Life Insurance and Taxation of Business Entities

TAXATION OF INCOME AND DISTRIBUTIONS FOR VARIOUS ENTITY FORMS					
	"C" Corporation	**"S" Corporation**	**Partnership**	**Sole Proprietorship**	**LLC**
Income Taxation	• Corporation pays income tax if it has taxable income. • Compensation paid is deductible, if reasonable.	• S Corporations do not pay income tax on S Corp earnings. • Income flows-through to shareholders and reported on individual Shareholder K-1, Form 1120S; income taxable to shareholder but not subject to FICA taxes. • Compensation subject to FICA taxes.	• Partnerships do not pay income tax. • Income flows through to shareholders and reported on individual Partner K-1, Form 1065. • Partners pay self-employment tax on their distributive share of partnership income.	• All income is self-employment income, subject to self-employment tax as well as income tax.	• LLCs choose how they are taxed; can elect to be taxed as a C Corp, S Corp, Partnership, or Sole Proprietorship.
Distributions	• Dividends to shareholders are taxable at 18.8% (15% + 3.8%) - 23.8% (20% + 3.8%), depending on shareholder's modified AGI, to extent of E&P. • 0% tax rate if shareholder in15% or lower tax bracket.	• AAA, undistributed S Corporation taxable income. • Dividend from E&P (if former C Corp), taxable to Shareholder at 18.8% (15% + 3.8%) - 23.8% (20% + 3.8%), depending on shareholder's modified AGI; not deductible by S Corp. • Return of Basis: Not taxed to shareholder; but shareholder's basis is reduced by amount of distribution. • Capital Gain: distributions exceeding Shareholder's basis, subject to capital gains tax.	• Distributions reduce partner's basis in partnership. • Cash distributions in excess of basis trigger capital gain.	• N/A	• LLCs choose how they are taxed; can elect to be taxed as a C Corp, S Corp, Partnership, or Sole Proprietorship.

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Distributions of Appreciated Property (FMV in excess of basis)	• Gain (FMV - Basis) taxable to Corporation. • If distributed as dividend, no deduction to Corporation and Corporation has income to extent of gain. • Tax deductible at FMV if distributed as compensation, if reasonable; deduction will off-set gain.	• Gain (FMV - Basis) taxable to shareholders. • If distributed as compensation, Corporation can deduct, if reasonable; deduction will off-set gain. • Deduction flows-through to shareholders. • If distributed as dividend, no deduction to Corporation and shareholder recognizes income to extent of gain.	• No gain triggered by partnership distribution to partner.	• Sole Proprietor owns property outright; no distributions.	• LLCs choose how they are taxed; can elect to be taxed as a C Corp, S Corp, Partnership, or Sole Proprietorship.
Shareholder / Partner receives Distribution of Appreciated Property	• Taxable amount equals FMV. • Dividends to shareholders are taxable at 18.8% (15% + 3.8%) - 23.8% (20% + 3.8%), depending on shareholder's modified AGI. • Compensation is taxed at shareholder's marginal income tax rate.	• Compensation: taxable at shareholder marginal rate. Dividend from C Corp E&P: taxable at 18.8% (15% + 3.8%) - 23.8% (20% + 3.8%), depending on shareholder's modified AGI. • Distribution from AAA: not taxable as a dividend. • Return of basis: not taxable to shareholder. • Distribution in excess of basis: capital gain income to shareholder.	• Gain generally not recognized on distribution; however, gain recognized at time of sale by distribute partner. • Distribution reduces basis.	N/A	• LLCs choose how they are taxed; can elect to be taxed as a C Corp, S Corp, Partnership, or Sole Proprietorship.

Case Example: C Corporation

Agewell Corporation owns a life insurance policy on Charles, a key employee. The policy has a basis of $50,000, which is sum of total premiums paid on the policy. The current cash value is $75,000. What are the tax ramifications should Agewell transfer the policy to Charles?

Agewell will recognize gain on the policy [since the fair markets value (FMV) of the policy ($75,000) exceeds the cost / basis of the policy ($50,000)]. The gain on the policy is $25,000: $75,000 - $50,000. The $25,000 gain is included in Agewell's ordinary income.

Treatment of Distribution as a Dividend (assuming sufficient E&P): $75,000 to Charles; not deductible from Agewell's income. The dividend is not deductible by Agewell, but Agewell will report ordinary income for the amount of the gain: $25,000 ($75,000 - $50,000).

Treatment of Distribution as Compensation: $75,000 to Charles, deductible from income by Agewell. $50,000 net deduction by Agewell ($75,000 deduction; $25,000 gain.)

S-Corporation

Wine-Seats, Corporation, owns a life insurance policy on Al. Cash value in the policy is $40,000; basis is $50,000. What are the tax ramifications should Wine-Seats transfer the policy to Al?

Treatment of Distribution as a Dividend: There is no gain or loss, because there is no gain in the policy.

Treatment of Distribution as Compensation: $40,000 net tax deduction. S Corporations cannot recognize the loss on distribution of life insurance contract.

Partnership

ABC LLC, owns a life insurance policy on Bettye. The cash value is $300,000, and ABC's basis in the policy is $80,000. What are the tax ramifications should ABC LLC transfer the policy to Bettye?

No gain or loss to ABC LLC on appreciated property distributed to partner.

No gain or loss to Bettye; however, Bettye's basis in the partnership will be reduced because of the distribution.