House Legislative Analysis Section
Olds Plaza Building, 10th Floor
Lansing, Michigan 48909
Phone: 517/373-6466

LIMITED LIABILITY COMPANIES: REFLECT IRS TAX DECISIONS

House Bill 4606 (Substitute H-1)
First Analysis (5-13-97)

Sponsor: Rep. Kirk Profit
Committee: Commerce

THE APPARENT PROBLEM:

In 1977, Wyoming became the first state to authorize a new kind of business entity, the limited liability company (LLC), followed by Florida in 1982. The LLC often is characterized as being a cross between a corporation and a partnership because it combines the corporate advantage of limited liability with the "pass through" tax advantages of a partnership. But it was not until after a 1988 ruling by the Internal Revenue Service (IRS) that there began to be significant interest in this new kind of business entity. In 1988 the Internal Revenue Service issued a ruling (Rev. Rul. 88-76, 1988-2 C.B. 360) holding that a Wyoming limited liability company, none of whose members was liable for debts of the company, was taxable as a partnership rather than as a corporation for federal income tax purposes, (Subsequently, the IRS issued a "private letter ruling" reaching the same conclusion with respect to Florida LLCs.) Once it had been established that at least one form of LLC could be eligible for the tax advantages of a partnership as opposed to a corporation, a number of states, Michigan included, began drafting and enacting legislation authorizing LLCs.

As with partnerships, any income to the LLC "passes through" the company untaxed to the individual owners (called "members"), which is why LLCs are sometimes referred to as "pass through" business entities. This kind of tax treatment is in contrast with what is sometimes referred to as the "double" taxation imposed on corporations, because income earned by a regular corporation is taxed once to the corporation and a second time when distributed to the corporation's shareholders. Although there a special kind of corporation, known as an "S corporation," that also qualifies for a form of pass through tax treatment, these kinds of corporations a subject to numerous technical restrictions that make inadvertent disqualification a significant risk. For example, S corporations are restricted as to the number (35) and type of eligible owners (no corporations, partnerships, nonresident aliens, or trusts, other than a special type), and may have only a single class of stock.

The other advantage of an LLC, at least in contrast to a partnership, is that no member of the company is personally liable for the debts or other obligations of the LLC. Limited partnerships have been used to limit liability while avoiding the restrictions applicable to S corporations, but still must have at least one member -- the general partner -- who is personally liable for the obligations of the business. In addition, the partners in a limited partnership may lose their limited liability if they take part in the management of the partnership business.

Reportedly, Michigan's 1993 Limited Liability Company Act was drafted to closely match the 1988 Internal Revenue Service Wyoming ruling, which required that LLCs have at least two members and that Wyoming's LLCs were eligible for partnership tax treatment because they lacked at least two of the four characteristics that distinguish corporations from partnerships, namely, limited liability; centralized management; continuity of life; and free transferability of interests. Since limited liability already was part of an LLC, this in effect meant that to qualify for taxation as a partnership for federal income tax purposes, LLCs could have, in addition, only one more of the three remaining corporate characteristics if they were to keep the more favorable partnership tax status instead of the less favorable corporate tax status.

According to a 1989 article in the Michigan Tax Lawyer, federal Treasury rules at the time provided that an entity, regardless of its treatment as a partnership under state law, would be taxed as a corporation if it had a preponderance of the four characteristics that are deemed to distinguish a corporation from a partnership. (Richard Soble, "Choice of Entity: Limited Liability Companies.") An organization is considered to lack "continuity of life" if, under local law, any member has the power to dissolve the organization. Thus, for example, a limited partnership formed under a statute corresponding to the Uniform Limited Partnership Act (ULPA) -- such as Michigan's Revised Uniform Limited Partnership Act -- lacks the corporate characteristic of continuity of life because, under ULPA, the death,

retirement, resignation, expulsion, or bankruptcy of a general partner dissolves the limited partnership. "Free transferability of interest" does not exist unless a member of the organization has the power, without the consent of any other members, to substitute another person who is not a member in his or her place. Generally, "free transferability of interests" is absent in the case of limited partnerships because the limited partners cannot transfer their interests (and cause the transferee(s) to be admitted to the partnership) without the consent of the general partner. Finally, the Treasury Regulations provided that an organization formed as a limited partnership under state law possessed the corporate characteristic of "centralization of management" if "substantially all of the interests in the partnership [were] owned by the limited partners." The purpose is to secure for limited partners the tax advantages of owning as much of their interests in the partnership as possible directly as limited partners rather than indirectly as shareholders of the corporate general partner.

Thus, the Michigan Limited Liability Company Act requires that a Michigan LLC have at least two members who are protected against personal liability for the debts of the company, and no more than one of the remaining three characteristics of a corporation (namely, centralized management, continuity of life, and free transferability of interests).

However, reportedly as of January 1997, new IRS tax regulations took effect that would allow LLCs to choose their preferred tax classification, and lifted the restraints on the kinds of corporate characteristics that an LLC can have without affecting their preferred tax status. Because Michigan law still has these constraints on LLCs, reportedly Michigan companies wishing to form LLCs are organizing under the laws of Delaware, which has more flexible requirements. Legislation has been proposed that would add greater flexibility to Michigan's law governing LLCs.

THE CONTENT OF THE BILL:

The bill would amend the Michigan Limited Liability Company Act to eliminate the requirements that an LLC be organized and operated by two or more members, and that an LLC choose among the three corporate characteristics -- centralized membership, continuity of life, and free transferability of interests -- other than limited liability. Under the bill, an individual could form and operate a limited liability company. And instead of being limited to choosing one of the three corporate characteristics, a limited liability company could adopt any or all of those features, including centralized membership, continuity of life, and free transferability of interests.

In addition, the bill would make numerous changes in the act, many of which are clarifying or technical in nature. Among them are the following:

Duration. The bill would make the maximum duration of a limited liability company perpetual unless otherwise provided in the articles of incorporation.

Mergers. The bill would add new language regarding mergers between domestic limited liability companies and other business entities (domestic or foreign corporations, limited partnerships, general partnerships, or other businesses). It would allow mergers between these types of businesses so long as the merger was permitted under the law of the jurisdiction in which each business was located, each foreign constituent business organization complied with applicable Michigan laws, and each domestic limited liability company complied with the provisions of the bill. The provisions would require the adoption of a plan of merger describing the merging businesses, the surviving business entity, and the terms and conditions of the proposed merger. The bill requires that such a plan be approved by each constituent domestic limited liability company affected, and allows dissenting members to withdraw. The bill also provides for the continued use of an assumed name by a company resulting from such a merger.

Conflicts. The bill would make the articles of organization controlling if there was a conflict between the articles and an operating agreement.

Conversions. The bill would allow a domestic partnership or domestic limited liability partnership to convert to a limited liability company. Terms and conditions of such a conversion would have to be approved by the partners in the same manner as amendments to the partnership agreement, and a $25 fee would have to be paid to the administrator (the Department of Consumer and Industry Services) to obtain a required certificate of conversion.

Distributions, voting. Under the act, voting on business matters and distributions of a company's assets are based upon the proportionate amount of contributions (cash, property, services, etc.) made by each member to the company. Under the bill, each member of a limited liability company would have one vote, and distributions would be made in equal shares (although a company in existence on the effective date of the bill could choose to continue to distribute assets proportionately).

Withdrawals. The bill would allow limited liability companies to provide in their articles of incorporation or operating agreements for additional distributions to members who withdraw from a company.

Management. The bill would provide additional detail regarding the delegation of management of a limited liability company to managers, including provisions regarding voting by managers, conflicts of interest, and illegal or fraudulent acts by managers.

Cause of action. The bill would allow a member of a limited liability company to bring an action in circuit court to establish that acts of a manager or member in control of the company were illegal, fraudulent, or willfully unfair and oppressive.

MCL 450.4102 et al.

FISCAL IMPLICATIONS:

According to the House Fiscal Agency, the bill will have no fiscal implications for the state. (5-12-97)

ARGUMENTS:

For:

The bill would reflect the new changes in IRS regulations regarding limited liability companies (LLCs), making Michigan's law one of the most flexible among the states. Currently, reportedly those in Michigan wishing to form an LLC are going out of state to organize, to one of the few states (such as Delaware) that currently have the flexibility in their laws to take advantage of the new IRS regulations. The bill would allow those wishing to form an LLC in Michigan to take the maximum opportunity allowed under IRS regulations. Michigan would be on the cutting edge of allowing this new flexibility, and would no longer lose filing fees (and business activity) to other, more flexible states such as Delaware.

POSITIONS:

The Business Law Section of State Bar of Michigan supports the bill. (5-12-97)

The National Federation of Independent Businesses supports the bill. (5-12-97)

Analyst: S. Ekstrom

■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.