

BENEFIT *Advisor*

In This Issue

As tax time rolls around again, this ninth issue of the McGraw Wentworth Benefit Advisor will focus on the tax consequences of group term life insurance as defined in TITLE 26--INTERNAL REVENUE CODE, Subtitle A--Income Taxes, CHAPTER 1--NORMAL TAXES AND SURTAXES, Subchapter B--Computation of Taxable Income, PART II--ITEMS SPECIFICALLY INCLUDED IN GROSS INCOME, Section 79. Group-term life insurance purchased for employees. Or as it is generally known, IRC Section 79.

This issue provides a general explanation of Section 79 and its impact on employer-sponsored group term life insurance plans. It highlights non-discrimination requirements, plan discrimination determination and the tax treatment of group term life insurance as well as recent revisions to Table I.

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Internal Revenue Code: Section 79 TAX CONSEQUENCES OF GROUP TERM LIFE INSURANCE

Internal Revenue Code (IRC) Section 79 sets forth rules governing the income tax treatment of employer-sponsored group term life insurance on employees. Additionally, it prohibits group term life insurance plans from favoring key employees by establishing non-discrimination rules.



This technical bulletin addresses the key provisions of Section 79 and offers guidance for determining what portion, if any, of your employer-sponsored group term life insurance amount may be taxable to an employee and how to determine the appropriate cost for tax purposes. We will also address the revised Table I rates that went into effect July 1, 1999 and its impact on employers and employees alike.

General Explanation

Under a plan that meets the requirements set forth in Sections 79 (a), (b) and (d), all employees may be provided group term life insurance coverage up to \$50,000 without income tax consequences. Amounts in excess of \$50,000 gen-

erate taxable income to the insured employee (imputed income). If a plan is found to be discriminatory under the terms of Section 79 — that is, if the plan favors key employees — the “cost” of the entire amount of employer-sponsored group term life insurance to those key employees is taxable.

Any portion of the benefit that is taxable must be added to the gross income of that employee’s W2. The amount to be included in the gross taxable income, the “cost” of the life insurance, is specifically outlined in Section 79.

Further, Section 79(b) sets forth two exceptions to the taxation rules. The value of employer-sponsored group term life insurance need not be included in the taxable income of an employee in either of these circumstances:

- *When an individual has terminated employment and is disabled for the purposes of*

IRC Sec. 72(m)(7). The employee must provide proof of disability with the income tax return for the first year of disablement; thereafter, a statement indicating continued disablement is required.

- *If a charitable organization is named the sole beneficiary of all or part of the policy. There can be no contingent beneficiary and the assignment or designation must be in effect for the full taxable year.*

Non-Discrimination Requirements

IRC Section 79(d) contains non-discrimination requirements, which a plan must meet in order for the \$50,000 exclusion to apply to all employees. As noted above, if the plan is found to discriminate in favor of key employees, the "cost" of the entire amount of employer-sponsored group term life insurance on each key employee, including the first \$50,000, must be included in the individual's gross taxable income.

For a group term life insurance plan to be considered non-discriminatory, it must meet both a "benefit eligibility" standard and a "benefit amount" standard. Failure to meet either standard changes the tax treatment for key employees.

Benefit Eligibility

The "benefit eligibility" standard requires that the plan not discriminate in favor of key employees in determining eligibility to participate in the plan. A group term life insurance plan satisfies the benefit eligibility standard if it meets any one of the following four criteria:

- *The plan benefits at least 70% of all employees of the employer.*
- *At least 85% of all employees who are participants under the plan are not key employees.*
- *The plan benefits employees who qualify under a classification set*

up by the employer and found by the Treasury Secretary not to discriminate in favor of key employees.

- *If part of a cafeteria plan, the plan satisfies the non-discrimination requirements applicable to such plans under IRC Sec. 125.*

In determining if a plan satisfies the benefit eligibility requirement, the employer may disregard certain groups of employees. These include a) employees who have not completed at least three years of service, b) part-time or seasonal employees, c) employees who are

covered by the terms of a collective bargaining agreement if the benefits provided under the plan were the subject of good-faith bargaining between the employer and the employees (even if the union employees are not covered by a comparable plan) and d) employees who are non-resident aliens and receive no



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DEFINITIONS

Employee	A person who performs services if his or her relationship to the person for whom services are performed is the legal relationship of employer or employee
Group of Employees	All employees of an employer, or less than all employees if membership in that group is based solely on age, marital status, or factors related to employment.
Key Employees	An employee who is any one of the following: -an employee owning more than 5% interest in the employer, whether incorporated or not; -an employee owning more than 1% interest and whose compensation or earned income from the employer exceeds \$150,000 per year; -an officer of the employer whose annual compensation exceeds 50% of the annual defined benefit plan limitation in effect for any of the preceding 5 plan years. No more than 50 of the most highly compensated officers need to be recognized for the purpose of identifying key employees. If there are less than 50 officers, only the most highly compensated 10%, but not less than three, are recognized.
Group Term Life Insurance	Life insurance that meets the following conditions: -provides a general death benefit that is excludable from gross income. -provided to a group of employees. -provided under a policy carried directly or indirectly by the employer. -amount of insurance provided to each employee is computed under a formula that precludes individual selection.

earned income from the employer.

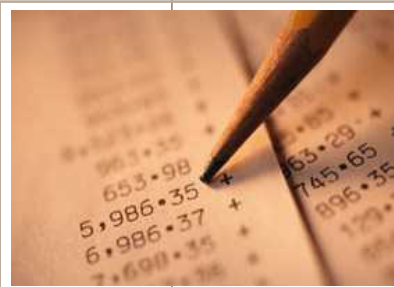
The “benefit eligibility” standard applies to disabled employees, former employees and retired employees. In determining if a plan is discriminatory, retiree coverage should be tested separately from active employee coverage, just as former employee coverage should be tested separately from active employee coverage.

Benefit Amount

The “benefit amount” standard requires that the type and amount of benefits under the plan not discriminate in favor of key employees. A group term life insurance plan satisfies the benefit amount standard if the plan provides the same amount of insurance for all employees. It also satisfies this standard if the benefit amount is based upon the identical percentage of each employee’s compensation (e.g., 200% of annual earnings on all employees).

If the plan does not provide the same amount for all employees, such plans will be considered to not discriminate in favor of key employees, as to the amount of benefits available, if the plan contains no group of employees that, if tested separately, would fail the “benefit eligibility” standard.

For example, a plan has 500 participants, 10 of whom are key employees. The 10 key employees and 90 of the non-key employees receive a benefit equal to 200% of compensation. The remaining 400 non-key employees receive a benefit equal to 100% of compensation.



The plan does not discriminate in favor of key employees because, when tested separately, the group of participants receiving an amount of insurance equal to 200% of compensation satisfies the “benefit eligibility” standard (where 85% of participants are not key employees).

If one of the key employees received an amount of insurance equal to 300% of compensation, the plan would discriminate in favor of key employees, because, when tested separately, the group consisting of the single key employee receiving an amount of insurance equal to 300% of compensation would fail to satisfy the “benefit eligibility” standard (where 85% of participants are not key employees).

In determining the groups of employees to be tested, allowances are made for reasonable differences in amount of insurance due to rounding, the use of compensation brackets, or similar factors. All of the facts and circumstances are taken into account

in determining whether the plan is discriminatory.

Special Exceptions

The IRC provides two exceptions to the non-discrimination rules under IRC Sec. 79(d).

- **A church plan of group term life insurance maintained for church employees is not subject to the IRC Sec. 79(d) non-discrimination requirements. For purposes of the exclusion, a church plan is a plan established and maintained by a church for its employees.**
- **Additional group term life insurance purchased by an employee at the employee’s own expense is not taken into account in determining if a plan is discriminatory. The exception is available even if the group of employees who actually purchase the additional coverage would not satisfy the eligibility requirements if tested separately. However, if additional coverage is available to key employees but is not available to non-key employees, the plan is considered discriminatory.**

Affect of Optional Life

If a company provides employees the option to purchase additional (optional) coverage, it could trigger taxable income to the employee. If the employees

HOW TO CALCULATE THE COST OF GROUP TERM LIFE INSURANCE

For all employees in a non-discriminatory plan or non-key employees in a discriminatory plan:

Step 1: Determine the total group term life insurance benefit amount and subtract \$50,000.

Step 2: Multiply the result from Step 1 by the monthly uniform premium amount in Table I based upon the employee's age at year end.

Step 3: Multiply the result from Step 2 by the total number of months which the employee's coverage was in force during the year.

Step 4: From the result from Step 3, subtract the total dollar amount the employee contributed toward the cost of group term life insurance during the year.

For the key employees under a discriminatory plan, the calculation is more complicated. It requires a copy of the insurer's table of premium rates (on an attained age basis) used to calculate the group composite premium rate. Once this table has been obtained, several steps are required to determine the greater of "actual cost" or the Table I costs.

If you find that your plan is discriminatory, ask your broker/consultant or insurance company representative to assist you in obtaining the table from your insurer and in calculating the appropriate taxable cost of the group term life insurance on key employees.

pay the premium with post tax earnings, and the company plan has rates that straddle (e.g., are both higher and lower than Table I), any employee paying less than Table I must have the difference in cost added to their gross income. If the employees pay premium with pre-tax earnings (e.g., IRC Section 125), the amount of optional coverage purchased is added to any company paid (basic life) benefits, and if the total exceeds \$50,000, imputed income tax is payable.

Taxation

In a plan that is found to be non-discriminatory, all employees qualify for the exclusion on the first \$50,000 of employer-sponsored group term life insurance. Coverage in excess of \$50,000 results in taxable income in an amount equal to the "cost" of group term life insurance coverage. The "cost" of group term life insurance is calculated based on the employee's age and the monthly uniform premium amount shown in Section 79, Table I, which is included in this bulletin. For step-by-step in-

structions on calculating the cost to be reported as taxable income, see the section entitled "How to Calculate the Cost of Group Term Life Insurance".

In a plan that is found to be discriminatory, key employees lose the tax exclusion on the first \$50,000 of coverage. They are taxed on the value of the entire amount of the group term life insurance coverage, less any employee contributions. However, in this instance the cost of group term life insurance is the greater of the "actual cost" or the monthly uniform premium amount in Table I. The "actual cost" does not mean the typical composite rate presented to the plan sponsor by the insurer. Instead, it means the age-graded term costs (based on the key person's actual age), as actuarially determined by the insurer.

The following chart summarizes the rules on the taxation of group term life insurance coverage based upon their plan discrimination status:

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Taxation Rules	Non-Discriminatory Plan	Discriminatory Plan
Non-Key Employees	Amounts in excess of \$50,000 are taxable. This cost is determined using Table I.	Amounts in excess of \$50,000 are taxable. This cost is determined using Table I.
Key Employees	Amounts in excess of \$50,000 are taxable. This cost is determined using Table I.	The full amount is taxable. The cost is determined by the greater of the actual cost or Table I.

The 1999 Regulations

The IRS issued new Section 79 regulations that were effective July 1, 1999. The new regulations modified the Table I rates and provided guidance to employers that offer group term life insurance to their employees. There were three key changes:

- *Added one age bracket (age 25-29) to Table I*
- *Reduced uniform rate schedule of Table I*
- *Increased likelihood that optional life plans will create taxable income to employees (even when paid with after-tax earnings)*

Prior to July 1, 1999, Table I had only 10 age brackets with the lowest age bracket being "Under 30". Effective July 1, 1999, there was an additional age bracket (25-29) added, with the lowest being "Under 25". Through December 31, 1999, employers were able to choose to use the 25-29 or under 25 age bracket for those employees under the age of 25. Therefore, changes to payroll systems did not have to be in place until January 1, 2000. Employers' payroll systems should reflect the additional age bracket.

Because the 1999 regulations reduced the Table I rates, employers were to carefully review their optional life plan rate structure. Prior to July 1, 1999, most optional life plan costs were lower than Table I rates, and so employees purchasing coverage using after-tax income

had no imputed income. Due to the 1999 regulations the case may have changed. The change to the Table I rates lead to an increased potential for "straddling" (some rates higher and some rates lower) to occur. When straddling occurs, those employees paying lower than the Table I rates would have imputed income equal to the difference. It is important to remember, those plans in effect prior to July 1, 1999 that did

not "straddle" the old Table I rates do not have to start using the new Table I rates to determine if the policy is employer or employee paid until January 1, 2003. Remember, employees who paid for coverage with pre-tax earnings are treated differently (see "Affect of Optional Life" section). **MW**

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Previous and New Table I Rates Reviewed

Age Bracket	New Table I - Cost/\$1,000	Old Table I - Cost/\$1,000
Under 25 (new bracket, was combined as under 30)	\$0.05	\$0.08
25 to 29	\$0.06	\$0.08
30 to 34	\$0.08	\$0.09
35 to 39	\$0.09	\$0.11
40 to 44	\$0.10	\$0.17
45 to 49	\$0.15	\$0.29
50 to 54	\$0.23	\$0.48
55 to 59	\$0.43	\$0.75
60 to 64	\$0.66	\$1.17
65 to 69	\$1.27	\$2.10
70 and above	\$2.06	\$3.76

