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A Radical Route to Funding Urban Revitalization: Profitable Philanthropy Through Limited Liability Companies and a Market-Based Return on Investments

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A RADICAL ROUTE TO FUNDING URBAN REVITALIZATION:

PROFITABLE PHILANTHROPY THROUGH LIMITED LIABILITY COMPANIES AND A MARKET-BASED RETURN ON INVESTMENTS

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"The issue posed in this article is simple. Why should we restrict the return on investment of those we beg to invest in charitable causes? The answer is far more complicated."

INTRODUCTION

The Basic Economics of the Urban Investing Landscape

A, B, and C, are three people alone on an island. The only food on the island is the fish they catch. They have no equipment so it takes them all day to catch one fish. It is mere subsistence living since they only have time to catch enough fish to barely survive. Then A decides that he will build a net because he believes he can catch his one fish quicker plus other fish if he wants. B and C say A is crazy because if it takes all day or a week to make the net, A will starve to death before the net is made. "Plus," they say, "the darn thing may not even work!" A agrees it will take him at least a day to make the net but making the net is worth the risk. Person A did make the net in a day, went to bed very hungry but the next day used the net to catch 5 fish, all in the morning. That same day, four new people found the island and bought A's fish. A then used the money to construct a stronger, larger and more efficient net. A caught more

fish, sold them to newer islanders who traded concrete and other useful items for the fish, which A then used to build a plant, build a house, and live happily ever after.

What A did was create a capital asset (the net) to increase production, but only because he believed the net would bring him a return on his investment (more fish) that was greater than what he risked and cost to make the net (i.e. his labor and a single day of starvation).[2] In a similar hypothetical, an economist called the net-caught fish "spare production [which] is the lifeblood of a healthy economy."[3]

In America, our economy is healthiest when investors and banks who loan money, conclude as did A, that making an investment is worth the risk because it will bring a return greater than the cost of the investment.[4] The investor or the bank makes a capital investment into A's net-production business. Assuming a quality product of desirability, the more efficient net facilitates increased economic activity, including consumer spending. The economy grows as a result. Indeed, it is oft reported that roughly three-fourths of our economic activity is consumer spending.[5] Businessperson A uses the proceeds to repay investors and hires people to build the home and business. Those builders and laborers receive money that they can spend on some other needs or desires, all of which continues the growth of the economy.

Consider A to be one of many small businesses, which comprise the majority of businesses in America. According to the U.S. Census Bureau in 2007 there were 6.05 million

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[2] Peter D. Schiff and Andrew J. Schiff, *How an Economy Grows and Why It Crashes."* John Wiley & Sons, Inc. (2010), p. 2-9.
[3] Peter D. Schiff and Andrew J. Schiff, *How an Economy Grows and Why It Crashes."*, John Wiley & Sons, Inc. (2010), p. 2-9.
[4] Id.
[5] See Lucia Mutikani, *Economy Expands as Consumer Spending Picks Up,* Reuters, April 30, 2010 (last visited August 7, 2010). Specifically, the economic activity is a reference to the country's gross domestic product ("GDP"), which is the gross market value of all production. See the World Bank Databank, http://data.worldbank.org/indicator/NY.GDP.PCAP.CD (last visited August 7, 2010). The

firms in US, and 5.4 million of them had less than 20 employees. [6] The passage below illustrates the essence of their typical conventional financing arrangement:

> "A bank officer authorizes a $100,000 loan to a small-business - a judgment that the businessman's future earnings will be sufficient to repay the loan, that his enterprise would create real value in the future, which would justify the risk and the creation of the additional money."[7]

But the above description is more difficult to find in low income communities.[8] In too many instances, the small business in the low income area has an anemic financial statement and the bank or investor believes those on that proverbial urban island cannot afford or are unwilling to purchase the fish. The bank/investor therefore lacks confidence that the loan will be repaid with an additional return to satisfy its standards, so the risk of its capital is too high compared to its anticipated return on the capital invested.[9]

Without a change in the status quo, we appear doomed for more of the same – undercapitalized small businesses struggling to survive serving a struggling community doing the same. And each denial of equity capital is a lost opportunity for America to have its healthiest economy. How do we change the seemingly perpetual urban economic poverty? This author attempts to provide one piece of the answer to that question.

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[6] U.S. Small Business Administration, Office of Advocacy, based on data provided by the U.S. Census Bureau, Statistics of U.S. Businesses
[7] William Greider, *Secrets of the Temple,* Touchstone, (1987), p. 59
[8] For a discussion of various barriers to access for minority businesses in low income communities see the United States Department of Treasury Advisory Letter to CEOs of all National Banks, at http://www.occ.treas.gov/ftp/advisory/98-9.txt dated July 15, 1998, (last visited August 13, 2010.
[9] As will be discussed below an investor made this claim to the internal revenue service in Priv. Ltr. Rul. 199943044; 1999 PLR Lexis 1213, p. 2.

(a) A Role for Profitable Philanthropy?

We are a country that does not live by profit alone.[10] In our hypothetical, assume A no longer had to worry about making a qualitative living. So he changed his focus to improving the quality of life of others, even if he foregoes profits to do so. In America, we have private foundations designed for the same purpose.[11] A recent private foundation designed to help low income communities with equity capital for community businesses identified the issue.[12] It proclaimed that without a new profit-like investment, the project would fail for lack of investment capital because private investors "viewed the risk versus return ratio too high".[13] Stated differently there was no venture capital because the venture was too risky with too little return to justify the contribution of capital.[14]

The fact that the charitable-minded foundation had to explain this to the IRS which was going to tax the foundation's investments is salt in the charitable wound. That reality is ever-present across urban landscapes in America. The "Invest in America" vitriol lacks resonance in

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[10] Forty wealthy families and individuals joined Microsoft Corp. co-founder Bill Gates and billionaire investor Warren Buffett to pledge at least half of their wealth to charity. Caril J. Loomis, *The $600 Billion Challenge,* Fortune Magazine, Vol. 162, No. 1, July 5, 2010, p. 82, 85. See also Wall Street Journal on line at http://online.wsj.com/article/AP49485b04c8aa4921b669c074d849373e.html, (last visited August 5, 2010). In what they term the "giving fund", Gates and Buffett estimate amassing as much as $600 billion in charitable giving. Id., at 86. The pledgees include Oprah Winfrey, TBS network and Atlanta Falcon owner, Ted Turner, and New York Mayor Bloomberg. Id., at 88. See also Giving Pledge: http://www.givingpledge.org.

[11] Id.

[12] The foundation was making its case before the internal revenue service, reported in a private letter ruling. See Priv. Ltr. Rul. 199943044; 1999 PLR Lexis 1213.

[13] Priv. Ltr. Rul. 199943044; 1999 PLR Lexis 1213, p. 2. The target area to be served was designated by a state as economically depressed, with high rates of unemployment particularly among recent immigrants. Id, at 3.

[14] The IRS characterized the private foundation as "operat(ing) much like a venture capital organization" in light of its investment in start-up or struggling businesses. Priv. Ltr. Rul. 199943044; 1999 PLR Lexis 1213, p. 2.

that context. The non-rhetorical question needs to be asked: How will the clearly inadequate status quo investments in urban core America change? This article explores an investment model designed with a philanthropic paradigm to increase equity investments. To do so, the author advocates modifying existing tax laws so they become enablers than "taxers" of such ventures in profitable philanthropy.

(b) Reformulating the Incentives Model to Allow Market-Based Returns

Congress has long recognized an increasing need to infuse private equity investments into decaying core cities.[15] The United States has historically used its tax laws not only to generate revenue but also to provide incentives for charitable ventures to help cure our urban ills.[16] Those incentives have primarily been confined to the tax benefits, primarily tax deductions and credits.[17] This article suggests that private investors are far more interested in cash return on investment than deductions. And that form of incentive would be more effective at increasing equity investment for financially risky projects than tax deductions and credits. The underlying

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[15] Congressional Record – Senate, _Proceedings and Debates of the 106th Congress,_ Title VI America's Private Investment Companies, p. 14318, July 13, 2000. (The purposes of this title are to — (1) license *private* for profit *community* development entities that will focus on making *equity* and credit *investments).*

[16] Tax incentives for economically distressed communities include New Markets Credits, IRC Section 45D for qualified equity investments with credits equal to 39% over 7 years, i.e. 5% of the investment for the first three years, IRC § 45D(a)(2)(A); Regs. §1.45D-1(b)(3) and 6% for the remaining 4 years of the credit allowance period, IRC § 45D(a)(2)(B); Regs. §1.45D-1(b)(3); tax exempt bond financing for enterprise zones where 95% of the net proceeds are used for enterprise zone facilities, IRC§ 1394(a); and more recently recovery zone economic development bonds and credits for designated recovery zones due to the sub-prime mortgage housing and banking crisis under the American Recovery and Reinvestment Act of 2009, IRC§ 1400U-2, added by the American Recovery and Reinvestment Act of 2009 (2009 ARRA) P.L. 111-5, Div B., 1401, effective for obligations issued after Feb. 17, 2009.

[17] For a comprehensive list of such incentives, see James Edward Maule, *Tax Incentives for Economically Distressed Areas,* Tax Management Portfolio No. 597 -The Bureau of National Affairs, Inc. (2007).

premise is that the market-based risk and reward analysis should be incorporated more robustly into US tax incentive policy. Investors in charitable projects should not have to choose between a low return on a high risk venture and not investing at all. Charitable investors ought to have the opportunity in certain narrowly defined circumstances to gain a high reward for high risk ventures just like the private sector. In essence this charitable investor can then be part of what this author considers "profitable philanthropy". [18] It is also wise tax policy to increase the private equity investments for such cases since they may correspondingly decrease the need for public subsidies.[19]

It is also asserted here that for low income projects viewed as high risk investments, incentivizing a large number of investors to contribute smaller amounts designed for the business is a more effective means of increasing equity investments than relying on a few investors to contribute very large amounts in those same risky ventures. This is especially recommended where conventional financing with market-based rates of return are unavailable.[20] This article therefore challenges the myth that charitable ventures should not be profitable. More precisely,

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[18] This author defines profitable philanthropy as the activity of investing for primarily charitable purposes while also gaining market returns on the assets invested.

[19] For a discussion of the tax policy benefits of broadening the private equity base see Roger M. Groves, *More Private Equity, Less Government Subsidy, and More Tax Efficiency in Urban Revitalization*, 8 FLORIDA STATE BUSINESS REVIEW 93 (2009).

[20] The scope of this article involves amendments to existing tax law. An article is forthcoming that models urban financing techniques and strategies more precisely. That article is a work in progress entitled: "Venture Capital and Philanthropic LLC's: The Future Financing Vehicle of Choice for Urban Frontiers". Specifically, this author suggests the careful correlation between risk and return through an investment model so that nonprofits undertaking high risk ventures receive a correspondingly high return without jeopardizing exempt status when jointly financing the venture. To avoid comingled investment risk between the exempt members and the for-profit members, the capital investment can be separated – tranched – so that the charitable project is undiluted. As the profit entity gains market returns, the nonprofit continues under constrained circumstances or leaves the venture, liquidating its interests at fair market value. If the venture continues to fulfill primarily charitable objectives, the nonprofit member can continue in the venture only if maintains control to maintain the charitable purposes. If the charitable purpose is converted to primarily profit purposes, the nonprofit member must liquidate its interests or risk a recapture of benefits and penalties for failing to timely disclose the conversion. This model also includes factors and schedules to add clarity and predictability to determining the limits of a nonprofit's return on investment ("ROI"), and to ascertain when the profit conversion occurs.

investors that take on highly risky ventures to assist disadvantaged communities should be allowed to let typical market forces operate. Rather than forced into a high risk, low return venture, they should be allowed to engage in high risk – high return ventures. Our tax laws should not thwart those dynamics.

Current tax laws and internal revenue service pronouncements raise serious doubt as to whether tax exempt private foundations, when joint venturing with for-profit entities for a truly charitable venture can be highly profitable. In select circumstances there is a blurring of an otherwise bright line between nonprofit organizations focused only on giving and companies with the primary goal of earning a net return to its investors. The idea that charitable "giving" must mean relegating the entity to essentially a break even economic existence with no material economic return in excess of the giving is in need of exceptions. Indeed, exceptions do exist, but they are primarily obscured in individual unpublished private letter rulings. This article advocates shinning a brighter light on certain types of business relationships to remove them from jurisprudential shadows. Those relationships are between tax exempt foundations and for-profit entities that joint venture through limited liability companies to invest in charitable ventures.

Part One of this article lays a foundation that certain tax exempt charity-based corporations (public charities) may joint venture with for-profit entities through a limited liability company (LLC), and that the investments made by the LLC in charitable projects are authorized by law.[21] Part Two introduces the background and rationale for extending the exemption of joint venture investments beyond public charities to private foundations. The investments must qualify

[21] The LLC is sometimes referred to as a philanthropic LLC that makes "mission-based investments" since its mission is charitable in nature.

as "program-related investments" under statutory requirements. Part Three codifies the claim that the investment returns by the foundation and the LLC should be broadened to match the customary risk-reward experience in the private marketplace**.** The rationale is two-fold: First, an underlying reason for restrictions generally on private foundations (to prevent unfair competition) should not apply to philanthropic LLCs; and secondly, that flexibility of the prudent investor standard provides opportunities for the LLC manager to operate without violating the spirit of the tax laws. Part Four advocates an expanded definition for the type of program related investments that qualify as "special allocations" for investment income. This section explores the unique advantages of the LLC operating agreement to lawfully distribute those special allocations. Part Five contains proposed amendments to existing IRS regulations to overcome three of the major restrictions on special allocations so that investors in philanthropic LLCs can receive investment incentives through allocated tax benefits with greater certainty. Part Six examines the various excise taxes that could be imposed as penalties against the philanthropic LLC. This section calls for a statutory remedy that adds certainty to the law and assures investors in these taxes shall not be imposed if certain other requirements are met. The result is to avoid the chilling effect of those taxes on investment activity of LLC members. Part Seven concerns the positive tax policy implications of allowing greater investment returns and encouraging private equity investors to contribute mission-related investments. This section introduces a principle of tax benefit reciprocity, where the entity only benefits from exemption in proportion to the benefit it provides in lessening the burden of government to providing for the target communities.

PART ONE

Joint Venture Opportunities for Nonprofit Corporations through LLCs –

Without Return on Investment Limitation

This article focuses on joint ventures because it is an attempt to go beyond the status quo investments that to date have not had transformative effects in the most needy core areas of major cities across America. Joint ventures represent an "innovative and increasingly important part of business strategy", valuable for all stages of a project's development, including therefore start-ups or fledgling businesses in low income areas, for a wide array of business sectors.[22] Joint ventures also have transactional advantages and flexibility for shared risks and allocations of burdens, important factors for risky ventures like those that serve low income areas.[23]

This article also examines the pooling of capital among the entity's investors into a fund for investment into a start-up entity or one that is fledgling.[24] The practical relevance is that the entities within the target low income communities are often those types of businesses in need of investment capital. Thus, the entities at the center of this article are akin to venture capital firms with a venture capital fund.[25]

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[22] See Organisation for Economic Co-Operation and Development, *Competition Policy and Joint Ventures,* OECD (self published) p. 1.

[23] See Organisation for Economic Co-Operation and Development, *Competition Policy and Joint Ventures,* OECD (self published) p. 23.

[24] A start-up company is one essentially without revenues. A. David Silver, *Up Front Financing,* John Wiley & Sons, Inc., (1982), p. 25.

[25] According to one source, "most private venture capital funds have a strong preference for start-ups" due to their superior industry and market acumen and thus the opportunity to control the venture. A. David Silver, *Up Front Financing,* John Wiley & Sons, Inc., (1982), p. 25. In a forthcoming article,

Rev. Rul. 98-15 (released March 23, 1998) is the primary authority allowing a federally tax exempt 501(c)(3) organization to joint venture with a profit entity and retain its exempt status, though both were members of an LLC.[26] The nonprofit entity was an acute care hospital exempt from federal income tax under Section 501(c)(3) of the internal revenue code.[27] The for-profit member was a for-profit hospital that owned and operated numerous hospitals.[28] The nonprofit contributed all of its operating assets, primarily its hospital, into the LLC. The profit hospital also contributed assets into the LLC. Income generated through the LLC would then flow back to these members in proportion to their contributions to the LLC assets.

(a) The Aggregate Principle – Treatment of the LLC as a Partnership

In determining whether the nonprofit could retain its exempt status, the IRS first examined whether the type of activities undertaken by the LLC are the type authorized for exempt entities.[29] While promoting health through a hospital form can be "charitable" under Section 501(c)(3), a hospital owned and operated for profit by private owners is not.[30] That led the IRS to scrutinize the relationship between the exempt entity and those with whom it conducted business – the profit entities. The IRS synthesized several prior tax court opinions where an exempt entity was in a partnership or limited partnership with a profit entity.[31]

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[26] Rev. Rul. 98-15, 1998-1 C.B. 718.
[27] Rev. Rul. 98-17, 1998-1 C.B. 718. Section 501(c)(3) in relevant part exempts from federal income tax entities organized and operated exclusively for charitable, scientific, or educational purposes as long as no part of the net earnings inures to benefit any private shareholders or individuals. I.R.C. §501(c)(3).
[28] Rev. Rul. 98-17, 1998-1 C.B. 718.
[29] Rev. Rul. 98-15, 1998-1, C.B. 719.
[30] Rev. Rul. 98-15, 1998-1, C.B. 719.
[31] Rev. Rul. 98-15, 1998-1, C.B. 720.

In what it termed the "aggregate principle" the IRS relied on a case in which a partner was allowed a business bad debt deduction for a loan he made to the partnership because the partner "by reason of being a partner" was entitled to receive a tax benefit from his association with the partnership, i.e. the individual partner benefit and the partnership benefit were aggregated rather than separated for tax purposes.[32] In another case a charitable organization retained exempt status though it raised funds to produce a play through creating a limited partnership, where limited partners included private individuals and for-profit corporations.[33] In these cases, when the partnership operations primarily furthered the exempt purposes, and the profit entities had no control over those operations, the exempt status was afforded to the partnership and exempt status retained for the exempt partner.[34] Conversely, if the for-profit members used the non-profit entity as an "instrument" to further their for-profit purposes, the partnership did not qualify as a 501(c)(3) organization.[35] These statements of relevant law led the IRS in the instance before them to analyze whether 501(c)(3) status would attach *to an LLC,* rather than a partnership. That discussion immediately follows.

The question was therefore how to characterize the LLC. Was it exempt or rather taxable when owned by both tax exempt and taxable for-profit corporations? The IRS relied on two sources: the cases embodying the aggregate principle and secondly, the Code section that taxes a partnership with trade or business income unrelated to its otherwise exempt activity.[36] Under

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[32] Rev. Rul. 98-15, 1998-1, C.B. 720. The case was Butler v. Commissioner, 36 T.C. 1097 (1961).
[33] Rev. Rul. 98-15, 1998-1, C.B. 720. The case was Plumstead Theatre Society, Inc. v Commissioner, 74 T.C. 1324 (1980), aff'd 675 F. 2d 244 (9th Cir. 1982).
[34] See particularly, *Plumstead*, *supra* note 14, referenced at Rev. Rul. 98-15, 1998-1, C.B. 720. See also Broadway Theatre League of Lynchburg, Virginia, Inc. v U.S., 293 F. Supp. 346 (1968) when exempt status was retained though the exempt partner hired a for-profit booking agent for its theatrical performances.
[35] Rev. Rul. 98-15, 1998-1, C.B. 720, citing Estate of Hawaii v. Commissioner, 71 T.C. 1067 (1979).
[36] Rev. Rul. 98-15, 1998-1, C.B. 720. As will be discussed in detail later, an entity may retain 501(c)(3) status but still have tax liability for income received from a trade or business unrelated to its exempt activities. See I.R.C. § 512 (c), which is specific to partnerships.

Section 512(c), the partner (or in this case an LLC member) must include its share of the partnership's gross income as part of its own unrelated business income in computing its individual amount of unrelated business income tax.[37] In light of this symbiotic attribution between the partner and the partnership, the IRS not only reaffirmed that a 501(c)(3) entity can form and operate a partnership, but that an LLC shall be treated as a partnership for federal income tax purposes.[38] The IRS then stated the rule that if the LLC, like a partnership, furthers exempt purposes and only incidentally benefits for-profit members, the LLC can achieve 501(c)(3) exemption.[39] Similarly, the LLC can be exempt even if it executes a management contract with a for-profit entity, as long as the for-profit entity has only reasonable compensation and terms, and does not use the nonprofit entity as an instrumentality for for-profit purposes.[40]

As applied to the facts presented, the IRS examined the LLC articles of organization and the operating agreement ("governing documents").[41] Two factors appeared to have primary importance, that the LLC board had the affirmative duty to operate in furtherance of the

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[37] IR.C. § 512(c)(1).

[38] Rev. Rul. 98-15, 1998-1, C.B. 721. The analysis was devoid of comparisons between a partnership and an LLC but that will be discussed immediately after the discussion of the Revenue Ruling.

[39] Rev. Rul. 98-15, 1998-1, C.B. 721.

[40] Rev. Rul. 98-15, 1998-1, C.B. 721, citing both *Plumstead* and *Broadway Theatre League.*

[41] Rev. Rul. 98-15, 1998-1, C.B. 718. A more comprehensive summary of significant aspects of management as follows :

1. The LLC must operate the hospital only in a manner that furthers the charitable purposes.
2. The charitable purposes musts promote health for a broad cross-section of the community.
3. The majority of the managing board is chosen by the exempt entity (3 of the 5 board members).
4. A majority of the board must have decision-making authority over important operating matters of the LLC, including but not limited to the following:
   a. Annual capital budgets and operating budgets
   b. Earnings distributions
   c. Selection of key executives
   d. Facilities acquisitions or dispositions
   e. Contracts beyond a threshold level
   f. Renewal or termination of management contracts.
5. The exempt entity has veto power over any attempt by a profit member to amend the governing documents. Id.

charitable purposes of the nonprofit LLC member, and secondly, if conflicts arose between nonprofit goals and for-profit goals, the governing documents made clear that the nonprofit purposes would govern.[42] Since the governing documents prioritized charitable purposes in the operation and governance of the LLC, the IRS concluded that the LLC would be operated primarily for exempt purposes, and that any benefits to its for-profit member were incidental.[43] Accordingly, the exemption of the nonprofit member was retained. [44]

(b) No Limit on the Return on Investment

Of particular relevance for this article is the fact that the IRS did not specifically limit the return on investment ("ROI") of the tax exempt member, despite its joint operation of the hospital with a for-profit entity. The determination of exempt status did not hinge on whether the return on the investment was above a certain threshold, or was beyond that of the for-profit member, or was greater than the market-based return of other for-profit entities. Instead, the IRS authorized income from the LLC operations to be returned in relation to their respective contributions of assets. Hypothetically therefore, if no other statutes or rules applied, the nonprofit member contributed $20 of assets, and the for-profit contributed $10, the nonprofit would be authorized to receive twice the amount of income as the for-profit entity because it

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[42] Rev. Rul. 98-15, 1998-1, C.B. 718.
[43] Rev. Rul. 98-15, 1998-1, C.B. 721.
[44] The IRS also noted facts under which the exemption status would be lost. In what it termed "situation 2", the same general circumstance existed where a nonprofit 501(c)(3) hospital forms an LLC with a for-profit hospital provider. The differences were that each member had equal representation on the managing board, both members had the right to veto major document revisions, and must jointly approve major decisions regarding budgets, earnings distributions, and day-to-day management was provided by a wholly owned subsidiary of the profit member. Under this scenario, the IRS concluded that the nonprofit hospital member would lose its 501(c)(3) exemption for its failure to establish that the LLC would operate for sufficiently exempt purposes. Rev. Rul. 98-15, 1998-1, C.B. 718-719.

contributed twice the assets to the LLC. As long as the income was generated while the LLC was operating in furtherance of the exempt purposes, and significant operating control resided in the nonprofit member, the amount of the income generated was not a basis for eliminating exempt status for the nonprofit member.[45]

In Rev. Rul. 98-15 the IRS was only faced with a tax exempt hospital under section 501(c)(3), not a private foundation. Its conclusion clarified that the exemption is allowed but the entity was not a private foundation.[46] As will be discussed below, this author asserts that Rev. Rul. 98-15 should also have application to private foundations.

Part TWO

The Extension of Rev. Rul. 98-15 to Private Foundations – Meeting the Requirements for Program Related Investments ("PRI")

(a) The Public Charity - Private Foundation Distinction

Not all nonprofits have the same exemption, and not all have the same rules for what investments they can make and what the return they can receive from those investments. The focus of this article is on the investments by private foundations, particularly the economic return

[45] There are, however, other restrictions under the tax code that impair, chill, or otherwise penalize the return on investment that were not at issue in that Revue Ruling. Some of those restrictions as applied to private foundations will be discussed below.

[46] Rev. Rul. 98-15, 1998-1, C.B. 722.

they derive on those investments. In Rev. Rul. 98-15, the nonprofit hospital was an entity exempt from federal income tax under 501(c)(3) of the internal revenue code.[47] For the sake of clarity, the IRS stated the hospital was not a private foundation, which is a separate sub-type of exempt entity.[48] The 501(c)(3) hospital's governing documents declared that it relies upon a wide base of the general public for its financial support and qualified as a "public charity" under the internal revenue code. That is legally distinct from a private foundation which derives contributions primarily from a narrow group of contributors or its own funds.[49]

The public charity – private foundation distinction is therefore most evident from the difference in the source of the contributed funds. Public charities are just what they sound like, charities supported primarily by the general public and the government.[50] More specifically, the funding sources for public charities requires a receipt of more than one-third of its support each year from "gifts, grants, membership fees", and less than one-third of its support from investment income.[51] Private foundations, on the other hand, find exempt status under Section 509 of the Code, outside of the public charity definition found in Section 501(c)(3).[52] Major philanthropists are typically high net worth individuals donating their own funds rather than from general public solicitations, and desire to designate and control where and to whom those funds

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47 IRC § 501(c)(3).

48 Rev. Rul. 98-17, 1998-1 C.B. 718. A 501(c)(3) corporation can avoid private foundation status (under Section 509 (a) of the Code) when it has the principal purpose of providing hospital care under I.R.C. § 509(a)(1), which incorporates by reference hospitals under I.R.C. § 170(b)(1)(A)(iii).

49 For the public support requirements see IRS Regs § 501(c)(3)-2. The private foundation exemption is found in IRC § 509.

50 I.R.C. § 170(b)(a)(A)(i)-iv. Public charities also include churches, schools, hospitals, and governmental units under that section. Other qualifications of public charities include organizations that

51 I.R.C. § 509(a)(2).

52 Section 509(a) defines a private foundation as a organization qualifying as a 501(c)(3) but is not receiving more than one third of its support from public sources such as gifts, grants, membership fees, and gross receipts from admissions. I.R.C. § 509(a)(2)(A)(i)(ii), and not more than one-third of its support each year from gross investment income. I.R.C. § 509(a)(2)(B)(i).

are donated.[53] As such, they most often qualify as private foundations for their charitable entity.[54]

Since a private foundation has the ability to self-direct a donor/founder's own funds, the potential exists for the donor to invest those funds in a way that is more closely connected with personal self interest. Quite conceivably there could be abuse of charitable purposes compared to a public charity. Accordingly, IRS has reasonable if not compelling grounds to be more discriminating as to what types of investments should be allowed by a private foundation. And therefore it may be a stretch to interpret Rev. Rul. 98-15 as covering private foundations. The Ruling only concerned the public charity, which is not rife with the self interest potential of the private foundation. So arguably, the Ruling does not extend the same continued exempt status it gave the 501(c)(3) organization for a joint venture with a profit member of an LLC. This issue is raised since little has been written about the distinctions among types of exempt entities for joint ventures, and why there are differences in rules between public charities and private foundations. The above discussion should provide an underlying rationale for the particular rule for private foundations discussed immediately below.

(b) Program-Related Investments as a Qualifier and Gatekeeper

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[53] See Victoria B. Bjorklund, *Current Developments in Giving to Donor-Advised Funds Supporting Organizations and Private Foundations* in CHARITABLE GIVING TECHNIQUES 97 (A.B.A Sec. Continuing Legal Educ., 2007); See also Roger M. Groves, *More Equity, Less Government Subsidy, and More Tax Efficiency in Urban Revitalization*, 8 FLORIDA STATE BUSINESS REVIEW 93 (2009), at 101.

[54] See Victoria B. Bjorklund, *Current Developments in Giving to Donor-Advised Funds Supporting Organizations and Private Foundations* in CHARITABLE GIVING TECHNIQUES 97 (A.B.A Sec. Continuing Legal Educ., 2007); See also Roger M. Groves, *More Equity, Less Government Subsidy, and More Tax Efficiency in Urban Revitalization*, 8 FLORIDA STATE BUSINESS REVIEW 93 (2009), at 101.

In light of the public charity- private foundation distinction, it is logically and legally consistent for the IRS to impose more stringent rules for private foundations; rules that provide greater assurance that foundation investments and activities are sufficiently tied to truly exempt purposes. Such a rule is codified in Section 4944 of the internal revenue code, and requires the private foundation's investment in a for-profit venture to qualify as a "program related investment" ("PRI").[55] Under that section, investments must (1) be primarily designed to accomplish charitable purposes, (2) have "no significant purpose" to produce "income or appreciation of property", and (3) have no purpose that furthers substantial legislative or political activities.[56] Failure to conform to those requirements jeopardizes the exempt status of the private foundation violating the edit that such entities avoid investing "in such a manner as to jeopardize the carrying out of any of its exempt purposes.[57] The consequences for that failure are grave, subjecting the private foundation to excise taxes, penalties, and potential revocation of exempt status.[58]

PART THREE

Market-Based Investment Returns

Part of the thesis of this article is that investment returns by the foundation and the LLC should be broadened to match risk-reward experience customary in the private marketplace. One justification for this broadened opportunity is that the congressional intent for imposing restrictions on private foundations generally does not apply for the philanthropic LLC.

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55 IRC § 4944(c).
56 IRC § 4944(c); Reg. §53.4944-3(a)(1).
57 IRC § 4944(a)(1).
58 There is an initial excise tax of 5 percent of the invested sums for each year, imposed on the PF and some managers. IRC §4944(e).

(a) Foundational Relevance of the UBIT and the Principle of Unfair Competition

A limit on the economic return on investments for tax exempt entities and other related restrictions on the use of those investments is likely rooted in the principle of unfair competition. Before the enactment of the internal revenue code of 1954, President Harry S. Truman made a request to Congress to revise the tax laws.[59] His initiative to improve the US tax system included closing tax loopholes "which enable some few to escape their share of the cost of government at the expense of the rest of the American people."[60] In particular, the President stated:

> "some tax loopholes have…developed through the abuse of the tax exemption accorded educational and charitable organizations…
>
> ….exemption[s] intended to protect educational activities [have] been misused…to gain *competitive advantages* over private enterprise through the conduct of business and industrial operations entirely *unrelated* to educational activities."[61]

President Truman also decried instances where charitable trust funds used their exempt status "as a cloak for speculative business ventures and the funds intended for charitable purposes, buttressed by tax exemption, have been used to acquire or retain control over a wide variety of industrial enterprises."[62] President Truman did not just make this up on the spur of the moment. He readily admitted the appropriate congressional committee "has already undertaken to correct this situation…"[63] By 1954 the internal revenue code imposed a tax on the "unrelated

[59] H. Doc. 451, 81st Cong. 2d Sess., January 23, 1950. The document was referred to the Committee on Ways and Means.
[60] H. Doc. 451, 81st Cong. 2d Sess., January 23, 1950, p. 3.
[61] H. Doc. 451, 81st Cong. 2d Sess., January 23, 1950, p. 5.
[62] H. Doc. 451, 81st Cong. 2d Sess., January 23, 1950, p. 5.
[63] H. Doc. 451, 81st Cong. 2d Sess., January 23, 1950, p. 5.

business taxable income" of federally tax exempt organizations and certain exempt trusts ("UBIT").[64]

The UBIT rationale underpinning the regulation of investment income by exempt organizations is, in this author's view, in need of an update to meet the current urban crisis and conditions. More precisely, this article suggests the unfair competition rationale is not at issue when the competition does not exist. In numerous circumstances noted below nonprofits invest in ventures that the private sector would not, in large part because the mission is tied to benevolence not maximum profitability. If the profit entity would not pursue the project, then there is no competition and no compelling reason to prohibit the nonprofit from making whatever risk-reward dynamic the market will bear. The result should be no different if the nonprofit exempt entity joins forces with a for-profit entity as a joint venture as long as the charitable purposes are primary.

In the later described circumstance, the for-profit may desire to invest, but will only do so if a joint venture partner incurs the greater risk. In still other circumstances, the profit entity would invest in a project, but only if the other joint venture partner provides financing or tax benefits that can flow to the profit entity (i.e. gap financing or transferrable tax benefits or credits).Under either of these two scenarios, but for the investment by the nonprofit entity, the project would not be initiated. Accordingly, the entities are not competing for the same opportunity. They are cooperating in order to bring that project to fruition. The profit entity's goal of raising revenue is not thwarted. Rather, the entrepreneurial goal is enhanced by a venture that would not have occurred and economic returns would not have been made but for the

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[64] The tax is known as the unrelated business income tax or ("UBIT"). I.R.C. §511(a)(1)-(2) and I.R.C. §512. August 16, 1954, c. 736, 68A Stat. 169.

investment by the nonprofit entity. And rather than losing a competitive opportunity, the profit entity may elect a dual goal – profitability and philanthropy rather than focus solely on profitability. This may create fiduciary duty issues for the corporate board of directors, but that issue is beyond the scope of this article.[65]

A related reason for allowing the private market rules to apply is rooted in tax policy. If government programs continue as the primary means of rehabilitating urban and rural America, then those expenditures continue to drain the treasury. If, however, increased return from investing spurs greater economic activity by investors, it may well be that those private sector funds, not the governmental treasury is the growing source of funding. The result can be a stimulated economy and long term benefits from allowing profit incentives to increase the private equity investments and reduce the governmental subsidy over time. And beyond merely raising revenue, allowing the government to reduce expenditures in this area leaves more of its funds for other governmental purposes. The result is a net gain to the treasury because rather than simply raising revenue, it is keeping more of what is raised.

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[65] A for-profit entity has a primary duty to its shareholders and/or partners to pursue profitability for the entity. See Dodge v. Ford, 204 Mich. 459 (1919). There are nonetheless methods of gaining shareholder approval/ratification that could authorize this dual bottom line, including executing shareholder agreements that govern the making of distributions. See the Model Business Corporation Act, MBCA § 7.32(a)(2). Voting rights may be afforded some shareholders and not others through voting trusts which may enhance approvals of philanthropic ventures by the entity. MBCA § 7.30(a). The shareholders may elect board members specifically because of their social philanthropic ideals. There are even statutory provisions that have become increasingly popular authorizing a board of directors to consider the effect of their decision on communities in which the business is located. See Pennsylvania Business Corporation Act, 15 Penn. Stat. § 1715 (a)(1). For more comprehensive discussion of corporate social responsibility see Robert W. Hamilton, Jonathan R. Macey, Douglas K. Moll, Corporations including Partnerships and Limited Liability Companies, Eleventh Edition, Thomson Reuters, 2010. p. 504 -514.

Another principle articulated by President Truman is just as valuable now as it was in 1950 – the need to balance the revenue need with the need to incentivize and proliferate charitable organizations. In his words:

> "It has properly been the policy of the Federal Government since the beginning of the income tax to encourage the development of these organizations. That policy should not be changed. But the few glaring abuses of the tax-exemption privilege should be stopped."[66]

This article advocates an updated high octane way to also encourage the development of charitable organizations – through joint ventures between exempt and for-profit entities in a limited liability company. The investments made in that form can stay within certain safeguards that did not exist in 1950 or for nearly two decades thereafter.[67] The investments further the exempt purposes, not abuse the exemption to gain a competitive advantage over taxable entities or use the exemption to acquire or control industrial enterprises for their own pecuniary interests. That, this author asserts, retains the balance President Truman sought. So while there are necessarily tax laws to prevent exemption abuses, some of those laws should be amended. And those amendments can be accomplished without, as President Truman said, "jeopardizing the basic purposes of those organizations which should rightly be aided by tax exemption." [68] This article specifically suggests a clear ability to allow market-based investment returns and expanding the flexibility to allocate tax benefits among the exempt and for-profit investors in the charitable joint venture. And since unfair competition was the policy behind such restrictions,

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[66] H. Doc. 451, 81st Cong. 2d Sess, p. 5.
[67] As will be discussed, the joint venture investments must qualify as program-related investments under section 4944 of the Code. I.R.C. §4944.
[68] H. Doc. 451, 81st Cong. 2d Sess, p. 5.

those restrictions should be lifted where the unfair competition threat is nonexistent or already minimized.

In sum, the primary benefits of uncapped investment returns may be three-fold: (1) increased investment returns should stimulate more private equity investment in the target low income communities, (2) the additional investments, when coupled with existing investments may eclipse what would otherwise be garnered without prospect of higher returns and (3) the private investment can become an increasing share of the total cost of urban revitalization as it lessens the governmental burden.[69] An underlying premise is that greater financial returns will spur more investment, and even more investment than would have occurred if government restrictions severely impair the investor's entrepreneurial motivations.

The underlying premise is not novel. Profit theorists have long maintained that entrepreneurs will not contribute to a venture and assume the risks associated with it "without the expectation of a compensation in excess of the actuarial value of the risk," and that an "inducement" is required to assume risk, namely the "prospect of a surplus over and above *all* costs…"[70] The more comfortable, therefore, the entrepreneur is with the prospects of compensation beyond the costs and risk taken, the more likely he or she will become an investor in the venture. And in the context of this article, "all" costs include tax liability and governmental restrictions on the entrepreneur's investment return. The investor motivations posited in this article are a mix of philanthropy and profitability, which makes this type of

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[69] Admittedly, benefits one and two are hopes, not empirically established. The third benefit of uncapped returns is addressed in more detail as part of the "tax benefit reciprocity" discussion. A second argument against an uncapped investment return could be that it would allow the donor to distribute less to the intended charitable target. This author asserts that existing regulations against undistributed income and excess business holdings are well designed to curb that abuse, but that modifications are necessary to sufficiently incentivize private investors to meet the current urban crisis.
[70] Robin Cowan and Mario J. Rizzo, *Profits & Morality,* University of Chicago Press, p. 29.

investor a social entrepreneur.[71] Nonetheless, the profitability motivations are part of the equation which this author believes must be addressed anew if we are to move beyond the investment status quo within urban America.

There is a lesser likelihood of the above-referenced surplus if the return on an investment is restricted and if the investor is restricted to below-market returns on the investment. The government, through IRS regulations and other pronouncements leave significant doubt as to whether it will allow market-based returns for charitable investments. IRS regulations and private letter rulings discussed below illustrate the problem.

The most explanatory regulation provides various examples interpreting Section 4944 and the PRI exception in particular. In one instance, a private foundation provided a loan to a business designed to increase economic opportunities for low income residents and prevent community deterioration.[72] The loan was made "at an interest rate below the market rate for commercial loans of comparable risk."[73] The Service stated the loan "would not have been made *but for* such relationship between the loan and [the private foundation's] exempt purpose."[74] The Service concluded that the loan had no significant purpose for income production and therefore the loan was a program-related investment ("PRI"). Presumably, though not directly stated, the Service rationale was that if the entity makes a loan at below market rates, it must not have made that investment primarily for income production.

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[71] Roger M. Groves, *TIME TO STEP UP: MODELING THE AFRICAN AMERICAN ETHNIVESTOR FOR SELF-HELP ENTREPRENEURSHIP IN URBAN AMERICA*, Michigan Journal of Law and Race 2007, p. 111 13 MIJRL 99.
[72] Reg. §53.4944-3(b), example (4).
[73] Id.
[74] Id.

The Service would also grant PRI status to a private foundation's below-market financing when conventional financing was unavailable, thereby filling a gap in a venture's capital needs.[75] A private foundation made a loan at below market interest rates to "induce" a financially secure publicly traded business to build a new plant in a deteriorated urban area.[76] A significant fact cited by the Service was that the business "would be unwilling to establish [the plant] absent such inducement."[77] It appears that the Service to date is willing to conclude there was no significant income production purpose only if the foundation provides less desirable below market financing for risky ventures that banks or other conventional sources would not finance.

It should be assumed that the conventional sources would use conventional time-honored methods of ascertaining the degree of risk and return and overall worthiness of investment capital, including but not limited to debt-equity ratios, present value and future income projections based on capitalization rates, cash flows and expense normalization.[78] And from a review of such data, the bank would not make the loan. The scary conclusion a reasonable mind could reach from the above authorities is that the Service would only grant PRI status to a private foundation if it essentially ignores such well established investment criteria and conclusions, threw caution to the wind, and made the loan or stock purchase.

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[75] Reg. §53.4944-3(b), example (5).

[76] Id.

[77] Id. The Service concluded the loan still a program-related investment even though the loan was made to a large established entity, because it still provided employment opportunities for low income persons at the new plant.

[78] See generally the discussion of the various techniques used to value an enterprise, Robert W. Hamilton, Richard A. Booth, *Business Basics for Law Students,* Chapter 7, Valuation of a Going Business, p. 161-198. Aspen Law & Business, (2002). In particular, new entities have heightened scrutiny of projected cash flows and a calculation of an internal rate of return compared to the cost of capital. Id. at 178.

Not surprisingly, the Service looked favorably on a foundation's loan that was interest-free so that an economically disadvantaged individual could attend college.[79] If an entity has no return on the investment whatsoever, obviously the loan was not principally made for income production. It should be remembered that the Service provides the regulations and examples to provide guidance as to how the Service would rule on similar facts. In none of the numerous examples, however, did the Service grant PRI status to an investment where the loan or stock purchase was provided at a market-based return based on conventional financing criteria.

In this author's view, it should not be necessary to reject market-based investment criteria and rate of return expectations in order to remain exempt or prevent substantial excise taxes. This article proposes clarifications and amendments so that a charitably-minded investor that undertakes risky ventures can receive market or above-market returns on high risk investments, as would the market absent government regulation.

As will be discussed immediately below, another statutory requirement puts the foundation in a precarious position when making investment decisions and leaves uncertainty that harms rather than encourages mission-based investments in low income communities.

(b) Flexible Investment Parameters **under the Prudent Investor Standard**

As noted above, the only guidance provided by the Service on retaining PRI status for an investment is that risky below-market loans are acceptable when the conventional criteria would suggest rejection of the investment. At the same time, the foundation must make investment

[79] Reg. §53.4944-3(b), example (9).

decisions using a "prudent investor" standard.[80] An investment jeopardizes the exempt status if the manager fails to exercise ordinary business care and prudence in making the investment.[81] That standard can be viewed as both a curse and an opportunity. This author chooses the latter. In fact, if the standard is interpreted broadly enough to allow significant flexibility by the manager, it should allow market returns and uncapped investment income and still qualify as a program-related investment.

The Service has articulated the need for the manager to analyze the two primary elements of return and risk when making investments on behalf of the entity. In one of its most explanatory private letter rulings, the Service stated:

> "In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital) the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return)."[82]

The Service also provides a four-fold rule of potential benefit to the foundation manager:

(1) There are no investments that are per se jeopardizing though certain categories of investment will be closely scrutinized"[83]

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[80] Treas. Reg. §53.4944-1(a)(2).
[81] Treas. Reg. §53.4944-1(a)(2).
[82] Priv. Ltr. Rul. *9237035*, p.7.
[83] As the Service stated in Priv. Ltr. Rul. *9237035*, "No category of investments shall be treated as a per se violation of section 4944." p. 7. The categories given close scrutiny are stated as: Trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells. The purchase of "puts" and "calls," and "straddles," the purchase of warrants, and selling short." p.8.

(2) The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes is made on a case by case, i.e. investment by investment basis[84]

(3) But in each case taking into account the foundation's "portfolio as a whole"[85] ; and

(4) The determination is only made "as of the time that the foundation makes the investment and not subsequently on the basis of hindsight."[86]

The above rule can be interpreted as allowing significant discretion and flexibility on investment decisions. No investment is automatically jeopardizing the exempt status or imposition of excise taxes. Importantly, the investment is judged only based on reasonable information available to the manager at the time of making the decision, even if it turns out later to be a bad investment. The Service reaffirmed that it will follow those rules when it scrutinizes foundation investments when stating:

> "Therefore, once it has been ascertained that an investment does not jeopardize the carrying out of a foundation's exempt purposes, the investment shall never be considered to jeopardize the carrying out of such purposes, even though, as a result of such investment, the foundation *subsequently realizes a loss*."[87]

Conversely, this no-hindsight rule should be equally acceptable if the investment realized a gain, rather than a loss. If the Service were to read in a requirement that at the time of making the investment the manager should have forecasted a loss, the author suggests to wiser rule would be to resist such an implication. An investment decision should still be prudent when a manager

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[84] Priv. Ltr. Rul. *9237035,* p.7.
[85] Priv. Ltr. Rul. *9237035,* p.7.
[86] Priv. Ltr. Rul. *9237035*, p. 8.
[87] Priv. Ltr. Rul. *9237035*, p. 8.

remains focused on the twin goals of philanthropy and profitability. At the time of making the investment the manager could easily doubt or be unsure about whether the investment will be profitable, since each goal may compromise the other. The investment should therefore still qualify as a program-related investment, and the entity should not have to avoid the investment for fear of jeopardizing its exempt status or the imposition of the substantial excise taxes.

The primary point from the above standard and four-part rule is that the prudent investor standard should be interpreted broadly enough to allow a market-based risk-reward analysis, and allow high level returns on highly risky ventures, without second guessing the judgment used when making the investment. But the regulations and private letter rulings discussed above leave considerable uncertainty as to whether the Service will interpret the prudent investor standard in that manner.

The current state of uncertainty has caused some foundations or their related philanthropic LLCs to make individualized requests to the Service for private letter rulings. ("PLR") . As noted above, the Service has most often, if not exclusively, authorized PRI status for ventures that anticipated below market investment return. In PLR 199943044, a private foundation provided seed money for start up and struggling businesses to promote economic development in economically disadvantaged areas.[88] It faced a typical hurdle to such an investment: "The project is unable to raise investment capital, probably because private investors viewed the risk versus return ratio as too high."

As seen in the regulation examples, if the investment was made when banks using conventional investment criteria would not, the Service would likely conclude that the

[88] Priv. Ltr. Rul. 199943044, 1999 PLR Lexis 1213, p. 2.

investment was not made with a significant purpose for income production and it is instead a program-related investment.

But what if the manager had facts at the time that the investment had potential to have a huge return despite the huge risk? Since the investment is judged at the time of making the investment, and at best a fifty-fifty gamble, the investment should be program-related even if the huge return is subsequently realized. There would need to be some other evidence of an income-production purpose to justify a refusal to allow program-related investment status. Such evidence may come from Board of Director minutes stating: "while the community would benefit from this addition, our stakeholders' financial interests are paramount, and we are mindful that if they do not achieve a return consistent with other investments they may withdraw their capital. Accordingly, this investment will not be made." But absent such expressions of financial prioritization at the expense of the charitable mission, the Service should make clear that if a foundation manager states "there is a potential for a substantial return on this venture", the investment will still qualify as a program related investment.

If the above factual pattern and result were added as an example in the Regulations, exempt entities and their for-profit co-venturers would be more inclined to make equity capital investments in low income communities. They would not have to sacrifice profitability potential just to do what is designed to help needy communities. Again, Congress has a policy to encourage such mission-related investments. But the current uncertainty as to how the IRS may rule absent an individualized private letter ruling is not, in this author's view, the type of incentive that encourages social entrepreneurs or private investors to see the requisite surplus to invest.

The IRS has stated that an entity does not jeopardize its exempt status nor is therefore subject to excise taxes just because the entity generated significant amounts of income from its investments.[89] This regulation provides a basis of hope but none of the guidance from statues or the Service assures the entity that if significant income is generated what other facts are sufficient for the investment to be program-related and not for the purpose of income production. Without the added clarity, our laws miss an opportunity to instill investor confidence that would bring an increase in the equity investments sorely needed in the target communities.

PART FOUR: Harmonizing PRI's With LLC Flexibility

(a) Expanding "Special Allocations" of Tax Benefits Through the LLC Operating Agreement

The above authorities allow the private foundations to engage in certain investments through an LLC. Yet there is little discussion and even less clarity in nonprofit tax jurisprudence as to how much freedom should be afforded this type of LLC manager when allocating profits from those charitable mission-related investments. This section concerns harmonizing and expanding the tax law with the statutory authority given to an LLC. Through what are termed "special allocations" a foundation that is a manager of an LLC should be able to provide unique and customized incentives for private investors and the foundation. The hopeful result is an increase in the use of this LLC model and infusion of more equity capital into worthy projects for urban redevelopment.

(b) LLC Flexibility

[89] Reg §53.4944-3(a)(iii).

One of the beneficial hallmarks of an LLC is the flexibility of self governance under its governing documents, particularly its operating agreement. The flexibility has the muscularity to even trump non-mandatory provisions of a statute. An oft-cited illustration of that proposition is *Elf Atochem North America, Inc. v Jaffari*, 727 A.2d 286 (Del. Sup. Ct.1999). In that case, a Delaware LLC executed an operating agreement that stated any dispute between members be arbitrated in California. Although Delaware statutes clearly authorized arbitration, the Delaware court held the arbitration clause was effective because of the stated policy to maximize the contractual freedom of the LLC.[90]

The LLC is particularly well suited for this article's model LLC joint venture because of statutory flexibility in management and profit distribution. Regarding management, the LLC members determine whether to manage the entity through a single manager or any agreed configuration of a group of members regardless of respective ownership interests.[91] These managers need not have any particular amount of ownership interests.[92] Under the PLRs and regulations, the foundation must have primary authority to assure the invested amounts by members into the fund shall be distributed consistent with the charitable and educational

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[90] Elf Atochem North America, Inc. v. Jaffari and Malek LLC, 727 A.2d 2 86(1999), at 296.

[91] The relevant provision of the Delaware Code states: "A limited liability company agreement may provide for classes or groups of managers having such relative rights, powers and duties as the limited liability company agreement may provide…" DE § 18-404.

[92] The relevant provision of the Delaware Code states: "Unless otherwise provided in a limited liability company agreement, the management of a limited liability company shall be vested in its members in proportion to the then current percentage or other interest of members in the profits of the limited liability company owned by all of the members." (emphasis added).DE § 18-402.

purposes.[93] Under the Delaware LLC statutes, the foundation can be the manager by whatever terms are established in the operating agreement.[94]

Regarding distributions, the LLC operating agreement may govern the allocation of profits among members even if that allocation is different from the pro-rata ownership of the entity. [95] The Delaware LLC Act explicitly states the Act's policy "to give the maximum effect to the principle of freedom of contract and to the enforceability of [LLC] agreements. The Supreme Court of Delaware noted, "…commentators observe that only where the agreement is inconsistent with mandatory statutory provisions will the members' agreement be invalidated. [96]As will be discussed below, that flexibility would allow the foundation and the for-profit members to adjust their respective profits and other tax benefits to meet the complex requirements of the excise tax statutes and regulations in order to retain program related investment status for the foundation's investment and the LLC distributions.

(c) "Special Allocations" of LLC Income

The LLC's ability to "maximize" the freedom of contract principles under *Jaffari* and the LLCs ability to be treated as a partnership under the Code as interpreted by Rev. Rul. 98-15 leads to particular advantages when the LLC desires to creatively spread economic benefits

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93 *Supra* note _______, which is See Victoria B. Bjorklund, Current Developments in Giving to Donor-Advised Funds Supporting Organizations and Private Foundations, 116, The American law Institute, (2007).
94 DE §18-402 and§ 18-404.

95 Elf Atochem North America, Inc. v. Jaffari and Malek LLC, 727 A.2d 286(1999). There is no statutory mandate in Delaware that LLC's divide their profits in exact accord with the ownership interests of the members. See also 2010(10) CCH –*Standard Federal Tax Reports*, ¶25,124.01, CCH Explanation, regarding partnership allocation rules. Corporations, however, must allocate on a pro-rata basis according to a shareholder's ownership interests. Id.
96 Elf Atochem North America, Inc. v. Jaffari and Malek LLC, 727 A.2d 286(1999).

among the members.[97] Section 704 of the Code specifically relates to a partnership, and is applicable to LLCs under Rev. Rul. 98-15.[98] Section 704 provides that a partner's distributive share of "income, gain, loss, deduction, or credit" shall be determined "by the partnership agreement".[99] The LLC equivalent of the partnership agreement is typically the operating agreement, which articulates the contractual relationship among members, internal operation and day-to-day management of the entity.[100] The contractual relationship obviously also includes the manner in which income and profits shall be distributed. As stated by one authoritative text, "Generally, partners may allocate these items among themselves in any manner they choose."[101]

It is therefore permissible for an LLC taxed as a partnership to allocate tax items either in conformance with ownership interests or instead choose "special allocations" where an item such as income or a deduction is disproportionately allocated to a member or partner in greater or lesser proportion than his ownership percentages.[102] These special allocations are of prime importance in the context of this article since the allocation of profits between the exempt foundation and for-profit members is contemplated in the philanthropic LLC model. And as noted below, such allocations can be used as important incentives for private investors to contribute equity capital into these often risky ventures.

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97 See Phillip Jelsma and Pamela Nollkamper, *The Limited Liability Company*, ¶12:240, James Publishing, Inc, (2009), p. 12-20.
98 In Rev. Rul. 98-15, the IRS concluded that the LLC with exempt and nonexempt members will be treated as a partnership for federal income tax purposes. See *supra* note ______.
99 I.R.C. §704(a). If the partnership agreement does not so allocate those items, the determination is made by "taking into account all facts and circumstances". I.R.C. §704(b)(1).
100 See Fla. Stat § 608.402. The operating agreement is not customarily required by statute but sets forth the relationships between the members, describes entity interests, but cannot unreasonably restrict access to records or eliminate the duty of loyalty. See Fla. Stat. § 608.4101 and § 6084224, respectively.
101 2010(10) CCH – *Standard Federal Tax Reports*,"CCH Explanation", ¶ 25,124.01, p. 46,667
102 2010(10) CCH – *Standard Federal Tax Reports*,"CCH Explanation", ¶ 25,124.01, p. 46,667. This is a particular advantage for partnerships and LLCs over corporations that must allocate those tax items on a pro rata basis. Id.

(d) The Twin Requirements of Substantial Economic Effect

While an LLC is generally free to allocate distributive share of tax items among members there is a substantial limitation. The Code appears innocent enough. It initially states in relevant part: "A partner's distributive share of income, gain, loss, deduction, or credit shall, *except as otherwise provided in this chapter*, be determined by the partnership agreement."[103] And as a general rule, the amount of a partner's income, gain, loss, deduction, or credit ("tax items") will be allocated in accordance with the partner's ownership interests.[104] So a partner with 20 percent ownership interests should receive 20 percent of the distributable income at the end of a particular tax year.

But if an allocation under a partnership agreement attempts to vary the allocation so that the partner with 20 percent ownership interest receives say 40 percent of the distributable income, the Code provides that such an allocation must have a "substantial economic effect." (also termed SEE in this article).[105] The treasury regulations provide the most illumination, and are designed to "ensure that the members' distributive shares of tax items conform to their shares of the economic consequences of those items…a balance between allowing special allocations of partnership tax items to accommodate legitimate business concerns while avoiding the exploitation that would be permitted by complete freedom in making tax allocations."[106] The regulations require the allocation "be consistent with the *underlying* economic arrangement of

[103] I.R.C. §704(a).
[104] I.R.C. §704(b).
[105] I.R.C. §704(b)(2).
[106] See Phillip Jelsma and Pamela Nollkamper, *The Limited Liability Company*, ¶12:240, James Publishing, Inc, (2009), p. 12-20.

the partners" and a correlation between the allocation and the non-tax benefit or burden received from the allocation.[107]

The general rule is that an allocation will be viewed as having substantial economic effect if there is a "reasonable possibility that the allocation will impact the dollar amounts received by the partners *apart from the tax consequences* arising therefrom."[108] Thus, even where dollar impacts occur, the requirement is not met if one member has an increased after-tax benefit, and no other partner has an after-tax reduction in benefits.[109] Similarly, if the partnership agreement states the partners will share equally the risk of potential loss value in partnership property, an allocation that grants all the deductions for cost recovery (from that same risk) to only one partner is inconsistent with the underlying economic arrangement of the partners.[110] The Service will not respect the allocation and require the cost recovery deductions to be allocated based on the partners' respective ownership interests.[111] If the allocation fails the SEE test, then the allocation will be made consistent with the pro-rate interests of the LLC members.[112]

The Treasury regulations explain the twin requirements that an allocation must have both (1) an economic effect, and (2) the effect is substantial ("the substantiality test").[113] More specific discussion of the twin requirements of the SEE test including proposed regulatory amendments follows.

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107 Treas. Reg. §704-1(b)(2)(ii)(a).
108 2010(10) CCH – *Standard Federal Tax Reports*," CCH Explanation", ¶ 25,124.01 p. 46,667 The references are to partnerships, but as noted above the IRS has allowed LLCs to be treated as partnerships for tax purposes. (Emphasis supplied).
109 2010(10) CCH – *Standard Federal Tax Reports*," CCH Explanation", ¶ 25,124.01, p. 46,668.
110 Treas. Reg. §704-1(b)(5). See Example 1(i).
111 Treas. Reg. §704-1(b)(5). See Example 1(i).
112 2010(10) CCH – *Standard Federal Tax Reports*," CCH Explanation", ¶ 25,124.01, p. 46,668. Beyond the scope of this article are rules that mandate certain allocations apart from the pro-rata ownership interests and not eligible for special allocations by the members/partners (e.g. allocations in family partnerships, (I.R.C. §704(4), contributed property or services where gain is allocated to the party who contributed the item (I.R.C. §704(c), changes in partnership interests (Code§706(d).
113 Treas. Reg. §704-1(b)(2)(i).

(e) Economic Effect (and the Application of an Alternative)

The SEE test is designed to "ensure that the tax treatment of …allocations reflects the *actual economic arrangement of the partners*."[114] The actual economic consequences among the partners/LLC members must be reflected in the members' capital accounts, and such accounts follow certain accounting rules that track items relevant to income, gain, liabilities and contributions to the entity.[115] Generally, an LLC operating agreement that authorizes special allocations must follow the required capital account formulation to satisfy this economic effect element.[116]

Total compliance with the SEE requirements involves meeting three criteria known as the safe harbor rules, all of which involve the capital account referenced above. The LLC's operating agreement must provide that:

1. Maintenance of the capital accounts during the full term of the LLC existence.[117]
2. Firm proceeds upon liquidation shall be allocated according to the *positive* capital account balances by the end of the tax year or 90 days after liquidation, and
3. After liquidation of his entity ownership interests, the member is unconditionally obligated to restore any *deficit* balance in his capital account.[118]

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[114] 2010(10) CCH – *Standard Federal Tax Reports*," CCH Explanation", ¶ 25,124.01, p. 46,667.
[115] Treas. Reg. §704-1(b)(2)(iv)(*b*). Each member's capital account is increased by her cash or property contribution to the entity, minus liabilities assumed by the partnership. The capital account is decreased by the cash or property distributed to the member from the LLC minus liabilities assumed therewith by the member. Id.
[116] Id. This is stated as a general rule because the Regulations allow alternatives to the capital accounts element. A few of those alternatives shall be discussed infra, involving qualified income offsets, Treas. Reg. §704-1(b)(2)(ii)(d), and "economic effects equivalence". Treas. Reg. §704-1(b)(2)(ii)(i).
[117] Treas. Reg. §704-1(b)(2)(iv).

Consistent with the Service's intent to deter use of allocations to avoid or evade tax, the safe harbor generally prevents perpetual capital account deficits caused by special allocations. This author however advocates two narrow exceptions described below for philanthropic LLCs with legitimate program-related investments.

(f) Expansion of "Economic Effect Equivalence"

If the LLC does not conform to the three-pronged safe harbor capital account requirements, the allocation may still meet the economic effect requirements if the LLC uses an equivalent method to reach the same result that would have occurred through the safe harbor rules.[119] This exception, as with any exception is an attempt to be flexible. It is also an attempt to reach the substance of an allocation, even when the form used is noncompliant (i.e. not following the book accounting requirements of capital account balances). Consistent with this codified flexibility is the need to incorporate the underlying reasons for the safe harbor provisions.

As noted above, Congress and the Service imposed these provisions to balance legitimate business reasons for allocation tax items amongst the owners while avoiding the exploitation that would be permitted by complete freedom in making tax allocations.[120] The dreaded exploitation most assuredly meant using these rules to prevent surreptitiously designed tax evasion through sophisticated allocation schemes.[121]

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118 Treas. Reg. §704-1(b)(2)(ii)(b).
119 Treas. Reg. §704-1(b)(2)(ii)(i).
120 See Phillip Jelsma and Pamela Nollkamper, *The Limited Liability Company*, ¶12:240, James Publishing, Inc, (2009), p. 12-20.
121 See legislative history to the Tax Reform Act of 1976. S. Rep No. 938, 94th Cong. 2nd Sess 98 (1976).

The philanthropic LLC model presents a type of “legitimate” business interest not typically contemplated when regulating for-profit entities. Those wholly for-profit entities have a fiduciary duty to their respective members to pursue profitability as a primary activity. Naturally the investments are means to attain profitability and should be made in conformity with the profitability priority.[122] That pursuit of profitability understandably puts foundation managers of the LLC first in line as potential manipulators of allocation rules to avoid tax. Obviously the less tax they pay, the more revenue hits the bottom line. The philanthropic LLC has legitimacy tied to a different source - its charitable causes and attendant mission-related investments. It is that legitimacy that should be balanced against the potential tax evasion considerations when determining what is “equivalence” for meeting the economic effects element.

When an entity that already qualifies as a tax exempt organization and already has program-related investments, this author asserts there is a need for a broader definition of equivalence. The result of the allocation should not be as narrow as that contemplated for the for-profit entities. The allocation should have more leeway to allow some tax advantages to members because of the public policy to encourage for-profit entities to invest in charitable ventures. Indeed, it is precisely because the investors desire to sacrifice some profitability that they would contribute capital to such ventures. The balance should weigh more favorably for those who pose a lesser risk of the ills the law is attempting to prevent.

Additionally, the allocation rules include the statutory requirement to consider “*all* facts and circumstances” in determining whether the LLC’s own special allocation is to be

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[122] See Dodge v Ford, 204 Mich 459 (1919), where the Michigan Supreme Court stated the business is organized primarily for profit, and it is unlawful for the Board of Directors to refuse to issue dividends to benefit non-shareholders or otherwise make profit purposes incidental. The Court actually required a distribution to shareholders because it viewed Mr. Ford’s refusal to do so part of an arbitrary scheme to share company profits with the public. See also

respected.[123] Congress therefore obligates the Service to incorporate this requirement into its analysis. As applied to this article, the facts and circumstances include differences discussed above between philanthropic and wholly for-profit entities when balancing legitimate business interests in making allocations of tax benefit items.

As additional support for the public policy reasons for expanding equivalence, and as part of the facts and circumstances test, the circumstances should also include the big-picture realization that Congress has enacted many other statutes designed to encourage private investors to contribute capital into philanthropic ventures.[124] While there is certainly value in keeping tax considerations in proper context and categories, there should still be an overall congruent tax policy. There should be defined goals for tax statutes and the regulations that implement those laws. As will be discussed below, part of this country's policy and statutory scheme involves using tax benefits as incentives to encourage certain behaviors. Those behaviors include charitable investing by joint ventures between nonprofit and for-profit entities in economically disadvantaged communities.[125] Congress has authorizes such ventures to gain tax-exempt financing, non-recognition and exclusion of gross income, bond credits, tax credits, expense

[123] I.R.C. §704(b)(2).
[124] As just one example, a federally sponsored multi-billion dollar tax credit program (New Markets Tax Credits) provides incentives to lure investors into projects designed to revitalize urban communities in America. The federal authorizing statue is 26 U.S.C. §45D. See also Groves, *The De-Gentrification of New Markets Tax Credits*, 8 FLA. TAX REV. 213 (2007).
[125] James Edward Maule, 597 T.M., *Tax Incentives for Economically Distressed Areas*, (2007) Tax Management, Inc, subsidiary of The Bureau of national Affairs, Inc. (p. A-29).

deductions and favorable depreciation rates.[126] The aggregation of those benefits has often been the missing piece that allows the venture to make economic sense – essentially gap financing.[127]

It is also important from a policy perspective to recognize the relationship between exempt entities and governmental costs. Specifically an exempt entity is lost tax revenue, correspondingly increasing the government burden, i.e. foregone tax revenue. So to some extent every entity and person should contribute to the costs of government since we are all benefitted from what the government provides.[128] Congress recognized over 40 years ago this relationship when it first enacted the jeopardizing investment laws, and required those foundations that violated the new law to make a "contribution, a tax…of their investment income, toward the cost of government."[129] Those taxes "may be viewed as being in part a user fee".[130] Isn't it logical therefore for the corollary also applies - that exempt entities that relieve rather than increase the governmental burden, be afforded customized benefits? As discussed below, the role of a private foundation in governmental relief is "tax benefit reciprocity" and can be a formulaic part of the economic "equivalence" definition which in turn allows allocated tax benefits among philanthropic investors that furthers the LLC's exempt purposes.

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126 For a comprehensive list of tax incentives for such projects see James Edward Maule, 597 T.M., *Tax Incentives for Economically Distressed Areas*, (2007) Tax Management, Inc, subsidiary of The Bureau of national Affairs, Inc.
127 James Edward Maule, 597 T.M., *Tax Incentives for Economically Distressed Areas*, (2007) Tax Management, Inc, subsidiary of The Bureau of national Affairs, Inc. (p. A-29).
128 The legislative history for the laws that created the current restrictions on private foundation investments states, "…since the benefits of government are available to all, the costs should be borne, at least to some extent, by all of those able to pay. Your committee believes that this is true for private foundations as it is for taxpayers generally….This tax, then, may be viewed as being in part a user fee. House Report No. 91-413 on Pub. L. 91-172 (Tax Reform Act of 1969), p. 1318. This passage of legislative history is published in the 1969 U.S. Code Cong. and Admin. News, p. 1645. The Act was considered the most substantive and comprehensive reform of the income tax laws since its initial passage in 1954. Id, at 1313.

129 House Report No. 91-413 on Pub. L. 91-172 (Tax Reform Act of 1969), p. 1313.
130 House Report No. 91-413 on Pub. L. 91-172 (Tax Reform Act of 1969), p. 1319.

PART FIVE: Regulatory Amendments

(a) Amendment to Regulations for "Equivalence" and other restrictive allocation regulations

The reasons for a broader reading of "equivalence" to justify a special allocation for the philanthropic LLC lead to specific language to be inserted into the existing regulation. The italicized language below is an attempt to codify those principles.

(i) "Economic effect equivalence. Allocations made to a partner that do not otherwise have economic effect…shall nevertheless by deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year…or…any future year would produce the same economic results to the partners as would occur if [safe harbor] requirements…had been satisfied, regardless of the economic performance of the partnership…*except where the partnership has qualified program-related investments pursuant to applicable treasury pronouncements, and the return on those investments continues to be used by the partnership for exempt purposes. In such circumstances, the partnership may specially allocate a partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit is such a way that is reasonably designed to perpetuate or accelerate investments by partners in ventures that further the exempt purpose, subject to the limitations of subsection (ii).*

(ii) *The extent of tax benefit shall be limited to* _____ *percent beyond the amount of tax benefit otherwise calculated under this section, unless the partnership*

establishes tax benefit reciprocity where the extent of community value reasonably appears to replace or other reduce existing governmental subsidies to the target community.[131]

(iii) *The determination of whether sufficient tax benefit reciprocity exists shall be determined by the Commissioner or his delegated agency on a case by case basis under regulations specifically designed for such a determination.*

(iv) *This subsection also applies to items of allocation that are by definition incapable of have economic effect for the lack of economic equivalents under this section, since equivalents in this subsection include community benefits determined under the tax benefit reciprocity regulations.*

Proposed subsections (ii) and (iii) reference a determination of "tax benefit reciprocity" by the Service. That principle is an attempt to codify tax policy that provides incentives for private equity contributions to charitable ventures. The policy is discussed in greater detail below.

Subsection (iii) recognizes the need to measure and quantify tax benefits. This author therefore suggests a new regulation that incorporates factors already used in a comparable context. To stimulate the investment of private equity capital into low income urban and rural America, the 106th Congress in the waning years of the Clinton administration amended the

[131] The percentage would be the product of Congressional debate much like any other numerical tax standard. The marginal income tax rates and capital gains rates for example have fluctuated to accommodate forecasted revenue needs weighed against philosophical issues of what groups of taxpayers should bear a heavier burden. See Robert Hamilton and Jonathan Macey, *Cases and Materials on Corporations including Partnerships and Limited Liability Companies*, Thomson-West, 9th ed, p. 132-133.

internal revenue code[132] to allow a tax credit if that taxpayer invested in low income communities, termed "new market tax credits".[133]

The similarities in these tax laws are several but not previously correlated. Under the NMTC program, tax credits were the incentives for laudable projects in low income communities.[134] In the philanthropic LLC context, the incentives are the allocations of income, gain, loss, deduction or credit.[135] In the NMTC scheme, the method of qualifying equity investments for the tax credit is determined based on a detailed and comprehensive list of factors, including community benefit to be achieved by the project.[136] The credit is allowed only after the equity investments are deemed "qualified equity investments" under statutory guidelines.[137] Similarly, under the proposed subsection (i), the philanthropic LLC threshold qualification is that the LLC have program-related investments. That threshold already incorporates the Service's best practices on avoiding abusive investment schemes designed to use exempt entities as a mere instrumentality for profitability.

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[132] On May 23, 2000, President Clinton and Speaker of the House Dennis Hastert publicly announced an agreed proposal that led to the introduction of the Community Renewal and New Markets Act of 2000. HR 4923, 106th Cong. (2000). What emerged from the conference deliberations of both chambers was the bill entitled The Community Renewal Tax Relief Act of 2000 ("CRTRA") H.R. 5662, 106th Cong. (2000). Despite its complexity and permutations, the bill was introduced December 14, 2000, and voted on and passed the same day. Robert W. Oast, Jr., *Incentives for Economic Development in Underserved Communities and for Affordable Housing: A Selective Look at the Legislative Initiatives in the 106th Congress*, 33 Urb. Law. 793, 795 Urban Lawyer (Summer 2001). The CRTRA was signed into law on December 21, 2000, tucked away into obscurity within the massive appropriations act. Title I of the Consolidated Appropriations Act of 2001, PUB. L. NO. 106-569, 114 Stat. 2944 (2000) Thus, it received little fan-fare or public attention beyond those already in the know. Actual legislative history is equally obscure.

[133] I.R.C. § 45D(a)(2)(A-B) (2004).

[134] The credit is in the amount of 39% of a taxpayer's equity investment over a 7-year period. See I.R.C. § 45D (a) (2) (A-B) (2004.

[135] I.R.C. § 704(a).

[136] See the discussion of the 25 point system discussed below.

[137] I.R.C. § 45D (a)(1).

In the NMTC program, the tax credit is measured as a flat percentage of the equity investment.[138] Under the new allocation regulation, the new regulation also sets a flat percentage basis for the amount of tax benefit to be allocated by the LLC. The difference is that under the proposed regulation there is a two-tiered measurement system. There is a super-benefit if the LLC provides a super benefit under tax benefit reciprocity factors. Again the NMTC factors for qualifying the equity investment are highly relevant because they are essentially designed for the same purpose – ascertain whether an equity investment is sufficiently aligned with the Congressional intent to help disadvantaged communities to deserve a tax subsidy.

Under the NMTC scheme, the equity investor submits an application that is evaluated by the designated agency on the following four categories, Business Strategy, Capitalization Strategy, Management Capacity, and Community Impact. Each category has a maximum of 25 points. There are additional "priority points" under the business strategy category if the applicant (1) already has a record of providing capital or technical assistance to disadvantaged businesses or communities or (2) intends to funnel substantially all of its cash investment to low income businesses. Each applicant is then given a numeric score and ranked. [139]

For the philanthropic LLC regulation, the LLC would also make application with the designated agency for the super-benefit allocation. The agency would use a modified form of the NMTC factors that specifically relate to community benefit. The factors would be designed to reveal to extent to which the project replaced or reduced the government subsidies or revenue loss to the treasury from servicing the same community targeted and assisted by the LLC.

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138 These sections specifically provide for a credit of 5% of the equity investment for the first 3 years, followed by a 6% credit for the remaining four years. I.R.C. § 45D(f)(1)(A-D).

139 See *Notice of Allocation Availability*, 69 Fed. Reg. 49951-49952 (August 12, 2004).

Among the four NMTC factors, greater weight may be given to "community impact" and the "priority points". The NMTC priority points are awarded based on the following:

(1) targeting areas of high distress,

(2) prior performance

(3) economic development impacts,

(4) community development impacts, and

(5) other community benefits.[140]

To customize the NMTC factors to the allocation regulation, the agency would need to list the types of government subsidies and governmental burdens currently carried on behalf of the target communities. That would allow LLC applicants to present an apples-to-apples comparison with its own alleged benefits. While the LLC would have the burden of establishing how its venture reduced the governmental burden, the agency would also need to provide guidelines as to whether specific investments were the proximate cause of the reduced government burden, or whether it is sufficient to merely establish that the venture was successful at reducing or supplanting governmental burdens. For perspective purposes, it is important to recall that success in this context is not whether the LLC received huge economic returns from the investment. Rather, success in reducing or supplanting a governmental cost or burden is the basis for allowing the expanded benefits in the allocation process. The existing regulations allow

[140] See General Accountability Office Report to Congressional Requesters, GAO-09-536, *New Markets Tax Credit, Minorities are Less Successful in Obtaining Awards Than Non-Minority Entities.*

losses and deductions as permissible items for allocation.[141] This proposed regulation does not seek to add or detract from those classifications.[142]

An additional benefit of the proposed regulation is that it could add certainty - a welcomed attribute for all those who attempt to interpret and advise clients on what allocations can or cannot be made for specific types of entities. Entities under the philanthropic LLC model with returns on qualified program-related investments translate into distributable allocations to its members. Under the proposed regulation, they would already have some certainty as a threshold benefit from the allocation. Currently, the LLC would have three expensive options, receiving a legal opinion or a private letter ruling based on a drafted attorney's request, or without either of the above taking a chance that the substantial excise tax liabilities and exemption loss do not occur.

As the Service has already recognized, there must be some flexibility build into a regulatory scheme where the complexity and variations bring issues currently unforeseen. Under the proposed subsection (iii) the Commissioner or its delegated agency would make case by case determinations. This is again analogous to the NMTC program. An agency was established to analyze each applicant for the tax credits under specific factors and qualification guidelines.[143] If the LLC considers the allocations say of additional income or deductions to a for-profit member as a reward for extraordinary contributions to the charitable venture, the LLC would have the burden to show that it provided a greater benefit to the community reasonably correlated to a

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[141] See I.R.C. §704(a).

[142] The proposed regulation and the philanthropic LLC model also does not attempt to alter which members of an LLC are entitled to participate in the earnings and profits. That is a contractual matter, and in any event do not involve capital interests subject to the allocation of tax items. Treas. Reg. §704-1(e)(1)(v).

[143] The United States Treasury delegated the responsibility for tax credit distribution and administration of the program to the Community Development Fund Institution. 26 C.F.R. pts. 1, 602 (2004).

long term reduction in government subsidies – hence some reciprocity in tax benefits. The designated agency would then analyze the request in accordance with those factors.

For example, a philanthropic LLC may claim that it provided start-up capital for a new health care clinic that specializes in a disease that disproportionately affects Hispanics or African Americans in a particular community. The LLC then provides statistics revealing that the clinic has caused a reduction in Medicaid costs in that community, or hiring of the previously unemployed residents in the area reduced the government's payment of unemployment benefits. The designated agency would have to generate a means of correlating the allocated tax benefit to government savings, but if the insurance industry can correlate a lost limb and to worker's compensation benefits based on actuarial tables, a benefits analysis can be created for tax benefits reciprocity as well.

Finally, subsection (iv) is meant to clarify whether certain items precluded from having economic effect by inherent definition are within this relaxed standard. Since the "equivalence" is expanded beyond traditional economic benefits, the basis for the preclusion disappears. Thus, tax credits, for example are regarded as lacking economic equivalents, and therefore must be allocated based on a partner's ownership interests.[144] For administrative convenience, it is preferable to apply the fixed percentage from the subsection rather than calculating the extent of tax benefit reciprocity in every case, since there is no tax benefit apart from what flows from the partner's ownership interest.

These principles are also the groundwork for recommended modifications of two other existing allocation rules, as discussed below. Both are part of the Service's attempt to find

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[144] 2010(10) CCH- *Standard Federal Tax Reports,* ¶25,124.028, p. 46,674 regarding Treas. Reg. §7.704-1(b)(4)(ii).

flexible alternate tests to find economic effect under atypical circumstances. As argued herein, the philanthropic LLC that is fortunate enough to receive market or above-market returns on a risky joint venture is such an atypical circumstance to receive its own unique regulation.

(b) The Qualified Income Offset

Investment returns provide a potential source for distribution of profits. Much of the current authority from the Service leaves uncertainty about the extent to which a private foundation can receive a return at market or above market level without jeopardizing exempt status or the imposition of significant excise tax liability. We are better served over the long term by allowing the return based on whatever the market will bear and then allow the entity to use whatever portion becomes a distributable amount as a qualified income offset, ("QIO") with forgiveness of remaining deficits in capital accounts thereafter. The forgiveness would be based on private sector factors used successfully by the banking industry for decades.

Under current regulations, a special allocation will generally not be respected under the safe harbor provisions if a partner/LLC member has a deficit account balance upon liquidation of his entity interests and he cannot restore the amount of the deficit to the entity by the end of that tax year or within 90 days after the liquidation.[145] Without the restoration, the item will be allocated consistent with the member's ownership interests. If therefore an investor made a substantial contribution to the charitable venture that unexpectedly fails there is a loss to the entity, resulting in a deficit capital account balance. The regulation is clear that the partner/member must be "unconditionally obligated to restore the amount of such deficit."[146]

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145 Treas. Reg. §704-1(b)(2)(ii)(b)(3).
146 Treas. Reg. §704-1(b)(2)(ii)(b)(3).

To mitigate the harshness of this provision, a separate regulation allows an LLC operating agreement to contain a "qualified income offset."[147] Under that section, a contribution from the entity to offset the deficit brings the allocation within the safe harbor as an allocation that has economic effect. It often benefits limited partners who are not contractually obligated to make additional capital contributions for the entity's ventures.[148] For example, assume a for-profit member of the LLC contributes $10,000 but is not required to provide additional capital for the LLC ventures. The general safe harbor provisions limit his allocation of deductions, losses, etc, to $10,000 since that is the extent of his economic risk. But if the member receives an unexpected distribution of cash that causes an unexpected deficit balance for his capital account, the partnership agreement can require the partnership provide an allocation of gross income items to offset and cure the deficit.

Under the philanthropic LLC model, the vast majority if not all of current decisions from the Service have only characterized as program-related investments those investments where anticipated ROI have been below market, and where conventional financing was unavailable and the venture itself is high risk. This author advocates allowing the entity to benefit from typical market forces without governmental caps on the investment return. If the risky venture brings extraordinary returns, let it be. And then allow the portion of those returns that become distributable to LLC members into the capital accounts to restore deficit capital accounts if necessary. Remembering that LLCs have the advantage of contractual freedom in framing operating agreements, that tax policies and statutes encourage for-profit joint ventures for charitable causes, and these allowances may reduce a government burden, the extent of investment returns should not be reduced. Those returns can be effectively used as incentives

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[147] Treas. Reg. §704-1(b)(2)(ii)(d)(3).
[148] 2010(10)CCH- *Standard Federal Tax Reports*, ¶25,124.0225, p. 46,670.

through economic equivalence and qualified income offsets and further our nation's tax policy perspectives too.

(c) **Substantiality and Amendment of the De Minimis Rule.**

Even if a philanthropic LLC established an economic effect for its special allocation, the regulations require that the effect be substantial.[149] The substantiality of the allocation is determined independent of the tax consequences of the allocation.[150] It is the dollar amounts of partners that must be substantial, and this is as of the time the allocation becomes part of the LLC/partnership agreement.[151]

There is again an exemption wherein the Service customized a provision for deserving circumstances. Exemptions at their root involve tax policy decisions. Indeed our basic federal income tax method of calculating tax is a progressive tax system, a policy that those with more income pay a higher percentage of tax that those less wealthy.[152] So too is the Service's exemption from the safe harbor allocation rules. Not unlike other tax exemptions for those with low amounts of gross income, the allocation exemption concerns those with low amounts of ownership interests.[153] The regulations state that a partner of a partnership that owns, directly or indirectly, less than 10 percent of the capital and profits of a partnership, and who receives less than 10 percent of the allocable items is exempt from the substantiality requirements – ("the de

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[149] Treas. Reg. §704-1(b)(2)(iii).
[150] Treas. Reg. §704-1(b)(2)(iii).
[151] Treas. Reg. §704-1(b)(2)(iii).
[152] For example, corporations with taxable income over $50,000 and no more than $75,000 are taxed at a marginal rate of 25% on that income for 2010. Corporations with taxable income over $75,000 and up to $100,000 pay a higher 34 percent tax. See Hamilton Macey, Table 1, *Corporations, including Partnerships and Limited Liability Companies,* Thomson Reuters, 2010, p 7.
[153] Treas. Reg. §704-1(b)(2)(iii)(e).

minimis rule".[154] Presumably, this exemption was borne out of a policy perspective and an effort to show reasonableness – let's not hold someone with a small amount of ownership interests to the same restrictions as every other LLC member.

This author advocates expanding the exemption to philanthropic LLC modeled entities. The policy is essentially saying: "Let's not hold an LLC that is only trying to help others with qualified program-related investments to the same restrictions as all other LLCs who only seek to maximize profits." The most effective way to encourage private investment of capital through such entities is to simply increase the de minimis percentage for entities with qualified program-related investments that are used in allocating benefits to LLC members. The exact amount of that ownership percentage would be determined like any other, through a political process within the Service and with Congress. Particularly if there is a second tier finding that the LLC actually provides tax benefit reciprocity, the ownership interests of the LLC member could also be tiered progressively higher in correlation to the reduced burden of the government.

To summarize this section, the regulatory allocation scheme should be expanded so a philanthropic LLC has greater ability to allocate tax items in a way that furthers their exempt purposes – i.e. creating tax benefits that in turn are incentives for the for-profit investors to joint venture with tax exempt private foundations for projects designed primarily to help low income communities. For such a scheme to work, high risk ventures should be able to translate into high economic return without artificial government investment caps. If the regulations allow greater flexibility for the LLC to allocate tax items in a way that atypically benefits investors *because* of the mission-based investment, the regulation will have the effect of encouraging such investments. As emphasized elsewhere in this article, encouraging private investors to contribute

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[154] Treas. Reg. §704-1(b)(2)(iii)(e).

equity capital to those types of investments is consistent with existing Congressionally-approved programs.

In particular, this proposal expands the SEE definition for this particular type of LLC. Rather than restriction the allocation so that the benefits of tax items are ignored, they are allowed even if distributed differently from ownership interests. Because the LLC's philanthropic purposes are beyond pure economic return its investor members, this proposal seeks to incorporate a broader consideration of the value of philanthropy into the equation. For this type of LLC the analysis is not just about the allocations that reflect the actual economic arrangement of the partners."[155] This is bigger than partner economic distributions. These partners voluntarily sacrificed purely economic returns to prioritize the charitable venture, and should receive the tax benefits that a more flexible allocation scheme can allow.

So under the facts of Rev. Rul. 98-15, the operating agreement could provide a formula that specifically authorizes a significant ROI for whichever members are most benefited from the allocation, be they the for-profit member or the nonprofit foundation, and even if the allocation benefits a member disproportionately from ownership interests. The restrictions from the Rev. Rul. 98-15 still apply - the activities that generated the return must still further the exempt purposes; the for-profit entity does not use the exempt member as an instrumentality of the profit members and non-charitable purposes. In this author's view, the proposed amendments to the allocation regulations have sufficient safeguards against tax evasion or perversion of Congressional intent. And the amendments to the safe harbor rules would be applicable to a narrow group of entities that pass rigorous qualifications as factor-tests administered by a treasury agency.

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[155] 2010(10) CCH – *Standard Federal Tax Reports,"* CCH Explanation", ¶ 25,124.01, p. 46,667.

PART SIX

Excise Tax Considerations and a Call for Statutorization

With the amendments noted above, the LLC operating agreement can be carefully crafted to allow the profits and other tax items to be adjusted between the foundation and the for-profit members without violating the Section 4944 jeopardy investment regulation or Section 704 allocation laws and regulations. In both cases, the proposals increase flexibility of the managing member. One benefit of such increased flexibility is to more easily navigate ways to prevent unintended liability for the other excise taxes potentially imposed on the LLC's investments. Code Sections 4940 through 4945 present a complex array of companion regulations that are cause for very careful analysis before a foundation invests in and jointly with for-profit ventures.[156] The investment decision therefore is a high risk game.

Attached Table A depicts the various excise taxes, the reason they are imposed and potential penalties, respectively. Most relevant for this article, the exempt private foundation and/or its LLC cannot avoid a net investment income tax if it loses or fails to qualify for exemption.[157] It cannot avoid an excise tax for self-dealing between the between foundation manager(s) or other certain other foundation contributors and the private foundation.[158] It cannot avoid paying an excise tax if it fails to distribute a minimum amount of its investment return toward the philanthropic mission.[159] The LLC also cannot avoid a separate excess business

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[156] There is a tax on the private foundation's net investment income under I.R.C. § 4940(c) each act of self-dealing between foundation manager(s) or other certain other foundation contributors and the private foundation under I.R.C. § 4941(a)(1)(2), undistributed income under I.R.C. § 4942(a)-(e), excess business holdings under I.R.C. § 4943(a)(c) and spreading propaganda under I.R.C. § 4945(a)-(h).
[157] I.R.C. § 4940(b).
[158] I.R.C. § 4941(a)(1)(2).
[159] I.R.C. § 4942(a)-(e).

holdings tax if the private foundation holds stock or other interests in an enterprise it otherwise would be required to divest.[160]

The Table reveals a very significant amount of potential liability, which could certainly chill, rather than encourage equity investments in already risky charitable ventures. If an investment is high risk for economic returns, with low anticipated returns, yet sporting high potential for substantial tax liability, the equation is not well-designed as an incentive. If the imposition of those taxes can be avoided by investing under the incentive-laden model proposed in this article, the result should be an increase in the equity capital for the target communities, which is consistent with long stated balancing of revenue generation while increasing equity participation. Once an investment qualifies as a PRI under Section 4944(c) of the Code, it is by definition excluded from the category of jeopardy investment which would subject the entity to excise taxes under that section.[161] Importantly, the Service has often also concluded that if a tax exempt private foundation meets the PRI qualification, other excise taxes are avoided as well. In the aforementioned PLR199943044, the Service not only found that the private foundation's acquisition of stock in the for-profit business was a PRI and therefore not a jeopardizing investment subject to the excise tax under Section 4944.[162] It also concluded that the investment was a qualifying distribution and therefore not subject to tax on undistributed income under Section 4942, or excess business holdings under Section 4943.

Unfortunately for the philanthropic LLC, this private letter ruling was writing by the Chief of Exempt Organizations, a technical branch within the IRS.[163] By its own terms, the PLR

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[160] I.R.C. § 4943(a)-(c).
[161] I.R.C. §4944(c).
[162] Priv. Ltr. Rul. 199943044, 1999 PLR Lexis 1213, p. 13.
[163] Priv. Ltr. Rul. 199943044, 1999 PLR Lexis 1213, p. 14.

is “directed only to the organization that requested it” and “may not be used *or cited* as precedent.”[164] The only statutory means of making a PLR precedential is for the IRS to establish it as a regulation.[165] There are no statutory triggers to force the Service into action on such an issue.

The Service has provided regulations designed to give taxpayers and exempt entities notice of relevant interpretations and authority they can rely upon regarding program-related investments, but no such guidance is codified in a single source for navigating the excise alligators discussed above. Without even the ability to cite the PLRs, the exempt entity facing ultra-hazardous decisions about joint venturing in already risky projects with for-profit entities in under-resourced communities may be an over-the-top deal breaker without receiving reasonable clarity and certainty of tax outcomes from the Service.

To remedy that malady, this author suggests a process of “statutorization”.[166] By that term, this author means a process whereby Congress incorporates non-statutory rulings and pronouncements from the IRS, otherwise obscure to the general public, into statutory law on a fast-track basis. The core reason is no different than the rationale often used to justify a statute – to add clarity and certainty in an otherwise amorphous area.[167] Thereby, counsel to private

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164 Priv. Ltr. Rul. 199943044, 1999 PLR Lexis 1213, p. 14. See I.R.C. § 6110(j)(3) for the statutory precedent prohibition.

165 I.R.C. § 6110(j)(3).

166 That process could also include public hearings that could generate even more outside-the-box suggestions from the business community. See Groves, *MORE PRIVATE EQUITY, LESS GOVERNMENT SUBSIDY,*
AND MORE TAX EFFICIENCY IN URBAN REVITALIZATION: Modeling Profitable Philanthropy and Investment Incentives.

167 *See* HAMILTON & MACEY, *supra* note **Error! Bookmark not defined.**, at 196-97 (where the excerpt from a proxy statement from Dole Food Company, Inc. notified the stockholders of the desire to reincorporate in Delaware as opposed to Hawaii because the statutory corporate law provides “a greater measure of predictability” and proposed statutory amendments help “meet changing business needs”).

foundations and potential for-profit joint venture partners will have greater certainty as to the state of the law and their clients should have greater certainty that such ventures are worth the investment risk. The process and statutory mandate should also include extraordinary public notice to those who meet the profile of the private equity pool. Congress has the resources to inform the public of this investment opportunity as completely as it would inform the public of say, an increase in the tax rate, or the availability of amnesty. It is a matter of Congressional will. If breaking the cycle of perpetual poverty and governmental dependence in the core of urban and rural America is a high priority, statutorization could easily be accomplished.

As applied, the PRI statute could have a subsection added to accomplish what many "safe haven" provisions accomplish in complicated or otherwise ambiguous areas of tax law – provide greater clarity and certainty of likely results.[168] This safe harbor provision would state the following:

> "*An organization recognized as exempt under section 501(c)(3) of the internal revenue code or related entity that carries on the exempt purposes of said organization that meets the requirements of this section for program-related investments and therefore have no excise tax as a jeopardy investment under this section, shall have a rebuttable presumptive exemption from the other excise taxes in Sections 4940 through 4945 of the internal revenue code. The exemption may be rebutted by the Commissioner or delegated agency on any basis authorized under the Code for assessment of taxes, penalties, and interest. The Secretary shall establish regulations to provide adequate guidance as to the*

[168] One such safe harbor is discussed elsewhere in this article where the IRS attempts to clarify through numerous examples what types of allocations of income, credits, gains, and deductions a partnership or LLC may provide to its partners (or its LLC members taxed as partnerships) that are disproportionate from their respective ownership interests. See I.R.C. §704 and Treas. Reg. §704-1(2)(b).

types of facts and circumstances that may likely cause imposition of any of the above-referenced excise taxes.

Such a statutory provision, and any eventual interpretive regulations, provides potential equity investors and/or their legal advisors with a more stable basis for decision making. If they can better anticipate less risk of significant tax liability, they can factor in tax savings, along with the other benefits of this article in determining what amounts to invest, what type of return absent the excise tax liability is reasonable to expect, whether to joint venture, and if so, what rate of return fulfills each investor's risk appetite.

Congress has not provided a mandate as to when private letter rulings must become statute, as presumably the political process has too many vicissitudes. But there should be some guidance for Congress, albeit self-imposed, especially where something as important as tax revenues upon which so many governmental functions and services depends upon is at stake. For example, Congress could include a triggering event, "when the federal deficit reaches X point, Congress shall conduct public hearings through an appropriate joint committee to ascertain whether prior pronouncements from the treasury have such revenue-generating potential that they should become statutes with extraordinary notice and opportunity for public input."

PART SEVEN

Policy Considerations

Uncapping ROI as an Economic Stimulant Tempered by Tax Benefit Reciprocity

Another justification for uncapping the return on investment for private foundations is based on tax policy and economics. When the 1950 UBIT legislation was being debated, President Truman sought to spur economic growth. More capital investment by foundations into businesses allows businesses hire employees, increase their own buying and selling of goods and services, which incentivizes customers to do the same. All of these activities create taxable events and new tax revenues to federal, state and local treasuries. And this in turn brings more economic efficiently to previously underutilized resources (i.e. employing the previously unemployed is a more economically efficient use of human capital than a perpetual state of unemployment). The result should be an economic net plus. More revenue should be generated from the various businesses and individuals who must pay taxes than the excise taxes on the single foundation that invest in those businesses. There is a multiplier effect to the positives flowing from the LLC's investment capital into a business, including but not limited to the taxes those businesses pay, the taxes the employees of the business pay, the taxes paid by purchasers of the goods and services provided by the business, and various other benefits from the increased economic activity.

But no rational tax policy for a country should view tax or revenue benefits only flowing in one direction, to the benefit of one and continual detriment of another. If a private foundation is already exempt from contributing income taxes to the US treasury it should not be able to receive even greater returns on investment without a corresponding benefit to the tax collector. And there should be some alternate basis beyond taxes for measuring the extent of a private foundation's contribution. The government is burdened with providing some aspects of a basic standard of living for our most needy citizenry. The philanthropic LLC should be able to have its

contribution to relieving that governmental burden through more than the imposition of excise taxes or an unrelated business income tax.

A fundamental principle for tax-related contributions was established in the 1700's by Adam Smith, the person many economists regard as the "economic prophet of Western capitalism." [169] According to Smith, "…the greater part of the members of any society should contribute to the public revenue in proportion to their respective expense…"[170]

The philanthropic LLC's proportionate expense to the US treasury is therefore the focus of inquiry. In theory then if an entity is of no expense to the treasury it should not have to contribute to that treasury. In reality of course there are revenue demands, comparative fairness among entities, among other political factors to consider. But as an underlying principle, an LLC's justification for greater tax benefits should be in proportion and in some manner correlated to a reduction in its expense to the government. In this author's view, the Smith proportionality model translates into a theory of "tax benefit reciprocity". The term codifies the principle that the amount of the tax benefit flowing to an entity should be measured by the amount of reciprocal advantage to the government that generates the tax.

An even more ancient source for such a theory may be traced to Aristotle and the notion that "people should be rewarded in accordance with their merits" be it a distribution of political

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[169] The reference is to Adam Smith, as described by economist Thurman Arnold, in *The Future of Democratic Capitalism,* University of Pennsylvania Press, (1950), p. 3. Smith was also termed "the first economist" by celebrated economist, John Kenneth Galbraith. John Galbraith, *The Age of Uncertainty,* Houghton Mifflin Company, (1977), p. 15. Smith may or may not appreciate being called an economist. Commencing in 1751, he became a professor of logic, and then moral philosophy. Galbraith, p 15. Yet his seminal publications examined causes of wealth on a comparative basis between Great Britain, the American colonies, and beyond. See *The Wealth of Nations, supra.*

[170] Adam Smith, *The Wealth of Nations*, J.M. Dent & Sons LTD, Vol. 2, p. 364, last reprinted 1966.

status, property or in this context, a distribution of tax benefits.[171] It is also akin to theories of "distributive justice" to the extent that the "state" has an obligation to a "certain level of material means" to all its citizenry, and if those threshold benefits are not provided, "the state may need to redistribute goods to correct for market imperfections."[172] Implicit in that theory is the need for society and its human capital to contribute –i.e. the market has a role in creating and distributing the benefits shared by all.[173] Attributed to Aristotle is the further notion that on a project-by-project basis, one's contribution to a cause is the proper basis to determine what one receives from that project.

"Aristotle allows the meaning of 'merit' (axia) to vary quite widely – merit is for him often relative to a common project, such that a person who contributes more capital to a mercantile venture, for instance, deserves more of its profits. (NE 1131b29 – 1131b30)."[174]

If indeed there is a societal obligation to take care of its least fortunate and most needy, then it is wiser policy for the societal obligation to be a shared obligation by not only the government but also those to whom much has been given. And for those who are recipients of governmental benefits – like tax exemptions, any gifting should be based on merit. Merit for private foundations and philanthropic LLCs should incorporate the benefits bestowed on others

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[171] See Samuel Fleischacker, *A Short History of Distributive Justice,* Harvard University Press (2004), p. 5.

[172] See Samuel Fleischacker, *A Short History of Distributive Justice,* Harvard University Press (2004), p. 4. Distributive justice is also termed "economic justice" or "social justice. Id, at 1. The author admits that while Aristotle did not birth the name "distributive justice" he did opine about resource allocation and rewarding people based on merit. Id, at 1-2. His book attempts to connect Aristotle's theories to modern concepts of distributive justice. He also admits that "the history of ideas is a messy affair, and there is neither universal agreement today on what 'distributive justice' means, nor a neat time line in the past by which the premises …for modern distributive justice came, one by one, into wide acceptance." Id. at 16.

[173] See Samuel Fleischacker, *A Short History of Distributive Justice,* Harvard University Press (2004), p. 4.

[174] See Samuel Fleischacker, *A Short History of Distributive Justice,* Harvard University Press (2004), p. 14.

through their mission-based investments. . The extent of benefits they should receive is based on what meritorious activities justify the benefit. What they deserve under the tax benefit reciprocity principle is therefore correlated with the amount of reciprocal benefit they give back to the government, the amount of relief of the government burden. Whether the LLC member's contribution in the Aristotelian sense is capital or services, if that investment provides societal benefits that relieve part of the government's burden, the extent of the benefit and contribution is still a concept of meritocracy. Indeed the LLC member should receive some profits and tax benefits based on the merit of value conferred in the community and the governmental relief. The tax benefit reciprocity incorporates the Aristotelian concepts and a trading of values, commoditized through the language of tax benefits.

This confluence of tax benefits and burdens, as applied to this discussion is between the LLC, the government. The LLC contribution may be, for example, capitalizing businesses that serve the underserved with financing otherwise unavailable from conventional sources. The government too subsidizes programs and businesses in need at the expense of the treasury, and the more philanthropic LLCs subsidize the projects, the lesser the burden on the government in that shared assistance.

Accordingly, this article asserts an LLC with mission-based investments should only retain the benefits of tax exemption and PRI status that avoids excise taxes if it provides a corresponding benefit to the tax system. The reason for this relationship is because for every exemption from tax there is lost tax revenue. The remaining non-exempt taxpayers must therefore make up for the lost revenue. To justify the loss revenue, the entity that received the tax

exemption should give back to the system something to reduce the burden on the nonexempt taxpayers. The model LLC with mission-related investments can justify its exemption by providing equity capital for businesses in economically disadvantaged areas. If the foundation provides the capital to start up or maintain a viable business in such an area, that business may employ someone previously unemployed. The government would no longer have to allocate to those individuals unemployment compensation or provide health or social services at the same level because the capital-infused business would be picking up that tab.

This theory is sufficiently analogous to the "economic equivalence" test already used by the Service. Economic equivalence is an available alternative when an allocation by the partnership/LLC does not meet the generally required capital accounts requirements for meeting the economic effect portion of the SEE test. To its credit the Service was more focused on the substantive result rather than form. It opined that even if the form of capital accounts is inadequate, the economic effects still exist if the substantive aspects of the test are met through other means.[175] This author merely expands the equivalence definition to include the reciprocity of benefits that are consistent with tax policy and the "all facts and circumstances" element of the SEE analysis.

Thus it is wise tax policy to provide incentives for investors to infuse private equity into businesses that serve areas and people that are underserved, because that is where a disproportionate governmental burden can be ameliorated. More private equity should result in

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[175] See examples from the Treasury Regulations for Section 704 ___, noted in Michael L. Holland, *Bulletproofing Special Allocations*, Entrepreneurial Executive, Annual, 2008. The substance required is that the allocation reflects the actual economic arrangement of the partners." See 2010(10) CCH – *Standard Federal Tax Reports*," CCH Explanation", ¶ 25,124.01, p. 46,667.

more tax efficiency therefore.[176] At bottom, all tax benefits given to individuals or entities have an element of incentives. An entity has an incentive to be charitable when certain qualified income it receives from that activity is not taxed. A greater incentive would exist if the return on charitable investments would have a broader qualification without a cap on profits. The author has attempted to delineate the limits on such a return to minimize abuses, but the underlying principle remains.

It is also important to recognize that these proposed regulations do not attempt to dilute the most vital reasons for the tax treatment of a foundation's investment income. Clearly, Congress quite appropriately sought to eliminate a certain the tax benefit incongruity. Prior to the 1969 amendments, a private foundation could invest in assets and accumulate income from those assets and receive substantial tax benefits from making the contribution.[177] But the charity would receive no current benefit because no actual distributions to the charity were required. A key feature of the 1969 amendments was to distribute income currently from a certain percentage of investment assets, and taxes as a penalty on undistributed income.[178] The excess business holdings laws meet that challenge.[179] In a forthcoming article this author suggests altering the required distributions imposed by the IRS regulations. The difficult task of balancing a required immediate distribution to currently help the charity and accumulation of investment income to

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[176] See Roger M. Groves, *More Private Equity, Less Government Subsidy, and More Tax Efficiency in Urban Revitalization: Modeling Profitable Philanthropy and Investment Incentives,* 8 Florida State U Business Review 93 (2009). The premise of the Florida State article was that as a matter of tax policy, increasing the private sector contribution to charitable projects should reduce the need for as many governmental subsidies, and the preferred method of increasing investor participation is to increase the amount of investment return rather than focus on tax deductions.
[177] House Report No. 91-413 on Pub. L. 91-172 (Tax Reform Act of 1969), p. 1319-1320.
[178] House Report No. 91-413 on Pub. L. 91-172 (Tax Reform Act of 1969), p. 1319-1320.
[179] The reference is to the work in progress is entitled, *Frontiers in Urban Investing: Let the Philanthropic LLC Keep More of its Investment Return and It Will Invest More.*

incentivize the equity investor must be adjusted periodically to meet the challenges of the day. But that is an article for another day.[180]

CONCLUSION

This article suggests we change the investment incentive paradigm for charitable investments in urban America if there is to be a serious change to the status quo of economic development in those under-resourced target communities. Market based investment strategies should be allowed to reward high risk ventures on par with the private sector if a philanthropic LLC makes investments that are true to its charitable purposes and qualify as program-related investments. Accordingly, various amendments to federal tax regulations are proposed to increase the investor's return on investments, and increase thereby the private equity contributions. The intent is to generate more equity capital for the urban communities in greatest need of economic revitalization. The overall effect of the existing excise tax regulations may be effective at preventing abuse of exempt investment income, but in the aggregate they are short-sighted in assisting Congress achieve its oft-stated goal of increasing private equity capital into disadvantaged areas of this country. [181].

This article also asserts that it is wiser tax policy and an overall net plus to revenue collection over time to uncap the return on investment for mission-based investments of LLC's that otherwise meet the safeguards contained in the program related investment provisions. The current state of law leaves serious doubt as to whether the philanthropic LLC's return on

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[180] The reference is to the work in progress is entitled, *Frontiers in Urban Investing: Let the Philanthropic LLC Keep More of its Investment Return and It Will Invest More.*

[181] While this article concerns the higher profile Section 4944 jeopardizing investment regulation, there are additional hurdles to overcome through regulations that were not designed for philanthropic investors that nonetheless chill transformative investments. That shall be the detailed in a future article.

investment can be at or above market. That ambiguity chills private investment in such joint ventures. To encourage private investment, this article advocates allowing market-based returns to incentivize investors, and amending existing regulations to facilitate those achievable and desirable outcomes.

To be realistic and politically pragmatic, there must be a balanced approach. This author proposed retention of the regulations that curb abuses, but amend provisions that add incentives for philanthropic LLCs and similarly outfitted social entrepreneurs. They too need a balance between philanthropic missions and profitability. This author is merely attempting to give them enough incentives to make many nets for others so that we no longer have an island defined by its poverty but rather by its prosperity.

TABLE A

POTENTIAL EXCISE TAXES FOR A PRIVATE FOUNDATION

ON ITS INVESTMENTS

TYPE	1ST TIER Calculation	2ND TIER Calculation	MANAGER JOINT & SEVERABLE?
Net Investment Income on Nonexempt Private Foundations (§ 4940)	Gross Investment + Capital Gain – Deductions x 2%	None	No
Self-Dealing (§ 4941)	• 10% on Self-Dealer • 5 % on Manager (20K cap)	• 200% on Self Dealer • 50% on Manager (20K cap)	No
Undistributed Income (§ 4942)	30% of undistributed amount	100% of undistributed amount	No

Excess Business Holdings (§ 4943)	**10 % of excess holdings**	**200% of excess holdings**	**No**
Jeopardizing Investments (§ 4944)	• **10% on Foundation** • **10% on Manager (10K cap)**	• **20% on Foundation** • **5% on Manager (20K cap)**	**Yes**
Taxable Expenditures (propaganda, etc) (§ 4945)	• **20% on Foundation** • **5% on Manager (10K cap)**	• **100% on Foundation** • **50% on Manager (20K cap)**	**Yes**