



SMALL BUSINESS & NONPROFIT CLINIC

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Michigan Nonprofit Limited Liability Companies

The Limited Liability Company (hereinafter “LLC”) is the business entity often chosen in lieu of other business entities because of its managerial flexibility through its operating agreement; its avoidance of corporate formalities; its ease of transferability; its less costly management structure; and its partnership tax incentives. The concept of an LLC is relatively new, and having become the predominant business entity of choice, especially for small-business owners, only within the past decade or so. Traditionally, business owners who desire to start a business in the nonprofit sector have only had the option of creating a corporation as their business entity. In Michigan, the formation requirements for nonprofit corporations are outlined under the Michigan Nonprofit Corporation Act (hereinafter “Nonprofit Act”) and the Business Corporation Act of 1982 (hereinafter “Corp. Act”). A fast developing issue, however, is whether business owners in Michigan can presently choose to take advantage of the LLC business entity as opposed to the corporation when forming a nonprofit organization.

In Michigan, the predominant statutory code that governs LLC formation is the

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Michigan Limited Liability Company Act of 1993 (hereinafter “Michigan Act”). Unlike other states, such as Minnesota, which has a statutory section of its Limited Liability Company Act pertaining to nonprofit LLCs, or Tennessee, which has an entire Nonprofit Limited Liability Company Act, the Michigan Act remains silent on specific information pertaining to the nonprofit side of LLCs. Under its purpose section, the Michigan Act dictates that an LLC “may be formed under this act for any lawful purpose.”

Furthermore, the IRS, under its application 501(c)(3), Form 1023, for tax-exempt status, permits the applicant under Part II ‘Organizational Structure,’ question 2, to select a Limited Liability Company as its business entity applying for tax-exempt status. It may be assumed, therefore, based upon the Michigan Act’s purpose clause and the IRS’s organizational structure selection clause that a nonprofit LLC may be legally formed in the state of Michigan. This is further evidenced by the absence of any contradictory Michigan and federal law against the formation of a nonprofit LLC.

Assuming that a business owner is now able to create a nonprofit LLC in Michigan, the first step is to determine what are the advantages and disadvantages of such a formation as opposed to a nonprofit corporation. The second step is then to determine why few, if any, nonprofit LLCs exist in Michigan. As outlined in the introductory paragraph, the same advantages which apply to for-profit LLCs also apply to nonprofit LLCs. The only exception exists under the partnership tax incentive in the circumstance in which the nonprofit organization has received federal tax exemption.

Most of the disadvantages of Michigan nonprofit LLC arise because of statutory silence. Nonprofit, tax-exempt organizations must have: specific information in their articles of formation limiting factors including a limited purpose to nonprofit activities; a

dissolution clause; no distribution of profits to members/shareholders; financially disinterested board members; and termination, redemption, and reporting requirements. Since the Michigan Act is structured for-profit, it may need some bridge or amendment to dictate that a nonprofit LLC must follow the same or similar requirements of a nonprofit corporation. Otherwise, exclusive of the requirements for 501(c)(3) federal tax-exempt status, loopholes that could later lead to both timely and costly litigation may exist in the areas cited above.

The most significant issue and disadvantage that erupts under the tax aspect of a nonprofit LLC, as briefly noted by Taleen Alexander in her article entitled '*Charity-Owned Limited Liability Companies*,' is what happens when an individual taxpayer makes a donation to a nonprofit, tax-exempt LLC: does the taxpayer receive a tax deduction as he would for a tax-exempt nonprofit corporation for his charitable donation or doesn't he? Unfortunately, the IRS has remained silent on this issue, leaving the tax-exempt LLC at a disadvantage for fundraising and soliciting contributions.

Lastly, it appears that the lack of nonprofit LLCs in Michigan is due to the fact that there is no significant Michigan statutory code or case law pertaining to nonprofit LLCs. With nonprofit corporations, the nonprofit organization has a stronger likelihood to stay tax-exempt when it is granted 501(c)(3) status because of precedent set in case law pertaining to nonprofit corporations, requirements outlined and curtailed toward nonprofit corporations by the IRS, and statutory code under the Nonprofit Act and Corp. Act.

In conclusion, until additional statutory laws are passed, it is still preferable that the business owner and the attorney, if one is used to form the business entity and/or

apply for federal tax-exempt status, to continue to create nonprofit corporations in lieu of nonprofit LLCs for organizations wishing to obtain federal tax-exempt status. Despite the structural benefits, especially for a single-member business entity, the risk of costly and timely litigation, as well as the risk in not obtaining or losing federal tax-exempt status, is just simply not worth the resources at this point in time for a tax-exempt organization.