McGraw Wentworth

BENEFIT Advisor

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In This Issue

In this eleventh issue of the McGraw Wentworth Benefit Advisor for 2008, we provide our annual review of Section 79 of the Internal Revenue Code. This Advisor will address the impact of Section 79 on employer-sponsored group term life plans. Section 79 also addresses the non-discrimination requirements of term life plans and the tax consequences of certain employer-provided life insurance 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"

Section 79 of the Internal Revenue Code addresses the potential tax implications for employer-sponsored group *term* life insurance. It addresses the tax consequences of all the following situations involving employer-sponsored group term life insurance:

- Employer-paid term life coverage that exceeds $50,000.
- Impact on "key employees" if the life plan is deemed discriminatory.
- Employer-sponsored voluntary life coverage that may be deemed "carried" by the employer.
- Employer-sponsored voluntary life insurance paid for with pre-tax dollars under a Section 125 plan.

Providing an employer term life plan is considered non-discriminatory, Section 79 permits up to $50,000 of employer-paid group life insurance coverage to be considered tax-free. Every year, employers must calculate the impact of offering employees more than $50,000 in employer-paid life coverage. Employers must also conduct non-discrimination testing on the life plan to determine if there may be additional tax consequences on key employees. Finally, employers need to review their voluntary life coverage to determine if any income needs to be imputed on the voluntary plan as well.

This *Advisor* clarifies the key areas that your organization needs to review at the end of each year for Section 79.

Each section explains how to determine if Section 79 impacts the tax status of your life insurance benefits. If you determine your organization should impute income on any life insurance provided to the employee, each section will discuss how to calculate the appropriate imputed income amount.

Remember, Section 79 does **not** pertain to employer-sponsored *whole* life insurance or accidental death and dismemberment coverage.

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Tax Implications for Non-Discriminatory Employer-Paid Life Insurance Coverage That Exceeds $50,000

Providing your plan is considered non-discriminatory, up to $50,000 of employer-paid term life insurance coverage is tax-exempt under Section 79. Discriminatory plans will be discussed in the next section. To determine whether this part of Section 79 will affect your employees, you will need to review the benefits your plan provides.

The first step is to determine if your plan is considered an ***employer-paid group term life*** insurance plan. If you pay the employee's entire life coverage premium, the coverage amount is considered employer-provided. Some employers pay for base coverage, but allow employees to pay for additional life insurance coverage. This section concerns only the group term life benefits your organization pays for your employees.

Section 79 defines "group of employees" as:

- All employees or a controlled group of employees.
- Employees considered to be in a covered group because of one of the following factors:
  - Age (subject to ADEA requirements).
  - 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 you provide $50,000 or less in employer-paid group term life coverage, your employees do not have to pay tax on the insurance value. On the other hand, if you provide more than $50,000 in coverage, your organization will most likely need to include the value of the additional coverage in any *affected* employees' gross income.

In the following three circumstances, even if the value of the coverage you provide exceeds $50,000, you do not need to include the value in the employee's gross income:

1. If a terminated employee is considered disabled under the terms of Section 72(m)(7) of the Internal Revenue Code. In order to qualify for this exception, employees must submit proof they are disabled with their tax returns for the first year of disability and submit 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. This exception applies if the employer is named the beneficiary of the policy as well.
3. Your plan existed on January 1, 1984 and the life benefit is for an employee that retired before January 2, 1984 and was covered by the plan at retirement. The employee also must have reached age 55 before January 2, 1984 and was employed by your organization or it's predecessor.

As you can see, there are very limited situations when an employee or former employee will not be taxed on the value of employer provided life insurance exceeding $50,000.

Table I Rates Per $1,000 of Coverage

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

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Calculating the Tax Consequences

Employer-Paid Group Term Life Coverage that Exceeds $50,000

If you pay the full cost of your employees' group term life coverage, and provide coverage of more than $50,000 for certain employees, follow the steps below to calculate imputed income for those employees:

Step 1: Determine employee's life benefit.

For this example, let's assume you offer all employees $100,000 of coverage.

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

$100,000 - $50,000 = $50,000

Step 3: Divide the Step 2 difference by 1,000.

$50,000/$1,000 = 50

Step 4: Multiply the result from Step 3 by the Table I rate on page 2 (based on the employee's age at the end of the year). The result is the employee's monthly imputed income. If the employee in this example is 43 years old, imputed income is 50 x $0.10 = $5.00 a month.

Imputed income can be reported on a per pay basis, or per quarter basis or even annually. However, imputed income must be reported at least once per year. Imputed income amounts are subject to FICA withholding.

Who is a Key Employee?

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

- A more than 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 $150,000 for 2008 (for 2009, the compensation must exceed $160,000).

Tax Implications for Discriminatory Employer-Paid Life Insurance Plans

Under some circumstances, key employees may not be allowed the tax exemption for $50,000 of employer-paid life insurance. For the tax exemption to apply to key employees, your organization's term life plan must meet the Section 79 non-discrimination requirements.

Section 79 does not allow plans to favor key employees in terms of eligibility for the plan or in benefits available under the plan. If your plan design discriminates in favor of key employees, the value of the entire amount of life insurance coverage provided by your organization becomes taxable **for key employees only**. Separate non-discrimination tests address eligibility and benefits.

Your first step in non-discrimination testing should be to determine which employees in your organization qualify as a key employee under your life insurance plan. Review the box in the above right hand corner to identify your key employees. Once all your key employees have been identified, your organization can conduct the eligibility and benefits tests to determine if your plan is discriminatory.

Benefits Eligibility Test

The benefits eligibility test is designed to determine if your plan favors key employees when it determines who may participate in the employer-paid group life plan. A group life plan is considered discriminatory if it cannot pass at least one of these "tests":

a) The plan benefits 70% of all employees.

b) At least 85% of all participants are not considered "key employees."

c) The plan covers a non-discriminatory class of employees as determined by the Internal Revenue Service.

d) If the plan is offered under a cafeteria plan, the cafeteria plan must satisfy the non-discrimination requirements of Section 125.

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Your organization may disregard the following employees when you are trying to determine whether your plan meets the non-discrimination requirements:

- Employees who have not completed at least 3 years of service.
- Part-time or seasonal employees.
- Employees covered by a collective bargaining arrangement if the benefits provided under the plan were agreed upon in good faith bargaining between the employer and union.
- Non-resident aliens who receive no earned income from the employer.

Non-discrimination standards apply to current, disabled, former or retired employees. If your organization offers life benefits to these classes, you must test these classes separately from active employees.

Many organizations offer employer-paid life insurance to all full-time employees. If this is the case, the plan will be considered non-discriminatory in terms of eligibility. The plan benefits at least 70% of all employees. If not all employees are covered by the plan, the other tests need to be consider. Next, identify all key employees. If at least 85% of all participants are not considered "key employees", then the plan is considered non-discriminatory in eligibility. The next test would be to determine if the plan covers a non-discriminatory class of employees as determined by the Internal Revenue Service. This test requires your plan seek IRS comment. And finally, if the plan is offered under a cafeteria plan, the cafeteria plan must satisfy the non-discrimination requirements of Section 125.

Benefit Amount Test

Section 79 also states group life plans cannot favor key employees in coverage amount. These tests are designed to determine if your plan favors key employees in benefit amount.

Your plan will automatically pass this test if:

- Your plan provides the same amount of employer-paid life insurance to all employees; for example, a flat $20,000 life benefit to all employees.

or

- Your plan determines the benefit amount on a percentage of income and uses the same percentage of earnings for all covered employees. For example, all eligible employees are covered for an amount equal to their annual earnings.

Even if a plan does not provide the same coverage amount or percentage for all employees, the plan will not automatically be considered discriminatory. The plan simply cannot favor key employees. If you offer different benefits for different classes of employees, in order to pass the "benefit amount" test, your organization must determine if each class can pass the eligibility test described in the previous section.

This is confusing but the following example will help:

> ABC Company has 500 employees and offers two classes of employer-paid group term life coverage. It offers all 400 of its hourly employees a life benefit equal to their annual earnings. At the same time, it offers 100 salaried employees a life benefit equal to double their annual earnings. No key employees are in the hourly class, and 10 key employees are in the salaried class. Only the salaried class must meet benefits eligibility standards because that life insurance benefit class covers key employees. This class has a total of 100 participants and 10 are considered key employees; since fewer than 15% of the salaried employees are key employees, this plan design would not be considered discriminatory

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Notable Thoughts

The greater the obstacle, the more glory in overcoming it.

Moliere

for ABC Company with the current headcounts. The benefit design passes eligibility test "b" described in the previous section, at least 85% of all participants are not considered "key employees".

If ABC Company adds a third class of employer-paid group term life coverage with benefits equal to triple annual earnings but offers it only to key employees, then this class would not meet the eligibility test. The plan would be considered discriminatory, and there would be tax consequences for the key employees **only**.

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

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

Employers need to review their life coverage annually to determine if the plan discriminates in favor of key employees.

Calculating the Tax Consequences

Plans That Favor Key Employees

If an employer-provided group term life plan favors "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; you must calculate imputed income based on the full amount of their life insurance coverage.
2. You must use the greater of Table I rates or the actual rate the insurer charges when you calculate imputed income for key employees in a discriminatory plan.

Unfortunately, the IRS does not clearly define the term "actual rate." In general, you should not use the composite rate charged per $1,000 of life coverage. To determine a composite rate, your insurance carrier melds age-banded rates representative of your employee demographics. You will need to ask your life insurer for the actual cost (or age banded rates) for your key employees. 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 annual composite rate during the quoting process, you could take that discount off your key employee age rate before you determine actual cost for imputed income purposes.

Potential Tax Issues for Voluntary Employee-Paid Life Insurance Plans

Many employers are not aware that they may need to calculate imputed income for employee-paid optional life plans. However, imputed income may apply in two instances with employee-paid life insurance:

1. ***Is your optional life insurance plan deemed to be "carried" by the employer?*** Optional life plans are considered to be employer-carried if the employee-paid plan rates straddle the Table I rates in any given age category. Your organization will need to review your voluntary life age bands to determine whether you need to calculate imputed income for certain employees. If your plan's optional life rate table "straddles" Table I rates, you may need to add the cost difference to any affected employee's W-2. This applies even if the employee pays life premiums with after-tax dollars.

   Compare your optional life rate table to the Table I rates shown in the chart on page 2. If rate tiers are neither equal or completely over nor completely under Table I, then certain age brackets benefit more from employer-sponsored group life plan. You must impute income for the value of the coverage for rate tiers that fall below Table I.

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2. ***Does the employee pay for the voluntary life coverage on a pre-tax basis?*** If so, your organization must determine if imputed income will apply to the life insurance coverage elected.

In these two situations, organizations will need to determine imputed income for voluntary life coverage that is employee-paid.

Calculating the Tax Consequences

Voluntary Life Rate Table Straddles Table I

To calculate imputed income for employees who straddle the Table I rates, first identify the employees in the rate tiers that fall below the Table I rates. **As long as the premium deductions are taken after-tax**, the only individuals who will have imputed income issues are those whose age bands fall below Table I.

In this situation, both employer-paid and supplemental life coverage ***must*** be included when you determine each affected employee's Section 79 imputed income. For the example below, the employer's plan straddles Table I in the age 45-49 category.

Example: Let's assume you provide $50,000 in employer-paid coverage. The plan also allows employees to buy an extra $50,000, $100,000 or $200,000 in voluntary coverage with after-tax dollars. Assuming your employee is 46 years old and buys an extra $100,000 in life coverage, the voluntary life rate is $0.10 per $1,000 in coverage. The Table I rate at this age is $0.15 per $1,000.

Imputed income for this example should be calculated as follows:

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

$50,000 employer-paid plus
$100,000 employee-paid
$150,000-$50,000 = $100,000

Step 2: Determine the imputed income per month on Step 1 coverage amount (calculate using Table I).

$100,000/$1,000 = 100
100 x $0.15 (Table I rate for 46 year old) = $15.00

Step 3:
Determine the premium for optional life paid on an after-tax basis (calculate using your voluntary plan rate table).

$100,000/$1,000 = 100
100 x $0.10 (optional life rate for 46 year old) = $10.00

Step 4: Subtract optional premium from imputed income calculation.

$15.00-$10.00 = **$5.00 per month**

While this example seems complicated, it simply calculates the difference between the plan's age band premium rate and Table I, and it imputes income on that amount.

In the above example, supplemental life coverage is paid on an after-tax basis. Most organizations design voluntary life plan deductions to be taken after-tax to avoid additional imputed income calculations.

Voluntary Life Paid on a Pre-Tax Basis

If your organization deducts life premiums on a pre-tax-basis, additional calculations may be required. Pre-tax premium contributions are treated as employer contributions and, therefore, need to be calculated as imputed income on life amounts more than $50,000.

The new proposed Section 125 regulations include guidance for employers that allow employees to pay voluntary term life coverage on a pre-tax basis. The following are two examples of situations where employers allow employees to pay all or some of their life premiums on a pre-tax basis:

Example 1: All premiums are paid on a pre-tax basis through a Section 125 plan. ABC Company's employee, John Smith is 48 and has elected a total of $200,000 in life insurance coverage:

- John's annual premium for $200,000 of coverage is $312. The $312 premium is tax free because it is made under a Section 125 plan.
- Section 79 allows for $50,000 in coverage to be tax-favored. Employers must take the total coverage amount ($200,000) and subtract $50,000 to determine $150,000 in coverage has tax-implications.

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- ABC Company must impute income on $150,000 in coverage. The Table I rate for a 48 year old is $0.15 per $1,000. ABC Company must impute income of $270 for John's life insurance coverage. (150 x .15 = $22.50 per month or $270 per year)

Example 2: Same facts as Example #1 but John pays $150 of premium after-tax. The calculation changes a bit:

- John's annual premium for $200,000 of coverage is $312. The $162 of the premium is tax free because it is made under a Section 125 plan; $150 of the premium is paid for with after tax dollars.
- Section 79 allows for $50,000 in coverage to be tax-favored. Employers must take the total coverage amount ($200,000) and subtract $50,000 to determine $150,000 in coverage has tax-implications.
- ABC Company must impute income on $150,000 in coverage. The Table I rate for a 48 year old is $0.15 per $1,000. The premium for $150,000 under Table I is $270, but John has paid $150 of that premium with after tax dollars. Therefore ABC Company only needs to impute income on $120 ($270 - $150).

Section 79 can affect voluntary life plans in two ways. If the voluntary life rate table straddles Table I, there may be tax implications for the age brackets deemed carried by the employer. It can also impact voluntary plans that are paid for with pre-tax dollars via a Section 125 plan.

Section 79 Exceptions

Section 79 requirements apply only to **group term life plans**. Group term life plans do not include:

- Accidental Death and Disability coverage, travel accident insurance, or accident and health coverage.
- Any permanent life insurance coverage that includes additional paid up options or cash surrender values.
- *Minimal* fringe benefits, up to $2,000 of employer-paid dependent life insurance is considered minimal (*de-minimis)* and is tax free.

Conclusion

You need to review your group life plans annually to determine whether your organization needs to impute income for employee life coverage.

Section 79 of the Internal Revenue Code requires you to calculate imputed income if:

- Your organization provides employer-paid coverage that exceeds $50,000 on any employees.
- Your life plan favors key employees. In this case, calculate imputed income on the full value of the life insurance provided to these key employees.
- Your organization offers voluntary life coverage and the plan's age banded rates straddle Table I. In this case, calculate imputed income on employees whose rates fall below the Table I rates.
- Your organization allows employees to pay for coverage on a pre-tax basis via a Section 125 plan.

Section 79 can affect both the employer-paid and the employee-paid supplemental life benefits your organization sponsors. Review your organization's plan to determine whether you have any obligation to impute income under Section 79.

Please call your McGraw Wentworth Account Manager with any questions on imputed income. MW

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