Group Term Life Insurance: Taxation

Anne Hensley, JD
Senior Vice President & Practice Leader | National Specialty Practices

Questions: We provide a basic group term life insurance policy of $50,000 to employees. We understand that providing a group life insurance policy under $50,000 would not require an imputed income calculation, but what about supplemental life insurance? Can you provide a high-level overview of group term life insurance and when an employer might have to calculate imputed income on this coverage?

Summary:

Generally, anything that an employee receives from his or her employer as compensation, including fringe benefits such as life insurance, is included in the employee's gross income unless a specific Internal Revenue Code (Code) exclusion applies. Code Section 79 governs employer-sponsored group term life insurance plans and provides us with an income exclusion of the cost of up to $50,000 of employer-provided group term life insurance coverage.[1]

Whether or not an employer must calculate imputed income on life insurance coverage varies based on whether the group term life insurance plan is discriminatory, how the premiums are paid (employer paid, employee paid pre-tax, or employee paid after-tax) and whether or not the plan is considered "carried" by the employer as defined in Code Section 79.

In the question posed above, if an employee receives more than $50,000 of employer-provided group term life insurance coverage, then the "cost" (or imputed income) of the insurance in excess of $50,000—less any amount paid by the employee with after-tax contributions—should be included in the employee's gross income for both federal income tax and Federal Insurance Contributions Act (FICA) purposes.

Below we will provide an overview of group term life insurance, the rules surrounding the income exclusion found in Code Section 79, and how and when employers might be required to perform an imputed income calculation.

An imputed income calculation on excess coverage provided in the same policy as the employer paid basic life policy is required no matter if the excess coverage is employer paid, or if the employees pay on a pre-tax or after-tax basis.

Detail:

Internal Revenue Code Section 79 and Group Term Life Insurance

Group term life insurance is one of the most common benefits of employment enjoyed by employees. According to a recent Department of Labor (DOL) study, approximately 56% of all employees in private industry were offered access to employer-based life insurance in 2021 and nearly all of those who were offered the insurance chose to participate in the benefit plan. 83% of employees in private industry working for employers with 500 or more employees were offered access to group term life policies, and 81% of those workers chose to participate.[2]

With such a large number of employees participating in group term life policies, it would be easy to assume that employers have a good handle on taxation issues associated with these plans. That is not the case, however, as taxation of life insurance proves to be one of the most poorly understood areas of employee benefits for employers and plan administrators. While there are many different forms of life insurance, our discussion is focused on group term life insurance, which is defined under Code Section 79 as life insurance that:

- provides a general death benefit that is excludable from income under Code §101(a);
- is provided to a group of employees;
- provides to each employee an amount of insurance that is computed under a formula that precludes individual selection; and
- is provided under a policy carried directly or indirectly by the employer.[3]

The coverage can be paid for entirely by the employer, the employee, or a combination thereof, and employee contributions can be made on a pre-tax or after-tax basis.

Employers might be required to calculate imputed income on the following types of group term life insurance: 1) any coverage in excess of $50,000 that is provided in the same policy as the employer paid basic life (regardless of whether the excess is employer paid, employee paid pre-tax, or employee paid after-tax), 2) a discriminatory employer paid group term life plan that favors key employees, 3) coverage in excess of $50,000 provided through a separate supplemental life insurance policy where the employer either pays for a portion of the coverage or employees pay on a pre-tax basis, and 4) any supplemental life policy paid for entirely by the employees on an after-tax basis but for which the employee premium rates “straddle” the Table 1 rates.

Excess Coverage in Employer Paid Basic Term Life Policy

An imputed income calculation on excess coverage provided in the same policy as the employer paid basic life policy is required no matter if the excess coverage is employer paid, or if the employees pay on a pre-tax or after-tax basis.

It is important to note that while Code Section 79 provides an exclusion of the cost of coverage up to $50,000, this exclusion is limited and is only applicable to the insurance on the life of the employee, not to life insurance purchased on the life of the employee’s spouse or dependent child.

The imputed income amount is determined by calculating the cost of benefits in excess of $50,000, **less any amounts paid by employees towards the insurance on an after-tax basis.**

The imputed income or cost of the excess coverage should be included in the employee's gross income for both federal income tax and FICA purposes.

The period of coverage used to determine an employee's imputed income resulting from employer-provided group term life insurance is the calendar month. If an employee has coverage for only part of a calendar month, there is no prorating. If premiums were charged by the insurer for that partial month, that is treated as a period of coverage.

The “cost” of the excess coverage, here, generally referred to as imputed income, means cost as determined under the Uniform Premium Table (Table 1) provided in the Internal Revenue Service (IRS) regulations, which is given below.[4] Table 1 is used to determine how much imputed income applies to an employee. The cost of the excess coverage is based on the Table 1 rates and not the amount the employer or employee pays for the coverage. The rates included in Table 1 are age-banded and the employee’s age of the last day of the taxable year must be used in these calculations.

Uniform Premium Table[5]

Age	Cost of $1,000 of GTL per Month	Cost of $1,000 of GTL for One Year
Under 25	$0.05	$0.60
25-29	$0.06	$0.72
30-34	$0.08	$0.96
35-39	$0.09	$1.08
40-44	$0.10	$1.20
45-49	$0.15	$1.80
50-54	$0.23	$2.76
55-59	$0.43	$5.16
60-64	$0.66	$7.92
65-69	$1.27	$15.24
70 and above	$2.06	$24.72

Here are the steps for calculating imputed income on coverage that exceeds $50,000 in a basic term life policy:

1. Determine the employee’s life benefit for each coverage period. For purposes of this example, let’s say the employer offers all employees $100,000 worth of coverage. If an employee's coverage amount changes during a period of coverage, the coverage amount used to determine the cost of the employee's group term life insurance coverage is the average of the coverage at the beginning and the end of the period of coverage.[6]
2. Subtract $50,000 from the amount of the life benefit: $100,000-$50,000 = $50,000.
3. Divide Step 2 number by $1,000 = 50.
4. Multiply the number from Step 3 by the Table 1 rate. This is based on the employee’s age at the end of the calendar year. The resulting number is the employee’s monthly imputed income. If the employee in this example is age 39, then the monthly imputed income is $4.50 ($.09 x 50).

The resulting imputed income must be reported at least once a year and is subject to federal income and FICA taxes.

Discriminatory Employer Paid Basic Life Coverage

Code Section 79 also contains nondiscrimination requirements which must be met in order for the $50,000 tax exemption to apply to key employees.[7] Key employees are defined as those employees who at any time during a plan year are: 1) a more than 5% owner, 2) an employee who owns more than a 1% interest in the company and whose compensation exceeds $150,000 per year, or 3) an officer of the employer whose compensation exceeds $200,000 for 2022.[8]

Discrimination in favor of these key employees is prohibited under Code Section 79 and if a life insurance plan does favor such employees, the amount of the entire life insurance coverage that an employer provides is taxable to the key employees.

There are two components to the Code Section 79 nondiscrimination tests - the Eligibility Test and the Benefit Amount Test.

1. The Eligibility Test determines whether an employer's group term life insurance plan favors key employees in terms of eligibility for such plan. A plan is considered discriminatory under this test if it cannot meet at least one of the following:
    a. The plan benefits at least 70% of all employees.
    b. At least 85% of all participants are considered non-key employees.
    c. The plan covers a nondiscriminatory class of employees as determined by IRS.
    d. Premiums are taken on a pre-tax basis through a Section 125 plan, and the plan meets the Section 125 nondiscrimination requirements.[9]

Employees who have been employed for less than three years, part-time or seasonal, covered by a collective bargaining agreement, and non-resident aliens with no U.S.-sourced income from the employer are disregarded for purposes of this nondiscrimination testing.[10] Separate discrimination testing must be performed for current employees, disabled employees, and former or retired employees.

2. The Benefit Amount Test says that group term life insurance plans cannot provide key employees with richer benefits than non-key employees.[11] There are two ways to pass the Benefit Amount Test:
    a. The employer's plan provides the same amount of employer paid life coverage to all employees (a flat dollar amount); or
    b. The life insurance plan uses a percentage of income on which to base the life insurance benefit and uses this percentage for all covered employees.

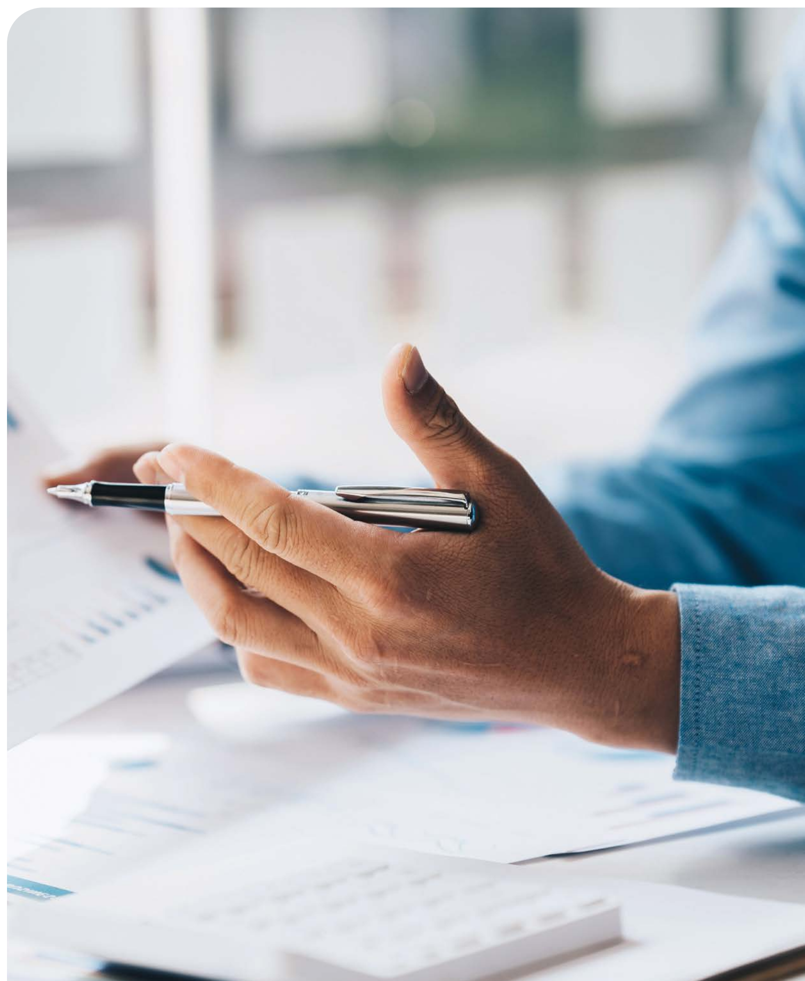
If a life insurance plan does discriminate in favor of key employees, employers will need to impute income on those employees only. In other words, under a discriminatory plan, key employees do not get the benefit of the $50,000 exception or exclusion and the imputed income calculation is performed on the entire amount of their life insurance coverage. When calculating the imputed income amount, employers must use the greater of the Table 1 rates or the actual rate charged by the insurer. Complicating this calculation is the fact that we don't have a good definition of the term actual rate that has been provided by the IRS. Plan sponsors should seek guidance from their life insurance carrier for the actual cost or age-banded rates for key employees instead.

Supplemental Life Insurance

Employers often provide employees with the opportunity to purchase additional life insurance coverage through a policy that is separate from the employer's basic term life insurance policy. This is referred to as supplemental life insurance and will require imputed income calculations if "carried" by the employer. Code Section 79 provides that a policy is carried either directly or indirectly by an employer when the employer pays for a portion of the coverage in the supplemental policy or the employee pays for a portion on a pre-tax basis, or if employees pay for the supplemental policy on an after-tax basis but the premium rates "straddle" the Table 1 rates.

In order to avoid being carried by the employer, supplemental group term life insurance plans must meet all of the following requirements:

- Employees must pay premiums for the supplemental plan using after-tax dollars.
- If there is a separate employer paid group term life insurance plan, the insurance premiums and coverage must be properly allocated between the employer paid plan and the supplemental plan.
- The rates charged under the supplemental life plan for all age groups must be either (a) completely at or above or (b) completely at or below the corresponding Table 1 rates.[12]



1. **Supplemental Life Insurance: Employer Paid or Employee Paid on a Pre-Tax Basis**

If coverage is provided in a supplemental life insurance policy separate from the employer's basic term policy and either 1) the employer pays for a portion of the coverage, or 2) employees pay for the coverage on a pre-tax basis, any coverage in excess of $50,000 will require an imputed income calculation as illustrated in Section B above.

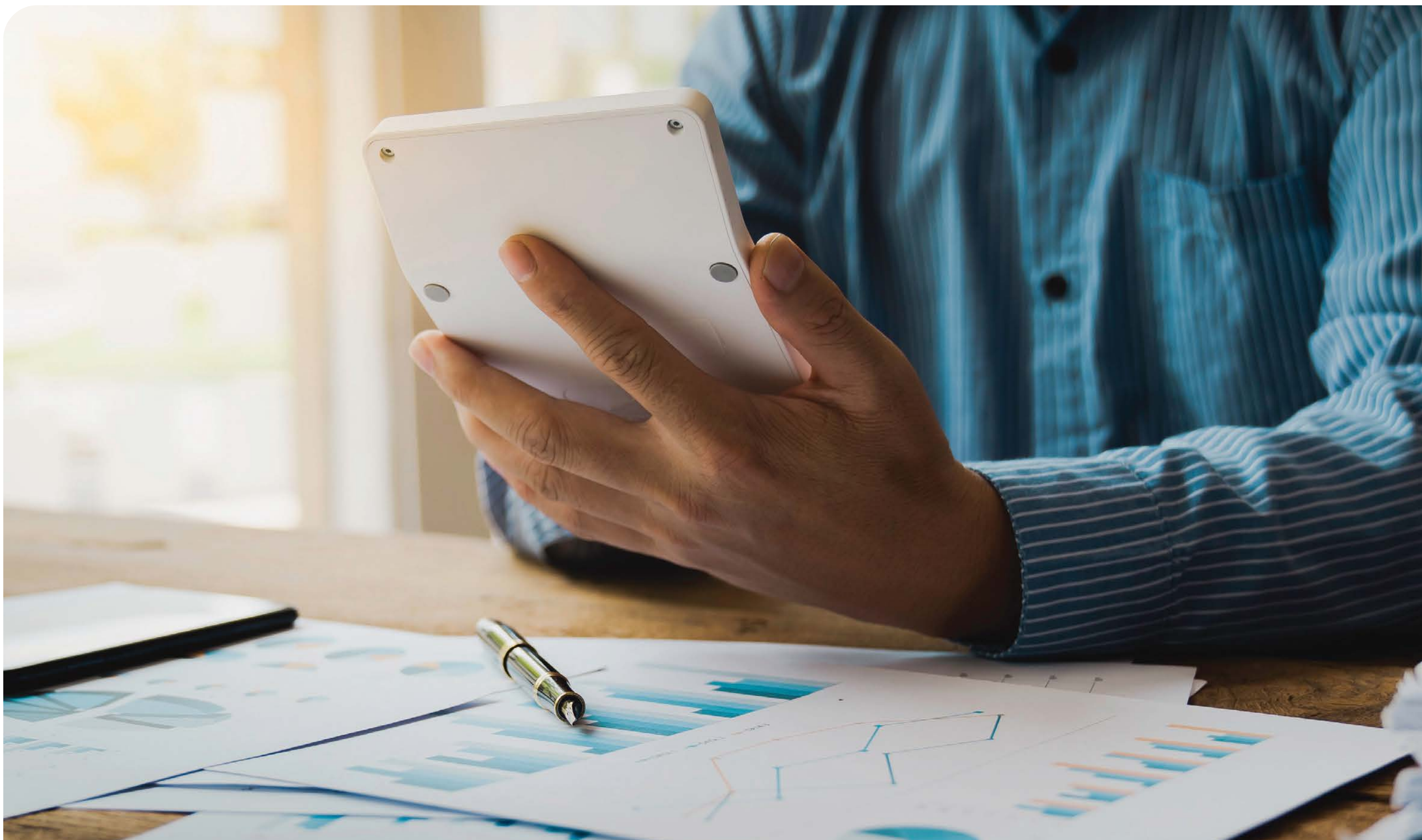
Most plan sponsors attempt to avoid imputed income issues by requiring employees to purchase supplemental life insurance on a post-tax basis. However, the Code Section 125 regulations do not preclude employees from purchasing supplemental life insurance coverage with pre-tax dollars. The regulations do provide that if pre-tax dollars are used to purchase this supplemental coverage, the pre-tax premiums are considered employer contributions and must be included when calculating the imputed income on amounts over the $50,000 exclusion.

Here is an example of this imputed income calculation when employees use pre-tax funds to purchase supplemental life coverage:

1. Employee Y, age 40, purchases $150,000 worth of life insurance coverage on a pre-tax basis. The annual premium amount is $275.
2. Code Section 79 allows for the $50,000 exclusion. Employee Y's employer must use the total coverage amount of $150,000 less the $50,000 exclusion and impute income on the remaining $100,000.
3. The Table 1 rate for a 40 year old is $0.10 per $1,000. Employer must impute income of (100,000/1,000) x .10 = $10/month or $120 per year for Employee Y's life coverage.

If both pre-tax and after-tax dollars are used to purchase coverage, the calculation changes a bit:

1. Employee Y purchases $150,000 worth of life insurance coverage, with $175 premium pre-tax and the remaining $100 on an after-tax basis.
2. Code Section 79 allows for the $50,000 exclusion. Employee Y's employer must use the total coverage amount of $150,000 less the $50,000 exclusion and impute income on the remaining $100,000.
3. Employer must calculate imputed income on the $100,000 from Step 2.
4. The Table 1 rate for a 40 year old is $0.10 per $1,000. Employer must impute income of (100,000/1,000) x .10 = $10/month or $120 per year for Employee Y's life coverage.
5. However, because Employee Y paid $100 of the annual premium on an after-tax basis, Employer only has to impute income on the amount paid with pre-tax dollars, or $120-$100 = $20.



2. Employee Paid, After-Tax Supplemental Life Insurance

A supplemental life insurance policy paid entirely by employees on an after-tax basis will be deemed "carried" by the employer, and therefore subject to Code Section 79, if the employer arranges for payment of the cost of the life insurance by its employees and the rates "straddle" the Table I rates such that at least one employee's rate is lower than Table I rates and at least one employee's rate is equal to or higher. This will result in imputed income for employees with rates below the Table I rate. Many employers and employees are taken by surprise upon discovering that a 100% after-tax, employee paid supplemental plan can create imputed income if the plan's premiums rates "straddle" the IRS uniform monthly premium rates.

Both the employer paid basic group term life coverage and the supplemental life coverage must be included in the imputed income calculation for any affected employee.

a. No Straddle

If the employee rates for a supplemental, employee paid after-tax plan do not straddle the Table I rates, the policy is not deemed carried by the employer and there is no imputed income calculation required.

b. Straddle

If the employee rates for a supplemental, employee paid after-tax plan "straddle" the Table I rates such that at least one employee's rate is lower than Table I rates and at least one employee's rate is equal to or higher than the Table I rates, the employer will need to calculate imputed income for employees with rates below the Table I rate.

Example of the Straddle Test and Tax Consequences

Employers will need to identify which of its employees fall below the Table 1 rates.

1. If the employee premium deductions are taken on an after-tax basis, the employer will only need to worry about those employees and their imputed income whose age bands are below Table 1.
2. The imputed income calculation includes both employer paid basic life coverage and supplemental life coverage when imputed income is calculated.

Let's take an employer who offers its employees $50,000 in employer paid basic group term life coverage but also allows employees to purchase supplemental coverage under a separate policy on an after-tax basis.

Employee X, age 39, purchases an additional $100,000 in coverage with after-tax dollars. The supplemental rate is $0.075 per $1,000 in coverage and the Table 1 rate for a 39 year old is $.09. **Because the employee rate for Employee X falls below the Table 1 rate of $.09, we must calculate the difference between the supplemental plan's age-banded premium rate and the Table 1 rate, and then impute income on that amount:**

Step 1: Total coverage provided less $50,000:
Total coverage in this example is $150,000 ($50,000 employer paid plus the additional $100,000 employee paid coverage) - $50,000 = $100,000.

Step 2: Imputed income per month on the amount from Step 1 (using Table 1 rates):
$100, 000 / $1,000 = 100 x $.09 (Table 1 rate for 39 year old) = $9.

Step 3: Using an employer's plan's rate table, calculate the premium for optional life coverage paid for by employees with after-tax dollars:
$100, 000 / $1,000 = 100
100 x $0.075 (supplemental life rate for a 39 year old) = $7.50.

Step 4: Subtract the supplemental premium from Step 3 from the imputed income calculation from Step 2:
$9.00 - $7.50 = $1.50/month.

Spousal/Dependent Life Insurance

Many employers also offer group term life insurance on the lives of employees' spouses and dependents. Because Code Section 79 does not apply to dependent or spousal life insurance coverage, this coverage does not qualify for the tax advantages afforded to coverage on the lives of employees.[13] Unless this coverage qualifies as a de minimis fringe benefit, the employer-provided portion of the cost will be treated as income of the employee whose dependents are covered.[14] We can treat the dependent life insurance as a nontaxable de minimis fringe benefit if the cost of employer provided group term life insurance on the life of an employee's spouse or dependent does not exceed $2,000. Dependent and spousal life insurance can be offered either as employer paid or supplemental. If the coverage is over $2,000, the life insurance benefit is taxable as imputed income based on Table 1 rates. What takes many employers and employees by surprise is that the entire amount of the benefit is taxable - there is no exclusion for the $2,000, like the $50,000 exclusion for employees discussed earlier.[15] Employers must determine the cost of coverage using the Table 1 rates, less any post-tax employee contributions for the coverage, and the difference is taxable as imputed income. Dependent life insurance coverage may not be purchased with pre-tax dollars.

Conclusion:

Group term life comes with some unexpected tax implications that both employees and employers should be aware of. Employers would be well-advised to consult their payroll vendors and tax advisors for additional information, as well as their life insurance carriers who can be an excellent source of educational materials for both employers and employees. Group term life plans should be reviewed to see if imputed income is required because employer paid coverage exceeds $50,000, the plan is discriminatory and favors key employees, the employer offers supplemental life which employees may purchase on a pre-tax basis, or the employer offers supplemental life which employees may purchase on a post-tax basis but the rates straddle the Table 1 rates.

References

1 - Code §79(a). The same amount can be excluded from the employee's wages for purposes of FICA (Social Security and Medicare) taxes. See Code §3121(a)(2)(C).

2 - https://www.bls.gov/news.release/pdf/ebs2.pdf

3 - Treas. Reg. §1.79-1(a).

4 - Treas. Reg. §1.79-3(d).

5 - Publication 15B: Employer's Tax Guide to Fringe Benefits

6 - Treas. Reg. §1.79-3(b)(2).

7 - Code §79(d)(1)(A) and Temp. Treas. Reg. §1.79-4T, Q/A-6 and Q/A-11.

8 - Code §416(i)(1)(A).

9 - Code §79(d)(3)(A).

10 - Code §79(d)(3)(B).

11 - Code §79(d)(2)(B) and Code §79(d)(4).

12 - Symetra, *Imputed Income and Straddle Rule.*

13 - Treas. Reg. §1.79-1(f)(3) (referring to rules under Code §61(a) when insurance is provided on the life of a non-employee (i.e., an employee's spouse)); Treas. Reg. §1.79-3(g)(2).

14 - Treas. Reg. §1.61-2(d)(2)(ii)(b) ("insurance on the life of an individual other than an employee (such as the spouse or dependent of the employee) provided in connection with the performance of services by the employee is includible in the gross income of the employee").

15 - *IRS Chief Counsel Advice Memo 201350037* (citing ***Treas. Reg. §1.132-6(d)(4)***).

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