



# Opportunity Zone Funds, L<sup>3</sup>Cs, PRIs, & DAFs

The keys to making sure Opportunity Zone investments help those who need them most

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## Introduction

Bringing together Opportunity Zone funds, L<sup>3</sup>Cs, PRIs and DAFs creates the *perfect storm* which will insure that the deferred capital gains will be used to maximize the benefits to society.

## Opportunity Zones

The Tax Cuts and Jobs Act of 2017 included provisions for deferring the taxes on capital gains by investing them in businesses located in areas defined as Opportunity Zones (OZ). Opportunity Zones, designated with guidance from Treasury, are distressed areas, as selected by all the states and territories, as in need of investment capital. Congress wrote the bill with the intention of incentivizing individuals to invest in markets and businesses that they might otherwise ignore because of the opportunity to defer their capital gains tax and eventually eliminate a substantial portion of that tax and up to 100% of the gains generated from the investment of the deferred dollars. As a vehicle Congress provided for the creation of OZ Funds which would grant the taxpayer immediate deferment upon investing in an OZ Fund. The OZ Fund would then invest in an acceptable vehicle in an OZ.

One concern of Congress was that the funds would be used in situations where they provided true societal benefit and not merely help the "rich get richer." Much criticism has been directed at the EB-5 program which was created with an eye on getting wealthy foreigners to invest in distressed areas in exchange for green cards. While it has partially fulfilled its goals EB-5 has also been used to develop some very high end real estate projects such as the Hudson Yards project in NYC. This project could probably have been built with other funds, although at a higher cost to the developers, and the project has had the negative effect of driving out small businesses and poorer residents of surrounding areas. So the question remains, how do we prevent similar distortions with Opportunity Zone investments.

The key is the organization of the fund. If the fund is organized in typical Wall Street fashion it will seek to maximize return as it should. It immediately becomes agnostic to the social benefits. However, if the fund is organized as an L<sup>3</sup>C or other social enterprise, it will then look for investments that maximize furtherance of charitable purpose. In the case of the L<sup>3</sup>C, it is important to remember the requirements of its charter.

## The L<sup>3</sup>C

The L<sup>3</sup>C or Low-profit Limited Liability Company was created in the mid 2000s by Robert Lang and codified in 2008 when Vermont became the first state to make the L<sup>3</sup>C part of their Limited Liability Company body of law. The term Low-profit was used since the furtherance of a charitable mission usually requires the entity to sacrifice some portion of the profit. If it could operate at normal profit margins and still further a charitable purpose it would organize as a regular LLC. The key elements of the law, which are written into the L<sup>3</sup>C section of appropriate state LLC laws are:

*"L3C" or "low-profit limited liability company" means a person organized under this*

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*chapter that is organized for a business purpose that satisfies and is at all times operated to satisfy each of the following requirements:*

*(A) The company:*

*(i) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code of 1986, 26 U.S.C. §170(c)(2)(B); and*

*(ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.*

*(B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person 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.*

*(C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Internal Revenue Code of 1986, 26 U.S.C. §170(c)(2)(D)."*

The result of forming an OZ fund manager as an L<sup>3</sup>C is a fund that seeks out OZ investments with the most social impact/economic development potential.

OZ Fund L<sup>3</sup>C created as an organization whose purpose is to further charitable purpose can then use PRIs (Program Related Investments) and DAFs (Donor Advised Funds) for its capital stack. Once so organized the OZ Fund L<sup>3</sup>C can amalgamate capital gain dollars from investors wanting to defer gains who want to see the money invested where it will do the most good and hopefully return them further substantial profit. What we are doing is taking much of the profit out of the management side of the fund without penalizing the individual investors. It becomes a win-win for all. At the end of the day the Foundations making PRIs and the public charities sponsoring DAFs will receive some income and can recover their investment when the fund is dissolved or sold.

### The PRI

The PRI is an investment that a foundation can make into a for profit vehicle with grant dollars, not endowment dollars. The Ford Foundation, an early user of PRIs defines them thusly:

*"In 1968, the Ford Foundation pioneered use of a new tool known in the philanthropic sector as program-related investments (PRIs). Ford-funded PRIs use low-cost loans, loan guarantees and equity investments in a strategic way to strengthen the work of our grantees and to provide risk-capital for cutting-edge initiatives.*

*"Financed from the foundation's endowment, PRIs support the work of organizations in the United States and around the world by helping them to establish a loan repayment history, generate earned income, gain access to new funding from mainstream banks and other funders, and to develop new financial management strategies... Program-related investments*

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*offer foundations an alternative to the traditional grant. They provide a tool that can help bring long-term financial stability to organizations that are addressing critical social needs." ( <http://www.fordfoundation.org/grants/program-related-investment> )*

Congress codified the term Program Related Investment, in tax laws written in 1969, and specifically provided for PRIs to replace a grant, as part of a private foundation's required yearly distribution. The IRS states:

*"To be program-related, the investments must significantly further the foundation's exempt activities. They must be investments that would not have been made except for their relationship to the exempt purposes. The investments include those made in functionally related activities that are carried on within a larger combination of similar activities related to the exempt purposes." ( <http://www.irs.gov/Charities-&-Non-Profits/Private-Foundations/Program-Related-Investments> )*

Further insight might be gained from these words by the MacArthur Foundation:

*"Program-related investments (PRIs) are a statutorily defined exception in the Internal Revenue Code to the rules prohibiting private foundations from making jeopardizing investments. PRIs can take many forms, including loans, equity investments, bank deposits and guarantees. PRIs must be made for the primary purpose of accomplishing a charitable purpose and not primarily for financial gain. One of the tests used is whether an investor solely interested in making a profit would be unwilling to provide capital on similar terms. In practice, this means that the PRI will have an interest rate or financial return objective that is lower than prevailing market rates for loans and investments of similar duration, credit quality and risk."*

The PRI is a form of venture capital investment, used for social impact investment and the corpus of the PRI may someday be returned to the foundation. This happens when a loan is repaid, the enterprise is sold, or something else causes return of capital.

### DAFs

DAFs are a way for an individual to create a vehicle similar to a private foundation without the administrative or reporting burdens of a foundation. The IRS has published a simple guide to DAFs. A couple of paragraphs from this guide summarize what DAFs are and how they work:

*"Donor-advised funds ('DAFs') have been part of charity for nearly a century, and have long been a staple of community foundations. Prior to the Pension Protection Act of 2006 (Pub. L. No. 109-208), the term 'donor-advised fund' was not defined in the Code or Regulations, but it was understood to include arrangements by which some charitable organizations (including community foundations) established separate funds or accounts to receive contributions from donors. Donor-advised fund arrangements were comparable to component funds maintained by certain community trusts.*

*In general, contributions to a DAF are treated as contributions to a public charity, thus providing*

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*donors some advantages over private foundations. For example, donors may claim a higher charitable contribution deduction (up to 50% of adjusted gross income (AGI) to a public charity vs. 30% to a private foundation), and donor-advised funds are not subject to the Chapter 42 restrictions that apply to private foundations, such as the section 4941 self-dealing rules and the section 4942 annual payout requirements. (Note that the Pension Protection Act expanded the taxes on excess business holdings applicable to private foundations to donor-advised funds.) Other advantages touted by promotional literature include: estate planning benefits, donor anonymity, lower start-up costs, and lower expenses in connection with legal, administrative, and accounting services to establish and maintain donor-advised fund accounts as compared to private foundations. While donor-advised funds have been in existence in some form since the 1930s, during the 1990s, for-profit financial investment firms began to establish affiliated nonprofit organizations to maintain donor-advised fund accounts. Typically, these 'commercial' DAFs hire the affiliated for-profit investment firm to manage the investment of the assets in the accounts for a fee that varies based on the balance in the account and the number of annual transactions."*

*( [http://www.irs.gov/pub/irs-tegedonor\\_advised\\_explanation\\_073108.pdf](http://www.irs.gov/pub/irs-tegedonor_advised_explanation_073108.pdf) )*

Today DAFs are available at many Community Foundations and through large commercial investment companies. As we will see, the ability of a DAF to operate much as a private foundation makes it perfect for our purposes. From the perspective of the donor the DAF has significant benefits. They can be created in the space of a day or two, without the need to determine what their eventual charitable use will be, but the donor gets an immediate tax deduction for the entire amount and at the higher public charity rate. The DAF can make an investment in a social enterprise such as an L<sup>3</sup>C the same way a foundation can make a PRI.

### **Finance is the Key**

The answer to many of our social issues is not with more nonprofits. They already try to do too much. Under their regulatory structure they cannot organize or operate the kind of robust business structure needed to solve problems or take advantage of opportunities in much of our society. Just as a venture capitalist can provide high risk capital to a for profit with high potential ROI so a PRI or similar investment by a DAF can provide "venture" capital to a social enterprise with low ROI potential. For Opportunity Zone Funds the combination of players can create an ideal situation. Foundations and many individuals who have created DAFs want to make investments with social impact. Providing the capital for an OZ fund allows them to leverage their dollars to attract billions of dollars of capital gains and see it invested in projects with high economic development potential.

For More Information Regarding the L<sup>3</sup>C :  
<http://americansforcommunitydevelopment.org/>

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...where the L<sup>3</sup>C was created