

PART II: GROUP TERM LIFE INSURANCE

Group Term Life Insurance

In General

224. What are the tax benefits of employer provided group term life insurance?

An employer may provide employees with up to \$50,000 of group term life insurance protection each year without cost to employees. The taxable value of group term insurance in excess of the exclusion amount generally is determined under a table (Table I) provided by the IRS (Q 229). The exclusion generally is not available unless the insurance provided under the plan satisfies the definition of group term life insurance (Q 225, Q 227). If insurance provided does not meet the definition of group term life insurance, an employer's premium cost is includable in employee income.

If a plan provides group term life insurance that is discriminatory, the exclusion is not available to key employees (Q 232). The taxable cost to a key employee of the entire amount of insurance under a discriminatory plan is the higher of the actual cost or the cost under Table I.

A premium paid by an employer is deductible. Group term life insurance may be provided under term policies or under policies providing a permanent benefit (Q 237). An employer also may provide permanent life insurance to employees on a group basis (Q 240, Q 241).

A death benefit of group life insurance, whether term or permanent, generally is excludable from a beneficiary's income (Q 242).

225. What is group term life insurance?

For group term life insurance to qualify for special tax exclusion by employees, the life insurance must meet the following four conditions:¹

General Death Benefit

First, it must provide a general death benefit that is excludable from gross income under IRC Section 101(a). Under the regulations, travel insurance and accident and health insurance including amounts payable under a double indemnity clause rider do not provide a general death benefit.¹ Employer contributions for these benefits are contributions to a health plan under IRC Section 106 instead of Section 79 (Q 315).

Group of Employees

Second, it must be provided to a group of employees as compensation for personal services performed as an employee. A group of employees are all of the employees of an employer, or fewer than all if membership in the group is determined solely on the basis of age, marital status, or factors related to employment including membership in a union, duties performed,

¹ Treas. Reg. §1.79-1(f)(3).

compensation received, and length of service. The purchase of something other than group term life insurance generally is not a factor related to employment. For example, credit life insurance provided to all employees who purchase automobiles is not provided to a group within the definition, because membership is not determined solely on the basis of age, marital status, or factors related to employment.

Participation in an employer's pension, profit sharing, or accident and health plan is considered a factor related to employment, even if employee contributions are required. Ownership of stock in an employer corporation is not a factor related to employment. Participation in an employer's stock bonus plan, however, may be a factor related to employment. A group of employees may include stockholder-employees, other than more-than-2 percent shareholders in an S corporation.¹ If a group of employees consists of fewer than 10 employees, see Q 227.

A person is an employee if his or her relationship to the person for whom services are performed is that of employer-employee, or if he or she formerly performed services as an employee, except to the extent the person currently performs services as an independent contractor.² Insurance on the life of a self-employed person, whether he or she is the employer or someone who performs services for the employer as an independent contractor, is not excludable. Thus, insurance for a partner or sole proprietor is not excludable even though he or she is included in the coverage for employees.

S corporation employees who own more than 2 percent of the outstanding stock or more than 2 percent of the total voting power of the S corporation are treated as partners; therefore, insurance is not excludable to the extent it covers such stockholders.³ Other S corporation employees may take the exclusion.

Insurance provided for an individual in his or her capacity as a corporate owner or as a director does not qualify for the exclusion.⁴

Insurance for a commission salesperson is not excludable unless an employer-employee relationship exists between the salesperson and the company that pays the premiums.⁵ Full-time life insurance salespersons who are classified as employees for Social Security purposes are considered employees for group term.⁶

Employer Provided Policy

Third, the insurance must be provided under a policy carried directly or indirectly by an employer. A policy meets this requirement if an employer pays any part of the cost, directly or through another person, or arranges for payment by employees and charges at least one employee less than his or her Table I cost and at least one other employee more than his or her Table I cost. The policy can be a master policy or a group of individual policies.

1. Treas. Reg. §1.79-0.

2. Treas. Reg. §1.79-0.

3. IRC Sec. 1372.

4. *Whipple Chrysler-Plymouth v. Comm.*, TC Memo 1972-55; *Enright v. Comm.*, 56 TC 1261 (1971).

5. Rev. Rul. 56-400, 1956-2 CB 116; see also IRC Sec. 3508.

6. IRC Sec. 7701(a)(20); Treas. Reg. §1.79-0.

Regulations define the term policy as including all obligations of an insurer that are offered or that are available to a group of employees because of the employment relationship, even if they are in separate documents.¹ An employer may elect to treat obligations not providing permanent benefits as separate policies if the premiums are properly allocated. An employer also may elect to treat an obligation providing permanent insurance as a separate policy if:

- (1) the employee buys the policy directly from the insurer and pays the full cost;
- (2) the employer's part in the sale is limited to selection of the insurer, the type of coverage, and certain sales assistance, such as providing employee lists to the insurer, permitting use of the employer's premises for solicitation, and collecting premiums through payroll deduction;
- (3) the obligation is sold on the same terms and in substantial amounts to individuals who do not purchase, and whose employers do not purchase, any other obligations from the insurer; and
- (4) no employer-provided benefit is conditioned on purchase of the obligation.²

Computed under a Formula

Fourth, the amount of insurance provided each employee must be computed under a formula that precludes individual selection of such amounts. The formula must be based on factors such as age, years of service, compensation, or position. This requirement may be satisfied even if the amount of insurance provided is determined under alternate schedules based on the amount each employee elects to contribute. The amount of insurance under each schedule must be computed under a formula that precludes individual selection.

Where one factor, percentage of compensation, of a two factor formula covered all employees but one, and the other factor, position, applied to only one position held by only one individual, the president, the Tax Court held that the formula did not preclude individual selection of jumbo coverage for the president.³

On the other hand, a formula based on positions that included several individuals in each category was held to preclude individual selection.⁴

Where the amount of an employee's insurance protection under a group program is reduced by the amount of the employee's death benefit under the employer's pension plan, the group protection is not group term life insurance because the formula for determining the amount is based on a factor other than, and not comparable to, age, years of service, compensation, or position.⁵

1. Treas. Reg. §1.79-0.

2. Treas. Reg. §1.79-0.

3. *Towne v. Comm.*, 78 TC 791 (1982). See also *Whitcomb v. Comm.*, 84-1 USTC ¶9472 (1st Cir. 1984).

4. *N.W.D. Investment Co. v. Comm.*, TC Memo 1982-564.

5. Let. Rul. 8342008.

A provision in a group term life insurance plan that offered employees the option to reduce their coverage by certain amounts, but not below \$50,000, was found not to preclude individual selection of the insurance amounts.¹

Instead of a lump sum settlement of death benefits, an employer may select payment of equal installments over a fixed period of time without affecting the plan's status as group term life insurance.²

Federal group term life insurance covering federal civilian employees qualifies as group term life insurance.³

Term life insurance to be provided after retirement that is offered by certain educational institutions under a cafeteria plan is treated as group term life insurance (Q 3501).⁴

If employer-provided term life insurance does not qualify as group term insurance, the premium paid by the employer is includable in the employee's income.⁵

If an insurer providing group term life insurance also makes available a permanent benefit to members of the group because of the employment relationship, see Q 237.

226. Is supplemental life insurance coverage treated as group term life insurance?

Supplemental group term life insurance paid for entirely by employees was not considered group term life insurance under IRC Section 79 where the supplemental policy and the basic group term life insurance paid for by the employer were not considered the same policy because they were provided by unrelated insurers.⁶

Where employee-paid supplemental group term life insurance was purchased from the same insurer providing basic employer-paid group term life insurance, the supplemental and basic coverages were treated as one policy under IRC Section 79. Because premiums were allocated properly, the employer could elect to treat the coverage as three separate policies (basic coverage, supplemental smoker coverage, and supplemental nonsmoker coverage) for purposes of deciding whether the policies were carried directly or indirectly by the employer. Thus, the employees had no imputed income from the supplemental coverage.⁷

In another private ruling, supplemental life insurance coverage offered by a VEBA was considered part of an employer's policy issued by the same insurer, but the employer could elect to treat it as a separate policy because there were no permanent benefits and the premiums were properly allocated between the VEBA's supplementary coverage and the employer's coverage.

1. Let. Ruls. 9701027, 9319026.

2. Rev. Rul. 77-163, 1977-1 CB 18.

3. Rev. Rul. 55-357, 1955-1 CB 13.

4. IRC Sec. 125(d)(2)(C).

5. Treas. Reg. §1.61-2(d)(2)(ii)(A); Let. Rul. 8636018.

6. Let. Rul. 8518037. See also Let. Rul. 8820022.

7. Let. Ruls. 9227019, 9149033. See also Let. Rul. 200033011.

The coverage under the VEBA's policy was not provided directly or indirectly by the employer because the employer was not paying any part of the coverage and because all rates charged the participants were less than the Table I rates.¹

In a similar situation, a supplemental employee group term life insurance program provided through a VEBA was not treated as a policy carried directly or indirectly by an employer. Thus, assuming that the employer elected to treat its basic life insurance program and its supplemental group term insurance as separate policies, no income was imputed to employees under IRC Section 79(a) who purchased supplemental coverage.²

227. Is term insurance provided to a group of fewer than ten employees "group" term insurance?

Yes.

As a general rule, life insurance provided to a group cannot qualify as group term life insurance for income tax purposes unless, at some time during the calendar year, it is provided to at least ten full-time employees who are members of the group of employees of the employer.

Insurance for fewer than ten employees, however, may qualify as group term life insurance if:

- (1) it is provided for all full-time employees; and
- (2) the amount of protection is computed either as a uniform percentage of compensation or on the basis of coverage brackets established by an insurer under which no bracket exceeds 2½ times the next lower bracket and the lowest bracket is at least 10 percent of the highest bracket. Eligibility and amount of coverage may be based on evidence of insurability but determined solely on the basis of a medical questionnaire completed by the employee and not requiring a physical examination.³ Additional voluntary medical information may not be made the basis of a premium rate determination.⁴

For the purposes of determining how many are included in a group, and if all of them are eligible, employees who elect not to receive insurance are considered included even if they would have to contribute toward the cost of term insurance. If an employee must contribute to the cost of benefits other than term insurance, such as permanent benefits, to get term insurance, the employee is not counted in determining if term life insurance is provided to ten or more employees if the employee declined the term insurance.⁵

Although bona fide brackets that are temporarily empty probably do not disqualify a plan, a bracket not used since a plan's inception the previous year was disregarded in one case with

1. Let. Rul. 8906023.

2. Let. Ruls. 9611058, 9549029, 201350032.

3. Treas. Reg. §1.79-1(c).

4. Rev. Rul. 75-528, 1975-2 CB 35.

5. Treas. Reg. §1.79-1(c)(5).

the result that protection provided in the bracket immediately above was more than 2½ times that provided in the bracket immediately below.¹

If evidence of insurability is not a factor, then insurance not meeting the above requirements, which provides protection for fewer than ten full-time employees, may nevertheless qualify if: (1) it is provided under a common plan to employees of two or more unrelated employers, and (2) insurance is restricted to, but mandatory for, all employees of an employer who belong to or are represented by a particular organization, such as a union, that carries on substantial activities other than obtaining insurance.

Insurance for fewer than ten full-time employees will not be disqualified merely because, under the terms of a policy, no insurance is provided for those employed less than six months or who are part-time employees, that is, whose customary employment is not more than twenty hours per week or five months in any calendar year, or those who are age sixty-five or older.²

For purposes of determining how many employees are provided insurance, all life insurance provided under policies carried by an employer is taken into account even if the policies are with different insurers.³ This gives support to the concept that supplemental coverage for fewer than ten may be superimposed on an existing group term life insurance program covering more than ten employees without taking into consideration the special requirements for groups of fewer than ten.⁴

228. Are premiums paid for group term life insurance deductible business expenses?

Yes.

Premiums paid by an employer for group term insurance on the lives of employees are deductible.⁵ This is so even if a plan discriminates in favor of key employees (Q 232).

A corporation may deduct premiums it pays for coverage on the lives of commission salespersons irrespective of whether an employer-employee relationship exists between the salesperson and the corporation.⁶

No deduction will be allowed for the cost of coverage on the life of an employee if an employer is directly or indirectly a beneficiary under a policy.⁷

If group term proceeds are to be used to fund a buy-sell agreement between stockholders of a corporation, the IRS may deny the corporation a business expense deduction for its premium payments (Q 284).

1. Rev. Rul. 80-220, 1980-2 CB 35.

2. Treas. Reg. §1.79-1(c)(4).

3. Treas. Reg. §1.79-1(c).

4. See also Rev. Rul. 70-162, 1970-1 CB 21.

5. IRC Sec. 162(a); Rev. Rul. 56-400, 1956-2 CB 116.

6. Rev. Rul. 56-400, *supra*.

7. IRC Sec. 264(a).

Contributions will not be deductible unless, when considered with all an employee's other compensation, they are reasonable (Q 3515).

Current deduction of contributions to a welfare benefit fund (Q 3963) to provide group life insurance to employees is strictly limited. Contributions to a welfare benefit fund to provide life insurance benefits to employees are subject to certain requirements (Q 3965).

229. Is the cost of group term life insurance coverage provided by an employer taxable income to an insured employee?

The cost of up to \$50,000 of group term life insurance coverage generally is tax exempt. The cost of coverage in excess of \$50,000 is taxable to employees. An employee who is working for more than one employer must combine all group term coverage and is entitled to exclude the cost for no more than \$50,000. If an employee contributes toward the cost of the insurance, all of the employee's contribution for coverage up to \$50,000 and for excess coverage is allocable to coverage in excess of \$50,000. In other words, the employee may subtract his or her full contribution from the amount that would otherwise be taxable to the employee.¹ The employee cannot carry over from year to year any unused portion of his or her contributions.

The cost of coverage in excess of \$50,000, which is the amount that is taxable to an employee, is to be calculated on a monthly basis. The steps are as follows:

- (1) Find the total amount of group term life insurance coverage for the employee in each calendar month of the employee's taxable year, and if a change occurs during any month, take the average at the beginning and end of the month;
- (2) subtract \$50,000 from each month's coverage;
- (3) to the balance, if any, for each month, apply the appropriate rate from the tables of monthly premium rates (below);
- (4) from the sum of the monthly costs, subtract total employee contributions for the year, if any.²

The cost is determined on the basis of the life insurance protection provided to an employee during the employee's tax year, without regard to when the premiums are paid by an employer.

To compute the cost of excess group term life insurance coverage, the rates in the table immediately below should be used.³

1. IRC Sec. 79(a).

2. Treas. Reg. §1.79-3.

3. Treas. Reg. §1.79-3(d)(2).

Uniform Premiums for \$1,000 of Group Term Life Insurance Protection*

**Rates Applicable to Cost of Group-Term Life Insurance
Provided After June 30, 1999**

5-Year Age Bracket	Cost per \$1,000 of Protection for One-Month Period
Under 25	\$0.05
25 to 29	.06
30 to 34	.08
35 to 39	.09
40 to 44	.10
45 to 49	.15
50 to 54	.23
55 to 59	.43
60 to 64	.66
65 to 69	1.27
70 and above	2.06

*In using the above table, the age of the employee is the employee's attained age on the last day of the employee's taxable year.

The exemption of the cost of up to \$50,000 of group term life is not available with respect to group term insurance purchased under a qualified employees' trust or annuity plan; the provisions of IRC Section 72(m)(3) and Treasury Regulation Section 1.72-16 apply to the cost of the protection purchased under qualified plans and no part of the cost is excludable from an employee's gross income (Q 3842).¹

Premiums for supplemental insurance in excess of \$50,000 provided by an employer under a group term insurance plan are not taxable to an insured employee when paid by a family member to whom the employee has assigned the insurance.² If the cost of the coverage in excess of \$50,000 is shared by an employer and assignee, the employer's portion of the cost is includable in the insured employee's gross income.³

The exemption for the first \$50,000 is not available to key employees if a plan discriminates in their favor (Q 232).

230. Is group term life insurance coverage on the lives of an employee's spouse and dependents taxable income to the employee?

Group term coverage on the lives of an employee's spouse and dependents is not included in the exemption. The cost of this coverage will be income-tax free, however, if the face amount

1. IRC Sec. 79(b)(3); Treas. Reg. §1.79-2(d).

2. Rev. Rul. 71-587, 1971-2 CB 89.

3. Rev. Rul. 73-174, 1973-1 CB 43.

does not exceed \$2,000.¹ In determining whether coverage in excess of \$2,000 is excludable from income as a de minimis fringe benefit, only the excess of the cost over the amount paid by the employee on an after tax basis for the coverage is taken into consideration.

In one case where dependent group term life insurance was available to employees through a voluntary employees' beneficiary association ("VEBA") and the employer's only role in the arrangement was to provide administrative services as an independent contractor, the life insurance coverage was not a fringe benefit subject to taxation under Treasury Regulation Sections 1.61-21 or 1.61-2(d)(2)(ii)(b). No amount was therefore includable in employees' income.²

Where an employer's group term life insurance plan permits employees to extend group life benefits to domestic partners and their dependents, the cost of this group term coverage is not excludable from income under either IRC Section 79 or IRC Section 132(a)(4). Rather, the Table I cost of the coverage is includable in an employee's gross income under IRC Section 61.³

231. Are there any exceptions to the general rule that limits the annual exclusion for term life insurance to \$50,000 per employee?

There are certain exceptions to the \$50,000 ceiling on tax-exempt coverage discussed in Q 229. The cost of group term life insurance, even for amounts over \$50,000, is tax-exempt:

- (1) to a former employee who (x) has terminated his or her employment as an employee with the employer and has become permanently disabled, (y) has terminated his or her employment on or before January 1, 1984, and was covered by the plan or by a predecessor plan when he or she retired if the plan was in existence on January 1, 1984, or the plan is a comparable successor to such a plan, or (z) who has terminated his or her employment as an employee after January 1, 1984, having attained age fifty-five on or before January 1, 1984, and having been employed by the employer at any time during 1983 if the plan was in existence on January 1, 1984, or the plan is a comparable successor to such a plan, unless the individual retires under the plan after 1986 and the plan is discriminatory after that date not taking into account insurance provided to employees who retired before January 1, 1987;
- (2) if a charitable organization is designated as beneficiary, where this designation may be made with respect to all or any portion of the proceeds, but no charitable contributions deduction is allowable for such a designation; or
- (3) if an employer is beneficiary, unless the employer is required to pay proceeds over to an employee's estate or beneficiary.⁴

Any contribution toward group term life insurance, but not toward permanent benefits, made by an employee during a taxable year generally reduces, dollar for dollar, the amount that

1. Notice 89-110, 1989-2 CB 447.

2. Let. Ruls. 9549029, 9151033.

3. Let. Rul. 9717018.

4. IRC Sec. 79(b); Treas. Reg. §1.79-2; TRA '84 Sec. 223(d), as amended by TRA '86, Sec. 1827(b)(1); Temp. Treas. Reg. §1.79-4T, A-1. See also Let. Rul. 9149010.

otherwise would be included in the employee's gross income for term insurance. No reduction is permitted, however, for a prepayment made by an employee for coverage after retirement or for payments allocable to insurance where the cost is not taxed because of one of the foregoing exceptions.¹

232. Must group term life insurance provide nondiscriminatory benefits? How is group term life insurance taxed if a plan is discriminatory?

If a plan covers any key employees and the plan discriminates in favor of them either as to eligibility to participate or with respect to the kind or amount of benefits, the key employees may not exclude the cost of the first \$50,000 of coverage. A key employee in a discriminatory plan must include the higher of the actual cost or the specified uniform premium Table I cost (Q 229). Employees who are not key employees may exclude the cost of \$50,000 of coverage even if a plan is discriminatory.² For a discussion of when a group term life insurance plan will be found to be discriminatory, see Q 223.

A key employee essentially is the same as a key employee in a top heavy plan (Q 3828). A key employee is an employee who, at any time during the employer's tax year was:

- (1) an officer of an employer having annual compensation greater than \$170,000 in 2014 (up from \$165,000 in 2012 and 2013). Not more than the greater of three individuals or 10 percent of the employees need be considered officers, but in any event no more than fifty individuals may be considered officers;
- (2) a more-than-5 percent owner of an employer; or
- (3) a more-than-1 percent owner, determined without considering those employees who are not counted in testing for discriminatory eligibility, having an annual compensation from an employer of more than \$150,000.³

A key employee also is any former employee who was a key employee when he or she retired or separated from service.⁴

For purposes of determining corporate ownership, the attribution rules of IRC Section 318 apply. Rules similar to the attribution rules apply to determine non-corporate ownership as well in calculating attribution, a 5 percent ownership test will apply rather than a 50 percent test.

In determining the percentages of ownership, only the particular employer is considered; other members of a controlled group of corporations or businesses under common control and other members of an affiliated service group are not aggregated. They are aggregated, however, for purposes of determining the employee's compensation and in testing for discrimination.⁵

1. Treas. Regs. §§1.79-2(a)(2), 1.79-3(g)(2).

2. IRC Sec. 79(d).

3. IRC Sec. 416(i)(1)(A).

4. IRC Sec. 79(d)(6).

5. IRC Sec. 414(t); Temp. Treas. Reg. §1.79-4T, A-5.

Exemption for Church Plans

Church plans for church employees are exempt from nondiscrimination requirements. A church plan generally is one established by a church or convention or association of churches that is tax-exempt under IRC Section 501(c)(3). A church employee includes a minister, or an employee of an organization that is tax-exempt under IRC Section 501(c)(3), but does not include an employee of an educational organization above the secondary level, other than a school for religious training, or an employee of certain hospital or medical research organizations.¹

233. How is it determined whether a group term life insurance plan is discriminatory?

A plan is considered discriminatory in favor of key employees with respect to eligibility to participate unless:

- (1) it benefits at least 70 percent of all employees;
- (2) at least 85 percent of participants are not key employees;
- (3) the plan benefits a class of employees found by the IRS not to be discriminatory; or
- (4) if the plan is part of a cafeteria plan, the requirements for cafeteria plans are met (Q 3501).²

Individuals who do not need to be counted include:

- (1) employees with fewer than three years of service;
- (2) part-time and seasonal employees;
- (3) employees excluded from a plan who are covered by a collective bargaining agreement if group term life insurance was the subject of good faith bargaining, and
- (4) certain nonresident aliens.³

Benefits are discriminatory unless all benefits available to key employee participants are available to all other participants.⁴ Benefits are not discriminatory, however, merely because the amount of insurance bears a uniform relationship to the total compensation of employees, or to their basic or regular rate of compensation.⁵

All policies providing group term life insurance to a key employee or key employees carried directly or indirectly by an employer will be considered a single plan for purposes of determining whether an employer's group term insurance plan is discriminatory. An employer may treat

1. IRC Sec. 79(d)(7).

2. IRC Sec. 79(d)(3)(A).

3. IRC Sec. 79(d)(3)(B).

4. IRC Sec. 79(d)(4).

5. IRC Sec. 79(d)(5).

two or more policies that do not provide group term life insurance to a common key employee as constituting a single plan.¹

234. Is the cost of employer-provided group term life insurance subject to Social Security tax?

Yes. The cost of group term life insurance that is includable in the gross income of the employee is considered wages subject to Social Security tax.²

The general rule is that an employee may exclude the cost of the first \$50,000 of employer-provided group term life insurance from income (Q 229). Therefore, only the cost of coverage in excess of \$50,000 generally will be subject to the Social Security tax.

An employer is required to report amounts includable in the wages of current employees for purposes of the Social Security tax on employees' W-2 forms. An employer generally may treat wages as though paid on any basis so long as they are treated as paid at least once each year.³

Social Security tax must be paid by an employee if a payment for group term life insurance is considered wages and is for periods during which there is no longer an employment relationship between the employer and the employee. An employer is required to separately state the portion of an employee's wages that consist of payments for group term life insurance and the amount of Social Security tax.⁴

235. What information returns must an employer that maintains a group term life insurance plan file with respect to the plan?

The cost of excess group term life insurance is not subject to withholding, but an employer that provides excess coverage must file an information return for each calendar year and must provide statements to employees receiving the excess coverage. Each employer reports as if it were the only employer carrying group term insurance on an employee.⁵

An employer that maintains a group term life insurance plan is required to file an information return with the IRS indicating the number of its employees, the number of employees eligible to participate in the plan, the number of employees participating in the plan, the cost of the plan, the taxpayer identification number of the employer and the type of business in which it is engaged. The employer also must report on the return the number of its highly compensated employees, the number of highly compensated employees eligible to participate in the plan, and the number of highly compensated employees actually participating in the plan.⁶ For plan years beginning prior to the issuance of further guidance from the IRS, group term life insurance plans are not required to meet the reporting requirements of IRC Section 6039D.⁷

1. Temp. Treas. Reg. §1.79-4T, A-5.

2. IRC Sec. 3121(a)(2).

3. Notice 88-82, 1988-2 CB 398.

4. IRC Sec. 3102(d).

5. IRC Sec. 6052(a).

6. IRC Sec. 6039D.

7. Notice 90-24 1990-1 CB 335, as modified by Notice 2002-24, 2002-1 CB 785.

Group Carve-Out Plan

236. If an employer provides life insurance under a group term life insurance policy, what are the advantages of a group carve-out plan to employees and to the employer?

Under a group carve-out plan, an employer removes or carves-out one or more highly-compensated employees from the life insurance coverage provided by a group term life insurance policy under IRC Section 79. The carved-out employees are provided life insurance coverage through individual policies. Low term insurance rates on individual policies and lower minimum premiums on permanent policies contribute to the popularity of this type of plan. The portability of the individual policies also makes this arrangement attractive to highly-compensated executives who typically are selected to participate.

Early in the development of the group carve-out plan, employees were provided coverage with individual policies that still were a part of the group insurance plan (Q 225). Currently, the purchase and ownership of individual life insurance policies often is structured in one of several ways, including a split dollar arrangement (Q 3898), an IRC Section 162 bonus plan (see Q 255), or a death benefit only arrangement (Q 96).

Under a group carve-out plan, the income tax consequences to both employer and carved-out employees are the same as if the alternative method of providing life insurance coverage existed independently of the group term plan. In a possible exception to this general rule, however, the IRS concluded that a split dollar arrangement entered into as part of a group carve-out plan should be taxed as group term life insurance. Thus, the economic benefit taxed to an employee was measured by Table I rates (Q 229) rather than the insurer's substitute rates that were used with the split dollar arrangement (Q 3899).¹ Despite this Technical Advice Memorandum from 2000, it seems almost universally accepted by practitioners that a group carve out plan structured as split dollar should be taxed as a split dollar plan and not as group term under the Table I rates.

In deciding whether to adopt a carve-out arrangement, the fact that individual policy arrangements mentioned above generally do not afford an employer a deduction for policy premiums must be considered. The premiums for group term life insurance generally are deductible to an employer (Q 228).

Permanent Benefits

237. May any part of a benefit under a policy be treated as group term life insurance if the policy also provides permanent benefits? If so, what part?

Yes. A policy that provides a permanent benefit may be treated in part as group term life insurance if (1) the policy or the employer designates in writing the part of the death benefit provided each employee that is group term life insurance, and (2) the part of the death benefit designated as group term for any policy year is at least the difference between the total death

1. TAM 200002047.

benefit under the policy and the employee's deemed death benefit (defined below) at the end of the policy year.¹

A permanent benefit is an economic value extending beyond one policy year that is provided under a life insurance policy.² For example, paid-up or cash surrender values are permanent benefits. The following features are not permanent benefits:

- (1) a right to convert or continue life insurance after group life insurance coverage terminates;
- (2) any other feature that provides no economic benefit to an employee other than current insurance protection; and
- (3) a feature providing term life insurance at a level premium for a period of five years or less.

To determine whether a policy provides a permanent benefit, it is necessary to determine what a policy is. Under the broad definition of "policy" provided in regulations (Q 225), if permanent benefits are provided by reason of the employment relationship under unrelated plans to members of a group provided group term life insurance issued by the same insurer or an affiliate, they would appear to be permanent benefits under the same policy that provides group term life insurance.

If a policy providing group life insurance provides permanent benefits, the cost of the permanent benefits, reduced by amounts paid for them by an employee, but not by amounts paid for group term life insurance, is included in the employee's income according to a formula. The formula for determining the annual cost of the permanent benefit is: $X(DDB2 - DDB1)$. DDB2 is the employee's deemed death benefit at the end of the policy year; DDB1 is the employee's deemed death benefit at the end of the preceding policy year; and X is the premium for one dollar of paid-up whole life insurance at the employee's attained age at the beginning of the policy year.³

The deemed death benefit at the end of a policy year is equal to R/Y where R is the net level premium reserve at the end of that policy year for all benefits provided to an employee by the policy, or if greater, the cash value at the end of the policy year; and Y is the premium for one dollar of paid-up whole life insurance at the employee's age at the end of the policy year.⁴

The net level premium reserve (R) and the net single premiums (X or Y) in the formulas must be based on the 1958 CSO Mortality Table and 4 percent interest.⁵

If a policy year and an employee's tax year are not the same, the cost of the permanent benefits is allocated between an employee's tax years. The cost allocated to the tax year in which the policy year begins is determined by multiplying the cost of the permanent benefit for the

1. Treas. Reg. §1.79-1(b)(1).

2. Treas. Reg. §1.79-0.

3. Treas. Reg. §1.79-1(d)(2).

4. Treas. Reg. §1.79-1(d)(3).

5. Treas. Reg. §1.79-1(d)(4).

policy year, using the formula for determining cost, by the fraction of the annual premium paid during an employee's tax year. The balance of the cost, if any, is allocated to the next employee tax year. Each tax year the employee totals the costs of permanent benefits allocated to that year.

238. What are the tax consequences of dividends paid to an employee under a policy that provides both permanent benefits and group term life insurance?

If an employee pays nothing toward the cost of permanent benefits, all dividends under a policy that actually are received or that are constructively received by an employee are includable in the employee's income.¹

If an employee pays a part or all of the cost of the permanent benefits, the amount of dividends includable by the employee is determined under this formula: $(D + C) - (PI + DI + AP)$, where D equals the total dividends received by the employee in the employee's current and all preceding taxable years; C equals the total cost of permanent benefits for the employee's current and all preceding tax years, using the formula in Q 237; PI equals the total premium included in the employee's income under the formula in Q 184 for the employee's current and all preceding tax years; DI equals the total amount of dividends included in the employee's income under the formula in this answer for all preceding tax years of the employee; and AP equals the total amount paid for the permanent benefits by the employee in the current and all preceding tax years of the employee.² It appears that an employee who pays no more than allocated cost will be taxed under the formula on the amount of dividends the employee receives.

Retired Lives Reserves

239. What is a retired lives reserve? Is an employee taxed on employer contributions to such a reserve? May an employer deduct contributions to a reserve?

A retired lives reserve is a fund for continuing group term life insurance on retired employees. Employer contributions to a reserve should not be taxable to a current employee if he or she has no present interest in the fund which means that the employee is not in actual or constructive receipt of any part of the fund or of a current economic benefit.

When an employee retires, the present value of any future group term life insurance coverage that may become non-forfeitable on retirement, or the value of the amount set aside by an employer to fund such coverage, will not be taxed to the employee immediately on retirement. The cost of group term insurance will be included in the income of a retired employee under IRC Section 79 in the year in which the coverage is received, regardless of whether the coverage vests upon retirement.³

1. Treas. Reg. §1.79-1(d)(5).

2. Treas. Reg. §1.79-1(d)(5).

3. IRC Sec. 83(e)(5).

Contributions to a retired lives reserve to fund postretirement life insurance benefits over the working lives of covered employees may be subject to limits on deduction of contributions to welfare benefit funds (Q 3965). Temporary regulations provide that certain retired lives reserves maintained by an insurance company are “funds” (Q 3963)¹ and contributions to a fund to provide postretirement life insurance for a key employee must be accounted for separately (Q 3971).

The conclusion reached in one letter ruling was that there was no income to an employer arising out of:

- (1) an employer’s assignment to an IRC Section 501(c)(9) trust, a voluntary employees’ beneficiary association, of all its rights in an insurance policy under which the insurer maintained a retired lives reserve;
- (2) an agreement by a trustee with an insurance company that amounts credited to a reserve would be invested under the general direction of the trustee in a separate account of the insurer or used to purchase annuity contracts; and
- (3) payments to a trustee under annuity contracts to be used to provide group term life insurance for retired employees.

The conclusion reached in the ruling was based on the fact that at the time of the transfer the employer had no right to recover the reserve as long as any active or retired employee remained alive and the possibility of reversion was unrealistic because of the large number of employees (Q 3973).²

If a plan provides life insurance benefits exclusively for retirees, legislative history indicates that the plan will be considered to be a deferred compensation plan.³ H.R. Conf. Rep. No. 98-861 (TRA ’84) reprinted in 1984-3 CB 411. An employer’s deduction would be limited under IRC Section 404(a)(5) to the amount includable in an employee’s income, and allowed only if separate accounts are maintained for each covered employee.

Group Permanent Insurance

240. Is the cost of group permanent life insurance paid by an employer taxable income to an insured employee?

Yes. Where a group life insurance policy provides permanent benefits but does not meet the requirements necessary for any part of the benefit to be treated as group term life insurance (Q 237), an insured employee will be taxed as follows: premiums paid by an employer for insurance on the life of an employee generally will be includable in the insured employee’s gross income if the proceeds of the insurance are payable to the beneficiary of the employee.⁴ For the tax treatment of the cost of group permanent insurance under a qualified plan, see Q 3843.

1. Temp. Treas. Reg. §1.419-1T, A-3(c); Ann. 86-45, 1986-15 IRB 52.

2. Let. Rul. 8741021. See also Let. Rul. 9542022.

3. H.R. Conf. Rep. No. 98-861 (TRA ’84) reprinted in 1984-3 CB 411.

4. Treas. Reg. §1.61-2(d)(2)(ii).

241. Are premiums that an employer pays on group permanent life insurance for its employees deductible by the employer?

Yes, if each employee's right to the insurance on his or her life is non-forfeitable when the premiums are paid.

If an employee has only a forfeitable right to the insurance, an employer cannot deduct premium payments.

If an employee's rights change from forfeitable to non-forfeitable, an employer may deduct the fair market value of the policy in the employer's taxable year in which or with which ends the employee's tax year in which the employee's rights become non-forfeitable, and the fair market value (Q 139) of the policy is includable in the employee's gross income.¹

An employee generally will be deemed to have properly included the amount as compensation in gross income if the employer satisfies the reporting requirements of IRC Section 6041 or IRC Section 6041A.² Premiums paid after the employee's rights become non-forfeitable are deductible when paid.

Death Benefits

242. Are death proceeds payable under group life insurance exempt from income tax?

Yes.

Death proceeds received by individuals are wholly tax-exempt whether received from group permanent or group term insurance.³ Where group term life insurance coverage is provided to domestic partners of employees by an employer, death proceeds paid on the death of a domestic partner are excluded from income under IRC Section 101.⁴ The same rules as are applicable to proceeds under individual policies generally apply (Q 62 to Q 70). Special rules apply if insurance is payable under a qualified pension or profit sharing plan (Q 3865, Q 3866).

Group Survivor Income Benefit

243. What is group survivor income benefit insurance?

A group term product that provides for a death benefit only if there is a survivor who qualifies for benefits under the plan (a lump sum payment of the commuted value of benefits is not available) may be called a reversionary annuity or life insurance. Regardless of the name, a plan that shifts the risk of loss resulting from premature death from an individual or family to a large group is an essential ingredient of insurance.⁵

1. IRC Sec. 83(h); Treas. Reg. §1.83-6(a)(1).

2. Treas. Reg. §1.83-6(a)(2).

3. IRC Sec. 101(a); Treas. Reg. §1.101-1.

4. Let. Rul. 9717018.

5. *Helvering v. LeGierse*, 312 U.S. 531 (1941).

An individual survivorship annuity was characterized as life insurance in *Cowles v. U.S.*¹ Benefits under a self-insured state program were held to be life insurance proceeds in *Ross v. Odom*.²

On the other hand, another self-insured state program was held not to be insurance because of the lack of actuarial soundness and the lack of a definite death benefit payable on death, as there was no death benefit if there was no surviving spouse. The court reasoned that absent a definite benefit payable in any event on the employee's death, there was no risk-shifting.³

Following the reasoning of this case, the IRS concluded that a program that paid a monthly benefit only to certain survivors on an employee's death did not exhibit the risk-shifting characteristic of life insurance. Thus, the death benefit was not eligible for tax-free treatment under IRC Section 101(a), and was taxed as an employee death benefit.⁴

Policies issued after December 31, 1984, generally are life insurance contracts if they meet the definition discussed in Q 64. If these products are held to be life insurance, they are taxed as group term life insurance if they meet the requirements in Q 225.

If they are annuities, the tax consequences are explained in Q 3523 to Q 3531 and Q 96.

1. *Cowles v. U.S.*, 59 F. Supp. 633 (S.D.N.Y. 1945), rev'd, 152 F.2d 212 (2nd Cir. 1945).

2. *Ross v. Odom*, 401 F. Supp. 464, 22 AFTR 2d 5624 (5th Cir. 1968).

3. *Davis v. U.S.*, 323 F. Supp. 858, 27 AFTR 2d 71-844 (S.D. W. Va. 1971). See also *Barnes v. U.S.*, 801 F. 2d 984, 86-2 USTC ¶9692 (7th Cir. 1986), cert. denied, 480 U.S. 945 (1987).

4. TAM 9117005.

