Taxable Income on Group Term Life Insurance Plans Update

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Update: In the past, we have produced a late-year SilverLink Special Bulletin regarding the potential tax consequences of employer-sponsored group term life insurance plans. For the most part, these rules have generally remained unchanged for the past decade.

However, the IRS recently issued a Private Letter Ruling, (PLR 201542003), which addresses a common question posed by many employers when calculating income attributable to Group Term Life Plans. A brief summary of that Ruling is as follows:

In this Private Letter Ruling, the taxpayer (also an insurance carrier) requested a Ruling that the optional life insurance offered to employees be deemed not “to be carried by the employer,” because optional coverage rates did not straddle Table I rates and that the coverage was not sold in conjunction with other coverage. In addition, the taxpayer pleaded that the insurance did not involve “permanent” insurance and that the premiums were “properly allocated” between policies.

Up to the time of this request for a Ruling, in most cases, the optional life insurance coverage is included in the calculation of the value of Group Term (Section 79) Life insurance. In this case, the IRS concluded that the employer could treat the optional life as separate and no income would be imputed to employees under Section 79.

Note: Before treating basic and optional group term life plans separately for tax purposes, we want to advise you that such rulings apply only to the named taxpayer, and you should secure written assurances from the insurance carrier that such coverage meets all of the above conditions, and contact competent legal counsel. It is our experience that most optional group term life insurance plans contain rating structures that straddle the Table 1 rates and, therefore, the Ruling may not apply.

Background

Many employers include Group Term Life Insurance as part of their employee benefits package. The Internal Revenue Code provides regulations to be followed in computing taxable income for employees and dependents covered under a Group Term Life Plan.

This Bulletin will assist sponsors of Group Term Life insurance plans by discussing the following:

- IRC Section 79 regulations, in general.
- The steps necessary to calculate imputed income for employees or retirees with group term life benefits in excess of $50,000 in a nondiscriminatory plan.
- Procedures to determine whether a group term life plan is discriminatory.
- The steps necessary to calculate imputed income for employees or retirees in a discriminatory plan.
- The application of IRC Section 79 rules to FICA and FUTA taxes, supplemental and dependent life insurance plans and IRC Section 125 cafeteria plans.
IRC Section 79 Regulations, In General

The value of employer-provided group term life insurance up to $50,000 is tax exempt under IRC Section 79(a). The value of amounts exceeding $50,000 is taxable to the employee or retiree. For the purposes of the exclusion, “employee” is defined as a person who performs services in the legal relationship of employer and employee. Therefore, a partner or a sole proprietor would not be eligible for the $50,000 exclusion. A “retiree” is a former employee who has satisfied the retirement provisions of the plan.

The taxable cost of the coverage is determined from Table I in the regulations, Section 1.79-3(d)(2). Any employee contributions made on an after-tax basis are subtracted from the cost of the coverage over $50,000.

When is Group-Term Life Carried Directly or Indirectly by the Employer?

An important step in determining if a benefit is group-term life insurance under Section 79 is whether it is “carried directly or indirectly” by the employer. Group term life insurance is “carried directly or indirectly” by an employer if: 1) the employer pays any part of the cost of the insurance directly; or 2) the employer arranges for payment of the cost of the insurance by the employees, and at least one employee pays under the cost as determined by Table I and one pays over the Table I cost.

Note: If employees pay with after-tax dollars and all the rates are either above or below the Table I rates, the insurance is not “carried directly or indirectly” by the employer and there is no imputed income. This applies only for the payment of a separate policy where there is no cross-subsidization with employer-provided group term life insurance.

Nondiscriminatory Plans

A Nondiscriminatory Plan provides each employee an amount of Group Term Life coverage that is either a constant multiple of salary or the same flat amount. Additionally, a Nondiscriminatory Plan applies a common eligibility requirement and contribution level to all employees.

If the cost of life insurance is paid entirely by the employer, or if the employee contributes to the cost on a pretax basis through a Section 125 Plan, employers are required to report the cost of coverage in excess of $50,000 as “other compensation” on the employee’s Form W-2.

The steps necessary to calculate the amount to be charged as income to an employee in a Nondiscriminatory Plan are as follows:

1. Determine the total amount of group term life benefit currently provided. From this total life benefit, subtract the $50,000 exclusion.

2. Multiply the result of Step 1 by the monthly uniform premium amount for the insured’s current age at year end (See Table I).

3. Multiply the result of Step 2 by the number of months for which coverage was in force during the current year.

4. Subtract any amount contributed by the employee on an after-tax basis.
**Sample Calculation**

**Non Contributory Plan**—The employer pays the entire premium.

**Assumptions:**
Employee age 55 with $125,000 of coverage  
Spouse age 42 with $55,000 of coverage

**Employee:**
Total insurance amount $125,000  
Less $50,000 exemption* - 50,000  
Annual cost of employee insurance/Table I  
\[\$0.43 \times 75 \times 12 = 387.00\]  
**Dependent:**
Annual cost of dependent insurance/Table I  
\[\$0.10 \times 55 \times 12 = 66.00\]  
Total amount included in employee’s gross income  
and subject to FICA tax (if employee’s income is  
less than $118,500) $453.00

* Under discriminatory plans, key employees would lose the $50,000 exemption.

**Discriminatory Plans**
The discussion of discriminatory plans will center on the answers to three questions:
1. Who is a key employee?  
2. What is a discriminatory plan?  
3. How is the value computed for key employees in a discriminatory plan?

1. **Who is a key employee?**
IRC Sections 79(d)(6) and 416(i) define a key employee as any employee who, at any time  
during the plan year, is one of the following:
   a. An officer having an annual compensation in excess of $170,000 in 2015 (family  
       attribution rules apply). No more than 50 employees (or, if less, the greater of three  
       employees or 10% of employees) shall be treated as officers;  
   b. A more than 5% owner of the employer; or  
   c. A more than 1% owner of the employer having an annual compensation of more than  
       $150,000 (family attribution rules apply, and determined without considering those  
       employers who are not counted in testing for discriminatory eligibility).

*Note:* The term “key employee” also includes any former employee who was a key  
employer when he/she retired or separated from services (IRC Section 79(d)(6)).

If the employer is part of a controlled group of corporations (IRC Section 414(b)), businesses  
under common control (IRC Section 414(c)), or an affiliated service group (IRC Section 414  
(ml)), its employees are aggregated with employees of the other organizations in the group  
for purposes of the discrimination review.
2. **What is a discriminatory plan?**

The second step is to determine whether the plan satisfies the eligibility and benefit requirements of IRC Section 79.

**Nondiscriminatory Eligibility Requirements**—A plan will satisfy the eligibility requirements established under IRC Section 79(d)(3)(A) if the plan meets any one of the following:

a. The plan benefits 70% or more of all employees of the employer.
b. The plan benefits a group of employees of which at least 85% are not key employees.
c. The plan benefits employees who qualify under a classification set up by the employer and found by the Secretary of the Treasury not to discriminate in favor of key employees.
d. The plan is part of, and meets the requirements of, a cafeteria plan as determined by IRC Section 125.

The following groups of employees may be excluded for purposes of the eligibility review:

a. Employees with less than three years of service.
b. Part-time or seasonal employees.
c. Employees covered under a collective bargaining agreement.
d. Nonresident aliens who receive no U.S. source of income.

**Nondiscriminatory Eligibility Example**—An employer with 100 employees covers 40 employees under the plan. Of the 40 employees covered, 8 are key employees. The plan fails the eligibility test because it does not benefit 70% of all employees, nor are 85% of the plan participants non-key employees.

**Nondiscriminatory Benefit Requirements**—If the plan provides a fixed amount of insurance which is the same for all covered employees, the plan will automatically satisfy IRC Section 79 nondiscriminatory benefit requirements. In all other situations, except one, the plan will satisfy the benefit requirements only if benefits available to participating key employees are also available to all other participating employees. The one exception is for plans which offer a uniform percentage of earnings benefit to both key and non-key employees. Plans will not be considered discriminatory merely because the amount of life insurance provided to employees bears a uniform relationship to compensation (e.g., all employees are provided an amount of life insurance equal to 100% of their earnings).

Guidelines for the nondiscriminatory benefit requirements are outlined in Question & Answer 9 of Treasury regulations, Section 1.79-4T. These are reviewed below:

a. Once key employees are identified, separate plan participants into one or more groups consisting of at least one key employee and all other participants (including other key employees) who receive an amount of insurance (as a multiple compensation) equal to or greater than the amount of insurance received by such key employees.
b. Each of these groups will then be tested separately under the requirements of IRC Section 79(d)(3)(A) as described previously, with respect to the eligibility requirements.
c. If any of the groups fail to satisfy the requirements, as outlined in Step b above, the plan does not satisfy the nondiscriminatory benefit requirements.

**Nondiscriminatory Benefit Example**

*Example 1:* An employer’s plan has 500 participants. Of the participants, 400 are non-key employees who receive an amount of insurance equal to one times compensation. Also participating are 90 non-key employees and 10 key employees who receive an amount of insurance equal to two times compensation. The plan satisfies the benefits test because the
group of participants receiving an amount of insurance equal to or greater than two times compensation (the only group that must be separately tested in this example) satisfies the requirement that at least 85% of the employees in the two times group are non-key employees.

**Example 2:** Using the same fact situation as above, except that one of the key employees receives an amount of insurance equal to three times compensation, the plan fails the benefits test because, when tested separately, the group consisting of the single key employee receiving three times compensation cannot satisfy the nondiscriminatory eligibility requirements of IRC Section 79(d)(3)(A).

3. **How is the actual cost computed for key employees in discriminatory plans?**

Key employees in discriminatory group term life insurance plans must, under IRC Section 79 (d)(1)(B), include in gross income the greater of actual cost or Table I cost for such coverage. The $50,000 exclusion does not apply. However, this amount may be offset by the employee’s after-tax contribution, if any.

The discriminatory status of the plan does not affect the employer’s tax deduction. Even if the plan is discriminatory, the employer will not lose its tax deduction under IRC Section 162(a).

“Actual cost” does not mean the typical blended rate charged by the insurance company; it means the age-rated term costs (i.e., tabular premiums) as actuarially calculated to the insurer. The formula is described in Question & Answer #6 of Treasury Regulations Section 1.79-4T. This Section is not reproduced herein due to the length of the 1960 Basic Group Rate Tables.

The steps necessary to calculate the amount to be charged as income to a key employee in a discriminatory plan are as follows:

a. Calculate the “Actual Cost” according to Question & Answer #6 of Treasury Regulations Section 1.79-4T.

b. Compare the actual cost calculated in Step 1 to the Table I cost for the key employee. The key employee must then include as taxable gross income the value of the coverages as determined by the greater of actual cost or Table I.

c. Multiply the result of Step 2 by the number of months the key employee’s coverage was in force during the year.

**Sample Calculation**

**Contributory/Discriminatory Plan**— The employer pays a portion of the premium and the employee pays a portion with after-tax contributions.

**Assumptions:** Key employee age 60 with $200,000 coverage (employer pays $.30; employee pays $.15 on an after-tax basis)

**Key Employee:**

Actual Cost $2,520

**Key Employee: Table I Cost**

\[
\text{[$0.66 \times 200 \text{ (# of thousands)} \times 12 \text{ (months)}]} \quad 1,584
\]

\[
\text{\$4,104}
\]
Greater of Actual or Table I Cost

LESS: Cost of Key employee insurance attributable to employee’s after-tax contribution
[$.15 x 200 (# of thousands) x 12] 360

Total amount included in employee’s gross income and subject to FICA tax (if employee’s income is less than $118,500) $2,160

Other Issues

Retiree Coverage
Retirees receiving group term life insurance must be taxed on the value of coverage in the same manner as are active employees. Retirees also receive the $50,000 exclusion unless the plan is discriminatory. In determining if a plan is discriminatory, retiree coverage should be tested separately from active employee coverage. For purposes of the discrimination requirements, a retiree is considered a “key employee” if he was a key employee at the time of his retirement.

An exception to the taxable income rules applies to those who satisfy any one of the following:
- Retirees who retired prior to January 1, 1984.
- Retirees who had attained age 55 on or before January 1, 1984, if the retiree plan is currently discriminatory.
- Retirees who attained age 55 on or before January 1, 1984, even if the plan is discriminatory, if they actually retired prior to January 1, 1987.

Employee-Paid Basic, Supplemental or Optional Life Insurance
IRC Section 79 states that there will be no tax implications for employees who pay the entire cost of the group term life insurance if there is no direct or indirect subsidy of the cost of the insurance by the employer. No subsidy exists if the cost of the insurance, for all employees, is either above or equal to Table I rates, or below or equal to Table I rates. If the cost of insurance for some employees is above Table I rates and below Table I rates for other employees, a subsidy exists.

If a subsidy exists, an employee whose cost exceeds Table I cost will have no imputed income, while an employee whose cost is less than Table I cost will have imputed income.

Dependent Life
Dependent group term life insurance is considered by the IRS to be a nontaxable benefit if the insurance amount does not exceed $2,000 per dependent. If the benefit is greater than $2,000, the employees must include as income the cost of the entire employer-provided coverage. The rules outlined in this Bulletin relative to employee group term life insurance also apply to the calculation of taxable amounts for dependent life coverage.

To calculate imputed income, Table I rates are used based on the dependent’s age in the same manner used for employee group term life coverage. The entire employer-provided amount is taxable if the benefit amount exceeds $2,000. Unlike the first $50,000 of employee coverage, the first $2,000 of dependent coverage is not an exclusion.

As with employee-only coverage, however, the after-tax contributions by the employee toward the cost of dependent coverage can be used to offset the taxable amounts computed under these rules. If, after deducting the employee’s after-tax contribution, the excess amount is equal to or less than Table I cost for a face amount of $2,000 of insurance, then the benefit will be treated as nontaxable.
The IRS has stated that there will be no imputed income only if the employee pays the entire Table I cost of employer-provided dependent life coverage for each dependent. Therefore, it will still be necessary for employers with noncontributory flat rate plans to make calculations of imputed income for employees with multiple dependents.

**FICA Taxes**
In addition to the income tax assessed on amounts of group term life insurance in excess of $50,000, it also requires that FICA (Social Security) taxes be imposed on amounts of group term life in excess of $50,000.

Most employers calculate group term life imputed income on an annual basis. Therefore, the IRS allows employers to withhold the FICA taxes applicable to the group term life coverage from the employee’s last paycheck of the year. Employees who terminated employment mid-year are responsible for remitting their share of the FICA taxes applicable to the imputed income. Retirees are subject to the FICA tax provisions unless they retired prior to January 1, 1989.

**FUTA Taxes**
The value of an employee’s group term life insurance, which is includable as taxable income under IRC Section 79, is not subject to Federal Unemployment Tax (FUTA).

**IRC Section 125 Cafeteria Plans**
Contributions funded through an IRC Section 125 cafeteria plan or premium conversion plan on a pre-tax basis cannot be used to reduce the taxable income, which must be added to an employee’s W-2 under IRC Section 79. In the past, Notice 89-110 issued by the IRS indicated that an employee who received life insurance under a cafeteria plan included in his or her gross income the greater of the employee’s contribution toward such insurance or the Table I cost. However, a provision of the New Proposed Section 125 Regulations changes the manner in which group term life insurance in excess of $50,000 is taxed when provided on a pre-tax basis. The new rule indicates that the salary reduction is tax-free in all circumstances, and the amount included as income is the Table I rate for pre-tax coverage in excess of $50,000, even if the salary reduction is greater.

<table>
<thead>
<tr>
<th>Five Year Age Bracket</th>
<th>Cost per $1,000 of Protection for One-Month Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 25</td>
<td>$0.05</td>
</tr>
<tr>
<td>25 through 29</td>
<td>0.06</td>
</tr>
<tr>
<td>30 through 34</td>
<td>0.08</td>
</tr>
<tr>
<td>35 through 39</td>
<td>0.09</td>
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<td>40 through 44</td>
<td>0.10</td>
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<tr>
<td>45 through 49</td>
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<td>55 through 59</td>
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<td>65 through 69</td>
<td>1.27</td>
</tr>
<tr>
<td>70 and above</td>
<td>2.06</td>
</tr>
</tbody>
</table>

In using the Table, the age of the employee/dependent is the attained age on the last day of the taxable year.