Guide to Taxation and Life Insurance (IRS Section 79)

An explanation of the tax implications based on the type of life insurance issued

Overview

Taxation of Life Insurance is handled very differently than the taxation of Disability Insurance. Who pays the premium is not the sole determiner. Instead, the Internal Revenue Service (IRS) uses a concept called "imputed income" to determine the tax liability of Life Insurance. The following paper will cover all the concepts involved, including how "imputed income" is figured, the taxation of the Death Benefits, as well as "straddling" and "discriminatory" schedules.

Taxation of Death Benefit

The Death Benefit paid to the beneficiary is not subject to taxation. The taxation is instead handled on the amount of Life Insurance held.

Taxation of Basic Life Insurance

Generally, the value of Basic Life Insurance up to $50,000 is tax exempt. The value of coverage that exceeds $50,000 is taxable to the employee, using Table I rates. The taxation of Life Insurance is covered under Section 79 of the Internal Revenue Code (IRC). Basic Life is always subject to taxation for amounts over $50,000.

Taxation of Dependent Life Insurance

The Death Benefit is still tax-free. On Dependent Life, for employer-paid coverage, the first $2,000 is tax-exempt. Amounts over $2,000 are subject to taxation. Taxation impact is figured using the Table I rates. For employee paid coverage, all dependent amounts are tax-free.

Taxation of Accidental Death & Dismemberment (AD&D)

On AD&D, the Death Benefit will be tax-free to the beneficiary. Also, the amount of AD&D insurance held will not be subject to taxation (no Imputed Income impact for AD&D).

Taxation of Voluntary Life Insurance

For an employee-paid (i.e. Voluntary) insurance arrangement to be considered apart from Section 79, the following requirements must be met:

- The Voluntary Term Life program is employee pay-all.
- The Voluntary Term Life rates are adequate on their own, and determined independently of the rates for Basic Life.
- The Voluntary Term Life rates do not "straddle the Table I rates set by the IRS. (See next section for details.)
- The employer elects to treat Voluntary Term Life and Basic Life as separate policies.
- The Voluntary Life plan is not under Section 125 and is paid with pre-tax dollars (changed in 2007).

The IRS has determined that if all of these requirements are met, Voluntary Term Life Insurance will not be considered a policy of Life Insurance carried "directly or indirectly" by the employer, and hence the employees will not be subject to Imputed Income under Section 79.

Straddling and Table I (Voluntary Life Insurance)

"Straddling" occurs when one employee is charged a rate higher than the Table I rates and another employee is charged a rate less than the Table I rates. Once the rates "straddle", the Voluntary Term Life would fall under Section 79, and Imputed Income would apply.

With the current Voluntary Life rate calculation, it is very possible for younger employee age bands (less than age 45) to be lower than the Table I rates. (In general, for employees over age 45, the rate calculation is going to produce rates higher than Table I.)

It is a good idea to keep the Table I rates handy, and to quickly check to see if any of the less-than-45 rates are less than Table I. If there is a rate lower than Table I, the rates provided will "straddle" Table I, and the plan will be subject to imputed income.

If so, the easy solution is to increase those rates to be equal to Table I rates for those age bands. **As long as the rates provided are all equal to or greater than Table I, the plan will not "straddle," and the plan should not be subject to imputed income.**

Imputed income

The value of Life Insurance exceeding $50,000 is included in the gross income of the employee. The taxable value of Life Insurance is called "imputed income" as employees are taxed as if they had received income equal to the taxable value of the coverage. If the employee contributes to the cost of the insurance, all of his or her contributions will be credited to the amount that would otherwise be taxable to him or her.

The taxable value is determined by multiplying the amount exceeding $50,000 by a set of age-banded rates provided by the IRS. These rates are the Table I rates.

Table I rates

The IRS publishes a table of rates, Table I, to determine the value of the Life Insurance. The table is age-banded, and the ages in the table represent the employee's age as of the last day of the calendar year. So, to determine which age applies as of January 1 of any year, the employee would use their age as of December 31st of the same year. Therefore, if an employee turns age 40 on the last day of the year, he or she would use age 40 for the entire year.

Current Table I Rates (July 1, 1999)

Age	Rate	Age	Rate
Under 25	$0.05	**50-54**	$0.23
25-29	$0.06	**55-59**	$0.43
30-34	$0.08	**60-64**	$0.66
35-39	$0.09	**65-69**	$1.27
40-44	$0.10	**70+**	$2.06
45-49	$0.15		

Examples of imputed income calculation

Non-contributory Basic Life coverage

To calculate the imputed income amount for Basic Life, take the amount of Life insurance held minus the $50,000 credit. Then take the new amount divided by 1,000, times the age-equivalent Table I rate to determine the monthly Imputed Income. Adjust for payroll frequency.

Contributory Basic Life coverage

- **Pre-tax Contributions:** When the Basic Life is contributory, with the employee paying his/her contributions on a pre-tax basis, the calculation of imputed income will follow the same procedures as full non-contributory coverage.
- **Post-tax Contributions:** When the Basic Life is contributory, with the employee paying his/her contributions on a post-tax basis, the employee will receive credit for his/her contribution to the cost of the coverage. This method of calculating imputed income will be similar to the method for Voluntary Life (post-tax). Please see next page for those rules and calculations.

Here is a chart showing examples of imputed income calculations, using a 37-Year-old employee.

Plan Type	Non-Contributory	Contributory (Pre-Tax)	Contributory (Post-Tax)
Life Amount	$180,000	$200,000	See Voluntary
Amount Minus $50,000	$180,000 - $50,000 = $130,000	$200,000 - $50,000 = $150,000	—
Table I Rate	$0.09	$0.09	—
Calculation	$130,000/ $1,000 = 130 x $0,09 = $11.70	$150,000/ $1,000 = 150 x $0,09 = $13.50	—
Monthly Imputed Income Amount	$11.70	$13.50	—

Employee is paid on a semi-monthly basis. Divide the monthly imputed income by two (2). In example one, the imputed income (often called "Cost of Group Life" or "COGL") per check is $5.85. This amount is added to the check and taxed as income, and is subject to FICA withholding.

Voluntary Life coverage (when subject to imputed income)

- **" Voluntary Life coverage (Post-tax Contributions)** The Voluntary Life calculation, when paid with post-tax dollars, and subject to imputed income, is very different. The procedure is to add the Basic (if applicable) plus Voluntary Life amounts for a Total Life Volume. Subtract the $50,000 credit and calculate the imputed income amount. Then subtract the cost paid by the employee for the Voluntary Life from the imputed income, to get a final monthly imputed income amount.

This chart will illustrate the steps. The example will use a 40-year-old employee, with a Table I rate of $0.10. The Voluntary Life rate for the employee is $0.09. The Basic Life rate for the Contributory example is $0.08.

Contribution Method	Voluntary	Contributory Basic (Post-Tax)
Life Volume	Voluntary: $150,000 Basic: $120,000	Basic: $300,000
Total Volume	$150,000 + $120,000 = $220,000	$300,000
Amount Minus $50,000	$270,000 - $50,000 = $220,000	$300,000 - $50,000 = $250,000
Cal. of Imputed Income	$220,000/$1,000 = 220 x $0.10 = $22.00	$250,000/$1,000 = 250 x $0.10 = $25.00
Life Premium	$150,000/$1,000 = 150 x $0.09 = $13.50	$250,00/$1,000 = 250 x $0.08 = $20.00
Monthly Imputed Income Amount	$22.00 - $13.50 = $8.50	$25.00 - $20.00 = $5.00

Convert the monthly imputed income to the appropriate payroll frequency to determine the Cost of Group Life for each pay period.

- **Voluntary Life coverage (pre-tax contributions)** Generally, Voluntary Life is not paid with pre-tax contributions, as there is no tax advantage under Section 79 for this method. When Voluntary Life is paid with pre-tax dollars, the premiums are not taxed with the rest of the employee's income, and therefore the entire volume (Basic and Voluntary Life, minus the $50,000) is subject to imputed income. The calculation will not give credit for premium paid (as in the post-tax example). The calculation for pre-tax is similar to the calculation for Basic Life (non-contributory).

Discriminatory schedules and impact on imputed income

A Group Life plan that unfairly favors (discriminates) in favor of "key employees" has an additional tax implication. There are two tests (Eligibility and Benefits), for determining if a plan is discriminatory or non-discriminatory.

A "key employee" is defined as:

- An officer having annual compensation greater than $175,000. (As of 2017 — this figure is adjusted annually).
- A 5% owner of the company; or
- A 1% owner with annual compensation greater than $150,000.

The first test is the eligibility test:

A plan will be non-discriminatory if it can pass at least one of these tests:

1. It benefits at least 70% of all employees;
2. At least 85% of the participants are not key employees;
3. The plan benefits a class of employees that is found to be non-discriminatory according to the IRS;
4. If the plan is under Section 125, the non-discrimination requirements under Section 125 are met.

The second test is the benefits test:

Under this test, the plan is discriminatory if the benefits available to key employees are not made available to all other employees. (So, a plan may not cover key employees only, and still be considered non-discriminatory).

However, there are exceptions, one of which is that the benefits provided bear a relationship to the compensation. For example: a plan may provide higher benefits to the key employees, as long as the benefits are comparable to the compensation. If key employees generally make five times what other employees make, it would therefore be acceptable to have a plan that has a schedule that is five times higher for the key employees — but not one that is ten times higher. So, a $50,000 plan for officers is acceptable if the other employees receive $10,000. However, $500,000 for key employees and $10,000 for all other would likely be discriminatory.

Consequences of a discriminatory plan

If a plan is deemed to be discriminatory in favor of the key employees, then there is an impact to the key employees' (but not other employees') imputed income calculation. The $50,000 exception to imputed income is removed, and the key employees must pay imputed income results based on their volume of Life insurance from dollar one.

Assessing plans issued by Guardian

The consequences of a plan being deemed discriminatory is one reason that it is best to avoid "unbalanced" schedules, as doing so would encourage a situation with potentially negative imputed income results for the key employees. If the planholder and benefit advisor are all aware of the consequences, such a schedule may be written, even though it is not recommended.

Important note

This overview is meant to provide general information regarding the taxation of Life insurance, and how to calculate imputed income.

Guardian does not provide tax advice. Imputed income impact does not reflect on any of the rates, billing, or claims payments. Such calculations and impacts are under the purview of the planholder, and their payroll company (if utilized). Planholders should discuss any questions regarding taxation of Life insurance with a qualified tax advisor.

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