

**Part IV**  
**Choosing the Appropriate Business Entity**

by  
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**A. INTRODUCTION**

Limited liability companies have advantages and disadvantages to other forms of organizing a business. This portion of the outline will focus on the features of various forms of business organizations and compare and contrast them to limited liability companies.

**B. PARTNERSHIPS**

**1. State Law**

State law does not determine whether an organization is *taxed* as a partnership.<sup>1</sup> In fact, tax law definition of partnership is broader than common law meaning. 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.<sup>2</sup>

**2. Case Law**

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<sup>1</sup>     Treas. Reg. §301.7701-1(c).

<sup>2</sup>     Treas. Reg. §301.7701-1(c).

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## Choosing the Appropriate Business Entity

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Intent of the parties to enter into a partnership is the single most important consideration.<sup>3</sup> 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.

b. General Partnerships

A general partnership is “an association of two or more persons to carry on as co-owners a business for profit.”<sup>4</sup>

Organization: Formation of a general partnership does not require any formalities (such as a partnership agreement). Partners may not even know they are partners.

Management: Each partner has an equal right to participate in management.<sup>5</sup>

Danger: Partnerships are required to make tax elections at the partnership level. 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.

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<sup>3</sup> *Comm'r v. Culbertson*, 337 U.S. 733 (1949).

<sup>4</sup> 35-10-202, M.C.A.

<sup>5</sup> 35-10-401(6), M.C.A..

## Choosing the Appropriate Business Entity

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Liability: The partnership, and thus each partner, is liable for the torts of the other partners acting in the ordinary course of business.<sup>6</sup>

Agency: Each partner is an *agent* of the partnership for the purpose of its business.<sup>7</sup>

Fiduciary Duty: Each partner owes a *fiduciary duty* of loyalty and of care to the partnership and to the other partners.<sup>8</sup>

c. Limited Partnerships

Organization: Requires filing of certificate of limited partnership.<sup>9</sup>

Management

- (a) Must have at least one general partner.
- (b) Limited partners cannot participate in management.

Liability

- (a) Limited partners have no liability for firm obligations beyond their investment in the partnership.<sup>10</sup>
- (b) Limited liability can be lost if limited partner “participates in the control of the business.”<sup>11</sup>
- (c) General partners are fully liable.

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<sup>6</sup> 35-10-305 and 35-10-307, M.C.A.

<sup>7</sup> 35-10-301, M.C.A..

<sup>8</sup> 35-10-405, M.C.A..

<sup>9</sup> 35-12-601, M.C.A..

<sup>10</sup> 35-12-703, 35-12-902, M.C.A..

<sup>11</sup> 35-12-703, M.C.A.

## Choosing the Appropriate Business Entity

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### d. Similarities of LLC's and Partnerships

Continuity of life. Dissolution occurs upon:

- (a) death;
- (b) resignation;
- (c) bankruptcy;
- (d) retirement;
- (e) expulsion; or
- (f) insanity of any member.

Membership interests are not freely transferable.

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.

### e. Differences Between LLC's and Partnerships

A LLC does not have a general partner personally responsible for all business debts and liabilities. All members enjoy limited liability.

Isn't a LLC really a limited partnership, with all limited partners?

- (a) There are similarities, but also important differences.
- (b) First, there is a basic difference in the extent of participation. A limited partner is prohibited from participating in the control of the

## Choosing the Appropriate Business Entity

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limited partnership (other than by exercising rights and powers as a limited partner).<sup>12</sup> A member of a LLC is *not* prohibited from participating in the management of the LLC.

- i) 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.
- ii) 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>13</sup>

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<sup>12</sup> 35-12-703(1), M.C.A..

<sup>13</sup> 35-12-703(1), M.C.A..

## Choosing the Appropriate Business Entity

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- iii) 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.
- (c) Second, there is a difference as to liability exposure.
  - i) In a limited partnership, there has to be at least one general partner, who has unlimited liability.
  - ii) 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.

## C. CORPORATIONS

### 1. Similarities

#### a. Limited Liability

Corporations and limited liability companies share the feature of limited liability; that is, the shareholders of a corporation and the members of a LLC, in general, are not personally liable for the debts and obligations of the business.

#### b. Formalities of Organization

Both a corporation and a limited liability company require the following of formalities in order to be organized. A corporation is formed by filing Articles of

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## Choosing the Appropriate Business Entity

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Incorporation with the Secretary of State,<sup>14</sup> and a limited liability company by filing Articles of Organization.<sup>15</sup>

### 2. Differences

#### a. Tax Treatment

Corporations are separate tax-paying entities for income tax purposes. A corporation is taxed on its net income.<sup>16</sup> Although a LLC may be taxed as a corporation, if it is organized without modification to the default provisions of the Montana Limited Liability Company Act, it should be taxed as a partnership.<sup>17</sup> Partnerships file an informational income tax return, but the partnership's items of income and expense are reported on the tax returns of the partners.<sup>18</sup> In other words, a partnership is a "flow-through" entity for purposes of income tax.

#### b. Organization

There are differences in the manner in which corporations and LLCs are organized:

- (a) No Board of Directors for a LLC.
- (b) No President or other officers for a LLC ... Although, the LLC in Montana may be governed by managers, which would be similar to having officers.

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<sup>14</sup> 35-1-220, M.C.A.

<sup>15</sup> 35-8-206, M.C.A.

<sup>16</sup> IRC §11.

<sup>17</sup> See Part V of this outline.

<sup>18</sup> IRC §701.

- (c) No statutory restrictions on the issuance of stock for a LLC.

## **D. S CORPORATIONS**

### **1. Qualifying as an S Corporations**

a. *Requirements Under the Internal Revenue Code*

S Corporations are in most respects the same as regular corporations, except that a tax election has been filed with the Internal Revenue Service to be treated as an S Corporation.<sup>19</sup> Only a “small business corporation” can elect to be treated as an S Corporation.<sup>20</sup> A “small business corporation”:

- (a) is a domestic corporation
- (b) does not have more than 35 shareholders
- (c) does not have as a shareholder a person who is not an individual
  - i) There is an exception for an estate
  - ii) There is an exception for a qualified subchapter S trust
- (d) does not have a nonresident alien as a shareholder; and
- (e) does not have more than 1 class of stock.<sup>21</sup>

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<sup>19</sup> IRC §1362.

<sup>20</sup> IRC §1361.

<sup>21</sup> IRC §1361(b)(1).



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## Choosing the Appropriate Business Entity

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The corporation cannot be part of an affiliated group or, in general, a financial institution, an insurance company, a corporation to which an election under §936 applies, or a DISC or former DISC.<sup>22</sup>

b. Effect of S Corporation Status

As with partnerships, S Corporations are in general “pass-through” entities for tax purposes. That is, items of income, loss, deduction or credit are reported on the tax returns of the shareholders.<sup>23</sup> The corporation files an informational income tax return, but the tax liability rests with the shareholders.

## 2. Differences in Tax Requirements

LLCs are not subject to the same requirements under the Internal Revenue Code as are S Corporations.

- (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).

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<sup>22</sup> IRC §1361(b)(2).

<sup>23</sup> IRC §1366.

## Choosing the Appropriate Business Entity

<b>S Corporations</b>	<b>LLCs Taxed As Partnerships</b>
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. This can be a distinct advantage in obtaining funding for a start up enterprise.
S Corporations can only have one class of stock.	LLC offers flexibility in structuring capital and allocating profits and losses.
S Corporations are limited to 35 shareholders.	LLC can have an unlimited number of members (disregarding practical limitations).
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.
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 effect of this is to limit the losses which the shareholders can deduct.	LLC members get outside basis adjustments for the liabilities of the LLC.

## E. STATUTORY CLOSE CORPORATIONS

### 1. Similarities to LLCs

Statutory Close Corporations are quite similar to LLC's.

- (a) Both are formed pursuant to statute; they do not come into existence merely by the relationship of the parties, as do partnerships.

## Choosing the Appropriate Business Entity

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- (b) 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.
- (c) The owners are not personally liable for the corporate obligations.
- (d) An owner's interest may not be transferred without the consent of the other owners.
- (e) One or more owners may dissolve the corporation (if provided in the Articles of Incorporation/Articles of Organization).
- (f) Both may be operated without a board of directors,<sup>24</sup> or the functional equivalent.

## 2. Partnership Tax Treatment of Statutory Close Corporations

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>25</sup>

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<sup>24</sup> 35-9-301, M.C.A.

<sup>25</sup> 35-9-301(2)(c), M.C.A.

## Choosing the Appropriate Business Entity

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But the IRS does not treat Statutory Close Corporations as partnerships. 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>26</sup>

§761(a) of the Internal Revenue Code, which defines a partnership, specifically excludes corporations.

### 3. Differences

There are also differences between a LLC and a Statutory Close Corporation.

In some states, the statutes that permit Statutory Close Corporations do not permit the same degree of flexibility as do the LLC statutes.

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>27</sup>

Close corporation statutes impose requirements that do not exist under LLC statutes.

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<sup>26</sup> Keatinge, Ribstein, Hamill, Gravelle & Connaughton, Vol. 47, No. 2, The Business Lawyer, “The Limited Liability Company: A Study of the Emerging Entity,” p. 381, 384 (February 1992).

<sup>27</sup> 35-9-301, M.C.A..

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## Choosing the Appropriate Business Entity

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- (a) Share transfer restrictions;
- (b) Buy-out provisions;
- (c) Dissolution rights.

Minority shareholder protections may apply to Statutory Close Corporations, even if not expressed in the statutes.<sup>28</sup>

A LLC may be preferable if these requirements are not desirable.

## F. MASSACHUSETTS BUSINESS TRUSTS

Does anyone use these anymore?

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>29</sup>

A business trust is subject to the provisions of corporate law.<sup>30</sup>

- (a) Issuance of securities;
- (b) Filing of required statements and reports;
- (c) Service of process;
- (d) General grants of power to act;

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<sup>28</sup> *Donahue v. Rodd Electrotpe Co.*, 328 N.E.2d 505, 511-21 (Mass. 1975).

<sup>29</sup> 35-5-1-1, M.C.A..

<sup>30</sup> 35-5-103, M.C.A..

## **Choosing the Appropriate Business Entity**

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- (e) Withdrawal;
- (f) Right to sue and be sued;
- (g) Limitation on individual liability of shareholders;
- (h) Rights to acquire, mortgage, sell, lease, operate, and otherwise deal in or with real property.

These almost certainly would be considered associations taxable as corporations.

## **G. LLCs**

### **1. Tax Considerations**

Limited liability companies often are selected over other forms of business so that the owners will receive pass-through tax treatment, similar to that of a partnership, and at the same time receive limited liability protection similar to that of a corporation.

Consider the following tax rates for 1994:

## Choosing the Appropriate Business Entity

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### 1994 Income Tax Rates

Taxpayer	Tax Rate	On Amounts Over
Single	15%	\$0
	28%	\$22,750
	31%	\$55,100
	36%	\$115,000
	39.6%	\$250,000
Married Filing Joint	15%	\$0
	28%	\$38,000
	31%	\$91,850
	36%	\$140,000
	39.6%	\$250,000
Corporations	15%	\$0
	25%	\$50,000
	34%	\$75,000
	39%	\$100,000
	34%	\$335,000
	35%	\$10,000,000
	38%	\$15,000,000
	35%	\$18,333,333

### Choosing the Appropriate Business Entity

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As this shows, the top marginal tax rate for an individual is 39.6%, while the top marginal rate for a corporation is 39%, although at other levels of taxable income, the corporate rate may exceed the individual rate.

<b>Taxable Income</b>	<b>Taxpayer</b>	<b>Marginal Tax Rate</b>
\$25,000	Single	28%
	Married Filing Joint	15%
	Corporation	15%
\$50,000	Single	28%
	Married Filing Joint	28%
	Corporation	25%
\$100,000	Single	31%
	Married Filing Joint	31%
	Corporation	39%
\$250,000	Single	39.6%
	Married Filing Joint	39.6%
	Corporation	39%

The corporate income tax rates, of course, would not apply to S Corporations, since the income of such a corporation is taxed to the shareholders.

If the corporation were to distribute a dividend to the shareholders, the dividend would not be deductible to the corporation but would be taxable to the shareholder. Thus, corporate earnings are said to be subject to a “double tax.” The corporation is taxed on its net income, then when what remains is distributed to the shareholders in the form of a dividend, it is again subject to income tax. If the earnings can be left in the



## Choosing the Appropriate Business Entity

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corporation, at certain levels of income it makes sense to do so. Very often, however, there will be less total tax cost if the income is taxable directly to the owners of the business, in which event a LLC taxable as a partnership may be appealing.

### **2. Paperwork**

Tax accounting for a partnership is considerably more difficult than for a corporation. Corporations are simpler to operate than LLC's in this regard.

## **H. THE CHOICE OF ENTITY CHART**

On the following pages is a thorough chart for helping determine the proper choice of entity, that has been reproduced with the permission of the authors (Donald H. Kelley, of Kelley, Scritsmier & Byrne, P.C., Denver, Colorado and North Platte, Nebraska, and Scott Heard, of Crowley, Haughey, Hanson, Toole & Dietrich, Billings, Montana) and the *Colorado Lawyer*, the magazine in which it was first published in 1994 (though subsequently modified specifically for Montana).