, FASTCASUAL.COM (Jan. 12, 2011), http://www.fastcasual.com/article/178719

greatly benefit the adjacent poor, troubled neighborhood as the residents there will be able to acquire many of the goods and services they need for free or at a deeply discounted price. Of course, to prevent abuse of the program, the leases with TPM Owner will provide that each retailer has the right to refuse to sell goods or provide services in appropriate circumstances.[30] Sam also anticipates creating an internship program so business students at TC interested in innovative business models can work at and learn from The People's Market as well as the retailers located therein.

Sam projects that it will cost $10 million to acquire and restore the warehouse and construct the necessary improvements to accommodate various retail businesses. Sam has created a detailed business plan that addresses both the financial aspects of acquiring and operating The People's Market as well as the "social good" (e.g., job creation, community revitalization, environmental sustainability, and assisting the poor) that will be accomplished by the project. Despite the challenges The People's Market project presents, Sam is confident he can raise $4 million for the project from friends and family, but to do so, Sam must find a way to finance, at a competitive inter`est rate, the remaining $6 million. Sam has approached numerous banks, pension funds, insurance companies, and other sources of conventional real estate capital, but no one is willing to provide Sam $6 million on any terms, much less at a "competitive" rate. Every normal capital source that Sam approaches believes the project is much too risky and the "name-your-price" program in particular dooms the project to failure. Nevertheless, Sam remains undaunted and unwilling to compromise his vision for The People's Market.

Fortunately for Sam, the Terminus Community Foundation, a local public charity that also sponsors a donor-advised fund,[31] has

/Panera-Bread-prepares-to-open-third-pay-as-you-go; *see also* Press Release, Panera Bread Foundation, Inc., Panera Bread Foundation Opens Third Panera Cares Community Cafe in Portland, OR (Jan. 16, 2011), *available at* http://www.panerabread.com/pdf/pr-20110116.pdf (announcing the opening of a new cafe and explaining the concept behind Panera Bread's "pay-as-you-go" experiment).

30. For example, items that cost the retailer more than ten dollars per item might be exempt from the "name-your-price" program. Furthermore, customers that return again and again to purchase items but never offer to pay at all could be refused service.

31. Prior to the Pension Protection Act of 2006, Pub. L. No. 109-208, 120 Stat. 780, the Internal Revenue Code did not define the term "donor-advised fund." Nevertheless, the term commonly was understood to refer to component funds of

taken a great interest in The People's Market project. The Community Foundation is interested in the project not only for the potential benefit to the adjacent poor neighborhood and its residents, and for the internship program with TC, but also because the Community Foundation believes that many of the retail businesses opening in The People's Market will be eligible to obtain partially guaranteed Small Business Administration loans through another local charitable organization, Terminus Community Loan Fund, Inc., or "TCLF."[32] The Community Foundation and its members have been long-time supporters of TCLF, and Sam's project seems well-suited for the mission of TCLF. In addition, the Community Foundation and its members also have supported TC in the past, and The People's Market is expected to benefit TC and its students as well.

Nevertheless, the Community Foundation itself cannot provide the $6 million in financing that Sam needs. As a sponsor of a donor-advised fund, the Community Foundation is established primarily to make grants to other charitable organizations at the direction of its donor-advisors, not to fund projects like The People's Market. The Community Foundation also is subject to a number of special, complex tax rules applicable to donor-advised funds[33] that inhibit the Community Foundation's ability to make such a loan. Likewise, although its mission would extend to providing debt financing for The People's Market, TCLF does not have the funds to make such a large commercial real estate loan.

certain community trusts. *See* Treas. Reg. § 1.170A-9(f)(10), (11) (2010). The term also typically was used "to refer to an account established by one or more donors but owned and controlled by a public charity to which such donors or other individuals designated by the donors could provide nonbinding recommendations regarding distributions from the account or regarding investment of the assets in the account." I.R.S. Notice 2006-109, 2006-2 C.B. 1121, *superseded in part by* Rev. Proc. 2009-32, 2009-28 I.R.B. 142. In many respects, then, donor-advised funds operated, and continue to operate, in a manner similar to private foundations, but the privileges of the donor are in an advisory role only and do not legally bind the public charity. *See id.*

32. *See, e.g.*, Rev. Rul. 81-284, 1981-2 C.B. 130 (stating that a nonprofit small business investment company licensed under § 301(d) of the Small Business Investment Act of 1958 may qualify for exemption under I.R.C. § 501(c)(3)). For general information regarding the Small Business Administration's loan programs, see *SBA Loan Programs*, U.S. SMALL BUS. ADMIN., www.sba.gov/category/navigation-structure/loans-grants/small-business-loans/sba-loan-programs (last visited Oct. 30, 2011).

33. I.R.C. § 4966 (2006). For further discussion, see *infra* text accompanying notes 225–33.

TC also does not have the funds to make the $6 million loan, even if it could justify such an investment as part of its educational mission.

Although neither the Community Foundation, TCLF, nor TC can provide the remaining $6 million in necessary capital for The People's Market project, Terminus is home to a number of successful private foundations,[34] several of which are focused upon alleviating poverty and supporting community revitalization. Through the efforts of the Community Foundation, TCLF, and TC, two of these private foundations have committed to provide $3 million each to fulfill the $6 million of remaining capital that Sam needs to open The People's Market. Despite their size and sophistication, though, these two private foundations always have been traditional, grant-making foundations,[35] and neither has ever made a PRI or any other grant requiring the exercise of "expenditure responsibility" under § 4945.[36]

Moreover, neither foundation is willing to make an outright grant to TCLF, thereby allowing TCLF to either re-grant or loan $6 million to TPM Owner for The People's Market project. Instead, each foundation desires to monitor the project closely throughout the process of acquiring the warehouse, renovating it, and then leasing space to the retail tenants. Unless the foundations have approval rights and are satisfied that The People's Market is indeed following Sam's business plan as promised, they will cease to provide funds for the project.

To complicate matters further, the two foundations desire to

34. As noted at *supra* note 9, although private foundations also are organizations described in I.R.C. § 501(c)(3), because they are not described in I.R.C. § 509(a), private foundations are subject to a different regime of taxes than are public charities. For example, private foundations are subject to an excise tax if they do not make at least a minimum level of qualifying distributions each year. *See* I.R.C. § 4940 (2006 & Supp. III 2007–2010). Private foundations also are subject to an excise tax if they make certain "taxable expenditures" (i.e., improper grants or other disbursements). *See* I.R.C. § 4945 (2006). Taxable expenditures include, but are not limited to, certain grants to organizations unless the private foundation exercises "expenditure responsibility" (i.e., due diligence in investigating, monitoring, and reporting the expenditure) with respect to the grants. *See id.* § 4945(h); Treas. Reg. § 53.4945-5(b) (2010).

35. Most private foundations do not engage in charitable activities directly; rather, they support the charitable activities of public charities by making periodic grants to those organizations. They usually do not make grants to individuals or for-profit organizations.

36. *See* I.R.C. § 4945(d), (h) (2011). For further discussion, see *infra* text accompanying notes 160–62.

participate in The People's Market project in slightly different ways. One of the participating foundations, Foundation One, is willing to enter into a conditional pledge agreement with TCLF agreeing to grant up to $3 million provided certain conditions (as specified in the pledge agreement) are met over time as the warehouse is acquired and renovated. The other foundation, Foundation Two, is not as well-funded as Foundation One and therefore desires to loan its $3 million to TCLF as a line of credit allowing draws over time if, in the discretion of Foundation Two, the project is proceeding according to plan. Although Foundation Two's commitment is a line of credit subject to repayment, Foundation Two has agreed that it will be an interest-free loan.

So, how does Sam create a legal structure that combines the $4 million in private investment dollars from his friends and family with the $6 million in philanthropic dollars committed by the two local, private foundations so that he can build The People's Market? Parts III and IV of this article explore both the nonprofit and for-profit options, while Part V proposes a "contract hybrid" to accomplish Sam's objectives.

III. TPM OWNER AS A TAX-EXEMPT NONPROFIT

It likely would be possible to form TPM Owner as a nonprofit corporation and then obtain tax-exempt status from the Internal Revenue Service.[37] Although it is difficult to uncover the precise

37. *See, e.g.*, Rev. Rul. 76-419, 1976-2 C.B. 146 (stating that an industrial park giving rental preference to employers hiring previously unemployed workers qualifies for exemption under I.R.C. § 501(c)(3)); Rev. Rul. 76-147, 1976-1 C.B. 151 (stating that an organization formed to improve conditions in an area of a city where income is higher and housing is better than other areas nonetheless can qualify as exempt under I.R.C. § 501(c)(3) because it counteracts housing deterioration); Rev. Rul. 70-585, 1970-2 C.B. 115 (discussing a nonprofit organization, qualifying for exemption under I.R.C. § 501(c)(3), formed to revitalize a particular area of a city, part of its plans involve the purchase of an apartment building that it will rehabilitate and lease to low- and *moderate*-income families in the area); Rev. Rul. 68-167, 1968-1 C.B. 255 (stating that a nonprofit organization establishing a market for products made by disabled individuals may qualify for exemption under I.R.C. § 501(c)(3)); Rev. Rul. 67-138, 1967-1 C.B. 129 (stating that a nonprofit organization created to provide low-income families instruction and guidance regarding building their own homes may qualify for exemption under I.R.C. § 501(c)(3)); *Chasing the Coveted (c)(3)*, FARMERS MKT. COAL. (Jan. 13, 2010), http://farmersmarketcoalition.org/501c3. *But see* Rev. Rul. 78-131, 1978 C.B. 157 (stating that an annual community art show is not exempt under I.R.C. § 501(c)(3), but is exempt under I.R.C. § 501(c)(4)); Rev. Rul. 71-395, 1971-2 C.B. 223 (stating that a cooperative art gallery selling works of

nature of the operations of exempt farmers' market organizations through Internet research, the Internal Revenue Service has granted § 501(c)(3) exempt status to at least sixty organizations that use the terms "farmers market" in their names.[38] To secure tax-exempt status, Sam might need to modify his vision for The People's Market somewhat—such as by offering regular educational programs on entrepreneurship, environmental sustainability, or organic farming, and emphasizing serving the poor and disadvantaged—but tax-exempt status from the Internal Revenue Service would appear to be realistic.[39]

A. *Principal Advantages of Forming TPM Owner as a Tax-Exempt Nonprofit*

Assuming that TPM Owner is formed as a state-law nonprofit corporation ("TPM Owner, Inc.") that obtains tax-exempt status under § 501(c)(3),[40] what are the principal advantages of doing so?

First and foremost, TPM Owner, Inc. will be exempt from federal and, generally, state income taxes.[41] Depending upon the jurisdiction, this exemption can extend to sales taxes and property taxes, as well as income taxes.[42] In addition, anyone contributing money or property to TPM Owner, Inc. usually will be entitled to claim a charitable contribution deduction for federal and state income tax purposes.[43] If formed as a public charity, TPM Owner,

participants is not exempt under I.R.C. § 501(c)(3)); Rev. Rul. 67-430, 1967-2 C.B. 220 (stating that a cooperative farmers' market is exempt under I.R.C. § 521); I.R.S. Priv. Ltr. Rul. 200833031 (Aug. 15, 2008) (stating that a farmers' and artisans' market is not exempt under I.R.C. § 501(c)(3)); I.R.S. Priv. Ltr. Rul. 200818028 (May 2, 2008) (stating, similarly, that a farmers' and artisans' market is not exempt under I.R.C. § 501(c)(3)).

38. *See Search for Charities, Online Version of Publication 78*, I.R.S., U.S. DEP'T OF THE TREASURY, http://www.irs.gov/app/pub-78/forwardToSearch.do (enter "farmers market"—without a possessive apostrophe—in the search field to return the proper results) (last visited Oct. 30, 2011).

39. *See* I.R.C. § 501(c)(3) (2006); Treas. Reg. § 1.501(c)(3)-1(d)(3)(i) (2010) (defining education to include "museums, zoos, planetariums, symphony orchestras, and other similar organizations"). The Internal Revenue Service is hereinafter referred to as the "Service."

40. I.R.C. § 501(c)(3) (2006). *See generally* FRANCES R. HILL & DOUGLAS M. MANCINO, TAXATION OF EXEMPT ORGANIZATIONS ¶ 1.01 (2010) (describing the convergence of activities of exempt and non-exempt organizations).

41. *See, e.g.*, HILL & MANCINO, *supra* note 40, ¶ 1.01 (discussing the effect of classification under the Internal Revenue Code).

42. *See id.* ¶ 2.01.

43. *See* I.R.C. § 170(a) (2006).

Inc. will be eligible to receive grants from private foundations and, possibly, government grants.[44] There also is an overall "halo" effect when an organization is bestowed tax-exempt status by the Service. Being tax-exempt, the public thus would presume that TPM Owner, Inc. operates for the benefit of society at large, not primarily for private interests.[45]

There are non-tax advantages of nonprofit status as well. For instance, debt instruments issued by a nonprofit can qualify for an exemption from federal and state securities laws.[46] Volunteers serving nonprofit organizations generally are exempt from the Fair Labor Standards Act, although they must be true volunteers.[47] Charitable immunity laws in some states protect nonprofits and volunteers of nonprofits from certain categories of tort liability arising out of their charitable activities.[48] Like their for-profit counterparts, nonprofit corporations provide liability protection for those individuals conducting the activities of the organization.[49] TPM Owner, Inc. would benefit from these non-tax advantages.

B. Principal Disadvantages of Forming TPM Owner as a Tax-Exempt Nonprofit

There are a number of significant disadvantages associated with being a tax-exempt nonprofit. One very significant disadvantage is the additional administrative and regulatory burden that accompanies exempt status. For instance, the Service estimates that it takes approximately ninety hours of recordkeeping time to complete the Form 1023, Application for Exempt Status.[50] There also normally is an $850 fee payable to the Service in connection with filing the application.[51] The fee usually is not

44. *See, e.g.*, HILL & MANCINO, *supra* note 40, ¶ 8.02 (describing public charities as a "favored class" with regard to fundraising); *see also* Wexler, *supra* note 3, at 575 (indicating that governments may provide grants where organizations relieve government burdens).

45. LANE, *supra* note 3, at 66.

46. MARILYN E. PHELAN, 2 NONPROFIT ORGANIZATIONS: LAW AND TAXATION § 14:26 (2010), *available at* Westlaw NPOLT § 14:26.

47. LANE, *supra* note 3, at 28.

48. 2 PHELAN, *supra* note 46, § 14.8.

49. *Id.* § 14.7; LANE, *supra* note 3, at 84.

50. *See* I.R.S., U.S. DEP'T OF THE TREASURY, INSTRUCTIONS FOR FORM 1023 APPLICATION FOR RECOGNITION OF EXEMPTION UNDER SECTION 501(C)(3) OF THE INTERNAL REVENUE CODE, CAT. NO. 17132Z, 24 (Nov. 2006).

51. Rev. Proc. 2011-8, 2011-1 I.R.B. 237, § 6.07(2).

refundable, even if exempt status is denied.[52] Moreover, in a few jurisdictions, a separate state application must be submitted as well.[53] Even after exempt status is obtained, completing and filing the annual Form 990, Return of Organizations Exempt from Income Tax, generally is a very time-consuming task.[54] Furthermore, once filed, the Form 990 is required to be made public upon request.[55] In fact, certain companies are in the business of obtaining Form 990s and making the forms available to the public.[56] The Form 990 includes a great deal of potentially sensitive information, including compensation of top executives and payments to affiliates.[57] Note as well that tax-exempt organizations nevertheless remain liable for employment taxes,[58] and in some states, property taxes,[59] and sales taxes.[60] Furthermore, because of the unique nature of its rental income, TPM Owner, Inc. conceivably could be subject to the unrelated business income tax even though it otherwise is tax-exempt.[61]

There are a host of other special tax rules as well that can apply to a tax-exempt organization. These rules are designed to safeguard against the use of tax-exempt status to benefit private interests controlling or doing business with an exempt organization. These special rules include prohibitions on private inurement, private benefit, and excess benefits.[62] Certain other rules generally prohibit or restrict exempt organizations from engaging in political and lobbying activities.[63]

Non-tax disadvantages of operating as a nonprofit include

52. *Id.* § 10.01.

53. *See* HILL & MANCINO, *supra* note 40, ¶ 2.01.

54. *Id.* ¶ 8.02.

55. I.R.C. § 6104(d) (2011). *See generally* HILL & MANCINO, *supra* note 40, ¶ 33.08.

56. *See generally* CHARITY NAVIGATOR, www.charitynavigator.org (last visited Oct. 30, 2011); GUIDESTAR, www.guidestar.org (last visited Oct. 30, 2011).

57. *See, e.g.*, I.R.S., U.S. DEP'T OF THE TREASURY, FORM 990, RETURN OF ORGANIZATION EXEMPT FROM INCOME, CAT. NO. 11282Y, 7 (2010) (providing the proper form with which to claim exemptions from income taxes under § 501(c)).

58. Daniel B. Rosenbaum, *Federal and State Governments Target Employment Tax Compliance*, TAX'N EXEMPTS, Sept.–Oct. 2010, at 19, 19.

59. *See* Gil A. Nusbaum, *Weighing the Options on State and Local Property Taxes*, TAX'N EXEMPTS, July–Aug. 2007, at 18, 18.

60. Steven Chiodini & Gregory L. Colvin, *The Use of LLCs in Fiscal Sponsorship—A New Model*, TAX'N EXEMPTS, May–June 2011, at 15, 15.

61. *See infra* text accompanying notes 126–44.

62. *See* HILL & MANCINO, *supra* note 40, ¶ 4.01.

63. *Id.* ¶ 5.02.

regulation by each state's attorney general and special rules across all fifty states that govern fundraising activities.[64] Perhaps most important of all, nonprofit status does not permit any type of equity participation in the growth and enterprise value of the organization. Reasonable compensation and bonuses may be paid to employees, but nonprofits have no owners and hence all net earnings remain inside the nonprofit for use in fulfilling the mission of the organization. Upon liquidation of a nonprofit, the net proceeds must be distributed to another nonprofit or to the government.[65]

Therefore, in order to adopt the tax-exempt, nonprofit model for The People's Market, Sam would have to eliminate any equity investment by himself and his friends and family. Sam and his friends and family could donate $4 million to TPM Owner, Inc. and receive a charitable contribution deduction for tax purposes,[66] but unless they are extraordinarily wealthy and in need of a large income tax deduction, a donation of such magnitude is not likely. Tax-exempt, nonprofit status for TPM Owner, Inc. would have the countervailing benefit of allowing Terminus's private foundations to make grants, or possibly PRIs,[67] to fund the entire $10 million in capital needed for The People's Market; but in the author's experience, if the private foundations were willing to fund the entire capital needs of the project, they likely would demand control over all aspects of the project's organization and operation, meaning that Sam would not necessarily be involved. Moreover, funding principally through donations and grants is contrary to the essential nature of social enterprise, which endeavors to be self-sustaining by relying upon recurring revenues without the necessity of charitable contribution dollars.[68]

1. *Participating Debt Issued by TPM Owner, Inc.*

Although equity investment in a tax-exempt, nonprofit organization is not permitted, it is possible for an exempt

64. *See* 2 PHELAN, *supra* note 46, § 13.1.
65. *See* HILL & MANCINO, *supra* note 40, ¶ 2.02[5].
66. This is subject to numerous requirements that are beyond the scope of this article. *See* I.R.C. § 170 (2011).
67. For further discussion on program-related investments (PRIs), see *supra* note 10; *infra* text accompanying notes 150–70.
68. *See supra* text accompanying note 4.

organization to borrow money and issue debt instruments.[69] Thus, if we assume that Sam decides that he can live with all of the above restrictions with the exception of eliminating himself and his friends and family as investors in The People's Market, then the question arises whether the private investment in TPM Owner, Inc. might take the form of debt. Would it be possible, for instance, to launch The People's Market by raising $6 million in donations, grants, and charitable loans and raising the remaining $4 million by issuing subordinated debt instruments to Sam and his friends and family? These debt instruments might even be structured to call for a low rate of base interest plus additional "kicker" interest determined by reference to the cash flow of TPM Owner, Inc. In other words, the debt instruments issued to Sam and his friends and family perhaps could be equity-like in their terms,[70] thus allowing the private investors to obtain de facto equity in TPM Owner, Inc.

As the reader might have guessed, though, creating an equity-like debt instrument—often referred to as "participating debt"[71]—that is issued to private investors in a tax-exempt, nonprofit organization violates several fundamental tax rules and is not permitted.[72] Namely, such an arrangement violates the prohibitions on private inurement and private benefit. Even if the arrangement somehow escaped the private inurement and private benefit prohibitions, it would be caught by the restrictions on "excess benefit transactions." In addition, the unrelated business income tax rules, especially the rules regarding unrelated debt financed income, could be problematic.

Even though established law tells us that an exempt organization cannot issue participating debt, the underlying reasons why such debt is not permitted are important to

69. If it were not possible, there would be no need for I.R.C. § 514 (2011).

70. *See* Paul Carman & Kelley Bender, *Debt, Equity or Other: Applying a Binary Analysis in a Multidimensional World*, 107 J. TAX'N 17, 26 (2007).

71. *See id.* at 26–27.

72. Treas. Reg. § 1.501(c)(13)-1(d) (1980) (stating that, with respect to exempt cemetery organizations but applicable to other exempts as well, "[participating debt] is considered an interest in the net earnings of [an] organization" and is not permitted); *see also* Rev. Rul. 61-137, 1961-2 C.B. 118 (stating that the sale of land at the contingent sales price bars exempt status for otherwise nonprofit cemetery organization); Rev. Rul. 77-70, 1977-1 C.B. 149 (stating the same); Rev. Rul. 69-279, 1969-1 C.B. 152 (stating that exempt status will be denied to a charitable trust if payments of percentage of income are made to the grantor). *See generally* HILL & MANCINO, *supra* note 40, ¶¶ 4.03[5][a], 19.06.

understand for the remainder of this article. Therefore, summarized below are the rules relating to private inurement, private benefit, excess benefit transactions, and unrelated business taxable income, all of which would be implicated if TPM Owner, Inc. were to operate as an exempt organization that issued participating debt to Sam and his friends and family.

2. *Private Inurement*

Section 501(c)(3) grants tax-exempt status to an organization only when "no part of [its] net earnings . . . inures to the benefit of any private shareholder or individual."[73] Treasury regulations define "private shareholder or individual" for purposes of § 501(c)(3) as "persons having a personal and private interest in the activities of the organization."[74] Persons having a personal and private interest in an exempt organization—as opposed to the general public—are informally referred to as "insiders."[75] Further, this prohibition on insiders participating in the net earnings of an exempt organization generally is referred to as "inurement" or "private inurement."[76]

The private inurement restriction is intended to differentiate between improper benefits (typically financial benefits) granted to insiders versus benefits granted to the public (which may include insiders) as a natural part of the organization's exempt purpose. Thus, the capacity in which an individual receives a financial benefit from the organization often determines whether private inurement exists. If a person receives a benefit as part of the charitable class of intended beneficiaries, as opposed to receiving a financial benefit in his or her personal capacity, then the private inurement prohibition usually is not violated and exempt status may be preserved.[77] In addition, reasonable compensation paid to insiders and others, even where it is tied in part to gross earnings, is permitted under the right circumstances.[78] In general, however, if

73. I.R.C. § 501(c)(3) (2010).

74. Treas. Reg. § 1.501(a)-1(c) (2011).

75. *See* Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1066 (1989).

76. *See* HILL & MANCINO, *supra* note 40, ¶ 4.03.

77. *See id.*

78. For example, in Rev. Rul. 69-383, 1969-2 C.B. 113, the Service allowed compensation paid to a radiologist based upon a percentage of the adjusted gross revenues of a radiology department. The Service considered whether private inurement existed, "but found that (1) the arrangement was negotiated at arm's length, (2) the physician had no control over, or management authority with

private inurement is found to exist, then any amount, no matter how small, can preclude tax-exempt status under § 501(c)(3).[79] Moreover, when the financial relationship between a tax-exempt entity and its insiders is tantamount to an equity interest in the organization, then *per se* inurement almost certainly will be found.[80]

3. Private Benefit

In addition to private inurement, private benefit is another central principle applicable to tax-exempt organizations. The private benefit principle derives from the § 501(c)(3) statutory language mandating that an organization be "organized and operated exclusively" for charitable purposes.[81] Treasury regulations relax this restriction slightly by interpreting the term "exclusively" to mean that an organization must engage "primarily" in activities that accomplish one or more exempt purpose.[82] The Supreme Court has interpreted this "exclusively" language in a similar, slightly relaxed manner: "[T]he presence of a single [non-charitable] purpose, *if substantial in nature*, will destroy the exemption regardless of the number or importance of truly [charitable] purposes."[83]

Put differently, then, if more than an insubstantial part of an organization's activities is in furtherance of a nonexempt purpose, then it will not qualify under § 501(c)(3).[84] Treasury regulations elaborate, stating that to be exempt, an organization must establish that it is not organized or operated for the benefit of: private

respect to the hospital, and (3) the amount received did not represent excessive or unreasonable compensation for the services actually performed." I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991). The Service cautioned, though, that the presence of a percentage compensation arrangement will destroy the organization's exemption where it essentially is a device for distributing profits to persons in control. Rev. Rul. 69-383, 1969-2 C.B. 113.

79. Spokane Motorcycle Club v. United States, 222 F. Supp. 151, 153 (E.D. Wash. 1963) (holding that $825.31 of inurement resulted in revocation of exempt status). Under more current rules, for small infractions, the Service most likely would seek to impose so-called "intermediate sanctions" under I.R.C. § 4958 (discussed in more detail *infra*) rather than revoke an organization's exempt status. In egregious cases, though, the Service will pursue revocation of exempt status.

80. *See* sources cited *supra* note 72.

81. I.R.C. § 501(c)(3) (2010).

82. Treas. Reg. § 1.501(c)(3)-1(c) (2011).

83. Better Bus. Bureau v. United States, 326 U.S. 279, 283 (1945) (emphasis added).

84. *See* Treas. Reg. § 1.501(c)(3)-1(c).

interests such as designated individuals; the creator or his family; shareholders of the organization; or persons controlled, directly or indirectly, by such private interests.[85] This private benefit prohibition applies to all types of individuals and other organizations, not just "insiders." Inurement is thus a subset of private benefit. The Tax Court has said with respect to the private inurement/private benefit distinction: "[W]hile the prohibitions against private inurement and private benefits share common and often overlapping elements, the two are distinct requirements which must independently be satisfied."[86] The court went on to state that the presence of private inurement violates both prohibitions, but the absence of inurement does not mean the absence of private benefit. Instead, private benefit arises from "nonincidental benefits conferred on disinterested persons [that] serve private interests."[87]

Determining whether a benefit flowing to private individuals precludes exempt status requires balancing. As the Service has stated:

> Any private benefit arising from a particular activity must be "incidental" in both a qualitative and quantitative sense to the overall public benefit achieved by the activity if the organization is to remain exempt. To be qualitatively incidental, a private benefit must occur as a necessary concomitant of the activity that benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefiting private individuals. Such benefits might also be characterized as indirect or unintentional. To be quantitatively incidental, a benefit must be insubstantial when viewed in relation to the public benefit conferred by the activity. It bears emphasis that, even though exemption of the entire organization may be at stake, the private benefit conferred by an activity or arrangement is balanced only against the public benefit conferred by that activity or arrangement, not the overall good accomplished by the organization.[88]

An example of a *qualitatively* incidental benefit is found in

85. *Id.* § 1.501(c)(3)-1(d)(1).
86. Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1068 (1989) (citations omitted).
87. *Id.* at 1069.
88. I.R.S. Gen. Couns. Mem. 39,862 (Dec. 2, 1991).

Revenue Ruling 70-186.[89] There, an organization was formed to preserve and enhance a lake as a public recreational facility by treating the water. The lake was large and bordered on several municipalities. The public used the lake extensively for recreation. Along its shores were public beaches, launching ramps, and other public facilities. The organization was financed by contributions from lake front property owners, members of the adjacent community, and municipalities bordering the lake. In addressing the issue of private benefit, the Service concluded in the ruling that the organization's activities primarily benefited the general public through well-maintained and improved public recreational facilities.[90] Any private benefit derived by the lake front property owners was incidental and was not at the expense of the public benefits flowing from the organization's operations.[91]

In contrast, Revenue Ruling 75-286[92] describes an organization formed by the residents of a city block to preserve and beautify that block, to improve all public facilities within the block, and to prevent physical deterioration of the block. The organization's activities consisted of paying the city government to plant trees on public property within the block, organizing residents to pick up litter and refuse in the public streets and on public sidewalks within the block, and encouraging residents to take an active part in beautifying the block by planting shrubbery in public areas within the block.[93] Membership in the organization was restricted to residents of the block and those owning property or operating businesses there. The Service concluded in this ruling that the organization did not qualify for exemption under § 501(c)(3) because the private interests served were not qualitatively incidental. In fact, the private benefits were fundamental to the organization's purpose.[94]

To be *quantitatively* incidental, private benefit must be insubstantial in amount. "The private benefit must be compared to

89. Rev. Rul. 70-186, 1970-1 C.B. 129.
90. *Id.*
91. *Id.*
92. Rev. Rul. 75-286, 1975-2 C.B. 210.
93. *Id.*
94. *Id.* The organization did qualify, however, under I.R.C. § 501(c)(4) as a social welfare organization. *Id.* Although exempt, social welfare organizations do not possess all the tax benefits of an I.R.C. § 501(c)(3) organization. For instance, a contribution to a social welfare organization does not give rise to a charitable contribution deduction under I.R.C. § 170. *See* I.R.C. §§ 170(c)(2), 501(c)(3) (2011).

the public benefit of the specific activity in question, not the public benefit provided by all of the organization's activities."[95] The more precisely one can quantify private benefit, the more likely it is to be non-incidental. Private benefit also is more likely to be found substantial if the group receiving the benefit is small.[96] Furthermore, unlike inurement, finding private benefit does not require that payments for goods or services be unreasonable or exceed fair market value.[97]

Revenue Ruling 72-147[98] provides an example of these latter aspects of private benefit. In that ruling, a nonprofit organization was formed to provide low-income housing to families; however, the organization gave preference for housing to employees of a separate farm proprietorship owned and operated by the founder of the nonprofit.[99] In addition, all of the housing units were in fact occupied by employees of the founder's farm proprietorship. The Service held that even though providing low-income housing is a charitable activity, the private benefit bestowed upon the farm proprietorship precluded exemption.[100]

Another important point about private benefit is that, unlike inurement, an insider need not be involved. Private benefit involves non-incidental benefits to anyone other than the charitable class served by the organization's exempt activities. The court's holding in *Westward Ho v. Commissioner*[101] illustrates this point. Westward Ho was created by three restaurant owners to provide funds to "indigent and antisocial persons" to enable them to leave Burlington, Vermont.[102] The Tax Court concluded that the organization's true purpose was to provide its creators with a more desirable business environment by removing disruptive homeless persons from the area. The organization did not qualify for exemption even though it provided direct "assistance" to members of a charitable class.[103]

95. ANDREW MEGOSH ET AL., I.R.S., U.S. DEP'T OF THE TREASURY, PRIVATE BENEFIT UNDER IRC 501(C)(3) 137 (2001), *available at* http://www.irs.gov/pub/irs-tege/eotopich01.pdf.

96. *Id.*

97. *Id.* at 138–39 (citing Church by Mail v. Comm'r, 765 F.2d 1387 (9th Cir. 1985), *aff'g* Est of Haw. v. Comm'r, 71 T.C. 1067 (1979)).

98. Rev. Rul. 72-147, 1972-1 C.B. 147.

99. *Id.*

100. *Id.*

101. 63 T.C.M. (CCH) 2617 (1992).

102. *Id.*

103. *Id.*

Similarly, in Revenue Ruling 68-504,[104] an organization conducted an educational program for bank employees. It furnished classrooms and employed university professors and others to teach courses on various banking subjects.[105] Only members could take courses, but membership was open to all bank employees in the area.[106] In *American Campaign Academy v. Commissioner*,[107] the organization conducted an educational program for professional political campaign workers. It furnished classrooms, materials, and qualified instructors.[108] Admission was through a competitive application process.[109] Both Revenue Ruling 68-504 and *American Academy* involved organizations pursuing an exempt activity—education—but the organization in *American Academy* in fact was operated to benefit only Republican candidates, whereas the organization in Revenue Ruling 68-504 benefited employees from *any* local bank. If the organization in *American Academy* had been non-partisan, it might have qualified for exemption, whereas had the organization in Revenue Ruling 68-504 served only one bank, it probably would not have qualified for exemption.

4. Excess Benefit Transactions

Whenever private benefit is found but is not so severe as to justify revocation of exempt status, § 4958[110] permits so-called "intermediate sanctions" to be imposed upon an offending transaction. Specifically, § 4958 imposes certain excise taxes on "excess benefit transactions" between "disqualified persons" and tax-exempt organizations described in either § 501(c)(3) or § 501(c)(4).[111] The excise taxes under § 4958 are punitive in nature so as to discourage certain behavior, and are imposed upon both the offending "disqualified person" and, if a knowing, willful

104. Rev. Rul. 68-504, 1968-2 C.B. 211.
105. *Id.*
106. *Id.*
107. Am. Campaign Acad. v. Comm'r, 92 T.C. 1053 (1989).
108. *Id.* at 1057.
109. *Id.* at 1057–58.
110. I.R.C. § 4958 (2006 & Supp. 2009).
111. *Id.* § 4958(a)(1), (c)(4). Social welfare organizations, like the one described in Rev. Rul. 75-286, 1975-2 C.B. 210, see *supra* note 90, may qualify for tax-exempt status under I.R.C. § 501(c)(4) (2006); but, that status often is not as beneficial as exemption under I.R.C. § 501(c)(3) (2011). *See supra* note 94 and accompanying text.

violation occurs, management.[112]

The definitions and sub-definitions under § 4958 are numerous and technical, but for purposes of this article suffice it to say that a "disqualified person" is any person in position to exercise (regardless of whether the person actually has exercised) substantial influence over an exempt organization. Officers, directors, substantial contributors, key employees, and others with close ties to an exempt organization thus are disqualified persons. In addition, family members of, and entities controlled by, disqualified persons also are "disqualified" under § 4958.[113]

Again, the precise definitions and rules are more complex, but as one might suspect an "excess benefit transaction" generally is defined as follows: a transaction whereby (1) an economic benefit is provided by an organization, directly or indirectly, to or for the use of a disqualified person, and (2) the value of the economic benefit provided by the organization to or for the use of the disqualified person exceeds the value of the consideration received by the organization in return for providing the benefit.[114] In other words, an excess benefit transaction is one in which a tax-exempt organization does not receive equivalent value in return for benefits provided to an influential person (or his family or controlled entities) associated with the organization. A simple example of an excess benefit transaction is paying unreasonable compensation to an exempt organization's Executive Director.[115]

An excess benefit transaction may be found even where the tax-exempt organization did not authorize any payment to the disqualified person. For instance, embezzlement constitutes an excess benefit transaction; but any associated excise taxes should be imposed only upon the offending disqualified person—assuming management was not aware of the embezzlement and takes steps to recover the funds once the embezzlement is discovered.[116] The rules of § 4958 thus are quite strict, but Treasury regulations offer some comfort by enumerating certain "rebuttable presumption" procedures that, if followed, allow an exempt organization to

112. I.R.C. § 4958(a)(1)–(a)(2) (2011).
113. *See id.* § 4958(f).
114. *Id.* § 4958(c)(1)(A).
115. Treas. Reg. § 53.4958-4(a)(2)(iv) ex. 2 (2007).
116. LAWRENCE M. BRAUER ET AL., I.R.S., U.S. DEP'T OF THE TREASURY, AN INTRODUCTION TO I.R.C. § 4958 (INTERMEDIATE SANCTIONS) 264 (2002), *available at* http://www.irs.gov/pub/irs-tege/eotopich02.pdf.

safeguard against a finding of an excess benefit transaction.[117] The regulations also provide exceptions to § 4958 for retirement plans, fringe benefits, and certain other payments.[118]

Although the Treasury regulations under § 4958 provide significant guidance as to what is and what is not an excess benefit transaction, the regulations do not specifically address rules applicable to "revenue-sharing" arrangements. Previously proposed regulations under § 4958, however, did address such arrangements and set forth a slightly modified test for determining whether they would be treated as excess benefit transactions.[119] Under the proposed regulations, a "revenue-sharing transaction" is defined as one in which an economic benefit provided to or for the use of a disqualified person is determined in whole or in part by the revenues of one or more activities of the organization.[120] The proposed regulations, like the final regulations, stated that a facts and circumstances analysis generally would apply to determine if any arrangement gives rise to excess benefits.[121] The proposed regulations went further, though, to provide that if the benefit in question was compensation, then regardless of whether the revenue-sharing arrangement exceeded fair market value under the circumstances, the arrangement constituted an excess benefit transaction if at any time it permitted a disqualified person to receive additional compensation without providing proportionate additional services.[122] The proposed regulations also stated that the ability of an affected disqualified person to control the outcome of the revenue-sharing arrangement would influence the analysis as to whether the arrangement would constitute an excess benefit transaction.[123]

As noted above, the final regulations under § 4958 omitted any

117. Treas. Reg. § 53.4958-6 (2007).
118. Treas. Reg. § 53.4958-4(a)(4).
119. *See* Prop. Treas. Reg. § 53.4958-5(a), 63 Fed. Reg. 41486, 41492 (Aug. 4, 1998), *available at* http://www.gpo.gov/fdsys/pkg/FR-1998-08-04/html/98-20419.htm.
120. *Id.*
121. *Compare* Treas. Reg. § 53.4958-4(a), *with* Prop. Treas. Reg. § 53.4958-5(a), 63 Fed. Reg. 41486, 41492 (Aug. 4, 1998), *available at* http://www.gpo.gov/fdsys/pkg/FR-1998-08-04/html/98-20419.htm.
122. *See* Prop. Treas. Reg. § 53.4958-5(a), 63 Fed. Reg. 41486, 41503 (proposed Aug. 4, 1998), *available at* http://www.gpo.gov/fdsys/pkg/FR-1998-08-04/html/98-20419.htm.
123. *See id.*

specific rules addressing revenue-sharing arrangements.[124] Thus, until final regulations on revenue-sharing transactions are issued, such arrangements will be evaluated under the same principles (i.e., generally, a facts and circumstances analysis) that apply to all excess benefit transactions between a disqualified person and an exempt organization.[125]

5. Unrelated Business Income and Unrelated Business Income Tax

Although organizations that are exempt under § 501(c)(3) generally are not subject to federal or state income taxes, such organizations are subject to the unrelated business income ("UBI") rules and the unrelated business income tax ("UBIT"). Section 512(a) imposes a separate tax on the gross income (less directly and certain indirectly connected expenses) derived by an exempt organization from an "unrelated trade or business."[126] Although a detailed discussion of the UBI rules is beyond the scope of this article,[127] a basic understanding of these rules is relevant to the analysis of The People's Market project.

Basically, three elements determine whether an activity constitutes an unrelated trade or business subject to UBIT: the activity must be (1) a trade or business, (2) regularly carried on, and (3) not substantially related to the organization's exempt purpose.[128] Exempt organizations report UBI and calculate UBIT on IRS Form 990-T.[129]

A trade or business generally is defined as any activity carried on for the "production of income from the sale of goods or the performance of services."[130] The phrase "production of income

124. *See* Treas. Reg. § 53.4958-5(a) (stating "reserved").

125. *See id.*

126. I.R.C. § 512(a) (2006).

127. *I.R.S. Publication 598*, which was revised in March of 2010, is a good, general reference source for the UBI rules. *See generally* I.R.S., U.S. DEP'T OF THE TREASURY, PUB. NO. 598, TAX ON UNRELATED BUSINESS INCOME OF EXEMPT ORGANIZATIONS (2010).

128. *See* I.R.C. § 513(a) (2006); Treas. Reg. § 1.513-1(a) (2007).

129. *See* I.R.S., U.S. DEP'T OF THE TREASURY, FORM 990-T: EXEMPT ORGANIZATION BUSINESS INCOME TAX RETURN, CAT. NO. 11291J (2010). Section 501(c)(3) organizations also must make their Form 990-T available for public inspection. I.R.C. § 6104(d)(1) (2006).

130. I.R.C. § 513(c) (2006); Treas. Reg. § 1.513-1(b). The fragmentation rule, the exploitation rule, and the dual use rule also are important to the "trade or business" analysis, but because they are not particularly relevant here, any discussion of these rules is omitted. *See generally* HILL & MANCINO, *supra* note 40,

from sale of goods or performance of services" is broadly interpreted by the Service and the courts such that virtually any income-producing activity beyond mere passive investment will be considered a trade or business.[131]

Trade or business activities are "regularly carried on" if they are frequent and continuous and conducted in a manner that is comparable to commercial activities of for-profit organizations.[132] On the other hand, if income-producing activities are conducted infrequently or intermittently by an exempt organization, then they do not meet the "regularly carried on" requirement. For example, a once-a-year bake sale conducted by a local PTA chapter is not considered "regularly carried on." The sale of advertising in an annual yearbook, however, is considered "regularly carried on" where there is a solicitation program during the entire year.[133]

Whether an activity is "substantially related" depends upon the connection between the activity and the organization's exempt purpose or purposes. If the activity contributes importantly (other than by generating revenue) or directly furthers the organization's exempt purpose, the income produced by the activity is not UBI. For example, the sale of greeting cards displaying printed reproductions of selected works from a folk museum's collection was determined by the Service to be substantially related to the museum's exempt purpose; however, the sale of science books by the same folk museum was determined to be unrelated, thereby producing UBI, even though such sales by a science museum would serve an educational purpose consistent with § 501(c)(3).[134]

Sections 512(b), 513, and 514 provide numerous specific exclusions from, and modifications to, UBI for certain types of revenue.[135] A discussion of all of these exclusions and modifications is beyond the scope of this article; however, the rental income exclusion and the unrelated debt-financed income modification are relevant and are summarized below.

¶¶ 22.02[2], 22.09, 22.10.

131. HILL & MANCINO, *supra* note 40, ¶ 22.02[1].
132. Treas. Reg. § 1.513-1(c)(1).
133. *See id.* § 1.513-1(c)(2)(ii).
134. Rev. Rul. 73-105, 1973-1 C.B. 264.
135. I.R.C. §§ 512(b), 513, 514 (2006).

6. *Rental Income Exclusion*

Rental income from real property generally is excluded from UBI.[136] This exclusion is not a blanket exception, though, and it is limited strictly to real property and to rents from incidental personal property leased with real property (not exceeding ten percent of total rent).[137] The exception does not apply to rent solely from personal property.[138] Further, this exception applies only to passive rental activities that do not involve rendering any significant services to the occupant. Under the regulations, cleaning services are viewed as significant, so payments for lodging in a hotel are not considered rent.[139] The exception likewise does not apply if the rents are based in whole or in part on the income or profits derived by any person from the leased property (other than an amount based upon a fixed percentage of gross receipts or sales).[140] This is an important distinction, since rental formulas based upon net profits are customary for commercial leases.

7. *Unrelated Debt-Financed Income Modification*

Income that otherwise would be exempt (e.g., rental income) nevertheless is taxable as UBI if the income is not substantially related to an organization's exempt purpose and is derived from property that is subject to "acquisition indebtedness." Acquisition indebtedness exists with respect to property if any of the following conditions are found: (1) debt is incurred to acquire or improve property; (2) debt is incurred before the property was acquired if it would not have been incurred but for the planned acquisition; or (3) debt is incurred after the property is acquired if the debt would not have been incurred but for the acquisition of the property and the need for such debt was reasonably foreseeable when the

136. *Id.* § 512(b)(3). As only the Internal Revenue Code can do, the exclusion from UBI for rental income actually is contained in a section of the statute entitled "modifications." Then, I.R.C. § 513 contains a number of "exclusions" that may be more accurately referred to as modifications (because they "modify" the calculation of UBIT by removing income from a volunteer business, a thrift shop, and other sources). Because these statutory labels are more confusing than helpful in the context of this summary, the author has not adopted those labels for this discussion.

137. Treas. Reg. § 1.512(b)-1(c)(2)(ii)(b) (2011).

138. *Id.* § 1.512(b)-1(c)(2)(ii).

139. *Id.* § 1.512(b)-1(c)(5).

140. *Id.* § 1.512(b)-1(c)(2)(iii)(b).

property was acquired.[141] Further, the income is taxable as UBI whether the acquisition indebtedness is outstanding at the time such income is produced or within the previous twelve-month period.[142] This type of taxable UBI from encumbered property is commonly referred to as unrelated debt-financed income.

There are several exceptions to the debt-financed rules that result in income from encumbered property nevertheless being excluded from UBI,[143] but further discussion of these exceptions is beyond the scope of this article. Furthermore, special rules apply to determine the portion of income from debt-financed property that must be included in UBI, but an analysis of these rules also is outside the scope of this article.[144]

C. Application of Exempt Organization Rules to The People's Market

It should be obvious—perhaps almost painfully obvious—to the reader at this point that organizing and operating TPM Owner as a tax-exempt nonprofit corporation is problematic, if not impossible, especially if Sam desires to issue participating debt to himself and his friends and family. The prohibitions on private inurement and private benefit prohibit tax-exempt status for an organization that issues equity-like debt to insiders.[145] Further, payments received by Sam and his family (although perhaps not by his friends if they do not occupy positions of influence with TPM Owner, Inc.) likely would be subject to excise taxes under the excess benefit rules of § 4958. Furthermore, the UBI rules likely would treat as disguised service income the "rent" received by TPM Owner, Inc. from the retail businesses locating in The People's Market, especially if TPM Owner, Inc. provides substantial services (e.g., cleaning, consulting, advertising, recycling, etc.) in connection with the leases. Alternatively, since the income is based in part upon the net revenues of the retail businesses located in The People's Market, such income would not meet the technical rules defining rent for UBIT purposes. In either case, then, TPM Owner, Inc.'s income could be subject to UBIT, thereby defeating one of the principal reasons for seeking tax-exempt status. Last, but not least, even assuming the income paid to TPM Owner, Inc.

141. *Id.*
142. I.R.C. § 514(b)(1) (2006).
143. *See id.* § 514(b)–(c).
144. *See id.* § 514(a)(1)–(3).
145. *See supra* notes 73–109 and accompanying text.

by the retail businesses could be restructured to qualify as rent within the rental income exception to the UBI rules, because the income is debt-financed, it potentially would become taxable as UBIT under the unrelated debt-financed rules unless TPM Owner, Inc. could demonstrate that the income is substantially related to its exempt purpose.

All of the foregoing obstacles to organizing and operating TPM Owner as a tax-exempt nonprofit corporation point to some other form of organization for The People's Market.

IV. TPM OWNER AS A FOR-PROFIT LLC

As mentioned previously, Sam could organize and operate TPM Owner as a normal limited liability company or, perhaps, even as an L3C.[146] Because organizing and operating TPM Owner as an LLC ("TPM Owner, LLC") follows a much more traditional path for a commercial real estate project, this article does not extensively discuss all of the legal pros and cons of such an approach.[147] Rather, this article summarizes the principal advantages and disadvantages as contrasted with using the tax-exempt nonprofit approach. Following that discussion, this article proceeds with a brief analysis of financing TPM Owner, LLC in part with program-related investments.

A. Advantages and Disadvantages of Forming TPM Owner as a For-Profit LLC

The principal advantages associated with organizing and operating TPM Owner as an LLC primarily consist of avoiding the

146. This article will not address the relative advantages or disadvantages of forming TPM Owner as an L3C versus an LLC. See sources cited *supra* note 12 for commentary both for and against the use of L3Cs. In particular, with regard to the balancing of fiduciary duties of managers as between LLCs and L3Cs, see Tyler, *supra* note 12, for an excellent and thorough discussion.

147. This article also does not discuss other "social enterprise" organizations that might be used for The People's Market such as a corporation or a general or limited partnership. For a good discussion of these other legal vehicles for social enterprise, see Fei, *supra* note 3. Generally, though, in the author's experience, an LLC is the default choice for most for-profit enterprises absent a compelling reason (such as the demands of venture capital investors) to choose some other form of for-profit entity. For a general discussion of relevant choice of entity considerations in the for-profit context, see BISHOP & KLEINBERGER, *supra* note 8, ¶ 1.09.

disadvantages of tax-exempt status:[148]

- The time consuming and costly process of applying for and maintaining exempt status.
- The onerous restrictions associated with exempt status (such as public disclosure of IRS Form 990, no political activities, no lobbying, no private inurement, no private benefit, etc.).
- No requirement to publicly disclose the organization's income tax returns.
- Private ownership and equity participation clearly are permitted.
- State-law "fundraising" restrictions are inapplicable (although securities law applies).
- Attorney general supervision and interference is not avoided, but is less common than in the case of nonprofit organizations.

Forming TPM Owner as a for-profit LLC also has certain disadvantages:[149]

- Contributors to TPM Owner, LLC will not be entitled to an income tax deduction.
- The members of TPM Owner, LLC will be taxable on their distributable shares of the income from TPM Owner, LLC (but they also may be able to use any losses generated by TPM Owner, LLC to offset other income).
- TPM Owner, LLC will be subject to applicable sales, use, and property taxes.
- TPM Owner, LLC will not benefit from the "halo" effect and the public's presumption of trustworthiness that usually are bestowed upon a tax-exempt nonprofit.
- In addition to the fact that contributors to TPM Owner, LLC will not be entitled to an income tax deduction, TPM Owner, LLC *generally* will not be eligible for private foundation grants; however, government grants may be available, and under narrow circumstances TPM Owner, LLC could receive private foundation grants, especially in the form of program-related investments.
- TPM Owner, LLC will not benefit from any tort shield—"Good Samaritan"—protection.
- TPM Owner, LLC generally will not qualify for the "volunteer"

148. *See supra* notes 50–68 and accompanying text.
149. *See supra* notes 69–89 and accompanying text.

exception under FLSA and other employment laws.

B. Program-Related Investments (PRIs)

Under § 4944(a) and (b),[150] if a private foundation "[i]nvests any amount in such a manner so as to jeopardize the carrying out of any of its exempt purposes," then a tax is imposed on such private foundation in an amount of ten percent of the jeopardizing investment (with the possibility of an additional tax of twenty-five percent if the jeopardizing investment is not corrected in a timely fashion). Section 4944 may impose a tax on foundation managers as well. These excise taxes effectively prohibit private foundations from making extremely risky or imprudent investments.

Section 4944 was created in the Tax Reform Act of 1969 to curb abusive or extremely risky investment-related activities undertaken by private foundations. But an exception to the general prohibition in § 4944 for extremely risky or seemingly imprudent investments was created for PRIs.[151] Pursuant to § 4944(c), no jeopardizing investment excise tax is imposed on any investment "the primary purpose of which is to accomplish one or more of the purposes described in § 170(c)(2)(B),[152] and no significant purpose of which is the production of income or the appreciation of property." In addition, Treasury Regulation § 53.4944-3(a)(1)(iii) imposes an additional requirement on PRIs: "[n]o purpose of the investment is to accomplish one or more of the purposes described in § 170(c)(2)(D)."[153] Section 170(c)(2)(D)[154] restricts activities that involve influencing legislation and participating in political campaigns. In short, PRIs may not support lobbying or political campaign activities.

By enacting § 4944(c) of the Internal Revenue Code, Congress recognized that private foundations may carry out their exempt activities through means other than providing outright grants. The Treasury has followed Congress's legislative directive by promulgating regulations with helpful (albeit old) examples of PRIs,[155] and the Service has ruled on numerous occasions that PRIs may take the form of loans to qualifying organizations or

150. I.R.C. § 4944(a)–(b) (2006).
151. *Id.* § 4944(c).
152. *Id.*
153. I.R.C. § 170(c)(2)(D) (2006); Treas. Reg. § 53.4944-3(a)(1)(iii) (2010).
154. I.R.C. § 170(c)(2)(D).
155. *See* Treas. Reg. § 53.4944-3(c).

individuals[156] as well as equity investments in certain business entities.[157] As recently as 2006, the Service ruled favorably on a PRI that was structured as an LLC venture fund established to make investments in start-up enterprises in order to further economic development and education by supporting entrepreneurs.[158]

Nevertheless, PRIs are rarely used. It is estimated that less than one percent of the approximately $90 billion expended each year by private foundations takes the form of PRIs.[159] There are several reasons why PRIs are relatively scarce.

First, unlike grants to public charities, PRIs are subject to the taxable expenditure rules of § 4945[160] and thus require the investing foundation to exercise "expenditure responsibility."[161] To comply with the expenditure responsibility rules of § 4945, a private foundation generally must undertake all reasonable efforts and establish adequate procedures to: (1) see that the PRI is spent only for the purpose for which it is made; (2) obtain full and complete reports from the recipient organization on how the funds are spent; and (3) make full and detailed reports on the PRI to the Service.[162] Most private foundations simply want to make grants to public charities without having to engage in the due diligence, monitoring, and reporting required for expenditure responsibility.

Further, unlike grants, PRIs conceivably can produce unrelated business taxable income ("UBTI") depending upon how the PRI is structured. Because interest normally qualifies for an exception to the UBI rules,[163] PRIs structured as loans typically do

156. *See, e.g.*, Rev. Rul. 78-90, 1978-1 C.B. 380 (ruling that PRIs include loans to blind persons unable to obtain loans through commercial sources); I.R.S. Priv. Ltr. Rul. 8225073 (Mar. 24, 1982) (concluding that a loan for the construction of a hotel in a blighted area was a PRI); I.R.S. Priv. Ltr. Rul 200034037 (May 31, 2000) (holding that below-market loans to foreign media entities are PRIs).

157. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 199943044 (Jul. 26, 1999) (ruling that a private foundation may own a for-profit entity's stock as a PRI); I.R.S. Priv. Ltr. Rul. 8526084 (Apr. 5, 1985) (holding that the acquisition by a private foundation of an equity interest in a newly formed corporation to create employment opportunities in an economically depressed area was a PRI).

158. *See* I.R.S. Priv. Ltr. Rul. 200610020 (Dec. 13, 2005).

159. Steven Lawrence, *Doing Good with Foundation Assets: An Updated Look at Program-Related Investments*, *in* THE PRI DIRECTORY: PROGRAM RELATED INVESTMENTS AND LOANS BY FOUNDATIONS xiii, xiii (Jeffrey A. Falkenstein & David G. Jacobs eds., 3d ed. 2010); Ragin, *supra* note 13, at 57.

160. I.R.C. § 4945 (2006).

161. Treas. Reg. § 53.4945-5(a)(1) (2010).

162. *Id.* § 53.4945-5(b)(1)(i–iii).

163. *See* I.R.C. § 512(b)(1) (2006 & Supp. III 2009).

not generate UBTI, but certain equity investments, particularly in partnerships and LLCs (including L3Cs), could generate UBTI.[164] Arguably, a PRI that is "substantially related" to the tax-exempt purpose of the investing private foundation, including an equity investment in an LLC or L3C, should not give rise to UBTI because the income would not be from an "unrelated" trade or business.[165] This also should be the result if the underlying LLC or L3C has debt financing in place. (Oddly, however, the author has found no clear, black-letter law statement of this seemingly fundamental principle.) The possibility of generating UBTI thus undoubtedly discourages PRIs among private foundations.

In other respects, however, PRIs can be superior to outright grants. First, like grants, PRIs (including administrative costs incurred in making them) count toward a private foundation's annual five percent minimum distribution requirement under § 4942.[166] Yet, as distinguished from grants, PRIs hold the very real promise of being repaid and perhaps even earning a profit. Second, under § 4940, interest and dividends on PRIs constitute gross investment income for purposes of the two percent annual excise tax on private foundations, but capital gains on PRIs are excluded.[167] Accordingly, PRIs have a distinct tax advantage to private foundations. Third, PRIs qualify as an exception to the excess business holdings rule of § 4943, which generally prohibits private foundations from owning more than twenty percent (but less than one hundred percent) of a for-profit business.[168] Finally, because they generally require repayment of some kind, PRIs may encourage greater accountability than grants, which ordinarily are not required to be repaid by the recipient organization.[169]

But PRIs may have additional significant drawbacks. For example:

The main problem with PRIs, and the main reason why

164. A discussion of the interrelationship between unrelated business taxable income and PRIs is beyond the scope of this article. *See generally* HILL & MANCINO, *supra* note 40, ¶¶ 12.02, 21.01–26.06 (discussing tax consequences of the investments of private foundations and unrelated business income).

165. *See* I.R.C. § 512.

166. I.R.C. § 4942 (2006); Treas. Reg. § 53.4942(a)-3(a)(2) (as amended in 1986).

167. I.R.C. § 4940 (2006); Treas. Reg. § 53.4940-1(f) (as amended in 1992).

168. I.R.C. § 4943 (2006); Treas. Reg. § 53.4943-10(b) (1977).

169. For a more thorough discussion comparing and contrasting grants and PRIs, see James P. Joseph & Andras Kosaras, *New Strategies for Leveraging Foundation Assets*, TAX'N EXEMPTS, July–Aug. 2008, at 22, 22.

> they are not more prevalent, is that there is no inexpensive route through which private foundations can . . . be confident that they have met [and will continue to meet all the] applicable [legal] requirements. Currently, the only truly safe route to making a PRI is either to (1) . . . [obtain] a private letter ruling from the IRS or (2) obtain an opinion of knowledgeable tax counsel. The primary difficulty with private letter rulings is that they take months to be issued and they are very costly in terms of legal fees. [Similarly,] an opinion of tax counsel generally is expensive as well. Furthermore, a legal opinion is not binding upon the IRS, and the IRS is free to disagree with the opinion and challenge the PRI. Because the stakes are very high [with PRIs] (i.e., an investment that does not satisfy the PRI requirements of Section 4944(c) would result in imposition of the excise tax and possibly a loss of tax-exempt status), and because of the time and cost involved in obtaining a legal opinion or private letter ruling, most private foundations [avoid PRIs altogether].[170]

C. *Financing The People's Market with a $6 Million PRI*

As noted above, to launch The People's Market, Sam must find $6 million in financing in addition to the $4 million to be invested in TPM Owner, LLC by himself and by his friends and family. Two of Terminus's private foundations are willing to provide this financing, but they are extremely resistant to providing the funds to TPM Owner, LLC via a PRI. These private foundations remain resistant even though Sam can point to a very similar PRI loan made to a for-profit entity as described in a Treasury regulation example that has been law for roughly forty years.[171] Furthermore, Sam's argument for the appropriateness of a PRI loan for The People's Market is bolstered by a recent ABA Tax Section submission to the Service proposing more modern examples of

170. Brewer & Rhim, *supra* note 7, at 12–13. Although not discussed further here, this common aversion to PRIs was the impetus behind the creation of the L3C. The state-law requirements for organizing and operating an L3C dovetail with the requirements for a valid PRI; however, this seemingly simple solution has its problems and complexities as well. For further information, see sources cited *supra* note 12.

171. Treas. Reg. § 53.4944-3(b) ex. 5 & 6 (1972) (authorizing below-market-rate loans to encourage businesses to operate in economically depressed areas).

PRIs.[172] Nevertheless, Foundations One and Two, although supportive of The People's Market project, remain unwilling to make a PRI loan to TPM Owner, LLC and will not expend the funds necessary to obtain a legal opinion or a private letter ruling.

Even if Terminus's two supportive private foundations might consider simply granting the funds over time to TPM Owner, LLC—grants to for-profit organizations are permitted—such grants nonetheless would require compliance with the expenditure responsibility rules of § 4945.[173] For this reason, Foundations One and Two are unwilling to grant funds to TPM Owner, LLC.

Absent the foregoing grants or PRI loans, no other source can be found to provide the remaining $6 million in capital that Sam needs. As a result, Sam has concluded that the for-profit model for The People's Market is inadequate.

V. TPM OWNER AS A "CONTRACT HYBRID"

Although it is possible for The People's Market to be owned and operated by either a tax-exempt nonprofit or a for-profit entity, neither model is optimal. The nonprofit model is appealing as a traditional, "tried and true" approach, but it forces Sam to forgo one of his primary commitments underlying the project: equity participation by Sam and his friends and family. The for-profit model permits equity participation, but because of legal uncertainties and associated tax compliance, the for-profit model eliminates any financing from Terminus's two interested private foundations. If Sam is unwilling to compromise in order to fit neatly within either the nonprofit or for-profit models, then perhaps a "contract hybrid" is the solution.

As previously noted in this article, LLCs are extraordinarily flexible legal entities.[174] An LLC is permitted to have managers that are not members and members that have no economic rights but do have voting rights. Unlike a corporation, where natural persons must comprise its board of directors, an LLC may have a juridical entity, such as another LLC, serve as its manager with the power and authority to direct and control the activities of the underlying

172. Letter from Stuart M. Lewis, Chair, ABA Section of Taxation, to Hon. Douglas Shulman, Comm'r, I.R.S. (Mar. 3, 2010), *in ABA Members Propose Additional Charitable Program-Related Investment Examples*, TAX NOTES TODAY, Mar. 5, 2010, *available at* 2010 TNT 43-16 (LexisNexis).

173. I.R.C. § 4945 (2006).

174. *See supra* Part I.

LLC.[175] In addition, LLCs that have only one member owning an economic membership interest are disregarded for income tax purposes, even where the same LLC may have other members without economic interests but who vote and otherwise influence the activities of the LLC.[176] In fact, with respect to an LLC wholly owned by a charitable organization, as noted above, the Service determined in 2010 that such an LLC may receive grants from private foundations without requiring the private foundations to exercise expenditure responsibility.[177]

With the foregoing in mind, suppose the following structure is implemented to launch The People's Market project: Sam will form TPM Owner, LLC to acquire and renovate the abandoned warehouse and to rent space to the participating retail businesses. Sam and his friends and family will capitalize TPM Owner, LLC with $4 million and will be the only "economic" members.[178] Sam and two other economic members will serve as the managers of TPM Owner, LLC and will direct its day-to-day activities. TPM Owner, LLC will finance, via a $6 million loan as described below, the remaining amount needed to acquire and renovate the warehouse that will house The People's Market. As stated in its operating agreement, the purpose of TPM Owner, LLC will be to own and operate The People's Market as envisioned by Sam; therefore, distributable profits to the economic members may be less than one might expect in a normal commercial real estate LLC. To the greatest extent legally permissible, the operating agreement will exculpate and indemnify Sam and the other two managers for pursuing the quasi-charitable purpose of the LLC over pure revenue generation.[179] The operating agreement for TPM Owner, LLC also will address capital calls, allocations and distributions to the members, buy-sell rights, transfer restrictions, and other terms common to operating agreements for a commercial real estate project.

In many respects, then, TPM Owner, LLC will resemble most

175. BISHOP & KLEINBERGER, *supra* note 8, ¶ 7.04[3][a].
176. *Id.* ¶ 2.07[1].
177. I.R.S. Info. Ltr. 2010-0052 (June 25, 2010).
178. As explained further below, "economic" members participate in allocations and distributions from an LLC and are treated as the owners of the LLC for income tax purposes. *See generally* BISHOP & KLEINBERGER, *supra* note 8, ¶ 1.04[5] (discussing the LLC as a bankruptcy remote entity or special purpose vehicle).
179. For a general discussion, see Tyler, *supra* note 12.

LLCs formed to acquire, own, and lease real estate. Importantly, however, the operating agreement for TPM Owner, LLC will be modified to accommodate a special, noneconomic voting member in addition to Sam and his friends and family: Foundation Member, LLC. As a noneconomic voting member of TPM Owner, LLC, Foundation Member, LLC will not be entitled to any allocations or distributions of income or losses from TPM Owner, LLC. As provided in the TPM Owner, LLC operating agreement, however, Foundation Member, LLC will be entitled to virtually all other rights and privileges of being a member of an LLC, including voting and approval rights, the right to inspect books and records, the right to receive financial statements, and (as discussed further below) certain special approval and veto rights over the actions of Sam and the other two managers of TPM Owner, LLC.[180] For instance, as long as it is a member, the operating agreement of TPM Owner, LLC could provide that Foundation Member, LLC must consent to any action that would alter the fundamental nature of The People's Market as a neighborhood-revitalization and job-creation vehicle that also is environmentally friendly. Foundation Member, LLC also could have the right to approve any future financings or refinancings of TPM Owner, LLC; the admission of other members to TPM Owner, LLC; and any other "major decisions" as defined in the operating agreement of TPM Owner, LLC. It is important to note, in this regard, that although Foundation Member, LLC will have substantial control rights with respect to TPM Owner, LLC—because it is a member and not a manager, and TPM Owner, LLC is manager-managed—Foundation Member, LLC will owe no fiduciary duties to the other members of TPM Owner, LLC in exercising its rights as a member.[181]

Foundation Member, LLC will be a newly formed LLC owned entirely by Terminus Community Loan Fund, Inc. ("TCLF").[182] Furthermore, Foundation Member, LLC itself will have a unique aspect to its formation and operation. Specifically, Foundation Member, LLC will be capitalized with a small capital contribution from TCLF of $10,000, a conditional $3 million *pledge* (not an outright grant) from Foundation One, and a $3 million conditional

180. *See* BISHOP & KLEINBERGER, *supra* note 8, ¶ 1.04[5][b][i][C].

181. *See id.* ¶ 1.04[5][b][ii][B] (discussing the fiduciary duties that members and managers of an LLC owe to members).

182. Conceivably, if TCLF were unwilling or unable, Foundation Member, LLC could be owned entirely by TC.

zero percent interest *line of credit* from Foundation Two.[183] The pledge and line-of-credit agreements entered into by Foundation One and Foundation Two will have discretionary limitations and conditions upon each foundation fulfilling its financial commitment. Most importantly, Foundations One and Two will insist that they have ongoing approval rights over funds that are advanced to TPM Owner, LLC as a loan from Foundation Member, LLC. Therefore, TCLF has decided that Foundation Member, LLC will have three initial non-member managers: one representative from each of Foundations One and Two and one representative from TCLF. If at any time either foundation no longer has a representative appointed as a manager of Foundation Member, LLC, such foundation may cease funding the project.

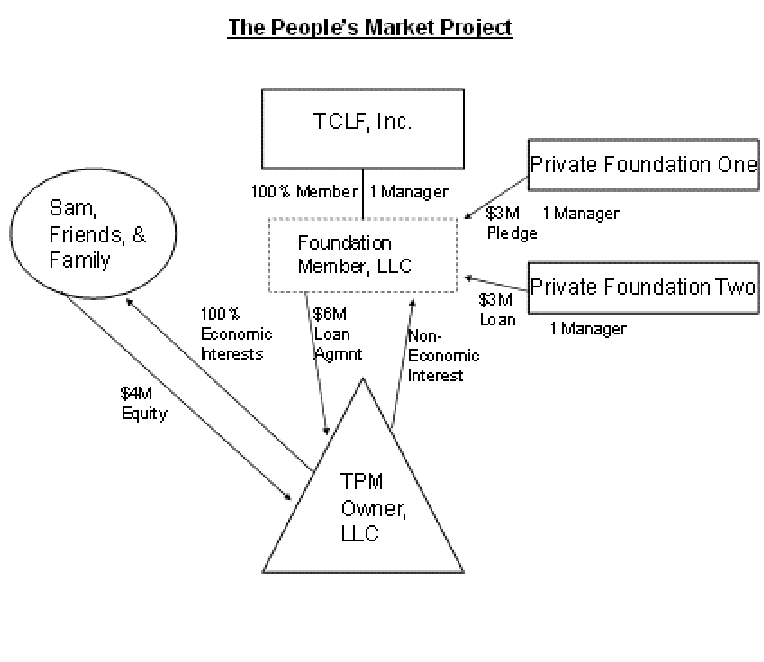
Accordingly, the operating agreement will grant day-to-day control of Foundation Member, LLC to its three nonmember managers (who may delegate authority to appointed officers). In addition, the operating agreement will provide the greatest possible exculpation and indemnification rights to the three managers (and any appointed officers) of Foundation Member, LLC. As the sole member, TCLF will retain sole right to appoint and remove the managers, but TCLF understands that funding from Foundations One and Two is conditional on those foundations having representative managers. Further, as the sole member, TCLF will be entitled to terminate and liquidate Foundation Member, LLC at any time in its discretion; and in connection with any such termination and liquidation, all of Foundation Member, LLC's remaining assets after payment of liquidation expenses will be distributed to TCLF. TCLF also will be entitled to transfer its membership interest in Foundation Member,

183. Foundations One and Two might be able to set aside $3 million each and have those set-asides count as qualifying distributions under § 4942(g)(2)(B) of the Internal Revenue Code. Under § 4942, private foundations generally are required to distribute five percent of their funds annually or pay certain penalty taxes. *See* I.R.C. § 4942(a)–(e) (2006). If certain conditions are met, set-asides may count as a "qualifying distribution," even if the funds are not actually released to the eventual recipient. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2011-05-051 (Nov. 9, 2010) (funds set aside to improve camp facilities over three-year period); I.R.S. Priv. Ltr. Rul. 2011-05-052 (Apr. 26, 2010) (funds set aside to provide technical support, capacity building, and financing for five-year conservation easement project). In any event, when the funds are provided to Foundation Member, LLC, either as a grant from Foundation One or a loan from Foundation Two, for reasons explained in detail below, those expenditures will count against the five percent annual distribution requirement.

LLC at any time to a third party.

Thereafter, Foundation Member, LLC will enter into a loan agreement with TPM Owner, LLC, whereby if certain conditions are met in the discretion of its three nonmember managers, Foundation Member, LLC will advance up to $6 million in periodic increments (like a standard construction loan) to TPM Owner, LLC. When combined with the $4 million in capital contributed by Sam and his friends and family (which will be expended first), the $6 million commitment provided by Foundation Member, LLC will round out the capital needed to fund The People's Market project. The loan will be full recourse to TPM Owner, LLC, will be secured by a first mortgage on the to-be-renovated warehouse and the underlying real estate, and will bear interest at a below-market rate of two percent. The two percent rate is meant to cover the administrative and other costs TCLF will incur in connection with making the loan. The loan agreement will prohibit, and will treat as an event of default, any use of the funds for lobbying or political activities.

An ownership diagram of The People's Market project as so-conceived is set forth below:



A. *Overview*

The above-described "contract hybrid" structure for The People's Market obviously carries with it substantial complexity. The critical question, though, is whether this added complexity nevertheless achieves Sam's objectives, especially his goal of raising capital from both philanthropic and private sources. Before delving into the specific pros and cons, though, there are a few key aspects of the structure that deserve special emphasis.

1. *Income Tax Treatment of TPM Owner, LLC and Foundation Member, LLC*

Initially, it is important to understand the federal income tax treatment[184] of TPM Owner, LLC and Foundation Member, LLC. As a multimember LLC, TPM Owner, LLC will be treated as a partnership for federal income tax purposes.[185] This means that TPM Owner, LLC generally will not pay income taxes, but instead the income earned by the enterprise will be allocated to the members, and the members then will report and pay tax on their respective shares of the enterprise's income.[186] This is why limited liability companies are commonly referred to as "flow-through" or "pass-through" entities for income tax purposes.

A very simple example illustrates the point. Assume a tax-exempt organization and unrelated wealthy individuals form an investment fund as an LLC. The fund is set up to function purely as a passive investment vehicle. The LLC thus invests in publicly traded stocks and bonds and does not incur debt. The exempt organization owns a ten percent membership interest in the LLC as a portion of its normal endowment assets, while the wealthy individuals own the remaining ninety percent of the LLC. If in a given tax year the LLC earns $1,000 in capital gain income and $100 in taxable interest income, then generally speaking $100 of

184. State income tax treatment is important to know as well but, for the sake of convenience, this article assumes that in the case of TPM Owner, LLC and Foundation Member, LLC, the state income tax treatment mirrors the federal income tax treatment.

185. TPM Owner, LLC could elect corporate treatment, but such an election would not be typical in a commercial real estate venture. *See* BISHOP & KLEINBERGER, *supra* note 8, ¶ 2.01 ("Unincorporated, multi-member U.S. business organizations have a 'default classification' as partnerships, unless they check-the-box to elect otherwise.").

186. For a thorough discussion of limited liability companies and their income tax attributes, see generally BISHOP & KLEINBERGER, *supra* note 8, ¶ 2.

capital gain income and $10 of interest income will be allocated to the exempt organization for tax purposes. Further, with respect to the exempt organization, because the income (i.e., interest and capital gain) falls within § 512 exceptions and is not debt-financed, it is not subject to UBIT.[187] The rest of the capital gain and interest income will be allocated to the wealthy individuals who will pay federal (and generally state) income taxes at their prevailing rates on the income so allocated to them. In other words, the income of the LLC "passes through" to its members who are responsible for reporting and, if applicable, paying taxes on the income in accordance with their particular tax status.

Next, it is critical to understand the federal income tax treatment of Foundation Member, LLC. Although Foundation Member, LLC is a member of TPM Owner, LLC, it is not a "partner" of TPM Owner, LLC for federal income tax purposes. Foundation Member, LLC has no economic interest in TPM Owner, LLC, so Foundation Member, LLC is not entitled to allocations or distributions of profits or losses from TPM Owner, LLC. The LLC statutes of many states expressly permit this separation of economic and other rights.[188] When it comes to determining income and who is taxable on that income, federal tax law generally focuses on economic rights, and not necessarily other rights (e.g., voting, access to books and records, approval of amendments). Foundation Member, LLC will be entitled to interest and repayments of principal with respect to its loan to TPM Owner, LLC, but it will receive those payments in its capacity as a creditor, not as a member.[189]

187. I.R.C. § 512(b) (2006).

188. *See, e.g.*, DEL. CODE §§ 18-107, 18-301(d), 18-302(e) (2011) (providing for the rights and obligations of LLCs, contribution requirements for admission into LLCs, and amendment limits of LLC agreements); *see also* BISHOP & KLEINBERGER, *supra* note 8, ¶ 1.04[5][b][ii][B] ("If state law indicates that only members may be a party to the operating agreement and also provides that a person can be a member without making a capital contribution, the remote creditor (or its representative) may become a noneconomic member for purposes of protecting the operating agreement from unwanted amendment.").

189. This article does not attempt to address the debt-equity issues inherent in the structure. Suffice it to say that if the loan from Foundation Member, LLC to TPM Owner, LLC has all of the normal attributes of a standard commercial real estate loan (regular payments of interest and principal, adequate security, stated maturity date, etc.), it should be respected as debt, not equity. If, on the other hand, the loan from Foundation Member, LLC to TPM Owner, LLC was a "participating loan" as described previously in this article, then the debt-equity issue would be much more sensitive. In this case, if the loan were re-characterized

This ability to separate other rights from economic rights in an LLC and have that separation recognized for federal income tax purposes is relatively well accepted. For example, in Private Letter Ruling 199914006, the Service held, in a similar loan arrangement as described above, that a noneconomic member would not be treated as a partner for federal income tax purposes, even though the noneconomic member's consent was required for the LLC to (1) engage in any business activity beyond its stated purpose, (2) file a voluntary petition for bankruptcy, (3) merge or consolidate with any other entity, (4) sell substantially all of its assets, or (5) amend its governing documents.[190]

In addition, it is equally important to understand that because Foundation Member, LLC is a single-member limited liability company (i.e., its only member is TCLF), Foundation Member, LLC is completely disregarded for federal income tax purposes.[191] In fact, Foundation Member, LLC will not even file a federal income tax return because all of its profits and losses (if any) and other activities will be reported on TCLF's income tax return (IRS Form 990).[192] That does not mean, however, that Foundation Member, LLC is not respected for purposes other than federal income taxation. Quite the opposite is true. Foundation Member, LLC will possess all of the privileges of any LLC and generally will be respected as an entity separate and apart from its sole member, TCLF. Thus, even though Foundation Member, LLC is disregarded for income tax purposes, it can enter into contracts (such as the loan to TPM Owner, LLC) and otherwise conduct business. Moreover, if Foundation Member, LLC operates independently from TCLF, and not merely as its agent, then TCLF will be protected from liability arising out of the activities of Foundation Member, LLC.[193] The managers of Foundation Member, LLC also may be protected from fiduciary liability to

as equity, then Foundation Member, LLC becomes a "partner" for income tax purposes and the tax treatment of the entire structure falls apart. *See generally* Carman & Bender, *supra* note 70 (discussing the debt-equity test to classify an entity as a partner for federal income tax purposes).

190. I.R.S. Priv. Ltr. Rul. 199914006 (Dec. 23, 1998).

191. Treas. Reg. § 301.7701-2(c)(2)(i) (2011).

192. *See* Rev. Rul. 2004-77, 2004-2 C.B. 119; *see, e.g.*, I.R.S., U.S. DEP'T OF THE TREASURY, INSTRUCTIONS FOR SCHEDULE R (FORM 990), CAT. NO. 51519M (2010).

193. *See* Cassady Brewer & Sean Reynolds, *Business and Tax Planning with Controlled Organizations*, TAX'N EXEMPTS, July–Aug. 2007, at 3; Dominic Daher & Barry Brents, *Achieving Enhanced Liability Protection Through SMLLCs*, TAX'N EXEMPTS, Nov.–Dec. 2006, at 137.

TCLF (the sole member) by exculpatory provisions in the operating agreement of Foundation Member, LLC,[194] and they may be protected from third-party liability (such as to TPM Owner, LLC) through indemnification provisions in Foundation Member, LLC's operating agreement.[195]

2. *TCLF and Private Foundations Have Control Without Fiduciary Liability*

There is a very important aspect of this structure that deserves reiteration. TPM Owner, LLC is a manager-managed LLC. Its managers, Sam and his two colleagues, will have fiduciary duties to the members of TPM Owner, LLC (including Foundation Member, LLC). Under many state LLC statutes, those fiduciary duties can be modified and to some extent waived by TPM Owner, LLC's operating agreement, but as a member and signatory to the operating agreement, Foundation Member, LLC will have control over the breadth of any such modification or waiver of fiduciary duties. Foundation Member, LLC also will have rights to financial and other information from TPM Owner, LLC and may inspect the books and records of TPM Owner, LLC. Moreover, Foundation Member, LLC, as a member in a manager-managed LLC, will owe no fiduciary duty whatsoever to the other members of TPM Owner, LLC. Thus, Foundation Member, LLC generally can act entirely in its own self-interest when deciding to exercise its rights under the operating agreement of TPM Owner, LLC. This in turn allows TCLF and Foundations One and Two to build into the operating agreement of TPM Owner, LLC certain approval or other rights that prohibit TPM Owner, LLC from behaving in a manner that is inconsistent with its quasi-charitable purpose. These control provisions in TPM Owner, LLC's operating agreement help safeguard the tax-exempt status of TCLF and Foundations One and Two.[196]

194. *See, e.g.*, DEL. CODE § 18-1101(b) (2011); *see also* BISHOP & KLEINBERGER, *supra* note 8, ¶¶ 1.04[5][b][ii][C], 7.09 (noting that every manager normally owes a fiduciary duty of loyalty to members but that, when properly structured, the members may modify in their operating agreement the duty of loyalty that the creditor's representative manager owes its members).

195. *See, e.g.*, DEL. CODE. § 18-108 (2011); *see also* BISHOP & KLEINBERGER, *supra* note 8, ¶ 10.08 (stating that enabling statutes generally authorize LLCs to indemnify managers by including indemnification provisions in operating agreements that delineate or restrict manager indemnification).

196. *See* sources cited *supra* note 194.

3. The Loan Model Aligns with Established Precedent

Unlike either the nonprofit model or the for-profit model, and despite its novelty, the hybrid model described above aligns with established precedent. For instance, in Revenue Ruling 74-587, the Service approved tax-exempt status for an organization that made low-cost or long-term loans to business enterprises in economically depressed areas.[197] These loans were designed to "relieve poverty, eliminate prejudice, reduce neighborhood tensions, and combat community deterioration"[198] by encouraging entrepreneurship and economic growth in the otherwise impoverished area. The following statement from the Revenue Ruling is instructive:

> Although some of the individuals receiving financial assistance in their business endeavors under the organization's program may not themselves qualify for charitable assistance as such, that fact does not detract from the charitable character of the organization's program. The recipients of loans and working capital in such cases are merely *the instruments by which the charitable purposes are sought to be accomplished.*[199]

This published ruling thus makes the very important and established point that charitable purposes sometimes are best accomplished through organizations that are not in and of themselves charitable.

Another salient point about the contract hybrid described herein is that the loan from Foundation Member, LLC to TPM Owner, LLC is *not* a PRI, although it is purposely designed to be substantially similar.[200] As discussed above, a PRI is an investment (debt or equity, or even a guaranty) that meets the requirements of § 4944(c).[201] Namely, it is an investment made primarily to accomplish a charitable purpose, not to generate a profit, and would not have been made but for the accomplishment of that charitable purpose.[202] The loan from Foundation Member, LLC to

197. Rev. Rul. 74-587, 1974-2 C.B. 162.
198. *Id.*
199. *Id.* at 2 (emphasis added).
200. *See* Treas. Reg. § 53.4944-3(b) ex. 5 (2011) (below-market interest rate loan to publicly traded company to entice company to build manufacturing facility in deteriorated urban area); *id.* § 53.4944-3(b) ex. 6 (below-market interest rate loan to nonprofit community development corporation to market agricultural products for low-income farmers in a depressed rural area).
201. *See supra* notes 150–70 and accompanying text.
202. I.R.C. § 4944(c) (2006). Lobbying and political expenditures also are

TPM Owner, LLC is being made at a below-market interest rate to a quasi-charitable project that has been unable to obtain any other source of financing. Technically, though, the loan is not a PRI because the lender is not a private foundation.[203] Instead, for federal income tax purposes, the loan is treated as having been made by TCLF, a public charity, through its wholly owned, disregarded LLC subsidiary, Foundation Member, LLC. Pursuant to Information Letter 2010-0052,[204] any grants or loans made to Foundation Member, LLC by Foundations One and Two, which in turn fund the loan to TPM Owner, LLC, are treated as grants to a public charity and do not require the exercise of expenditure responsibility.[205]

This conclusion really should be no surprise. There is ample prior precedent to support the Service's determination in Information Letter 2010-0052 that a wholly-owned, disregarded subsidiary of a public charity should be ignored for federal income tax purposes, including with respect to grants to the subsidiary.[206]

4. *The Conduit Rules of Section 4945*

On the other hand, there are rules that prohibit a private foundation from using a public charity as a mere conduit to funnel

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prohibited for PRIs. Treas. Reg. § 53.4944-3.

203. *See* James Joseph, *Program-Related Investments and You—Perfect Together*, TAX'N EXEMPTS, Mar.–Apr. 2010, at 10 (suggesting that PRI-like investments by public charities create "sustainable" giving in a time when philanthropic dollars are limited).

204. I.R.S. Info. Ltr. 2010-0052 (Mar. 15, 2010), *available at* http://www.irs.gov/pub/irs-wd/10-0052.pdf; *see also* Mitchell Rogovin, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View from Within*, 46 DUQ. L. REV. 323, 352 (2008) ("An information letter is a statement, issued either by the Office of Chief Counsel or by the Service, which does no more than call attention to a well-established interpretation or principle of tax law, without applying it to a specific set of facts."). The purpose of an information letter is simply to impart general information to the individual or organization seeking such information. *Id.* at 352–53. The government, however, is not bound by any statements made within an information letter, as these letters are not rulings. *Id.*

205. This remains true even though, as discussed below, the loan from Foundation Two to Foundation Member, LLC is in fact a PRI.

206. I.R.S. Priv. Ltr. Rul. 200606047 (Nov. 14, 2005); I.R.S. Priv. Ltr. Rul. 200538027 (Sept. 23, 2005); I.R.S. Priv. Ltr. Rul. 200436022 (June 9, 2004); I.R.S. Announcement 99-102, 1999-43 I.R.B. 545 (Oct. 25, 1999). A number of articles also discuss the available planning possibilities through the use of single-member LLCs owned by charitable organizations. *See* Brewer & Reynolds, *supra* note 193; Daher & Brents, *supra* note 193.

grants to private individuals and organizations without exercising expenditure responsibility. Those rules conceivably could apply to any grants being made to Foundation Member, LLC that are in turn used to fund a loan to TPM Owner, LLC. Applicable regulations provide as follows:

> A grant by a private foundation to a grantee organization which the grantee organization uses to make payments to another organization (the secondary grantee) shall not be regarded as a grant by the private foundation to the secondary grantee if the foundation does not earmark the use of the grant for any named secondary grantee and there does not exist an agreement, oral or written, whereby such grantor foundation may cause the selection of the secondary grantee by the organization to which it has given the grant. For purposes of this subdivision, a grant described herein shall not be regarded as a grant by the foundation to the secondary grantee even though such foundation has reason to believe that certain organizations would derive benefits from such grants so long as the original grantee organization exercises control, in fact, over the selection process and actually makes the selection completely independently of the private foundation.[207]

At first glance, the above-quoted language seems damning. Specifically, with respect to the contract hybrid structure described herein, it is clear that Foundations One and Two will be making grants[208] to Foundation Member, LLC solely to allow it to fund the loan to the "secondary grantee," TPM Owner, LLC. This process could be construed as "earmarking" the grant contrary to the above-quoted regulation. Furthermore, pursuant to an operating agreement, Foundations One and Two will have representatives (appointed by TCLF) as two of the three managers of Foundation Member, LLC. Such an arrangement certainly would seem to be an "agreement" to cause the "selection of the secondary grantee" in violation of the regulation such that Foundation Member, LLC will not be acting "completely independently" of Foundations One and Two.

The author believes, though, that the contract hybrid structure described herein nevertheless is permitted and does not violate

207. Treas. Reg. § 53.4945-5(a)(6) (2011).
208. Pursuant to Treas. Reg. § 53.4945-4(a)(2) (2011), the term "grants" for this purpose includes loans.

either the "earmarking" prohibition or the "complete independence" requirement of the regulations. The author's conclusion is based upon a careful reading of the regulations under § 4945[209] and by comparing and contrasting two accompanying examples in the regulations. Moreover, as explained below, the Service's interpretation of the above-quoted regulatory language and the accompanying examples in one very illustrative Private Letter Ruling supports the author's position.

a. Regulatory Examples and Illustrative Private Letter Ruling

With respect to the prohibition on conduit grants through public charities, the Treasury regulations under § 4945 set forth substantially similar rules for testing grants to individuals and grants to organizations. Treasury Regulation § 53.4945-4 concerns conduit grants to individuals,[210] while § 53.4945-5 concerns conduit grants to organizations.[211] In particular, § 53.4945-4(a)(4)(iv) sets forth two examples that illustrate the concepts of "earmarking" and "complete independence" for purposes of determining whether a public charity is a mere conduit for a grant that otherwise would require expenditure responsibility.[212]

In the first example,[213] a tax-exempt university requests that a private foundation grant the university $100,000 to hire an exceptionally qualified biochemist. The foundation, after deciding that it wishes to support the effort to hire the biochemist, grants the university $100,000. The example states that even if the foundation may withdraw the grant if the university is unable to hire the specified biochemist, because the facts and circumstances demonstrate that the university, not the foundation, initially identified the biochemist, there is an "objective manifestation" that the university is in control of the process and is not acting as a mere conduit.

Conversely, in the second example,[214] the facts show that there

209. I.R.C. § 4945 (2006).

210. Treas. Reg. § 53.4945-4 (1972) (containing special rules relating to grants for "travel, study, or other similar purposes" for individuals as opposed to a grant to an indigent person to allow him or her to purchase furniture, although the underlying principles relating to "earmarking" and "complete independence" essentially are the same).

211. Treas. Reg. § 53.4945-5 (as amended in 1973).

212. Treas. Reg. § 53.4945-4(a)(4)(iv).

213. *Id.* § 53.4945-4(a)(4)(iv) ex.1.

214. *Id.* § 53.4945-4(a)(4)(iv) ex.2.

are a number of qualified biochemists and the foundation, not the university, initially identifies the biochemist to be hired. Further, the facts recite that the university is not authorized to keep the grant funds if it is unable to hire the particular biochemist identified by the foundation. In this case, the facts and circumstances demonstrate that the selection of the biochemist was made by the foundation, not the university. Therefore, the university is acting as a mere conduit, and the foundation must comply with the expenditure responsibility rules of § 4945.

Private Letter Ruling 199943058 further illustrates how the initial involvement of the public charity in the selection process avoids the conduit prohibition, even where the selection of the recipient is monitored by the private foundation.[215] In this private ruling, a private foundation, Foundation X, proposed to establish a loan program to facilitate start-up or expansion of businesses in a foreign country, Country M. Because Country M was war-torn and economically depressed, affordable growth capital there was virtually nonexistent. Foundation X's proposed loan program consisted of two parts: a "government program" and a "direct loan or investment program." In the government program, Foundation X would make a zero percent interest loan to the government of Country M. Country M in turn would make loans to privately owned banks within Country M. Those banks then would lend funds to private enterprises to finance start-up businesses or expansion and would charge reasonable rates of interest. Although the government of Country M would select the local banks to participate in the loan program, Foundation X retained the right to approve the local banks chosen by the government before funding the loans. The private ruling stated that Foundation X's purpose for reserving its approval rights was to ensure compliance with the terms of the overall loan program between Foundation X and the government of Country M. The private ruling also stated that Foundation X would *not* exercise expenditure responsibility over the funds advanced under the government loan program.

With respect to the direct loan program, Foundation X proposed to make direct loans or equity investments in businesses in Country M that need start-up or expansion capital. Foundation X would select the eligible businesses in the direct loan program, and Foundation X *would* exercise expenditure responsibility for the

215. I.R.S. Priv. Ltr. Rul. 199943058 (Aug. 6, 1999).

direct loan program.

Foundation X sought a number of rulings with respect to its loan program. Most of those rulings are not directly relevant to the conduit prohibition discussed in this article, but they are noteworthy. Specifically, the Service held that Foundation X's proposed loan program (1) would qualify as a permissible charitable endeavor, (2) would not violate the self-dealing rules of § 4941,[216] (3) would meet the qualified distribution rules of § 4942,[217] (4) would be treated as a PRI so as not to constitute a jeopardizing investment under § 4944,[218] and (5) would not give rise to UBIT (either because the loan program would be a substantially related activity or any interest or gains derived from the loans would qualify for an exception to UBI).[219] Furthermore, in a follow-up private ruling[220] relating to the fact that Foundation X proposed to charge no interest on its loans, the Service determined that §§ 483, 1273, 1274, and 7872[221] would not apply to impute interest income to Foundation X. Otherwise, as a result of the imputed interest, Foundation X would have been subject to the tax on net investment income under § 4940 even though it had not planned to charge interest on its loan to the government of Country M.[222]

With respect to the application of the expenditure responsibility rules of § 4945,[223] the Service applied a very precise analysis to rule in favor of Foundation X with respect to both the government loan program and the direct loan program. In particular, the Service ruled that Foundation X's proposed loan to the government of Country M *would* constitute a PRI; however, Foundation X was not required to exercise expenditure responsibility with respect to this PRI because, pursuant to applicable Treasury regulations, the government of Country M is treated the same as a public charity for purposes of § 4945 so long as the grant to the government is made for charitable purposes.[224] Therefore, because the government of Country M initially selected

216. I.R.C. § 4941 (2006).
217. I.R.C. § 4942 (2006 & Supp. 2009).
218. I.R.C. § 4944 (2006).
219. I.R.C. § 512(a), (b) (2006 & Supp. 2009).
220. I.R.S. Priv. Ltr. Rul. 200036050 (June 13, 2000).
221. I.R.C. §§ 483, 1273, 1274, 7872 (2006).
222. I.R.C. § 4940 (2006 & Supp. 2009).
223. I.R.C. § 4945 (2006).
224. Treas. Reg. § 53.4945-5(a)(4)(iii) (2007).

the local banks to participate in Foundation X's government loan program, Foundation X's rights to monitor the selection process and approve the selected banks did not violate the regulation's prohibition on using a public charity—in this case, the government of Country M—as a mere conduit.

With respect to Foundation X's proposed direct loan program, the Service similarly determined that its loans would constitute PRIs, but contrary to the government loan program, would require the exercise of expenditure responsibility. The Service reasoned that the direct loan program would require the exercise of expenditure responsibility because Foundation X would choose the eligible recipients rather than the government of Country M.

b. The Structure Does Not Violate the Conduit Rules of Section 4945

Similar to the selection processes described in the first regulatory example mentioned above and in Private Letter Ruling 199943058, TCLF identified The People's Market project and approached Foundations One and Two for funding, not the reverse. In addition, as its sole member, TCLF retains complete control over Foundation Manager, LLC. TCLF has the right to appoint and remove the managers of Foundation Member, LLC, as well as the right to liquidate or transfer its ownership in Foundation Member, LLC at any time, even though exercising such rights will terminate funding by Foundations One and Two. The author believes that such powers constitute an "objective manifestation" of "completely independent" control over the grant funds such that Foundations One and Two will not be treated as having "earmarked" the funds for The People's Market and thus will not have violated the conduit rules of § 4945.

5. Could Foundation Member, LLC Be Considered a Donor Advised Fund?

Another potential obstacle to using the contract hybrid described in this article is § 4966.[225] Section 4966 was enacted in 2006 to curtail certain perceived abuses by donor advised funds with respect to grants to individuals and non-charitable organizations. This relatively new law imposes an excise tax on a

225. I.R.C. § 4966 (2006).

"sponsoring organization" for each "taxable distribution" it makes from a "donor advised fund."[226] It also imposes an excise tax on any fund manager of the sponsoring organization that knowingly permitted the taxable distribution.[227] Although it is important to set forth herein the legal analysis as to why, in the author's opinion, § 4966 does not apply to Foundation Member, LLC or The People's Market, the reader is forewarned that the analysis is very technical. (Thus, the trusting reader may want to skip the next few paragraphs.)

In general, under § 4966(c), a taxable distribution is "any distribution from a donor advised fund" to any natural person, or to any other person, if (1) the "distribution is for any purpose other than one specified in section 170(c)(2)(B),"[228] or (2) "the sponsoring organization [maintaining the donor advised fund] does not exercise expenditure responsibility with respect to such distribution in accordance with section 4945 (h)."[229] Under § 4966(c)(2), a taxable distribution does not include a distribution from a donor advised fund to: (1) "any organization described in section 170(b)(1)(A) (other than a disqualified supporting organization)," (2) "the sponsoring organization of such donor advised fund," or (3) "any other donor advised fund."[230]

For these purposes, a "donor advised fund" is defined as:

> [A] fund or account owned and controlled by a sponsoring organization, which is separately identified by reference to contributions of a donor or donors, and with respect to which the donor, or any person appointed or designated by such donor ('donor advisor'), has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of the funds.[231]

A "sponsoring organization" is defined for this purpose as a § 170(c) organization that is not a governmental organization (referenced in § 170(c)(1) and (2)(A)) or a private foundation that maintains one or more donor advised funds.

226. *Id.* § 4966(a)(1).
227. *Id.* § 4966(a)(2).
228. *Id.* § 4966(c)(1)(B)(i) (identifying groups organized and operated for charitable, religious, educational, and other specified exempt purposes).
229. *Id.* § 4966(c)(1)(B)(ii) (describing rules pertaining to the exercise of expenditure responsibility).
230. *Id.* § 4966(c)(2).
231. *Id.* § 4966(d)(2), *interpreted by* I.R.S. Notice 2006-109, 2006-2 CB 1121, *superseded in other respects by* Rev. Proc. 2009-32, 2009-28 I.R.B. 142.

Conceivably, § 4966 could be read to treat TCLF as a "sponsoring organization" and Foundations One and Two as "donor advisors." If that were the case, then Foundation Member, LLC could be considered a "donor advised fund." The loan from Foundation Member, LLC thus would be a taxable expenditure unless Foundation Member, LLC (for tax purposes, TCLF) exercised expenditure responsibility with respect to the loan.

Sensibly, however, § 4966 contains an exception to the term "donor advised fund" that is applicable here. Specifically, § 4966(d)(2)(B) provides that a donor advised fund does not include a fund or account: (1) that makes distributions only to a single identified organization or governmental entity or (2) with respect to which a donor advises a sponsoring organization regarding grants for travel, study, or similar purposes if certain further conditions are met.[232] Because Foundation Member, LLC is a "single identified organization" (which in turn is disregarded for tax purposes such that TCLF actually is the relevant "organization"), § 4966 should not apply to The People's Market project.[233]

Having established that the contract hybrid described herein complies with applicable law, an examination of the advantages and disadvantages of the structure is in order. The following discussion highlights the primary advantages and disadvantages, especially as compared to the pure for-profit and nonprofit models.

B. *Principal Advantages*

The contract hybrid described herein preserves the ability for donors to take charitable contribution deductions for their donations to The People's Market, albeit somewhat indirectly. Those donors could contribute funds to TCLF, take an income tax deduction for a contribution to a public charity, TCLF could contribute the funds to the capital of Foundation Member, LLC, and then cause Foundation Member, LLC to use the contribution

232. *Id.* § 4966(d)(2)(B).

233. For example, the Service interpreted this exception so as to exclude from § 4966 employer-sponsored disaster relief funds that follow certain standard requirements for selecting beneficiaries. *See* I.R.S. Notice 2006-109, 2006-2 C.B. 1121, *superseded in other respects by* Rev. Proc. 2009-32, 2009-28 I.R.B. 142. Typically, an employer-sponsored disaster relief fund receives contributions from the employer and its employees. *Id.* § 1. In turn, through an independent selection committee that uses objective criteria, the fund provides financial assistance to employees and their families that are the victims of a major disaster. *Id.*

to fund portions of the loan to TPM Owner, LLC. Logically, donors should be able to contribute funds directly to Foundation Member, LLC and obtain an income tax deduction since Foundation Member, LLC is disregarded for income tax purposes; however, the IRS has yet to rule publicly that a contribution to a wholly-owned LLC subsidiary of a tax-exempt entity qualifies for the charitable contribution deduction under § 170.[234]

The interest payable on the loan by TPM Owner, LLC to Foundation Member, LLC will qualify for an exception to UBI and therefore will not constitute UBIT.[235] If Foundation Member, LLC made an equity investment into TPM Owner, LLC, the rental income from the retail businesses generally would not qualify for an exception to UBIT because it is tied to net, as opposed to gross, revenues. It also would be hard for TCLF to argue that the income from TPM Owner, LLC flowing through Foundation Member, LLC is "substantially related" to TCLF's exempt purpose, which is lending money to disadvantaged businesses, not acting as a landlord.

As discussed in detail above, the contract hybrid described herein does not require Foundation One or Foundation Two to comply with the expenditure responsibility rules. This is true even though Foundation Two's loan to Foundation Member, LLC is a PRI. Because TCLF is a public charity, and its wholly-owned subsidiary, Foundation Member, LLC is disregarded, § 4945 does not apply.[236] Compliance with the expenditure responsibility rules of § 4945 is one of the more significant impediments to private foundations using PRIs as part of their philanthropic mission.[237] The contract hybrid described herein avoids this impediment.

The contract hybrid also preserves the ability for Sam, his friends, and his family to participate in the earnings and growth of The People's Market. Assuming The People's Market is profitable, then after payment of interest to Foundation Member, LLC, the remaining profit will be allocable and distributable to the members of TPM Owner, LLC. This accomplishes one of Sam's central objectives in conceiving The People's Market.

234. *See* Letter from Charles H. Egerton, Chair, ABA Section of Taxation, to Hon. Douglas Shulman, Comm'r, I.R.S. (July 25, 2011), *available at* http://taxprof.typepad.com/files/aba-tax-section.pdf.

235. I.R.C. § 512(b)(1) (2006).

236. I.R.C. § 4945 (2010); *see supra* note 235 and accompanying text; *infra* notes 239–47.

237. *See* Ragin, *supra* note 13.

C. Principal Disadvantages

Complexity obviously is a significant disadvantage of the contract hybrid described in this article. Two LLCs, instead of one, will be required. The terms of the loan between Foundation Member, LLC will be complicated. TPM Owner, LLC, TCLF, and Foundations One and Two all may need legal and tax counsel to even begin to get comfortable with the structure. In the author's experience, however, the level of complexity created by the contract hybrid described herein is typical of most private commercial real estate transactions. Thus, the cost in terms of legal fees should not be out of the ordinary. On the other hand, as can be seen from the discussion above, all of the special rules applicable to tax-exempt organizations, especially private foundations, must be taken into account in addition to the normal complexities. Counsel must be familiar with these special rules and engaging counsel with such expertise undoubtedly will increase legal costs. Hopefully, this article goes a long way to provide guidelines for knowledgeable counsel to follow. Regardless, complexity is inevitable in balancing diverse and competing interests of several parties to a transaction, and the contract hybrid described herein unfortunately is no exception.

Perhaps the most significant disadvantage, which is one of the most vexing issues that tax-exempt organizations must consider when entering into complex transactions with for-profit enterprises, is the private benefit prohibition. The private benefit prohibition is discussed in significant detail elsewhere in this article,[238] so it will not be revisited here. As the reader will recall, the essential question is whether TCLF and Foundations One and Two have conferred an impermissible amount of private benefit upon TPM Owner, LLC by entering into the financing of The People's Market. There is no question that some private benefit is being bestowed upon Sam, his friends, and his family via TPM Owner, LLC. Clearly, The People's Market project could not be launched without the financing provided by Foundations One and Two. The test, however, is not whether any private benefit exists, but whether any private benefit bestowed is "incidental"—in both a qualitative and quantitative sense—to the overall public benefit achieved. There are no bright line rules to follow when undertaking this analysis. Determining whether any private benefit

238. *See supra* notes 81–109 and accompanying text.

is incidental in a qualitative and quantitative sense is inherently a facts and circumstances inquiry. As the Tax Court stated in *Pulpit Resource v. Commissioner* with regard to the private benefit analysis: "[I]t is apparent that the relevant facts in each individual case must be strained through those [private benefit] principles to arrive at a decision on the particular case."[239]

Tax-exempt organizations, particularly private foundations—with some notable exceptions[240]—are notoriously hesitant concerning PRIs or PRI-like arrangements.[241] Part of that hesitancy stems from the need to comply with the expenditure responsibility rules of § 4945. The contract hybrid structure described herein eliminates that obligation.[242] Furthermore, only Foundation Two has engaged in a PRI under our example, and the PRI consists of a debt investment in a public charity. The author submits that such a PRI—a zero percent interest loan to public charity to allow it to use those funds in connection with its tax-exempt mission—does not create a significant risk of private benefit.

The risk that TCLF has crossed the prohibited private benefit threshold likewise seems to be very low. Even though the loan from Foundation Member, LLC is not a PRI, it has all of the elements: it is a last-resort, below-market interest rate loan designed to further environmental sustainability, community revitalization, and job creation in an economically depressed urban area. The terms of the loan also prohibit use of the funds for lobbying or political activities. If an investment by a public charity meets the standards for a PRI, the author would argue that the risk of private benefit in such a case is extremely low. At least one other commentator has made the same argument:

> The PRI rules offer useful guidance on how to structure an investment by a public charity to ensure that the investment qualifies as a charitable activity that will not be subject to UBIT or constitute private benefit that jeopardizes the public charity's tax-exempt status.[243]

As far as the author has uncovered, however, there is no black-letter

239. Pulpit Res. v. Comm'r, 70 T.C. 594, 612 (1978).
240. *See* Lawrence, *supra* note 159, at xv (listing by total amount invested over the years of 2006 through 2007 the top twenty-five private foundations that made PRIs during that period; the total PRIs made ranged from a high of approximately $77.5 million to a low of approximately $6.7 million).
241. Ragin, *supra* note 13, at 56.
242. *See supra* notes 174–83 and accompanying text.
243. Joseph, *supra* note 201, at 11.

law drawing the same conclusion, for example, that a valid PRI per se cannot constitute private benefit. Therefore, impermissible private benefit presumably remains a risk in the contract hybrid structure described herein, but the level of risk certainly seems to be relatively low.

VI. CONCLUSION

As previously established, there is no single-entity structure that satisfies all the demands of the typical social entrepreneur. Most social entrepreneurs want the best legal and tax attributes of both the for-profit and nonprofit models for conducting business. Such an entity currently does not exist, at least not in the United States.[244] By default, social entrepreneurs may choose the tax-exempt nonprofit model, but for those who insist that private ownership must be accommodated, the LLC is increasingly becoming the entity of choice. Despite its tremendous flexibility, however, a single LLC used to own and operate a social enterprise usually is not enough. Instead, like the Marines, creative attorney/advisors to social entrepreneurs must "improvise, adapt, and overcome"[245] to meet the demands of their clients. Using multiple LLCs and combinations of debt and equity to raise capital, a contract hybrid structure potentially can be created to get close to the "best of both worlds." Nevertheless, such contract hybrids inevitably result in substantial complexity, primarily because they must pass through a maze of highly technical and extremely punitive tax rules. The multiple LLC contract hybrid structure proposed in this article is indeed complex, but in the right circumstances could be an elegant solution for combining philanthropic and private capital.

244. *See* Wood, *supra* note 22, at 46–48 (describing the L3C and the "CIC," Community Interest Corporation, that has been created under the laws of the United Kingdom).

245. Glenn Knight, *Improvise, Adapt and Overcome*, AN UNOFFICIAL UNABRIDGED DICTIONARY FOR MARINES, http://4mermarine.com/USMC/dictionary/i.html (last visited Oct. 30, 2011) (describing this phrase as the unofficial mantra of the Marine Corps).