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James J. Haag, Director
200 North Capitol Avenue, Suite 300, Lansing, MI 48933
517-373-8080 • FAX 517-373-5874 • www.house.state.mi.us/hfa

RECENT LEGISLATIVE CHANGES TO MICHIGAN'S LIMITED LIABILITY COMPANY ACT

Mitchell E. Bean, Senior Economist; and Marjorie Bilyeu, J.D., LL.M.

The Limited Liability Company (LLC) is a relatively new form of business entity that is rapidly rising in popularity and replacing other forms of business organization in Michigan.

Organizing as an LLC allows Michigan-based businesses to lower their federal tax liability by taking advantage of federal pass-through provisions. As income that was formerly taxed as business income by the federal government becomes personal income, the state income tax base increases and state personal income tax revenue will increase.¹

With recently passed state legislation,² drafted in response to new federal regulations,³ there is increased opportunity for using a Michigan LLC as a choice of business entity.

Fewer restrictions applying to this relatively new form of business entity make it easier for businesses to qualify for favorable tax treatment. The resulting expansion in tax and nontax planning possibilities for Michigan businesses has further contributed to the pro-business climate of the state.

A recent study has shown that, nationally, small and mid-sized businesses employ 53% of the private work force and are responsible for

creating 75% of the new jobs that were created in 1995.⁴ The LLC structure allows small and mid-sized businesses to take advantage of federal provisions which lower their federal tax burden and thus stimulate commerce and job creation.

As a noncorporate form of business, an LLC combines the benefits of a corporation with those of a partnership. Like corporations, LLCs limit the personal liability of their owners (known as members) and managers, shielding them from the LLC's debts, liabilities and obligations. Like partnerships, LLCs allow for a single layer of taxation which, if structured correctly, can permit members to receive "pass-through" partnership tax treatment. This means that the income, losses, credits and deductions of an LLC can pass directly to a company's members for use on their own respective income tax returns.⁵

In contrast, a corporation is generally taxed separately on its federal income,⁶ while its

¹ The data required to estimate the revenue impact of pass-through on Michigan's tax base are not available at this time.

² P.A. 52 of 1997, 89th Leg., (Mich. 1997).

³ Treas. Reg. §§1.581-1, 1.581-2, 1.761-1, 301.6109-1, 301.7701-1, 301.7701-2, 301.7701-3, 301.7701-4, 301.7701-6, 301.7701-7, 602.101 (as amended by T.D. 8697, 1997-2 I.R.B. 11).

⁴ *Survey of Small and Mid-Sized Businesses: Trends for 1997*, conducted by Arthur Anderson's Enterprise Group and National Small Business United.

⁵ These businesses are still subject to the SBT.

⁶ An exception applies to an S corporation which allows pass-through tax treatment to its shareholders, but which has very strict eligibility requirements. An S corporation is still subject to certain types of corporate level taxes, including those on built-in gains and excess net passive losses.

shareholders are taxed separately on distributions from the corporation. Partnership income, taxed on just one level of federal income rather than two, is therefore generally preferred from a taxpayer's standpoint.

Because of these advantages, the LLC has become a desirable entity through which to conduct business. Use of the LLC as a type of business has steadily increased over the last five years; since 1993, when Michigan adopted its LLC statute, over 23,000 LLCs have formed in this state.⁷

Because of certain statutory limitations in Michigan's approach to LLCs, many businesses formed in the last few years have either chosen alternative forms of business, or have been doing business here as foreign entities after organizing as LLCs in states such as Delaware (a state which has flexible LLC organizational requirements). With the recently-passed legislation, these statutory limitations have disappeared, and Michigan is now likely to see exponential growth in the number of LLCs formed in the state.

As the role of LLCs increases in Michigan, it becomes important to understand this type of business entity and how the recent amendments affect business entity classification in this state.

On January 1, 1997, the Internal Revenue Service (IRS) issued its final "check the box" regulations.

Among other things, these regulations simplify entity classification rules and make it easier for an LLC to receive partnership tax treatment. Unless a taxpayer affirmatively elects to be taxed as a corporation, pass-through partnership tax treatment at the federal level will now be automatic for all LLCs.

This is a significant departure from the IRS' prior position, which gave partnership tax treatment to an LLC only when it possessed no more than two of the four traditional corporate characteristics: limited liability, centralized

management, continuity of life, and free transferability of assets.⁸

In the past, when an LLC was found to have more than two of these characteristics, it was classified as a corporation and taxed accordingly.

Because of these new IRS regulations, an LLC can now take on an unlimited number of corporate characteristics without risking loss of pass-through partnership tax treatment on the federal level. This provides more business planning options, and allows the flexibility to structure a business entity according to the needs of a particular company.

Before the recent amendments to the Michigan Limited Liability Act⁹ (the Act), a Michigan LLC was not able to take full advantage of the flexibility of the new IRS classification rules.

This was because under Michigan law, it was impossible for an LLC to possess more than two corporate characteristics. Changes to the Act were therefore necessary so that Michigan LLCs could benefit from the new federal regulations. On July 1, 1997, such legislation went into effect making appropriate changes to the LLC classification requirements, adding enabling provisions for cross-entity mergers, and clarifying certain points.

Corporate Characteristics:

The most significant change to the Act involves the effect on an LLC possessing more than two corporate characteristics. Prior to the amendments, a Michigan LLC could obtain favorable partnership tax treatment only when an LLC had no more than two of the four traditional corporate characteristics.

⁸ "Limited liability" assures that in general, an entity's owners are not personally responsible for the entity's debts, liabilities or obligations. This characteristic is inherent in all LLCs. An entity has "centralized management" where it delegates management authority and power to a person or group of persons. "Continuity of life" is a concept that implies the entity is intended to endure forever, notwithstanding what may happen to the owners of the entity. "Free transferability of interests" means that owners are free to assign their respective interests in the entity to another owner.

⁹ MCL 450.4101, *et seq.*

⁷ Source: Corporation and Securities Bureau of the Michigan Department of Commerce.

Under the new amendments, a Michigan LLC can now take on an unlimited number of corporate characteristics and still receive pass-through partnership tax treatment. This will allow greater flexibility in business planning, permitting an organizer to choose as many corporate characteristics as are desired.

One-Member Organizations:

No longer will a Michigan LLC be required to have at least two members. §102(i) allows one individual to conduct business as an LLC and obtain the limited liability protection not available for sole proprietorships.

Duration:

Prior to the amendments, an LLC adopting the corporate characteristic of perpetuity risked being considered a corporation for tax purposes. (Whereas a corporation is perpetual for tax purposes, an LLC is traditionally considered to be an entity of limited duration.) §202(2) eliminates this concern by making "perpetual" the maximum duration of an LLC.

Conflict:

§214 specifies that the articles of organization (original documents filed with the state officially organizing an LLC) will control where there is a conflict with the operating agreement (a written agreement among the members of the LLC relating to conduct of the business).

Managers:

§402-405 add certain technical provisions relating to managers. For example, §402(2) specifies that an operating agreement can require that a manager also be a member. §402(4) specifically gives notice to third parties that managers, where their powers are designated by the articles of organization, have agency power and can bind the LLC. This codifies the common law rule and provides public protection for those entering into contracts with LLCs.

Distributions/Contributions:

§303 directs how an LLC's cash and assets are distributed in the absence of an operating agreement. LLCs formed after July 1, 1997 will distribute cash and assets in equal shares to all members, unless an operating agreement specifies otherwise. LLCs formed prior to July

1, 1997, in the absence of an operating agreement provision stating otherwise, will continue to distribute cash and assets according to each member's equity interest in the LLC.

In addition, pursuant to §501, a member no longer has to make a contribution to be admitted to an LLC, but, in the case of a newly formed LLC, can simply sign the initial operating agreement or articles of organization. In the case of an existing LLC, a member can be admitted by unanimous vote of the other members, or by any other means specified in an operating agreement.

Voting Rights:

Pursuant to §502, in the absence of an operating agreement otherwise establishing member voting rights, members of LLCs each receive one vote. Members of LLCs in existence prior to July 1, 1997 will continue to vote in proportion to their respective shares in the company (in the absence of an applicable operating agreement provision) — although this can be changed by an amendment to an operating agreement.

Member Withdrawal/Expulsion:

The amendments restrict the ability of a member to withdraw from an LLC. The prior statute allowed a member to withdraw either pursuant to an operating agreement, or by giving 90 days written notice to the LLC and its members. Because of concern that the unrestricted right of a member to withdraw might cause harm and instability to an LLC, the 90-day written notice provision was removed; §509(1) now provides that a member may withdraw from an LLC *only* as stated in an operating agreement.

In addition, a provision was added (§509(2)) giving an LLC the right to include reasons for the expulsion of a member in its operating agreement. Before this addition, expulsion of a member led to automatic dissolution of the LLC, unless one of two things occurred: (1) within 90 days after the expulsion, the majority of remaining members voted on the LLC's continuing existence, or (2) an LLC chose the corporate characteristic of continuity of life, with a specific provision in its operating agreement stating that the expulsion or other

occurrence would not result in automatic dissolution.

Court Actions:

§515 changes procedures and broadens the rights of members to bring court action against LLCs and its managers or other members. While the prior Act allowed a member to bring an action on behalf of the LLC where certain requirements were met, the amendments give broader remedies and allow members to personally sue an LLC and its members and managers for acts that are “illegal, fraudulent or willfully unfair and oppressive.” Patterned after a similar provision of the Michigan Business Corporation Act¹⁰ dealing with wrongful distributions, this section is designed to protect members with minority interests from the oppressive acts of majority members. This is an especially important safeguard in light of the new restrictions placed on a member’s ability to withdraw from an LLC.

Mergers:

§701-705A add many new technical provisions relating to mergers between an LLC and other business entities. In general, these merger provisions specify how cross-entity mergers are to be accomplished and what requirements must be met. Until amendments are adopted which add identical provisions to Michigan’s Business Corporation Act and Uniform Partnership Act,¹¹ these merger provisions will be of limited effectiveness.

Conversion:

It is now simpler to convert from a partnership to an LLC. §707 sets forth the requirements and procedures for converting to an LLC from an existing domestic partnership. In general, conversion from a partnership to an LLC can be accomplished tax-free and automatically (after partnership agreement) by filing a certificate of conversion with the state. After the conversion,

¹⁰ MCL 450.1551, MSA 21.200 (551).

¹¹ SB 414, 88th Leg., (Mich 1996) would amend the Business Corporation Act to provide for, among other things, mergers with cross-entities. The bill has passed the Michigan Senate, but is still pending in the Michigan House of Representatives. A bill in the House of Representatives, HB 6182, 88th Leg., (Mich. 1996), which would have amended the Uniform Partnership Act, died in Committee.

all assets, liabilities and rights of the partnership become that of the LLC.

Dissolution:

The prior version of the Act specified that an LLC automatically dissolved upon the occurrence of a certain event. For example, the death, withdrawal, expulsion, bankruptcy, or dissolution of a member resulted in automatic dissolution of the LLC, unless the majority of members voted to continue the LLC within 90 days of the happening of the event, or unless the operating agreement chose the corporate characteristic of continuity of life.

Amendments to §801 now specify that an LLC will dissolve only in one of four situations:

- 1) when and where the members have so specified in their articles of organization;
- 2) upon the happening of an event specified in the article of organization or operating agreement along with a vote of the members;
- 3) upon the unanimous vote of all members entitled to vote; or
- 4) upon the entry of a decree of judicial dissolution.

Conclusion

Because of recent changes to Michigan’s Limited Liability Company Act, it is now easier for a business entity to qualify as an LLC in Michigan, and it will no longer be necessary to go out of state to find more flexible LLC requirements. Clarifications and changes to many of the old provisions make the statute easier to apply; additional provisions will facilitate the merger of cross-entities such as partnerships and corporations.

Since the LLC structure allows pass-through, income that was formerly taxed as business income by the federal government will become personal income; the state income tax base will then increase and state personal income tax revenue will increase.

The State’s current law governing LLCs helps ensure that in the future, the LLC will be the business entity of choice in Michigan.