

It's Time...To Impute Income on Group Term Life Insurance

If an employee has more than \$50,000 in group term life insurance coverage through his or her employer, the excess coverage may be taxable under federal law. If it is, federal law also requires the employer to impute income to the employee. Some employers satisfy the requirement by imputing income on life insurance coverage as it is provided during the year. Other employers wait until the end of the year. Both methods are permitted as long as imputing is completed by the end of the year.

This *Employee Benefits Alert* explains how to determine the amount of income that must be imputed in such cases.

Background

The federal tax code excludes the cost of the first \$50,000 in group term life insurance coverage that an employer provides to an employee. Because there is no tax code exclusion for additional employer-provided coverage, the cost of excess coverage is subject to federal income and FICA (Social Security and Medicare) taxes. The employer providing the excess coverage must report the cost of it on the employee's W-2 and must withhold the employee's portion of FICA taxes and pay the employer's portion.

NOTE: The imputing requirement may be avoided in some cases if the premium rates under the group term life insurance policy(ies) meet certain requirements. This design strategy is discussed in Chapter 8 of the *Willis Online Compliance Manual*, but is beyond the scope of this *Alert*.

The Employee Pays, but the Employer Provides

If an employee pays the entire premium for life insurance, one might assume that the coverage is not employer-provided. For group term life insurance, however, that is not always the case. First, if the employee pays for coverage using pre-tax dollars, the coverage is treated, for tax purposes, as if the employer paid those premiums. Second, even if the employee pays the entire premium on an after-tax basis, the coverage may be considered partly employer-provided. That can happen when the cost of coverage for tax purposes is higher than the premium that an insurer charges.

The IRS Determines the "Cost" of Group Term Life Insurance

IRS regulations include a table of rates (reproduced below) for calculating the

cost of excess group term life insurance for tax purposes. The Table I rates are not indexed for inflation, so they do not change each year – the rates are the same for 2007 as they were for 2006 and will not change until the regulations are revised.

Table I Rates for Group Term Life Insurance

Monthly Cost/\$1,000 of Coverage

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

*When imputing income for 2007, use the employee's age on December 31, 2007.

Of course, the IRS-determined rates may be higher or lower than the premiums actually paid for group term life insurance coverage. If the IRS rates are higher, an employee who paid 100% of the premiums for excess coverage with after-tax pay may nonetheless have additional taxable income due to the excess coverage.

Determining the Amount of Income to Impute

If an employer pays the premiums for all of an employee's group term life insurance coverage, determining the amount to impute is easy: subtract \$50,000 from the total group term life insurance coverage in effect for the employee during the year and multiply the remaining coverage amount by the applicable Table I rate. If the employer does not pay all of the premiums, but the employee's contributions are made on a pre-tax basis, this same calculation applies.

NOTE: The rule for imputing income when an employee pays group term life insurance premiums on a pre-tax basis changed last August. The current rule, stated above, applies to any

amounts imputed after August 6, 2007. For amounts imputed before then, an employer must compare the Table I rate with the actual premium charged by the insurer and use the higher amount as the cost of coverage.

If the employee pays all or part of the premium for any group term life insurance coverage (including the first \$50,000) on an after-tax basis, an additional calculation is needed. After finding the Table I cost of all coverage above \$50,000, as described above, deduct from that amount all of the employee's after-tax contributions toward the coverage (including contributions for coverage under \$50,000). If the result is a positive number, that is the amount to impute.

NOTE: If an employee is covered by more than one group term life plan, the coverages are aggregated so that the employee may not exclude the cost of more than \$50,000 in coverage for the year.

W-2 Reporting and FICA Taxes

As taxable income, the imputed amount must be included in the employee's taxable income reported on Form W-2, but the employer is not required to withhold for the employee's federal income tax liability. FICA taxes apply, however, and the employer must withhold the employee's portion of FICA taxes. The employer also must pay its portion of FICA taxes, and remit both the employer and employee FICA amounts. For 2007, the Social Security tax rate is 6.20% on annual pay up to \$97,500. The Medicare tax rate is 1.45% on all pay, without a maximum limit.

Other Reasons to Impute Income on Group Term Life Insurance

In addition to imputing income based on an employee's coverage over \$50,000, an employer might be required to impute income for employees in a few other circumstances.

Discrimination in Favor of Key Employees

If group term life insurance discriminates in favor of key employees (usually by limiting eligibility to certain owners and officers or by offering those individuals broader coverage), additional imputing requirements apply. The employer is required to impute income to these individuals on their entire coverage amount – not just amounts exceeding \$50,000. In addition, the cost of coverage to be imputed is the greater of the Table I cost or the actual cost of coverage. (Any after-tax contributions would be deducted from the cost.) Actual cost for

this purpose may not be the premium rate paid to the insurer; it may be a higher amount determined according to IRS regulations.

Dependent Life Insurance

The cost of employer-provided term life insurance on the lives of an employee's dependents must be imputed to the employee unless the benefit provided is \$2,000 or less. If the \$2,000 limit is exceeded, all dependent life insurance, including the first \$2,000, is taxable. The Table I rates – using the dependents' ages to select the applicable rate – must be used in calculating the amount to impute to the employee. As with the employee's life insurance, any after-tax contributions toward the cost of coverage are deducted when determining the amount to impute. If the dependent coverage is no greater than \$2,000, the value of the coverage is excluded from the employee's income as a *de minimis* fringe benefit.

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