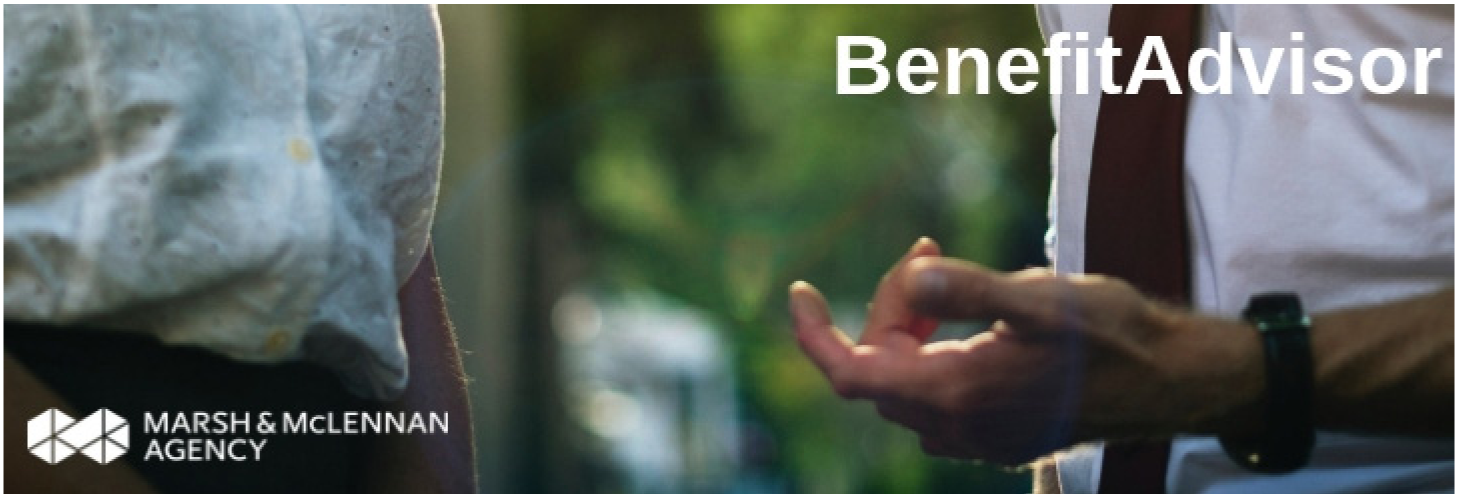

Volume Twenty-One, Issue Seven November 2018

INTERNAL REVENUE CODE SECTION 79

Section 79 of the Internal Revenue Code details the tax implications for employer-sponsored *group term life insurance*. It does **not** apply to employer-sponsored whole life insurance or accidental death and dismemberment coverage. Your employees may have to pay taxes on the value of the following types of employer-sponsored group term life insurance:

- Employer-paid group term life benefits that exceed $50,000
- Discriminatory employer-paid term life plans
- Employer-sponsored voluntary life coverage
- Employer-sponsored voluntary life insurance paid for with pre-tax dollars under a Section 125 plan

This *Advisor* clarifies the areas to review at the end of each calendar year to determine Section 79 implications. Each section details potential tax consequences for each situation. The sections will explain how to calculate any potential tax liability.

TAX IMPLICATIONS FOR NON-DISCRIMINATORY EMPLOYER-PAID LIFE INSURANCE COVERAGE THAT EXCEEDS $50,000

Up to $50,000 of employer-paid term life insurance coverage is tax-exempt under Section 79, so long as the plan does not favor key employees. To decide whether this part of Section 79 affects your employees, you will need to review your plan to determine whether it is considered an ***employer-paid group term life*** insurance plan. If your organization pays the employee's entire life coverage premium, the coverage amount qualifies as employer paid. Some employers pay for base coverage, but allow employees to pay for additional life insurance. This section applies **only** to the employer-paid portion.

Section 79 defines a "group of employees" as:

- All employees or a controlled group of employees.

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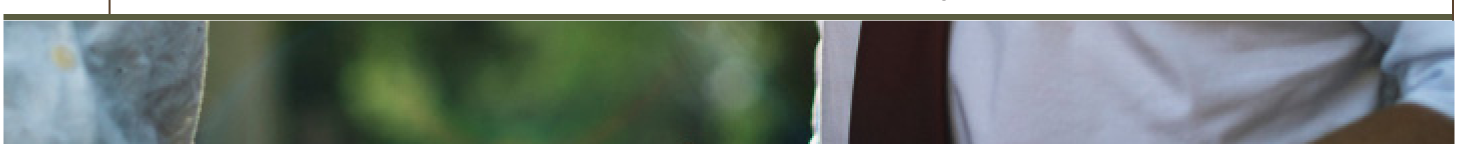
We welcome your comments and suggestions regarding this issue of our Benefit Advisor. For more information, please contact your Account Manager or visit our website at www.mma-mi.com.



- 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 the employer-paid group term life coverage is $50,000 or less, then your employees should not have to pay tax on the insurance value (a discriminatory plan may have tax consequences; see the next section). If you provide more than $50,000 in coverage, your organization will probably have to include the value of the excess amount only in your *affected* employees' gross income.

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

1. If a terminated employee is considered disabled under Section 72(m) (7) of the Internal Revenue Code. In order to qualify for this exception, employees must submit proof of disability with their tax returns for the first year of disability, and 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 also applies if the employer is named the beneficiary of the policy.
3. If your plan existed on January 1, 1984, and the life benefit is for a covered employee who retired before January 2, 1984. The retiree also must have turned 55 before January 2, 1984, and have been employed by your organization or its predecessor.

Other than in these cases, employees or former employees will have to pay taxes on the value of employer-provided life insurance exceeding $50,000.

TABLE I RATES	
Age Bracket	**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

CALCULATING THE TAX CONSEQUENCES

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

Follow the steps below to calculate the imputed income for employees that have employer-paid life coverage that exceeds $50,000:

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 above (based on the employee's age at the end of the calendar year). This result is the employee's monthly imputed income. If an employee in this example is 43 years old, imputed income is $5 a month (50 x $0.10).

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Imputed income can be reported for each paycheck, quarterly or even annually. Imputed income must be reported at least once a year, and is subject to FICA withholding.

TAX IMPLICATIONS FOR DISCRIMINATORY EMPLOYER-PAID LIFE INSURANCE PLANS

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

Section 79 does not allow plans to favor key employees in either eligibility or benefits. If your plan favors key employees, the value of the **entire** amount of life insurance coverage that your organization provides becomes taxable **for those employees only**. Separate non-discrimination tests consider eligibility and benefits.

Your first step in non-discrimination testing should be to identify key employees under your life insurance plan. The box below describes employees that fall into that category. Then you need to conduct the eligibility and benefits test to determine whether your plan favors these employees.

Benefits Eligibility Test

The benefits eligibility test determines whether your plan favors key employees based on the eligibility requirements for an employer-paid group life plan. A group life plan is considered discriminatory if it cannot meet at least one of the following criteria:

1. The plan benefits at least 70 percent of all employees.
2. At least 85 percent of all participants are not considered key employees.
3. The plan covers a non-discriminatory class of employees as determined by the Internal Revenue Service.
4. Premiums are deducted pre-tax through a cafeteria plan and the plan satisfies the Section 125 non-discrimination requirements.

You can disregard the following employees when you are determining whether your plan meets the non-discrimination requirements:

1. Anyone employed for less than three years
2. Part-time or seasonal employees
3. Employees covered by a collective bargaining agreement between the employer and union
4. Non-resident aliens who received no earned income from the employer

Non-discrimination standards apply to current, disabled, former or retired employees. You must test life benefits for these classes separately from current employees.

Benefit Amount Test

Group life plans cannot offer a key employee better benefits than they offer a non-key employee. Your plan will automatically pass this test if either of the following applies:

- Your plan provides the same amount of employer-paid life insurance to all employees, such as a flat $20,000 life benefit to all employees
- 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

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Who Is A Key Employee?

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

1. A more than 5 percent owner.
2. An employee owning more than a 1 percent interest in the company and whose compensation or income from the employer exceeds $150,000 a year.
3. An officer of the employer whose compensation exceeds $175,000 for 2018 ($180,000 in 2019).

Even if a plan does not offer the same coverage amount or percentage for all employees, it still might not necessarily favor key employees. If you offer different benefits for different classes of employees, your organization must determine whether each class can pass any of the eligibility tests described in the previous section. The following example clarifies this point:

> 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 twice their annual earnings. No key employees are hourly, and 10 key employees are salaried.
>
> Only salaried employees must meet benefits eligibility standards because that benefit class covers all key employees. Of the 100 salaried participants, only 10 are considered key employees. Since fewer than 15 percent of the salaried employees are key employees, this plan design would **not** be considered discriminatory with the current headcounts. The benefit design passes the second eligibility test described in the previous section: at least 85 **percent** of all participants are not considered key employees.
>
> Let's assume ABC Company adds a third class of employer-paid group term life coverage. The third class is offered **only** to key employees. The benefits equal three times annual earnings. This class would not pass the benefits test. The plan would be considered discriminatory, and key employees would face tax consequences.

Employers should review their life coverage annually to make sure their plan doesn't favor key employees.

CALCULATING THE TAX CONSEQUENCES

Plans That Favor Key Employees

Employers need to impute additional income on key employees **only** when the life plan is considered discriminatory. Consider the following when you calculate this imputed income:

1. Key employees do not get the $50,000 benefit exemption; you must calculate imputed income based on the entire 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.

Unfortunately, the IRS does not clearly define the term *actual rate*. In general, you should not use the composite rate charged for each thousand dollars of life coverage. To determine a composite rate, your insurance carrier melds age-banded rates representing 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 gives you a 15 percent discount on the annual composite rate, you could apply that discount to the key employee's age rate before you determine the actual cost for imputed income purposes.

POTENTIAL TAX ISSUES FOR VOLUNTARY EMPLOYEE-PAID LIFE INSURANCE PLANS

Employers may need to calculate imputed income for employee-paid optional life plans. Imputed income may apply in two instances with employee-paid life insurance:

1. ***Is your optional life insurance plan considered "carried" by the employer?*** Optional life plans are considered "employer-carried" if the employee-paid plan rates straddle the Table I rates in any given age category. 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 the affected employee's

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W-2. This rule 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 all rate tiers are neither completely over nor completely under Table I, then certain age brackets benefit more from the employer-sponsored group life plan. You must impute income for the value of the coverage for rate tiers that fall below Table I.

2. ***Do your employees pay for the voluntary life coverage with pre-tax dollars?*** If so, you must determine whether imputed income will apply to their life insurance coverage.

In these two situations, you will need to determine imputed income for employee-paid voluntary life coverage. However, calculating the tax consequence is different in each situation.

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 who fall below the Table I rates. **So long as the premium deductions are taken with after-tax dollars**, the only employees who will have imputed income issues are those whose age bands fall below Table I.

In this situation, you **must** include both employer-paid and supplemental life coverage when you determine each affected employee's Section 79 imputed income. For the example below, the only optional life rate band that falls below Table I rates is the 45-49 age-band.

Example: Let's assume you provide $50,000 in employer-paid coverage. The plan also allows employees to purchase an additional $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

Total coverage is $150,000 ($50,000 employer-paid plus $100,000 employee-paid)

Subtract $50,000 from that total ($150,000 minus $50,000) = $100,000

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

Divide $100,000 by $1,000 = 100

Multiply 100 by $0.15 (Table I rate for 46 year old) = $15

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

Divide $100,000 by $1,000 = 100. Then multiply 100 by $0.10 (optional life rate for 46-year-old) = $10

Step 4: Subtract optional premium from imputed income calculation

$15 minus $10 = **$5 a month**

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

To avoid potential imputed income issues with the voluntary life plan, make sure the voluntary life rates do not straddle Table I at the point of purchase.

In the example above, supplemental life coverage is paid for with after-tax dollars. Most organizations require after-tax voluntary life plan deductions in order to avoid additional imputed income calculations. However, Section 125 regulations issued in 2007 explain how employers should handle imputed income if employees pay for voluntary life coverage with pre-tax dollars.

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Voluntary Life Coverage Paid Pre-Tax

If your organization deducts life premiums before taxes, you may need to make additional calculations. Pre-tax premium contributions are treated as employer contributions, and, therefore, must be calculated as imputed income on life amounts exceeding $50,000.

The 2007 proposed Section 125 regulations include guidance for employers that allow employees to pay for voluntary term life coverage with pre-tax dollars. Following are two examples of situations where employers allow employees to pay all or some of their life premiums pre-tax:

Example 1: All premiums are paid pre-tax through a Section 125 plan. ABC Company's employee, John Smith, is 48 and has 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. ABC Company must take the total coverage amount ($200,000) and subtract $50,000 to determine that $150,000 in coverage is taxable.
- 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 a month or $270 a 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 tax-free part of the premium is $162 because it is under a Section 125 plan; the remaining $150 of the premium is paid for with after-tax dollars.
- Section 79 allows for $50,000 of coverage to be tax-favored. Subtract that $50,000 from the $200,000 total coverage amount. The $150,000 difference is taxable.
- ABC Company must impute income on the $150,000 difference 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 needs to impute income on only $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 considered to be employer-carried. It can also impact voluntary plans that are paid for with pre-tax dollars through a Section 125 plan.

Section 79 Exceptions

The Internal Revenue Code lists two specific 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 pay for out-of-pocket is not included in the non-discrimination determination. If this additional life insurance coverage is available only for key employees, however, the plan is considered discriminatory.

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

- Accidental death and dismemberment coverage, travel accident insurance, or accident and health coverage.

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- Any whole life insurance coverage that includes additional paid-up options or cash surrender values.
- Up to $2,000 of employer-paid dependent life insurance. These benefits are considered minimal (de minimis) and, therefore, tax-free.

CONCLUSION

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 certain employees. In this case, calculate imputed income only on the amount of life insurance that exceeds $50,000.
- Your life plan favors key employees. In this case, calculate imputed income on the full value of key employees' life insurance coverage.
- 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 with pre-tax deductions through a Section 125 plan. In this case, you will have to calculate imputed income on life coverage that exceeds $50,000.

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 need to impute income under Section 79. Your Marsh & McLennan Agency | Michigan team will be glad to answer your questions on imputed income. MMA

MARSH & McLENNAN AGENCY

HEALTH & BENEFITS
3331 W. Big Beaver Road
Suite 200
Troy, MI 48084
248.822.8000 (Phone)
248.822.4131 (Fax)
www.mma-mi.com

PROPERTY & CASUALTY
15415 Middlebelt Road
Livonia, MI 48154
734.525.0927 (Phone)
734.525.0612 (Fax)
www.mma-mi.com