

In This Issue

In this twelfth issue of the McGraw Wentworth Benefit Advisor for 2003, we will review Section 79 of the Internal Revenue Code. Section 79 addresses the tax treatment of employer-sponsored group term life benefits. Several areas of Section 79 can impact your employees. Each year, employers should review their life programs to determine if they need to calculate imputed income on any employees for employer-paid or supplemental life coverage.

We welcome your comments and suggestions regarding this issue of our technical bulletin. For more information on this Benefit Advisor, please contact your Account Manager or visit the McGraw Wentworth web site at www.mcgrawwentworth.com.

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

Section 79 of the Internal Revenue Code governs the tax treatment of employer-sponsored group term life insurance. Many organizations are familiar with the provision that employer-paid life insurance coverage amounts up to \$50,000 can be considered tax-free to the employee. This provision is only one part of Section 79. Section 79 also addresses several situations which could result in tax implications to your employees related to your life insurance program. When reviewing your organization's life plan, the following are key questions to consider:

- How does an employer meet the \$50,000 tax exemption for employer-paid life insurance?
- What are the non-discrimination requirements of Section 79 and how may that impact the tax treatment of life coverage provided to "key employees"?
- How does Section 79 guide the tax treatment of employer provided "dependent" life coverage?
- How may Section 79 impact an employee pay all supplemental or optional life insurance program?

- If necessary, how should an organization calculate the imputed income required by Section 79?

Section 79 is more complicated than most organizations realize. In an effort to clarify Section 79, we will address these issues as they apply to organizations that sponsor group term life insurance programs.



Employer Sponsored Coverage - \$50,000 Tax Free

In order to meet the \$50,000 tax exemption for employer-paid life benefits, it must be determined if the coverage is provided by a group life insurance plan. Section 79 defines "group of employees" as:

- All employees of an employer or a controlled group.
- A group of some employees of an employer, where membership in a covered group is determined by one of the following factors:
 - Age (subject to the requirements of the ADEA).

- Employment-related factors, including union membership, job duties, length of employment, compensation or participation in a company retirement, stock bonus or group insurance plan.

If the coverage is provided through a group term life insurance plan and the coverage amount is \$50,000 or less, the value of the insurance is not taxable to the employee. If the employer provides coverage in excess of \$50,000, the value of the additional coverage should be included in an individual's gross income. Section 79(b) contains two exceptions to the \$50,000 limit. In these two circumstances, even if the value of the employer provided coverage exceeds \$50,000, it is not includible in an individual's gross income:

1. If an employee is terminated and is considered disabled under the terms of Section 72(m) (7) of the Internal Revenue Code. In order to qualify for this exception, an individual must provide proof

of the disability with his tax return for the first year of disability and provide proof of continuing impairment for subsequent years.

2. If an employee names a charitable organization as defined under Section 170(c) as the sole beneficiary of all or part of life insurance proceeds. The charitable organization must be the named beneficiary for the entire plan year and a contingent beneficiary cannot be named. This exception applies if the employer is named the beneficiary of the policy as well.



Section 79 Non-Discrimination Requirements

For the tax exemption to apply to coverage amounts up to \$50,000 for

key employees, the plan must also meet the non-discrimination requirements of Section 79. The non-discrimination tests address eligibility and benefits.

Benefits Eligibility Standard

The plan cannot discriminate in favor of key employees when determining eligibility to participate in the employer paid group life plan. A group life plan will be considered discriminatory unless:

- The plan covers 70% of all employees.
- Eighty-five percent of all participants are not considered "key employees."
- The plan covers a non-discriminatory class of employees as determined by the Internal Revenue Service.
- If the plan is offered under a cafeteria plan, the cafeteria plan must satisfy the non-discrimination requirements of Section 125.

The following employees can be disregarded in determining if the benefit eligibility non-discrimination requirements are met:

- Employees who have not completed at least 3 years of service.
- Part-time or seasonal employees.
- Employees who are covered by a collective bargaining arrangement if the benefits provided under the plan were the subject of good faith

What is a Key Employee?

A key employee is any employee who at any time during the plan year is:

- A 5% owner;
- An employee owning more than a 1% interest in the company and whose compensation or income from the employer exceeds \$150,000 per year;
- An officer of the employer whose compensation exceeds \$130,000.

The Economic Growth and Tax Relief and Reconciliation Act of 2001 simplified the definition of key employee for plan years beginning after December 31, 2001. This law also added an indexing provision of threshold compensation of company officers. The \$130,000 amount will be indexed in \$5,000 increments and any increment that is not a multiple of \$5,000 will be rounded down to the next lowest multiple of \$5,000.

Continued on Page 3

bargaining between the employer and union.

- Employees who are non-resident aliens and receive no earned income from the employer.

In conducting the benefits eligibility testing, the non-discrimination standards apply to current, disabled, former or retired employees. Each class of employee offered benefits should be tested separate from active employees.

Benefit Amounts Standard

Section 79 also requires that a group life plan does not discriminate in favor of key employees by coverage type or amount.

A plan can automatically meet this standard if:

- The same amount of insurance is provided to all employees. For example, the plan provides a flat \$20,000 life benefit to all employees.
- If the benefit amount is based on a percentage of income, the plan provides the same percent of earnings to all covered employees. For example, all eligible employees are covered for one times their annual earnings.

If a plan does not provide the same coverage amount or percent to all employees, it does not mean the plan is discriminatory. The plan cannot discriminate in favor of key employees. If benefits are different across classes of employee, the plan needs to perform the eligibility test on each class.

An example will help clarify this situation. ABC Company offers all 400 of their hourly employees a life benefit equal to one times annual

earnings. All 100 salaried employees are covered for two times their annual earnings. There are no key employees in the hourly class and there are 10 key employees in the salaried class. If the benefits eligibility standards are applied, since at least 85% of the salaried employees are not key employees, this plan is not considered discriminatory.

If a third class of employees were added to ABC Company's plan and they received a benefit of three times earnings and the only members of this class were key employees, then this class would not meet the eligibility standards. The plan would be considered discriminatory.

Section 79 Exceptions

The Internal Revenue Code provides two exceptions to the non-discrimination rules:

- A church plan of group life insurance that is maintained for church employees. This does not apply church supported institutions of higher learning (other than a school for religious training) or a church supported non-profit medical or hospital facility.
- Any additional life insurance that is purchased by employees at their own expense is not included in the non-discrimination determination. If additional life insurance coverage is only made available to key employees, however, then the plan is considered discriminatory.

It is important to remember Section 79 requirements only apply to group term life plans. Group life plans do not include:

- AD&D coverage, travel accident insurance, or accident and health coverage
- Any permanent life insurance coverage that includes additional paid up options or cash surrender values
- Up to \$2,000 of employer-paid dependent life insurance is considered a "de minimis" fringe benefit and the value of this benefit is tax-free. If dependent coverage is paid for by the employee on an after-tax basis, it is still considered a "de-minimis" benefit.

Optional Life Insurance

Optional life insurance coverage could trigger taxable income to the employee. If the employee pays life premiums on an after-tax basis but your plan's optional life rate table "straddles" Table I rates, the employee may need to have the difference

in cost added to the W-2. This means that if your organization compares your optional life rate table to Table I rates and rate tiers are not "all over" or not

"all under" Table I, then certain age brackets are benefiting more from the employer sponsoring the group life plan. The employer must impute income for the value of the coverage for rate tiers that fall below Table I.

Table I is a rate table the IRS uses to calculate the "value" of employer



provided life insurance. Back in 1999, the IRS lowered Table I rates. If your organization has not checked your optional life rates against the new Table I rates, it should. Employers could use the old Table I rates when determining the straddle effect up to January 1, 2003. However, for the upcoming year, Table I rates are shown in the chart at the bottom of the page.

Calculating the Tax Consequences

The process for computing the tax ramifications to individuals is different depending on the situation. We will outline these three situations:

- I. Employer paid coverage that exceeds \$50,000
- II. Employer paid coverage that exceeds \$50,000 and the employee elects supplemental life coverage.

III. Employer plan offers benefits that discriminate in favor of key employees.

I. Employer Paid Coverage that Exceeds \$50,000

If an employer pays the full cost of life coverage, but provides coverage in excess of \$50,000 for certain employees, the imputed income calculation is fairly simple. First, your organization needs to identify which of your employees has life coverage in excess of the \$50,000 limitation. For the employees that exceed \$50,000 of employer-funded life benefit:

Step 1: Determine employee's life benefit.

For this example, the employer offers \$100,000 of coverage to all employees.

Step 2: Subtract \$50,000 from the amount of the life benefit.

$$\begin{aligned} \$100,000 - \$50,000 &= \\ \$50,000 \end{aligned}$$

Step 3: Divide the Step 1 result by 1,000.

$$\$50,000 / \$1,000 = 50$$

Step 4: Multiply the result from Step 2 by the Table I rate (based on the employee's age at the end of the year). The result here is the employee's monthly-imputed income.

If the employee is 43 years old, imputed income is $50 \times \$0.10 = \5.00 per month.

Step 5: Convert the result in Step 4 into a payroll frequency amount.

Note: Calculations made on a per payroll basis are not required, but they may be the most convenient method for the employer. That is because imputed income is subject to FICA withholding (but not federal income tax withholding) and that withholding amount must be paid at least once a year. If the employer does not withhold FICA on a per payroll basis, it will have to collect that amount at year-end or at the time of an employee's termination if an employee ceases employment during the year.

II. Employer paid coverage that exceeds \$50,000 and the employee elects supplemental life coverage

Often organizations offer a core life insurance benefit that is paid entirely by the employer. Employers also allow employees to purchase additional life coverage. Plans should set up the contributions on a post-tax basis to avoid complicating the imputed income issue. However, two specific scenarios can occur in these arrangements:

Table I Rates

Age Bracket	Table 1 Rates Per \$1,000 of Coverage
Under 25	\$0.05
25 to 29	\$0.06
30 to 34	\$0.08
35 to 39	\$0.09
40 to 44	\$0.10
45 to 49	\$0.15
50 to 54	\$0.23
55 to 59	\$0.43
60 to 64	\$0.66
65 to 69	\$1.27
70 and above	\$2.06

- Employer and employee life insurance combined exceed the \$50,000 limit. The optional life rate schedule does not straddle Table I rates and all rate tiers are above Table I.
- Same situation as outlined above, except several rate tiers fall below Table I.

Although these circumstances are similar, the calculation of imputed income varies.

Situation #1: Imputed income may be lowered where all employees pay for supplemental coverage with after-tax dollars at rates above the Table I rates.

An employer provides and pays for the base group term life insurance coverage for its employees equal to two times an employee's salary (rounded up to the next \$1,000). The plan allows employees to purchase, with after-tax dollars, supplemental coverage of one times salary at a rate that is at a rate above Table I (\$0.20 per \$1,000). For this example, we will assume the employee makes \$59,000 a year and is 46 years old. The employer provides \$120,000 in coverage and the employee purchases an additional \$60,000 on a post-tax basis. In this situation, an employer can use the supplemental benefit to calculate imputed income (which often is to the advantage to the employee) or it can calculate imputed income on just the employer-paid benefit as noted above. The following details how this situation should be handled:

Part A: Review the following calculation:

Step 1: Determine the total coverage provided and subtract \$50,000

\$120,000 employer paid plus
\$60,000 employee paid

$$\$180,000 - \$50,000 = \$130,000$$

Step 2: Determine the imputed income per month

$$\$130,000 / \$1,000 = 130$$

$$130 \times \$0.15(\text{Table I rate for 46}) = \$19.50$$

Step 3: Determine the premium for optional life paid on an after-tax basis

$$\$60,000 / \$1,000 = 60 \times \$0.20 (\text{optional life rate}) = \$12.00$$

Step 4: Subtract optional premium from imputed income calculation

$$\$19.50 - \$12.00 = \mathbf{\$7.50 \text{ per month}}$$

Part B: If the employer only used the employer paid benefit, the calculation and imputed would be as follows:

Step 1: \$120,000 - \$50,000 = \$70,000

Step 2: \$70,000 / 1,000 = 70

Step 3: \$0.15 x 70 = **\$10.50 per month**

As this example demonstrates, it is generally advantageous to include supplemental coverage in the imputed income calculation when employees pay for that coverage on an after tax basis at rates above the Table I rates. This is because the imputed income calculation is offset by rates that all fall above Table I.

If the situation were reversed and all the optional life rates fell be-

low Table I, then it is not in your employee's best interest to calculate imputed income taking into account supplemental life coverage.

Situation #2: Imputed income where some employees pay for supplemental coverage with after-tax dollars at rates above the Table I rates and other employees pay at rates below the Table I rates (the "straddle" situation):

Where some employees pay for supplemental coverage with after tax dollars at rates above the Table I rates, and other employees pay at

rates below the Table I rates, the "straddle" circumstance occurs. In this situation, the IRS indicated that the supplemental group term life insurance plan is

deemed "carried", which means some individuals are benefiting more from the employer sponsoring the plan than others, and, despite the fact the coverage is entirely paid by the employee, there should be a tax implication. If this is the situation with your plan, both employer-paid and supplemental life coverage *must* be included when determining employees' Section 79 imputed income. The calculation will be the same as outlined in Part A of the example above.

From a practical standpoint, your employees with life rate tiers above Table I will benefit from the combined calculation, and those with rate tiers below Table I will have additional imputed income. Your organization, however, is required to calculate imputed income taking into account both employer paid and supplemental coverage when



your optional life rate table "straddles" Table I.

In all the above examples, supplemental life coverage is paid on an after-tax basis. Life insurance coverage paid by employees on a pre-tax basis offers no economic benefit to employees. Any reduction in an employee's taxable wage income will be offset by a corresponding increase in that employee's imputed income.

III. Employer plan offers benefits that discriminate in favor of key employees

If an employer-provided group term life plan discriminates in favor of "key employees," the imputed income calculation is different for **key employees only** in two ways:

1. Key employees do not get the \$50,000 benefit exemption; the full amount of their life insurance is subject to imputed income calculations.
2. The calculation must be done using the Table I rates or the actual rate charged by the insurer. The employer should use the greater of Table I or actual carrier rates when reporting the imputed income.

Important Note: The IRS does not clearly define the "actual rate" charged by the insurer. It is clear that employers should not use the composite rate charged per \$1,000 of life coverage. Your composite rate is determined by melding age-banded rates for your employee population. You will need to ask your insurer for the actual cost for your key employees to determine the actual carrier cost. It could be argued that the actual cost can also take into account any effective discounts the carrier has applied to your composite rate. For example,

if your insurer took a 15% discount off the manual composite rate during the quoting process, you could take that discount off your key employee age rate prior to determining actual cost for imputed income purposes.

Conclusion

Organizations need to review their group life plans to determine if imputed income needs to be added to employees' pay. There are several opportunities for imputed income to be required as determined by Section 79 of the Internal Revenue Code.

Employers should review the following questions to determine if their plans are affected:

- **Does your organization provide employer paid life insurance that exceeds \$50,000?** If so, imputed income needs to be calculated on the amounts that exceed \$50,000.
- **Does your organization offer supplemental life coverage?** If so, check the rate table

against the Table I rates in this Advisor. If the rates straddle Table I, imputed income will need to be calculated accordingly.

- **Does your group life plan discriminate in favor of key employees?** If it does, imputed income needs to be calculated on the full value of your key employees' life coverage as outlined in this Advisor.

Section 79 can affect both employer paid and supplemental life benefits sponsored by your organization. Review your organization's plan to determine if you have any obligation to impute income based upon the requirements of Section 79. **MW**

Our technical bulletins are written and produced by McGraw Wentworth staff and are intended to inform our clients and friends on general information relating to employee benefit plans. They are not intended to provide either legal or tax advice. Before implementing any welfare or pension benefit program, employers are urged to consult with their benefits advisor and/or legal counsel for advice that is appropriate to their specific circumstances.

McGraw Wentworth
3250 West Big Beaver Road, Suite 500
Troy, MI 48084
Telephone: 248-822-8000 Fax: 248-822-4131
www.mcgrawwentworth.com