S CORPORATIONS AND NON-QUALIFIED DEFERRED COMPENSATION PLANS: KEY TAXATION CONSIDERATIONS

Overview

In general, a corporation that elects to be taxed under subchapter S of the Internal Revenue Code (S Corp) does not pay any federal income taxes. Instead, the corporation's net income or net losses are passed through to the shareholder(s), who then report the net income or net loss on their own individual income tax returns. This is called single taxation; in contrast, if a corporation is taxed as a C corporation (C Corp), it will face double taxation, meaning both the corporation's profits and the shareholders' dividends will be taxed.

For example, if the S Corp receive $1 of net income, $1 is reported on the shareholder's income tax return and the tax of $.40 (assuming a tax rate of 40%) is paid by the individual shareholder.

A Non-Qualified Deferred Compensation Plan (NQDCP) and certain types of informal funding may create additional income for an S Corp, which results in considerable incremental taxation to the shareholder.

S Corp Taxes and NQDCPs

1. **Salary and bonus deferrals:** Corporate cash that would otherwise have been paid to employees as compensation creates additional income to the S Corp. As the compensation is not paid, there is no reduction in income for the S Corp related to the deferred compensation at the time of the deferral. Since the S Corp pays no taxes and receives no tax benefits, the individual shareholder must pay the taxes due on the additional net incremental income. Accordingly, if the income is retained by the S Corp, but is set aside to pay the future NQDCP distributions, the S Corp shareholders will be taxed currently on the additional income, but will not receive the cash.
2. **Distributions**: Distributions are paid out by the S Corp and result in a decrease in earnings passed to the shareholder. The S Corp receives a deduction for the benefit payments via a reduction in income.
   - While the benefits paid out decrease income, the tax savings from paying those benefits flows to the shareholder.
   - The net impact to the shareholder of losing the tax savings on deferrals -- but gaining the tax savings on the benefit payments -- can be positive over the life of the plan (ignoring the time value of money and assuming a constant ownership group).
3. **Company contributions expense and crediting of investment gains:** These items are not cash items; they are accrual items that increase the liability on the balance sheet.
   - Interest expense does not decrease (or increase) company income, and there is no adjustment made to the shareholder's income and therefore, no tax impact.

(continued)

S Corps 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 S Corp; there is no net increase or decrease to assets or earnings. Similarly, any withdrawal of basis 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 individual shareholder.
2. **Capital gains, interest income and dividend income:** Any net income recognized in the portfolio is passed to, and reported by, the individual shareholder, who would be responsible for paying the taxes.
   - » This result is dependent upon positive earnings rates; results may differ in years of down performance
3. **Other factors to consider**
   - » Corporate capital gains tax rates do not apply; it is the shareholder's individual tax rate.
   - » No corporate dividend exclusion for S Corps.

S Corps 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 shareholder's income, and 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 shareholder.

While Mullin Barens Sanford 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 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 On 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 310-473-0060. 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.

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