Issue Brief

Group Term Life Insurance Nondiscrimination Testing
Why they matter… or don't… to an employer
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Background

Section 79 of the Internal Revenue Code ("IRC") provides that the value of the first $50,000 of employer-provided group term life insurance coverage is generally excluded from the gross income of the employees covered under the plan. In other words, the value of the benefit is not taxable. Conversely the value of employer-provided coverage in excess of $50,000 is included in the gross income of employees and thus, is subject to income, FICA and Medicare taxes.

The taxable value of employer-provided group term life insurance is called "imputed income," because even though the employees do not receive cash, they are taxed *as if* they had received cash in an amount equal to the taxable value of their coverage. Essentially the imputed value of the employer-provided coverage is determined by multiplying the amount of coverage in excess of $50,000 by an age-related valuation rate established by the Internal Revenue Service ("IRS")[1]. For contributory plans, the IRS allows employers to subtract the employee's after-tax contribution toward the cost of the coverage from the amount that would otherwise be taxable.

Non-Discrimination Requirements

In order for a group term life insurance benefit to receive the favorable tax treatment afforded under IRC §79, it must not discriminate in favor of "key employees" either as to eligibility to participate or as to the amount or type of life insurance benefit being provided. To this end, §79 of the Code imposes the following two nondiscrimination tests on all employer provided group term life insurance benefits.

Eligibility Test: The plan must satisfy any one of the following four tests:

(i) 70% of all employees benefit under the plan, or
(ii) at least 85% of the participants are not key employees, or
(iii) the plan benefits a non-discriminatory classification of employees, or
(iv) if part of a cafeteria plan, the requirements relating to cafeteria plans are met.

Benefits Test: The amount and type of benefit cannot discriminate in favor of key employees. This test is satisfied if:

(i) benefits bear a uniform relationship to compensation, and
(ii) the benefits provided to key employees are provided to all other participants.

For purposes of these tests, a "key employee"[2] is an employee who, at any time during the *preceding* plan year, satisfies any one of the following three criteria:

- an officer earning in excess of $160,000 annually[3], or
- an employee who owns more than 1% of the outstanding stock and earns more than $150,000 annually, or
- an employee who owns more than 5% of the outstanding stock.

[1] The table used to calculate imputed income is called "Uniform Premiums for $1,000 of Group-term Life Insurance Protection" (or simply "Table I") and is found in IRS Reg. §1.79-3(d)(2).
[2] IRC §416(i)(1)
[3] Indexed figure… adjusts annually in a manner similar to IRC 415(d)

Note that inherent in the definition of "key employee" is the fact that an employee that is not an officer, and does not own any interest in the employer, *cannot* be considered a key employee. Treasury regulations also indicate that no more than 50 employees (or, if lesser, the greater of 3 or 10% of employees) shall be treated as officers.

The regulations also identify a number of individuals that may be excluded for testing purposes:

- employees with less than 3 years of service, and
- part-time (work 20 hours per week or less) or seasonal (work 5 months or less per year) employees, and
- certain collectively bargained employees, and
- non-resident aliens with no U.S. source income.

The Sanction… and a Common Response

Technically, if an employer's group term life insurance benefit fails to satisfy either of the two tests described above, key employees lose the benefit of the income tax exclusion on the first $50,000 of employer-provided benefit. As a result, the value of the total amount of employer-provided life insurance benefit (as determined using Table I) becomes subject to treatment as imputed income to the key employee and reported on the employee's W-2 at year end.

However, because the value of the exclusion is often felt to be insignificant many employers have opted to assume a posture of "conscious noncompliance" rather than redesign their discriminatory life insurance programs.

An example will best illustrate this point:

Under a discriminatory life insurance program, based on the value of life insurance defined in IRS Table I, the additional *annual* income that would be imputed on a 60 year old key employee with a $200,000 life insurance benefit would amount to $396... if that key employee were 50 years of age the additional *annual* imputed income would drop to $138. And in all cases, even if a plan is considered discriminatory, all life insurance benefits paid to beneficiaries of group term life insurance plans are received income tax-free.

So once a group term life insurance benefit is tested and determined to be discriminatory, is it worth changing the design of the program and then re-communicating the revised design to employees? Only the plan sponsor can make that determination… but in many cases the answer is "no" and employers decide to add the value of the $50,000 as imputed income to key employees.