

**JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS**

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**SUBCHAPTER K vs. SUBCHAPTER S—EIGHT KEY
FEDERAL INCOME TAX DIFFERENCES**

EXECUTIVE SUMMARY. Under the U.S. Treasury Entity Classification Regulations, the two main federal income tax options for multi-member LLCs are Subchapter K (partnership taxation) and Subchapter S. (For the vast majority of companies, the double-tax regimen of Subchapter C, which is also available under these regulations, is usually a bad choice.)

In my experience, there are eight main federal income tax issues on which differences between Subchapter K and Subchapter S can have a significant practical impact on clients. These issues and their very different treatment under, respectively, Subchapter K and Subchapter S are briefly outlined in the table below. Subsequent newsletters will discuss in greater detail each of these differences and the real-world impact of each.

SUBCHAPTER K vs. SUBCHAPTER S—TABLE OF ISSUES AND DIFFERENCES.

| ISSUE | SUBCHAPTER K | SUBCHAPTER S |
|--|--|---|
| 1) <u>Pass-through taxation.</u> Does entity income pass through to owners and is it taxable only to them (and not at the entity level, as under Subchapter C)? | Yes – but Subchapter K imposes no eligibility or election requirements. (Section 701) | Yes—but Subchapter S does impose potentially burdensome and risky eligibility requirements (e.g., the single class of stock requirement) and election requirements. |
| 2) <u>Special allocations.</u> Can the entity allocate and distribute its profits to the members in a manner that is disproportionate to their respective contributions (“special allocations”)? | Yes. (Section 704(a)) | No. |
| 3) <u>Entity dispositions of contributed property.</u> When an entity disposes of contributed property, can this trigger gain to the contributor? To the non-contributor? | Contributor may realize gain under Section 704(c)(1)(A) (the “Subchapter K pre-contribution gain” rule). Under the same section, non-contributors will not; and these non-contributors can take deductions in respect of the contributed property. | Subchapter S has no equivalent of Section 704(c)(1)(A). |

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| 4) <u>Treatment of post-formation contributions of property.</u> Can post-formation contributions of appreciated property trigger a tax to the contributor? | No. (Section 721) | Yes—if the Section 351(a) “80% control rule” is violated. (See also Section 368(c) (definition of “control”).) |
| 5) <u>Distributions of appreciated property.</u> Are distributions of appreciated property by an entity to its owners taxable to the owners upon receipt? | Generally no. (Section 731) | Generally yes. These distributions are treated as deemed sales. Section 311(b)(1). |
| 6) <u>Owner redemptions.</u> When the entity redeems the interests of an owner, can the entity (and thus the remaining owners) get a stepped-up basis in the entity’s assets? | Yes, under Sections 734 and 754. | No. In Subchapter S, there is no equivalent of Sections 734 or 754. |
| 7) <u>Purchases of owners’ interests in entities by other persons.</u> When another person purchases the interests of an owner in an entity, can the purchaser get a stepped-up basis in the entity’s assets? | Yes, under Sections 743 and 754. | No. In Subchapter S, there is no equivalent of Sections 743 or 754. |
| 8) <u>Inclusion of entity debt in owners’ basis.</u> When an entity incurs debt, can this debt be included in the owners’ basis in their ownership interests and thus enable them to offset entity losses against their gains from other entities? | Under Section 752, 705 and other sections, yes. | No. Under Subchapter S, shareholders may include in the basis of their stock only their direct loans to their corporation. Section 1366(d)(1). |