

S CORPS' CORPORATION OWNED LIFE INSURANCE (C.O.L.I):
NO ACCUMULATED ADJUSTMENT ACCOUNTS (AAA) EFFECT

By

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Estate planners commonly deal with clients who own interests in S corporations. Many times the planning involves life insurance to provide funds to pay off debts to lenders, or to provide a means for the corporation to survive at the death of the S corporation shareholder, or for other reasons. Those companies purchase and maintain S corporation-owned life insurance, generally referred to as "C.O.L.I." or, in this case "S.C.O.L.I." A question that has been raised from time to time is the impact of the payment of premiums for S.C.O.L.I. on the "accumulated adjustment accounts," or "AAA." AAA track the amount of undistributed income that has been taxed to the S corporation shareholder, similar to the manner in which E&P generally tracks a C corporation's undistributed income. AAA are the mechanism that allows previously-taxed but undistributed income to be distributed tax-free to S corporation shareholders to the extent of the shareholders' basis in their stock. If the payment of premiums reduces the AAA, then the S corporation's shareholders can take fewer distributions tax free.

Rev. Rul. 2008-42, 2008-30 IRB1, answers the question in a positive way for taxpayers, saying that the payment of premiums does not reduce AAA. As a result, the undistributed income accounted for in AAA is not reduced, and the shareholders may continue to take that amount tax free to the extent of their basis. The Service reasoned that Sec. 264(a)(1) prohibits the S corporation from taking a deduction for premiums paid on any life insurance, endowment or annuity contract if the S corporation is directly or indirectly a beneficiary. Similarly, Reg. Sec. 1.264-1(a) provides that premiums paid for life insurance on the life of any officer, employee or other person financially interested in a business carried on by the taxpayer, including an S corporation, are not deductible where the S corporation is directly or indirectly a beneficiary of the policy.

Reg. Sec. 1.1368-2, provides for the calculation and maintenance of AAA. It says that AAA are generally decreased by certain items of loss or deduction, including any non-deductible expense not properly chargeable to a capital account. Because premiums on life insurance are not deductible, then that portion of the regulation would indicate that the AAA should be reduced by those premiums.

However, the Service cited Reg. Sec. 1.1366-1(a)(2)(viii) which provides that, for the purposes of Subchapter S, tax-exempt income is permanently excludable from gross income in all circumstances. Normally, we might think of income from municipal bonds as tax-exempt. But, the Service reasoned that death benefits are also tax-exempt income. Sec. 1368(e)(1)(A) regulations under that, previously cited, say that the non-deductible expenses referred to above reduce AAA, unless the expenses are related to tax-exempt income. Since the premiums are related to the life insurance death benefits, and because the death benefits are tax-exempt income, even though the premiums are non-deductible and are not properly chargeable to a capital account and, thus, otherwise would reduce AAA, the exception for expenses related to tax-exempt income means that AAA are not reduced by those premiums.

This ruling is important. Without it, some would have suggested that having the S corporation buy, pay for, and be the beneficiary of, a life insurance policy, would have a double-negative effect: (1) the payment of the premiums would not be deductible; and (2) the payment would reduce AAA, thus making distributions taxable that otherwise would not have been. With this ruling, that double-negative effect is eliminated. The premiums are still not deductible; thus, the income used to pay them is still taxable, not being offset by any such deduction. But, at least the premiums don't increase the amount of tax on distribution from AAA as previously suggested.