

Discrimination and taxation of group term life benefits

How does this apply to you?

Each situation is different. The information we share here is simply a general overview of a topic. To find out how this information might affect your benefits plan, we encourage you to consult your own ERISA or tax advisor. That way, you will have the advice you need to best manage your benefits plan. We do not provide ERISA, tax, or legal advice.

Understanding the key issues surrounding discrimination and taxation

Employer-provided group life insurance is often a family's only source of life insurance protection. In fact, only 44% of Americans own any individual life insurance,¹ placing tremendous importance on employer-provided group life. It is, therefore, critical for plan sponsors to understand the key issues surrounding discrimination and taxation as they relate to group term life insurance plans.

What's Discriminatory in Group Term Life Insurance?

Employer-provided group term life benefits are considered discriminatory in favor of key employees unless the plan meets the following eligibility and benefits requirements.

Eligibility requirements

For your plan to be nondiscriminatory, employers must follow these rules:

- The plan benefits 70% or more of all employees or,
- At least 85% of all employees who participate in the plan are not key employees or,
- The IRS issues a determination letter saying the plan does not discriminate, or
- If the plan is part of a cafeteria plan, it satisfies the nondiscrimination requirements under Internal Revenue Code (IRC) Sec. 125.

Excluded employees

Certain employees may be excluded in testing for eligibility:

- Employees with less than 3 years of service.
- Part-time employees (less than 20 hours per week) or seasonal employees (less than 5 months in a calendar year).
- Union employees not in the plan, if the plan's life insurance benefits were the subject of collective bargaining.
- Certain nonresident aliens.

Benefits test

For your plan to be nondiscriminatory, employers must follow these rules:

- All benefits available to key employee participants under the plan are also available to all other participants.
- If benefits do not bear a uniform relationship to the total basic or regular compensation of covered employees, then the determination of whether a plan is nondiscriminatory will be based on all facts and circumstances. For example, "x-times" salary plans and flat amounts available to all participants are considered nondiscriminatory.
- In addition, the terms must be nondiscriminatory. For example, a conversion feature cannot be offered only to key employees.

Definition of key employee

The Internal Revenue Code Sec. 79(d)(6) defines a key employee as an employee who, at any time during the plan year, is:

- An officer of the employer having annual compensation greater than \$165,000 (IRC Sec. 416(i)(1)(A)(i) and IRS Notice 2010-78, but note that this amount may change annually, as it is indexed to inflation).
- A 5% owner of the employer (IRC Sec. 416 (i)(1)(A)(ii)); or
- A 1% owner of the employer with annual compensation from the employer of more than \$150,000 (IRC Sec. 416 (i)(1)(A)(iii)).

"Key employee" also includes any former employee, when he retired or separated from service, was a key employee (IRC Sec. 79 (d)(6)).

Taxation of Group Term Life Insurance

Tax treatment

Under a group term life insurance plan, the cost of up to \$50,000 of coverage paid for by the employer is excluded from the covered employee's income and is exempt from employment taxes. This applies to group term life coverage. Other forms of life insurance are not given the same tax-preferred treatment. Refer to IRS Publication 525: Taxable and Nontaxable Income.

If a group term life insurance plan is nondiscriminatory, it is eligible for favorable tax treatment.

Nondiscriminatory plans

Group term life insurance amount	Employee	Key employee
Up to \$50K	Not taxed	Not taxed
Over \$50K	The cost of the amount over \$50K at the IRS Table I rate is taxable income to the employee*	The cost of the amount over \$50K at the IRS Table I rate is taxable income to the employee*

If a group term life insurance plan is discriminatory, it is not eligible for favorable tax treatment for key employees.

Discriminatory plans

Group term life insurance amount	Employee	Key employee
Up to \$50K	Not taxed	Taxed. The amount of taxable income is based on the greater of the actual cost of the coverage or the cost determined at the IRS Table I rate.*
Over \$50K	The cost of the amount over \$50K at the IRS Table I rate is taxable income to the employee*	Taxed. The amount of taxable income is based on the greater of the actual cost for all of the coverage or the cost determined at the IRS Table I rate.*

The calculated cost of insurance above the \$50,000 (reduced by any employee payment) is reported as part of the employee's wages on the year-end W2 statement.

* Any after-tax amounts that an employee contributes toward the cost of group term life insurance will reduce the tax liability incurred.

Frequently Asked Questions

How is the amount of taxable income calculated?

The amount of taxable income, often referred to as imputed income, is determined by calculating the cost for each month of coverage. The steps are as follows:

1. Find the total amount of group term life coverage.
2. Subtract \$50,000 from the amount of group term life coverage.
3. Divide the Step 2 difference by \$1,000.
4. Multiply this amount from Step 3 by the Table I rate (based on the employee's age at the end of the year). This result is the employee's monthly imputed income.
5. Multiply the monthly imputed income by 12. The result is the employee's annual cost of the coverage over \$50,000.
6. Subtract the employee-paid premiums from the annual cost. The result is the employee's imputed income for the year.

What are the Table I rates?

The IRS Table I rates are shown below. The IRS lowered the IRS Table I rates in 1999 to reflect improved mortality experience and a higher number of females entering the workforce.

Age on last day of tax year	Cost	Age on last day of tax year	Cost
Under 25	\$.05	50-54	\$.23
25-29	\$.06	55-59	\$.43
30-34	\$.08	60-64	\$.66
35-39	\$.09	65-69	\$1.27
40-44	\$.10	70 and over	\$2.06
45-49	\$.15		

IRS Table I Rates: Cost per \$1,000 of coverage for one month (effective 7/1/99).

Here's an example using the Table I rates:

In the following example, the employee is 51 years old with \$80,000 of group term life coverage in each of the 12 months. (The employee contributed \$5 per month toward his total group term life coverage.)

Employee's coverage	\$ 80,000
Less exclusion amount	-\$ 50,000
Excess amount	\$ 30,000

Multiply monthly excess amount by number of full months covered.

Excess amount	\$ 30,000
Full months covered	x 12 months
Total amount of excess insurance	\$ 360,000

From the table, multiply total excess insurance amount by cost per \$1,000 per month for age 51.

Total amount of excess insurance	(\$360,000 / \$1,000)
Cost per \$1,000 per month for age 51	x \$.23
Cost of excess insurance for tax year	\$ 82.80
Premiums paid by employee	- \$ 60.00
Cost to be included as wages in income:	\$ 22.80

Are there any exceptions to these rules?

There are instances where the cost of excess coverage does not have to be included as imputed income on the employee's W-2 statement:

- The coverage is provided to a former employee who terminated employment with a permanent disability.
- A charitable organization is designated as the employee's sole beneficiary.
- The employer is directly or indirectly the beneficiary.

Special rules apply if the group term life insurance is being provided through a Section 125 cafeteria plan. Also, if either paid-up or cash value life insurance is provided, the rules for group term life generally do not apply. Special tax rules for permanent life insurance will apply.

What about other life insurance coverages?

Optional life?

An optional life plan can be considered exempt from imputed income, and thus not included in the calculations, if it meets the following two criteria:

1. The premiums must be "properly allocated" between the basic life (employer paid) and optional life (employee-paid) coverage. Both coverages must be priced on a self-supporting basis.
2. The plan does not have "crossover" rates. A plan has crossover rates when at least one of the employee age-banded rates is less than the corresponding Table I rate, and at least one is greater than the Table I rate.

Generally, an employer will want to set up their optional life plan to be exempt from imputed income. This will minimize administrative hassles and may avoid additional taxable income for some of the employees.

Accidental death & dismemberment (AD&D)?

AD&D insurance provided to employees is treated like health insurance and is not taxable. AD&D coverage and contributions are not included in the imputed income calculations for group term life.

Life insurance on dependents?

If the face amount of the coverage is less than or equal to \$2,000, the cost is not taxable. (If the coverage is being provided for a domestic partner, the cost is taxable.)

But if the face amount exceeds \$2,000, the cost of all the dependent coverage less the employee's contribution is considered taxable income. The \$50,000 exclusion mentioned above for employee coverage does not apply.

What about retirees and former employees?

The same imputed income rules apply for retirees and other former employees whose life insurance premium is paid by the employer. However, there are exclusions for retirees that are outlined fully in IRS publication 525. Please refer to it for more information.

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1. LIMRA, Trends in Life Insurance Ownership, 2010, www.limra.com

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