Article 4

BANK SUBCHAPTER S-CORPORATIONS AND NON-QUALIFIED BENEFIT PLANS

Financial institutions across the country are flocking to convert from C-Corporation (C-Corp) to S-Corporation (S-Corp) status in large numbers. More and more eligible financial institutions are considering this conversion ever since the Internal Revenue Service relaxed the S-Corp restrictions in January 1997. The main reason for conversion is to save on federal income taxes.

One consideration that may be overlooked in the conversion process is the effect that S-Corp status has on an already existing non-qualified benefit plan. A non-qualified benefit plan is a contractual promise by the bank to pay selected senior management and/or board members a supplemental benefit, typically at retirement. These plans often are informally funded by the purchase of single premium bank owned life insurance (BOLI) insuring the lives of those that are to receive the benefits.

BOLI provides two types of tax-free income. The bank gets annual tax-free income through increases in cash surrender value, which can be used to offset the annual expenses related to the non-qualified benefit plan. The bank also gets tax-free income in the form of death proceeds when the insured officer or director dies.

As a C-Corp, the financial institution had been recording nondeductible, generally accepted accounting principle (GAAP) accruals in order to properly account for the future benefits the financial institution had promised to pay the participant. Upon conversion to S-Corp status, that liability represents real dollars from the shareholders' pockets. As the liability increases each year, the shareholders are funding it by paying additional federal income taxes.

In addition, when the C-Corp financial institution with an existing nonqualified benefit plan converts to an S-Corp it has to reverse the deferred tax benefit it has been accumulating over the years that is associated with the benefit accrual. This accounting entry negatively affects GAAP income.

What remedies are available for financial institutions in this situation? The most pressing problem is to alleviate the tax burden to the shareholders associated with the non-qualified benefit plan. The use of secular trusts can usually accomplish this objective. Even though the tax burden is a timing difference, the shareholder might have to wait a significant amount of time to get a tax deduction without the use of a secular trust.

A 'secular trust,' which is an irrevocable grantor trust, is established for each participant in the plan. The bank writes a check for the amount of liability currently on its books to the participant's secular trust. At this point, income taxes are withheld for the participant bank and the bank receives a tax deduction. All future contributions to the secular trust are handled in the same manner.

It is important to note that the secular trust method does not work for every individual. Detailed fact-finding and individual analyses are necessary in determining whether a participant should utilize a secular trust for their retirement benefits.

Another interesting feature about banks that are S-Corps is that they are created in one of two ways.

Currently the more common method is for a C-Corp to convert to an S-Corp. The other way is for a new bank to elect S-Corp status in its initial year. The latter method would mean that the bank would have been formed no earlier than January 1, 1997. Both of these methods for a bank to become an S-Corp are perfectly acceptable, but each method has very different accounting ramifications with respect to non-qualified benefit plans.

The S-Corp that has converted from a C-Corp has three equity accounts for tax purposes:

1. Accumulated Adjustments Account
2. C-Corp Earnings and Profits
3. Other Adjustments Account

The S-Corp that originally incorporated as an S-Corp has only two tax equity accounts:

1. Accumulated Adjustments Account
2. Other Adjustments Account

The originally incorporated S-Corp has the advantage over the converted C-Corp with respect to non-qualified benefit plans.

The difference in the tax equity accounts between the two types of S-Corps is that the converted C-Corp has an Earnings and Profits Account. This account represents the taxable dividend paying capacity of the C-Corp at the time of conversion. As shareholder taxable income or loss and distributions are recorded each year for the S-Corp, they increase or decrease the Accumulated Adjustments Account. If that account were ever to go below zero via a distribution, then the S-Corp shareholders could be taxed to the extent the excess distribution represents Earnings and Profits when they were a C-Corp.

As noted above, non-qualified benefit plans are frequently informally funded by bank owned life insurance and this investment generates tax- free income to the bank. For S-Corps, this tax –free income is recorded in the "Other" Equity Account. At the end of a plan where the bank has received tax-free income in the form of death proceeds, the originally incorporated S-Corp may distribute money to its shareholders tax free to the extent of the balances in the Accumulated Adjustments Account and the Other Adjustments Account. In other words, the S-Corp that was previously a C-Corp does not have the ability to distribute tax-free the equity in the "Other" Adjustments Account without first fully exhausting the Earning and Profits equity account. As previously mentioned, a distribution of Earnings and Profits causes a taxable dividend situation.

The new popularity of S-Corp in the banking industry poses new dilemmas and opportunities for planners in the non-qualified benefit plan arena. Planners must be cognizant of the type of S-Corp that they are advising. Non-qualified benefit plans must be properly structured to mitigate the tax burden to the shareholders.

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