

LLCs AND NONQUALIFIED DEFERRED COMPENSATION PLANS: KEY FEDERAL TAXATION CONSIDERATIONS

Overview

A limited liability company (LLC) with at least two members is classified as a partnership for federal income tax purposes by default. However, an LLC may elect to be classified as an association taxable as a C corporation or as an S corporation, if applicable. After an LLC has determined its federal tax classification, it can later elect to change that classification. The following discussion is applicable to LLCs that are classified as partnerships or have elected to be classified as an S corporation.

In general, a limited liability company's (LLC) profits or losses are divided among and passed through to the members, who must then report the income or loss on their own individual income tax returns. The LLC itself does not pay federal income taxes. This is called single taxation; in contrast, if an entity is taxed as a C corporation, it will face double taxation, meaning both the entity's profits and the shareholders' dividends will be taxed.

For example, if an LLC receives \$1 of income, \$1 is reported on the members' income tax returns and the tax of \$.40 (assuming a tax rate of 40%) is paid by the LLC's members. It is important to note that each LLC member must pay taxes on his or her whole distributive share; most operating agreements provide that a member's distributive share is in proportion to his or her percentage interest in the business. This means that each LLC member is liable for income tax on his or her rightful share of that money.

Determining Federal Tax Liability

Key concepts to keep in mind are functions of accounting:

- Book vs. tax income
- Cash vs. accrual accounting

"Book items" that do not create actual cash flow generally will not generate taxable income or deduction for the member to report, and therefore result in no tax impact. Any incremental company income that creates an adjustment to the members' income will result in additional tax owed.

It is also important to remember that buying a depreciable asset results in cash flow, but no immediate tax benefits. The tax benefits occur as depreciation is taken for book and tax purposes. The result is that the LLC member has not received cash because it was used for the asset, but still has taxable income because the purchase did not reduce taxable income.

LLC Federal Taxes and NQDCPs

A nonqualified deferred compensation plan (NQDCP) and certain types of informal funding may create additional income, which may result in considerable incremental taxation to the members.

While NQDCPs may provide valuable benefits to non-member employees of an LLC, these plans are of limited utility to employees who are LLC members. This limitation is a function of the single taxation nature of the LLC. Any deferral by an employee-LLC member on the employee side results in a corresponding loss of deduction on the LLC side, effectively resulting in a wash. Similarly, when the deferred compensation is ultimately distributed to the employee-LLC member, the LLC gets the deduction—again, effectively resulting in a wash.

The single taxation structure of the LLC also has important consequences to consider for the LLC and its members even where the NQDCP participants are non-member employees:

- 1. Salary and bonus deferrals:** Corporate cash that would otherwise have been paid to employees creates additional income to the LLC. As the compensation is not paid, there is no tax deduction for the LLC related to the deferred compensation at the time of the deferral. Since the LLC pays no taxes and receives no tax benefits, the individual members must pay the taxes due on the additional incremental income. Accordingly, if the income is retained by the LLC but is intended to be used to pay the future NQDCP distributions, the LLC members will be taxed currently on the income, but will not receive the cash.
- 2. Distributions:** Distributions are paid out by the LLC and result in a decrease in earnings passed to the members. The LLC would be able to receive a deduction for the benefit payments. While the benefits paid out decrease income, the tax savings from paying those benefits flows to the members.
- 3. Company contributions expense and crediting of deemed investment gains:** These items are not cash items; they are accrual items that increase liability on balance sheets. Crediting of deemed investment gains/losses to participant NQDCP accounts does not decrease (or increase) company income, and there is no adjustment made to the shareholder's income and therefore, no tax impact.

LLCs and Taxable Securities

- 1. Investment and Withdrawals:** An investment in taxable securities to informally fund an NQDCP represents a shift in existing assets from cash to securities for the LLC; there is no net increase or decrease to assets or earnings. Similarly, any withdrawal from the taxable securities portfolio is also a shift in balance sheet assets. Assuming that the portfolio is invested in a variety of taxable securities, there would be a gain or loss upon liquidation, which could have a tax impact for the LLC members.
- 2. Capital gains, interest income and dividend income:** Any income recognized in the portfolio is reported by the individual LLC members, who would be responsible for paying the taxes, even though they may not receive the income if it is used to fund the earnings credited to the deferred compensation plan. It is important to note that this income could also be subject to the 3.8% Medicare tax on investment income if individual LLC members meet the applicable income thresholds (even though the income was generated inside of the LLC).
 - » This result is dependent upon positive earnings rates; results may differ in years of down performance.
- 3. Other factors to consider**
 - » There is no corporate dividend exclusion because the LLC does not pay taxes for the assets, the individual members do.
 - » Corporate capital gains tax rates do not apply; it is the member's individual tax rate(s).

LLCs and Corporate Owned Life Insurance

- 1. Premiums and Withdrawals:** Similar to the taxable securities portfolio, these amounts represent a shift in balance sheet assets. They do not create any adjustment to the individual member's income, and, if the policy is not a modified endowment contract (MEC), generally no taxable event would occur unless the amount withdrawn/surrendered exceeded the amount of the premiums paid.
- 2. Death Proceeds and Increase in Cash Surrender Value:** Because of the tax-advantaged status of both of these components of life insurance, there is no taxable event for the individual members. Note that the requirements under IRC Section 101(j) generally must be satisfied in order for the corporate-owned life insurance to be eligible for income tax free treatment.

It is also important to note that if death proceeds are used to pay deferred compensation to the employee's spouse or estate, there is a tax deduction for the LLC that flows through to the LLC members. In that situation, there would be a tax-free infusion of cash coupled with a tax-deductible outflow of cash.

(continued)

While MullinTBG cannot and does not engage in the practice of law or accounting, we are committed to offering ongoing technical support to our clients and associates. As part of this commitment, the preceding information has been prepared to provide a high-level overview of certain tax and accounting issues related to NQDCPs and related informal funding for S Corps. Nothing in this document should be construed as legal, tax or accounting advice, or as a solicitation to provide legal, tax or accounting advice. You are urged to seek independent accounting, tax and legal advice in applying this information.

Notes Life Insurance:

Investors should consider the investment objectives, risks, charges and expenses of any variable life insurance product carefully before investing. This and other important information about the investment company is contained in each fund's prospectus, which can be obtained by calling 800-824-0040. Please read it carefully before you invest.

Variable life insurance products are long-term investments and may not be suitable for all investors. An investment in variable life insurance is subject to fluctuating values of the underlying investment options and it entails risk, including the possible loss of principal.

Product guarantees, including the death benefit, are subject to the claims-paying ability of the issuing insurance company.