DAVID Y. IGE
GOVERNOR

SHAN S. TSUTSUI
LT. GOVERNOR

STATE OF HAWAII
OFFICE OF THE DIRECTOR
DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS
335 MERCHANT STREET, ROOM 310
P.O. Box 541
HONOLULU, HAWAII 96809
Phone Number: 586-2850
Fax Number: 586-2856
cca.hawaii.gov

CATHERINE P. AWAKUNI COLÓN
DIRECTOR

JO ANN M. UCHIDA TAKEUCHI
DEPUTY DIRECTOR

TO THE HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT & BUSINESS
THE TWENTY-NINTH LEGISLATURE
REGULAR SESSION OF 2017

Wednesday, February 15, 2017
9:00 a.m.
Conference Room: 309

TESTIMONY ON HOUSE BILL NO. 19
RELATING TO BUSINESS

TO THE HONORABLE MARK M. NAKASHIMA, CHAIR,
AND TO THE HONORABLE JARRETT KEOHOKALOLE, VICE CHAIR,
AND MEMBERS OF THE COMMITTEE:

Thank you for the opportunity to testify. My name is Henry Tanji, Acting Commissioner of Securities and head of the Business Registration Division of the Department of Commerce and Consumer Affairs (Department). The Department opposes this bill and requests that it be held.

This bill amends HRS chapter 428 to provide for the formation of a new type of limited liability company ("LLC") called a "low-profit limited liability company" ("L3C"). L3Cs are an inappropriate way to use state business registration laws to establish a mechanism to label private businesses as charitable or socially beneficial. Such "branding" misleads customers and business owners alike. Secondly, L3Cs are no

better at increasing capital to socially beneficial business enterprises than existing LLCs or nonprofit corporations and are, therefore, unnecessary.

This bill provides that a LLC may become a L3C if it:

1) At all times significantly furthers a charitable or educational purpose as defined by the Internal Revenue Code section governing the tax deduction for donations to tax-exempt charitable entities;
2) Indicates in its articles of organization that it intends to qualify for L3C status and further states that it does not have a significant purpose of producing income; provided that the significant production of income alone will not disqualify it from continuing as a L3C; and
3) It does not engage in political lobbying.

In the case of a LC3 that no longer satisfies the above-mentioned requirement, the entity is required to promptly amend its articles to remove the LC3 designation. The bill also requires that all chief operating officers, directors[1], or managers of the company are subject to HRS chapter 556, relating to the Uniform Fiduciaries Act.

In the past, proponents of L3Cs have argued that the entities are tailor-made to receive "program-related investments" or "PRIs" from private foundations, which are required by the Internal Revenue Service (IRS) to annually use 5% of their assets in furtherance of their mission in order to maintain their tax exemption. Foundations, like other charitable organizations, are required to keep their assets safe to ensure they can continue their charitable work. These target investments may often be low-profit

[1] Though LLCs through their operating agreements have wide latitude in choosing officer titles, terms like "chief operating officer" and "director" are usually associated with corporations. LLCs mainly use the terms "members" and "managers."

because they have charitable or educational purposes without a strong focus on earning profits. Thus, proponents argue that the L3C provides a kind of "short cut" for foundations to find qualifying LLC investments.

However, whether a foundation's investments qualify as a PRI wholly depends on the actual activities of the LLC in which the investment is made -- not on whether it is merely registered as a L3C with the State's ministerial business registry. To be clear, the IRS has not conferred any tax privileges upon L3Cs, and it is unlikely that the IRS would grant tax-exempt status based on entity type alone.

L3Cs will confuse and mislead the public and well-meaning business owners who may incorrectly assume that they are automatically endowed with IRS tax- exempt status by virtue of their official registration with the State. In addition, because BREG maintains purely ministerial duties over the registry, the system should not be used as a way for private businesses to imply that their activities are charitable or educational as there will be no oversight to determine the accuracy of that branding.

In a May 2012 working paper (which was presented to the Minnesota legislature when it was considering the adoption of L3C legislation) the American Bar Association's Business Law Section on behalf of its Committee on LLCs, Partnerships, and Unincorporated Entities and its Committee on Nonprofit Organizations stated: "In regards to the myriad requirements of federal tax law, the L3C has no significant advantage whatsoever over the ordinary LLC…In sum, from the perspective of federal tax law, the L3C is at best a distraction and more likely a simplistic trap for the unwary." [2]

[2] Kleinberger, Daniel S., *ABA Business Law Section, on Behalf of its Committees on LLCs and Nonprofit Organizations, Opposes Legislation for Low Profit Limited Liability Companies (L3Cs)* (May 10, 2012). William

In 2014, North Carolina repealed its L3C law (passed in 2010) purportedly because the law was "deadwood." [3] Since traditional LLCs can be used for many purposes and contractual agreements, North Carolina came to see that there was no need for the L3C. Likewise, under Hawaii law, business owners are given wide latitude to organize their LLCs "for any lawful purpose." HRS §428-111(a). Hawaii law does not prohibit a LLC's operating agreement from further describing and regulating its affairs and the conduct of its business. See HRS §428-103. HRS §428-101 defines the term "business" to include "every trade, occupation, profession, and other lawful purpose, whether or not carried on for profit." (Emphasis added.) Therefore, low-profit activities are already authorized under current law.[4]

For these reasons, we respectfully ask that this bill be held. Thank you for the opportunity to testify.

Mitchell Legal Studies Research Paper No. 2012-05. Available at SSRN: http://ssrn.com/abstract=2055823 or http://dx.doi.org/10.2139/ssrn.2055823.

[3] See Field, Anne. *North Carolina Officially Abolishes The L3C - Forbes*. Forbes. Forbes Magazine, 11 Jan. 2014. Web. 29 Jan. 2016. <http://www.forbes.com/sites/annefield/2014/01/11/north-carolina-officially-abolishes-the-l3c/#2d54e87b1ee1>.

[4] The bill seems to reference the ability for existing LLCs to operate with charitable or educational purposes in proposed HRS section 428(e): "Nothing in this section shall prevent a limited liability company that is not organized as a low-profit limited liability company from electing a charitable or educational purpose in whole or in part for doing business under this chapter."

DAVID Y. IGE
GOVERNOR

SHAN TSUTSUI
LT. GOVERNOR

MARIA E. ZIELINSKI
DIRECTOR OF TAXATION

DAMIEN A. ELEFANTE
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809
PHONE NO: (808) 587-1540
FAX NO: (808) 587-1560

To: The Honorable Mark M. Nakashima, Chair
and Members of the House Committee on Economic Development and Business

Date: Wednesday, February 15, 2017
Time: 9:00 A.M.
Place: Conference Room 309, State Capitol

From: Maria E. Zielinski, Director
Department of Taxation

Re: H.B. 19, Relating to Business

The Department of Taxation (Department) appreciates the intent of H.B. 19, but has serious concerns over the measure, and provides the following comments regarding H.B. 0019 for your consideration.

H.B. 19 authorizes the formation of a Low-profit Limited Liability Companies (L3C) as a form of business if it is created for the accomplishment of charitable or educational purposes and not for the significant purpose of production of income or appreciation of property or influencing legislation. The measure is effective upon its approval.

Background of L3Cs

A L3C is a hybrid entity, combining the flexibility of Limited Liability Company (LLC) with a low-profit, socially beneficial charitable, educational objective. Because investors in a for-profit business generally require a high rate of return on investment, and most socially beneficial businesses are not, these businesses are generally set up as non-profit corporations. However, Internal Revenue Service (IRS) regulations substantially restrict the profit-seeking objectives of a non-profit.

In 2008, Vermont became the first state to enact legislation authorizing the creation of the L3C as a new business entity, and several states since have enacted legislation. Structurally, a L3C is the same as a LLC, with members, managers, an operating agreement, and flexibility with ownership rights. From a legal standpoint L3Cs differ from LLCs only in one significant area: profit motive. In general, legislation authorizing the creation of L3Cs have three requirements: (1) that the company significantly further charitable or educational purposes as defined by the IRS; (2) that no significant purpose of the company is the production of income or appreciation of property; and (3) that no purpose of the company is to accomplish political, legislative, or lobbying activities. These requirements are found in this measure.

L3Cs were intended to be an attractive option for private foundations to use as investment vehicles, which by law is required to distribute at least 5% of the foundation's net assets each year. The Tax Reform Act of 1969 authorized a Program-Related Investment (PRI) as an additional means of satisfying this 5% obligation. A PRI is an investment with its primary purpose to accomplish one or more of the foundation's exempt purposes, regardless of the potential for profits and dividends. However, the production of income or appreciation of property cannot be a significant purpose, nor can influencing legislation or taking part in political campaigns on behalf of candidates.

The IRS imposes strict rules on how private, tax-exempt foundations use their monies, and there is a risk that the IRS will not recognize a PRI as such, with the end result being that the private foundation would incur significant taxes and penalties. This caused private foundations to avoid investing in PRIs unless a private letter ruling was obtained from the IRS. With the introduction of the L3Cs, it was hoped that private foundations would have a way to invest in PRIs without the cost and time of obtaining a private letter ruling from the IRS, since the legislation authorizing L3Cs is predefined to meet the requirements of a PRI.

Despite its socially-conscious mission, an L3C is not a tax-exempt organization under section 501(c) of the Internal Revenue Code, and donations and investments in L3Cs are not tax deductible. The profits of an L3C pass through to its members and are taxed to the member, and experts believe there are serious tax and other issues that cannot be overcome, such that the L3C is not the proper vehicle for private foundation PRI investing. On January 1, 2014, North Carolina became the first state to repeal its L3C legislation (which was only enacted in 2010).

In April 2012, the American Bar Association Business Law Section, on behalf of its LLCs, Partnerships and Unincorporated Entities Committee and its Nonprofit Organizations Committee sent a Letter (Letter) to the Minnesota House of Representatives, opposing the proposed legislation for L3Cs, and urged its rejection, noting that "[t]he L3C is no better than any other business form for receiving program related investments from private foundations".

Concerns of the Department

First, the Department notes that the measure fails to provide any enforceable standard to guide the enterprise's pursuit of social benefits or for the Department to determine the same. For example, the measure provides that a significant purpose of a low-profit limited liability company must not be "the production of income or the appreciation of property", how does one determine whether or not it is a significant purpose? This is important because the legislation itself provides that "the fact that the company actually produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property", but fails to state what other factors should be considered in making this determination.

Second and more importantly, being a L3C will not provide advantages over any other legal form of business organization, since a regular LLC can already do these same things. While the measure purports to meet the federal standards for a PRI, state law cannot override federal law, and the IRS will always have the power to review if an investment made into a L3C is in fact a PRI, the same as any other investment. Being a L3C will not guarantee a private foundation that an investment is in fact a PRI. Furthermore, a private foundation could be risking its tax exempt status if it is discovered that the L3C's primary purpose was for the production of income. In this case, an investing private foundation could face substantial penalties.

Third, a non-profit entity has certain reporting requirements, which the public may access through the attorney general's website. However, this measure contains no such reporting, monitoring, and oversight requirements. As currently drafted, the public will not be able to determine whether an entity is in fact a L3C based on their operations.

Thank you for the opportunity to provide comments.

TESTIMONY OF
THE DEPARTMENT OF THE ATTORNEY GENERAL
TWENTY-NINTH LEGISLATURE, 2017

LATE

ON THE FOLLOWING MEASURE:
H.B. NO. 19, RELATING TO BUSINESS.

BEFORE THE:
HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT AND BUSINESS

DATE: Wednesday, February 15, 2017 **TIME:** 9:00 a.m.

LOCATION: State Capitol, Room 309

TESTIFIER(S): Douglas S. Chin, Attorney General, or
Hugh R. Jones, Deputy Attorney General

Chair Nakashima and Members of the Committee:

The Department of the Attorney General (Department) appreciates the intent of this measure and offers the following comments on this bill.

This bill proposes to authorize the formation of a new type of business entity called a "Low-Profit Limited Liability Company" (L3C) and requires that the primary purpose of the entity be to further the accomplishment of one or more charitable or educational purposes.

1. The proposed L3C is a hybrid of a "for-profit" and a nonprofit organization, and has characteristics of each. As with a nonprofit, an L3C must be formed in furtherance of some charitable or educational purpose or mission. However, as with a for-profit entity, an L3C may have equity owners who have the right to receive distributions of profits and appreciation in the value of the business entity. Although the entity functions similarly to a traditional limited liability company (LLC), an L3C is required to carry on a business that has a charitable purpose, but is allowed to generate modest profits from its business. As currently written, the bill does not appear to clearly identify regulatory oversight or enforcement and/or safeguard mechanisms applicable to this new type of hybrid charitable entity. Such safeguards, if identified, could prevent and remedy abuses and mismanagement of charitable assets, which may potentially be diverted from public purposes to private for-profit interests.

2. The business model of an L3C permits the distribution of some portion of the entity's profits to individual investors, rather than utilizing those profits to advance the entity's charitable objectives. Traditional nonprofit entities are required to reinvest all of their net earnings to further their charitable purposes. Section 414D-19, Hawaii Revised Statutes (HRS), provides as follows:

> A corporation under this chapter shall not authorize or issue shares of stock except for limited-equity housing cooperatives. No dividend shall be paid and no part of the income or profit of a corporation shall be distributed to its members, directors, or officers. A corporation may pay compensation in a reasonable amount to its members, directors, or officers for services rendered, may confer benefits upon its members in conformity with its purposes, and upon dissolution or final liquidation may make distributions to its members as permitted by this chapter; provided that no such payment, benefit, or distribution shall be deemed to be a dividend or a distribution of income or profit.

As currently written, this bill does not appear to provide any measurable standards that may be applied to an L3C to determine how much of an L3C's profits could lawfully be distributed before those distributions might be deemed to interfere with the accomplishment of the L3C's charitable objectives.

3. The bill permits an L3C that no longer satisfies the requirements of an L3C to convert and continue to exist as an LLC by simply amending its articles of organization. Converting to an LLC may limit the entity's ability to receive future charitable funding. The bill, however, currently contains no mechanism requiring the repayment of any financial gains received as a result of improper use of charitable assets and seems to provide few deterrents to prevent private, for-profit interests from utilizing the L3C format for private gain and to the detriment of the organization's charitable purposes. Currently there are no provisions that would allow a traditional nonprofit corporation to "convert" to a for-profit entity by simply amending its articles of incorporation. Additionally, in cases where a nonprofit corporation proposes to sell, lease, exchange, or otherwise dispose of all or substantially all of its property through a transaction that is not in the regular course of the corporation's activities, the nonprofit corporation is required to provide twenty days notice to the Attorney General. See

Section 414D-222, HRS. This bill does not appear to contain any provisions to deter or protect against the misuse of charitable assets held by the L3C.

4. Similarly, the bill does not seem to provide for safeguards to preserve charitable assets in the event that an L3C is unable to carry out the charitable purpose for which it was initially formed and dissolves. Under chapter 414D, HRS, when a traditional nonprofit entity is no longer able to carry out the charitable purpose for which it was formed, the organization may voluntarily dissolve and is required to provide written notice to the Attorney General of the intent to dissolve. In cases where the assets of a traditional public benefit corporation are being misapplied or wasted or if the corporation is no longer able to carry out its charitable activities, the Attorney General may petition the court to judicially dissolve the corporation. See Section 414D-252, HRS.

5. The proposed bill does not appear to establish whether an L3C is subject to the public reporting requirements applicable to traditional charitable organizations and does not seem to provide for other mechanisms through which the public could obtain and evaluate information about how L3Cs are accomplishing the delineated charitable objectives and the extent to which the L3C's profits are being reinvested for public purposes or distributed to private individuals.

Thank you for the opportunity to provide comments.

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