

**LIMITED LIABILITY COMPANIES**

**RICHARD M. BASKETT, J.D., C.P.A.**  
Datsopoulos, MacDonald & Lind, P.C.  
201 West Main  
Missoula, Montana 59802  
Ph. (406) 728-0810



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## LIMITED LIABILITY COMPANIES

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### I. OVERVIEW

- A. A Limited Liability Company (LLC) is a hybrid business entity. It offers the limited liability protection of a corporation to all members with possible income tax advantages of a partnership.
1. Authorized in at least 34 States including:
    - a. Alabama; Arizona; Arkansas; Colorado; Connecticut; Delaware; Florida; Georgia; Idaho; Illinois; Indiana; Iowa; Kansas; Louisiana; Maryland; Michigan; Minnesota; Missouri; Nebraska; Nevada; New Hampshire; New Mexico; North Dakota; Oklahoma; Oregon; Rhode Island; South Dakota; Texas; Utah; Virginia; West Virginia; and Wyoming.
    - b. Montana
  2. Members are personally liable for the obligations and liabilities of LLC to the extent of member's actual and outstanding capital contribution to the LLC.
  3. Income is taxed to members.
  4. In general, think of an LLC whenever the business owners desire limited liability, pass-through taxation, and management control.
  5. Particularly useful for businesses such as:
    - a. real estate development;
    - b. family owned businesses;
    - c. start-up and entrepreneurial businesses;
    - d. joint ventures; and
    - e. extraction industries.
- B. Focus on Montana
1. There is no standardization of LLC statutes, being of relatively recent origin. The LLC is a creature of statute, and therefore will change from state to state. We will focus on the Montana LLC statute, and many of its provisions are found in other state statutes, but be aware that differences do exist, and if it is important to your situation, do not fail to check the specific requirements of the applicable state statute.
  2. The Montana statute is one of the most flexible and extensive in the country. The good part of this is that it permits the sophisticated advisor to help create a tailored LLC that may be taxed as a partnership or as a corporation. The bad part of this is that the unwary may find consequences they did not intend.

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## II. ACCOUNTING ISSUES

- A. This is a relatively undeveloped area for accounting because LLC's are so new. The threshold issue would appear to be whether the LLC is a corporation or a partnership, since different accounting and reporting requirements may then apply.
- B. At the present, neither FASB nor the AICPA has any projects addressing LLC's.<sup>1</sup>
- C. While today's discussion is not intended to focus on tax issues, there are tax issues that will have an accounting impact. For example, if an LLC is not a pass-through entity, there might be the need for an accrual for income tax liability or benefit.
- D. The LLC by nature is closely held, and therefore the reporting requirements that apply to publicly traded corporations generally should not apply to a LLC.

## III. HISTORY OF LLC'S

- A. The first forerunner of the LLC in the United States is the partnership association or limited partnership association created in Pennsylvania, Michigan, New Jersey and Ohio between 1874 and 1881.<sup>2</sup> These were organizations in which the owners were not personally liable for the obligations of the organization.
- B. Statutory Close Corporations are quite similar to LLC's.
  - 1. The owners are not personally liable for the corporate obligations.
  - 2. An owner's interest may not be transferred without the consent of the other owners.
  - 3. One or more owners may dissolve the corporation (if provided in the articles of incorporation).
  - 4. A LLC may be operated without a board of directors.<sup>3</sup>
- C. A statutory close corporation might be organized such that it ought to qualify as a partnership. In fact, the Montana Close Corporation Act expressly contemplates this possibility. The Act provides broad latitude with regard to any shareholder agreement, even though "its effect is to treat the corporation as a partnership . . ."<sup>4</sup>
- D. But the IRS does not treat Statutory Close Corporations as partnerships.
  - 1. The IRS has taken the position that an entity that is "incorporated" cannot be a partnership within the meaning of the Internal Revenue Code. See PLR 79-21-084 (Feb. 27, 1979).<sup>5</sup>
- E. Query: What accounting effect would there be if a statutory close corporation were organized in such a manner that it would be recognized as a partnership for state law purposes, but would have to be treated as a corporation for federal income tax purposes?
- F. Wyoming passed the first LLC statute, as special interest legislation for an oil company.<sup>6</sup> This legislation was passed in 1977, after the IRS had classified some limited partnership associations as partnerships, but before it had ruled that no close corporation could be treated as a partnership.<sup>7</sup> A LLC formed under the Wyoming statute was granted a private letter ruling permitting partnership treatment for tax purposes.<sup>8</sup>
- G. Florida adopted the second LLC statute in 1982.
- H. No other state enacted a LLC statute until 1990.
- I. The IRS at one time issued proposed regulations that would have disallowed partnership tax status if no member had personal liability.<sup>9</sup>

These proposed regulations were subsequently withdrawn.

- J. Six years later, the IRS announced that limited liability alone was not a basis for denying partnership tax status.<sup>10</sup>
- K. In Rev. Rul. 88-76, 1988-2 C.B. 360, the Service ruled that a Wyoming LLC qualified as a partnership for tax purposes.
- L. Beginning with Colorado and Kansas in 1990, the floodgates have been opened for states enacting LLC legislation.
  - 1. In 1993 alone, the Service ruled that a LLC qualified as a partnership for tax purposes in the following:
    - a. Rev. Rul. 93-5, I.R.B. 1993-3 (Virginia);
    - b. Rev. Rul. 93-6, I.R.B. 1993-3 (Colorado);
    - c. Rev. Rul. 93-30, I.R.B. 1993-16, 4 (Nevada);
    - d. Rev. Rul. 93-50, I.R.B. 1993-25, 13 (West Virginia);
    - e. Rev. Rul. 93-53, I.R.B. 1993-26, 7 (Florida).
  - 2. More importantly, the Service has now twice ruled that a LLC qualified as a partnership or as an association taxable as a corporation, for tax purposes, depending on the provisions adopted in the LLC's articles of organization or operating agreement, because of the flexibility provided by the state statute.
    - a. Rev. Rul. 93-38, I.R.B. 1993-21, 4 (Delaware); and
    - b. Rev. Rul. 93-49, I.R.B. 1993-25, 11 (Illinois).
  - 3. As a result of these series of Revenue Rulings, there should be little doubt as to the tax treatment of LLC's.
- M. In the Fall of 1991, the Limited Liability Subcommittee<sup>11</sup> of the State Bar of Montana's Tax, Probate and Business Section, was formed, which will from time to time be referred to herein as the "Subcommittee." The Subcommittee was responsible for drafting and finding a sponsor in the Legislature for the Montana LLC Act.
- N. The Montana LLC Act was ultimately based on the July 1992 Draft of the ABA Prototype Limited Liability Company Act, with some revisions.
- O. The 1993 Legislature adopted the Montana Limited Liability Company Act,<sup>12</sup> effective October 1, 1993. The Montana statute has the flexibility found in the Delaware and Illinois statutes, and therefore Montana LLC's ought to have the same degree of flexibility in being treated either as partnerships or as corporations, as fits the particular need.
  - 1. And what may be appropriate today may not be appropriate sometime in the future. Consider, for example, the rush to S Corporations since the 1986 tax act. With an LLC, changing from partnership to corporate tax treatment may involve no more than an amendment to the articles of organization or operating agreement (more on these later).
  - 2. Query: What tax consequences would flow from such a change in tax treatment? Deemed liquidation (if prior status was corporate) or deemed termination and reincorporation (if prior status was partnership)?

#### **IV. AN OVERVIEW OF LLC'S COMPARED TO OTHER BUSINESS FORMS**

- A. Isn't this really a limited partnership, with all limited partners?
  - 1. There are similarities, but also important differences.

2. First, there is a basic difference in the extent of participation. A limited partner is prohibited from participating in the control of the limited partnership (other than by exercising rights and powers as a limited partner).<sup>13</sup> A member of a LLC is not prohibited from participating in the management of the LLC.
  - a. Breaking this rule can be particularly costly for the limited partner. The cost of crossing over the line into active participation in the partnership is to be treated as a general partner. The danger is not knowing until later that there has been an impermissible "crossing." Often, the time this comes to light is upon the filing of a lawsuit, after it is too late to change what has occurred.
  - b. Some protection is provided to the limited partner by the Montana Uniform Limited Partnership Act. If the limited partner's participation in the control of the business is not substantially the same as the exercise of the powers of a general partner, he is liable only to persons who transact business with the limited partnership with actual knowledge of his participation in control.<sup>14</sup>
  - c. The member of a LLC is not subject to this trap. Participation in the management of the LLC is permitted, so there will be no inadvertent loss of limited liability.
3. Second, there is a difference as to liability exposure.
  - a. In a limited partnership, there has to be at least one general partner, who has unlimited liability.
  - b. In closely-held businesses, this may prevent the use of a limited partnership, since one partner may not be willing to shoulder the liability for everyone else.

B. Isn't a LLC basically an S Corporation?

1. There are basic differences in the organization.
  - a. No Board of Directors.
  - b. No President or other officers.
    - (1) Although, the LLC in Montana may be governed by managers, which would be similar to having officers.
  - c. No statutory restrictions on the issuance of stock.
2. There are basic differences in income tax requirements.
  - a. No requirement that there be only one class of stock.
  - b. No restriction as to the number of shareholders (S Corporations can have no more than 35).
  - c. No restriction as to the identity of shareholders (for example, a trust in general cannot be a shareholder of an S Corporation).

**V. FORMATION AND OWNERSHIP**

- A. LLC's are formed by filing "Articles of Organization", similar to Corporate Articles of Incorporation.
1. Filed with the Secretary of State.
  2. Notice Document only.

But, lets others know who has authorization to deal on behalf of the LLC.

3. Must specify the latest date on which the LLC is to dissolve.<sup>15</sup>

This is critical to the continuity of life factor discussed later (see XII beginning at page 14).

4. Specify whether the LLC is to be managed by a manager or by its members.<sup>16</sup>
  - a. This is important in determining whether the LLC has centralized management (see XIII beginning at page 15).
  - b. LLC's are owned by "members" instead of partners or shareholders.
  - c. Members hold ownership "interests" in the LLC.
  - d. A LLC may be managed by either its members or managers.
  - e. LLC's may be managed by managers, who may or may not be members.
  - f. Or LLC's may be managed by the members.
5. Filing fee required.

#### B. Number of Members

1. A LLC must have at least two members in order to be treated as a partnership for tax purposes.<sup>17</sup>
  - a. The formation of a LLC requires two members, if partnership tax treatment is intended.
  - b. The LLC must continue to have at least two members in order to avoid termination for tax purposes.
2. The definition of a partnership found in the Internal Revenue Code includes a "syndicate, group, pool, joint venture, or other unincorporated organization" that carries on any business.<sup>18</sup>
3. The Regulations define a partnership as a form of organization that contemplates two or more partners joining together as co-proprietors to engage in business and share profits.<sup>19</sup>
4. Under the Code and Regulations, a partnership will terminate for tax purposes if no part of its business continues to be carried on by its partners.
5. For a LLC to have tax treatment as a partnership, the same requirements would presumably apply.
6. The Montana statute does not require two members.<sup>20</sup> If partnership status is desired, therefore, the organization documents must provide that two members will be required at all times.
  - a. Whether to permit one-owner LLC's was an item of debate by members of the Subcommittee. The one-owner advocates prevailed.
  - b. The advantage is that this permits a one-owner business to obtain the benefits of limited liability.
  - c. The disadvantage is that the unwary may not realize this will not qualify for partnership tax treatment.
  - d. If partnership tax treatment is desired, the articles of organization may provide that at least two members are required at all times. The Montana statute is quite



flexible, and it states that the articles of organization may contain any provision not inconsistent with law that the members elect to set out.<sup>21</sup>

C. Professional LLC's are allowed.

## VI. OPERATION

A. LLC's are governed by an "Operating Agreement".

1. Operating Agreement is a hybrid of partnership agreements and corporate by-laws containing provisions on:

- a. who votes;
- b. who controls day to day operations;
- c. economic divisions; and
- d. transferability of interests.

2. Operating Agreement need not be filed with the Secretary of State.

In fact, there is no requirement that the operating agreement be in writing.<sup>22</sup>

3. LLC may be either member-managed or manager-managed.

a. A member-managed LLC is similar to a general partnership. Each member has a voice in the operation of the LLC.

b. A manager-managed LLC is similar to a limited partnership or corporation. The business of the LLC is run by the manager, not by each member.

(1) A manager is not required to be a member of the LLC.

(2) Statutory requirements of notice to third parties if manager-managed.

4. The Montana statute defaults to member management, but this may be changed by the articles of organization.<sup>23</sup>

B. Voting Rights

1. Voting is "one member, one vote" rather than in proportion to contributions to capital of the LLC.<sup>24</sup>

2. This can be changed by the articles of organization or the operating agreement, but this is the default.<sup>25</sup>

C. Allocation of Profits and Losses

1. Profits and losses are allocated equally.<sup>26</sup>

2. This too may be altered by the articles of organization or the operating agreement.<sup>27</sup>

D. Fiduciary Duty of Members

1. The LLC statute has multiple tiers of responsibility of members and managers.

a. A member is not liable to the LLC or to the other members for any action taken or for failure to act on behalf of the LLC unless the act or omission is gross negligence or willful misconduct.<sup>28</sup>

(1) The same standard applies to managers.<sup>29</sup>

- (2) This can be changed by the articles of organization or an operating agreement.<sup>30</sup>
- b. Any profit or benefit derived by a member or manager without the consent of a majority of the disinterested members or managers or other persons participating in the management of the LLC must be accounted for and held in trust for the LLC.<sup>31</sup>
  - (1) This applies to any transaction connected with the conduct or winding up of the LLC.
  - (2) It also applies to any use by the member or manager of the LLC property, including but not limited to confidential or proprietary information of the LLC or other matters entrusted to the member or manager.
- c. In manager-managed LLC's, a member who is not also a manager has no duty to the LLC or to the other members solely by reason of acting in the capacity as a member.<sup>32</sup>

#### E. Transfer of Interests

- 1. A transferee of an interest obtains full management rights only if the non-transferring members consent to the transfer.<sup>33</sup>
  - a. Note, the transferee would still be entitled, to the extent assigned, to receive the distributions to which the assignor would be entitled.<sup>34</sup>
  - b. Until the assignee becomes a member, the assignor continues to be a member and to have the power to exercise rights of a member.<sup>35</sup>
    - (1) The other members, however, may have the right to remove the assignor if the assignment has been prohibited by the articles of organization or the operating agreement.<sup>36</sup>
- 2. This results in the LLC failing to have free transferability of interests, a corporate "marker" under the regulations.

#### F. Dissolution and Continuation

- 1. A LLC will continue following a member's dissociation only if the remaining members unanimously consent to the LLC's continuation within 90 days.<sup>37</sup>
- 2. Contrast this to limited partnerships, which are permitted to have a written agreement allowing continuation of the partnership as long as there is at least one remaining general partner.<sup>38</sup>
- 3. This results in the LLC failing to have continuity of life, a corporate marker under the regulations.

### VII. LLC'S AND PARTNERSHIPS

#### A. State Law

- 1. State law does not determine whether organization is taxed as partnership. [Reg. §301.7701-1(c)]. In fact, tax law definition of partnership is broader than common law meaning.
- 2. State law does govern in determining whether the legal relationships are such that the tests are met for classifying the organization as a partnership for tax purposes. [Reg. §301.7701-1(c)].
- 3. General Partnerships:

- a. Uniform Partnership Act defines a general partnership as "an association of two or more persons to carry on as co-owners a business for profit." [UPA §6(1)].
- b. Organization: Does not require any formalities (such as a partnership agreement). Partners may not even know they are partners.

Danger: Partnerships are required to make tax elections at the partnership level. [§703(b)]. The time for the partnership to make tax elections may have passed by the time the partners discover that they are, indeed, partners. In the meantime, the partners may have been making inconsistent tax elections on their individual returns.

- c. Management: Each partner has an equal right to participate in management. [UPA §18(e)].
- d. Liability: Each partner is liable for the torts of the other partners acting in the ordinary course of business. [UPA §§13, 14].
- e. Each partner is an agent for the other. [UPA §9(1)].
- f. Each partner has the right to possess specific partnership property for partnership purposes. [UPA §18(b), (f)].
- g. Above can be modified by agreement of the partners.
- h. Each partner owes a fiduciary duty to the others. [UPA §20].

4. Limited Partnerships:

- a. Organization: Requires filing of certificate of limited partnership. [RULPA §201].
- b. Management:
  - (1) Must have at least one general partner.
  - (2) Limited partners cannot participate in management.
- c. Liability:
  - (a) Limited partners have no liability for firm obligations beyond their investment in the partnership. [RULPA §§303(a), 502(b)-(c)].
  - (2) Limited liability can be lost if limited partner "participates in the control of the business." [RULPA §303(a)].
  - (3) General partners are fully liable.

B. Case Law

- 1. Intent of the parties to enter into a partnership is the single most important consideration. *Comm'r v. Culbertson*, 337 U.S. 733 (1949).
- 2. Joint profit motive is often pivotal.
  - a. Look for risk.
  - b. "Profit" is not limited to cash profits.
  - c. Delay in receiving share of profit will not necessarily defeat finding of joint profit motive.

C. Similarities of LLC's and Partnerships:

1. No continuity of life. Dissolution occurs upon:
  - a. death;
  - b. resignation;
  - c. bankruptcy;
  - d. retirement;
  - e. expulsion; or
  - f. insanity of any member.
2. Membership interests are not freely transferable.
3. Flexible format.
  - a. No rigid requirements for meetings;
  - b. No rigid requirements for a Board of Directors;
  - c. Governed by an operating agreement entered into by its members.

D. Differences Between LLC's and Partnerships:

1. A LLC does not have a general partner personally responsible for all business debts and liabilities. All members enjoy limited liability.
2. All LLC members can take part in the management of the business whereas limited partners are precluded from this function to maintain their limited partner status.
3. Foreign investors are not prohibited from becoming members in LLC's as they are in partnerships.

**VIII. ADVANTAGES OVER S CORPORATIONS**

- |   |   |
|---|---|
| A. Shareholders of S Corporations must be individuals who are U.S. citizens. They cannot be corporations, partnerships, pension plans, certain trusts, or non-resident aliens.  | Members of LLC's can be any persons or entities, domestic or foreign.             |
| B. S Corporations can only have one class of stock.   | LLC offers flexibility in structuring capital and allocating profits and losses.  |
| C. S Corporations are limited to 35 shareholders.   | LLC can have an unlimited number of members (disregarding practical limitations). |
| D. S Corporations cannot own more than 80% of the stock of another corporation and thus cannot be part of an affiliated group.  | No such limitation applies to LLC's.  |
| E. When an S Corporation takes on debt there is no increase in the tax basis of the shareholders' shares, and taxes are not reduced. This can be planned around by having the shareholders borrow the money, then contribute it to the Corporation, but this requires planning. The | LLC members get outside basis adjustments for the liabilities of the LLC.         |

effect of this is to limit the losses which the shareholders can deduct.

## **IX. ADVANTAGES OF LLC'S OVER STATUTORY CLOSE CORPORATIONS**

- A. There are certain similarities between a LLC and a Statutory Close Corporation.
1. LLC's restrict the transferability of ownership interests, as do statutory close corporations. As a result, both forms of organization will be closely held.
  2. Both are formed pursuant to statute; they do not come into existence merely by the relationship of the parties, as do partnerships.
  3. Statutory close corporations are not required to have a board of directors and are not required to follow other corporate formalities. A LLC has no equivalent to a board of directors and is not required to follow formalities in order to retain limited liability.
- B. There are also differences between a LLC and a Statutory Close Corporation.
1. In some states, the statutes that permit Statutory Close Corporations do not permit the same degree of flexibility as do the LLC statutes.
    - a. E.g., shareholder agreements only on certain matters: management by shareholders and dissolution.
  2. In Montana, however, this is not so. The shareholders of a statutory close corporation may agree in writing to regulate:
    - a. the exercise of the corporate powers;
    - b. the management of the business and affairs of the corporation; or
    - c. the relationship among the shareholders of the corporation.Furthermore, the statute expressly does not prohibit any other agreement between or among shareholders.<sup>39</sup>
  3. Close corporation statutes impose requirements that do not exist under LLC statutes.
    - a. Share transfer restrictions;
    - b. Buy-out provisions;
    - c. Dissolution rights.
  4. Minority shareholder protections may apply to Statutory Close Corporations, even if not expressed in the statutes.<sup>40</sup>
- C. A LLC may be preferable if these requirements are not desirable.

## **X. BUSINESS TRUSTS**

- A. Does anyone use these anymore?
- B. A business trust (sometimes referred to as a Massachusetts Trust) is an unincorporated association or trust created by an instrument under which property is held and managed by trustees for the benefit and profit of such persons as are or may become the holders of transferable certificates evidencing beneficial interests in the trust estate.<sup>41</sup>
- C. A business trust is subject to the provisions of corporate law.<sup>42</sup>
1. Issuance of securities;

2. Filing of required statements and reports;
3. Service of process;
4. General grants of power to act;
5. Withdrawal;
6. Right to sue and be sued;
7. Limitation on individual liability of shareholders;
8. Rights to acquire, mortgage, sell, lease, operate, and otherwise deal in or with real property.

D. These almost certainly would be considered associations taxable as corporations.

## **XI. PARTNERSHIP CLASSIFICATION REQUIREMENTS**

- A. The so-called "Kintner" Regulations<sup>43</sup> distinguish corporations from partnerships.
1. An interesting Missoula side-note for those not otherwise aware of this: the Kintner regulations are so named because they were promulgated following a case<sup>44</sup> involving Dr. Kintner, one of the founders of the Western Montana Clinic in Missoula. At the time, physicians and other professionals could not incorporate. The Western Montana Clinic was operated as an "association" that had corporate characteristics, although it was not technically a corporation. The case was decided in favor of the Clinic, meaning that it could be taxed as a corporation, even though it was not organized as one. Following this case, the IRS issued the Kintner regulations to provide guidance as to classification of entities as partnerships or as associations taxable as corporations.
  2. LLC's somewhat turn the Kintner approach on its head. Rather than attempting to be classified as a corporation for tax purposes, even though the organization is in fact not a corporation, a LLC is an attempt to be classified as a partnership for tax purposes, even though the organization is in fact not a partnership.
- B. The regulations specify six corporate characteristics to consider in determining the proper classification of an organization.<sup>45</sup> They are as follows:
1. Associates;
  2. An objective to carry on business and divide the gains therefrom;
  3. Continuity of life;
  4. Centralization of management;
  5. Limited liability; and
  6. Free transferability of interests.
- C. An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership.<sup>46</sup>
1. Associates and an objective to carry on business and divide the gains therefrom are common to both corporate and partnership organizations.
  2. The remaining four characteristics are therefore highly scrutinized by the IRS in determining whether the LLC may be afforded partnership tax status.
  3. A LLC must lack two of the remaining four characteristics to be classified as a partnership for federal income tax purposes.

- a. All LLC's possess limited liability characteristics and cannot lack this characteristic.
  - b. A LLC must therefore lack any two of the characteristics of continuity of life, centralization of management, or free transferability of interests to retain its partnership tax status.
4. Characteristics common to partnerships are not material in attempting to distinguish between a corporation and a partnership.
- D. Not even all partnerships are taxed as partnerships
- 1. Virtually all disputes involve limited partnerships.
  - 2. Limited partnerships often strongly resemble corporations.
    - a. Look at general partner.
    - b. No problem being classified as partnership if general partner has personal liability, cannot transfer his interest or withdraw from the partnership without causing it to dissolve.
    - c. As general partner becomes less substantial, risk of classification as association taxed as corporation increases.

## XII. CONTINUITY OF LIFE

- A. Not present if dissolution caused by any of following:
- 1. Death
  - 2. Insanity
  - 3. Bankruptcy
  - 4. Retirement
  - 5. Resignation
  - 6. Expulsion
- B. "Dissolution"
- 1. Alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law.<sup>47</sup>
  - 2. Distinguish from winding up and liquidation.
- C. Agreement may provide that business will be continued by remaining members, but that will not establish continuity of life if under local law death or withdrawal of any member causes dissolution.<sup>48</sup>
- D. If agreement provides for stated period or until completion of stated undertaking, still no continuity if partner can dissolve at will.<sup>49</sup>
- 1. "Continuity of life" does not mean perpetual life. Can be fixed term or stated undertaking.
  - 2. §301.7701-2(b)(3): General partnership subject to UPA and limited partnership subject to ULPA both lack continuity of life.
- E. Members may agree to continue the LLC after a dissolution, by unanimous vote, without jeopardizing partnership tax status.<sup>50</sup>
- 1. If only a majority vote were required to continue the LLC, this would indicate continuity of life exists. This would be a corporate marker.

2. Unanimous vote indicates that although the organization has been dissolved, all members can agree to continue without causing continuity of life if under local law the death or withdrawal of any member causes a dissolution of the organization.<sup>51</sup>
3. Merely specifying that the life of an organization is for a term of years (e.g., limiting the life of a LLC to 30 years) does not have the effect of eliminating the characteristic of continuity of life under Treas. Reg. § 301.7701-2(b)(3).
  - a. The Montana statute requires that the articles of organization specify the latest date on which the LLC is to dissolve.<sup>52</sup>
  - b. Note, there is no limit on the length of term, other than what is specified by the articles of organization. The Montana statute does not provide, as Montana corporate statutes do, that the term of the organization may be perpetual.
  - c. In the original draft of the Montana LLC Act, a 30 year maximum term was provided, but that was deleted in subsequent drafts. The Subcommittee believed a 30 year maximum was cumbersome and would create traps for those who did not extend the corporate life at the end of the 30-year period. They were instead persuaded by the analysis of this issue found in Gazur & Goff, Assessing the Limited Liability Company, 41 Case Western Res. L. Rev., 399-400 (1991), which concluded that fixed maximum terms were not necessary for a LLC to lack the characteristic of continuity of life. Further support for this view is found in Treas. Reg. § 301.7701-2(b)(3), which provides that a stated period is only one method of providing for lack of continuity of life. Also mentioned are providing for termination upon completion of a stated undertaking and for termination at will or otherwise.

### **XIII. CENTRALIZATION OF MANAGEMENT**

- A. Definition<sup>53</sup>
  1. Continuing
  2. Exclusive
  3. Authority to make independent business decisions
  4. On behalf of the organization
  5. Which do not require ratification by the members of such organization.
- B. Power may be possessed by any person or group of persons which do not include all the members. Similar to board of directors of corporation.<sup>54</sup>
- C. Persons holding such power may or may not be members of such organization.<sup>55</sup> But, no centralized management if such persons are merely agents performing ministerial acts at the direction of a principal.<sup>56</sup>
- D. Exclusive<sup>57</sup>
  1. Sole authority to make decisions required.<sup>58</sup>
  2. E.g., stockholder cannot bind corporation; that power is vested in Board of Directors and officers.
  3. Centralized management not present in general partnership because of this factor.
    - a. Any one partner can bind partnership so not exclusive.
    - b. Even if agreement as to exclusive management, third party will not be bound by agreement.
- E. Can acquire this characteristic by creating a non-member run management system.
- F. Can acquire this characteristic by creating a member run management system where not



all members are managers.

- G. A LLC that reserves management powers to all members in proportion to their interests in the LLC and allowed each member to contract debts and incur liabilities on behalf of the LLC lacks the corporate characteristic of centralization of management.
- H. Must lack continuity of life and free transferability of ownership interest to qualify for partnership tax status if a management system is non-member run.

#### **XIV. FREE TRANSFERABILITY OF OWNERSHIP INTERESTS**

- A. Power without the consent of the other members to substitute for himself in the same organization a person who is not a member.
  - 1. Member confers all attributes of the member's interest in the organization, including voting rights and rights to distributions.
  - 2. Member does not retain any interest in the organization.
  - 3. Right to share in the profits does is not enough transfer of interest to constitute free transferability of interest.<sup>59</sup>
- B. Must include power to confer on substitute all attributes of his interest in the organization.
  - 1. E.g., would not be transferable if could transfer right to share of income but not right to participate in management.
  - 2. Also no transferability if under local law, transfer results in dissolution of old organization and formation of a new organization.
  - 3. Right of first refusal o.k. Requirement that member first offer his interest to other members will be accorded less significance than unmodified restriction. I.e., half a character.
- C. Must lack continuity of life and centralized management to qualify for partnership tax status.

#### **XV. OTHER PARTNERSHIP TAX ISSUES RELATED TO LLC'S**

- A. Formation
  - 1. The tax consequences of contributions of property to partnerships in exchange for a partnership interest are governed by § 721 of the Internal Revenue Code.
  - 2. Whether services, cash, promissory notes or other property, or some combination thereof, may be contributed in exchange for an LLC membership interest varies from state to state.
  - 3. In Montana, a membership interest may be acquired in exchange for property, services rendered, or a promissory note or other obligation to contribute cash or property or to perform services.<sup>60</sup>
  - 4. Under § 721, no gain or loss would be recognized either by the member or by the LLC for the contribution of cash, property or a promise to contribute cash or property in the future. The LLC would take a carryover basis in the property. The basis of the member in his LLC interest would equal the basis of the property contributed.
- B. Allocation of Profits and Losses: Basis Adjustments
  - 1. If the LLC qualifies as a partnership, profits and losses would be allocated in accordance with § 704 of the Internal Revenue Code.

2. Five sections determine basis of a partner's interest:
  - a. §722: As stated above, upon contribution of property to partnership in exchange for partnership interest, contributing partner gets basis in partnership interest equal to basis of property contributed.
  - b. §742: A partner who buys a partnership interest takes a cost basis.
  - c. §705: Once the beginning basis is determined (under §722 or §742), basis is adjusted for the partner's distributive share of income and expenses of the partnership. In general, increase basis for income and decrease for losses.
  - d. §733: Decrease basis (not below zero) for nonliquidating distributions from the partnership to the partner.
  - e. §752: Increase basis for partner's share of liabilities; decrease basis to the extent the partner is relieved of liabilities.
3. Why basis is important:
  - a. Losses can be deducted only to the extent of partnership interest basis.<sup>61</sup>
  - b. Basis is used to determine gain or loss realized on the sale of a partnership interest.<sup>62</sup>
  - c. Distributions in general are tax-free, but if money is distributed in excess of a partner's basis, the partner has capital gain.<sup>63</sup>

C. Terminations and Conversions

1. If the LLC qualifies as a partnership, the LLC would terminate for tax purposes upon a sale or exchange of 50% or more of the LLC interests in capital and profits in a twelve month period. A termination results in a deemed distribution of assets to the members, followed by a deemed recontribution to a new LLC.
2. There are at least three Private Letter Rulings permitting a partnership to convert to a LLC without treating the conversion as a termination,<sup>64</sup> as long as following the conversion:
  - the old partnership's business is continued; and
  - each partner's total percentage interest in profits, losses and capital remains the same.

D. Other Subchapter K Provisions

1. § 754 basis adjustments would be available to a LLC that qualifies as a partnership.
2. Built in gain from contributed property would have to be allocated back to the contributing partner, under § 704(c).

**XVI. BULLET PROOF STATUTES COMPARED WITH FLEXIBLE STATUTES**

- A. Distinction centers on how the statutes treat three of the four primary corporate characteristics which form the basis for determining whether an enterprise is to be categorized for federal income tax purposes as either a partnership or an association taxable as a corporation.
- B. Relevant characteristics are centralization of management, continuity of life and free transferability of interests.
- C. Bullet Proof statutes provide that all LLC's organized under them will always lack the

corporate characteristics of continuity of life and free transferability of interests. The statutes cannot be varied by the members.

1. Certain events will always lead to the dissolution of the LLC unless the members, by unanimous consent given after the event causing dissolution, elect to continue the LLC.
2. The assignee of the interest of a member cannot be admitted as a substitute member unless other members unanimously specifically consent to the admission of the new member.

D. Flexible statutes may provide that:

1. Assignees may become members automatically upon assignment of a member's interest without any subsequent consent of the members being required.
2. Events such as death, retirement, expulsion or dissolution of a member will not result in the dissolution of the LLC.
3. Events in 1 and 2 would automatically cause dissolution under a bulletproof statute.
4. Flexible statutes allow members to vary the rules by advance agreement, and provide greater planning possibilities.

E. Recent Revenue Rulings indicate that LLC's may be organized under flexible statutes and still have partnership tax status, as long as the articles of organization or operating agreement includes the appropriate provisions.<sup>65</sup>

## **XVII. OTHER MATTERS UNDER THE MONTANA LLC STATUTE**

A. Purposes

A LLC cannot be formed for Banking or Insurance entities, but can be formed for most other business purposes.

B. Powers

Powers include several enumerated powers, as well as "every other act not inconsistent with law that is appropriate to promote and further the business and affairs of the limited liability company."<sup>66</sup>

C. Articles of Organization

1. Signed and acknowledged by at least one person who need not be a member of the LLC.
2. Articles of amendment must be signed and acknowledged by an authorized person; and
3. Articles of cancellation must be signed and acknowledged by an authorized person.

D. Name<sup>67</sup>

1. Organization name shall contain the words "limited liability company" or "limited company" or the abbreviations "l.l.c.", "l.c.", "llc", or "lc". The word "limited" may be abbreviated as "ltd.", and the word "company" may be abbreviated as "co."<sup>68</sup>
2. May not contain a word or phrase that indicates the organization is organized for any purpose not stated in the Articles of Organization.
3. May not be the same as or similar to any existing:
  - a. Corporation, limited partnership, or limited liability company;

- b. Any foreign corporation, limited partnership, or limited liability company;
    - c. Any name reserved or registered.
  - 4. Names may be reserved if certain criteria are met.
  - 5. Articles of Organization may be amended for change of name.
  - 6. Distributions
    - a. Distributions may only be demanded by members to be made in cash and are restricted by certain requirements.
    - b. Prohibited if after the distribution, the LLC cannot pay debts as they come due in the ordinary course of business;<sup>69</sup>
    - c. Prohibited if after the distribution the liabilities of the LLC are less than its assets.
    - d. Distributions may be made based on:
      - (1) Financial statements prepared on the basis of accounting principles;
      - (2) Fair valuation that is reasonable under the circumstances.
    - e. Member or manager that authorizes a wrongful distribution is personally responsible for its repayment.<sup>70</sup>
- E. Assignment of Membership Interest<sup>71</sup>
  - 1. A membership interest is assignable in whole or in part, but an assignee is entitled only to the distribution to which the assignor would be entitled.
  - 2. Assignment of itself does not dissolve the LLC or entitle the assignee to participate in the management and affairs of the LLC.
  - 3. Until the assignee becomes a member, the assignor is still a member with all the powers members have, and the assignee assumes no liability.
  - 4. The assignor may be removed by a majority vote of the other members.<sup>72</sup>
  - 5. The assignor is not released from liability as a member solely as a result of the assignment.
  - 6. Member can be substituted upon majority vote of the members.
  - 7. Most of these provisions can be altered by the articles of organization or operating agreement.
- F. Dissolution<sup>73</sup>
  - 1. Happens upon:
    - a. Time specified in the Articles of Organization;
    - b. Happening of a specific event specified in the Articles of Organization;
    - c. Written consent of all members;
    - d. Event of dissociation<sup>74</sup> of a member, unless the business of the LLC is continued by consent of all remaining members within 90 days or as otherwise provided in writing in the articles of organization or operating agreement;

- e. Entry of a Decree of Judicial Dissolution upon application of a member.
- G. Winding Up<sup>75</sup>
- 1. Members may wind up the business affairs when:
    - a. One member applies to the court to do so.
      - (1) This requires that one or more of the members or managers have engaged in wrongful conduct or upon other cause shown.
    - b. The members or managers have authority to do so.
  - 2. Distribution of Assets<sup>76</sup>
    - a. First assets go to satisfy creditors;
    - b. Then to members and former members in satisfaction of liabilities for distributions;
    - c. Any excess to members first for return of contributions and second in proportion in which they share in distributions.
  - 3. Articles of Dissolution filed with the Secretary of State.<sup>77</sup>

## **XVIII. PROFESSIONAL LLC's**

- A. In General<sup>78</sup>
- 1. Professionals remain responsible for their own tort actions.
  - 2. Even though the statute permits professional LLC's, approval of the regulating body of each profession is required in order to practice as an LLC.
  - 3. Operating a professional practice as a S corporation may be difficult, because of the requirement that S corporations may have only one class of stock.<sup>79</sup>
- B. Attorneys
- 1. Attorneys practice as partnerships, even though there is no statute authorizing them to do so.
    - a. In general partnerships, of course, there is unlimited liability.
    - b. While the Montana Limited Partnership Act<sup>80</sup> does not expressly prohibit attorneys from operating as a limited partnership, it is difficult to see how an attorney could be a limited partner and still not violate the prohibition against participating in control of the partnership.
  - 2. The ABA Model Code of Professional Responsibility DR 6-102, EC 6-6 (1981) states that "[a] lawyer who is a stockholder in or is associated with a professional legal corporation may, however, limit his liability for malpractice of his associates in the corporation, but only to the extent permitted by law."
  - 3. Rule 1.8(h) of the ABA and the Montana Rules of Professional Conduct provides:
 

A lawyer shall not make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless permitted by law and the client is independently represented in making the agreement, or settle a claim for such liability with an unrepresented client or former client without first advising that person in writing that independent representation is appropriate in connection therewith.

4. Under these rules, a lawyer is permitted to practice in a professional corporation.<sup>81</sup>

C. Certified Public Accountants

1. Under Rule 505 of the AICPA Code of Professional Conduct, certified public accountants are allowed to practice accountancy in any form permitted by state law, which would include LLC's.
2. Prior to amendment of Rule 505 in 1990, the practice of accountancy had be conducted in the form of a proprietorship, partnership or professional corporation.
3. The Montana Accountancy laws have not been amended to provide for LLC's.

- a. It is illegal for a partnership or corporation to assume or use the title or designation "certified public accountant" or "CPA" unless it is properly registered.<sup>82</sup>

- (1) For partnerships engaged in the practice of public accounting:<sup>83</sup>

- (a) The partnership must register with the Department of Commerce;
- (b) Each partner or manager personally engaged in Montana in the practice of accounting must:
  - i) be a CPA of some state in good standing; and
  - ii) be certified in Montana.
- (c) Each partner (regardless of whether practicing in Montana) must be a CPA of some state in good standing.

- (2) For professional service corporations organized for the practice of public accounting:<sup>84</sup>

- (a) The sole purpose and business of the corporation must be to furnish to the public services not inconsistent with the Montana statutes and regulations for public accountants;
- (b) Each shareholder of the corporation must be a CPA in good standing;
- (c) Each shareholder of the corporation must be principally employed by the corporation or actively engaged in its business;
- (d) No other person may have any interest in the stock of the corporation;
- (e) The principal of the corporation and any officer or director having authority over the practice of public accounting by the corporation must be CPAs of some state in good standing; and
- (f) Each shareholder, officer, or manager of the corporation personally engaged within Montana in the practice of public accounting must be a CPA of some state in good standing and must be certified in Montana.

- b. There is no similar statute that specifically applies to professional LLC's.

- (1) The provisions governing professional LLC's<sup>85</sup> were adapted from parallel provisions under the Montana Professional Corporation Act.<sup>86</sup>
- (2) It might be argued, therefore, that a PLLC should be considered as a professional service corporation under the above rules, but that would be an aggressive reading of the statute.

#### D. Physicians

1. The American Medical Association does not regulate the manner in which physicians organize their practices, leaving that to state law.
2. In Montana, physicians are prohibited from practicing medicine as the with anyone who does not hold a license to practice medicine within Montana.<sup>87</sup> The statute expressly states that this does not prohibit the incorporation of one or more physicians as a professional service corporation, or practicing medicine as the partner, agent, or employee of or in joint venture with a hospital, medical assistance facility, or other licensed health care provider, but is silent as to LLC's.<sup>88</sup>
  - a. In all events, the physician's independent judgment in the practice of medicine must by unaffected by the relationship, the physician may not be required to refer any patient to a particular provider or supplier or take any other action the physician determines not to be in the patient's best interest, and there must be a written agreement that the relationship will not affect the exercise of the physician's independent judgment in the practice of medicine.<sup>89</sup>
3. In other words, although there is no express prohibition against practicing medicine in a LLC, the is no express authorization either. Since the practice of medicine in the form of a professional service corporation is permitted, there should be no conceptual reason not to permit the practice of medicine in the form of a professional LLC. Guidance from the Board of Medical Examiners may be necessary until such time as the Montana statute is amended.

#### XIX. INTERSTATE OPERATIONS OF LLC'S

- A. The Montana LLC Act permits LLC's to operate interstate.

35-8-107(2), MCA, provides that a LLC may "transact its business, carry on its operations, and have and exercise the powers granted by this section in any state; in any territory, district, or possession of the United States; and in any foreign country . . ."

- B. The larger issue is what recognition other states will give to a LLC.

1. Although LLC's have become increasingly popular in the last few years, not all states have LLC statutes. It is quite possible, therefore, that a LLC may operate in a state that has no LLC statute, raising the question of whether the LLC will be recognized by the foreign state, and whether the limited liability protection of a LLC will be available in such a foreign state.
2. The analysis of this area begins with the Interstate Commerce Clause of the U.S. Constitution,<sup>90</sup> which precludes states from imposing undue burdens upon corporation engaged in interstate commerce.<sup>91</sup>
  - a. A corporation organized in one state may enter into another state for purposes of interstate commerce, without obtaining permission from that other state.<sup>92</sup>
  - b. Consequently, an LLC organized in one state is constitutionally entitled to enter into all other states for purposes of interstate commerce, and those other states may not enact laws which bar or unduly burden an LLC's ability to engage in interstate commerce.<sup>93</sup>
3. This must be distinguished from the transaction of intrastate business. States do have the power to regulate intrastate business, and thus the right to regulate a foreign LLC that desires to transact intrastate business within its borders.<sup>94</sup>
  - a. Several states provide qualification procedures for foreign LLC's. Montana's statute provides a procedure for qualification of foreign LLC's.<sup>95</sup>
  - b. In Montana, failure of a foreign LLC to obtain a certificate of authority when one

is required leads among other things to the following results:

- (1) The LLC may not maintain a proceeding in any court in the state until it obtains a certificate of authority;
- (2) The LLC is liable for a civil penalty of \$5 for each day, but not to exceed a total of \$1,000 for each year.

Failure to obtain a necessary certificate of authority does not impair the validity of the foreign LLC's acts, nor does it prevent the LLC from defending any proceeding in the state.<sup>96</sup>

Note, the statute does not provide that the LLC loses its limited liability.

- c. In Montana, a certificate of authority authorizes a foreign LLC to transact business in this state, and provides the LLC the same rights and privileges as a domestic LLC, and subjects it to the same duties, restrictions, penalties, and liabilities imposed on a domestic LLC.<sup>97</sup>
- d. The Montana statute also provides that the certificate of authority does not authorize the state to regulate the organization or internal affairs of a foreign LLC.<sup>98</sup>
  - (1) Consequently, a foreign LLC operating with a certificate of authority in Montana would have all the organizational features provided by its home state, which almost certainly would include limited liability.
  - (2) Other states that have similar statutes would have to recognize the limited liability of a Montana LLC.
- e. The reader is directed to the Keatinge article<sup>99</sup> for a comprehensive discussion of the law that must be considered in determining whether the provisions for limited member liability in the LLC statutes will be recognized when an LLC transacts business in another state.<sup>100</sup> In summary, that article concludes that in the absence of an express statutory provision, the choice of law rules under the Restatement (Second) Conflict of Laws, the common law principle of comity, and the Full Faith and Credit Clause<sup>101</sup> and the Interstate Commerce Clause of the U.S. Constitution all indicate that in actions against an LLC in a foreign jurisdiction, the foreign court should treat the LLC as though it were a foreign corporation and should apply the limited liability provisions of the LLC's state of organization.<sup>102</sup>

## **XX. SECURITIES LAWS**

- A. The United States Supreme Court has defined as one type of security "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."<sup>103</sup>
- B. Under this definition, it is possible for a member's interest in a LLC to be considered a security.
  1. The determination will probably turn on the extent to which the members participate in the operation of the LLC.<sup>104</sup>
  2. One extreme in the spectrum would be an LLC operated by a manager with no participation by the members. The membership interests in such a LLC would have a relatively high risk of being classified as securities.
  3. The other extreme in the spectrum would be an LLC in which all the members actively participate. There should be relatively low risk of membership interests in such an LLC being classified as securities.



**XXI. BANKRUPTCY**

- A. The Bankruptcy Code<sup>105</sup> has certain provisions that differ for corporations and partnerships.
- B. The question becomes whether a LLC is properly classified as a corporation or as a partnership.

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62. IRC §1001.
63. IRC §731(a).
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83. 37-50-331, MCA.
84. 37-50-332, MCA.
85. Title 35, Ch. 8, Part 13, MCA.
86. Title 35, Ch. 4, MCA.
87. 37-3-322(23), MCA.
88. Id.
89. Id.
90. U.S. Const. Art. I, § 8, cl. 3. The Commerce Clause gives Congress the power "[t]o regulate Commerce with foreign Nations, and among the several States, and with Indian Tribes."
91. See, Keatinge, et al., p. 447.
92. Id., citing Dahnke-Walker Milling Co. v. Bondurant, 257 U.S. 282, 291 (1921).
93. Id.
94. Id.

95. MCA Title 35, Chapter 8, Part 10.
96. 35-8-1002, MCA.
97. 35-8-1008, MCA.
98. 35-8-1008(3), MCA.
99. See fn. 2.
100. Id., pp. 449-456.
101. U.S. Const. Art IV, § 1. The Full Faith and Credit Clause provides that "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof."
102. Id., p. 456.
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105. Title 11, United States Code.